

**STATE OF ARKANSAS
DEPARTMENT OF FINANCE & ADMINISTRATION
OFFICE OF HEARINGS & APPEALS**

ADMINISTRATIVE DECISION

IN THE MATTER OF [REDACTED]
[REDACTED]
ACCT. NO.: [REDACTED]

**COMPENSATING (USE) TAX
ASSESSMENT
AUDIT NO.** [REDACTED]
**AUDIT PERIOD: APRIL 2012
THROUGH MARCH 2015**

DOCKET NO.: 19-137

\$ [REDACTED]¹

TODD EVANS, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon written protest received March 16, 2017, signed by [REDACTED] (“Accountant”) on behalf of the [REDACTED], the Taxpayer. The Taxpayer protested an assessment issued by the Department of Finance and Administration (“Department”).

A hearing was held in this matter on November 13, 2018, at 9:00 a.m. in Little Rock, Arkansas. The Department was represented by Michelle Bridges-Bell Attorney at Law, Office of Revenue Legal Counsel (“Department’s Representative”). Also present for the Department was Elizabeth Isaac, Tax Auditor, (“Auditor”), and Judy Bowers, Audit Supervisor (“Audit Supervisor”). [REDACTED] (“Taxpayer’s Representative”) appeared at the hearing and represented the Taxpayer. Also present for the Taxpayer was [REDACTED] (“Taxpayer’s Consultant”), [REDACTED] (“Accounts

¹ This amount represents [REDACTED] (Use Tax) and [REDACTED] (Interest). This amount does not include concessions made by the Department.

Payable Specialist”), [REDACTED] (“Accounting Manager”), [REDACTED] (“Administrative Manager”), and [REDACTED] (“Engineering Manager”).

The record remained open after the administrative hearing for the parties to share information and attempt to resolve some of the issues raised during the administrative hearing. On December 21, 2018, this Office was informed that the parties had completed their discussions and did not desire post-hearing briefing. The record was closed and the matter was submitted for a decision on December 26, 2018.

ISSUE

Whether the Department’s assessment is correct under Arkansas law. Yes, in part.

FACTUAL ASSERTIONS AND CONTENTIONS OF THE PARTIES

Prehearing Filing

Within his Answers to Information Request, the Taxpayer’s Representative detailed the basis of the Taxpayer’s protest, stating as follows in relevant part:

The following are the categories of audit protest issues:

- 1 Tax erroneously assessed on the nontaxable service of inspection, which was separately stated on the invoice.
- 2 GR-55 COMPUTERS AND RELATED PERIPHERAL EQUIPMENT. Tax erroneously assessed on exempt complete replacement of PLCs which control the production machinery, and also on a recorder which records the production.
- 3 Tax was erroneously assessed on chain hoists which were purchased to replace the current chain hoists in their entirety, not a partial replacement. The chain hoists are used to convey the product from one stage of production to the next stage.
- 4 Tax was erroneously assessed on [REDACTED] used to convey the product through the production process and is also essential to the packaging and delivery of the product to the customer.

...

Attached is an EXCEL spreadsheet titled [REDACTED] - MASTER PROTEST LIST listing all of the items protested in the audit and explaining why no tax is due on each item listed. Each line item will be addressed in its respective category following below.

Nontaxable Inspection

Lines 2 - 4 [REDACTED] invoices (attached) separately state the charges for nontaxable inspection charges of [REDACTED], [REDACTED], [REDACTED], and also separately state the charges for the taxable calibration services. The separately stated charges for the nontaxable inspection services should be removed from the audit.²

Programmable Logic Controllers (PLC)

Lines 4 - 22 [REDACTED] purchased new PLCs that control the production machinery to completely replace the previous controls which were operated manually. The PLCs allow the machinery to be controlled with infinitesimal adjustments to the [REDACTED] during the production process. The increased control of the [REDACTED] made the overall process more efficient and productive. Attached is a WORD document named PICTURES [REDACTED] with pictures of the new PLC controllers and also the old controllers. The old controls were completely replaced with the new PLCs.

DFA Rule GR-55. J. COMPUTERS AND RELATED PERIPHERAL EQUIPMENT states:

Computers and related peripheral equipment that directly control or measure the manufacturing process meet the "used directly" requirement for manufacturing machinery and equipment and are exempt provided they meet the other requirements for the exemption. Computers and related peripheral equipment must either (i) directly control, measure, or record an aspect of the manufacturing process itself; or (ii) directly control, measure, or record the operation of other items of exempt manufacturing machinery and equipment used in the manufacturing process. Except as provided in GR-66, computers and related peripheral equipment that controls, measures, or records the environment, processes other than the processes directly involved in manufacturing, or equipment that does not itself qualify for the exemption as manufacturing machinery and equipment are not exempt.

² Within her Answers to Information Request, the Department's Representative asserted that calibrations are generally taxable, which she asserted encompassed all of the protested transactions within this category.

The question is whether the new PLCs qualify as an exempt "substantial replacement, since GR-55.J. clearly established computers controlling the manufacturing process are exempt if they meet the other exemption requirements like the "substantial replacement" criteria. The manufacturers machinery and equipment exemption is established by A.C.A. § 26-52-402 (attached with emphasis added) and explained by GR-55. Section 402 provides "machinery purchased to replace existing machinery" means that substantially all of the machinery and equipment required to perform an essential function is physically replaced with new machinery." Section 402 further explains that "*substantially*" is intended to exclude routine repairs and maintenance and partial replacements that do not improve efficiency or extend the useful life of the entire machine, but it is not intended to mean that foundations and minor components that can be economically adapted, rebuilt, or refurbished must be completely replaced when replacement would be more expensive or impracticable than adapting, rebuilding, or refurbishing the old foundation or minor components.

The new PLCs completely replaced the old controllers, and were not routine repairs, maintenance, or a partial replacement. The new PLCs extended the useful life of the entire machine, which fulfills the General Assemblies stated intent for the exemption to provide as an incentive for Arkansas manufacturing plants to modernize existing plants through the replacement of old, inefficient, or technologically obsolete machinery and equipment. [REDACTED] modernized its production process with the installation of the new PLCs, because the old controllers were obsolete and parts to repair them were no longer available. Accordingly, the new PLCs meet all of the criteria for an exempt replacement and should be removed from the audit.³

Recorder

Line 23 [REDACTED] purchased a recorder from [REDACTED] to record the manufacturing process rate of production and other production data. Recorders which monitor and or record the production process are exempt pursuant to GR-55.J. as exempt peripheral equipment.

Electric Chain Hoist

Line 24 [REDACTED] completely replaced the electric chain hoists with three purchased from [REDACTED]. On page 11 of the attached WORD document named PICTURES [REDACTED] is

³ Within her Answers to Information Request, the Department's Representative asserted that the PLC's are a component part of larger manufacturing machinery and, thus, do not represent substantial replacement of the larger manufacturing machine.

a picture of the hoist. The entire hoist was replaced with the exception of the overhead beam which the hoist moves on to convey the product through the manufacturing process. The beam is no more than a nonmechanical foundation for the hoist to roll on from one point to another. The exemption specifically explains that neither foundation nor minor components need to be replaced for the substantial replacement exemption criteria to be met. The electric chain hoist was replaced in its entirety with only the overhead beam not being replaced, which is no different from a foundation, so the exemption should apply and the hoist should be removed from the audit.⁴

██████████

Line 25 ██████████ uses ██████████ to convey the ██████████ through the manufacturing process and ultimately used to deliver the ██████████ to its customers. It is not physically possible to convey the ██████████ through the manufacturing process unless it is ██████████. See attached pictures. Additionally, the finished product could not be delivered to the customers without the ██████████, because ██████████ would be irreparably damaged if it were not ██████████. Accordingly, the ██████████ are exempt as equipment used directly in the production process and also as exempt packaging materials that are sent to the customer with the product.⁵

Hearing Testimony

A. Auditor's Testimony

The Auditor testified that she performed the relevant audit. She explained that the Taxpayer manufactures ██████████. The audit period is April 2012 through March 2015. She reviewed purchase invoices, fixed asset lists, and accruals. Ultimately, the Taxpayer determined that several taxable purchases had occurred without accrual. These errors can be grouped into the following categories: the programmable logic controllers ("PLCs"), service agreements,

⁴ Within her Answers to Information Request, the Department's Representative asserted that a chain hoist consisted of several components (including a track) and is only one component of the overhead system. Consequently, she reasoned that the replacement of the hoist did not represent a substantial replacement of the overhead system.

⁵ Within her Answers to Information Request, the Department's Representative asserted that the ██████████ do not qualify for the sale for resale exemption under Ark. Code Ann. § 26-52-401(12) (Supp. 2017) because the ██████████ are not resold to customers but returned to the Taxpayer.

calibrations⁶, chain hoists, and [REDACTED]. Regarding the PLCs⁷, she explained that these items are computers that control machines. While these items were replaced, they were not considered to be substantial replacements of the machines. Regarding the service agreements, she concluded that certain agreements involved the rendition of taxable services.⁸ Regarding calibrations, the Auditor explained that calibrations are generally taxable and the protested transactions appeared to be taxable calibrations based on the invoices provided by the Taxpayer. Regarding the chain hoists, the Auditor considered it to be taxable because it was a replacement of a single part of the overhead system. Regarding the [REDACTED], the Auditor deemed these items to be taxable (similar to returnable pallets) because they were returned to the Taxpayer by its customers, making the Taxpayer the consumer of these items. The Auditor also asserted that all of the protested items at issue represent tangible personal property, whose sale is generally taxable within the State of Arkansas. The Auditor ultimately concluded that [REDACTED] in sales had been improperly exempted and not accrued upon by the Taxpayer.

B. Accounts Payable Specialist's Testimony

The Accounts Payable Specialist testified that she was unable to find the invoices associated with the assessed amounts for lines 14 through 17 of

⁶ At this point in the administrative hearing, the Department's Representative requested that the record remain open after the hearing to review additional documentation submitted by the Taxpayer during the administrative hearing. The Taxpayer's Representative explained that the issue should be simple since any adjustments were taxable and any simple inspections would not be taxable.

⁷ The Department entered several internal project budget documents and invoices from the Taxpayer's records as Exhibit G.

⁸ At this point in the administrative hearing, the Taxpayer's Representative conceded that those transactions were taxable and submitted Taxpayer's Exhibit A as a complete listing of the transactions currently being protested by the Taxpayer.

Taxpayer's Exhibit 1 anywhere.⁹ She asserted that the calibration backup documentation provided during the hearing are the calibration certificates associated with the relevant invoices.

C. Engineering Manager's Testimony

The Engineering Manager testified that he is responsible for the plant's equipment/machinery and its facilities. He has worked for the Taxpayer for almost [REDACTED]. Providing a general overview of the manufacturing process, he explained that the Taxpayer's manufacturing process begins with [REDACTED]. That [REDACTED]. [REDACTED]. Eventually, the Taxpayer [REDACTED]. The Taxpayer then continues to [REDACTED]. The [REDACTED] [REDACTED] the Taxpayer's customers. The manufacturing process is roughly [REDACTED]. The process involves [REDACTED]. [REDACTED] can involve up to [REDACTED] steps. After [REDACTED], the [REDACTED] must be [REDACTED]. [REDACTED]. The Engineering Manager then proceeded to discuss the categories of protested items.

Regarding the calibration invoices from [REDACTED]¹⁰, the Engineering Manager stated that only the highlighted transactions involve actual adjustments to equipment. He explained that [REDACTED]

⁹ Post-hearing, the Department provided a copy of the listing sent by the Taxpayer to the Auditor. These line items were listed within that document as having occurred in November 2012 and not being accrued upon. The transaction was described as an improvement to the existing [REDACTED] [REDACTED] by replacing obsolete electrical controls.

¹⁰ See Taxpayer's Exhibit 2 (the relevant invoices with the dollar amounts).

arrives and inspects the Taxpayer's equipment for accuracy, including [REDACTED]. Any non-highlighted items were not adjusted but merely inspected.¹¹ He noted that several of the backup details list items received in tolerance and leaving in tolerance. He reasoned that those instances represent transactions where no calibration was performed, only inspections. He explained that a set fee is charged for each item by the vendor regardless of whether the items are calibrated or simply inspected.

Regarding the PLCs¹², the Engineering Manager explained that this category involved the replacement of programmable logic controllers. Programmable logic controllers are essentially computers that control the drives and motors on a machine. These controllers remotely control the machines and are not mounted on the machines. The replacement of these items were not maintenance, routine repairs, or incomplete replacements of the prior obsolete PLCs. The prior PLCs were, at least partially, manually operated. The new PLCs extended the useful life of their associated machines by twenty (20) years. The new PLCs provide more control over the [REDACTED].

The Engineering Manager proceeded to discuss the photos entered as Taxpayer's Exhibit 4. He explained that the [REDACTED] PLCs¹³ are the brain that control the [REDACTED] that perform the [REDACTED] of

¹¹ At this point, the Taxpayer's Representative asserted that only those transactions involving actual adjustments should be taxable and not the inspections. The Taxpayer's Representative also entered the calibration certificates as Exhibit 3 (described as the backup detail for Exhibit 2's invoices).

¹² Initially, the Taxpayer's Representative added photos of these items as Taxpayer's Exhibit 4. One photo shows the new [REDACTED] PLC. The second and third photo displays the [REDACTED] Controls. The fourth and fifth photo show the new [REDACTED] systems. The sixth photo shows the [REDACTED] PLC. The seventh and eighth photo show the [REDACTED] PLC. The ninth and tenth photo show the [REDACTED] Control Panel and [REDACTED].

¹³ The associated invoices for the replacement of the PLC for the [REDACTED] were entered as Taxpayer's Exhibits 5 and 6.

the [REDACTED]. If the [REDACTED] within the [REDACTED] [REDACTED] are not moving synchronously, [REDACTED]. The new PLCs primarily improved control of the stages by better maintaining [REDACTED]. These PLCs are also able to monitor the power usage at [REDACTED] of the [REDACTED]. Each [REDACTED] Machine has its own PLC that was replaced. A [REDACTED] Machine is unable to run without its PLC. The [REDACTED] PLC¹⁴ is computerized rather than the earlier knobs and buttons for the old controls. The [REDACTED] are in the middle section of the plant between [REDACTED] [REDACTED] and [REDACTED]. The [REDACTED] PLC makes sure that a proper amount of [REDACTED] enters the [REDACTED]. Prior adjustments were only performed after noticing the errors in the products. This new PLC allows the monitoring and adjustment of the plating to maintain a consistent amperage. The [REDACTED] PLCs¹⁵ represent the insertion of new systems that both collect data from the process (including the [REDACTED] [REDACTED]) and control the process. The data collection helps improve machine efficiency by reducing nonconforming products due to the [REDACTED]. Each [REDACTED] PLC connects to a single machine within the [REDACTED]. The [REDACTED] [REDACTED] PLCs replaced the simple preexisting control system that utilized hard settings and a sensor with an old controller to [REDACTED]. The Engineering Manager acknowledged that all PLCs are components of larger machines and lack an independent function. He concluded this section of his

¹⁴ The invoices associated with this transaction were entered as Taxpayer's Exhibit 8, addressing Lines 21 and 22 of Taxpayer's Exhibit 1.

¹⁵ The invoices associated with this transaction were entered as Taxpayer's Exhibit 7, addressing Lines 18 through 20 on Taxpayer's Exhibit 1.

testimony noting that good control of the machines is important to maintaining a consistent product.

Regarding the recorder¹⁶, the Engineering Manager explained that this item is a temperature recorder used in conjunction with the [REDACTED] furnace that [REDACTED]. A thermocouple is attached to a wire and runs through the furnace at startup to make sure that the right temperature is present in each of the [REDACTED] furnace at that time. That thermocouple is connected to the recorder. The temperature of the furnace [REDACTED]. A log is maintained by the chart recorder. This transaction represented a complete replacement of the recorder but not the thermocouple. The recorder is about the size of a printer and operates independently from the furnace. Besides the thermocouple, the recorder is not attached to anything else. When the prior recorder broke, the manufacturing process did not cease because the correct furnace readings were already established for that day.

Regarding the crane hoists¹⁷, the Engineering Manager explained that this machine is a motor with an extension that raises and lowers items. Each crane hoist manually rolls upon a rail above it. The Taxpayer purchased three complete electric chain hoists that are used to transport [REDACTED] within the manufacturing process. After an item is hoisted, the crane is moved along its associated beam by pushing or pulling it. A beam is a passive, nonmechanical apparatus suspended from the ceiling. The beam is simply a hollow piece of steel. Only one hoist is

¹⁶ The invoice for this transaction was entered as Taxpayer's Exhibit 9.

¹⁷ The invoice for this transaction was attached as Taxpayer's Exhibit 10. Handwritten on the bottom of that invoice is a note stating the following: "Conveys product from [REDACTED] machinery to packaging." See also page 11 of Taxpayer's Exhibit 4 for a photo of this item.

installed on each beam. Each hoist is positioned over a different set of machines. All the hoists at issue are used in the [REDACTED] area, covering about [REDACTED] of manufacturing space.

Regarding the [REDACTED]¹⁸, the [REDACTED] are used to [REDACTED] for eventual transport to the Taxpayer's customers. Customers would not purchase the [REDACTED]. The [REDACTED] is [REDACTED] by [REDACTED] and then transported to the packaging department for shipping. Before packaging but after [REDACTED], a [REDACTED]. The Engineering further testified that a [REDACTED] could not [REDACTED] and shipped without [REDACTED]. [REDACTED] is shipped to customers and [REDACTED] is specific to a customer based on the types of processing machines that are used by the customer. Most of [REDACTED] are returned by customers and reused by the Taxpayer. He explained that [REDACTED] are not analogous to a returnable pallet because [REDACTED] are specific to a customer and [REDACTED]. The Taxpayer could not produce [REDACTED] without [REDACTED]. [REDACTED] have a certain lifetime before they must eventually be removed from the process. The Engineering Manager considered [REDACTED] to be a step in the manufacturing process.

D. Assertions of Department's Representative

Regarding the calibrations, the Department's Representatives noted that calibrations are generally taxable. The Department's Representative explained that, for those invoice line items with the same description across multiple

¹⁸ The invoice for this transaction was entered as Taxpayer's Exhibit 11. Handwritten on the bottom of that invoice is a note stating the following: "Conveys product from [REDACTED] machinery to packaging." See also pages 12 through 16 of Taxpayer's Exhibit 4 for photos of this item.

invoice lines such as a pressure gauge, she was uncertain how to distinguish a pressure gauge (costing [REDACTED] for a calibration) and a different pressure gauge (costing [REDACTED] for a calibration). She also could not track a calibration document back to a particular line item on an invoice.¹⁹ Regarding the recorder, the Department's Representative asserted that this item was simply a repair and not a substantial replacement of the associated equipment.

E. Assertions of Taxpayer's Consultant

The Taxpayer's Consultant stated that, on Invoice [REDACTED] from [REDACTED], the Taxpayer accrued tax on [REDACTED] of the invoice but not the remaining [REDACTED] of the invoice.²⁰

After a general discussion of the burdens of proof in tax proceedings and a discussion of the applicable law, the parties' argument shall be addressed with a legal analysis and associated conclusions.

CONCLUSIONS OF LAW

Burdens of Proof

Ark. Code Ann. § 26-18-313(c) (Supp. 2017) provides, in pertinent part, as follows:

The burden of proof applied to matters of fact and evidence, whether placed on the taxpayer or the state in controversies regarding the application of a state tax law shall be by preponderance of the evidence.

¹⁹ This issue was also discussed by the hearing officer. The Taxpayer's Representative asserted that he would attempt to settle these items with the Department's Representative post-hearing. If that attempt was unsuccessful, however, he stated that he would supplement the record with the appropriate records to link the calibration certificates with particular line items on the invoices prior to submitting the record for a decision.

²⁰ See Taxpayer's Exhibit 5. This exhibit includes a copy of the relevant invoice in the amount of [REDACTED]. While no tax is listed on the invoice, the Exhibit includes evidence purporting to show that tax was included on [REDACTED] of this invoice. Post-hearing, the Department's Representative conceded that [REDACTED] of the tax base for this transaction had been accrued and would be removed prior to the issuance of a final assessment.

A preponderance of the evidence means the greater weight of the evidence. *Chandler v. Baker*, 16 Ark. App. 253, 700 S.W.2d 378 (1985). In *Edmisten v. Bull Shoals Landing*, 2014 Ark. 89, at 12-13, 432 S.W.3d 25, 33, the Arkansas Supreme Court explained:

A preponderance of the evidence is “not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other.

The Department bears the burden of proving that the tax law applies to an item or service sought to be taxed, and a taxpayer bears the burden of proving entitlement to a tax exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(d) (Supp. 2017). Statutes imposing a tax or providing a tax exemption, deduction, or credit must be reasonably and strictly construed in limitation of their application, giving the words their plain and ordinary meaning. Ark. Code Ann. § 26-18-313(a), (b), and (e) (Supp. 2017). If a well-founded doubt exists with respect to the application of a statute imposing a tax or providing a tax exemption, deduction, or credit, the doubt must be resolved against the application of the tax, exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(f)(2) (Supp. 2017).

Assessment

A. Purchases of Tangible Personal Property

Arkansas Compensating (Use) Tax generally applies to the privilege of storing, using, distributing, or consuming tangible personal property and taxable

services within the State of Arkansas that were purchased outside this state. Ark. Code Ann. § 26-53-106 (Supp. 2017). Initially, all of the pieces of machinery and equipment within these categories represent tangible personal property and, thus, are generally taxable unless the Taxpayer proves entitlement to a tax credit, deduction, or exemption. Sales tax exemptions must be applied uniformly to Arkansas Use Tax. Ark. Code Ann. § 26-53-112(2) (Supp. 2017).

The provisions of Ark. Code Ann. §26-52-402 (Repl. 2014) provide an exemption from tax on purchases of machinery and equipment purchased by a manufacturer for direct use in manufacturing an article of commerce. The statute actually creates three separate exemptions. The provisions of Ark. Code Ann. §26-52-402(a)(1) (Supp. 2017) provide an exemption for the purchase of machinery and equipment necessary to create a new manufacturing facility or to expand an existing facility. The provisions of Ark. Code Ann. §26-52-402(a)(2) (Supp. 2017) provide an exemption for the purchase of machinery and equipment that replace substantially all of an existing unit of machinery and equipment that is necessary to perform an essential function in the manufacturing process. The provisions of Ark. Code Ann. §26-52-402(a)(3) (Supp. 2017) provide an exemption for the purchase of machinery and equipment used to prevent or reduce pollution or contamination that might otherwise result from manufacturing operations.

1. Electric Chain Hoist

The Taxpayer's Representative asserted that this transaction involved a substantial replacement of the overhead system. Specifically, he noted that Ark. Code Ann. § 26-52-402(a)(2)(B) (Supp. 2017) provides the following guidance:

(i) As used in subdivision (a)(2)(A) of this section, "machinery purchased to replace existing machinery" means that substantially all of the machinery and equipment required to perform an essential function is physically replaced with new machinery.

(ii) As used in subdivision (a)(2)(B)(i) of this section, "substantially" is intended to exclude routine repairs and maintenance and partial replacements that do not improve efficiency or extend the useful life of the entire machine, but it is not intended to mean that foundations and minor components that can be economically adapted, rebuilt, or refurbished must be completely replaced when replacement would be more expensive or impracticable than adapting, rebuilding, or refurbishing the old foundation or minor components.

The Department's Representative disagreed that the components of the overhead system were substantially replaced during this transaction.

Here, the eleventh (11th) photo of Taxpayer's Exhibit 4 and the testimony demonstrate that the only other component of the electronic chain hoists that was not replaced during this transaction was the passive steel beams from which the cranes are hung. Additionally, each crane operates independently from the other cranes and is utilized to transport work in progress during the manufacturing process for different sets of machines. Based on the evidence presented, the passive steel beams represent minor component that need not be replaced to demonstrate a substantial replacement of each crane hoist system. The Taxpayer has proven that substantially all of the machinery and equipment associated with the crane hoists were replaced. Thus, the Taxpayer has proven entitlement to the manufacturing machinery and equipment exemption by a

preponderance of the evidence with respect to this transaction, and the Department incorrectly assessed these items.

2. [REDACTED]

The Taxpayer's Representative asserted that [REDACTED] are utilized during the manufacturing process to [REDACTED], which he asserted would qualify as exempt manufacturing equipment. The Department's Representative asserted that [REDACTED] do not qualify for the sale for resale exemption.

Initially, because [REDACTED] are intended to be and are returned the vast majority of the time, [REDACTED] do not qualify for the sale for resale exemption under Ark. Code Ann. § 26-52-401(12) (Supp. 2017). Arkansas Gross Receipts Tax Rule GR-53(C)(5).

In *Weiss v. The Bryce Co., LLC*, 2009 Ark. 412, 330 S.W.3d 756, the Arkansas Supreme Court held that items of tangible personal property must meet certain requirements to be exempt manufacturing machinery and equipment, specifically the items must (1) possess some degree of complexity, (2) possess continuing utility, and (3) be directly used in the manufacturing process by causing "a recognizable and measurable mechanical, chemical, electrical, or electronic action to take place as a necessary and integral part of manufacturing, the absence of which would cause the manufacturing operation to cease." *Id.* See also Arkansas Gross Receipts Tax Rule GR-55.

While the Taxpayer's Representative asserted that [REDACTED] should qualify as manufacturing equipment, the record does not contain specific evidence regarding the complexity or continuing utility of these items even assuming that the remaining requirements of the relevant exemption have been satisfied. This Office would have to speculate to find that complexity and continuing utility exist. At this stage in the administrative process, the Taxpayer has not proven that [REDACTED] qualify as manufacturing equipment by a preponderance of the evidence based on the record.

3. Programmable Logic Controllers

The Taxpayer's Representative asserted that the Taxpayer completely replaced its controllers, which should be analyzed as a stand-alone pieces of manufacturing machinery or equipment. The Department's Representative asserted that the controllers function as component parts of larger pieces of manufacturing machinery and, thus, did not represent a substantial replacement of all of the associated machinery.

The Arkansas Supreme Court has explained that all of the machines and devices that are interconnected to accomplish a single purpose must be analyzed as a single machine. *S H & J Drilling Corp. v Qualls*, 268 Ark. 71, 593 S.W.2d 178 (1980), and *Southern Steel & Wire Co. v. Wooten*, 276 Ark. 37, 631 S.W.2d 835 (1982). Arkansas Gross Receipts Tax Rule GR-55(D)(3) provides as follows:

When individual machines or machinery are interconnected in order to accomplish a single function and the function of each such individual machine is not complete before the adjacent machines begin to function,

the result is a new single identifiable machine. The machinery purchased to replace this resulting existing machine must satisfy the requirements of GR-55(D)(2) above and the exemption is not available for the replacement of only some of the individual machines that now form component parts of the aforementioned machine. . . .

Consequently, all components of a machine that function together to allow a machine to properly operate must be analyzed as a single machine. The Arkansas Supreme Court has previously addressed whether a control panel should be treated as a stand-alone piece of equipment or as a component part of a welding machine that it controlled, stating as follows in pertinent part:

There we held that where the appellant purchased certain items to replace existing items of a drilling rig, even if the individual item was considered a machine within the definition of *Heath v. Research-Cottrell, Inc.*, 258 Ark. 813, 529 S.W.2d 336 (1975), once they were assembled into a rig and are designed to accomplish a single purpose, they become a single unit and are not exempt from taxation. We find that reasoning controlling here. It appears undisputed that the control panels, air cylinders and transformers are physically combined with other existing components in order to construct a welding machine which has a single purpose and function. The control panels and welding machines are interconnected or component parts of welding machines and designed to accomplish a single purpose—welding wire to form shelves. They must function simultaneously as a single unit. The trial court correctly found these items did not constitute replacement of the welding machines in its entirety and, therefore, are not exempt.

Southern Steel and Wire Co. v. Wooten, 276 Ark. 37, 40–41, 631 S.W.2d 835 (1982).

Here, it is evident that the PLCs at issue are interconnected with and control various pieces of machinery. Under the Arkansas Supreme Court's analysis in *Southern Steel*, the PLCs should be considered component parts of their associated machines. Analyzed as such, the Taxpayer has not proven that the replacements of the PLCs qualify as a substantial replacement of all of their associated machinery. Thus, the Taxpayer has not proven entitlement to the manufacturing machinery and equipment exemption by a preponderance of the

evidence with respect to these transactions, and the Department correctly assessed these items.²¹

4. Recorder

The Taxpayer's Representative asserted that this item measures the manufacturing process and should be exempt. Regarding this category, Arkansas Gross Receipts Tax Rule GR-55(J) provides the following:

COMPUTERS AND RELATED PERIPHERAL EQUIPMENT. Computers and related peripheral equipment that directly control or measure the manufacturing process meet the "used directly" requirement for manufacturing machinery and equipment and are exempt provided they meet the other requirements for the exemption. Computers and related peripheral equipment must either (i) directly control, measure, or record an aspect of the manufacturing process itself; or (ii) directly control, measure, or record the operation of other items of exempt manufacturing machinery and equipment used in the manufacturing process. Except as provided in GR-66, computers and related peripheral equipment that controls, measures, or records the environment, processes other than the processes directly involved in manufacturing, or equipment that does not itself qualify for the exemption as manufacturing machinery and equipment are not exempt.

Ark. Code Ann. § 26-52-402(c)(1) (Supp. 2017) provides the following additional guidance:

- A) It is the intent of this section to exempt only the machinery and equipment as shall be used directly in the actual manufacturing or processing operation at any time from the initial stage when actual manufacturing or processing begins through the completion of the finished article of commerce and the packaging of the finished end product.

²¹ To the extent that the Taxpayer also asserts that the ██████████ PLCs are actually new machinery and equipment and not replacements, the Engineering Manager's testimony clarified that those items replaced a preexisting control system, even though that system was much simpler. Those items are properly analyzed as replacements.

- (B) As used in this subsection, “directly” is used to limit the exemption to only the machinery and equipment used in actual production during processing, fabricating, or assembling raw materials or semifinished materials into the form in which the personal property is to be sold in the commercial market.²²

Here, the record provides that the recorder and thermocouple are utilized prior to the initiation of the manufacturing process to test the furnace at startup and not to record the manufacturing process or the operation of the furnace while the manufacturing process is occurring. Consequently, this item is not utilized directly in the manufacturing process and does not qualify for manufacturing machinery and equipment exemption under Arkansas Gross Receipts Tax Rule GR-55(J). The Department correctly denied the Taxpayer’s exemption claim with respect to this item and the assessment is sustained with respect to this transaction.

B. Calibration Services

Though these services were initially described as calibrations upon the invoices, the Taxpayer’s Representative has asserted that additional documentation demonstrates that these transactions represent mere inspections without any alteration to the associated machinery and equipment.

Services to install, alter, add, clean, replace, and repair electrical devices, machinery, and mechanical tools are subject to sales and use tax absent proof of entitlement to exemption. Ark. Code Ann. §§ 26-52-301(3)(B)(i) (Repl. 2014) and

²² See also Ark. Code Ann. § 26-52-402(c)(2)(B)(iv) (Supp. 2017) that only allows: “Computers and related peripheral equipment that directly control or measure the manufacturing process; . . .”

26-53-106 (Rep. 2014). In *Cowan v. Thompson*, 178 Ark. 44, 49, 9 S.W.2d 790 (1923), the opinion of the Arkansas Supreme Court stated that definitions of the word “repair” include: (1) “to restore to a sound or good state”; and (2) “to restore or reinstate as in former standing”. The restoration of an electrical device (or machinery) to its original state, by or through calibration, is a repair of the electrical device (or machinery). Consequently, calibrations are generally taxable.

Here, it appears to be uncontested that a portion of the devices and equipment inspected by [REDACTED] are adjusted by that vendor. It also appears uncontested that, if an adjustment occurred, it would represent a taxable calibration. Further, the cost of the vendor’s services remains unchanged even if only an inspection is performed, preventing separation of the two types of service transactions based on cost. Absent persuasive evidence that the calibrations listed on the invoices did not actually occur, these transactions would generally be taxable.

The Taxpayer’s Representative has asserted that several items were not adjusted in any way by the relevant vendor and were combined on invoices with other items that may have been adjusted. The Taxpayer’s Representative provided various forms entitled “Calibration Documentation” to demonstrate that certain items began and ended in tolerance when serviced by the vendor. It remains uncertain, however, how the provided calibration reports can be linked to the particular invoices or any of the particular items listed on each invoice during the relevant transactions. This issue was raised by the Department’s Representative at the hearing and the Taxpayer’s Representative stated that the issue would be cured if the documents needed to be submitted after the hearing.

Post-hearing, the Taxpayer has largely provided the same records presented at the hearing and did not provide any additional supporting documentation to link any of the provided Calibration Documents to the particular items listed within the particular invoices that are at issue. At this point in the administrative process, the Department's assessment is sustained with respect to these items based on the record.

C. Interest

Interest must be assessed upon tax deficiencies for the use of the State's tax dollars. Ark. Code Ann. § 26-18-508 (Repl. 2012). Consequently, the assessment of interest on any sustained assessed transactions is likewise sustained after the adjustment required under Ark. Code Ann. § 26-18-405(d)(1)(C) (Supp. 2017).


DECISION AND ORDER

Subject to the limitation in Ark. Code Ann. § 26-18-405(d)(1)(C) (Supp. 2017), the assessment is sustained in part after the adjustments required by the above analysis and the concessions made by the Department during the administrative process. The file is to be returned to the appropriate section of the Department for further proceedings in accordance with this Administrative Decision and applicable law. Pursuant to Ark. Code Ann. § 26-18-405 (Supp. 2017), unless the Taxpayer requests in writing within twenty (20) days of the

mailing of this decision that the Commissioner of Revenues revise the decision of the Administrative Law Judge, this Administrative Decision shall be effective and become the action of the agency. The revision request may be mailed to the Assistant Commissioner of Revenues, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. A revision request may also be faxed to the Assistant Commissioner of Revenues at (501) 683-1161 or emailed to revision@dfa.arkansas.gov. The Commissioner of Revenues, within twenty (20) days of the mailing of this Administrative Decision, may revise the decision regardless of whether the Taxpayer has requested a revision.

Ark. Code Ann. § 26-18-406 (Supp. 2017) provides for the judicial appeal of a final decision of an Administrative Law Judge or the Commissioner of Revenues on a final assessment or refund claim denial; however, the constitutionality of that code section is uncertain.²³

OFFICE OF HEARINGS & APPEALS



TODD EVANS
ADMINISTRATIVE LAW JUDGE

DATED: April 22, 2019

²³ See *Board of Trustees of Univ. of Arkansas v. Andrews*, 2018 Ark. 12.