ST 95-35
Tax Type: SALES TAX
Issue: Machinery and Equipment Exemption - Manufacturing
Sales v. Service Issues
Disallowed General Deductions (No Documentation)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v.	)	No.
	)	IBT
	)	NTL
TAXPAYER	)	
Taxpayer	)	

FINAL ADMINISTRATIVE DECISION

APPEARANCES: Attorney, attorney, on behalf of TAXPAYER.

SYNOPSIS: A hearing was held in this cause, pursuant to notice, on the matter of the Department's issuance of a Notice of Tax Liability (XXXXX) against TAXPAYER. As a result of the hearing held, a recommendation for disposition was submitted to me, as Director, for consideration.

ISSUE:

The singular question in controversy here concerns the issue of whether certain machinery purchased by this taxpayer and used by it in the process of retreading tires for customers, is exempt pursuant to the "machinery and equipment" provision of the Use Tax Act. Specifically, are the items assessed by the Department not subject to tax under the auspices of 35 ILCS 105/3-5(18).

Upon due consideration, the underlying recommendation of the administrative law judge ("ALJ") that the tangible personal property in question meets all requirements for exemption cannot be accepted. In reaching a conclusion which rejects a significant portion of the ALJ's

analysis, interpretation of pertinent departmental regulations and the ultimate conclusion, I remain mindful of my responsibilities to the taxpayer as well as to the State. My decision is based solely upon competent evidence produced at hearing and those legal conclusions which may be fairly drawn from the evidence.

I have reviewed with particularity all evidence offered. Additionally, I have apprised myself of those pertinent sections of State law and regulation which related to the exemption sought and have considered the entire transcript of record, including, but not limited to, the testimony of witnesses and argument of counsel.

With due regard to the recommendation of the administrative law judge, I have determined that a sufficient record of proceedings was made to permit the appropriate review and issuance of a final administrative decision which differs from the initial recommendation, in accord with the provisions of 86 Ill. Admin. Code, Ch. I, Section 200.130. See also Highland Park Convalescent Home v. Health Facilities Planning Commission, 217 Ill. App. 3d 1088 (2nd Dist. 1991)

FINDINGS OF FACT:

1. The Department's prima facie case was established as a matter of record by the introduction and acceptance into evidence, without objection, of the correction of returns and Notice of Tax Liability for the sums established as due and owning. (DOR Ex. Nos. 1 & 2; Tr. p. 8)

2. TAXPAYER, during the period in question, was engaged in two separate business operations; a new-tire division and a retreading plant. (Tr. p. 33)

3. All of the machinery found in the auditor's exceptions were used in the process of retread(ing) tires. (Tr. p. 29). Such machinery taxed in this audit was not used for any other purpose, including the production of new tires. (Tr. p. 47)

4. The methods, systems and machinery utilized in the production of retread tires ordinarily constitutes the "manufacturing" of tangible personal property which would qualify for the machinery and equipment exemption. (TP Ex. Nos. 54 and 55) However, the ruling letters which support such finding do not distinguish between customer v. taxpayer owned casings.

5. Notwithstanding, in the majority of instances, the tire "casings" (i.e. old tire base) utilized as the foundation for the retread tire ultimately produced, were the property of TAXPAYER customers and not owned by the taxpayer nor taken out of taxpayer's inventory. (Tr. pp. 18-20)

6. In a few situations, tire casings used to produce retread tires were taken out of TAXPAYER own inventory. (Tr. p. 53)

7. Every customer of the taxpayer, whether the ultimate user of the retread or a dealer, was charged for the process of retreading a tire. (Tr. pp. 50-51)

8. A "sales tax" was charged to each customer on the gross amount of the retread price, irrespective of whether the casings were supplied by the customer or taken out of taxpayer's inventory. (Tr. p. 106)

9. When the retread produced by the taxpayer was from a casing supplied by the customer, there would be a discount based upon no charge being applied for the tire casing. (Tr. pp. 56, 88, 101)

10. The premise of the liability in question is that tangible personal property is not being sold or leased by the taxpayer as required for the M&E exemption, but rather is undergoing a repair "service". This is due to the fact that on the transactions being taxed the customer is supplying the casing, which becomes the basis for the refurbished (retread) tire. (Tr. p. 18)

CONCLUSIONS OF LAW: Although the administrative law judge here devotes considerable findings and analysis to the question of whether the

fabrication of retread tires constitutes "manufacturing" under the requisites of the Use Tax Act,1 there is no real dispute as to that issue. As evidenced by the ruling letter exhibits produced by the taxpayer and acknowledged as a matter of record, the process of producing retread tires is obviously manufacturing. That much was never in doubt and was at no time challenged by the auditor.

What is at issue, however, is whether the transactions which take place between the taxpayer and its customers in situations where the customer supplies the casing, are in actuality a service or a retail (sometimes wholesale) sale. Under the requisites of the statute, it is only where the latter exists that the machinery and equipment exemption can apply.

In searching for the answer to this question, one must turn first to the Department's own regulations. Under 86 Ill. Admin. Code, ch. I, Section 130.2015, which pertains to the Retailers' Occupation Tax Act, the regulations speak to situations in which a taxpayer sells tangible personal property in the performance of a service:

> 130.2015
>
> Persons Who Repair or Otherwise Service Tangible Personal Property.
>
> a) Persons Who Service or Repair Tangible Personal Property -- When Liable for Retailers' Occupation Tax.
>
> 1) When persons who service or repair tangible personal property sell tangible personal property to purchasers for use or consumption apart from their rendering of service, they incur Retailers' Occupation Tax liability. This is the case, for example:...
>
> b) Where a repairman repairs, rebuilds or reconditions property which belongs to himself and then sells such property to a purchaser for use or consumption apart from his rendering of service as a repairman. (emphasis added)

The regulations go on to distinguish situations where Retailers Occupation Tax would not apply to the transactions at issue. These refer to the following:

c) Persons Who Service or Repair Tangible Personal Property -- When Not Liable For Retailers Occupation Tax.

1) Persons who engage in the business of repairing tangible personal property belonging to others, (including, but not limited to... tire and tube repairmen,...(emphasis added)

Within the same section, the regulations include a variety of examples of repair work such as that performed by the taxpayer in this case:

d) Examples of Repair Work...

2) The repairing of tires and inner tubes includes, but is not limited to, the patching or vulcanizing of tires and inner tubes and the retreading or recapping of tire casings. (emphasis added)

It is therefore manifest, the opinion of the ALJ notwithstanding, that the Department considers the work performed by TAXPAYER, when it is done on tire casings belonging to the customers, not to be a transaction subject to ROT, but rather a service incurring Service Occupation Tax. See Ill. Admin. Code, ch. I, Sec. 130.2015(e). The materials transferred to customers of the taxpayer are therefore merely incident to the performance of the service of recapping tires.2

As a further matter, I take official notice of two ruling letters issued by the Department to XXXXX, the franchisor of TAXPAYER3 in regard to this very controversy. These ruling letters were issued on March 18, 1987 (87-0168) and on May 26, 1987 (87-0376) in response to questions in reference to the proper tax to be charged and the computation of that tax. In both instances the Department advised XXXXX, that since the retreading is being performed on property belonging to others, the franchise dealers (such as this taxpayer) would be considered servicemen. They would thereby be subject to SOT on the cost price of the materials transferred incident to the sale of that service.

In his rejection of the position of the auditor (reflecting that of the Department), that the matters at hand were sales of service rather than

tangible personal property, the ALJ set forth two points. In the first, he analogized the furnishing of the tire casing by the customer as merely supplying an "ingredient" of the final product. This position, however, misses the point.

Here a worn tire, regardless of how you wish to term it, is supplied and a reconditioned tire is returned.4 It is not a circumstance where true ingredients of the retreading process, such as crude rubber, steel, nylon, etc., are furnished to the taxpayer in order that it make a finished product out of the combined materials which, in and of themselves, do not constitute a tire. If I were to accept the ALJ's reasoning in this case, then persons who bring their shoes to be resoled and/or reheeled, buffed and shined, are in fact buying new shoes from the corner cobbler. This cannot be the result of logical thought.

On the second point, the ALJ accepts as unquestioned the fact that the taxpayer viewed these transactions as retail sales as determinative of the issue. This evaluation too, begs the question. If what taxpayer may have thought the transactions were, ultimately resolved or even influenced what should be the proper tax rather that what the law requires, there would be little need for auditors. A mistake of fact is just that, and it cannot act as a determiner of the true nature of what has transpired.

Inasmuch as it has been shown that TAXPAYER is, for the purpose of recapping customer-supplied tires, a serviceman, then the transfer of tangible personal property to customers in these circumstances is merely incident to the service performed. Accordingly, since no actual sale of tangible personal property occurs in such instance, the provisions of the machinery and equipment exemption have not been met. The imposition of Use Tax on the purchase of that machinery is therefore appropriate.

On the basis of the above, it is my determination as Director that the recommendation of the administrative law judge regarding the disposition of

this case is rejected as incongruent with prevailing law and regulation. It is therefore ordered that Notice of Tax Liability, XXXXX shall be affirmed, taking into account any revisions or reductions subsequently made by the auditor, and that a final assessment issue forthwith.

Kenneth E. Zehnder
Director of Revenue

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1. The presiding ALJ for some unknown reason, utilized the definition of "manufacturing" as found in Webster's Dictionary, and structures his analysis around that classification rather than as the word is defined under the Act. (35 ILCS 105/3-5(18)

2. The important distinction to be drawn here is that the recapping and/or retreading of tires becomes a service as a matter of law only when the casings on which the retreading is done belong to the customer. This constitutes the majority of transactions in which this taxpayer is involved through its recapping plant.

3. The Transcript of Proceedings, pages 30-33, conclusively shows that XXXXX, formerly the President, Secretary and CEO of TAXPAYER, also owns XXXXX franchises. It is therefore a reasonable inference that XXXXX knew or should have known of the respective ruling letters.

4. With apologies to XXXXX, a tire is a tire is a tire.