

Appeal No. SC91415

**IN THE
SUPREME COURT OF MISSOURI**

CUSTOM HARDWARE ENGINEERING & CONSULTING, INC.,

Appellants,

v.

DIRECTOR OF REVENUE,

Respondent.

**On Petition for Review from the
Administrative Hearing Commission
State of Missouri
The Honorable Karen A. Winn, Commissioner
Case No. 08-0154 RS**

APPELLANT'S BRIEF

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JURISDICTIONAL STATEMENT

Appellant Custom Hardware Engineering & Consulting, Inc. (“CHE”) is a company headquartered in Missouri which performs computer hardware maintenance and repair on “enterprise class” machines and computers, such as IBM mainframe computers. CHE has numerous customers both within and without the State of Missouri. CHE entered into firm fixed-price contracts, the fulfillment of which required CHE to purchase parts which were specific to each customer.

An audit was performed upon CHE by the Director of Revenue (“Director”) and use tax was assessed on certain parts and equipment reviewed thereby. CHE paid the tax calculated by the Director under protest pursuant to Mo. Rev. Stat. sections 143.631, 143.821, and 144.700.¹ It contested the Director’s assessment and argued to the Administrative Hearing Commission (“AHC”) that it was not liable for sales or use tax upon the parts and equipment because: (a) parts and equipment purchased to fulfill contracts with customers *outside* the state were not sold to customers in the state and were not subject to sales or use tax because they were not sold to customers in Missouri and not used or consumed within the state,

¹ Pursuant to Missouri Supreme Court Rule 84.04(h), the complete text of all statutes, ordinances, rules of court and agency rules are provided in the Appendix hereto.

nor were such parts or equipment stored for sufficient length of time to subject them to use tax, (b) parts and equipment purchased to fulfill contracts with any customer were not subject to use tax because there was a resale, (c) parts and equipment purchased to fulfill contracts with public post-secondary educational institutions, and (d) parts and equipment purchased to fulfill contracts with state clients were not subject to use tax because title vested in the state client.²

On December 2, 2010, the AHC rendered its decision. *See*, Decision, Appendix 1–24, *Custom Hardware Engineering & Consulting, Inc. v. Director of Revenue*, No. 08-0154 RS. Therein, the AHC ruled that parts purchased by CHE for fulfillment of firm fixed price contracts met each element of a “sale” (and “re-sale”), but were not a “taxable resale,” under *ICC Management, Inc. v. Director of Revenue*, 290 S.W.3d 699 (Mo. banc June 16, 2009, *rehearing denied*, September 1, 2009). The AHC further found that parts and equipment installed, and used, in enterprise class machines *outside* the state, but which spent *any* amount of time

² Additionally, though not at issue in this appeal, CHE argued that (i) taxes were in fact paid on certain parts, (ii) parts and equipment purchased to fulfill federal contracts were not subject to tax because title vested in the federal client due to the applicable contracts and federal regulations, and (iii) parts and equipment “dropped shipped” from a location outside the state and received in another location also outside the state had absolutely no nexus with Missouri and were not subject to tax.

within the state, were subject to tax under 12 C.S.R. 10-113.300(1) and *Fall Creek Construction Company, Inc. v. Director of Revenue*, 109 S.W.3d 165, 171 (Mo. banc 2003). The AHC also assessed a tax upon items which were purchased to fulfill contracts with clients which were Missouri public post-secondary educational institutions. Finally, the AHC *increased* tax due over that amount calculated in the audit, and paid under protest, and further assessed penalties for “negligence,” under Mo. Rev. Stat. section 144.250.3, on such *AHC increased* amounts. This was even though the amount calculated by the *Director* was in fact paid by CHE under protest to avoid such penalties and interest. CHE contests the findings and conclusions of law referenced in this paragraph.³

This petition for review concerns the validity of the AHC’s decision, as set forth above, interpreting the application of the Missouri sales and use tax. Under Article V, Section 3 of the Constitution, and Mo. Rev. Stat. section 621.189, this

³ The AHC also agreed that parts and equipment purchased for the fulfillment of federal contracts were not subject to tax under the holding of *McDonnell Douglas Corp. v. Director of Revenue*, 945 S.W.2d 437, 439 (Mo. banc 1997). The AHC permitted the concession by the Director that taxes were not due on (a) items “drop shipped” and (b) items for which taxes were paid in another jurisdiction. CHE does not contest the findings and conclusions of law referenced in this note.

Court has exclusive appellate jurisdiction in all cases involving the construction of the revenue laws of this state.

STATEMENT OF FACTS

This case involves a claim for refund for Missouri use tax paid by CHE on certain purchases of tangible personal property for fulfillment of fixed price contracts with state, federal, and private entities.

CHE is a company which performs computer hardware maintenance and repair on “enterprise class” machines and computers. Transcript (Tr.) 32, 33.⁴ CHE has numerous customers both within and without the state. Tr. 33. These customers own enterprise class computers and machines which differ by manufacturer and model from customer to customer. Tr. 34. CHE entered into firm fixed price contracts for the service of preventative and remedial maintenance for its customers’ enterprise class machines and computers. Tr. 36. CHE also factored in the price of labor, overhead, general and administrative expenses, and profit to arrive at the firm fixed price contract price. Tr. 37.

To meet its contractual obligations, CHE purchased parts and equipment which were specific to the particular machines and computers of each customer with which it had a firm fixed price contract. Tr. 48. The items and parts at issue were not consumed by CHE but, as the AHC found, were sold to the customer.

⁴ CHE does not sell enterprise class computers. Tr. 33.

Decision at 15. The parts were installed into enterprise class machines and computers which are owned by the customer, or used in the installation of same. CHE does not otherwise obtain any benefits from the parts. CHE does not charge the customers subject to this proceeding sales tax, nor is it factored into the contract price. Tr. 77.

CHE has private and municipal governmental customers outside the state. For these customers, the items were purchased for fulfillment of the respective customers' fixed price contract. The items were received by CHE in this state and then transferred to a private customer of CHE outside the state after a de minimis period of time (five to seven days). Tr. 59. During the period of time in which the items were within the state, the items were tested and certified by CHE technicians. Tr. 59. These items were identified on the exhibits reflected on pages 5-6 and 8 (relating to the City of Tampa, Florida, only) of the Decision.

CHE also had customers which were public post-secondary educational institutions, specifically the University of Missouri, Central Missouri State University, and Southwest Missouri State University. These items were identified on the exhibits reflected on pages 10-11 of the Decision.

The contract with the University of Missouri provides:

. . . Materials and services furnished the University are not subject to either Federal Excise Taxes or Missouri Sales Tax.

Exhibit 203, section 1.6.1(c).

The purchase order from Southwest Missouri State University provides:

Do not bill sales and/or use tax. Southwest Missouri State University, as a public supported educational institution, pursuant to sections 144.040 [*sic*] and 144.615 RSMo, is exempt from all such sales and use taxes.

Exhibit 205 at 4, section 10.

CHE relied upon this language when it entered into these contracts. Tr. 70. Had CHE believed it was subject to sales or use taxes, it would have increased the bid amount to the state post-secondary educational institutions. Tr. 70.

The Director audited CHE for the period from April 2001 through March 2006. Decision at 3, ¶ 8. The parties agreed to use calendar year 2005 as the sample period. *Id.*

The Director determined that CHE owed use tax on fixed assets in the amount of \$34,117.17. Decision at 4, ¶ 11. The Director determined that CHE owed use tax on expensed purchases in the amount of \$433,706.20. *Id.* Use tax was assessed at the rate for Fenton, Missouri: 4.225%. The amount of use tax assessed was \$19,765.49. CHE paid that amount, plus \$3,811.87 in interest and \$942.48 in additions, under protest. Decision at 4, ¶ 11; Exhibit B at A1.

After a hearing before the AHC on October 1, 2009, the AHC found that certain items were improperly assessed use tax, including those which were never in the state for any amount of time, those for which a tax in another jurisdiction had in fact been paid, and for those purchased for CHE's federal customers, none of which are subject of this appeal. Decision at 20-22. The AHC then affirmed the remaining findings of the Director's audit with respect to items which were for non-federal customers for items temporarily stored within the state and for state public post-secondary educational institutions.

The AHC reduced the incorrectly assessed fixed asset calculation to total \$29,867.17. Decision at 22. The use tax on CHE's fixed assets was calculated by the AHC to be \$1,261.89. Decision at 23.

The AHC then recalculated the expensed purchases amounts which it found were subject to tax (private customers outside the state, the City of Tampa, Florida, state public post-secondary educational institutions, and amounts conceded by CHE (fixed assets within the state)) to total \$263,994.70. Decision at 23. The AHC calculated the use tax on CHE's expensed purchased to be \$55,769.88. *Id.* This amount, \$37,445.79 greater than that calculated by the Director, is *well* in excess of the tax the Director assessed on the unadjusted expensed purchases set forth in the audit: \$18,324.09. Decision at 4, ¶ 11. *See also* Exhibit C at X1 (Appendix 25).

The AHC then assessed a 5% negligence penalty under section 144.250.3 on CHE's failure to pay use tax for purchases for its private customers. The tax on that amount totaled \$2,396.55. Decision at 24.

CHE timely filed its Petition for Review on January 3, 2011.

POINTS RELIED ON

I. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON ITEMS PURCHASED FROM AN OUT OF STATE VENDOR FOR AN OUT OF STATE CUSTOMER BECAUSE THE ITEMS WERE ONLY TEMPORARILY STORED IN THE STATE OF MISSOURI IN THAT INSPECTION, TESTING, AND CERTIFICATION OF THE ITEMS BY CHE DID NOT CONSTITUTE A TAXABLE USE.

L & R Egg Co. v. Director of Revenue, 796 S.W.2d 624 (Mo. banc 1990)

House of Lloyd, Inc. v. Director of Revenue, 884 S.W.2d 271 (Mo. 1994)

Mo. Rev. Stat. section 144.605(13)

12 C.S.R. 10-113(2)(C)

II. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON (A) ITEMS PURCHASED FROM AN OUT OF STATE VENDOR FOR AN OUT OF STATE CUSTOMER AND (B) ITEMS PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS BECAUSE SAID ITEMS WERE IN FACT SOLD AT RETAIL AND ARE EXEMPTED FROM USE TAX IN THAT THE ITEMS WERE PURCHASED FOR RESALE.

McDonnell Douglas Corp. v. Director, Revenue, 945 S.W.2d 437 (Mo. banc 1997)

III. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON ITEMS PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS BECAUSE ITEMS WHICH ARE PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS ARE EXEMPTED FROM USE TAX IN THAT THE STATUTES, REGULATIONS, AND CONTRACTS AT ISSUE SO PROVIDE.

Mo. Rev. Stat. section 144.030(22)

12 C.S.R. 10-110(2)(A)(10)

12 C.S.R. 10-110(3)(D)

IV. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN RECALCULATING THE AUDIT OF THE DIRECTOR AND INCREASING THE TAX ON EXPENSED PURCHASES BECAUSE CHE PAID THE TAX CALCULATED BY THE DIRECTOR UNDER PROTEST IN THAT IN CASES IN WHICH A REFUND IS SOUGHT, THE AMOUNT IN DISPUTE IS FIXED BY THE CLAIM FOR REFUND.

Matteson v. Director of Revenue, 909 S.W.2d 356, 360 (Mo. 1995)

Mo. Rev. Stat. section 143.631

Mo. Rev. Stat. section 143.821

Mo. Rev. Stat. section 144.700

V. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING PENALTIES UNDER SECTION 144.250.3 BECAUSE CHE DOES NOT OWE USE TAX ON PURCHASES FOR ITS PRIVATE CUSTOMERS IN THAT SUCH PURCHASES WERE NOT SUBJECT TO USE TAX.

Mo. Rev. Stat. section 144.250.3

ARGUMENT

Standard Of Review for All Points Relied On

The standard of review for this Court is that factual findings of the AHC are reviewed to determine whether they are supported by substantial evidence upon the record as a whole, but this Court is to conduct an independent review of the legal issues. Mo. Rev. Stat. section 536.140; *Gammaitoni v. Director of Revenue*, 786 S.W.2d 126, 128 (Mo. banc 1990). A question of statutory construction is strictly a matter of law. *Delta Air Lines, Inc. v. Director of Revenue*, 908 S.W.2d 353, 355 (Mo. banc 1995). This Court's review of the findings of law of the AHC is *de novo*. *Gammaitoni v. Director of Revenue*, 786 S.W.2d 126, 128 (Mo. banc 1990).

I. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON ITEMS PURCHASED FROM AN OUT OF STATE VENDOR FOR AN OUT OF STATE CUSTOMER BECAUSE THE ITEMS WERE ONLY TEMPORARILY STORED IN THE STATE OF MISSOURI IN THAT INSPECTION, TESTING, AND CERTIFICATION OF THE ITEMS BY CHE DID NOT CONSTITUTE A TAXABLE USE.

The AHC erred in holding that use tax should be assessed on parts and equipment which were shipped to its Fenton, Missouri location from an out-of-state vendor and then, within seven days, shipped from Fenton, Missouri to an out-

of-state customer. See Decision at 17-20. CHE inspected and assured that the parts received in its Fenton, Missouri location were those which had been ordered, and were in working order. The process by which CHE inspected and received parts in its Fenton, Missouri location was not a use and was not an exercise of dominion or control. To the extent the AHC's decision held otherwise, it is not supported by the decision, statutes or regulations of this state.

The AHC recognized that some of the parts and equipment were purchased from out of state vendors, and

shipped to CHE's location in Fenton, Missouri, tested and certified, then shipped (a) to private customers outside Missouri; (b) federal government customers in and outside Missouri;⁵ (c) other governmental customers outside Missouri; and (d) state government customers in the state.

Decision at 3, ¶ 5. Without citing to any authority, the AHC then determined (among other things) that the process by which CHE tested and certified the parts was an exercise of "dominion and control" so as to cause the temporary storage of such parts to be a "use" which is taxable. Decision at 18. The determination of

⁵ This finding is not a subject of this appeal.

whether testing or certifying⁶ parts or equipment is a “use” under the use and sales tax laws of Missouri is a matter of first impression for this Court.⁷ Further, the factual findings of the AHC on this issue are not supported by substantial or competent evidence. Mo. Rev. Stat. section 536.140; *Gammaitoni v. Director of Revenue*, 786 S.W.2d 126, 128 (Mo. banc 1990). The sole evidence on this issue comes from the testimony of David York, the President and CEO of CHE. Tr. 31. Mr. York explained that CHE tests a part because:

A From wherever we purchase the part for whomever customer we purchase the part for, we have to certify by contract that the part is indeed good before we can introduce it into a customer’s machine.

Q How long does this certification process take?

A On median average between a period of five to seven days.

Q And who performs the testing on the part?

⁶ To certify is defined as “: to attest authoritatively: as a : confirm b : to present in formal communication c : to attest as being true or as represented or as meeting a standard d : to attest officially to the insanity of[.]” <http://www.merriam-webster.com/dictionary/certifying?show=0&t=1306179641>

⁷ As discussed, *infra*, however, this Court has had numerous opportunities to define the terms processing, fabricating, producing, manufacturing, and in all of such definitions “testing” or “certifying” would not meet any such definition.

A Engineers that we have employed here in the state.

Q Employed by CHE?

A Employed by CHE, yes, sir.

Q After the testing of the part occurs, then what happens to the part?

A That part is then shipped directly to the client site and placed on the client site.

Q So how long on average would any certified part be with the state if it was, in fact, received by CHE?

A As I stated, a period of five not to exceed seven days.

Tr. 46-47. *See also* Tr. 59 and 76 (“[CHE’s warehouse is] a transitional place where machines are coming and going for our clients outside of the state.”).

If a company cannot verify a part is that which was ordered from the vendor or that the part is in working order, without losing the temporary storage exemption under section 144.610, such an interpretation would wrench the statute from the result intended by the legislature, and would be inconsistent with the import of the language of the statute. *See L & R Egg Co. v. Director of Revenue*, 796 S.W.2d 624, 625 (Mo. banc 1990); *State ex rel. Union Electric Co. v. Goldberg*, 578 S.W.2d 921, 923 (Mo. banc 1979).

An examination of Mo. Rev. Stat. section 144.610.1, and the regulations interpreting it, reflect an intent of the General Assembly to complement the sales tax:

A tax is imposed for the privilege of storing, using or consuming within this state any article of tangible personal property purchased This tax does not apply with respect to the storage, use or consumption of any article of tangible personal property purchased, produced or manufactured outside this state until the transportation of the article has finally come to rest within this state or until the article has become commingled with the general mass of property of this state.

Mo. Rev. Stat. section 144.610.1. “Storage” is defined as “any keeping or retention in this state of tangible personal property purchased from a vendor, except property for sale or property that is temporarily kept or retained in this state for subsequent use outside the state[.]” Mo. Rev. Stat. section 144.605(10). “Use” is defined as “the exercise of any right or power over tangible personal property incident to the ownership or control of that property, except that it does not include the temporary storage of property in this state for subsequent use outside the state, or the sale of the property in the regular course of business[.]” Mo. Rev. Stat. section 144.605(13).

The regulations further this conceit. They refine the definition of “temporary storage” into intentional⁸ and temporal⁹ elements. There is no dispute that the parts at issue were purchased with the *intent* to be subsequently used outside the state, and in fact, they *were* used outside the state for the purpose for which the parts were intended. Tr. 59-62. Furthermore, the parts were only within the state for five to seven days, well within the one year cut-off. Tr. 47.

The question raised by the AHC, then, relates solely to the “use,” or lack thereof, of the parts:

Use—The exercise of any *right or power* over tangible personal property **incident to the ownership or control of that property**, except temporary storage of property in this state for subsequent use outside the state, or for sale of the property in the regular course of business.

⁸ “In general, the temporary storage of property in this state with the intent to subsequently use the property outside the state is not subject to use tax.” 12 C.S.R. 10-113(1). *See, accord*, 12 C.S.R. 10-113(2)(A) (“ . . . To be ‘for subsequent use outside the state’ the purchaser must intend at the time the property is delivered to a Missouri location to subsequently use the property outside the state.”).

⁹ “Temporary—Generally, property kept or retained for less than a year may be considered temporary.” 12 C.S.R. 10-113(2)(B).

12 C.S.R. 10-113(2)(C) (emphasis added). The issue then is this: whether testing as required by contract (Tr. 47) to assure that a part is working, and is what was ordered from the vendor, is the “*exercise of any right or power incident to the ownership or control*” over the property. The answer is “no.”

The AHC found that CHE met the definition of a “sale at retail”:

CHE purchased the parts from its vendors and then transferred title or ownership, or the right to use, store or consume the property, for consideration. . . The definition of “sale at retail” requires the “transfer . . . of the ownership of, or title to, tangible personal property to the purchaser, for use or consumption . . . for a valuable consideration.” Each element of a sale is met in this case.

Decision at 15 (footnotes omitted).

The AHC correctly found that CHE transfers ownership of the parts to its customers for their use and consumption in the customers’ enterprise class machines. Decision at 13, 15. It is incongruous and inconsistent, then, that the AHC later found that the contractual testing of the reconditioned parts to assure that they were as represented to CHE, and therefore the customer, was a taxable “use.” There cannot be a “sale” under section 144.615(6) (and the installation into a customers’ machine) on the one hand and a “use” under section 144.605(13) (by

CHE to verify the identity and condition of the part or equipment) on the other with respect to the same item.

The use of the parts and equipment for the purpose they were intended occurred outside the state. The parts were installed into the customer's machines. Being *inspected* for usability was not the purpose for which the part was intended or purchased. Being *used* in the machine was the purpose for which it was intended and purchased. There was no addition of value to said parts or equipment within this state. CHE proved this to the AHC. This Court should reverse the AHC's result-oriented decision and remove the incongruity of precedent the AHC's decision would otherwise set.

If businesses cannot inspect and certify goods, parts, or equipment within the state for as short a period of time as one week, prior to using or installing them in computers and machines outside the state, then Missouri companies will be forced to consider moving the entirety of their business out of the State of Missouri to avoid such penal application of the use statute. CHE's out-of-state competitors need not pay such use taxes.

As discussed below, these goods, parts, and equipment merely pause in Missouri from an origin outside the state to a destination outside the state. No value was added in this state. If the wrong parts were received, they are returned to the vendor. Should this Court not reverse the ill-considered decision of the

AHC, CHE and similarly situated employers may have no other recourse than to reverse its impact by relocating its business elsewhere.

A. Inspections do not decide the fate of the items

As this Court has recognized, there is only a “use” if the taxpayer receives a non-incidental benefit from holding the property prior to its shipment to the end purchaser. *House of Lloyd, Inc. v. Director of Revenue*, 884 S.W.2d 271, 275 (Mo. 1994), overruling in part, *R & M Enterprises v. Director of Revenue*, 748 S.W.2d 171, 172 (Mo. banc 1988).¹⁰ In *House of Lloyd*, this Court reversed a decision of the AHC which held that the taxpayer received *some* benefit from the purchase of packing material because it assured “both its customers *and* itself that merchandise would arrive in an unspoiled condition, free from breakage or other damage.” 884 S.W.2d at 275. This Court held that where the evidence showed that the taxpayer’s end purpose was the sale of the packing material to its customers, the fact that the taxpayer received a benefit by using the packing material to protect its merchandise during shipping is not a use by the taxpayer sufficient to defeat the use tax resale exemption provided in section 144.615(6).¹¹

¹⁰ As discussed, *infra*, the AHC relied upon *R&M Enterprises* at page 19 of its Decision.

¹¹ This section provides:

If, as the AHC dubiously found, these inspections by CHE truly did “decide the fate” of the product, then taken to its logical conclusion such a finding would wholly eviscerate the temporary storage exemption and overrule *House of Lloyd*. The storage in this case was for less than seven days, and was therefore, by definition, “temporary.” 12 C.S.R. 10-113(2)(B). The AHC’s decision would require that any time a taxpayer placed a shipping label on otherwise temporarily stored items, this would “determine its fate” and make it immediately taxable. That is not the intent of section 144.615(6), the rules interpreting same, or the cases interpreting either the statute or the regulations. The entire point of the temporary storage exception is for a Missouri employer to maintain parts and equipment temporarily in this state and then ship them outside of this state for the ultimate use for the purpose for which the parts were intended. That is what occurred in this case. That should not preclude CHE from the temporary storage exemption.

There are specifically exempted from the taxes levied in sections 144.600 to 144.745: . . .

(6) Tangible personal property held by processors, retailers, importers, manufacturers, wholesalers, or jobbers solely for resale in the regular course of business[.]

Mo. Rev. Stat. section 144.615(6).

Finally, this would be the first decision of the courts of Missouri to find a “use” within the state where there is subsequent, and actual, use *outside* the state for the purpose for which the item was purchased. See, e.g., *Southwestern Bell Yellow Pages, Inc. v. Director of Revenue*, 94 S.W.3d 388 (Mo. 2002) (directories were distributed within the state). Even the cases relating to “dual use” scenarios such as in the airplane decisions hold that there must be a business use of the planes in the state in order to assess tax. *Director of Revenue v. Superior Aircraft Leasing Co., Inc.*, 734 S.W.2d 504, 507 (Mo. 1987) and *Fall Creek Const. Co., Inc. v. Director of Revenue*, 109 S.W.3d 165, 172 (Mo. 2003)).

Here, those items held for temporary storage are clearly *not* “used” within the state and are not subject to tax under Mo. Rev. Stat. section 144.605(13). No benefit of any kind was derived within the state. Clearly, these items were temporarily stored and are therefore exempt from tax. The AHC’s decision simply cannot be supported.

B. Missouri Regulations do not support the AHC decision

The Code of State Regulations on this issue do not support the decision of the AHC. The Regulations interpreting the use tax reveal an intent to apply the use tax to items temporarily stored in the state only when additional processing, fabricating, or other modifications occur within this state. Here, no such processing, fabricating or modifying occurred. CHE only verified that it received

parts and equipment it had ordered, and that said parts and equipment actually worked. The testing and certifying procedure required CHE, for example, to verify that scanners worked (see, *e.g.*, Exhibit 158) and to confirm that the correct number of wiping rags were enclosed in a shipment (see Exhibit, *e.g.*, 45).

The Regulations confirm this understanding. In a case in which the Regulations indicate use tax does *not* apply:

A Missouri contractor purchases from an out-of-state vendor materials and supplies for an out-of-state job. The items purchased are specifically ordered for the out-of-state job, are earmarked as such on the purchase orders and are delivered to the contractor temporarily in Missouri. **No further processing, fabricating or other modifications are performed on the items.** The materials and supplies purchased are not stock items that may be used in other ongoing jobs either within or without the state. The purchase of the materials and supplies would not be subject to use tax in Missouri.

12 C.S.R. 10-113(4)(A) (emphasis added). In the instant case, as in the above example, there is no further “processing, fabricating or other modifications.” CHE is merely confirming that the parts and equipment are what the vendor represented they were, and were in working order. That is no different than re-packing the parts or equipment in different boxes, that, as a practical matter, would have

occurred in the above example in the Regulation. The Code expressly permits a company to handle items and distinguish them from other similarly situated items without incurring a use tax. *Cf.* 12 C.S.R. 10-113(4)(E). Alternatively, if the items are not what was ordered, then they are returned to the seller.

The Regulations reveal that in the event the items are subject to processing, fabricating or modification (conceptually an addition to the items), a use tax is assessed, even if the storage would otherwise exempt them from taxation under 12 C.S.R. 10-113(1). To distinguish a non-tax situation from one in which a tax is assessed, the Code instructs:

Same facts as in [12 C.S.R. 10-113(4)(A)], however the Missouri contractor performs fabrication labor on the materials in preparation for the out-of-state job at its location in Missouri. The purchase of the materials would then be subject to Missouri use tax.

12 C.S.R. 10-113(4)(B).

The case at bar is not one in which “fabrication labor” was performed upon the materials. *Cf.* 12 C.S.R. 10-113(4)(B). The term “fabrication” means “construct, manufacture; specifically: to construct from diverse and usually standardized parts[.]”¹² In the 10-113(4)(B) scenario, the added fact was that the materials were altered by the contractor through fabrication upon them. That is

¹²www.merriam-webster.com/dictionary/fabricating?show=0&t=1305645291.

expressly *not* the case at bar. *See also* 12 C.S.R. 10-113(4)(C) (this is not an instance in which software is loaded onto materials purchased for installation in another state, and the AHC did not so find.)

The regulations stand for the proposition that when the parts and equipment obtain additional processing or fabricating, use tax is assessed. *See*, 12 C.S.R. 10-113.300(3)(C) (“The exclusion will not apply if any further processing, fabrication or other modifications are performed on or to the property while in this state.”) Testing and inspecting, however, is *not* further processing, fabrication or otherwise modifying. Here, the items were not altered in any way. They were merely inspected. If they worked, they were then shipped to be installed, and used, outside this state. If they did not work, they would be returned to the vendor. No taxable use occurred. No tax should be assessed.

Furthermore, when faced with defining whether “manufacturing,” “fabrication,” or “producing,” has occurred, this Court has held that actions such as “inspection” do *not* so qualify.

Previously, this Court held that “manufacturing” is “the alteration or physical change of an object or material in such a way that produces an article with a use, identity, and value different from the use, identity, and value of the original.” *Galamet, Inc. v. Director of Revenue*, 915 S.W.2d 331, 333 (Mo. banc 1996). This Court has further held that, in the related context of section 144.030.2,

manufacturing, mining, fabricating, and producing all transform an input into an output with a separate and distinct use, identity, or value. See *Southwestern Bell Telephone Co. v. Director of Revenue*, 78 S.W.3d 763, 767–68 (Mo. banc 2002); *Galamet*, 915 S.W.2d at 333; *House of Lloyd*, 824 S.W.2d 914, 919 (Mo. banc 1992); *L & R Egg Co. v. Director of Revenue*, 796 S.W.2d 624, 626 (Mo. banc 1990); *Jackson Excavating Co. v. Administrative Hearing Com'n*, 646 S.W.2d 48, 51 (Mo. 1983).

This Court held that cleaning and inspecting eggs did not meet the statutory definition of “manufacturing, mining, fabricating or producing a product which is intended to be sold ultimately for final use or consumption[.]” *L & R Egg Co.*, 796 S.W.2d at 626–27.

In *L & R Egg Co.*, the Court reached its conclusion not by relying upon the nature of the process and how it was conducted (i.e., culling eggs), but instead by comparing the end product to the input to determine whether there was a substantial change in use. In doing so, the Court found that “the fundamental ‘use’ for a batch of eggs when it arrives at appellant’s plant and when it leaves is the same—consumption,” and that the process applied to the eggs made “little difference in the way in which consumers use the eggs.” *L & R Egg Co.*, 796 S.W.2d at 626.

Galamet, Inc. v. Director of Revenue, 915 S.W.2d 331, 334 (Mo. 1996). Similar to the holding in *L & R Egg*, there is no difference between an item when it is received by CHE and when it leaves CHE. The “use” for which the AHC found the resale occurred was to occur outside the state. Here, there is no separate and distinct use, identity, or value added to the items.

Similarly, this Court previously defined processing, within section 144.030.2(12), as “a mode of treatment of certain materials to produce a given result. It is an act, or a series of acts, performed upon the subject matter to be transformed and reduced to a different state or thing.” *State ex rel. Union Electric Co. v. Goldberg*, 578 S.W.2d 921, 924 (Mo. banc 1979); *Wetterau, Inc. v. Director of Revenue*, 843 S.W.2d 365, 367 (Mo. 1992). This instant case is a situation analogous to inspection of eggs, not of fabrication of equipment. Just as in *Wetterau*, which maintained frozen meat in the same status that it receives it, there was no processing by CHE. *Wetterau, Inc. v. Director of Revenue*, 843 S.W.2d 365, 368 (Mo. 1992); *Branson Properties USA, L.P. v. Director of Revenue*, 110 S.W.3d 824, 826 (Mo. 2003).

This Court has similarly found that there was no manufacturing, mining, fabricating, or producing in the following situations:

- Retreading or recapping tires. *State ex rel. AMF Inc. v. Spradling*, 518 S.W.2d 58, 61–62 (Mo. 1974).

- Cleaning and repairing uniforms. *Unitog Rental Services v. Director of Revenue*, 779 S.W.2d 568, 570–71 (Mo. banc 1989).
- Equipment used for drilling test holes to search for minerals. *Rotary Drilling Supply v. Director of Revenue*, 662 S.W.2d 496, 500 (Mo. banc 1983).
- Repackaging products. *House of Lloyd*, 824 S.W.2d at 919.
- Transmitting or distributing electricity. *Utilicorp United v. Director Of Revenue*, 75 S.W.3d 725, 729 (Mo. banc 2001).

It simply belies reason to find that verifying a product is what is represented prior to shipping for its use outside this state will subject the Missouri taxpayer to use tax.

C. The AHC improperly relies upon *R & M Enterprises, Inc.*

The finding of the AHC appears to attempt to resurrect the overruled decision of *R & M Enterprises, Inc. v. Director of Revenue*, 748 S.W.2d 171 (Mo. banc 1988). Therein, it was held that:

The books, nevertheless, are delivered directly to the appellant at its principal office in Missouri, and until it ships them to the retailers, it has *complete dominion and control* over them. They come to rest in Missouri and may properly be said to have become “commingled with

the general mass of property of the state.” It has the privilege of “using,” in the sense of the statute. It makes no difference that it may assert this privilege only a very brief time. The privilege of using is the occasion for taxation.

748 S.W.2d at 172. This is exactly what the AHC held in its Decision. In fact the AHC explicitly relied upon *R & M Enterprises* to support its findings. Decision at 19.

R & M Enterprises was, however, reversed by *House of Lloyd, Inc. v. Director of Revenue*, 884 S.W.2d 271 (Mo. banc 1994), and is no longer good law. Further, the applicable temporarily storage regulation, 12 C.S.R. 10-113, became effective December 30, 2000. Appendix A49. That CHE stored parts and equipment for approximately one week does not destroy the exemption. Likewise, the 1988 holding of *R & M Enterprises* does not destroy CHE’s temporarily storage exemption, as it was effectively abrogated by the regulation. Should this Court permit the AHC’s decision to stand in this case, however, it would be the same as reinstating the *R&M Enterprises* decision and abrogating the temporary storage regulation. Items would be assessed use tax merely by receiving parts, items, and equipment under an overbroad definition of “use.” That is not what this Court has previously held, is not what the regulations state, and should not be the rule in Missouri.

D. Airplane decisions provide no guidance in this case

Here, the AHC arrived at the use tax by relying upon this Court's decision in cases that dealt with leasing and ownership of aircraft. The AHC posited that these decisions established that there was a non-de minimis use within the state. Decision at 18. This is not a situation where there are dual uses for aircraft. Those cases solely focus upon the issue of whether airplanes which were "stored" (hangared) in the state for a fractional period of time by the airplane's owner was subject to a use tax. Decision at 18 (citing *Director of Revenue v. Superior Aircraft Leasing Co., Inc.*, 734 S.W.2d 504, 507 (Mo. 1987) and *Fall Creek Const. Co., Inc. v. Director of Revenue*, 109 S.W.3d 165, 172 (Mo. 2003)).

In each of those two cases, the "use" at issue was the hangaring, flying, maintaining and owning of the airplane in Missouri.¹³ The use tax is a levy on the privilege of using within the taxing state property purchased outside the state, if the property would have been subject to the sales tax had it been purchased at home. *Southwestern Bell Telephone Co. v. Morris*, 345 S.W.2d 62, 66 (Mo. banc 1961).

¹³"No sales or use tax was ever paid on the purchase, use or storage of the aircraft in Kansas, Ohio or in any other state." *Superior Aircraft Leasing Co., Inc.*, 734 S.W.2d at 505. "Delivery of these interests occurred in Wichita, Kansas and neither Fall Creek nor Raytheon paid any sales or use tax to either Kansas or Missouri." *Fall Creek Const. Co., Inc.*, 109 S.W.3d at 167.

This Court found dominion where the taxpayers had “operational control,” under Part 91 of the Federal Aviation Regulations, for the taxpayers’ fractional interest in the airplane. *Fall Creek Const. Co., Inc.*, 109 S.W.3d at 172. Here, there is no control, no use, no dual use, and no airplane. The taxpayers in *Superior Aircraft Leasing Co.* and *Fall Creek Const. Co.* used the items (airplanes) as they were intended: as aircraft. Here, CHE did not use the items as intended, it only verified that the items were what they were represented to be by the vendor.

These airplane decisions, *Superior Aircraft Leasing Co.* and *Fall Creek Const. Co.*, are inapposite and the AHC erred in relying upon them to support the imposition of use tax upon the items at issue.

The decision of the AHC to the contrary should be reversed.

II. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON (A) ITEMS PURCHASED FROM AN OUT OF STATE VENDOR FOR AN OUT OF STATE CUSTOMER AND (B) ITEMS PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS BECAUSE SAID ITEMS WERE IN FACT SOLD AT RETAIL AND ARE EXEMPTED FROM USE TAX IN THAT THE ITEMS WERE PURCHASED FOR RESALE.

The AHC relied upon *ICC Management, Inc. v. Director of Revenue*, 290 S.W.3d 699 (Mo. banc June 16, 2009, *rehearing denied*, September 1, 2009) to hold that there must be a “taxable resale” for the reseller exemption to apply. Decision at 15-17.

The *ICC* decision, and that in *Westwood Country Club v. Director of Revenue*, 6 S.W.3d 885 (Mo. banc 1999), are bottomed upon the premise that the resale exemption is to avoid double taxation. See *ICC*, 290 S.W.3d at 703. A use tax was affirmed by this Court to assure that “a special benefit” was not provided to *ICC* “that is not enjoyed by other taxpayers.” *ICC*, 290 S.W.3d at 703. The key difference between those cases and the case at bar is that the taxpayers in *Westwood Country Club* and *ICC* both appeared to have a single class of customer: that which was exempt. This makes it simple for the taxpayers in *Westwood Country Club* and *ICC* to price its products accordingly. Here, CHE (under the

reasoning of the AHC) has two classes of customers: exempt federal customers and its private and its public post-secondary educational institutions which the AHC found were not exempt.

If *ICC* is correct, then how is the taxpayer to account for the use tax it is then required to pay? It cannot pass that along to the exempt entity. Instead, it must absorb that amount and pay the tax to the state. For CHE, this rate is 4.255%. For items with a profit margin below 4.255%, CHE is making a *negative* profit (a loss).

This Court should affirm and extend its holding in *McDonnell Douglas Corp. v. Director, Revenue*, 945 S.W.2d 437, 439 (Mo. banc 1997) to issues such as this. Therein, this Court permitted the resale to the federal government, a tax-exempt entity. This should be extended to all tax-exempt entities.

CHE's situation is analogous to the local church which is frequented has an account with the local hardware store. Supplies and materials purchased by the church would be tax exempt. Mo. Rev. Stat. section 144.030(19). Under *ICC*, sales or use tax would then be assessed against the hardware store which had the *misfortune* of selling to the local church. It would make good business sense for the store to refuse any sale in which the mark up (or profit margin) is equal to, or less than, the local tax rate.

Clearly, such a result is nonsensical and not what the legislature, or this Court, intended. Such a result would cause a downturn in employment, rather than

increasing employment. This Court should make clear that the decisions of *ICC* and *Westwood Country Club* do not apply to a reseller which has both tax exempt and non-exempt customers. To hold otherwise prejudices the reseller and limits the entities with which it can do business. Accordingly, this Court should reverse the decision of the AHC.

III. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING USE TAX ON ITEMS PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS BECAUSE ITEMS WHICH ARE PURCHASED FOR STATE PUBLIC POST-SECONDARY EDUCATIONAL INSTITUTIONS ARE EXEMPTED FROM USE TAX IN THAT THE STATUTES, REGULATIONS, AND CONTRACTS AT ISSUE SO PROVIDE.

The AHC assessed use tax on items purchased for CHE customers which were Missouri public post-secondary educational institutions. These customers were the University of Missouri, Central Missouri State University, and Southwest Missouri State University. The statute provides that “[a]ll sales made to any private not-for-profit elementary or secondary school” are exempt from sales and use taxes. Mo. Rev. Stat. section 144.030(22). The public schools with which CHE did business were also “exempt organizations” under 12 C.S.R. 10-110(2)(A)(10). As the Code affirms the statute: “[a]ll sales made to public . . . post-secondary institutions are exempt from tax.” 12 C.S.R. 10-110(3)(D).

The contract between CHE and the University of Missouri confirmed this and provided that “. . . [m]aterials and services furnished the University are not subject to either Federal Excise Taxes or Missouri Sales Tax.” Exhibit 203 at 3,

section A3. Further, the contract stated that “. . . [a]ll parts installed will become the property of the University.” Exhibit 203 at 13, section 1.6.1(c).

The purchase order from Southwest Missouri State University provides:

Do not bill sales and/or use tax. Southwest Missouri State University, as a public supported educational institution, pursuant to sections 144.040 [*sic*] and 144.615 RSMo, is exempt from all such sales and use taxes.

Exhibit 205 at 4, section 10.

The contracts specified that CHE should not bill sales or use tax. See Exhibit 205 at 4, section 10. See also Exhibit 203 at 3, section A3. Others indicated that, as discussed above with the federal customers, “[a]ll parts installed will become the property of the University.” Exhibit 203 at 13, section 1.6.1(c). CHE relied upon this language when it entered into these contracts. Tr. 70. Had CHE believed it was subject to sales or use taxes, it would have increased the bid amount to the state post-secondary educational institutions. Tr. 70.

The transactions with University of Missouri, Central Missouri State University, and the Southwest Missouri State University were not subject to sale or use tax under Mo. Rev. Stat. section 144.615 and 12 C.S.R. 10-110. To hold CHE responsible for a use tax for these same transactions would penalize a Missouri company for doing business with the public post-secondary educational institutions

of the State of Missouri. Such a result is contrary to that which is in the best interests of the state, its post-secondary educational institutions, and the businesses in this state which serve post-secondary educational institutions. The decision of the AHC imposing a use tax for CHE's transactions with its post-secondary educational institution customers should be reversed.

IV. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN RECALCULATING THE AUDIT OF THE DIRECTOR AND INCREASING THE TAX ON EXPENSED PURCHASES BECAUSE CHE PAID THE TAX CALCULATED BY THE DIRECTOR UNDER PROTEST IN THAT IN CASES IN WHICH A REFUND IS SOUGHT, THE AMOUNT IN DISPUTE IS FIXED BY THE CLAIM FOR REFUND.

The AHC also increased the amount of tax assessed over and above that amount calculated by the Director. This was improper and unsupported by statute or decisions of this Court.

The AHC relied upon this Court's decision in *J.C. Nichols Co. v. Director of Revenue*, 796 S.W.2d 16 (Mo. banc 1990)¹⁴ to increase the Director's calculation. See Decision at 22. The *Nichols* opinion does not apply because it involved a notice of deficiency proceeding under section 143.611. Section 143.611.1 provides:

As soon as practical after the return is filed, the director of revenue shall examine it to determine the correct amount of tax. If the director of revenue finds that the amount of tax shown is less than the

¹⁴ CHE acknowledges that the *Nichols* decision related to income tax, not use tax. The AHC relied upon it, however, and the provisions for protest payment are found in chapter 143 of the Code, which addresses income tax.

correct amount, he shall notify the taxpayer of the amount of deficiency *proposed* to be assessed. If the director of revenue finds that the tax paid is more than the correct amount, he shall credit the overpayment against any taxes due under sections 143.011 to 143.996 from the taxpayer and refund the difference.

(Emphasis added.)

This instant proceeding was not brought under section 143.611, but was for a *refund* pursuant to section 143.821:

. . . A taxpayer which has made a deposit under subsection 2 of section 143.631 and has received a *determination* of the director of revenue pursuant to section 143.641 shall be deemed for purposes of this chapter to have filed a claim for refund of an amount not greater than the deposit, on such grounds as were set forth in the taxpayer's protest filed under subsection 1 of section 143.631.

Mo. Rev. Stat. section 143.821 (emphasis added). Section 144.700 is the use tax counterpart of section 143.821.

The procedure by which a payment under protest is made expressly requires the Director to take action "*confirming* the amount of tax, interest, additions to tax and penalty to which the deposit has been applied." Mo. Rev. Stat. section 143.631.4 (emphasis added). Here, CHE in fact filed its protest affidavit.

On November 20, 2007, the Director responded:

The Division of Taxation and Collection received your Protest Payment Affidavit as required by Section 144.700, RSMo.

After reviewing your affidavit, it is the *final decision* of the Department of Revenue that the amount of \$24,519.84 is due and owed.

Exhibit A, Appendix at A26 (emphasis added). CHE paid the tax, interest, additions to tax and penalty, under protest. This Court has previously held that the *Nichols* opinion has limited application:

“The very use of [the word ‘proposed’] indicates that the amount set out is fluid, subject to adjustment upon the determination of additional facts.” *Nichols*, 796 S.W.2d at 21. In deficiency proceedings, therefore, the AHC's jurisdiction is de novo, even to the extent that the AHC may increase the director's assessment in a given case

Matteson v. Director of Revenue, 909 S.W.2d 356, 360 (Mo. 1995).

Here, there is absolutely no proposed deficiency. The Director affirmatively *confirmed* the amount due in its “final decision.” The rationale of *Matteson* is clear: in cases in which a refund is sought, the amount in dispute is fixed by the Director's decision and the claim for refund. In such cases, the AHC, even as an adjunct executive agency to the Director, cannot be given authority to change the

amount of the Director's final assessment. To hold otherwise would arbitrarily subject taxpayers to issues and liabilities which were not put in dispute by their claim for refund. The taxpayer expressly chose to seek a refund under sections 144.700, 143.631 and 143.821 to limit its exposure rather than to incur the risk of a changed assessment under section 143.611.

It is reasonable as a matter of policy, that the AHC should not engage in, nor should this Court support, on a refund claim the raising of issues *by the AHC* not raised by the Director at audit nor even the adjustment or correction by the AHC of the audit calculations of the Director.

Our tax system depends on self assessment and reporting by taxpayers. It only functions properly and efficiently when taxpayers act with integrity. Integrity is a two way street however, and the AHC should act in a manner that fosters the confidence of taxpayers in the fairness of the AHC. In short, if the Director and the AHC do not act with integrity (so as to permit taxpayers to intelligently manage the manner in which additional assessed taxes are disputed), they cannot expect taxpayers to do so.

The state unjustifiably prejudices the taxpayer if it first informed taxpayer that it owes "X" dollars, and then during an appeal brought in good faith by the taxpayer, the AHC tells the taxpayer they are wrong substantively, and that the proposed deficiency was actually *understated* and instead is "Y" dollars (which the

taxpayer would likely have no reason to suspect). Such a taxation scheme is arbitrary, unreasonable, and punitive.

While by far not perfect, the Internal Revenue Service, by contrast, understands that effective tax administration requires taxpayers to have confidence in the fairness of the system. The I.R.S. has in fact adopted a policy which provides that new issues may only be raised by an appeals officer at an appeal of a proposed assessment (essentially equivalent administratively, to the present appeal to the AHC in this case) in the rarest of circumstances. See, Appendix at 50-65. The state and this Court should similarly prohibit an increase of tax on appeal in which the taxpayer is seeking a refund.

The *Matteson* opinion prohibits the AHC from increasing the Director's assessment when seeking a refund. 909 S.W.2d at 360. See also *Commercial Bank of St. Louis v. James*, 658 S.W.2d 17, 23 (Mo. 1983). Accordingly, this Court should reverse the additional amounts improperly calculated by the AHC in its Decision.

V. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN ASSESSING PENALTIES UNDER SECTION 144.250.3 BECAUSE CHE DOES NOT OWE USE TAX ON PURCHASES FOR ITS PRIVATE CUSTOMERS IN THAT SUCH PURCHASES WERE NOT SUBJECT TO USE TAX.

The AHC noted that the Director “assessed additions of 5% of the tax she determined that CHE owes[,]” citing Mo. Rev. Stat. section 144.250.3. Decision at 23. It then found that “CHE was negligent, but only in its failure to pay use tax on the purchases for its private customers.” Decision at 24. The AHC erred in awarding a negligence penalty on *any* amounts attributable to any contract.

Taxing statutes that impose penalties are to be strictly construed against the taxing authority and in favor of the taxpayer. *Travelhost of Ozark Mountain Country v. Director of Revenue*, 785 S.W.2d 541, 546 (Mo. banc 1990). The statute at issue states:

In the case of failure to pay the full amount of tax required under sections 144.010 to 144.525 on or before the date prescribed therefor, . . . due to negligence or intentional disregard of rules and regulations, but without intent to defraud, there shall be added to the tax an amount equal to five percent of the deficiency. The director shall, upon request by a taxpayer, apprise the taxpayer of the factual

basis for the finding of negligence, or the specific rules or regulations disregarded if the director assesses a penalty under this subsection. . . .

If additions to tax are assessed under authority of this subsection, additions to tax may not be assessed by the director under authority of subsection 2 of this section.

Mo. Rev. Stat. section 144.250.3.

As set forth above, the AHC improperly increased the amounts due, and therefore any negligence attributable thereto is impossible to support, or even understand. This Court should reverse the AHC to the extent that it assessed any penalties for any reason whatsoever.

CONCLUSION

For the reasons set forth above, this Court should reverse the decision of the AHC to the extent that it held that parts and equipment installed in enterprise class machines outside the State of Missouri were subject to tax, that items purchased for Missouri public post-secondary educational institutions were subject to tax, that the AHC had the authority to increase the tax assessed over that amount calculated in the Director's audit, and that penalties were properly assessed.

CERTIFICATION PURSUANT TO RULE 84.06(c)

The undersigned hereby certifies that the foregoing Appellant's Brief:

1. Includes the information required by Mo. R. Civ. P. 55.03;
2. Complies with the limitations contained in Mo. R. Civ. P. 84.06(b) and (c); and
3. Contains 9,062 words.

The undersigned further certifies that the disk submitted with this Appellants' Brief has been scanned for viruses and is virus free.

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CERTIFICATE OF SERVICE

The undersigned certifies that one copy of the brief in printed form and one copy of the brief on floppy disk in MS Word format version 2003 was served via United States mail, First Class postage prepaid, upon the following:

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