STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

DIVISION OF TAXATION

ADMINISTRATIVE HEARING

FINAL DECISION AND ORDER

#2015-14

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
DEPARTMENT OF REVENUE
DVISION OF TAXATION
ONE CAPITOL HILL
PROVIDENCE, RHODE ISLAND 02908

IN THE MATTER OF:	:	**Cases No. 10-T-001; 11-T-0016**
	:	**sales and use tax**
Taxpayers	:	

DECISION

I. INTRODUCTION

The above-entitled matter came before the undersigned as a result of a Notice of Hearing and Appointment of Hearing Officer ("Notice") dated February 11, 2010 and issued to the above captioned taxpayer ("Taxpayer") by the Division of Taxation ("Division") in response to the Taxpayer's request for hearing filed with the Division. That matter was assigned Case No. 10-T-001. In addition, an Appointment of Hearing Officer was issued on August 9, 2011 to the Taxpayer regarding a second deficiency notice and in response to the Taxpayer's request for hearing. That matter was assigned Case No. 11-T-0016 and the cases were consolidated. As described below, the parties were able to resolve all issues except for one (1) issue that arose out of the second deficiency notice. The parties were represented by counsel and filed agreed facts and exhibits and briefs by March 3, 2015.

II. JURISDICTION

The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-18-1 *et seq.*, R.I. Gen. Laws § 44-19-1 *et seq.*, R.I. Gen. Laws § 44-1-1 *et seq.*, the *Division of Taxation*

Administrative Hearing Procedures Regulation AHP 97-01, and the *Division of Legal Services Regulation 1 Rules of Procedure for Administrative Hearings.*

III. ISSUE

Whether the inner envelopes and outer envelopes should be subject to tax at the time the Taxpayer purchases them or if the inner and outer envelopes are acquired as a resale inventory that is not subject to tax until they are mailed to Rhode Island addresses.[1]

IV. MATERIAL FACTS AND TESTIMONY

The parties agreed to the following facts:[2]

1. The Taxpayer is a foreign corporation organized under the laws of New York on December 20, 1916 and qualified to do business in Rhode Island as of November 9, 1995. The Taxpayer's principal place of business is located in New York. Exhibits One (1) and Two (2).

2. The Taxpayer engages in the business of data management, printing, personalization and high volume mailing for a wide variety of industries and operates from facilities in New York, Alabama, and Rhode Island. It has held a permit to make sales at retail (Sales Tax Permit) in Rhode Island since March of 1999. Exhibit Three (3).

3. At its Rhode Island facility, the Taxpayer's business activity is principally related to printing individualized account statements, benefit statements and similar institutional documents related to the customers of it clients (hereafter "Statements").

4. The Division is a state agency charged with the administration and enforcement of all state taxes.

5. In July of 2007, a routine sales and use tax field audit of the Taxpayer was commenced for the period encompassing October 2004 through September 2007 inclusive (Audit Period). Exhibit Five (5) (statute of limitations waiver).

6. During the Audit Period, the Taxpayer had a history of routinely filing and remitting sales tax to the Division. Exhibit Six (6).

7. Field work was performed at the Taxpayer's facility in Rhode Island. Exhibit Seven (7).

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[1] The parties agreed that the statutes directly at issue are R.I. Gen. Laws § 44-18-20, R.I. Gen. Laws § 44-18-21, R.I. Gen. Laws § 44-18-30(7), R.I. Gen. Laws § 44-18-30(22), and R.I. Gen. Laws § 44-18-25. The parties agreed that the regulations at issue are SU 07-58, SU 07-95 SU 07-87, SU 07-56 and their antecedents.

[2] See parties' agreed to statement of facts and agreed to exhibits filed with the undersigned.

8. During the course of the audit, the Division's agent reviewed the following records: general ledgers, corporate returns, sales and use tax returns, sales journals, asset additions and expenses. The Taxpayer's business records were complete, well organized and adequate for audit purposes. Due to the volume of business records involved, portions of the audit were conducted on the basis of test samples. Exhibit Eight (8).

9. The audit field work closed on or about May 1, 2009.

10. As a result of this audit, a Notice of Deficiency Determination (the "Initial Deficiency Notice") dated May 13, 2009 was issued to the Taxpayer. Exhibits 10 and 11.

11. On June 12, 2009, the Taxpayer filed a timely request with the Division for administrative review with regard to the Initial Deficiency Notice. Exhibit 12.

12. The Taxpayer was afforded an informal preliminary conference regarding the Initial Deficiency Notice. The parties were still in disagreement after the preliminary conference. The parties came for formal administrative hearing on March 11, 2010 and the parties agreed that the matter should be remanded for reaudit to consider the Taxpayer's right to claim the manufacturing exemption from the sales and use tax for various assets and expense items that had been assessed in the Initial Deficiency Notice. Following the reaudit, the determinations in the Initial Deficiency Notice were adjusted. Exhibits 15 and 16. The Taxpayer agreed to the Initial Deficiency Notice, as revised by the June 30, 2011 letter, and has paid the additional tax, interest, and penalty. Exhibit 21.

13. On July 4, 2011, the Division issued a second Notice of Deficiency ("Second Deficiency Notice") that provided for additional tax, interest, and penalties. Exhibit 17 (interest computation) and Exhibits 18-20 (copies of Second Deficiency Notice). The Second Deficiency Notice also covers the same Audit Period. On July 20, 2011, the Taxpayer filed a timely request with the Division for administrative review with regard to the Second Deficiency Notice.

14. The only matter that remains in dispute relates solely to the Second Deficiency Notice and the Division's determination that all of the Taxpayer's purchases of inner and outer envelopes are subject to tax. Exhibit 23 (Second Deficiency workpapers).

15. The Taxpayer has paid the additional tax, interest and penalties associated with the Second Deficiency Notice.

16. The clients the Taxpayer services at its Rhode Island facility include credit unions, insurance companies, banks and similar institutions, some of which are non-profit entities. On a recurring basis (generally monthly) the Taxpayer's clients transmit to the Taxpayer, via secure Internet connection, individualized data relating to their customers. This data includes each customer's name and mailing address and details of specific transactions involving the customer, such as the customer's account balance and similar information unique to the customer.

17. The Taxpayer prints the individualized electronic data for the clients' customers onto paper to create the Statements, folds the Statements and inserts them into mailing envelopes ("Outer Envelopes") for direct mailing to each of its clients' customers. The Taxpayer seals the Outer Envelopes, affixes postage and loads them into U.S. postal service carts that are picked up by and loaded onto U.S Postal Service trucks.

18. A portion of the Statements are mailed to addresses in Rhode Island and the balance of the Statements are mailed to addresses outside of Rhode Island.

19. Some of the Taxpayer's clients may request that the Taxpayer include a reply envelope ("Inner Envelope") with each Statement. In those cases, the Taxpayer prints the Statements, folds each of the Statements and inserts each Statement with an Inner Envelope, into an Outer Envelope. The Taxpayer then seals, posts and mails the Outer Envelope as described above.

20. The Outer Envelopes used by the Taxpayer at its Rhode Island facility include a clear window through which the individual customer's address, printed on the Statement, is visible. Similarly, the Inner Envelopes also have a clear window through which the client's return address, for the "reply portion" of the Statement, is visible. The Taxpayer uses one size envelope for its Outer Envelopes and a different but smaller size for its Inner Envelopes.

21. The Taxpayer does not fabricate the Outer or Inner Envelopes nor does it print addresses or other information on either the Outer or Inner Envelopes.

22. The paper used for the Statements, the Inner and the Outer Envelopes are not provided by the Taxpayer's clients. The Taxpayer purchases these items *extax* from third party vendors and does not remit use tax on its purchases of paper and envelopes.

23. The Taxpayer bills its clients on a monthly basis for the number of Statements it prints and the number of Outer Envelopes and Inner Envelopes that are utilized in their mailings. The charges for the paper and envelopes appear as separate line items on the Taxpayer's invoices to its clients.

24. The Taxpayer also keeps track of the addresses to where the mailings are sent so that it can charge, collect and remit Rhode Island sales tax on that portion of a client's mailings sent to Rhode Island addresses. The Taxpayer relies on the zip codes reflected on each individual piece of mail to determine the delivery point of the mailing. The Taxpayer does not charge any sales tax with regard to mailings performed for tax exempt clients; regardless whether the delivery point is within or without Rhode Island.

25. Following the reaudit, it was agreed that the Taxpayer's printing processes would qualify for the manufacturing exemption and that the Initial Deficiency Determination should be revised. The parties agreed that the manufacturing process ended at that point where the Statements and Inner Envelopes were inserted into Outer Envelopes. Accordingly, purchases for the Solimar System and the Xerox printers and purchases related to a portion of the equipment (the BluArc equipment) that received the Internet transmissions of customer information and

formatted that information for the printing process are exempt from the sales and use tax. Similarly, the machinery, equipment and supplies involved in the printing and preparation of the Statements are exempt from the tax. The Division did not deem machinery and equipment involved in inserting the Statements into Outer Envelopes or machinery and equipment involved in any later activity to be tax exempt.

26. In the reaudit, the Division allowed that the Taxpayer's purchases of the paper on which the Statements were printed were exempt from tax at the point of purchase. It was further allowed that only the amounts the Taxpayer charged its clients for Statements mailed to Rhode Island addresses would be subject to Rhode Island tax. However, the Division determined that the purchases of Inner Envelopes and Outer Envelopes should be subject to tax at the time of purchase. Since the Taxpayer charged its clients sales tax on the amounts it charged for envelopes (both Inner and Outer) that were mailed to Rhode Island addresses, the Taxpayer was given credit for taxes paid against the amount of additional taxes assessed.

V. DISCUSSION

A. Legislative Intent

The Rhode Island Supreme Court has consistently held that it effectuates legislative intent by examining a statute in its entirety and giving words their plain and ordinary meaning. *In re Falstaff Brewing Corp.,* 637 A.2d 1047 (R.I. 1994). If a statute is clear and unambiguous, "the Court must interpret the statute literally and must give the words of the statute their plain and ordinary meanings." *Oliveira v. Lombardi*, 794 A.2d 453, 457 (R.I. 2002) (citation omitted). The Supreme Court has also established that it will not interpret legislative enactments in a manner that renders them nugatory or that would produce an unreasonable result. See *Defenders of Animals v. Dept. of Environmental Management,* 553 A.2d 541 (R.I. 1989) (internal citation omitted). In cases where a statute may contain ambiguous language, the Supreme Court has consistently held that the legislative intent must be considered. *Providence Journal Co. v. Rodgers,* 711 A.2d 1131 (R.I. 1998). The statutory provisions must be examined in their entirety and the meaning most consistent with the policies and purposes of the legislature must be effectuated. *Id.*

B. Relevant Statutes

Pursuant to R.I. Gen. Laws § 44-18-18, Rhode Island imposes a sales tax of 7% on gross receipts of a retailer. Pursuant to R.I. Gen. Laws § 44-18-19, the retailer is responsible for the collection of sales tax. Pursuant to R.I. Gen. Laws § 44-18-20, a use tax is imposed on the storage, use or consumption of tangible personal property. "The use tax . . . is a complement to Rhode Island's sales tax . . . The sales tax applies to 'sales at retail in this state.' (citation omitted). The use tax, in contradistinction, is imposed on 'the storage, use, or other consumption in this state of tangible personal property.'" *Dart Industries, Inc. v. Clark*, 696 A.2d 306, 309 (R.I.1997).

R.I. Gen. Laws § 44-18-12 defines "sales price" in part as follows:

> "Sale price" defined. – (a) "Sales price" applies to the measure subject to sales tax and means the total amount of consideration, including cash, credit, property, and services, for which personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise, without any deduction for the following:

R.I. Gen. Laws § 44-18-10 defines use as follows:

> "Use" includes the exercise of any right or power over tangible personal property incident to the ownership of that property, except that it does not include the sale of that property in the regular course of business.

R.I. Gen. Laws § 44-18-11 provides as follows:

> Storage or use for export. – "Storage" and "use" do not include the keeping, retaining, or exercising of any right or power over tangible personal property shipped or brought into this state for the purpose of subsequently transporting the property outside of the state for use solely outside of the state, or for the purpose of being processed, fabricated, or manufactured into, attached to, or incorporated into other tangible personal property to be transported outside of the state and used solely outside of the state.

R.I. Gen. Laws § 44-18-25 provides as follows:

> Presumption that sale is for storage, use, or consumption – Resale certificate. – It is presumed that all gross receipts are subject to the sales tax, and that the use of all tangible personal property, or prewritten computer software delivered

electronically or by load and leave, or services as defined in § 44-18-7.3, are subject to the use tax, and that all tangible personal property, or prewritten computer software delivered electronically or by load and leave, or services as defined in § 44-18-7.3, sold or in processing or intended for delivery or delivered in this state is sold or delivered for storage, use, or other consumption in this state, until the contrary is established to the satisfaction of the tax administrator. The burden of proving the contrary is upon the person who makes the sale and the purchaser, unless the person who makes the sale takes from the purchaser a certificate to the effect that the purchase was for resale. The certificate shall contain any information and be in the form that the tax administrator may require.

Sales and Use Tax Regulation SU 07-87 Direct Mail, Printing and Related Industries ("SU 07-87") states in part as follows:

II. Services and Direct Mail

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Tax does not apply to the following direct mail charges provided such charges are stated separately on invoices and in the accounting records:

- Postage
- Addressing for the purpose of mailing (by hand or by mechanical means)
- Folding for the purpose of mailing
- Enclosing
- Sealing
- Preparing for mailing
- Mailing letters or other printed matters

Tax applies, however, to charges for envelopes.

III. Printers are consumers of special printing aids such as electrotypes, stereotypes, photo engravings, silk screens, steel dies, cutting dies, lithographic plates, artwork, single color or multicolor separation negatives, flats or any other properties purchased for use in the preparation of printed matter to be sold.

R.I. Gen. Laws § 44-18-30[3] states in part as follows:

Gross receipts exempt from sales and use taxes. – There are exempted from the taxes imposed by this chapter the following gross receipts:

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(7) *Purchase for manufacturing purposes*

[3] This statute was amended effective December 31, 2014. However, this is the statute that was in effect during the Audit Period.

(i) From the sale and from the storage, use, or other consumption in this state of computer software, tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, and water, when the property or service is purchased for the purpose of being manufactured into a finished product for resale, and becomes an ingredient, component, or integral part of the manufactured, compounded, processed, assembled, or prepared product, or if the property or service is consumed in the process of manufacturing for resale computer software, tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, or water.

(ii) "Consumed" means destroyed, used up, or worn out to the degree or extent that the property cannot be repaired, reconditioned, or rendered fit for further manufacturing use.

(iii) "Consumed" includes mere obsolescence.

(iv) "Manufacturing" means and includes manufacturing, compounding, processing, assembling, preparing, or producing.

(v) "Process of manufacturing" means and includes all production operations performed in the producing or processing room, shop, or plant, insofar as the operations are a part of and connected with the manufacturing for resale of tangible personal property, electricity, natural gas, artificial gas, steam, refrigeration, or water and all production operations performed insofar as the operations are a part of and connected with the manufacturing for resale of computer software.

(vi) "Process of manufacturing" does not mean or include administration operations such as general office operations, accounting, collection, sales promotion, nor does it mean or include distribution operations which occur subsequent to production operations, such as handling, storing, selling, and transporting the manufactured products, even though the administration and distribution operations are performed by or in connection with a manufacturing business.

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(22)(i) From the sale and from the storage, use, or other consumption in this state of tools, dies, and molds, and machinery and equipment (including replacement parts), and related items to the extent used in an industrial plant in connection with the actual manufacture, conversion, or processing of tangible personal property, or to the extent used in connection with the actual manufacture, conversion or processing of computer software as that term is utilized in industry numbers 7371, 7372, and 7373 in the standard industrial classification manual prepared by the technical committee on industrial classification, office of statistical standards, executive office of the president, United States bureau of the budget, as revised from time to time, to be sold, or that machinery and equipment used in the furnishing of power to an industrial manufacturing plant. For the purposes of this subdivision, "industrial plant" means a factory at a fixed location primarily engaged in the manufacture, conversion, or processing of tangible personal property to be sold in the regular course of business;

(ii) Machinery and equipment and related items are not deemed to be used in connection with the actual manufacture, conversion, or processing of tangible personal property, or in connection with the actual manufacture, conversion or processing of computer software as that term is utilized in industry numbers 7371, 7372, and 7373 in the standard industrial classification manual prepared by the

technical committee on industrial classification, office of statistical standards, executive office of the president, United States bureau of the budget, as revised from time to time, to be sold to the extent the property is used in administration or distribution operations;

(iii) Machinery and equipment and related items used in connection with the actual manufacture, conversion, or processing of any computer software or any tangible personal property which is not to be sold and which would be exempt under subdivision (7) or this subdivision if purchased from a vendor or machinery and equipment and related items used during any manufacturing, converting or processing function is exempt under this subdivision even if that operation, function, or purpose is not an integral or essential part of a continuous production flow or manufacturing process;

(iv) Where a portion of a group of portable or mobile machinery is used in connection with the actual manufacture, conversion, or processing of computer software or tangible personal property to be sold, as previously defined, that portion, if otherwise qualifying, is exempt under this subdivision even though the machinery in that group is used interchangeably and not otherwise identifiable as to use.

Sales and Use Tax Regulation SU 07-58 Manufacturing, Property and Public Utilities Service Used In ("SU 07-58") states in part as follows:

For the purpose of this regulation, the business of manufacturing, converting, processing, compounding, assembling, preparing, or producing shall be divided into three parts as follows:

1. Administration, meaning all administrative work such as general office operations, accounting, purchasing, collection, sales promotion, clerical work in production such as preparation of work records, production records and time records, and machinery or equipment or supplies used in the transporting of raw materials to the industrial plant.

2. Production, meaning all operations performed in the producing or processing room, shop or plant, including the production line starting with the handling and storage of raw materials in the industrial plant and continuing through the last step of production where the product is finished or completed and packaged for sale.

3. Distribution, meaning all operations subsequent to production such as handling, storing, selling, displaying, loading and transporting the manufactured products.

The sales or use tax applies to property and public utility services used in administration and distribution as defined above. The tax applies to property placed in the producing or processing room, shop, or plant if such property is used solely in administration or distribution work.

Retailers such as restaurants, donut shops, fast food businesses, etc., are not manufacturers as that term is commonly understood. Therefore, the manufacturing exemptions under sections 44-18-30(7) and 44-18-30(22) do not apply to such retailers.

C. Arguments

a. <u>The Division</u>

The Division argued that pursuant to R.I. Gen. Laws § 44-18-25, storage or use is presumed taxable unless a taxpayer demonstrates otherwise. The Division argued that the Taxpayer cannot demonstrate clearly and unequivocally that it is entitled to a tax exemption so that the Division must prevail. The Division made several arguments about why the Inner Envelopes and Outer Envelopes (collectively "Envelopes") are subject to the use tax.

First, the Division argued that the Taxpayer purchases the Envelopes *extax*, stores them temporarily in the State and then decides when and where they shall be withdrawn out of inventory to be used to mail Statements both within and without the State. The Division argued that pursuant to R.I. Gen. Laws § 44-18-11, the Taxpayer exercises enough powers and rights over tangible personal property to constitute storage or use thereof and that the Envelopes are not being temporarily stored in Rhode Island for transport for "use solely out of state."

Second, the Division argued that the Envelopes are not being "manufactured into, attached or incorporated into other tangible property to be transported out of the state and used solely out of the state" pursuant to R.I. Gen. Laws § 44-18-11. The Division argued that exemption does not apply since the Envelopes are standard items purchased and used by the Taxpayer, as is, with no further processing, printing or manufacturing by the Taxpayer.

Third, the Division argued that the Taxpayer's provision of Statements as described by the stipulated facts fall under direct mail as defined by R.I. Gen. Laws § 44-18-7.1(j). The Division argued that direct mail regulation delineates which taxes do not apply to direct mail charges (e.g. postage, enclosing, sealing) but specifically states that tax applies to charges for envelopes whether the cost of envelopes were incorporated as part of the overall price charged or

whether separately stated. The Division argued that SU 07-87 is *prima facie* evidence that the envelopes are taxable.

Fourth, the Division argued that even if the Taxpayer's entire Rhode Island facility was deemed a manufacturing operation, the Envelopes still would not be exempt under the manufacturing exemptions of R.I. Gen. Laws § 44-18-30(7) and R.I. Gen. Laws § 44-18-30(22). The Division argued that under the statute and pertinent regulation, the Envelopes fall under the distribution function and not manufacturing. The Division argued that based on the stipulated facts, the Envelopes are used in the distribution since they are not fabricated, processed nor altered by the Taxpayer and are not the products being processed or manufactured by the Taxpayer for sale but rather are purchased and used, as is, to distribute the finished product.

Fifth, the Division argued that that the Envelopes do not fall under the resale exemption. The Division argued that there is no evidence that the Taxpayer tenders resale certificates when it purchases the Envelopes but rather it purchases these items *extax* from a third source. The Division argued that in order for the Taxpayer to qualify for the resale exemption, the Taxpayer has to be acting as a retailer of envelopes and it is not.

Finally, the Division rejected the Taxpayer's reliance on out-of-state administrative law decisions regarding resale.[4]

b. <u>The Taxpayer</u>

The Taxpayer argued that a use tax should not be imposed on the Envelopes at the time they are purchased from the out-of-state vendors. The Taxpayer argued that its Inner Envelopes do not fall under R.I. Gen. Laws § 44-18-11 because it makes no use of the Inner Envelopes in

[4] The Division also argued that the Inner Envelopes did not meet the requirements for exemption as containers under R.I. Gen. Laws § 44-18-30(4). The Taxpayer did not argue that the Envelopes fell under said statute so there is no need to address this argument. A review of the statute demonstrates that the Envelopes are not the type of containers described in the statute.

Rhode Island and the Taxpayer is manufacturing a product and the Envelopes are a final product rather than a way to provide a service.

The Taxpayer also argued that only the Envelopes that are sent within Rhode Island should be subject to tax. The Taxpayer relies on the Division's Ruling Request 96-05 to argue that the Envelopes used solely for out-of-state use are separate and apart from those Envelopes sent within Rhode Island.

The Taxpayer argued that the Envelopes are not taxable because they are purchased to be manufactured into a finished product for resale. The Taxpayer disagreed that the Division can rely on the stipulated facts used to settle the Initial Deficiency in regard to what is or is not the manufacturing process. The Taxpayer argued that the Envelopes do not fall under administration or distribution as the Envelopes are essentially packaging a product (Statements) for sale and packaging is included in the production process under SU 07-58.

The Taxpayer argued that 07-87 provides that sales or use tax applies to separately itemized charge for envelopes sold to customers of direct mail services. The Taxpayer argued that the regulation makes clear that direct mailers should be charging their client sales tax for envelopes but implies that no use tax is imposed upon a direct mailer's use of envelopes in Rhode Island.

Finally, the Taxpayer relied on New York law and the Streamlined Sales and Use Tax Agreement to argue that the Envelopes should not be taxed.

D. Whether the Taxpayer Owes the Assessments

Not only are taxation exemption statutes strictly construed against the taxpayer, but "[t]he party claiming the exemption from taxation under a statute has the burden of demonstrating that the terms of the statute illustrate a clear legislative intent to grant such exemption." *Cookson v.*

Clark, 610 A.2d 1095, 1098 (R.I. 1992). Tax exemption statutes are also strictly construed in favor of the taxing authority and against the party seeking the exemption. *Fleet Credit Corp. v. Frazier*, 726 A.2d 452, 454 (R.I. 1999). Pursuant to R.I. Gen. Laws § 44-18-25, there is a presumption that the use of all tangible personal property is subject to the use tax.

a. R.I. Gen. Laws § 44-18-10 and R.I. Gen. Laws § 44-18-11 – Use

In *Safeway Systems, Inc. v. Norberg*, 341 A.2d 47 (R.I. 1975) the Rhode Island Supreme Court applied the use tax under R.I. Gen. Laws § 44-18-11 to packing materials that had been brought into Rhode Island and stored for approximately 30 days and then used to pack householders' belongings for transportation out of state. The Court found that property that flows in commerce from out-of-state into Rhode Island with a minor interruption of its journey in Rhode Island and then continues out-of-state is not subject to State taxation. However, if the journey is interrupted for reasons of convenience or business needs of the owner, the journey ceases and taxation by the State is possible. In *Paul Arpin Van Lines Co. v. Norberg*, 346 A.2d 655 (R.I. 1975), the Court found that the shipping packages that were brought only briefly into Rhode Island before resuming their journey were not taxable under R.I. Gen. Laws § 44-18-11. The Court held that the temporary storage and the withdrawal of the goods is not a taxable event "if the property in question is to be used exclusively outside Rhode Island." *Id.* at 656. The sole purpose of Arpin's packing materials stopping in Rhode Island was to wait for transportation and use beyond Rhode Island's borders.

Both parties rely on these cases to argue whether the Envelopes are taxable. The Division argued that the Envelopes are used in Rhode Island. The Taxpayer argued that the Inner Envelopes are not used in Rhode Island because unlike the packing material brought into Rhode Island and used to pack customers' belongings in *Safeway Systems*, the Inner Envelopes

are only used when they reach their destination (Taxpayer's clients' customers). The Taxpayer argued that the Inner Envelopes are only brought into Rhode Island for a short stop and then are used beyond Rhode Island's borders. However, the Taxpayer is printing Statements that are mailed using the Outer Envelopes with some customers also being sent Inner Envelopes. The Taxpayer is under contract to supply certain customers with Inner Envelopes for reply.

The Supreme Court has found that R.I. Gen. Laws § 44-18-10 does not require "total or even substantial control" over the property for it to be taxable. *Great Lakes Dredge & Dock Co. v. Norberg*, 369 A.2d 1101, 1104 (R.I. 1977). The Supreme Court has found that a taxable use may be found even when another entity is concurrently exercising a substantial degree of control over the property. *Id.* See also *WMS Gaming, Inc. v. Sullivan*, 6 A.3d 1104 (R.I. 2010). In this matter, there is no concurrent use, but rather the Taxpayer controls the Envelopes in providing the Statements and in the sending of the Statements.

The Taxpayer argued that its customers' clients use the Inner Envelopes; however, that is subsequent to the Taxpayer's use. The Inner Envelopes are not being sold in the regular course of business as set forth in R.I. Gen. Laws § 44-18-10. The Inner Envelopes are not being transported into Rhode Island to be used solely outside of the State. Since some Envelopes are used in Rhode Island, they cannot fall under R.I. Gen. Laws § 44-18-11 since they are not be used exclusively out-of-state. See *Arpin*. However, the Taxpayer argued that the Outer Envelopes are part of the manufacturing into a final product. The Outer Envelopes do not fall under being processed, fabricated, or manufactured so they are not excluded by R.I. Gen. Laws § 44-18-11 from the definition of use or storage. See below for discussion of manufacturing.

Neither the Inner nor Outer Envelopes are brought in to the state for use solely outside of the State. Instead, they are brought into the State under the power and control of the Taxpayer and used in the mailing of the Statements in-state and out-of-state.

b. SU 07-87

The parties agreed that the Statements are prepared for direct mailing[5] to the Taxpayer's clients. SU 07-87 does provide that for direct mailers certain charges that are stated separately are not taxed like postage, or addressing, or folding. However, the regulation indicates that tax applies to a charge by direct mailers for envelopes. The Taxpayer already charges customers tax for Envelopes it provides for its clients in Rhode Island. The Taxpayer argues that the regulation supports its position since it mentions nothing about the imposition of a use tax on the purchase of envelopes by direct mailers. The Division argues that since envelopes are to be taxed for Rhode Island customers, it follows that since direct mail is a service industry that tangible personal property provided by direct mail is a taxable supply item. While each party used this regulation to bolster their positions, the determination of this issue in matter will turn on statute.

c. R.I. Gen. Laws § 44-18-30(7) and (22) – Manufacturing

R.I. Gen. Laws § 44-18-30 exempts manufacturing from sales and use tax. R.I. Gen. Laws 44-18-30(7) defines the "process of manufacturing" as production operations performed in the producing or processing room, shop or plant insofar as the activities are connected with the manufacturing for resale of tangible personal property but the statute excludes from the "process of manufacturing" distribution operations which occur subsequent to production such as

[5] R.I. Gen. Laws § 44-18-7.1(j) defines "direct mail" as follows:

> (j) "Direct mail" means printed material delivered or distributed by United States mail or other delivery service to a mass audience or to addressees on a mailing list provided by the purchaser or at the direction of the purchaser when the cost of the items are not billed directly to the recipients. "Direct mail" includes tangible personal property supplied directly or indirectly by the purchaser to the direct mail seller for inclusion in the package containing the printed material. "Direct mail" does not include multiple items of printed material delivered to a single address.

handling, storing, selling and transporting the manufactured products, even though the administration and distribution operations are performed by or in connection with a manufacturing business.

The Taxpayer argued that the Envelopes fall under the manufacturing exemption and argued that it should not be held to the stipulated facts that were used to settle the Initial Deficiency Notice in regard to what is or is not manufacturing. However, while the stipulated facts may have been used to settle the initial deficiency, the parties agreed that those facts would be used in this matter. The parties certainly could have presented a different agreed statement of facts. *Randall v. Norberg*, 403 A.2d 240 (R.I. 1979) found that an agreed statement of facts operates to submit a controversy for consideration where both parties have agreed upon the ultimate facts so that no factual conflict exists for resolution so that a court is left with no independent fact-finding function. The Court further found that "the trier of fact may not reach beyond the undisputed record in reaching a decision," but "it is not precluded from drawing any reasonable inferences logically embraced by agreed statements." *Id.* at 717-718. Along the same line, the Court held in *Leone v. Town of Shoreham*, 534 A.2d 871 (R.I. 1987) that the defendants could not argue that the plaintiff did not have standing since the agreed statement of facts showed the plaintiff had standing and therefore, the agreed statement of facts removed any factual controversy pertaining to the agreed facts from the court's consideration.

In the agreed statement of facts in the matter, the parties agreed that the manufacturing process ended at that point where the Statements and Inner Envelopes were inserted into the Outer Envelopes. The Division did not deem machinery equipment involving inserting the Statements into the Outer Envelopes to be tax exempt. Thus, the Division argued that that the Envelopes are part of distribution. The Taxpayer argued that the Envelopes do not fall under

administration or distribution as the envelopes are essentially packaging a product which is included in the production process under SU 07-58.

With an agreed statement of facts, the undersigned is precluded from making new findings of facts since there is no factual controversy and there is an agreed statement of facts to which both parties agreed. Thus, the Envelopes are not part of manufacturing.[6]

d. <u>Resale</u>

R.I. Gen. Laws § 44-18-25 provides that a purchaser who purchases items for resale can provide a certificate for resale to the buyer so that no sales tax is charged. *Sales and Use Regulation SU 07-95 Resale Certificate* ("07-95") provides that sellers who accept a properly completed resale exemption certificate are relieved of improperly claimed exemptions. The Division argued that there was no resale of Envelopes by the Taxpayer pursuant to R.I. Gen. Laws § 44-18-25. The Taxpayer argued the Envelopes are purchased for the purpose of being processed into a finished product for resale under R.I. Gen. Laws § 44-18-30(7). The Division argued that the Taxpayer's main argument was that the Envelopes are not supply items but are acquired *extax* for resale. Pursuant to SU 07-95, the purchaser is to make sales in the regular course of business. There was no evidence that the Taxpayer tenders resale certificates pursuant to R.I. Gen. Laws § 44-18-25 when purchasing Envelopes or makes sales of envelopes in the regular course of business.

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[6] Nonetheless despite the agreed statement of facts being binding, the Division argued that even if entire facility was considered a manufacturing operation, the Envelopes are used in distribution since they are not fabricated, not processed, not altered, and not being processed. SU 07-58 separates the business of manufacturing into three (3) parts: administration, production, and distribution. Production is defined as operations performed in the processing room, shop, or plant including the production line starting with raw materials and continuing through the last step where the product is completed and packaged for sale. The Taxpayer argued that the inserting of the Statements into the Outer Envelopes along with the Inner Envelopes is packaging so is production. However, neither the Inner Envelopes or Outer Envelopes are being manufactured into a finished product nor are they a component of a manufactured, compounded, processed, assembled product. As the Envelopes are not part of manufacturing, they are used in the handling and transporting of the manufactured products so are used in distribution. The manufactured products are the printed Statements; not what is purchased to mail them or accompany the Statements. See R.I. Gen. Laws § 44-18-30(7) and (22) and SU 07-58. For a discussion of said manufacturing exemption, see *Taxation Administration Decision*, 2008 WL 5582991 (R.I.Div.Tax.).

e. **New York Law**

The Taxpayer argued that New York and Rhode Island have a similar statute and New York does not tax purchases of envelopes. In 2010 *Division Administration Decision*, 2010 WL 1933727 (R.I.Div.Tax.), the decision found that except for one (1) tangential court case that discussed R.I. Gen. Laws § 44-30-32(b)(2), there were no other court cases and no administrative decisions on said statute. The State of New York had an almost identical law to the pertinent Rhode Island statute and had numerous administrative tax decisions, court cases, and law review articles on the law. (Other states also had almost identical statutes but no developed law like New York). Thus, the 2010 *Administrative Decision* discussed the analysis used in New York State to determine whether intangible property income (exercise of stock options) was related to business carried on in-state.

In contrast to the 2010 *Administrative Decision*, there is significant state case law on the issues in this matter. *Woonsocket Hospital v. Quinn,* 173 A. 550, 552 (R.I. 1934) held that "exemption from taxation is to be determined, not by the policy or laws of other states but by the Constitution and laws of this State." The Rhode Island Supreme Court has further found "[i]t is clear to us that New York is free to adopt and follow any policy in the matter of taxation in general and of tax exemption in particular that it may deem just, and that Rhode Island can do likewise." *Wickes v. Stein*, 266 A.2d 911, 914 (R.I. 1970). Thus, there is no reason to look to New York law.

f. **Division's Ruling Request 96-05**

The facts in this ruling request was that a taxpayer purchased brochures from out-of-state vendors that shipped them to Rhode Island. When customers of the taxpayer returned a postcard requesting more information, the brochure would be sent to those customers in-state and out-of-

state. The Division found that brochures shipped to Rhode Island and stored in Rhode Island for transport out-of-state fell under the use tax exemption because they were not stored, used, or otherwise consumed in Rhode Island. The Taxpayer argued that the Inner Envelopes are analogous to the brochures in that they were not used in Rhode Island and the ruling supports its argument that the Inner Envelopes that are purchased and sent out-of-state should not be taxed. However, the Inner Envelopes are not mailed by themselves out-of-state like the brochures. Rather they are included in the Statements and fall under the control of the Taxpayer as discussed above so are "used" by the Taxpayer in Rhode Island prior to be sent out-of-state.

g. <u>Regulation SST 11-01</u>

Regulation SST 11-01 Streamlined Sales and Use Tax Agreement was promulgated on December 1, 2011 (and has been superceded by SST 13-01) to implement R.I. Gen. Laws § 44-18.1-1 *et seq.* which adopted the Streamlined Sales and Use Tax Agreement ("SSUTA"). R.I. Gen. Laws § 44-18.1-1 *et seq.* was enacted by P.L. 2006, ch. 246, art. 30 § 12 and was effective January 1, 2007. The Taxpayer acknowledged that the regulation was adopted in 2011 after the Audit Period but argued that since the SSUTA was adopted in 2002, the regulation that determines "other direct mail" is not subject to sales or use tax is persuasive. Rhode Island adopted the statute and it became effective during the Audit Period. The regulation was not in effect during the Audit Period so is irrelevant to determining the tax liability at that time.

D. Interest and Penalty

The Division imposed interest on the assessment pursuant to R.I. Gen. Laws § 44-19-11.[7] See Division's Exhibit 17 (interest calculation for second deficiency). In addition, the Division

[7] R.I. Gen. Laws § 44-19-11 states in part as follows:

> Deficiency determinations – Interest. – If the tax administrator is not satisfied with the return or returns or the amount of tax paid to the tax administrator by any person, the administrator may compute and determine the amount required to be paid upon the basis of the facts contained in the

properly imposed a 10% penalty on said deficiency pursuant to R.I. Gen. Laws § 44-19-12.[8] The statute clearly provides that if a taxpayer does not pay a tax because of negligence or does not pay, a 10% penalty is imposed. See *Brier Mfg. Co. v. Norberg*, 377 A.2d 345 (R.I. 1977).

VI. FINDINGS OF FACT

1. On or about February 11, 2010, the Division issued a Notice in response to the Taxpayer's request for hearing filed with the Division. On or about August 9, 2011 an Appointment of Hearing Officer was issued in regard to a Second Deficiency Notice and in response to the Taxpayer's request for hearing. The matters were consolidated and partially settled with the one (1) remaining issue being the subject of this hearing. The parties were represented by counsel and filed agreed facts and exhibits and briefs by March 3, 2015.

2. A sales and use tax field audit was conducted by the Division on the Taxpayer for the period of encompassing October 2004 through September 2007.

3. The Envelopes are under the control of the Taxpayer. The Envelopes are not part of the manufacturing process.

4. The facts contained in Sections IV and V are reincorporated by reference herein.

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return or returns or upon the basis of any information in his or her possession or that may come into his or her possession. One or more deficiency determinations may be made of the amount due for one or for more than one month. The amount of the determination, exclusive of penalties, bears interest at the annual rate provided by § 44-1-7 from the fifteenth day (15th) after the close of the month for which the amount, or any portion of it, should have been paid until the date of payment.

[8] R.I. Gen. Laws § 44-19-12 states as follows:

Pecuniary penalties for deficiencies. – If any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the provisions of this chapter and chapter 18 of this title, a penalty of ten percent (10%) of the amount of the determination is added to it. If any part of the deficiency for which a deficiency determination is made is due to fraud or an intent to evade the provisions of this chapter or chapter 18 of this title, a penalty of fifty percent (50%) of the amount of the determination is added to it.

VII. CONCLUSIONS OF LAW

Based on the testimony and facts presented:

1. The Division has jurisdiction over this matter pursuant to R.I. Gen. Laws § 44-1-1 *et seq.*, R.I. Gen. Laws § 44-18-1 *et seq.*, and R.I. Gen. Laws § 44-19-1 *et seq.*

2. Pursuant to R.I. Gen. Laws § 44-18-1 *et seq.*, the Envelopes are subject to the use tax and the Taxpayer owes the tax, interest, and penalty as forth in the Second Deficiency Notice. See Exhibits 18-20 (copies of Second Deficiency Determination).

VIII. RECOMMENDATION

Based on the above analysis, the Hearing Officer recommends as follows:

Based on the forgoing and pursuant to R.I. Gen. Laws § 44-18-1 *et seq.*, the Envelopes are not exempt from the use tax and are subject to the use tax so that the Taxpayer owes the tax, interest, and penalty as set forth in the Second Deficiency Notice.

Date: April 30, 2015

Catherine R. Warren
Hearing Officer

ORDER

I have read the Hearing Officer's Decision and Recommendation in this matter, and I hereby take the following action with regard to the Decision and Recommendation:

__X__ ADOPT
_____ REJECT
_____ MODIFY

Dated: May 26, 2015

David Sullivan
Tax Administrator

NOTICE OF APPELLATE RIGHTS

THIS DECISION CONSTITUTES A FINAL ORDER OF THE DIVISION. THIS ORDER MAY BE APPEALED TO THE SIXTH DIVISION DISTRICT COURT PURSUANT TO THE FOLLOWING WHICH STATES AS FOLLOWS:

R.I. Gen. Laws § 44-19-18 Appeals
Appeals from administrative orders or decisions made pursuant to any provisions of this chapter are to the sixth (6th) division district court pursuant to chapter 8 of title 8. The taxpayer's right to appeal under this chapter is expressly made conditional upon prepayment of all taxes, interest, and penalties, unless the taxpayer moves for and is granted an exemption from the prepayment requirement pursuant to § 8-8-26.

CERTIFICATION

I hereby certify that on the 27th day of May, 2015 a copy of the above Decision and Notice of Appellate Rights were sent by first class mail, postage prepaid to the Taxpayer's representative at the address on file with the Division of Taxation and by hand delivery to Bernard Lemos, Esquire, Department of Administration, One Capitol Hill, Providence, RI 02908.

Gail Belasco