

SYSCON INC
94 MCFARLAND BLVD
NORTHPORT, AL 35476-3348,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

§

§

§

§

§

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 04-1045

FINAL ORDER

The Revenue Department assessed Syscon, Inc. ("Taxpayer") for State sales and consumer use tax for January 2001 through December 2003. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on May 18, 2005. The Taxpayer's owner, Robert Wilson, represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

The Taxpayer developed a computerized document scanning and retrieval system that it licenses to various county governments in Alabama. The system is comprised of computers, scanners, and related equipment, together with the Taxpayer's own proprietary imaging and retrieval software used to operate the system. The counties use the system to scan deeds, abstracts, and other documents into their database. The information can then be electronically retrieved and printed as needed.

The Taxpayer concedes that the equipment is subject to sales or use tax. It argues, however, that the equipment should be taxed at the reduced 1 1/2 percent "machine" rate because the equipment qualifies as machines used in processing tangible personal property. The Department argues that the equipment should be taxed at the 4 percent general rate. It assessed the Taxpayer accordingly.

The reduced sales and use tax “machine” rate is levied on “machines used in mining, quarrying, compounding, processing and manufacturing of tangible personal property” See, Code of Ala. 1975, §§40-23-2(3) and 40-23-61(b), respectively. Alabama’s appellate courts have addressed the “machine” rate provisions in numerous cases. The Alabama Supreme Court has held that the word “process,” as used in the statute, is synonymous with “preparation for market” and “to convert into marketable form.” *Southern Natural Gas Co. v. State*, 73 So.2d 731, 735 (Ala. 1954). The Court has applied the “integral function” test, which it defined in *State v. Newbury Mfg. Co.*, 93 So.2d 400 (Ala. 1957), as follows:

Their (the machines’) status is not controlled by the material of which they are composed, but by the office they serve in the process. If the article in question performs an integral function in the procedure by which the tangible personal property is produced, we think it is part and parcel of the machinery used in its production.

Newbury Mfg., 93 So.2d at 402.

Alabama’s courts have held that the “machine” rate applied to (1) lumber used to make flasks that held sand in place in a mold during the casting process, *State v. Taylor*, 80 So.2d 618 (Ala. 1954); (2) sand and steel shot used in the casting process, *Newbury Mfg.*, *supra*; and (3) paper bags used in the production of magnesium ingots, *State v. Calumet & Hecla, Inc.*, 206 So.2d 354 (Ala. 1968), to name only a few.

The Administrative Law Division, following the applicable Supreme Court cases, has also held that the “machine” rate applied to stacking sticks used to separate lumber in the drying process, *Overseas Hardwood Co., Inc. v. State of Alabama*, S. 00-664 (Admin. Law Div. 10/1/01); coolant and lubricant that was necessary and performed an integral function in the production of roller bearings, *NTN Bower Corp. v. State of*

Alabama, S. 01-237 (Admin. Law Div. 10/1/01); and storage bins attached to a sawdust and wood chip conveyor system in a sawmill, *Kykenkee, Inc. v. State of Alabama*, S. 01-618 (Admin. Law Div. O.P.O. 5/7/02).

The purpose of the “machine” rate provision is to give industry a tax break on machines used in the manufacture or processing of tangible personal property. As illustrated by the above cases, the rate generally applies to machines used in factories, manufacturing facilities, mills, and the like.

The Taxpayer in this case argues that its hardware is entitled to the reduced rate because it processes paper images into digital form. However, the Taxpayer’s machines do not process the tangible deeds, abstracts, etc. into a new, finished product, as required for the “machine” rate to apply. That is, they do not perform “an integral function in the procedure by which the tangible personal property is produced. . . .” *Newbury Mfg.*, 93 So.2d at 402. Rather, they only convert or transfer the intangible information on the documents from written form to digital form. The machines thus do not qualify for the reduced rate.

The Taxpayer cites Dept. Regs. 810-6-1-.119 and 810-6-1-.195 in support of its position. Reg. 810-6-1-.119(4) provides that “mechanical equipment used in the production of photographic negatives, photographic prints, photostats and blue prints including cameras are taxed at the reduced machine rate. . . .” Reg. 810-6-1-.195 provides that “x-ray machines, heart catheterization machines, and computerized tomography machines (CT scan machines) process tangible personal property, and, therefore, qualify for the reduced machine rate. . . .” The Taxpayer argues that its

equipment is synonymous with the above machines, and consequently that the reduced machine rate should also apply to its equipment.

The Taxpayer's analogy at first blush appears valid because a camera and the other machines listed in the regulations produce an image or a copy of tangible property, as do the Taxpayer's scanners. However, the machines listed in the regulations can be distinguished because they produce or cause to be created a new product. For example, a camera or an x-ray machine produces or "manufactures" a tangible photograph or x-ray that did not previously exist. They are thus necessary and essential for the production of a manufactured product.¹ The same is not true concerning the Taxpayer's equipment.

The term "processing" can be given many meanings. Within the context of the sales and use tax "machine" rate statutes, the term was intended to mean an activity by which tangible property is altered or manufactured into a new, marketable product. Thus, while the Taxpayer's hardware may "process" the information on the scanned documents into digital form, it does not process or alter the tangible documents within the context of the "machine" rate statutes.

In short, I do not believe that the Alabama Legislature intended for the reduced "machine" rate to apply to computers, scanners, copiers, fax machines, etc.²

¹ Reg. 810-6-1-.195 states that x-ray machines "process" tangible property. That is incorrect. The subject being x-rayed is not being processed. Rather, x-ray machines are entitled to the reduced rate because they produce tangible property, i.e., the finished x-ray.

² Such machines would be entitled to the reduced rate, however, if they are a necessary and integral part of a manufacturing process by which tangible personal property is being created. For example, in *Konica Minolta v. State of Alabama*, S. 04-178 (Admin.

Otherwise, all such machines used in offices would be entitled to the reduced rate, as would all such items purchased by individuals for personal use.

In *Sizemore v. Franco Distributing Co., Inc.*, 594 So.2d 143 (Ala. Civ. App. 1991), the Court of Civil Appeals found that while the electricity used to operate video machines, juke boxes, etc. was altered in form, the machines did not process the electricity within the purview of the “machine” rate statute. In so holding, the Court stated “that when a literal interpretation would defeat the purpose of a statute, that interpretation should not be adopted. . . Likewise, a statute is to be given practical construction, and any general terms used therein are to be so limited in their application as not to lead to an absurd consequence.” *Franco Distributing*, 594 So.2d at 146, 147. The above also applies in this case.

The final assessments are affirmed. Judgment is entered against the Taxpayer for use tax and interest of \$3,298.67 and sales tax and interest of \$4,684.40. Additional interest is also due from the date the final assessments were entered, November 29, 2004.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered November 8, 2005.

BILL THOMPSON
Chief Administrative Law Judge

Law Div. 9/29/05), computers used to create and test software that became a necessary part of the printers being manufactured were taxed at the reduced rate.