WOODHAM'S CABINET SHOP, INC 8252 U.S. HIGHWAY 84 W DOTHAN, AL 36305-9314,	§ §	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 12-734
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed Woodham's Cabinet Shop, Inc. ("Taxpayer") for consumer use tax for January 2008 through May 2011. 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 February 19, 2013. David Johnston represented the Taxpayer. Assistant Counsel Kelley Gillikin represented the Department.

The Taxpayer is located in Dothan, Alabama. It manufactures and installs custom-built cabinets, countertops, molding, doors, etc. for both residential and commercial customers.

During the period in issue, the Taxpayer purchased various saws, edge-banding machines, mold-making devices, grinders, and other equipment from out-of-state vendors. It did not pay sales or use tax on the equipment to either Alabama or the states in which the vendors were located. It subsequently used the equipment to cut, mold, and otherwise shape the lumber and the other building materials that it used to build the cabinets, countertops, etc.

The Department audited the Taxpayer for the period in issue and determined that the Taxpayer owed Alabama use tax for the period. The Taxpayer agreed that it owed some of the tax, and paid it accordingly. It contested, however, the Department's finding

that the equipment used to cut, shape, or otherwise prepare the building materials for use should be taxed at the general four percent use tax rate levied at Code of Ala. 1975, §40-23-61(a). Rather, the Taxpayer contends that the equipment should be taxed at the reduced one and one-half percent use tax "machine" rate levied at Code of Ala. 1975, §40-23-61(b). The reduced "machine" rate applies to machines used in mining, quarrying, compounding, processing, or manufacturing tangible personal property. See generally, *Robinson & Associates (Ala.) v. Boswell*, 361 So.2d 1070 (Ala. 1970); see also, *NTN Bower Corp v. State of Alabama*, Docket S. 01-237 (Admin. Law Div. 10/1/2001), and cases cited therein.

The Department argues that the Taxpayer is a contractor, and not a manufacturer, because it does not build a standard finished product. It consequently contends that the "machine" rate does not apply because the equipment in issue is not used in manufacturing tangible personal property. The Department's audit report reads in part as follows:

> A cabinet shop that makes cabinets to specifications for specific jobs is not manufacturing tangible personal property for resale, but is a contractor. This taxpayer does not make any standard items for resale, therefore, it is considered a contractor making items to specifications for addition to real property. Thus, it was determined that the cabinet shop equipment and equipment parts purchased and used to make the cabinets, shelving, closets, etc., should be taxed at the general rate of tax.

The Department reiterates in its Post-Hearing Brief that the Taxpayer is not a manufacturer, and consequently that the equipment in issue is not used in manufacturing for purposes of the "machine" rate, because the Taxpayer does not produce a standard finished product.

> In this context, the manufacturing of such property has been equated with the production of a "standard finished product" saleable on the market and having any market value. *State v. Acker*, 233 So.2d 514 (Ala. Civ. App. 1970).
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> Applying this principal, courts have consistently rejected the contention that a taxpayer is engaged in the business of manufacturing tangible personal property when that business consists of fashioning building materials according to the specifications for a particular job into the component parts of cabinetry to be integrated into a completed system and affixed to realty property. *See State v. Acker, supra; State of Alabama Dep't of Revenue v. Montgomery Woodworks, Inc.*, 389 So.2d 510, 513 (Ala. Civ. App. 1980). In each case, the reasoning behind the courts' rejection of this contention is that such taxpayers are not manufacturing a "standard finished product" that has any marketable value prior to its installation and integration into a completed whole. *Id.*
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> Similarly, a contractor is not deemed to be manufacturing "items of tangible personal property" in the form of building materials unless such items are "standard" and "can be used on any job." Ala. Admin. Code r. 810-6-2-.29.
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> In sum, based on the foregoing, it appears that the Taxpayer is not engaged in manufacturing tangible personal property and that its use of the equipment in issue is thus not (taxable at the "machine" rate) on the grounds that it is used in the manufacturing of such property.

Department's Post-Hearing Brief at 5, 6.

I disagree with the Department's position. As explained below, the fact that the Taxpayer is a contractor that builds custom-build cabinets, countertops, etc., and not a manufacturer that produces a standard finished product, has no bearing on whether the equipment in issue is used in manufacturing or processing tangible personal property for purposes of the "machine" rate statute.

To begin, the Department's reliance on *State v. Acker* is misplaced. The "machine" rate provision was not in issue in *Acker*. Rather, the issue was whether the taxpayer, who like the Taxpayer in this case contracted to build and install custom-designed cabinets, was

a manufacturer within the purview of the "manufacturer" provision at Title 51, Section 786(2)(m), now Code of Ala. 1975, §40-23-1(b), or a contractor within the purview of the sales tax "contractor" provision at Title 51, §786(2)(j), now Code of Ala. 1975, §40-23-1(a)(10).

The "manufacturer" provision provides that when a taxpayer manufactures an item and then uses the item to fulfill a construction contract, the use of the item by the taxpayer constitutes a retail sale. In that case, sales tax is due on the "sales price," i.e., the reasonable and fair market value of the item when used by the manufacturer/taxpayer. Consequently, if the manufacturer provision had applied in *Acker*, as argued by the Department, the taxpayer would have owed sales tax on the fair market value of the cabinets when installed by the taxpayer.

The taxpayer in *Acker* argued that it was a contractor, and that the "contractor" provision at what is now §40-23-1(a)(10) applied. That statute defines "retail sale" to include the sale of building materials to a contractor for use in the form of real estate. The taxpayer thus asserted in *Acker* that it owed sales tax on its lower wholesale cost of the materials used to build the cabinets.

In deciding if the "manufacturer" provision applied, the Court in *Acker* opined that "[t]he term 'manufacturer' in its broadest sense implies any change wrought by hand." *Acker*, 233 So.2d at 517. It then stated, however, that such a broad definition was not helpful in the present case, and that the term, as used in the §40-23-1(b) "manufacturer" provision, should be given a narrower meaning, and specifically "that the transformation into a new form must be such as the new article has a 'distinctive name, character or use'

'or into a suitable form for use.'" *Acker*, 233 So.2d at 517.

The Court concluded in *Acker* that for a taxpayer to be a manufacturer for purposes of the §40-23-1(b) "manufacturer" provision, the taxpayer must produce a standard finished product. The Court thus held that the taxpayer was not a manufacturer for purposes of the "manufacturer" provision because it did not produce a standard finished product.

The Taxpayer in this case is also not a manufacturer for purposes of the §40-23-1(b) "manufacturer" provision because, like the taxpayer in *Acker*, the Taxpayer does not produce a standard finished product. It does not follow, however, that when the Taxpayer uses the equipment in issue to cut, shape, mold, and otherwise alter the raw building materials into the finished cabinets, countertops, etc., the equipment is not being used in manufacturing tangible personal property within the scope of the "machine" rate provision.

The Court in *Acker* applied a narrow interpretation of the term "manufacturer" based on what it believed to be the intent and purpose of the §40-23-1(b) "manufacturer" provision. There is no indication, however, that the Legislature intended a narrow definition of the term "manufacturing" as used in the "machine" rate statute. As indicated in *Acker* – "The term 'manufacturer' in its broadest sense implies any change wrought by hand." *Acker*, 233 So.2d at 517. The Taxpayer's use of the machines in issue to change or alter the lumber and the other building materials into the finished cabinets, countertops, etc. constitutes the manufacturing of those raw materials into the finished products. Even if the narrower definition stated in *Acker* is applied, and, "the transformation into a new form must be such as the new article has a 'distinctive name, character or use' 'or into a suitable form for use.'" *Acker*, 233 So.2d at 517, the Taxpayer's use of the equipment in issue to

transform the raw building materials into new articles, i.e., cut and shaped wood, molding, etc., that are in suitable form for use by the Taxpayer clearly constitutes manufacturing for purposes of the "machine" rate statute.

The Department further asserts that the equipment in issue also does not "process" the raw building materials for purposes of the "machine" rate statute because the materials are already in usable form.

> Similarly, the operations performed by the equipment in issue do not constitute the "processing" of tangible personal property as this term is used in section 40-23-61(b). These operations do not subject the building materials acquired by the Taxpayer to a process necessary to convert them to a marketable or usable form. Instead, these materials are in their commercially usable form when purchased by the Taxpayer, the ultimate consumer of these materials.

Department's Post-Hearing Brief at 4.

I again disagree. Although the raw lumber, etc. may be in usable form for some purposes, clearly it is not in the form required for the Taxpayer to build the custom-designed cabinets, countertops, etc. Rather, the materials must first be converted by the equipment in issue into a form usable by the Taxpayer.

The Department correctly argues that "the term 'processing' is 'intended to mean any activity by which tangible personal property is altered or manufactured into a new, marketable form,'" citing *Syscon, Inc. v. State of Alabama*, Docket S. 04-1045 (Admin. Law Div. 11/8/2005), at 4. Department's Post-Hearing Brief a 6. The Department further correctly asserts that "this Court has held that processing, as contemplated by (the 'machine' rate statute), occurs when the contractor subjects such materials to a process by which it is converted to a form usable by the contractor in providing the services it contracts

to perform," citing *Capitol Machine & Equip. Co., LLC v. State of Alabama*, Docket S. 08-619 (Admin. Law Div. 4/20/2008). Department's Post-Hearing Brief at 7.

The Department next attempts to distinguish the holding in *Capitol Machine*. In that case, the taxpayer manufactured insulation blowers that construction contractors purchased and used to separate and blow compacted insulation into the walls and attics of houses and buildings. The Department argued that the blowers were not machines for purposes of the "machine" rate provision because they did not sufficiently convert or process the insulation into a new or substantially different product. The Administrative Law Division disagreed and held that the "machine" rate applied.

The Department concedes that the insulation used in *Syscon* and the lumber and the other raw materials used by the Taxpayer in this case are building materials. It argues, however, that unlike the compacted insulation in *Capitol Machine*, the building materials used by the Taxpayer are already in usable form when purchased by the Taxpayer.

> Unlike the compressed insulation in issue in *Capitol Machines*, there is no evidence in the record that these materials must be subjected to some special process by which their physical state of density is altered before they can be used by the Taxpayer to construct the cabinets and woodwork in issue.
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> Moreover, unlike the blowing machines at issue in *Capitol Machines*, the equipment in the present case does not alter the underlying physical characteristics of the materials used by the Taxpayer in constructing cabinets or milling woodwork. To the contrary, this equipment does nothing more than allow the Taxpayer to modify the shape and size of these materials, sand them, and affix them to one another in accordance with the specifications for a particular job.

Department's Post-Hearing Brief at 8.

As discussed, the Taxpayer perhaps may be able to use a particular piece of lumber or other building material in building a cabinet without cutting or altering the material, but almost always the Taxpayer must necessarily use the equipment in issue to cut, shape, and otherwise alter the materials as necessary to build the custom-ordered cabinets, countertops, etc. That is, the machines convert the materials "to a form usable by the (Taxpayer) in providing the services it contracts to perform." And if the Taxpayer could use the building materials in the form purchased, it would have no need for the equipment in issue.

I agree that the machines may sometimes "not alter the underlying physical characteristics of the materials," as asserted by the Department. That is, a piece of raw lumber is wood when it is purchased by the Taxpayer, and it is still wood after it has been cut, shaped, shaved, etc. by the Taxpayer to the required size and shape. But clearly in the above instance the Taxpayer has used the equipment to process the raw lumber into a usable form.

It is also irrelevant that the lumber and the other building materials become a part of realty after the finished cabinets, countertops, etc. are installed. Such materials are clearly tangible personal property when they are being processed/manufactured by the machines into the finished products, and even the completed cabinets, countertops, etc. remain tangible personal property until they are installed.

Capitol Machine is instructive on this issue. The insulation contractors that used the blowers in *Capitol Machine* were contractors pursuant to the §40-23-1(a)(10) "contractor" provision, the same as the Taxpayer in this case. The blown insulation also became a part

of the buildings, houses, etc., i.e. realty, into which it was blown, again just as the Taxpayer's finished cabinets, countertops, etc. become a part of the realty when they are installed. But the Department only argued in *Capitol Machine* that the blowers did not sufficiently process the compacted insulation for purposes of the "machine" rate statute. It did not argue that the insulation was not tangible personal property because it ultimately became a part of realty. Likewise, the fact that the building materials ultimately become a part of realty in the form of installed cabinets, countertops, etc. is irrelevant in determining if the "machine" rate applies. What is relevant is that the building materials are tangible personal property when they are being processed/manufactured by the machines in issue.

Although not argued by the Department, there is certain language in *State of Alabama v. Montgomery Woodworks, Inc.*, 389 So.2d 510 (Ala. Civ. App. 1980), that on its face supports the Department position. The taxpayer in *Montgomery Woodworks* also manufactured custom cabinets. The Department conceded that if the taxpayer also installed the cabinets, the "contractor" provision applied and the taxpayer owed sales tax only on its cost of the materials used to build the cabinets. It argued, however, that if the taxpayer did not also install the cabinets, the "contractor" provision did not apply, and that instead the taxpayer was selling the cabinets at retail as tangible personal property. The Court disagreed, holding that the "contractor" provision applied, regardless of who installed the cabinets, as long as the cabinets were eventually installed and became a part of realty.

In refuting the Department's claim that the taxpayer was selling the cabinets in issue as tangible personal property, the Court noted that the Department had stipulated that the cabinets eventually became a part of realty. It then stated – "We hold that the cabinets

and woodwork fabricated by the taxpayer are not tangible personal property." *Montgomery Woodworks*, 389 So.2d at 513. As indicated, that statement on its face supports the Department's position in this case. The statement must, however, be viewed in context.

The sole issue in *Montgomery Woodworks* was whether the "contractor" provision applied to cabinets installed by third parties. If so, then by definition the retail sales occurred when the taxpayer purchased the lumber and the other building materials it used to construct the cabinets. In that case, the subsequent transfer of the cabinets to the customer did not constitute a retail sale of tangible personal property. In making the above statement that "the cabinets and woodwork . . . are not tangible personal property," the Court could only have meant either that the cabinets were not being sold at retail as tangible personal property, or that the cabinets were not tangible personal property after they were installed and became a part of realty.

A stand-alone cabinet clearly constitutes tangible personal property before it is installed and made a part of realty. And importantly, the lumber and the other building materials that are processed or manufactured into a completed cabinet unquestionably constitute tangible personal property. The "machine" rate accordingly applies to the equipment in issue that the Taxpayer uses to process and/or manufacture the lumber and the other building materials into the finished cabinets, countertops, etc.

In summary, the Taxpayer is a "contractor" within the purview of the "contractor" provision at Code of Ala. 1975, §40-23-60(5).[1] It is not a manufacturer within the scope of

[1] The use tax "contractor" provision at §40-23-60(5) is identical to the sales tax "contractor" provision at §40-23-1(a)(10).

the §40-23-1(b) “manufacturer” provision because it does not construct a standard finished product. That is irrelevant, however, in determining if the equipment in issue qualifies for the reduced “machine” rate. Clearly, it does because the equipment is used to process/manufacture the raw building materials, i.e., tangible personal property, into the finished cabinets, countertops, etc. The fact that the finished cabinets, countertops, etc. eventually become a part of real estate is irrelevant.

The Department is directed to recompute the use tax due by applying the reduced one and one-half percent “machine” rate. A Final Order will then be entered for the reduced amount due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 10, 2013.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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