No. 150A23 TENTH DISTRICT

SUPREME COURT OF NORTH CAROLINA

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NORTH CAROLINA DEPARTMENT OF REVENUE, Petitioner-Appellee, v. FSC II, LLC, Respondent-Appellant.	)	From Wake County No. 22CVS5410

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BRIEF OF AMICUS CURIAE
NORTH CAROLINA CHAMBER LEGAL INSTITUTE

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The North Carolina Chamber Legal Institute ("NCCLI") encourages the Court to prevent the North Carolina Department of Revenue (the "Department") from enforcing an unpromulgated rule against a taxpayer in direct violation of Section 150B-18 of the North Carolina Administrative Procedure Act ("APA"). Permitting a state agency to enforce such a secret rule would threaten North Carolina's business climate, undermine the political accountability of state agencies and erode the public's confidence that their government will treat them fairly.

INTRODUCTION[1]

NCCLI is dedicated to strengthening North Carolina's economy in order to provide opportunities to the citizens of our State. A strong economy depends on economic and political systems organized around the rule of law. *See, generally*, Max Weber, *Law in Economy and Society* (Cambridge 1954); Michael Todaro & Stephen Smith, *Economic Development* 133, n. 16 (9th ed. 2006); Robert Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge 1977).

One fundamental rule-of-law principle requires that binding norms be formulated openly and in advance. When rules are "fixed and announced beforehand," citizens can "foresee with fair certainty how the [government] will use its coercive powers in given circumstances" and "plan [their] affairs on the basis of this knowledge." Peter Boettke & J. Robert Subrick, *The Rule of Law, Freedom and Prosperity*, 10 Sup. Ct. Econ. Rev. 109, 112-13 (2003) (quoting Friedrich Hayek). *See also* Okezie Chukwumerije, *Rhetoric Versus Reality: The Link Between the Rule of Law and Economic Development*, 23 Emory Int'l L. Rev. 383, 402 (2009); Mark Agrast, Juan Botero & Alejandro Ponce, *The World Justice Project Rule of Law Index* (2015).

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[1] No person or entity, other than the North Carolina Chamber Legal Institute, its members and its counsel, either directly or indirectly wrote this brief or contributed money for its preparation.

The importance of this principle to economic growth is obvious. Players need to know the rules of the game before they roll the dice. When government agencies can exact penalties for the transgression of secret rules, even the most daring entrepreneurs will be reluctant to commit their capital into the future.

Making rules openly and in advance also ensures a measure of political accountability from agencies not subject to direct democratic control. "Members of the public and those politically responsible officials who have a duty to monitor law making can more easily ascertain the existence and content of agency law that is embodied in rules." Arthur Bonfield, *State Administrative Rule Making* 108, 151 (1986). *See also* Arthur Bonfield. *The Quest for an Ideal State Administrative Rulemaking Procedure*. 18 Fla. St. U. L. Rev. 617, 617-18 (1991). By contrast, when rules are developed in secret, the legislature "cannot intelligently delegate power or police the exercise of power already delegated." J. Skelly Wright, *The Courts and the Rulemaking Process: The Limits of Judicial Review*, 59 Cornell L. Rev. 375, 379-80 (1974).

In the last analysis, secret rulemaking is simply unfair. "After all, . . . individuals cannot observe [rule-based norms] if they do not know such norms exist or cannot easily discover their precise content." Bonfield, *State Administrative Rule Making*, *supra*, at 149. Ever since the plebians of ancient Rome wrested the Twelve Tables from the patrician magistrates, the right of

citizens to have the law set down in writing before it is enforced against them has been central to consensual government.

The General Assembly enacted the APA's rulemaking provisions precisely to avoid these evils. The Department must not be allowed to disregard them.

ARGUMENT

I. THE MILL MACHINERY EXEMPTION

FSC II, LLC ("LLC") purchased equipment to create hot mix asphalt ("HMA"). FSC sold some HMA to third parties and used some in its own construction projects. FSC did not pay North Carolina sales or use tax on the equipment it purchased from out-of-state vendors. FSC argues that its purchases from out-of-state vendors qualified for a North Carolina sales and use tax exemption for manufacturing equipment known as the "mill machinery exemption."

During the periods at issue, this exemption applied to "[a] manufacturing industry or plant that purchases mill machinery or mill machinery parts or accessories for storage, use, or consumption in this State." N.C. Gen. Stat. §§105-164.13(5a) and 105-187.51(a)(1) (both repealed 2018).

This statutory language means that a taxpayer must satisfy two requirements to come within the mill machinery exemption. The taxpayer must be a "manufacturing industry or plant," and the items purchased must

be "mill machinery." The Department does not contest that the items FSC purchased are "mill machinery" but denies that FSC is a "manufacturing industry or plant."

The statutes do not define "manufacturing industry or plant," but this Court has held that a manufacturer is a person who converts raw materials into new products through skill and labor. *See Master Hatcheries, Inc. v. Coble*, 286 N.C. 518, 520-21, 212 S.E.2d 150, 151 (1975); *Duke Power Co. v. Clayton*, 274 N.C. 505, 513, 164 S.E. 2d 289, 295 (1968).

The Department does not dispute that FSC created a new product out of raw materials using skill and labor. *See* Petitioner-Appellant's New Brief at 25, and R p. 1094. That would seem to make FSC a manufacturer and bring this case to an end. However, the Department insists that to claim the exemption FSC must satisfy *a third requirement not found in the statute*: its primary purpose must be selling its manufactured products to third parties.[2]

The Record in this case shows that the Department developed this primary purpose requirement internally, *see, e.g.,* R pp. 524, 659, 690 and 957,

[2] The Department has varied its expression of this requirement, sometimes referring to it as a "50%" requirement (R p.524), a "majority" requirement (R p. 659) or a "primary use" requirement (R p. 957). Most recently, the Department has referred to the requirement as the "whole entity" requirement. *See* Petitioner-Appellant's New Brief at 28. Regardless of the label, the substance of the Department's requirement is the same.

but the Department never published it.[3] FSC only learned of it during the audit. The APA expressly forbids the enforcement of such an unpromulgated rule.

II. THE APA

As long ago as 1975, a leading scholar "asserted with confidence" that the action of administrative agencies "pervasively impinges on the daily lives of [the] citizens" of North Carolina. Charles E. Daye, *North Carolina's New Administrative Procedure Act: An Interpretive Analysis*, 53 N.C. L. Rev. 833, 836 (1975). The General Assembly enacted the rulemaking provisions contained in Article 2A of the APA to control and restrain agencies in the exercise of their ever-expanding power over our daily lives. *See generally*, Jackson Nichols, *The New North Carolina APA: A Practical Guide to Understanding and Using It*, 9 Campbell L. Rev. 293, 297-98 (1987). While the Department is exempt from the notice and hearing requirements contained in Part 2 of Article 2A, it remains subject to Parts 1, 3 and 4 of that Article. N.C. Gen. Stat. §150B-1(d)(4).

Part 1 establishes certain principles to which agencies must adhere in adopting rules. These principles require that a rule be expressly authorized by law, necessary to serve the public interest, minimally burdensome, clearly written and reasonably necessary to implement or interpret the law. *See* N.C.

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[3] The Department admitted it never promulgated the requirement as a rule under the APA. *See* R pp. 1067 and 69.

Gen. Stat. §150B-19.1(a)(1)-(3). Part 3 requires that a rule be vetted by the Rules Review Commission ("RRC") to ensure compliance with these principles. *See* N.C. Gen. Stat. §150B-21.9(a). Part 4 requires rules approved by the RRC to be published in the North Carolina Register. N.C. Gen. Stat. §150B-21.17.

These requirements that rules be authorized by law, narrowly tailored, clearly expressed and publicly proclaimed, are essential to protect a free people from unfettered power wielded by agencies beyond direct democratic control. Indeed, the General Assembly has forbidden state agencies from "implement[ing] or enforce[ing] against any person a policy, guideline, or other interpretive statement that meets the definition of a rule contained in N.C. Gen. Stat. §150B-2(8a) if the policy, guideline, or other interpretive statement has not been adopted as a rule in accordance with this Article [2A]." N.C. Gen. Stat. §150B-18.

In this case, the Department is seeking to do *exactly* what the APA forbids. It has formulated a "policy, guideline, or other interpretive statement," (*i.e.,* the primary purpose requirement), which a taxpayer must satisfy to claim the mill machinery exemption. The Department is attempting to enforce this requirement against FSC without having complied with any of its Article 2A obligations. Most notably, the primary purpose requirement was not reduced to writing, reviewed by the RRC or published in the North Carolina Register.

The Department does not deny these failures. Instead, it argues that the primary purpose requirement is not subject to the APA because it is somehow pregnant in three court decisions and an existing Administrative Rule and related Bulletin.

The Business Court convincingly rejected this argument (R pp. 1096-1105), and its thorough reasoning does not need restatement here. Suffice it to say that, of the authorities cited by the Department to support its position, the first case, *In re Clayton-Marcus Co.*, 286 N.C. 215, 210 S.E.2d 199 (1974), involved a different sales tax exemption, and the Department's own counsel admitted in the proceedings below that the decision contained no language supporting a primary purpose requirement. Tr p. 76, 11:30. The second case, *Midrex Techs. v. N.C. Dep't of Revenue*, 369 N.C. 250, 794 S.E.2d 785 (2016), is an income tax case and has nothing at all to do with the sales tax. In the third case, *Oscar Miller Contractor, Inc. v. N.C. Tax Rev. Bd.*, 61 N.C. App. 725, 301 S.E.2d 511 (1983), the Department, as here, attempted to enforce the primary purpose requirement against an asphalt manufacturer, but the court *expressly refused* to allow it to do so. Finally, the Department's existing Administrative Rule (17 N.C.A.C. 07B.2603) and related Bulletin (Sales and Use Tax Technical Bulletin 34-1) simply do not apply to "dual-use" taxpayers

like FSC that sell some of their manufactured goods and use some in their own projects.[4]

Because the primary purpose requirement is not founded on judicial precedent and has not been adopted by prior rulemaking, its fate hinges on whether it is a "rule" within the meaning of the APA.

III. THE PRIMARY PURPOSE REQUIREMENT IS A RULE

The APA defines a rule by setting forth a general definition and then carving out exceptions. The general definition states that a "rule" is "[a]ny agency regulation, standard, or statement of general applicability that implements or interprets an enactment of the General Assembly or Congress or a regulation adopted by a federal agency or that describes the procedure or practice requirements of an agency." N.C. Gen. Stat. §150B-2(8a).

The most notable feature of this definition is its breadth. In the words of Professor Daye, the definition encompasses any "administrative pronouncement which sets forth law or policy" and "is sufficiently broad as to encompass the vast bulk of pronouncements by agencies." C. Daye, *supra*, at 850.[5]

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[4] In the proceedings below, when the Court pointed out that the Department's counsel had not identified any guidance that dealt with dual-use taxpayers like FSC, counsel's response was: "Right." Tr p. 52, 10:41.

[5] Professor Daye was describing the definition included in the original version of the APA as N.C. Gen. Stat. §150A-10 (repealed 1985). The current definition is substantially the same. The original definition referred to statements of

Consistent with this view, the courts generally have treated as a "rule" any agency policy position that adds a legal requirement beyond what the applicable statute demands. *See, e.g.*, *State ex. rel. Comm'r of Ins. v. North Carolina Rate Bureau*, 300 N.C. 381, 412, 269 S.E.2d 547, 568 (1980), *disavowed on other grounds by In re Redmond*, 369 N.C. 490, 797 S.E.2d 275 (2017) (data presented in ratemaking hearing required to be audited); *Walker v. N.C. State Board of Dental Examiners*, 245 N.C. App. 559, 562, 782 S.E.2d 518, 520 (2016) (dentists required to record the reasons for their prescriptions); *Dillingham v. N.C. Dep't of Human Resources*, 132 N.C. App. 704, 710, 513 S.E.2d 823, 827 (1999) (evidence required to be in writing); *Duke University Medical Center v. Bruton*, 134 N.C. App. 39, 52, 516 S.E.2d 633, 641 (1999) (Medicaid recipients required to file for Medicare); *McCrann ex rel. McCrann v. Department of Health and Human Services*, 209 N.C. App. 241, 249, 704 S.E.2d 899, 905 (2011) (Medicaid recipient not permitted to live in group home); and *Surgeon v. Division of Social Services*, 86 N.C. App. 252, 264, 357 S.E.2d 388, 394 (1987) (requirement limiting retroactive Medicaid coverage).

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general applicability that implement or prescribe "law or policy." The replacement of the phrase "law or policy" with the more detailed list of objects of implementation was intended "to limit agency rulemaking authority to those matters enacted and specifically delegated by legislation and to prevent rulemaking beyond delegated authority." J. Nichols, *supra*, at 301.

All these cases point to the same conclusion here. The mill machinery exemption statute requires only that the taxpayer be a manufacturing industry or plant and that the equipment at issue be mill machinery. The primary purpose requirement is not found in the statute or in any existing Administrative Rule. Yet the Department is seeking to enforce it against FSC in an adjudicatory proceeding without APA compliance. This is just what Section 150B-18 forbids.

IV. NO EXCEPTION APPLIES

The APA "Rule" definition is subject to several exceptions. Most are clearly irrelevant to this case, but three deserve comment.

A. The Secrecy Exception

In the proceedings below (R p. 1069), the Department argued that its primary purpose requirement falls within the exception for "statements that set forth criteria or guidelines to be used by the staff of an agency in performing audits, investigations, or inspections; in settling financial disputes or negotiating financial arrangements; or in the defense, prosecution, or settlement of cases." N.C. Gen. Stat. §150B-2(8a)g.

The Department misconstrues the purpose of this exception, which was intended to preserve the secrecy of sensitive information. "The exclusion applies only to those precise portions of agency statements for which a compelling case for secrecy has been made, and is limited to statements which

are directed to the agency staff." Arthur Bonfield, *The Iowa Administrative Procedure Act: Background, Construction, Applicability, Public Access to Agency Law, the Rulemaking Process*, 60 Iowa L. Rev. 731, 839 (1975); J. Nichols, *supra* at 303, n. 54.[6] For instance, this exception permits an agency to maintain the secrecy of its internal schedule for inspecting the businesses it regulates or the terms on which it instructs prosecutors it is willing to settle enforcement actions. *See* Bonfield, *The Iowa Administrative Procedure Act*, *supra* at 788. *See also Holly Ridge Associates, LLC v. N.C. Dep't of Environmental and Natural Resources*, 176 N.C. App. 594, 610, 627 S.E.2d 326, 338 (2006) (inter-agency memoranda pursuant to which one agency division would refer matters to another).

By contrast, the primary purpose requirement is directed to taxpayers and purports to be binding on them. There can be no legitimate governmental interest in maintaining the secrecy of such a rule.

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[6] As these articles note, both the Iowa and North Carolina versions of this exception have their origins in the Model State Administrative Procedure Act.

B. The Nonbinding Interpretative Statement Exception

The APA's "rule" definition is also subject to the exception for "nonbinding interpretative statements within the delegated authority of an agency that merely define, interpret, or explain the meaning of a statute or rule." N.C. Gen. Stat. §150B-2(8a)c.

As its name proclaims, this exception applies to agency statements *that do not purport to be binding*. *See* C. Daye, *supra*, at 852-53; J. Nichols, *supra*, at 303. For instance, in *Comm'r of Labor v. Weekley Homes, L.P.*, 169 N.C. App. 17, 30, 609 S.E.2d 407, 416 (2005), the Court of Appeals applied this exception to a state OSHA manual, because it did not impose sanctions for failure to comply.

An agency interpretation is binding if the agency attempts to enforce it. *See* Robert Anthony, *Interpretive Rules, Policy Statements, Guidelines, Manuals, and the Like – Should Federal Agencies Use Them to Bind the Public?,* 41 Duke L. J. 1311, 1313 (1992) (an agency's attempt to enforce an interpretation "as a practical matter . . . gives the interpretation binding effect."); Administrative Conference of the United States, *Recommendations of the Administrative Conference Regarding Administrative Practice and Procedure*, 57 Fed. Reg. 30101-01, at n. 3 (1992) (a Federal agency rule is binding "where noncompliance may form an independent basis for action in matters that determine the rights and obligations of any person outside the

agency"). *See also* Ronald Levin, *Rulemaking Under the 2010 Model State Administrative Procedure Act*, 20 Widener L.J. 855, 876 (2011).

The Department has treated the primary purpose requirement as binding by enforcing it directly against FSC, and that enforcement has carried the sanction of a significant assessment. The primary purpose requirement clearly is not a mere "nonbinding interpretative statement."

C. The Ad Hoc Rulemaking Exception

Finally, the Department's primary purpose requirement falls outside the exception for ad hoc rulemaking, *i.e.,* "[s]tatements of agency policy made in the context of another proceeding." N.C. Gen. Stat. §150B-2(8a)e.

While the United States Supreme Court has given federal agencies discretion to adopt rules either through regular rulemaking or adjudication, *see Securities and Exchange Commission v. Chenery Corp.*, 332 U.S. 194 (1947), and *N.L.R.B. v. Bell Aerospace Co.*, 416 U.S. 267 (1974), this Court has rejected the federal approach as "less than helpful" and confined ad hoc rulemaking to a narrow range. *See Rate Bureau*, 300 N.C. at 415, 269 S.E.2d, at 570.

Specifically, this Court has stated the North Carolina rule as follows: "Where an agency faces the alternative of proceeding by rule making or by adjudication, the process of rule making should be utilized except in cases where there is a danger that its utilization would frustrate the effective

accomplishment of the agency's functions." *Rate Bureau* 300 N.C. at 416-17, 269 S.E.2d, at 570.

The Court noted four circumstances where agency frustration might justify ad hoc rulemaking:

(1) where the problem to be solved was unforeseeable,

(2) where the problem to be solved cannot be solved by a general rule,

(3) where the agency has had insufficient experience with the problem, or

(4) where the problem is so specialized as to make formulation of a rule impossible.

See Rate Bureau, 300 N.C. at 4154, 269 S.E.2d at 570.

Under these principles, ad hoc implementation of the primary purpose requirement is not justified.

(1) The "problem" of the dual use of mill machinery to manufacture products for the manufacturer's own use and for sale was not unforeseen. Indeed, the Department litigated the issue forty years ago in *Oscar Miller*.

(2) The dual-use "problem" could be easily solved by a general rule. Indeed, the Department's primary purpose requirement is the expression of the general rule the Department would apply. There was nothing to prevent

the Department from promulgating this general rule through regular rulemaking.[7]

(3) The Department has had decades of experience with the mill machinery exemption.

(4) The solution to the perceived dual-use "problem" is not impossible of being reduced to a rule. While the factors that determine *what a taxpayer's primary purpose is* may vary from case to case, the requirement that a taxpayer *have a specific primary purpose* does not.

In short, none of the circumstances this Court has identified that might justify ad hoc rulemaking is present here. There is no justification for subjecting FSC to a heavy assessment based on an unannounced rule where the Department was alerted to the dual-use "problem" at least four decades ago and could have "solved" the problem by regular rulemaking. As this Court concluded in *Rate Bureau,* imposing a rule ad hoc would work a hardship

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[7] This is not to say that objections to the primary purpose requirement would be avoided if the requirement were adopted by rulemaking. Because there is no basis for the Department to add to the two statutory requirements of the mill machinery exemption, even if the primary purpose requirement were adopted by rulemaking, it would remain open to the charge that it was neither authorized by statute nor necessary to the interpretation of the statute, as required by N.C. Gen. Stat. §150B-19.1(a). The point is simply that there is nothing about the primary purpose requirement that excuses it from APA compliance. Indeed, had the Department proceeded by rulemaking as required by the APA, the RRC might have noticed these objections, and the current proceedings might have been avoided.

"altogether out of proportion to the public ends to be accomplished. The inequity of such an impact of policy upon appellants presents a striking example of the very reason for the enactment of administrative procedure acts across the land." 300 N.C. at 419, 269 S.E.2d at 572.

In summary, no exception takes the Department's primary purpose requirement out of the APA's expansive "rule" definition, and Section 150B-18 therefore forbids the Department from "implement[ing] or enforce[ing]" it "against any person" without complying with the APA.

V. SECRET RULEMAKING IS ECONOMICALLY AND POLITICALLY DAMAGING

This brief has already noted the philosophical importance of rule-of-law principles to economic growth, but it must be stressed that the relationship between principles and outcomes is profoundly practical. In a globalized world where hundreds of jurisdictions compete for highly mobile capital, maintaining a dependable legal order is critical to the prosperity of our citizens. Economic competition is a serious and constant challenge. The hard work of many individuals and public and private institutions over many generations has produced economic and political conditions in North Carolina that are the envy of many jealous competitors. But this hard-won success must be defended every day. A state agency's short-sighted disregard of fundamental principles of fairness for the sake of a fleeting victory will not go unnoticed or unremarked

upon by our sister states. If the Department is permitted to assess tax against a taxpayer for the violation of a rule it did not, and could not, know, a rule kept secret merely to skirt the mildly irksome requirements of APA rulemaking, North Carolina's reputation as a safe destination for capital will be seriously impugned, and the people of this State will pay the price.

NCCLI wishes to be clear, however, that the rule-of-law principles it advocates are not merely the necessary means to good economic ends. They are ends in themselves. Secret rulemaking offends our innate sense of natural justice. In the proceedings below, the Business Court asked the Department's counsel a rhetorical question that, like all such questions, implies its own answer, an answer that points to the only proper resolution of this case: "So if [a] contractor was sitting in the audience today . . . what would be the takeaway for it? How would it know what percentage it needs to sell of the [product] it produces in order to qualify for the exemption? *I mean, aren't taxpayers entitled to know this in advance?"* Tr p. 47, 10:34 (emphasis added).

CONCLUSION

This case presents the Court with a welcome opportunity to remind the Department and other state agencies that in enacting the APA the General Assembly meant what it said. The people of North Carolina have the right to expect that the APA's procedural safeguards will be honored and that they will not be subjected to binding rules without warning. "The burden placed on [an

agency] to comply with the APA is not heavy" (*Arrowood v. N.C. Dep't of Health and Human Services,* 140 N.C. App., 31, 42, 535 S.E.2d 585, 592 (2000)), especially when weighed against the interests of citizens in knowing what the law is. If the Department is allowed to enforce its unauthorized, unwritten, unvetted and unpromulgated primary purpose requirement, the APA's procedural safeguards will be an empty promise.

Respectfully submitted, this the 1st day of August, 2023.

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producing asphalt for use in the performance of construction contracts.

So one of the factors that's considered in that would be the amount of asphalt that was actually produced. Now, at the time of purchase, no asphalt was being produced yet. It's brand new equipment and had just taken it out of the box, if you will. But the -- it's a relevant factor to consider, and more than 51% would say, okay, well at least it's been principally used for the production of asphalt for sale.

THE COURT: So if contractor Q was sitting in the audience today and had been listening to your -- your argument over the past hour, what would be the takeaway for it? How would it know what percentage it needs to sell of the HMA it produces in order to qualify for the exemption, assuming the exemption still exists for them? I mean, aren't taxpayers entitled to know this in advance?

MS. MORGAN: Well, a tax taxpayer --

THE COURT: I think contractor A would be able to understand from your argument what the ramifications would be, and I think contractor Z would. But I'm worried about contractor Q.

MS. MORGAN: So contractor Q, I think it would be helpful to kind of look at what contractor Q could do if faced with this situation. First of all, we're dealing with

10:39 and that -- the deference that should be given to the
10:39 interpretation of the Department and the -- and the
10:39 published guidance that is out there that the Department has
10:39 published, the case law that is in existence, you know, and
10:39 is longstanding, along with these -- You know, the rules and
10:39 the bulletins are also longstanding. They've been around in
10:39 substantively this form for a very, very long time.
10:39 In the face of that guidance, you know, it is a
10:39 facts-and-circumstances analysis, but it's also -- we have
10:39 to look at what the taxpayer's obligation is in looking at
10:39 that. And if they are entitled to rely on, say, published
10:39 guidance, and they disagree with that, you know,
10:39 understanding that to qualify for an exemption, a taxpayer
10:40 has to bring themselves within the exemption, the onus would
10:40 be on the taxpayer to make that effort to get a
10:40 determination on the front end.
10:40 You know, the Department has to apply the statute
10:40 consistent with its understanding of, you know, longstanding
10:40 rules and guidance, the entire administrative body of law
10:40 that has developed around this, the inherent -- you know,
10:40 considering inherent ambiguity of the statute, and
10:40 considering the case law that has since developed. And
10:40 taxpayers have to do the same thing.
10:40 THE COURT: Well, we've spent a good bit of time
10:40 parsing through the bulletins and, by extension, the rules.

10:40 1 And, I mean, you still really haven't pointed to anything in
10:40 2 black and white that talks about the ability of a contractor
10:40 3 who also sells the TPP like FSC, whether or not -- any
10:41 4 regulation -- you've really not pointed to any regulation or
10:41 5 bulletin provision that addresses the situation we have
10:41 6 here, the hybrid as I keep calling it.
10:41 7 MS. MORGAN: Right. Because we're dealing with --
10:41 8 because the taxable sale is the sale of the equipment
10:41 9 itself, not the sale of the asphalt. And so we're looking
10:41 10 at whether the purchase of that equipment, which is a
10:41 11 one-time taxable event that happens, was -- was taxable or
10:41 12 not taxable, was exempt from tax or wasn't exempt. And so
10:41 13 that one time -- and that happens before the equipment is
10:41 14 ever put into use. That can't be, from an administrability
10:41 15 standpoint -- like, you can't decide in the -- in the
10:41 16 aftermath, oh, okay, the equipment ended up being used this
10:42 17 way and that way and, you know, we sold -- we sold this
10:42 18 percentage, and we -- and we used this percentage in
10:42 19 application for our -- to fulfill our contracts.
10:42 20 The Department has to tax that single transaction,
10:42 21 which is part of the reason -- one of the very first
10:42 22 questions you asked is, like, you know, how much does the
10:42 23 taxpayer's intent -- or FSC's intent weigh in here. I
10:42 24 think, again, it's another relevant factor. The Department
10:42 25 has to look at was this equipment purchased for the purpose

10:42 of producing something for sale or was it purchased for purpose of producing asphalt for use and fulfillment of its own contracts.

And so when you're looking at that, principal use is -- makes sense in -- in that context, in that analysis; that you've got to make that determination based off of the principal and primary use of the -- of the equipment.

THE COURT: So you've said that contractor A would feel pretty good about its chances of qualifying for the exemption. You said a few minutes ago that contractor Q who sold 51% to a third party would feel pretty good about their chances. What if contractor Q sold 49%, less good?

MS. MORGAN: Yeah, less good. Yes, Your Honor. Because I think that, you know, kind of bringing it back, you've got that other prong of the statute. You've got that -- you have to be a manufacturing industry or plant, and what is a manufacturing industry or plant. The North Carolina courts have been pretty clear that just the act of producing something by applying -- producing an article by applying --

THE COURT: This is a good time for a break because I do want to talk about the case law next. So why don't we take a -- the wall clock says it's about 20 till. Let's come back at 10:55. We'll be in recess till then.

(Court recessed.)

11:30 this asphalt, and we want to get into producing asphalt for
11:30 resale. We're pretty sure we want to sell most of it, and
11:30 they can seek a written determination from the Department.
11:30 THE COURT: All right. But going to back to
11:30 Clayton-Marcus, is there any language in Clayton-Marcus that
11:30 you contend expressly supports the imposition of a
11:30 primary/principal requirement?
11:30 MS. MORGAN: Just a moment, Your Honor.
11:30 THE COURT: Thank you.
11:30 (Pause in the proceedings.)
11:30 MS. MORGAN: No, Your Honor, at least not with the
11:30 primary/principal component. And I don't think that that is
11:30 really what Clayton-Marcus stands for. I think
11:30 Clayton-Marcus, as I've stated earlier, stands for the
11:31 proposition that the use of the material -- of what was
11:31 produced matters and is a relevant inquiry.
11:31 THE COURT: Okay. And just to close the loop on
11:31 Midrex, I mean, are you arguing that a reviewing court
11:31 should always insert the word primary/principal in a tax
11:31 statute, even if it's not there?
11:31 MS. MORGAN: Well, that's a pretty broad inquiry.
11:31 But, no, I would not argue that, Your Honor, at all, that it
11:31 should always be inserted. I think under circumstances
11:31 where the Department has to make a determination whether
11:31 a -- a taxpayer meets some defined -- or qualifies or falls