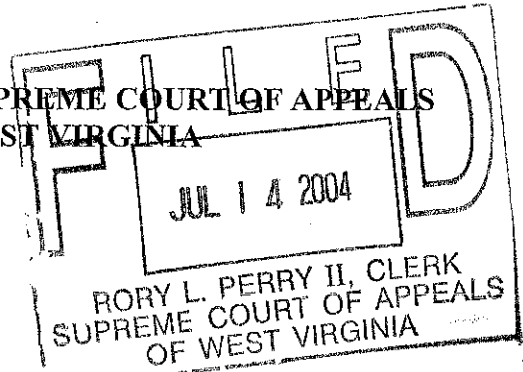


NO. 31735

BEFORE THE WEST VIRGINIA SUPREME COURT OF APPEALS
CHARLESTON, WEST VIRGINIA



MT. STATE BIT SERVICE, INC.,

Appellant / Petitioner below,

v.

**STATE OF WEST VIRGINIA
DEPARTMENT OF TAX AND REVENUE,**

Appellee / Respondent below.

BRIEF OF APPELLANT MT. STATE BIT SERVICE, INC.

GIANOLA, BARNUM & WIGAL, L.C.

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Counsel for Appellant
July 13, 2004

**MT. STATE BIT SERVICE, INC.,
a West Virginia Corporation;**

Petitioner,

v.

**STATE OF WEST VIRGINIA
DEPARTMENT OF TAX AND REVENUE;**

Respondent,

MT. STATE BIT SERVICE, INC.'S APPEAL BRIEF

TO: The Honorable Justices of the West Virginia Supreme Court of Appeals

KIND OF PROCEEDING AND NATURE OF RULING OF LOWER COURT

This proceeding is an administrative appeal of an assessment of the purchasers' and retailers' use tax by the West Virginia Department of Tax and Revenue. Mt. State Bit Service, Inc. ("Mt. State Bit"), filed a timely petition for reassessment with the West Virginia Department of Tax and Revenue, Office of Tax Appeals, on the basis that the purchases in question were exempt under the producer exemption, as contained in West Virginia Code § 11-15-9 [1991], and under the contractor exemption, as contained in West Virginia Code § 11-15-8a [1989]. A hearing was conducted before the Administrative Law Judge ("ALJ") on November 18, 1993. By Administrative Decision entered on July 28, 1998, the ALJ determined that (a) the contractors' exemption did not apply because Mt. State Bit was the ultimate consumer of all tangible property and services being purchased and (b) the producer exemption did not apply because Mt. State Bit was not engaged in the production of natural resources.

As a result of the ALJ's adverse ruling, Mt. State Bit filed a Petition for Appeal in the Circuit Court of Monongalia County on September 24, 1998. The Circuit Court did not conduct

a hearing on the Petition for Appeal and, by Order entered June 17, 2003, Mt. State Bit's Petition was denied.¹

STATEMENT OF FACTS

Mt. State Bit is a West Virginia corporation located in Morgantown, West Virginia. From 1990 through 1992, Mt. State Bit was engaged primarily in the business of selling blasting materials and supplies. These sales represented approximately 90% of its total business activities. The blasting materials purchased by Mt. State Bit and resold to its customers were exempt from sales and use tax.

Mt. State Bit also employs six licensed blasters and offers their services to its customers engaged in the production of natural resources. The blasting services, which are provided only to customers who purchase blasting supplies, comprise less than 10% of Mt. State Bit's total business activities. The blasting services are the only segment of Mt. State Bit's business activities at issue on appeal.

As the result of an audit conducted by the West Virginia Department of Tax and Revenue, Mt. State Bit was assessed purchasers' and retailers' use tax ("use tax") in the amount of \$78,443 for the 1990, 1991 and 1992 tax periods and interest in the amount of \$11,245, which will accrue until the date of payment, for a total due of \$115,152.² The use tax was assessed on supplies purchased from out-of-state vendors by Mt. State Bit and subsequently used in its blasting services.

¹ Although this case has been pending for nearly a decade, it should be noted that this delay is through no fault of the Petitioner. Mt. State Bit has timely filed all appeals and has never requested a continuance or extension that would delay resolution of this matter.

² Mt. State Bit was also assessed consumers' sales and service tax as a result of the audit, but that assessment is not at issue in this Petition.

ASSIGNMENT OF ERROR

Mt. State Bit asserts that the trial court erred in not finding that the ALJ's findings of fact and conclusions of law were arbitrary and capricious in that it failed to properly determine whether Mt. State Bit's blasting activities fell within the purchaser and/or contractor exemption. Specifically, the ALJ made insufficient factual findings to enable a proper application of law to the facts.

Mt. State Bit further asserts that it is exempt from the assessed use tax under the producer exemption because it is engaged in the production of natural resources.

Mt. State Bit further asserts that it is exempt from the assessed use tax under the contractor exemption because supplies purchased from out-of-state vendors and used in contracting activity in West Virginia are exempt when the contracting activity is performed for producers of natural resources.

POINTS AND AUTHORITIES

West Virginia Code § 11-15A-3	5, 8, 10
West Virginia Code § 11-15-9	5
West Virginia Code § 11-15-2(d)	5, 6
West Virginia Code § 11-15-2(i)	5
West Virginia Code § 11-15-2(t)	5-7
110 C.S.R. 15 § 123.4.3.2	6
West Virginia Code § 11-15-2(n)	7
110 C.S.R. 15 § 123.4.3.7.b.4	7
110 C.S.R. 15 § 123.4.3.7.a.....	8
110 C.S.R. 15 § 123.4.3.7.b.....	8
110 C.S.R. 15 § 123.4.3.5	9, 11
<u>Apex Powder Corp. v. Peck</u> , 122 N.E.2d 693 (Ohio 1954).....	9
<u>J.D. Lamison Drilling Co., Inc v. Pennsylvania</u> , 437 A.2d 1050 (Pa. 1981)	9
<u>Pennsylvania v. R.G. Johnson Co.</u> , 433 A.2d 465 (Pa. 1981).....	9
<u>International Salt Co. v. New York</u> , 79 A.D.2d 343 (N.Y. 1981).....	9
West Virginia Code § 11-15-8a	10
110 C.S.R. 15 § 8a.4.1	10

DISCUSSION OF THE LAW

I. **THE SUPPLIES PURCHASED BY MT. STATE BIT FOR DIRECT USE IN BLASTING SERVICES PERFORMED FOR NATURAL RESOURCE PRODUCERS ARE EXEMPT FROM SALES AND USE TAX UNDER THE PRODUCER EXEMPTION BECAUSE MT. STATE BIT WAS ALSO ENGAGED IN THE PRODUCTION OF NATURAL RESOURCES BY VIRTUE OF THE SERVICES PERFORMED**

Under West Virginia Code § 11-15A-3(a)(4), property and services that are not subject to consumers sales tax are also exempt from use tax. Therefore, if property and services are exempt from consumers sales tax under the producer exemption contained in West Virginia Code § 11-15-9(g), then they are also exempt from use tax. West Virginia Code § 11-15-9(g) provides that:

Sales of property or services to persons engaged in this state in the business of manufacturing, transportation, transmission, communication or in the production of natural resources: . . . Provided, however, . . . that the exemption provided in this subsection shall apply only to services, machinery, supplies and materials **directly used or consumed in the activities** of manufacturing, transportation, transmission, communication or **the production of natural resources** in the businesses or organizations named above and shall not apply to purchases of gasoline or special fuel[.]

(emphasis added). In other words, property or services purchased by an entity engaged in the production of natural resources are exempt from use tax if the following three-prong test is satisfied:

- (1) a sale of property or services, as defined by West Virginia Code §§ 11-15-2(d) and (i);
- (2) the sale was made to a natural resource producer, as defined by West Virginia Code § 11-15-2(t); and
- (3) the property or services is then directly used or consumed in the production of natural resources.

A. Sale of Property or Service

The producer exemption applies to Mt. State Bit's blasting activities because its purchase of explosive materials constitutes a sale of property under West Virginia Code § 11-15-2(d), which provides:

"Sale," "sales," or "selling" includes any transfer of the possession or ownership of tangible personal property for a consideration, including a lease or rental, when the transfer or delivery is made in the ordinary course of the transferor's business and is made to the transferee or his agent for consumption or use or any other purpose.

Therefore, the first prong of the producer exemption is satisfied because Mt. State Bit purchased supplies for consideration in the ordinary course of its suppliers' business which supplies were directly used in providing blasting services to producers of natural resources.

B. Natural Resource Producer

The second prong of the producer exemption requires that the purchaser of the property be a natural resource producer. West Virginia Code § 11-15-2(t) provides that:

"Production of natural resources" means the performance, by either the owner of the natural resources or another, of the act or process of exploring, developing, severing, extracting, reducing to possession and loading for shipment for sale, profit or commercial use of any natural resource products and any reclamation, waste disposal or environmental activities associated therewith.

(emphasis added). In other words, an entity other than the owner of natural resources may claim the exemption if that entity participates in one or more of the activities associated with the production of natural resources set forth in West Virginia Code § 11-15-2(t). Severing is defined as "the physical removal of the natural resource from the earth or waters of this State by any means or from the waste or residue of prior mining." 110 C.S.R. 15 § 123.4.3.2. The producer exemption applies to Mt. State Bit's blasting activities because it detonates explosives to

physically remove coal deposits from the overburden and, therefore, Mt. State Bit is directly involved in the process of severing and extracting coal. Accordingly, the second prong of the producer exemption is satisfied because Mt. State Bit is a producer of natural resources under West Virginia Code § 11-15-2(t) in that it engages in the process of severing and extracting coal.

C. Directly Used or Consumed in Production of Natural Resources

The third prong of the producer exemption requires that the property purchased be directly used or consumed in the production of natural resources. West Virginia Code § 11-15-2(n)(1) provides that:

“Directly used or consumed” in the activities of manufacturing, transportation, transmission, communication or the production of natural resources means used or consumed in those activities or operations which constitute an **integral and essential part** of such activities, as contrasted with and distinguished from those activities or operations which are simply incidental, convenience or remote to such activities.

(emphasis added). West Virginia Code § 11-15-2(n)(2) sets forth an inclusive list of uses of property that constitute an integral and essential part of the production of natural resources. Mt. State Bit’s blasting activities fall under West Virginia Code § 11-15-2(n)(2)(B), which provides that property “[c]ausing a direct physical, chemical or other change upon property undergoing . . . production of natural resources” constitute an integral and essential part of the production of natural resources. The detonation of explosives causes a direct physical change to property undergoing the production of natural resources where the purpose of the detonation is to extract or sever coal. Therefore, blasting activities are an integral and essential part of the production of coal.

Mt. State Bit’s blasting activities constituted a *per se* integral and essential part of the production of natural resources. 110 C.S.R. 15 § 123.4.3.7.b.4 provides that blasting

equipment and explosives used in coal mining and processing are *per se* used in the production of natural resources and, therefore, the blasting equipment and supplies purchased by Mt. State Bit and used in providing blasting services to coal companies are exempt from sales and use tax.

Upon examination of other specific exempt and non-exempt mining activities, it is clear that the West Virginia Department of Tax and Revenue State Tax Division intended for blasting activities to be exempt from use tax. For example, it is nonsensical to exempt security, safety, drainage, communication and pollution control equipment from use tax, but not blasting equipment and explosives used to remove the overburden from coal deposits. *See* 110 C.S.R. 15 § 123.4.3.7.a.1-3; 123.4.3.7.b.3, 8 and 11. Likewise, it is apparent that blasting equipment and explosives do not share common characteristics with activities and items that are non-exempt from use tax such as office supplies, janitorial supplies, reference materials or consultant services. *See* 110 C.S.R. 15 § 123.4.3.6.a.3, 4, 7 and 13. It is inconsistent with the spirit in which the direct use exemption was drafted for its application to result in water treatment facilities receiving an exemption from sales and use tax while entities that provide explosives and blasting services be forced to remit sales and use tax on its materials. In other words, the Legislature did not intend for those who treat settlement ponds twice a year to be deemed an integral and essential part of the coal mining process while the operations of those who provide explosives and blasting services to remove the overburden from coal deposits be treated as incidental and remote to the coal mining process and, as a result, subject to sales and use tax. Therefore, it is clear that the West Virginia Department of Tax and Revenue State Tax Division intended to exempt blasting equipment and

explosives from use tax because it constitutes a more integral and essential part of the production of natural resources than other activities and items specifically exempt from use tax and, furthermore, blasting equipment and explosives do not share any common characteristics with the activities and items that the West Virginia Department of Tax and Revenue State Tax Division has found to be specifically non-exempt from use tax.

Although the statutory law of other jurisdictions differs from that of West Virginia, it should be noted that courts within these jurisdictions have consistently held that explosives and blasting services are directly used in the production of natural resources for sales and use tax exemption purposes. Apex Powder Corp. v. Peck, 162 Ohio St. 189, 122 N.E.2d 693 (1954); J.D. Lamison Drilling Co., Inc v. Pennsylvania, 63 Pa. Commw. 155, 437 A.2d 1050 (1981); Pennsylvania v. R.G. Johnson Co., 495 Pa. 256, 433 A.2d 465 (1981); International Salt Co. v. New York State Tax Commission, 79 A.D.2d 343, 437 N.Y.S.2d 757 (1981).

In summary, Mt. State Bit is *per se* exempt from the assessed use tax under the producer exemption because Mt. State Bit is a natural resource producer who purchased blasting supplies from out-of-state vendors and those supplies were directly used in the production of natural resources in that they were an integral and essential part of the process to sever and extract coal. Furthermore, the exemption of blasting equipment and explosives from use tax is consistent with the overall spirit of the regulations promulgated by the West Virginia Department of Tax and Revenue State Tax Division in its determination of exempt and non-exempt coal mining activities and materials.

II. MT. STATE BIT'S BLASTING SERVICES ARE EXEMPT FROM SALES AND USE TAX UNDER THE CONTRACTOR EXEMPTION BECAUSE IT PROVIDED THESE SERVICES AS AN INDEPENDENT CONTRACTOR TO COAL COMPANIES ENGAGED IN THE PRODUCTION OF NATURAL RESOURCES

As previously discussed, property and services that are exempt from consumers sales tax are also exempt from use tax. W.Va. Code § 11-15A-3(a)(4). Therefore, contracting services that are exempt from sales tax under West Virginia Code § 11-15-8a are also exempt from use tax. West Virginia Code § 11-15A-3(a)(4) provides that:

The provisions of this article shall not apply to contracting services. However, purchases by a contractor of tangible personal property or taxable services for use or consumption in the providing of contracting services shall be taxable beginning the first day of March, one thousand nine hundred eight-nine, except as otherwise provided in this article.

In other words, services provided by contractors are exempt from sales and use tax, but purchases of property or services made by a contractor and used in providing the contracting services are subject to tax. However, the services of contractors engaged in the production of natural resources, as well as supplies purchased by contractors and directly used or consumed in the production of natural resources are exempt from the sales and use tax. 110 C.S.R. 15 § 8a.4.1 provides, in part, that:

Contract miners and other persons engaged by the producer of natural resources (as defined for severance tax purposes) to perform any reclamation, waste disposal or environmental activities associated with the production of natural resources are treated as engaging in the activity of producing natural resources with respect to such activities for consumers sales and service tax and use tax purposes. Purchases directly used or consumed in the production of natural resources are exempt from tax as provided in Section 9.4.1 of these regulations.

Therefore, Mt. State Bit's blasting services are exempt from sales and use tax because it contracted with producers of natural resources to perform services associated with the production of natural resources.

Additionally, Mt. State Bit is a "contract miner" engaged in the production of natural resources and, as a result, its blasting services are not subject to the sales and use tax. "A contract miner or cutter is a person engaged as an independent contractor in producing natural resources which are owned by others." 110 C.S.R. 15 § 123.4.3.5. It is undisputed that Mt. State Bit performed blasting services for coal companies as an independent contractor and that the coal companies owned, leased or otherwise controlled by the coal being produced. Furthermore, as previously set forth above, Mt. State Bit is engaged in the production of natural resources because its blasting services are an integral and essential part of severing and extracting coal. Therefore, Mt. State Bit is a contractor engaged in the production of natural resources and, as a result, its services are exempt from sales and use tax.

CONCLUSION

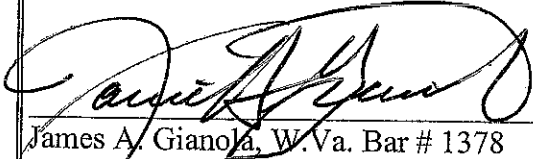
Mt. State Bit is exempt from the assessed purchasers' and retailers' use tax under the producer exemption and the contractor exemption because it is engaged in the production of natural resources. The ALJ and the trial court arbitrarily and capriciously applied West Virginia law in holding that the producer exemption and the contractor exemption did not apply to Mt. State Bit's blasting activities and, as a result, the decision of the trial court should be reversed. Alternatively, this case should be remanded to the ALJ for further factual findings.

PRAYER

WHEREFORE, Mt. State Bit respectfully requests that this Court reverse the decision of the Circuit Court of Monongalia County and declare that entities providing contract blasting services are exempt from sales and use tax under either or both the producer exemption and/or the contractor exemption. In the alternative, Mt. State Bit requests that this case be remanded to the ALJ for further factual findings.

MT. STATE BIT, INC.
By Counsel.

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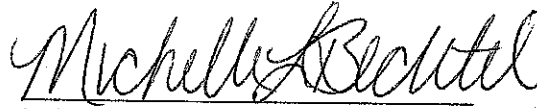


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CERTIFICATE OF SERVICE

I, James A. Gianola, certify that on July 13, 2004, I served Ester Van Doll, Esq., counsel for the Appellee, a copy of Mt. State Bit, Inc.'s Appeal Brief by mailing the same via United States first class mail, postage prepaid, to the following:

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