IN THE COURT OF APPEALS OF IOWA

No. 8-254 / 07-1534
Filed October 15, 2008

THE SHERWIN-WILLIAMS COMPANY,
Petitioner-Appellee,

vs.

IOWA DEPARTMENT OF REVENUE,
Respondent-Appellant.

Appeal from the Iowa District Court for Polk County, Carla T. Schemmel, Judge.

The Iowa Department of Revenue appeals from the district court's judicial review decision finding that Sherwin-Williams was exempt from Iowa's sales and use tax. **AFFIRMED.**

Thomas J. Miller, Attorney General, and Marcia Mason, Assistant Attorney General, for appellant.

Bruce W. Baker of Nyemaster, Goode, West, Hansell & O'Brien, P.C., Des Moines, and Joe Timmons, Laura T. Pizmont and John A. Panno of The Sherwin-Williams Company, Cleveland, Ohio, for appellee.

Heard by Sackett, C.J., and Miller and Potterfield, JJ.

POTTERFIELD, J.

I. Background Facts and Proceedings

Sherwin-Williams is an Ohio company that manufactures and sells paint and painting products in thirty-eight stores in Iowa. Until the 1960s, Sherwin-Williams manufactured all of its paints in a centralized factory and shipped the finished cans to retail locations. Then Sherwin-Williams switched to a decentralized system, which allowed each retail location to mix its own paint from base and colorants shipped to the individual stores. Sherwin-Williams also ships the base and colorants to other retail stores, such as Menards, Home Depot, or Lowes. All of the retail stores use similar machinery and equipment to produce the paint. The finished paint is sold to consumers under different brand names.

The untinted base is a thick liquid that is difficult to impossible to apply and requires the addition of colorant to make it usable to the consumer. Bases and colorants are combined using machinery that mixes and blends the two ingredients according to precise formulas. The machines at issue here are mixers which hold and shake one-gallon and five-gallon cans of paint; a Mini Accutinter, which inserts colorant into cans of base; and the Fluid Management Color Matching System, also called the spectrographic color-matching machine, which determines the formula for mixing the precise shade of color desired. The issue is whether these machines are exempt from use tax as items used for manufacturing under Iowa Code section 422.45(27)(a)(1) (1999) and the definition of manufacturing in section 428.20.

Effective July 1, 1997, the Iowa legislature expanded the manufacturing exemption to the use tax in section 422.45(27)(a)(1), eliminating language focused on the location of the activity and requiring only that a manufacturer use the machinery,

equipment, or computers. Prior to the changes, section 422.45(27) applied only to "industrial" machinery that was "real property." These restrictions were removed, broadening the exemption by focusing on the nature of the activity in question as opposed to the location or type of machinery. The department interpreted the words and phrases "directly used," "manufacturer," and "processing" in rule 18.58 of the Iowa Administrative Code. Iowa Admin. Code r. 701-18.58.

In 2001, Sherwin-Williams filed a claim for refund of use tax it had paid on the machinery it used to mix paints in its retail stores. Its claim for refund specified the period from July 1, 1992, through December 31, 2000. The department granted the refund for the years after July 1997, referring to the expansion in the statutory definitions effective July 1, 1997.

Sherwin-Williams requested a review of the denial of its claim for the years before July 1, 1997. The department denied the request. Additionally, the department revoked its earlier decision to grant a refund for the period after July 1, 1997, stating that the refund had been issued in error. Sherwin-Williams then formally withdrew its refund claim for the years before July 1, 1997. Thus, a February 4, 2004 hearing before an administrative law judge (ALJ), and this appeal, are limited to the period following July 1, 1997.

On May 31, 2006, the ALJ issued her proposed decision finding that the machinery used in the Sherwin-Williams stores was exempt from the use tax. The department appealed to the Director of the Department of Revenue (director). On October 5, 2006, the director reversed the ALJ's proposed decision, ruling that Sherwin-Williams did not meet the statutory definition of "manufacturer," and even if Sherwin-

Williams were a manufacturer, the spectrographic color-matching machine was not used directly in processing as required by Iowa Code section 422.45(27).

Sherwin-Williams appealed the director's ruling to the district court. On August 15, 2007, the district court overturned the director's decision on both grounds. The district court found that Sherwin-Williams is a "manufacturer" and that the spectrographic color-matching machine is used directly in processing. The district court concluded that the director's determination was clearly illogical as contrary to the plain language of the statutes and wholly unjustified based upon Iowa law. The court also concluded the machinery used by Sherwin-Williams was exempt from Iowa use tax under former section 422.45(27).

The department now appeals, arguing the director was correct in deciding that: (1) Sherwin-Williams does not qualify as a "manufacturer" for purposes of the use tax exemption under section 422.45(27)(1)(a); and (2) even if Sherwin-Williams does qualify as a manufacturer, the spectrographic color-matching machine is not directly used in processing, and so is not exempt under section 422.45(27)(1)(a).

II. Standard of Review

Judicial review of the decisions of the director is governed by Iowa Code chapter 17A. Iowa Code § 422.55(1) (1999). The court is required to give deference to the decisions of the director "with respect to particular matters that have been vested by a provision of law in the discretion of the agency." *Id*. § 17A.19(11)(c) (2007). Here, the director has the "power and authority to prescribe all rules not inconsistent with the provisions of this chapter, necessary and advisable for its detailed administration and to effectuate its purposes." *Id.* § 422.68(1). Consequently, we must uphold the director's

decision unless that interpretation is "irrational, illogical, or wholly unjustifiable." *Id.* § 17A.19(10)(*l*).

Because the director's factual determinations are vested by a provision of law in the discretion of the agency, the court is bound by the agency's findings of fact if supported by substantial evidence. *Lange v. Iowa Dep't of Revenue*, 710 N.W.2d 242, 246-47 (Iowa 2006). We can reverse the agency's findings of fact only if they are not supported by substantial evidence. *Mycogen Seeds v. Sands*, 686 N.W.2d 457, 465 (Iowa 2004).

III. Exemptions from Iowa Use and Sales Tax

Iowa Code section 422.43(1) imposes a tax on the gross receipts from all sales of tangible personal property sold at retail in the state to consumers or users except as otherwise provided. The exemptions, specified in section 422.45, are to be strictly construed in favor of taxation. *Heartland Lysine v. Dep't of Revenue & Fin.*, 503 N.W.2d 587, 588 (Iowa 1993).

The burden of proof of its entitlement to an exemption is on Sherwin-Williams. *Dial Corp. v. Iowa Dep't of Revenue*, 634 N.W.2d 643, 646 (Iowa 2001); Iowa Code § 421.60(6).

Sherwin-Williams claims it is exempt from Iowa sales and use tax on its purchase of machinery and equipment used to mix paint in its retail stores under subsections 422.45(27)(a)(1) and (2), which provided at all times material to this case:

> The gross receipts from the sale or rental of computers, machinery, and equipment . . . if such items are any of the following: (1) Directly and primarily used in processing by a manufacturer. (2) Directly and primarily used to maintain the integrity of the product or to maintain unique environmental conditions required for either the product or the computers, machinery, and equipment used in processing by a manufacturer,

> including test equipment used to control quality and specifications of the product.

Iowa code section 422.45(27)(d)(4) defines "manufacturer" for the purpose of the exemption, stating: "'[m]anufacturer' means as defined in section 428.20, but also includes contract manufacturers." Section 428.20 defines manufacturer as:

> A person who purchases, receives, or holds personal property of any description for the purpose of adding to its value by a process of manufacturing, refining, purifying, combining of different materials, or by the packing of meats, with a view to selling the property for gain or profit.

The fighting issues here are whether Sherwin-Williams is a manufacturer by virtue of the combining of base and colorant and, if so, whether the spectrographic color-matching machine is directly used in processing so that its sale to Sherwin-Williams is exempt from taxation.

The department argues that the court must read into section 428.20 a test of primary use of the business property. The support for the department's position is found in the definition of industrial real estate by the department's property tax division under chapter 441, which relates to property taxes. The department's rule 71.1 defines industrial real estate as primarily a manufacturing establishment, as compared to commercial real estate where goods are stored or offered for sale. Iowa Admin. Code r. 701-71.1.

Because Sherwin-Williams' stores are classified as commercial real estate for purposes of their property tax assessments, the department argues they cannot be manufacturers. The department contends that if manufacturing is only incidental to the property's use and the property is not a manufacturing establishment for purposes of property taxes, then the business cannot be a manufacturer for purposes of exemptions from sales and use taxes.

The director also relied on department rule 71.1, which involves a primary purpose test. Iowa Admin. Code r. 701-71.1. However, this rule is intended to supplement sections of the Iowa Code which relate to property taxes. *Id.* Thus, this primary purpose test is not included in Iowa Code section 422.45, nor is it included in the department's rules that were intended to supplement that section of the Iowa Code. Because the statute is clear and unambiguous, we do not need to investigate the legislature's intent or the common understanding of "manufacturer." Nor will we discuss the primary purpose of Sherwin-Williams' retail stores because that analysis is not required by the plain language of the statute. In addition, the definition of "manufacturer" given in section 428.20 does not exclude businesses that make retail sales.

The department also argues that section 428.20, as it applies to manufacturers, has previously been found to be ambiguous, requiring a strict construction of the statute against exemption, citing *Associated Contractors of Iowa v. State Tax Comm'n*, 123 N.W.2d 922 (Iowa 1963). In that case, the Iowa Supreme Court considered whether the word "manufacturer" in Iowa Code section 422.42(11) (1958) was used in a different sense than the definition in section 428.20. The court found that section 422.42(11) was ambiguous, not section 428.20. The section at issue here, section 422.45, expressly incorporates the definition of manufacturer in section 428.20. Iowa Code § 422.45(27)(d)(4) (1999).

After reviewing sections 422.45(27) and 428.20, we find that they are clear and unambiguous. "Where language is clear and plain, there is no room for construction." *Welp v. Iowa Dep't of Revenue*, 333 N.W.2d 481, 483 (Iowa 1983). The director erroneously relied in part on *Associated General Contractors* in making his

determination that the primary use of the property controls whether a person is a manufacturer.

We find that the director's application of case law and department rules was flawed. As a result, the director's interpretation of section 422.45(27) and subsequent application of that law to the facts were wholly unjustifiable based upon Iowa law.

Sherwin-Williams meets the statutory definition of "manufacturer" found in section 428.20. Sherwin-Williams receives and holds property (base and colorant) for the purpose of adding to its value by combining the materials with a view to selling the property for gain or profit. The combining of base and colorant is the final step in manufacturing paint. This step used to be performed in a factory, but now is done in the retail stores. The change in location does not render this final step any less necessary to the process of manufacturing paint.

The department's discussion of fast food cases is unpersuasive; manufacturing paint is clearly distinguishable from combining the ingredients for pizza, hamburgers, and ice cream cones. The cases cited by the department in support of this argument are clearly distinguishable from this case because the statutes pertaining to such exemptions in Oklahoma and North Carolina are not as broad as the Iowa exemption statue. The Oklahoma code at issue in *Dairy Queen of Oklahoma, Inc. v. Oklahoma Tax Comm'n*, 238 P.2d 800, 801 (Okla. 1951)[1], exempted machinery and equipment "purchased and used by persons establishing new manufacturing or processing plants in Oklahoma." Section 422.45 is not so strict as to require that the equipment be used

[1] This analysis also applies to a later Oklahoma statute at issue in *McDonald's Corp. v. Oklahoma Tax Commission*, 563 P.2d 635 (Okla. 1997).

by a manufacturing or processing plant. In addition, the Oklahoma statute provides no definition of "manufacturer," while the Iowa Code gives a clear definition.

The statute at issue in *HED, Inc. v. Powers*, 352 S.E.2d 265 (N.C. Ct. App. 1987), a North Carolina case cited by the department, also did not define "manufacturing industry," allowing courts to apply their own interpretation of the statute.[2] Because Iowa Code section 428.20 defines "manufacturer," our court should not interpret the clear language of the code, but should only apply the given definition. The Iowa Code clearly defines "manufacturer" in a way that includes the mixing of paint.

Further, the department's own rule, which supplements Iowa Code section 422.45(27), excludes from exemption restaurants, retail bakeries, and food stores. Iowa Admin. Code r. 701-18.58(6). This rule clearly prevents restaurants from claiming an exemption, but there is no portion of the rule that provides an exception to the exemption that would apply to Sherwin-Williams. Thus, the fast food cases are distinguishable from the case at hand based on the application of the department's rule. We agree with the district court that Sherwin-Williams is a manufacturer as required by Section 422.45(27) for purposes of exemption from the use tax.

IV. Direct Use of Spectrographic Color-Matching Machine

The department also argues that the spectrographic color-matching machine does not qualify for the use tax exemption because it is not "directly and primarily used in processing" as required by section 422.45(27). This section contains a clear and unambiguous definition of processing, which includes:

[2] This analysis also applies to the Arizona case cited by the department because the applicable statute failed to define "manufacturing" or "processing." *Arizona Dep't of Revenue v. Blue Line Distrib., Inc.*, 43 P.3d 214 (Ariz. Ct. App. 2002).

> a series of operations in which materials are manufactured, refined, purified, created, combined, or transformed by a manufacturer . . . . Processing encompasses all activities commencing with the receipt or producing of raw materials by the manufacturer and ending at the point products are delivered for shipment or transferred from the manufacturer.

Iowa Code § 422.45(27)(d)(5). The department's rule which supplements section 422.25(27) states that:

> Property is "directly used" only if it is used to initiate, sustain, or terminate the transformation of any activity. In determining whether any property is "directly used," consideration should be given to the following factors: 1. The physical proximity of the property in question to the activity in which it is used; 2. The proximity of the time of use of the property in question to the time of use of other property used before and after it in the activity involved; and 3. The active causal relationship between the use of the property in question and the activity involved. The fact that a particular piece of property may be essential to the conduct of the activity because its use is required either by law or practical necessity does not, of itself, mean that the property is directly used.

Iowa Admin. Code r. 701-18.58.

We agree with the district court that the spectrographic color-matching machine is directly used in processing. As previously described, the spectrographic color-matching machine is used as a color eye to analyze a color and create a formula that can be used to recreate that color. The spectrographic color-matching machine then sends the formula electronically to the Automatic Color Dispenser. This formula ensures that the desired color is produced for each gallon of paint ordered. Thus, the spectrographic color-matching machine fits within the department's definition of "directly used" because it is used to initiate the manufacture of paint.

In considering the factors set out by the department's rule, the physical proximity of the spectrographic color-matching machine to the manufacturing process is not relevant because the spectrographic color-matching machine transmits the needed information electronically. The spectrographic color-matching machine is used

immediately prior to the mixing of the colorant and the base, and it is the spectrographic color-matching machine that causes the colorant and base to be mixed. Because the spectrographic color-matching machine initiates the final step in the process of manufacturing paint, it is directly used in processing and qualifies for an exemption under section 422.45(27).

AFFIRMED.

Miller, J. and Potterfield, J. concur. Sackett, C.J., concurs in part and dissents in part**.**

SACKETT, C.J. (concurring in part and dissenting in part)

I concur in part and dissent in part.

The majority has correctly defined our scope of review and the case law applicable to determining exemptions to Iowa use and sales tax, and with this part of its opinion I concur.

I disagree, however, with its conclusion that Sherwin-Williams retail paint stores are manufacturers entitled to an exemption for sales and use tax on equipment used in the retail stores to mix and tint one-gallon and five-gallon cans of paint. I find that Sherwin-Williams, in at least two instances, failed to meet its burden to prove entitlement to be exempt from Iowa sales and use tax on the equipment.[3] First, I do not believe the equipment used to mix and tint is machinery "[d]irectly and primarily used in processing by a manufacturer." Secondly, I do not believe a person mixing and tinting paint after its purchase by a customer in a retail store meets the statutory definition of "manufacturer." Thirdly, I believe the evidence here clearly supports the director's factual finding the retail store was not directly and primarily using the equipment for processing as a manufacturer. And lastly, I find the director's decision rational, logical, and justifiable.[4]

Sherwin-Williams seeks its exemption under Iowa Code sections 422.45(27)(a)(1) and (2). Section 1 allows exemptions for items used for certain purposes "[d]irectly and primarily used in processing by a manufacturer." It is undisputed that we are dealing with a process that occurs in a retail store not a factory.

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[3] The burden of proof of its entitlement to an exemption is on Sherwin-Williams. Iowa Code § 421.60(6) (1999); *Dial Corp. v. Iowa Dep't of Revenue*, 634 N.W.2d 643, 646 (Iowa 2001).

[4] We must uphold the director's decision unless the interpretation is "irrational, illogical, or wholly unjustifiable." Iowa Code § 17A.19(10)(*l*).

The mixing and tinting is incidental to the primary purpose of the retail store and the primary purpose of the store is to sell paint and related supplies. While I recognize, as the majority states, section 428.20 does not exclude from the definition of manufacturer, businesses that make retail sales, it also does not include those engaged in retail sales. I believe the language of sections 422.45(27)(a)(1) and (2) clearly directs us to determine whether the equipment is primarily used in processing. The only conclusion I can reach in strictly construing the exemptions in favor of taxation, is that the equipment is primarily used to complete the sale of the paint, not for processing. *See Heartland Lysine v. Iowa Dep't of Revenue and Fin.*, 503 N.W.2d 587, 588 (Iowa 1993).

Furthermore I do not find that the persons working in the retail store meet the statutory definition of Iowa Code section 428.20, which defines manufacturer as: "A person who purchases, receives, or holds personal property of any description for the purpose of *adding to its value,* by a process of . . . ." (Emphasis supplied.)

The facts here do not support a finding that the mixing and tinting are done for the purpose of adding value to the paint and the tint. When displayed for sale at the retail store, the product is priced and the customer agrees to pay the price for the mixed and tinted product. The mixing and tinting does not add to the paint's value as that value or price has already been established.

Even if there are facts which would support a finding the retail paint store employees are manufacturers, there is substantial evidence they are not so as to support the factual findings of the director. We are bound by the director's findings if supported by substantial evidence. *Lange v. Iowa Dep't of Revenue*, 710 N.W.2d 242, 246-47 (Iowa 2006).

I am puzzled by the majority's opinion that finds the department's discussion of fast food cases unpersuasive. I see the majority opinion as opening the door for the exemptions to be applied to a wide variety of equipment in the food industry[5] and in other retail business.[6] If the door is opened it should be done by the legislature and not the court.[7] The director should be affirmed.

[5] For example, I find it difficult to distinguish the paint mixing equipment from a soft serve ice cream machine which takes a milk product and flavoring and mixes and freezes it for a product that will be sold. In fact this machine may be more akin to manufacturing than is the paint mixer because the ice cream is generally mixed and frozen before the product is sold rather than being mixed after a sale, as is the paint.

[6] A retail linen store monogramming a towel after a customer had purchased it would, I believe under the majority opinion, not be required to pay sales and use tax on the machine that did the monogramming.

[7] One must surmise that the exemption was created to encourage manufacturing in the state. There is a major difference in the impact on the state economy between a store that mixes paint by the gallon for a single customer and a plant that manufactures items that go into the stream of commerce.