Coates' Canons Blog: Court Of Appeals Continues to Expand Inventory Exclusion

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The property tax exclusion for inventory keeps getting bigger. Traditionally, the exclusion was limited to property that was held for sale and not put to any other use. But last year the North Carolina Court of Appeals ruled that the inventory exclusion applies to jet airplanes that are used for corporate trips so long as those jets remain for sale. And last month that same court expanded the inventory exclusion to cover property never even offered for sale in the Appeal of Michelin North American, Inc.

The *Michelin* case involved taxation of tires used in the company's testing facility in Mecklenburg County. The company argued that the tires, valued at roughly $500,000, should be considered excluded inventory. The county disagreed based on the fact that the tires were not held for sale. The dispute went before the Property Tax Commission, which ruled in favor of the county in late 2014. In early April 2015 the Court of Appeals reversed the PTC decision and ruled in favor of the company after an extended analysis of the Machinery Act's definition of "inventory."

The specific property at issue in the *Michelin* case—aircraft tires that must be approved by the Federal Aviation Administration and the U.S. military—is unlikely to be a concern for many other counties. But the principle involved in this case is extremely important for all counties: the inventory exclusion is no longer limited to property held for sale.

Here's how the court reached its questionable conclusion:

G.S. 105-275(33) excludes "inventories owned by manufacturers" from property taxation. G.S. 105-273(8a) defines inventory to include "goods held for sale in the regular course of business by manufacturers" (-273(8a)(a)) and "as to manufacturers, raw materials, goods in process, finished goods, or other materials or supplies that are consumed in manufacturing or processing or that accompany and become a part of the sale of the property being sold" (-273(8a)(c)).

Tires produced by Michelin and held for sale to its customers clearly would qualify as excluded inventory. But Michelin admitted that the tires at the testing facility would be destroyed in the testing process and would never be sold to customers.

If the tires Michelin sought to exclude from taxation were never intended to be sold to customers, the county reasonably asked, how could they qualify as inventory?

Because the Machinery Act doesn't require that a manufacturer's "finished goods" be held for sale in order to qualify as inventory, replied the court.

The county argued that -273(8a)(c) requires finished goods to be held for sale in order to be excluded from taxation because the phrase "part of the sale of the property being sold" modifies the term "finished goods."

Wrong, said the court. After a lengthy grammatical analysis of -273(8a)(c), the court decided that the "part of the sale" language modified only "other materials or supplies" and not "finished goods." This led the court to conclude that there is no requirement that finished goods be held for sale in order to be exempt.

This conclusion seems grammatically correct but legally questionable.

I agree that the "part of the sale" phrase in -273(8a)(c) does not apply to "finished goods." But that doesn't answer the key question of what exactly constitutes a "finished good." If that term includes only property held for sale, the court's grammatical analysis of the statutory language is irrelevant and unnecessary.

Sadly the Machinery Act doesn't define the term "finished good." You won't find a definition of that term anywhere else in the General Statutes, either.

A basic principle of statutory construction is that when a statutory term is not defined by the legislature then the court should rely on the commonly accepted definition of that term when interpreting the statute. If a statute "contains a definition of a word used therein, that definition controls," but if not then "words must be given their common and ordinary meaning." *In re Clayton–Marcus Co.*, 286 N.C. 215, (1974). (See also this discussion of how courts interpret federal statutes.)

The common definition of "finished goods" is tangible personal property that (i) has completed the manufacturing process and (ii) that is *ready for and held for sale*. (See here, here and here.)

If the court had considered the common definition of "finished goods," the tires in question would not have been excluded. Those tires would have lost their status as excluded inventory the second Michelin designated the tires to its testing facility and stopped holding them for sale.

The court's failure to grapple with the definition of "finished goods" undermines the credibility of its final decision in favor of Michelin. It also ignores decades of previous North Carolina court decisions that tied the inventory exclusion to the eventual sale of goods.

In the 1993 *Cone Mills* case, the Court of Appeals observed that the key question when applying the inventory exclusion is, "What was the primary purpose for which the taxpayer acquired the property?" If the primary purpose or use of the property is anything other than sale to customers, then the property is not excluded inventory.

In *Michelin,* the only use of the tires in question were for testing. In my view, that means the tires should not have constituted finished goods and therefore should not have been excluded inventory.

But my view and $2.95 (plus tax) will get you a tall caffe latte at Starbucks. The *Michelin* decision was unanimous at the Court of Appeals, meaning the county does not have an automatic right of appeal to the N.C. Supreme Court. It seems unlikely that the Supreme Court will grant a discretionary appeal. If so, the *Michelin* decision will be the law of the land unless the General Assembly chooses to clarify the meaning of "finished goods" so that it limits the inventory exclusion to goods held for sale. And the odds of today's General Assembly expanding a local government's taxing authority seems roughly equivalent to the odds of my beloved Blue Devils winning the 2016 national championship in football (2,000 to 1, if you are headed to Vegas anytime soon.)

Assuming the *Michelin* decision remains good law, manufacturers across the state will be able to exclude any goods used for research, testing, or other purposes even if they never intend to sell those goods. The inventory exclusion flies free, completely untethered from the sale of goods.

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