STATE OF MICHIGAN
DEPARTMENT OF LICENSING & REGULATORY AFFAIRS
MICHIGAN ADMINISTRATIVE HEARING SYSTEM
MICHIGAN TAX TRIBUNAL

Arrow Energy Services, Inc.,

Petitioner,

v

MTT Docket No. 404349

Department of Treasury,

Tribunal Judge Presiding
Paul V. McCord

Respondent.

_____/

ORDER GRANTING PETITIONER'S MOTION FOR SUMMARY DISPOSITION

ORDER DENYING PETITIONER'S REQUEST FOR COSTS AND FEES

FINAL OPINION AND JUDGMENT

James B. Jensen, Jr. (P31810) and Nicholas M. Oertel (P73334), for Petitioner.
Scott L. Damich (P74126), for Respondent.

INTRODUCTION

This use tax assessment case is before the Tribunal on Petitioner's motion for summary disposition under MCR 2.116(C)(10).[1] Petitioner moves for summary disposition in its favor, asserting that it did not use, store, or consume any tangible personal property associated with cementing various oil wells that would justify the imposition of use tax. Instead, according to Petitioner, any resulting tax liability for these transactions rests with its various subcontractors. Petitioner makes a similar argument with respect to its purchase of certain consumables and lease of specialized equipment; that liability rests with its various suppliers, vendors/lessors under Michigan's sales tax. Respondent objects to Petitioner's motion, arguing that the documentary evidence demonstrates that Petitioner purchased both specialized cement and nontaxable services from BJ Services before the cement was poured into the wellbore. As a result, Petitioner ". . . used and consumed the cement it purchased." Thus, according to Respondent, its assessment for use tax on these transactions was appropriate. Respondent further contends that as to certain consumables Petitioner purchased and Petitioner's rental of certain specialized equipment, "[Petitioner] . . . failed to provide documentation demonstrating sales tax was previously paid on

[1] Petitioner did not state under which sub-rule its motion was being brought, but given the sum and substance of its motion, we treat it as a motion for summary disposition under MCR 2.116(C)(10).

the subject transactions" [*Id.*], consequently, use tax was properly assessed on these transactions.

Following concessions by Respondent, including that a contractor-subcontractor relationship existed between Petitioner and certain of its vendors, and after concluding that this matter is ripe for summary disposition, we decide the following: (1) whether Petitioner is liable for use tax on the use or consumption of certain materials, supplies, and leased equipment used by its subcontractors; we hold it is not; (2) whether Petitioner is liable for use tax on certain transactions in the State of Michigan where the vendor invoices fail to show that sales tax was charged; we hold it is not; (3) whether Petitioner is entitled to a use tax refund for transfer tax paid on certain motor vehicles that Petitioner acquired from Canton Oil and Gas Acquisition in 2004; we conclude it is not; and finally, (4) whether Petitioner is entitled to reasonable attorney's fees and costs under MCL 600.2591 and TTR 145 for the expenses it incurred in this proceeding with Respondent; for the reasons explained below, we find that Petitioner is not. Accordingly, we shall grant Petitioner's motion for summary disposition and cancel Assessment Number Q404455, but deny Petitioner's request for refund of motor vehicle transfer tax and for reasonable attorney's fees and costs.

FINDINGS OF FACT[2]

At the prehearing conference held on April 13, 2012, the parties, while agreeing that this matter could be decided on summary disposition, requested the Tribunal open a limited factual record to receive the testimony of Mr. Timothy J. Brock, a professional engineering consultant and George C. Molski, Petitioner's sole owner and president. We granted the parties' request, receiving the offered testimony and oral argument on Petitioner's motion on June 6, 2012.

1. Petitioner's "Turnkey" Operations

Petitioner, Arrow Energy Services, is a Michigan corporation whose principal place of business is in in Kalkaska, Michigan. Petitioner is, among other things, in the business of servicing oil wells. Specifically, Petitioner offers so-called "turnkey" operations to its customers, typically owners of the working interest in a tract of land who are also the well operators, i.e., oil and gas producers. Turnkey describes a contractual relationship in which the drilling contractor, Petitioner, agrees to furnish all expertise, labor and materials necessary to drill a well to a certain depth or stage of completion for a specified sum of money. [Tr 39; P-5] The exhibits related primarily to Petitioner's development of a series of turnkey wells known as the "Arrowhead Ranch" in Montmorency County. [See P Mot Ex-10] One well in the Arrowhead Ranch is called the "Black River Ranch A1-15."

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[2] Ordinarily the "facts" presented in an order granting or denying summary disposition are stated solely for purposes of deciding the motion and are not "findings of fact" for purposes of the particular case. See MCL 205.751; MCL 24.285; *Jackhill Oil Co v Powell Production, Inc*, 210 Mich App 114, 117; 532 NW2d 866 (1995) (stating that a court may not make findings of fact when deciding a summary disposition motion). That said, we do have a factual record in this case where the parties offered direct and cross-examination together with supporting documentary evidence from which we can assess credibility and make findings of fact.

2. Respondent's Audit and Assessment

In 2008, Respondent opened a use tax audit of Petitioner for the taxable periods beginning May 1, 2004, through June 30, 2007. Using a block sampling method with the calendar year 2006 as the sampling period, Respondent issued its Final Audit Determination Letter on September 10, 2008, reflecting a deficiency in Michigan use tax in the amount of $461,244 together with interest and penalties. After an informal conference the deficiency as reflected on the intent to assess was reduced to $401,074, plus penalty of $976.00, with statutory interest thereon. Respondent's determination of a use tax deficiency relates to three primary areas: (1) whether Petitioner was a contractor-consumer of the cement furnished by BJ Services or whether a contractor-subcontractor relationship existed, (2) third-party invoices for materials and leased equipment used or consumed during Petitioner's turnkey operations of which sales tax was not charged., and (3) use tax on vehicles acquired by Petitioner when it purchased Canton Oil and Gas.

3. Well Drilling

Although the term "drilling" perhaps conjures images of the discrete act of plunging a drill bit into the ground, according to Mr. Brock's credible testimony and exhibits, the process of drilling a well involves a number of complex tasks. From time-to-time working interest owners must obtain leaseholds, titles, and right-of way access or other real estate interests in nearby parcels in order to meet geological, practical, and regulatory demands as a prerequisite to drilling. After the legal issues are settled, Petitioner, pursuant to its turnkey arrangement, goes about preparing the land, which includes clearing and leveling the land, and building access roads. [P-5] Conditions permitting, Petitioner may dig a reserve pit, complete with appropriate environmental containment, which is used to dispose of rock cuttings and drilling mud during the drilling process. [Tr 45] If the site cannot accommodate a reserve pit, Petitioner must run the site as a "closed system" meaning that the byproducts of the drilling process, cuttings, excess cement and mud must be disposed of offsite – trucked away instead of placed in a pit. [Tr 45; see also P-5] Because water is used in drilling, Petitioner must secure a source of water, either by drilling a well or arranging to have water trucked to the site. [See P-5]

Once the land has been prepared, the crew then begins drilling the main hole, often with a small drill truck rather than the main rig. The first part of the hole is larger and shallower than the main portion, at a depth of 40 to 100 feet, and is lined with a large-diameter pipe called the conductor casing. [Tr 13] The crew drives the conductor casing, basically hammering it into the ground until the point of "refusal." [Tr 13] The purpose of the conductor casing is to support the bore hole and prevent it from collapsing. [Tr 21-22]

The crew then sets up the drill rig and starts the drilling operations. First, from the starter hole, the team drills a surface hole down to a pre-set depth, at least 100 feet below or into bedrock, usually a shale formation, which is somewhere above where they think the oil trap is located. There are a number of steps to drilling the surface hole: (1) place the drill bit, collar, and drill pipe in the hole, (2) attach other specialized equipment and begin drilling, (3) as drilling progresses, circulate a displacement fluid (typically mud) through the pipe and out of the bit to

float the rock cuttings out of the hole, (4) add new sections (joints) of drill pipes as the hole gets deeper, and (5) remove the drill pipe, collar, and bit when the pre-set depth (anywhere from a few hundred to a couple thousand feet) is reached.

Once the crew reaches the pre-set depth, they must run the surface casing and cement it in place. This task is accomplished by placing casing pipe sections into the hole. The casing crew puts the casing pipe in the hole section by section with the individual pipe joints threaded and screwed together. The casing pipe has spacers around the outside to keep it centered in the hole.

4. Cementing Operations

At this point it is necessary to cement the casing in place. This task is accomplished by an oil well cementing service company – a specialty cementing contractor. During the taxable period at issue, Petitioner subcontracted BJ Services to perform the necessary cementing services in the construction of turnkey wells. The Conditions of Contract between Petitioner and BJ Services specify that BJ Services was an independent contractor. [R-4] The cement used for this process is a complex mixture, having to maintain a certain viscosity or consistency as it is pumped to depth. The cement must also achieve a certain set or cure to an engineered strength within a specified time frame over a wide pressure and temperature gradient as those parameters vary at the surface of the well bore to those at depth. In order to achieve these results, the cement mix is carefully engineered by the cementing contractor, BJ Services, and tailored to specific conditions at the well site through the use of various additives. The cement is trucked to the well site dry and mixed by the cementing contractor using specialized trucks and tested on site before pumping. [Tr 19-20; see also P Mot Ex 15]

The cement crew mixes and pumps the cement slurry, which is a mixture of cement and other additives and water, down the casing pipe using a rubber plug (called a bottom plug). [P Mot Ex 15] The bottom plug stops or seats in a float collar but continued pressure from the cement pumps causes the cement slurry to move down through the inside of the casing and then flow out of the casing and up filling the annular space between the outside of the casing and the wall of the hole. [P Mot Ex 15] A top plug is released as the last of the cement slurry enters the casing. The top plug follows the cement slurry down the casing as a displacement fluid (usually water or drilling mud) is pumped in behind the top plug. Pumping is then stopped when the top plug seats in the bottom plug. At this point cement is only in the casing below the float collar and in the annular space outside of the casing, the casing itself is filled with displacement fluid. The cement is then allowed to harden. Tests are then performed for such properties as hardness, alignment, and a proper seal. Although the drilling crew may be on site to assist, the cementing process is performed by the cementing contractor. Once the cement is pumped and cured, it is permanently affixed to the land and cannot be removed.

Drilling then continues in stages, the crew drills, then the cementing contractor is called back to cement new casings, then the drilling crew drills again. When the rock cuttings from the mud reveal the oil sand from the reservoir rock, the crew may have reached the well's final depth. At this point, crew members remove the drilling apparatus from the hole and perform

several engineering tests. As with the actual drilling process, many of these tests require the use of specialized equipment that Petitioner rented from various lessors or Petitioner hired additional subcontractors. During the audit period Petitioner rented equipment from equipment rental vendors where no tax was charged. [See P-8] Once the final depth is reached, Petitioner's crew completes the well to allow oil to flow into the casing in a controlled manner. [See, e.g., P-5]

5. Saw and Kiln Dust

During the cementing process, cement is allowed to overflow and run out of the well hole to ensure a complete seal. Where site conditions do not allow for a reserve pit to allow the excess cement and cuttings to solidify, this material has to be removed from the well site. Sugar is sprinkled on the excess cement to prevent the cement from setting up so it can be removed by truck from the site. Saw dust and kiln dust is added to the cuttings to solidify the material to a point where it can be shipped and accepted by a landfill or allowed to solidify in the ground. During the audit period, Petitioner purchased saw dust and kiln dust from local Michigan lumber yards and/or cement companies such as Meeder's Lumber Company in Mancelona, Michigan, and St. Mary's Cement, Inc. An invoice from Meeder's Lumber Company evidences Petitioner purchased 75 yards of saw dust. This invoice also reflects that no sales tax was charged to Petitioner on the transaction.

CONCLUSIONS OF LAW

1. Standard

We decide whether to grant Petitioner's motion for summary disposition in this use tax deficiency case. Summary disposition under MCR 2.116(C)(10) is intended to expedite litigation and avoid unnecessary and expensive hearings when no genuine issue of material fact exists. "A genuine issue of material fact exists when the record, drawing all reasonable inferences in favor of the nonmoving party, leaves open an issue upon which reasonable minds could differ." *West v General Motors Corp*, 469 Mich 177, 183; 665 NW2d 468 (2003). In deciding a motion for summary disposition under this rule, we must consider the pleadings, affidavits, depositions, admissions, and other documentary evidence then filed in the action or submitted by the parties in the light most favorable to the nonmoving party, in this instance, Respondent. MCR 2.116(G)(5); *Ritchie—Gamester v City of Berkley*, 461 Mich 73, 76; 597 NW2d 517 (1999). But such materials "shall only be considered to the extent that [they] would be admissible as evidence . . . ." MCR 2.116(G)(6); *Veenstra v Washtenaw Country Club*, 466 Mich 155, 163; 645 NW2d 643 (2002). The parties agree that Petitioner's motion can be decided by way of summary disposition, and so do we.

2. Background

Michigan's use tax, MCL 205.91 *et seq*, is an excise tax imposed for the "privilege of using, storing, or consuming tangible personal property in [Michigan]." MCL 205.93(1). The legal incidence of this tax falls on the consumer or purchaser. *Combustion Eng'g, Inc v Dep't of Treasury*, 216 Mich App 465, 468; 549 NW2d 364 (1996). In contrast, the General Sales Tax

Act, MCL 205.51 *et seq*, imposes a tax on the privilege of engaging in the business of making retail sales of tangible personal property in Michigan. *Terco, Inc v Dep't of Treasury*, 127 Mich App 220; 226; 339 NW2d 17 (1983). A retailer may include the amount of the tax in the selling price, but is not obligated to do so. *Id.* Therefore, although the tax is ordinarily passed on to the purchaser at retail, the retailer is obligated to pay the tax due and bears the direct legal incidence of the sales tax. *Sims v Firestone Tire & Rubber Co*, 397 Mich 469, 473; 245 NW2d 12 (1976); *Terco, supra.*

Although Michigan's sales and use taxes are imposed in different ways, they do not operate in isolation from each other. *General Motors Corp v Dep't of Treasury*, 466 Mich 231, 237; 644 NW2d 734 (2002). Rather, these taxes are complementary in the sense that the use tax applies only to transactions that would be subject to the sales tax but escaped, usually because the transaction occurs outside Michigan.[3] See *id.*; but see *Terco, Inc v Dep't of Treasury*, 127 Mich App 220, 229; 339 NW2d 17 (1983) (the tax is not limited to property brought into Michigan from other states); see also MCL 204.94(1)(a) (exempt from use tax if sales tax was "due and paid on the retail sale to a consumer"); MCL 205.94(1)(e) (allowing credit against use tax for sales, purchase, or use taxes paid in another state). Further, as explained by our Supreme Court in *Elias Bros Restaurants, Inc v Dep't of Treasury*, the exemption from use tax found at Section 4(a)(1) "is an expression of a legislative intent to avoid pyramiding of sales and use tax." 452 Mich 144, 153; 549 NW2d 837 (1996). In other words, a transfer of property that has already been subjected to Michigan's sales tax is not subject to this state's use tax. The Tribunal is asked to review numerous, specific, issues contested by the parties in which we must determine whether use tax was properly assessed; accordingly, we shall analyze each separately.

3. Cementing Invoices

a. Contractor/subcontractor

We first consider whether BJ Services was a subcontractor. Respondent assessed use taxes on Petitioner's purchase of raw materials, cement and other items from BJ Services. Petitioner claims that these taxes should not be assessed against it because Petitioner neither used nor consumed the cement as BJ Services was a subcontractor on the various turnkey well projects. As a result, according to Petitioner, any sales or use tax liability resulting from the purchase or use of those raw materials lies with BJ Services as the subcontractor-consumer. Respondent contends that, based on its examination of the various invoices, Petitioner purchased specifically itemized tangible personal property (i.e., the cement mixture) and installation services ancillary to its purchase. Respondent argues no contractor/subcontractor relationship existed between Petitioner and BJ Services. We disagree.

A construction contractor is considered to be the consumer of personal property, such as building materials, which are later incorporated into or become a part of real property; sales of

[3] Indeed, a purpose of the use tax is to prevent evasion of the sales tax. See MCL 205.93(1); *Banner Laundering Co v Gundry*, 297 Mich 419; 298 NW 73 (1941).

building materials by a contractor are subject to tax.[4] MCL 205.92(g); Mich Admin Code, R 205.71(2); *Miedema Metal Bldg Systems, Inc v Department of Treasury*, 127 Mich App 533, 534-537; 338 NW2d 924 (1983); See also *Sollitt Construction Company v Michigan Department of Treasury*, 6 MTT 505 (1990). The term "contractor" is defined in Mich Admin Code, R 205.71(1) as including "only prime, general, and subcontractors directly engaged in the business of constructing, altering, repairing, or improving real estate for others." The parties are in agreement that, based on this definition, Petitioner meets the definition of "contractor" and was "engaged in the business of constructing, altering, repairing, or improving real estate for others." The exhibits submitted in support of Petitioner's motion, together with the testimony of Mr. Brock and Mr. Molski, lend further support to this conclusion. While a construction contractor is subject to tax on its purchase of building materials and supplies to be later incorporated into a real estate construction project, the contractor cannot in turn charge its customer directly for any sales or use tax it incurs in the performance of its contract. Instead, the contractor may include the amount of any tax paid in the total contract price as part of builder's overhead. See RAB 1999-2.

Inasmuch as general contractors are "consumers" for purposes of sales or use tax liability on the building materials they purchase so too are subcontractors "consumers" in the performance of their contract to the general contractor. See Mich Admin Code, R 205.71(1) (including "subcontractors" among the definition of persons that are "contractors"). As a result, no sales or use tax liability rests with the prime or general contractor for the materials and supplies consumed by its subcontractors; the subcontractor is to build any tax liability it incurs for building materials and supplies into its contract price charged to the prime or general contractor.

Neither the statute nor the administrative code provide a definition of "subcontractor." In general, a subcontractor is a person who is awarded a portion of an existing contract by a prime or general contractor. See Black's Law Dictionary (8th ed, 2004). The subcontractor performs its portion of the work under a contract with a general contractor, rather than the principal who hired the general contractor. Although Michigan case law has not endeavored to specifically delineate the contractor/subcontractor relationship, determining whether someone is a subcontractor depends on the facts in each case, but is generally determined by: (1) The general contractor is under contract with an owner or one in position of an owner; (2) the general contractor occupies or is in control of the premises; (3) the general contractor entered into a subcontract; and (4) the general contractor entrusted a part of its work to the subcontractor on an independent versus dependent (i.e., as an employee) basis.

The parties do not dispute the presence of factors (1) and (2). The BJ Services Condition of Contract submitted as an exhibit by both parties establishes that Petitioner entered into a contract with BJ Services. While this contract explicitly classifies BJ Services as an independent contractor and is favorable in finding the existence of an independent contractor relationship, it does not definitively settle the issue. Nevertheless, we find factor (3) above is met.

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[4] There are limited exceptions to this general rule that apply to specific tax-exempt construction projects. Those exceptions do not apply here.

As to factor (4), an independent contractor is "one who, carrying on an independent business, contracts to do work without being subject to the right of control by the employer as to the method of work but only as to the result to be accomplished." *Candelaria v BC Gen Contractors, Inc*, 236 Mich App 67, 73; 600 NW2d 348 (1999). Neither the sales tax nor use tax acts set forth statutory criteria to be used in this regard. In the absence of statutory criteria, Michigan courts apply the common law "economic reality" test as the tool for discerning whether an employee-employer relationship exists. See *Hoste v Shanty Creek Management, Inc*, 459 Mich 561, 570; 492 NW2d 360 (1999). Although primarily applied in the context of tort and workers' compensation matters, courts have found the test instructive in other contexts as well. *Buckley v Professional Plaza Clinic Corp*, 281 Mich App 224, 234; 761 NW2d 284 (2008); see e.g., *Coblentz v Novi*, 475 Mich 558; 719 NW2d 73 (2006) (applying the test in a Freedom of Information Act case). The test is helpful in this case.

In applying the economic realities test, the courts generally consider the following four factors: "(1) [the] control of a worker's duties, (2) the payment of wages, (3) the right to hire and fire and the right to discipline, and (4) the performance of the duties as an integral part of the employer's business towards the accomplishment of a common goal." *Clark v United Technologies Automotive, Inc*, 459 Mich 681, 688; 594 NW2d 447 (1999). No one factor is dispositive as the list of factors is nonexclusive and a court may consider other factors as each individual case requires; it is the totality of the circumstances of the work performed that we must examine. *Buckley v Professional Plaza Clinic Corp*, 281 Mich App 224, 234-235; 761 NW2d 284 (2008).

The key feature that distinguishes an employee or agent from an independent contractor is the extent of control that may be exercised over the person in the performance of his or her duties. An agent or employee is subject to the control of the principal as to the means to be employed in the performance of the agent's work, whereas an independent contractor is not subject to control as to the method or means by which it produces the result contracted for. By extension here, if Petitioner retained control over the method of the cementing operations performed at the job site, than there was no contractor-subcontractor relationship and Petitioner may be appropriately regarded as the "consumer" of the goods and services furnished by BJ Services.

From the evidence presented, cementing a well is a complex and highly technical activity that requires specialized skills, expertise, and equipment to safely and properly perform. An improper or poorly executed cement job could lead to catastrophic failure with significant economic and environmental consequences. Petitioner did not possess the skills and equipment to accomplish this aspect of the work. Petitioner's evidence, including that through the testimony of Mr. Brock and Mr. Molski, plainly, clearly, directly, and unambiguously placed the preparation, engineering, testing, and control for cement work at the work site squarely on the shoulders of BJ Services.[5] These facts are contrary to Respondent's assertion that Petitioner

[5] In *DeShambo v Neilsen*, 471 Mich 27, 40; 684 NW2d 332 (2004), a tort case involving the inherently dangerous activity exception, our Supreme Court recognized that landowners often hire an independent contractor precisely because they want someone who "specialize[s] and routinely engage[s]" in the dangerous work and who is "better able to perform the activity in a safe manner."

controlled the method and manner of BJ Services' work, which would be required for a finding that Petitioner was the consumer of cementing services and supplies.

Respondent points to the fact that Petitioner was present on the job site when the cement work was being performed. This fact, according to Respondent, is indicative that Petitioner was in control of the cement work. The mere fact that Petitioner may have been present on the job site merely overseeing the project and monitoring general progress to ensure compliance with contract specifications as BJ Services was testing and pumping the cement does not necessarily mean that Petitioner was in control of the work. See *Plummer v Bechtel Const Co*, 440 Mich 646, 660; 489 NW2d 66 (1992). "[A] general contractor who 'has merely a general right to order the work stopped or resumed, to inspect its progress or to receive reports, to make suggestions or recommendations which need not necessarily be followed' would not be deemed to have retained control." *Id.*, quoting comment (c) to § 414 of Volume 2, the Second Restatement of Torts. We find that a contractor/subcontractor relationship exists between Petitioner and BJ Services.

b. Third-party Beneficiary

Respondent's final argument is that even if BJ Services is the party who bears the legal incident of the tax, Petitioner contractually accepted responsibility for the payment of taxes as evidenced by the BJ Services agreement. Respondent is essentially claiming a right to benefit from and enforce the terms of the agreement as a third-party beneficiary. Respondent is not a third-party beneficiary to the BJ Services/Petitioner agreement and may not recovery under this theory.

MCL 600.1405(1) states that "[a] promise shall be construed to have been made for the benefit of a person whenever the promisor of said promise had undertaken to give or to do or refrain from doing something *directly* to or for said person." [Emphasis added.] The statute's use of the word "directly" "indicates the Legislature's intent to assure that contracting parties are clearly aware that the scope of their contractual undertakings encompasses a third party, directly referred to in the contract, before the third party is able to enforce the contract." *Koenig v South Haven*, 460 Mich 667, 677; 597 NW2d 99 (1999). We need to look no further that the contract itself to determine whether a third-party beneficiary exists. *Schmalfeldt v North Pointe Ins Co*, 469 Mich 422, 428; 670 NW2d 651 (2003). To be found a third-party beneficiary of this agreement, Respondent needs to demonstrate not only that it is in a position to benefit from performance of the agreement, but also that there is "an express promise to act to the benefit of [Respondent]." *Kisiel v Holz*, 272 Mich App 168, 171; 725 NW2d 67 (2006), quoting *Dynamic Constr Co v Barton Malow Co*, 214 Mich App 425, 428; 543 NW2d 31 (1995). The relevant contractual clause states "[c]ustomer [Petitioner] agrees to pay all taxes based on or measured by the charges set forth on the face of this service order and field receipt." P Ex 17. Respondent fails to establish that the language of the agreement between BJ Services and Petitioner demonstrated an undertaking by Petitioner for Respondent's benefit. Accordingly, Petitioner is entitled to summary disposition on this issue.

4. Saw Dust and Kiln Dust Invoices

Respondent assessed Petitioner use tax on its purchases of saw and kiln dust from various Michigan vendors. Petitioner argues that the invoices from Meeder's Lumber Company and St. Mary's Cement Inc. for saw dust and kiln dust, respectively, reflect sales at retail and it was the retailers' responsibility to pay sales tax on the sale. [See P Ex 21.] Respondent disagrees and argues that Petitioner is liable for the use tax because it did not provide documentation to show that sales tax was paid on the transactions. Respondent also stated that "[t]he fact that the tangible personal property at issue was subject to sales tax does not prevent Treasury from assessing use tax." [R's Brief at 16.] This issue requires an analysis and application of the law recently announced by the Court of Appeals in *Andrie v Dep't of Treasury*, ___ Mich App ___; ___ NW2d ___ (April 26, 2012). At oral argument, Respondent contends that *Andrie* was wrongly decided and should not be followed. Respondent recognizes, however, that the Court of Appeals decision in *Andre* is binding on this Tribunal under MCR 7.215(C)(2),[6] and has presented no persuasive reasons for distinguishing *Andrie* from the present case.

Relying on *Combustion Eng'g, Inc v Dep't of Treasury,* 216 Mich App 465, 468; 549 NW2d 364 (1996), the Court of Appeals in *Andrie* held:

> In the present case, there is no dispute that the transactions in question involved Michigan retailers and transfers of title within the state of Michigan. Because the retailer has the ultimate responsibility to pay any sales tax, it is erroneous to place a duty on a purchaser to show that the sales tax was indeed paid to the state. *Combustion Eng'g,* 216 Mich App at 469. Thus, the transactions are not subject to use tax, and the trial court properly held in favor of plaintiff on this issue.

Andrie, supra, slip at 9.

Andrie extends the law beyond the facts of *Combustion Eng'g*. In *Combustion Eng'g,* the taxpayer was a general contractor engaged in the construction of improvements to real property. It was undisputed that Combustion Engineering actually paid sales tax to vendors that were not licensed under the sales tax act. *Id.* at 468. The department assessed the taxpayer for use tax related to purchases from the unlicensed vendors because Combustion Engineering could not prove that the vendors remitted the tax to the state. Recognizing that under MCL 205.94(a) the subject transactions were exempt from use tax only if sales tax was paid on the transaction the *Combustion Eng'g* Court held that the taxpayer, who had paid sales tax to the vendors, did not have the burden to prove that the unlicensed vendors actually remitted the sales tax to the state. ". . . [P]laintiff has no duty to prove that the sales tax that it paid to vendors was actually remitted to defendant." *Id.* at 469.

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[6] We are aware that on July 26, 2012, both the taxpayer and Respondent filed respective applications for leave in *Andrie*. Respondent also filed a motion to stay and a motion for immediate consideration. These facts, however, are of no moment as the court rule specifically provides that "[t]he filing of an application for leave to appeal to the Supreme Court or a Supreme Court order granting leave to appeal does not diminish the precedential effect of a published opinion of the Court of Appeals." MCR 7.215(C)(2).

The facts in *Andrie* were distinguishable from *Combustion Eng'g*, in that there was no evidence that the taxpayer in *Andrie* paid any sales tax to vendors located in Michigan, although the transactions were subject to sales tax. *Andrie, supra* at 9. Fully cognizant of the factual differences, the Court of Appeal in *Andrie* not only presumed that the seller remitted tax actually collected from the buyer at the point of sale, as in *Combustion Eng'g*, but also presumed that the Michigan seller filed a sales tax return remitting 6% of the purchase price to the state, even though it did *not* collect that amount from the buyer. See *id.* The court affirmatively found the taxpayer has no duty to "provide supporting documentation to show that sales tax had already been paid." *Id.* The law creates a rebuttable presumption that the Michigan seller paid the sales tax.

Here, there is no genuine issue of material fact that Petitioner purchased saw and kiln dust from Michigan sellers. Therefore, under *Andrie*, we apply a presumption in favor of Petitioner to establish that the seller was subject to and that sales tax was paid on the Michigan sales, unless rebutted by appropriate evidence that the tax was not paid. Respondent offered no proofs that various sellers did not pay sales tax as they were required to do.

Respondent posits that Petitioner may not have paid sales tax on the purchase of saw dust and kiln dust because it possesses an exemption certificate that prevented the charge of sales tax. Here we note that it is not fact that the purchaser may have acquired the goods pursuant to an exempt certificate that rebuts the *Andrie* presumption, but that the items were sold free of sales tax pursuant to an erroneously claimed certificate of exemption. However, Respondent offered no proof in support of its argument that the items in question were purchased pursuant to an exemption certificate in the first instance. While Mr. Molski admitted that Petitioner was in possession of an exemption certificate, he further testified that it is not possible that the certificate was presented to the retailer because the employee picking up the saw dust and kiln dust was a lower-level employee who would not be in possession of the exemption certificate. [Tr 51] Accordingly, the presumption that sales tax was paid by the seller has not been rebutted. Based on the above Findings of Fact, the presumption that the sales tax was paid by the Michigan seller on the expense items has not been rebutted, Petitioner is entitled to summary disposition on this issue as well.

5. Equipment rental

Petitioner next contends that Respondent erred in assessing use tax on 70 rental invoices with a combined taxable amount of $44,088.00. Petitioner argues that it is the lessor, and not Petitioner as the lessee, who bears the burden of the tax because the lessor is the party exercising the privilege of use, storage, or consumption of the property.

Michigan's use tax is intended to reach those purchases by Michigan consumers not subject to the sales tax act. Accordingly, the [burden] of the use tax falls on the consumer or purchaser, rather than the seller, because it is the purchaser that is exercising the taxable privileges of use, storage, or consumption in Michigan. MCL 205.93(1); see also *World Book, Inc v Dep't of Treasury*, 459 Mich 403, 415-416; 590 NW2d 293 (1999). In general, where one

purchases personal property for purposes of leasing it to others, sales or use tax is due on that transaction – the acquisition by the lessor, because at that time the lessor is a "consumer" or "purchaser" exercising the privilege of use, storage, or consumption. See *Terco, Inc v Dep't of Treasury*, 127 Mich App 220, 226; 339 NW2d 17 (1983) ("The legal incidence of the use tax falls on the consumer or purchaser"). This is because "use" means the "exercise of right or power" over the property "incident to the ownership of that property," which includes a "transfer of the property in a transaction where possession is given," i.e., a lease. MCL 205.92(b). Therefore, a lessor engages in a taxable "use" of its property when it leases its property as it is clearly exercising a right or power over the property incident its ownership of that property. *Devonair Enterprises, LLC v Dep't of Treasury*, ___ Mich App ___; ___ NW2d ___ (May 8, 2012) (slip op at 4).

Although sales or use tax is ordinarily due on the lessor's purchase of personal property, a lessor who is "engaged in the business of renting or leasing" may, however, elect to pay the use tax on its receipts from the rental or lease of the tangible personal property instead at the time the property is purchased or brought into Michigan. MCL 205.95(4); see also Mich Admin Code R 205.132 (so called "Rule 82" election). Where a lessor has made a Rule 82 election, the lessor typically passes the resulting tax on the periodic rental receipt on to the lessee, with the tax being separately stated on the invoice. We note, however, that while this is typically the case, neither the statute, rule, nor administrative guidance require the lessor to do so, as the lessor is liable for use tax on its total rental receipts.

Inasmuch as a Michigan lessor of tangible personal property is subject to sales or use tax on its purchase of personal property, a lessee may also be subject to tax on its lease or rental of tangible personal property in Michigan.[7] That said, however, there can be only one collection of the tax as the use tax is a complement to the sales tax and its legislative design was to cover those transactions not covered by the General Sales Tax Act. See *Master Craft Engineering, Inc v Dep't of Treasury*, 141 Mich App 56, 68; 366 NW2d 235 (1985). Inasmuch as the two taxes are complementary and the imposition of one precludes the imposition of the other; i.e., the two taxes are mutually exclusive. The legislative intent and purpose of the use tax was to serve as a conduit or means of collecting a sales tax from customers, as it provides for a more direct collection of the tax from the consumer where the purchase is made out-of-state. See *National Bank of Detroit v Dep't of Revenue*, 334 Mich 132, 144; 54 NW2d 278 (1952). Thus, while a lessee's in-state consumption of leased personal property "purchased" (by lease) from an out-of-state lessor may be subject to Michigan use tax, it is also established that when Michigan sales or use tax has been collected or paid by an in-state lessor, as it is required to do, the subsequent

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[7] The use tax is imposed on not just the use of personal property but also the privilege of "*consuming*" tangible personal property in Michigan. MCL 205.93(1). "Consuming" (as a verb) is not defined in the act, but "consumer" (as a noun) is defined as "the person who has *purchased* tangible personal property or services for storage, use, or other consumption in this state . . . ." MCL 205.92(g). And a "purchase" is an acquisition effected by a transfer of possession for consideration, which includes "rental in money." MCL 205.92(e). Therefore, a person "consumes" property that he or she has purchased, which includes the acquisition of the property by possession in exchange for consideration in the form of rent, i.e., a lease. This language supports a conclusion that the lessee of tangible personal property is also subject to use tax based on his, her, or its consumption of leased property in Michigan.

lease of the property is tax exempt. See *Kal-Aero, Inc v Dep't of Treasury*, 123 Mich App 46; 333 NW2d 171 (1983).

In this respect, we see no logical distinction between the imposition of use tax in the lessor/lessee context from that of the seller/purchaser in the retail sales context. In the present case, there is no dispute that the transactions in question involved Michigan lessees who leased equipment to Petitioner in Michigan. Because the lessor either paid sales tax when it acquired the items or has the ultimate responsibility to pay any use tax on the lease of its equipment, we extend the *Andrie* presumption here. Accordingly, Petitioner is entitled to a presumption that sales and/or use tax was paid by the lessor. Respondent has offered no proof to the contrary. The transactions are not subject to use tax, and Petitioner is entitled to summary disposition in its favor on this issue.

6. Motor Vehicle Transfers

Petitioner's final argument relates to Respondent's purported failure to apply a credit to Petitioner's use tax liability assessed in 2004, when Petitioner purchased the Canton Oil and Gas Company. Although most assets were exempt from use tax under MCL 205.94g, the exemption did not apply to purchase of the motor vehicles. Petitioner's Exhibit 24 is a check, dated June 21, 2004, payable to the State of Michigan for $41,982.00 for sales tax due on the vehicle purchase. Petitioner also submitted a June 8, 2004, letter from George Molski to Bill Green indicating Petitioner paid $14,118 in sales tax for transferring titles on the vehicles.[8] Exhibit 25. Petitioner contends that Respondent failed to apply a credit of $14,114 for the transfer tax paid to its use tax liability. Petitioner cites MCL 205.179 and MCL 205.191 in support of its proposition. MCL 205.179 states that:

> (1) there is levied upon and there shall be collected from every person in this state a specific tax on the privilege of storing, registering, or transferring ownership of any vehicle,
>
> * * *
>
> (3) A credit against the tax levied under subsection (1) is allowed for an amount equal to any use tax paid by the taxpayer on the same property. The credit under this section shall not exceed the tax imposed by this act.

Further, MCL 205.191 states that "[a]t the option of the taxpayer, the credits and refunds provided in this act may be applied to reduce the use tax due under the use tax act and the procedures implementing those use tax payment obligations." While Petitioner has established that it is entitled to a credit of the transfer tax paid, under MCL 205.179(1), subsection (3) limits the amount of that credit to an amount that "shall not exceed the tax imposed." MCL 205.179(3). Therefore, although Petitioner is not liable for additional use tax as a result of the

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[8] Although the June 8, 2004, letter states Petitioner paid sales tax, the individual Applications for Michigan Vehicle Title show that use tax was paid.

acquisition of motor vehicles, it is also not entitled to a refund as the credit applied cannot exceed the use tax imposed.

7. Costs and Fees

At the close of oral argument, Petitioner's counsel moved for an award of costs and attorney's fees. Generally speaking, litigation costs and legal expenses are not recoverable unless otherwise authorized by statute, case law, or contract. And the Tribunal is generally hesitant to award fees and costs. Nevertheless, Rule 145 provides that a prevailing party may be entitled to collect costs when provided for by the Tribunal in a decision or order. TTR 145.

While our rules permit an award of costs, they do not, of themselves, authorize an award of attorney's fees to the prevailing party. A prevailing party may recover attorney's fees through MCR 2.625(A)(2), as a sanction under MCL 600.2591(3), where the opposing party asserts, among other things, a "frivolous" defense. In practice before this Tribunal, MCR 2.625(A)(2) is incorporated through TTR 111(4). "Frivolous" means: (1) [t]he party's primary purpose in initiating the action or asserting the defense was to harass, embarrass, or injure; (2) the party had no reasonable basis to believe that the facts underlying that party's legal position were in fact true; or (3) the party's legal position was devoid of arguable legal merit. MCL 600.2591(3)(a)(i)-(iii).

Here, Petitioner is the "prevailing party" under MCL 600.2591(3)(b). Petitioner sought the cancelation of the assessment issued against it and we have so concluded here. Although Petitioner asserted a theory in its petition that it was exempt from use tax and later raised a setoff or claim in recoupment of transfer taxes on which Petitioner did not succeed, Petitioner nevertheless, prevailed on the whole record. See *Van Zanten v H Vander Laan Co, Inc*, 200 Mich App 139, 141; 503 NW2d 713 (1993) (when a party pleads different theories, each of which seeks to either recover or cancel the entire assessment, the party need only recover on one theory to be considered the prevailing party). In deciding whether to award fees, therefore, we address only the issue of whether Respondent's defense was "frivolous."

Respondent's position is not frivolous if Respondent acted reasonably in pursuing its litigating position on the basis of all the facts and circumstances and applicable legal precedents at the time it was asserted. See *Jerico Constr, Inc v Quadrants, Inc*, 257 Mich App 22, 35; 666 NW2d 310 (2003). Although Respondent's litigating position may have been incorrect in hindsight, it is not frivolous if the claim was premised on a reasonable belief that there is an arguable case. See *Robert A Hansen Family Trust v FGH Indus, LLC*, 279 Mich App 468, 486-487; 760 NW2d 526 (2008). And the fact that Respondent eventually loses a case does not establish that the position was frivolous. See *Kitchen v Kitchen*, 465 Mich 654, 663; 641 NW2d 245 (2002). We decide whether Respondent's position was frivolous by examining applicable facts and circumstances at the time Respondent asserted its position in its answer and at hearing. *Meagher v Wayne State Univ*, 222 Mich App 700, 728; 565 NW2d 1 (1997). Respondent's litigating position flowed from the following conclusions: (1) that Petitioner purchased cementing materials and supplies and used them in its turnkey well operations and/or (2) that

Petitioner failed to substantiate that it paid use tax, in the absence of the seller's invoice charge for sales tax.

Petitioner first contends that Respondent's audit determination was without a sound basis in fact, necessarily leading to a conclusion that Respondent's defense was frivolous by reference to the parties' settlement negotiations. We do not consider the parties' settlement negotiations in determining whether costs and fees should be levied. Further, whether Respondent ever considered settling this appeal or the reasoning behind why it ceased settlement negotiations does not imply that its position or defenses were frivolous.

Petitioner further argues that Respondent did not act in good faith during the audit process, which we infer means that Respondent's auditor used flawed methodologies or did not sufficiently investigate and research Petitioner's business or business operations and the context within which it was invoiced for goods and or services. As precedent too numerous to cite makes clear, the mistakenness of Respondent's position is not to be confused with its frivolity. In all litigation involving questions of law, there is ultimately one right – and one wrong – position. If Respondent just happens to be wrong, yet still advances, as here, with a reasonable argument, the prevailing party is not entitled to fee shifting. Although we may question some of Respondent's actions during the audit process with respect to the cementing invoices, we conclude that Respondent was simply wrong as to whom the user/consumer of the cement was. Had Respondent's factual conclusion been correct, then its litigating position would have been sustainable.

Finally, with regard to Respondent's lack of substantiation and equipment leasing claims, we decided these issues in Petitioner's favor based on the Court of Appeals recent decision in *Andrie v Dep't of Treasury*, ___ Mich App ___; ___ NW2d ___ (April 26, 2012), which was issued after both Petitioner and Respondent filed their respective motions and response and approximately one month before oral argument on the motions. As we mentioned, *Andrie* represents an extension of existing law regarding the burden of proof on such issue. Furthermore, *Terco, Inc v Dep't of Treasury*, 127 Mich App 220; 339 NW2d 17 (1983), and progeny, support Respondent's essential point that use tax applies not only to property brought into Michigan from other states but in-state purchases as well. Our evaluation of the facts and circumstances presented, as well as the legal environment from which Respondent's litigating position evolved, lead us to the conclusion in this case that Respondent's defense was not frivolous under the circumstances. We hold, therefore, that Petitioner is not entitled to an award of costs or attorney's fees.

We have considered carefully all remaining arguments made by the parties for a result contrary to that expressed herein, and, to the extent not discussed above, we consider them to be irrelevant or without merit.

To reflect the foregoing,

IT IS ORDERED that Petitioner's Motion for Summary Disposition under MRC 2.116(C)(10) is GRANTED.

IT IS FURTHER ORDERED that Assessment Number Q404455 is CANCELLED.

IT IS FURTHER ORDERED that Petitioner's Request for Costs and Fees is DENIED.

This Order resolves all pending claims in this matter and closes this case.

MICHIGAN TAX TRIBUNAL

Entered: AUG 20 2012 By: _____