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S.C. SUPREME COURT

THE STATE OF SOUTH CAROLINA
In The Supreme Court

APPEAL FROM THE ADMINISTRATIVE LAW COURT

H.W. Funderburk, Jr., Administrative Law Judge

Opinion No. Op. 5972 (S.C. Ct. App. filed March 1, 2023)

McEntire Produce, Inc. .... Petitioner,

v.

South Carolina Department of Revenue .... Respondent.

PETITIONER'S REPLY BRIEF

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TABLE OF CONTENTS

Page(s)

ARGUMENTS 1

I. THE SCOPE OF THE MANUFACTURING PROCESS FOR FRESH FOOD PROCESSORS MUST INCORPORATE THE DISPUTED ITEMS 1

II. PETITIONER HAS PRESERVED ITS ARGUMENTS REGARDING WHETHER THE PURCHASE OF DISPUTED ITEMS IS SUBJECT TO SALES AND USE TAX 8

III THE COURT OF APPEALS HAS CREATED A NEW, UNSUPPORTED "AS NEEDED" LIMITATION OF THE MACHINE EXEMPTION 19

CONCLUSION 22

TABLE OF AUTHORITIES

Cases

Chrome Deposit v. Indiana Department of State Revenue, 557 N.E. 2d 1110 (Tax Ct. Indiana 1990) 10
Hawes v. Custom Canners, Inc., 173 S.E.2d 40 (Ga. Ct. App. 1970) 4
Hercules Contractors and Engineers, Inc. v. S.C. Tax Comm'n, 280 S.C. 426, 313 S.E.2d 300 (1984) 5
Monroe v. Livingston, 251 S.C. 214, 161 S.E. 2d 243 (1968) 17
Nat'l Tube Co. v. Glander, 105 N.E.2d 648 (Ohio 1952) 4
Niagara Mohawk Power Corp. v. Wanamaker, 286 A.D. 446 (N.Y. 1955) 4
S.C. Dep't of Rev. v. Springs Industries, Inc., 2003-UP-029 (Ct. App. 2003) 5
Springs Industries, Inc. v. S.C. Dep't of Rev., Docket No. 99-ALJ-17-0153-CC (1999) 5, 17

Statutes

S.C. Code Ann. § 12-36-2120 2
S.C. Code Ann. 12-37-2120(17) 22

Regulations

S.C. Regs. § 117-302.5(C)(25) 19
S.C. Regs. § 117-302.1 10
S.C. Regs. § 117-302.1(e) 19
S.C. Regs. § 117-302.5 .... 3, 6, 10, 16
S.C. Regs. § 117-302.5(B)(5) 9
S.C. Regs. § 117-302.5(B)(5)(iii) 11
Treas. Regs. §117-302.3 16

Other Authorities

21 C.F.R. § 110.80 7
21 C.F.R. § 110.80(b) 15
21 C.F.R. § 117.93 7
S.C. Private Letter Ruling #90-3 10
S.C. Rev. Rul. #04-7 .... 5, 17
S.C. Tax Commission Decision 89-82 11

Pursuant to Rule 242(i) of the South Carolina Appellate Court Rules ("SCACR"), Petitioner McEntire Produce, Inc. ("Petitioner" or "McEntire") files this reply to the Respondent Department of Revenue's ("Department") Brief in response to this Court's certiorari review of the decision of the Court of Appeals styled *McEntire Produce, Inc. v. South Carolina Department of Revenue*, Op. No. 5972 (S.C. Ct. App. March 1, 2023) (Howard Adv. Sh. No. 8 at p. 23) ("Court of Appeals' Opinion"), which reversed the holding of the Administrative Law Court ("ALC") and found in favor of the South Carolina Department of Revenue ("Department"). Appendix ("App.") pp. 1-43 ("ALC Order").

ARGUMENTS

I. THE SCOPE OF THE MANUFACTURING PROCESS FOR FRESH FOOD PROCESSORS MUST INCORPORATE THE DISPUTED ITEMS.

Central to the Court of Appeals' conclusions in this case are the parameters of the manufacturing process and the role of each piece of tangible personal property at issue (the "Disputed Items"). For example, with respect to forklifts, pallet jacks, and their component parts (which constitute 7 of the 25 Disputed Items), even though the machines and their component parts were used in the climate-controlled/high care area and fed produce into the cutting room, App. p. 23-24, the Court of Appeals found they did not directly feed the first processing machine and thus were not tax-conveyance machines. App. p. 1320. However, this conclusion fails to recognize the unique concerns of a fresh food processor, which could only be ascertained by the finder of fact in this matter. For example, the ALC notes:

> Additionally, the Court finds that other items fall within the Machine Exemption because they are *integral and necessary to the manufacturing process by virtue of maintaining the integrity and safety of the finished food product by preventing its contamination....* State and federal agencies heavily regulate the fresh produce industry and dictate that certain requirements be met so that a product can safely enter the consumer marketplace. As such, *while many of the supplies at issue may not be used directly in the production line, they are integral and necessary to the*

> *processing of fresh produce under the Integrated Plant Concept and are integrated and harmonized as continuous and vital elements of production within the McEntire plant.*
>
> *Ever present in [McEntire]'s manufacturing process is the aspect of safety in producing a non-contaminated product, which is the subject of federal guidelines....*
>
> *It is evident that temperature and other environmental controls permeate the entire production process, from the time produce is harvested and delivered form the farms until the finished product leaves the McEntire plant.* In fact, testimony from Carter McEntire revealed that with the help of food safety engineers and experts, *the plant and much of the equipment inside of it was specially designed and built to correlate with the complete and other environmental controls that are required to reduce the possibility of food contamination.*

App. p. 26 (emphasis added).

In its current form, S.C. Code Ann. § 12-36-2120(17) exempts from sales tax the sale of "machines used in *manufacturing, processing, agricultural packaging*, recycling, compounding, mining, or quarrying tangible personal property for sale" (emphasis added) (the "Machine Exemption").[1] "Machines," according to the Machine Exemption, "include the parts of machines, attachments, and replacements used, or manufactured for use, on or in the operation of the machines and which ... are necessary to the operation of the machines and are customarily so used." § 12-36-2120(17).

The ALC Order (App. p. 22) found:

> In this case, the Court finds that given McEntire's highly regulated business as a fresh produce processor, the machinery and equipment used both before and after the actual production line processing of the fresh produce are integral and necessary not only to the overall manufacturing process, but also to the health and safety functions imbedded within the manufacturing of fresh produce. Without the processes that occur in the climate-controlled low-care areas of the plant, [Petitioner] would be unable to safely and efficiently produce a finished product for sale and distribution. These processes

[1] The term "agricultural packaging" was added to S.C. Code Ann. § 12-36-2120(17) on July 1, 2016, after the audit period in this case.

> contribute continuously and vitally to the plant's overall production and are also integrated and harmonized into the activities that occur directly in the production line, as conceived in the Integrated Plant Concept.

The ALC Order also stated (App. pp. 25-26) as follows:

> In this case, it is evident that temperature and other environmental controls permeate the entire production process, from the time the produce is harvested and delivered from the farms until the finished product leaves the McEntire plant. In fact, testimony from Carter McEntire revealed that with the help of food safety engineers and experts, the plan and much of the equipment inside of it was specially designed and built to correlate with the climate and other environmental controls that are required to reduce the possibility of food contamination.

S.C. Regs. § 117-302.5 provides a three-part test to determine whether a machine is "integral and necessary" to the manufacturing process:

> (1) The machine is used at a manufacturing facility. . . . It does not apply to machines used at a facility whose purpose is retailing, wholesaling, distributing, or some other non-manufacturing purposes.
> (2) The machine is used in, and serves as an essential and indispensable component part of the manufacturing process, and is used on an ongoing and continuous basis during the manufacturing process. A machine is not part of the manufacturing process merely because it is integral and necessary to the manufacturer.
> (3) The machine must be substantially "used in manufacturing . . . tangible personal property for sale." The statute does not required that the machine be used exclusively for manufacturing; however, incidental manufacturing use will not qualify for the exemption. For purposes of the exemption, more than one-third of a machine's use in manufacturing is substantial.

S.C. Regs. § 117.302.5(B). Only subpart (2) is at issue in this case.[2]

---

[2] Importantly, the Machine Exemption applies so long as 1/3 of the machine's use is devoted to manufacturing purposes. S.C. Regs. § 117-302.5 provides that in order to be exempt, the machine must be "substantially 'used in manufacturing...tangible personal property for sale.'" According to that regulation, "[t]he statute does not require that the machine be used exclusively in manufacturing; however, incidental manufacturing use will not qualify for the exemption. For purposes of the exemption, more than one-third of a machine's use in manufacturing is substantial." § 117-302.5(B)(1)(c). This means that a piece of machinery like a forklift can serve many purposes within a manufacturing facility and still be eligible for the Exemption, so long as the taxpayer can establish that more than 1/3 of its use is for manufacturing.

Generally, states follow one of two distinct lines of authority when determining what qualifies as machinery used in manufacturing: (1) the Integrated Plant Concept or (2) the "Ohio Rule". *See generally* Hellerstein, State Taxation, at § 14.05. The more restrictive Ohio Rule defines "manufacturing" as "essentially a transformation or conversion of material or things into a different state or form from that in which they originally existed." *Nat'l Tube Co. v. Glander*, 105 N.E.2d 648, 650 (Ohio 1952). Only those assets which physically transform raw materials during the manufacturing process into a different form are eligible for the exemption. In other words, "the test is not whether the property is essential to the operation of the plant but whether it is an actual part of the process of manufacture." *Hawes v. Custom Canners, Inc.*, 173 S.E.2d 40 (Ga. Ct. App. 1970).

On the other hand, the Integrated Plant Concept is less restrictive. As the name implies, machinery shall be eligible for the exemption if it performs an essential or indispensable function in the taxpayer's manufacturing operations, regardless of whether it actually causes a physical change. This test is derived from *Niagara Mohawk Power Corp. v. Wanamaker*, 286 A.D. 446 (N.Y. 1955). In finding that now material handling equipment including both coal handling and ash disposal equipment fell within the exemption (including the cranes and car dumper that unloaded incoming coal; conveyor belts that moved the coal to the boiler; crushers and sprayers that processed the coal; and slag lines that carried ash from the boiler), the *Niagara* court determined the relevant questions to be:

(1) Is the disputed item necessary to production?
(2) How close, physically and causally, is the disputed item to the finished product?
(3) Does the disputed item operate harmoniously with the admittedly exempt machinery to make an integrated and synchronized system?

The court found that the crane and car dumper were as essential to production as the generator itself, since a serious breakdown in operation would quickly stop or impair the output of

electricity. The court also noted that while some structures may not play as active a role as other parts, "activity is not the test of directness." Instead, "[t]he important thing is that all parts of the plant contribute, continuously and vitally, to production, and they are all integrated and harmonized."

In *Springs Industries, Inc. v. Department of Revenue*, 99-ALJ-17-0153-CC (1999), Chief Administrative Law Judge Kittrell acknowledged that Professor Walter Hellerstein, author of the above-cited treatise on state taxation, testified that South Carolina is classified as an "integrated plant theory state." In an unpublished opinion, the Court of Appeals affirmed the finding. It noted that although the Department urged the court to "interpret the term 'machines used in manufacturing' to include only items that are part of a production line," this position was "inconsistent with the result in *Hercules Contractors and Engineers, Inc. v. South Carolina Tax Commission*, 280 S.C. 426, 313 S.E.2d 300 (1984)] and the language in [§ 12-36-2120(17)] that only requires a machine to be 'used in manufacturing,' rather than 'used directly in manufacturing,' as the [Department] suggests." *S.C. Dep't of Revenue v. Springs Indus., Inc.*, 2003-UP-029 (Ct. App. 2003). Thus, South Carolina law provides that so long as the equipment in question performs an essential function in the taxpayer's manufacturing operations, it will qualify for the machine exemption to the sales tax. To reiterate: The Court of Appeals in *Hercules* held that machinery and its various parts and attachments are exempt if they are "integral and necessary to the operation of the system as a whole." In determining the entire facility to be exempt, the Court stated that "even its railings, walkways and ladders, which were required by state and federal laws and therefore 'necessary to the overall function' of the system were exempt." *Hercules*, 280 S.C. at 430, 313 S.E.2d at 303.

As a result of the *Hercules* and *Springs Industries* decisions, the Department issued S.C.

Rev. Rul. #04-7 and Regulation 117-302.5 to conform with these decisions. S.C. Rev. Rul. #04-7 states:

> Previously, the Department adhered to the "Production Line Theory" in determining what machinery was used in manufacturing. Under this theory, items were found to be exempt only if "used directly" in manufacturing process. Based upon the recent court decisions, the "Production Line Theory" will no longer be used. Instead, the court mandated machinery is exempt if such machinery is "integral and necessary" to the manufacturing process. This change is generally less restrictive than the Department's prior interpretation. As such, some machines that the Department would previously have held subject to the tax are exempt.

In this case, given Petitioner's highly regulated business as a fresh food processor, the tools and equipment used immediately before and after the actual processing of the fresh produce is integral to the overall processing/manufacturing process, as well as the health and safety functions. Without the process that occurs in these climate-controlled areas, it would seriously impair the ability of the taxpayer to efficiently and safely prepare a finished product for sale and distribution. The refrigeration itself, as well as the tools and equipment used therein, contributes, both "continuously and vitally, to production" and the assembly line production is surely "integrated and harmonized," as described in the Integrated Plant concept above. *See* App. p. 22 and *Niagara*, 286 A.D. at 449.

Moreover, as the ALC Order acknowledges, federal guidelines mandate all aspects of the refrigeration. According to Section VIII, Part C, Item 3, of the Food and Drug Administration's Guide to Minimize Microbial Food Safety Hazards of Fresh-cut Fruits and Vegetables, fresh–cut produce is recommended to be stored in areas with a temperature of less than or equal to 41 degrees Fahrenheit. App. p. 25. Regulations promulgated pursuant to the Food Safety Modernization Act of 2011, Section 117.93, provide even further requirements, mandating that any "[s]torage and transportation of food must be under conditions that will protect against allergen cross-contact and

against biological, chemical (including radiological), and physical contamination of food, as well as against deterioration of the food and the container." 21 C.F.R. § 117.93. Additionally, 21 C.F.R. § 110.80(b) provides:

> (b) Manufacturing operations. (1) Equipment and utensils and finished food containers shall be maintained in an acceptable condition through appropriate cleaning and sanitizing, as necessary. Insofar as necessary, equipment shall be taken apart for thorough cleaning.
>
> (2) *All food manufacturing, including packaging and storage, shall be conducted under such conditions and controls as are necessary to minimize the potential for the growth of microorganisms*, or for the contamination of food. One way to comply with this requirement is careful monitoring of physical factors such as time, temperature, humidity, aw, pH, pressure, flow rate, and manufacturing operations such as freezing, dehydration, heat processing, acidification, and refrigeration to ensure that mechanical breakdowns, time delays, temperature fluctuations, and other factors do not contribute to the decomposition or contamination of food.
>
> *(3) Food that can support the rapid growth of undesirable microorganisms, particularly those of public health significance, shall be held in a manner that prevents the food from becoming adulterated within the meaning of the act. Compliance with this requirement may be accomplished by any effective means.*

See also App. p. 25.

This regulation applies to Petitioner and is mandatory. App. p 166:19-25. Since keeping the temperature of this product at or below 41 degrees must be done to prevent contamination of our product, and must be stored (by Congressional Act) in certain areas of plant to prevent cross-contamination (storage racks are the only viable option) then it is considered continuous, on-going and integral to the manufacturing process and therefore exempt. Even once the product is loaded onto Petitioner's trucks, the 41-degree requirement must be met until it is ready to be sold inside a restaurant. Temperature recorders are required for refrigerated trucks to ensure that the product never went above this requirement at any time while in transit. In addition to federal law, customer

contractual requirements are equally as stringent.

Based on the foregoing, the ALC did not commit an error of law in expanding the exemption beyond those items used only in the cutting process. Instead, after taking the testimony of witnesses it recognized the highly specialized and highly-regulated nature of the food processing industry mandates a more expansive view of the manufacturing process to include activities both before and after the literal processing of the produce. Purchases of these items used in the manufacturing process are exempt from tax under the Machine Exemption.

II. PETITIONER HAS PRESERVED ITS ARGUMENTS REGARDING WHETHER THE PURCHASE OF DISPUTED ITEMS IS SUBJECT TO SALES AND USE TAX.

The Department alleges the Petitioner has not sufficiently challenged whether the disputed items were "machines used in manufacturing." However, the Department ignores the Petitioner's characterization of the Machine Exemption as it relates to Petitioner's manufacturing process, Petitioner's Brief at 9-11, which describes in depth the application South Carolina law to its specific process. It also emphasizes the ALC's characterization of Petitioner's manufacturing process, after listening to two days of testimony which included complex schematics (see, e.g., App. pp. 491-502) and testimony from McEntire employees and expert witnesses.

Further, the Department alleges that the Petitioner has abandoned its arguments regarding 23 of the 25 items at issue in this matter. That is simply not the case. To the contrary, the basis of Petitioner's argument is that the Court of Appeals ignored the extensive findings of fact established by the ALC regarding the use of the Disputed Items. In its Brief, the Petitioner specifically identified these discrepancies. Petitioner has relied on the ALC's characterization of the use and role that each of the Disputed Items plays in Petitioner's overall manufacturing operations. Petitioner does not dispute the ALC's characterization of these items. That reliance on the ALC's findings of fact and conclusions of law, quoted at length by Petitioner, cannot

conceivably be characterized as an abandonment of those issues. The following sections summarize the preservation of each of the 25 Disputed Items.

a. Protective Clothing – Coveralls, Eyewear, Gloves, Aprons, and Hairnets

The Department acknowledges the Petitioner has preserved its argument regarding whether the protective clothing at issue in this case qualifies for the Machine Exemption. And Petitioner agrees at first blush, protective clothing does not seem to fit the definition of machinery and equipment (any more than the ladders, walkways, and scaffolding in the *Hercules* case, or chemicals in a machine). *See* S.C. Regs. § 117-302.5(B)(5).

While Petitioner acknowledges the Department's published guidance provides that "[p]rotective clothing worn by an employee working in the area in which the manufacturing process occurs does not qualify as a machine and is not exempt from the tax as a machine used in manufacturing tangible personal property for sale under Section 12-36-2120(17)," that guidance is intended to apply to protect the worker's own clothing from dirt, paint, oils, etc. which are given off in the manufacturing process. On the other hand, as the ALC correctly noted,

> the protective clothing in this case is used for health and safety reasons to protect the product, the consumer, and the general public from foodborne illness. The clothing and gear at issue in this case is not used to protect the employee from hazards incurred during the manufacturing process.

App. p. 27. The clothing worn by Petitioner's workers serves a substantively different purpose than the protective clothing identified in the regulation. Petitioner's protective gear protects the produce from the worker (for the purpose of protecting the ultimate consumer). The protective gear puts a barrier between the end product – i.e., the chopped vegetable – and the workers entering the high care area. The protective gear is absolutely vital and is required by state and federal law as detailed above to maintain the physical environment necessary to produce Petitioner's finished product in a safe and unadulterated manner.

To reiterate, this position is consistent with the guidance in other states, including Massachusetts, Connecticut, and Indiana. In *Chrome Deposit v. Indiana Department of State Revenue*, 557 N.E. 2d 1110 (Tax Ct. Indiana 1990), for example, the Indiana Tax Court found that clothing worn to "prevent contamination of the product during production" qualified under the state's machine exemption, as it was "acquired for direct use in the direct manufacturing of other tangible personal property."

Further, we note that the Department already has significantly expanded the definition of "machine" through its published guidance well beyond established definition, including a "mechanical device" or a "collection of mechanical powers, parts [or] attachments." The following all qualify as "machines" for purposes of the Machine Exemption:

- "odorants purchased by gas companies" (§ 117-302.1(b)(a))
- "chemicals such as soda ash, alum, chlorine, etc., used in treating water for sale" (§ 117-302.1(b)(b))
- "refrigerants used by manufacturers to produce ice for sale" (§ 117-302.1(b)(c))
- "plates attached by a manufacturer to his product for identification" (§ 117-302.1(b)(e))
- "chemicals, greases, oils, lubricants and coolants" (§ 117-302.5(B)(5)(a))
- "chemicals used to clean the exterior or interior of an exempt machine" (§ 117-302.5(B)(5)(a)(iii))
- "chemicals used to prevent corrosion" (§ 117-302.5(B)(5)(a)(iv))
- "Traveling water screens" (§ 117-302.5(C)(2))
- "Tanks" (§ 117-302.5(C)(8))
- "Patterns" (§ 117-302.5(C)(9))
- "Boiler Tubes" (§ 117-302.5(C)(15))
- "insulation for pipe coverings, tank coverings, and boiler insulation" (§ 117-302.5(C)(30))
- "Parts or attachments to machines" (§ 117-302.5(B)(2)).

Like the protective clothing at issue in this case, these products only assume their "mechanical" nature once viewed in context of the entire manufacturing operation. Thus, if chemicals, stackliners, ash pond pipes, concrete and steel and metallic pool liner used to construct a gamma irradiator vault (S.C. Private Letter Ruling #90-3), liners used in radioactive waste

management services (S.C. Tax Commission Decision 89-82), storage containers with no moving parts (*Id.*), and the component parts of these products constitute "machines," then certainly the Department's attempt and the Court of Appeals' Opinion imposing a strict "mechanical" requirement is contrary to the Department's own guidance.

b. Floor Cleaning Chemicals

The Department contends Petitioner fails to challenge the Court of Appeals' Opinion with regarding the taxability of floor cleaning chemicals. However, Petitioner's challenge to the Court of Appeals' Opinion with respect to this issue is because that Court simply ignored the uncontradicted testimony presented at the hearing. To reiterate, although the Court of Appeals found "there was no testimony the chemicals were used on any exempt machines, they are not tax exempt," App. p. 1332, Mr. Carter McEntire testified "[w]e have an entire shift of sanitation where our sanitation technicians use this machine to take cleaning chemicals and both foam and sanitize the processing equipment." App. p. 88:18-22. He also testified this cleaning process was required by federal law. App. pp. 229:23-230:1. In response, the ALC Order found as a matter of fact that the chemicals were used to sanitize "the machines … in the high-care are" and that "both [were] used in the cutting room/high-care area to sanitize the machine and surfaces directly involved in the production line." App. p. 27.

Further, the findings of the ALC Order are supported by S.C. Regs. § 117-302.5(B)(5)(iii), which unequivocally exempts from sales and use tax "[c]hemicals used to clean the exterior or interior of an exempt manufacturing machine when the cleaning is integral and necessary to the manufacturing process, such as those that are essential in ensuring the quality of the product is maintained, and the use of such chemicals is an ongoing, continuous activity."

c. Floor Drain Covers

The Department contends Petitioner fails to challenge the Court of Appeals' Opinion with regarding the taxability of floor drain covers. However, Petitioner specifically addresses the nature of the floor drain cover, the factual findings regarding the use of the floor drain cover, and the Department guidance supporting such a position. See Petitioner's Brief at 26-28. Petitioner also identified the substantial evidence which the Court of Appeals disregarded in concluding the floor drain covers were not exempt with explicit citations to the record. *See id.*

d. Forklift Batteries, Forklift Parts, Forklift Repair Parts, Forklift Rental, Pallet Jacks, and Oil Lubricant for Hand Trucks and Pallet Jacks

The Department again contends Petitioner failed to preserve its argument regarding the taxation of forklift batteries, forklift parts, forklift repair parts, forklift rentals, pallet jacks, and oil lubricant for hand trucks and pallet jacks. However, the Petitioner addressed each of these items by reference to the ALC Order, which expressly both summarized the testimony provided with respect to each of these items and described the role each played in the manufacturing process. *See* Petitioner's Brief at 12-15. Petitioner also identified the substantial evidence which the Court of Appeals disregarded in concluding the floor drain covers were not exempt with explicit citations to the record. *See id.*

The factual record described by the ALC is crucial to Petitioner's position because it reflects the fact the Court of Appeals' ignored or overlooked the ALC's conclusions regarding how the forklifts and pallet jacks (and all of their component parts) were actually used by Petitioner in its manufacturing process.

e. General Maintenance Tools

The Department contends Petitioner fails to challenge the Court of Appeals' Opinion with regarding the taxability of general maintenance tools. However, Petitioner specifically addresses

the nature of the general maintenance tools, the factual findings regarding the use of the general maintenance tools, and the Department guidance supporting such a position. *See* Petitioner's Brief at pp. 24-25, 31-33. Petitioner also identified the substantial evidence which the Court of Appeals disregarded in concluding the general maintenance tools were not exempt with explicit citations to the record. *See id.*

Notwithstanding the Court of Appeals' imposition of an "as needed" limitation, discussed in Section III below, Petitioner contends the ALC Order clearly established the continuous and ongoing use of the general maintenance tools, which was especially necessary given Petitioner's unique manufacturing operations. According to the ALC Order, "[b]ecause the processing of fresh produce is regulated by climate control and other environmental controls, the cold and damp conditions inside the plant cause machinery to constantly require maintenance and repairs. Thus, general **Maintenance Tools (12)** that are used to maintain, repair, install and uninstall exempt machines inside of the plant are used on an ongoing, continuous basis and therefore fall within the Machine Exemption." App. p. 23 (emphasis in original). This is a factual determination the Court of Appeals ignored in inserting its own conclusion regarding the nature of the use of the maintenance tools.

f. Warehouse Racks, Blower Fans, Stacking Containers, and Pallet Flow Brakes

The Department contends Petitioner did preserve its argument with respect to warehouse racks but again failed to preserve its argument regarding the taxation of blower fans, stacking containers, and pallet flow brakes. However, the Petitioner addressed each of these items by reference to the ALC Order, which expressly both summarized the testimony provided with respect to each of these items and described the role each played in the manufacturing process. *See* Petitioner's Brief at 12-15. Petitioner also identified the substantial evidence which the Court of

Appeals disregarded in concluding this equipment was not exempt with explicit citations to the record. *See id.*

Additionally, in response to the Department's Brief, the items at issue here are component parts of Petitioner's refrigeration and cooling system. Petitioner uses the warehouse racks in storage coolers where palletized raw produce flows through from one side of the cooler to the other. App. p. 210:16-18. These racks help with efficiency, keeping the produce separated, and maintaining the temperature of the produce during storage. App. pp. 210:24-211:2. According to Mr. McEntire, "So what happens to the lettuce before it enters the cutting room it is stood in a rack system and that rack system is specifically designed to keep the product separated enough to allow air to flow across the storage container," App. p. 194:11-14, which in turn "enables [Petitioner] to maintain that [proper] temperature." App. p. 212:1-6. The ALC Order (App. p. 12) concluded the following with respect to the racks:

> These racks are specifically designed to assist in cooling and maintaining the required temperature of the produce during processing to avoid spoliation and prevent contamination. Since pallets cannot be stacked on top of each other due to cooling limitations, these racks are galvanized to withstand the cold, wet and humid atmosphere inside of the facility and to allow cold air to flow through the rack system and over the individual items of produce so that the temperature does not exceed 40 degrees. Because a temperature of 41 degrees or over means that [Petitioner] effectively has no product, maintaining the required temperature is essential to [Petitioner]'s manufacturing process.

Pallet flow brakes and stacking containers are part of the rack system, which is designed to efficiently cool produce in conjunction with its processing. Petitioner uses pallet flow brakes on the racks in the raw cooler areas. App. pp. 12, 213:18-22. Specifically, the pallet flow brakes slow down the speed of the pallets as they travel down the flow-through pallet system. App. p. 213:12-13. The ALC Order (App. p. 12) notes:

> The pallet flow brakes are used on the racks, which hold thousands of

> pounds of raw produce and finished product. The racks, which transport the produce into the cutting area, are potentially dangerous without the brakes as the pallets can fall off racks and injure employees. The brakes allow the 1,600 lb. pallets to rotate and flow through the facility at a safe rate. During the audit period, the pallet flow brakes were used in all three tomato coolers and in the raw cooler area

The ALC Order concluded with respect to warehouse racks, stacking containers, and pallet flow brakes:

> [T]estimony from Petitioner's witnesses showed that **Stacking Containers (6), Warehouse Racks (7), Pallet Flow Brakes (8),** and the **Blower Fan (11)** all work to maintain the proper temperature within the plant and also to hold and transport the produce before and after it is cut so that it cannot become adulterated or spoiled during processing, as outlined above in the FDA's Guide to Minimize Microbial Food Safety Hazards of Fresh-cut Fruits and Vegetables and in 21 C.F.R. § 110.80(b). Absent the climate and environmental controls provided by these machines, temperature inside of the plant and the temperature and integrity of the produce itself could not be maintained, resulting in an increased likelihood of contamination and/or adulteration. Without these machines, contamination occurs and McEntire would effectively have no product, thus making them integral and necessary to the manufacturing process under the general sales and use tax provision of the Machine Exemption. Additionally, in order to comply with the regulations governing the processing of fresh produce, these machines are integral and necessary to Petitioner's manufacturing process. As such, the Court finds that these items fall within the Machine Exemption.

Petitioner uses blower fans in both the high and low-care areas to move refrigerated air in order to maintain the mandated temperature level and to also filter any airborne contaminates. App. p. 250:9-23. The blower fans are used to maintain the temperature and they have a filtration system designed to remove pollution or contaminants that are in the area. App. p. 250:9-251:20. The ALC Order (App. p. 13) concludes:

> **(11) Blower Fan**
> Because the temperature in the facility must be maintained between 33-40 degrees, blower fans are used to circulate refrigerated air throughout the facility in both the high-care and low-care areas. Without the blower fans, [Petitioner] could not maintain the required temperature in the facility. Additionally, blower fans are used to prevent unfiltered air from entering

> the high-care area where air is filtered to an exact standard to maintain an elevated level of sanitation.

S.C. Regs. § 117-302.3 states "[t]his exemption [for fuel] applies to fuel used to control plant atmosphere as to temperature and/or moisture content, in the quality control of tangible personal property being manufactured or processed for sale." The Regulation also finds as exempt: "Machines used to condition air (including humidification systems) for quality control during the manufacturing process of tangible personal property made from natural fibers and synthetic materials." S.C. Regs. § 117-302.5(C)(24).

g. Water Tanks

The Department contends Petitioner failed to preserve its argument regarding the taxation of water tanks. However, the Petitioner addressed each of these items by reference to the ALC Order, which expressly both summarized the testimony provided with respect to the water tanks and described the role they played in the manufacturing process. *See* Petitioner's Brief at 20-21. Petitioner also identified the substantial evidence which the Court of Appeals disregarded in concluding the tanks were not exempt with explicit citations to the record. *See id.*

In addition, contrary to the Department's Brief, Petitioner utilized large water tanks both inside and outside the facility as part of its manufacturing process. The outside tank stores chilled water and mixes sanitation chemicals before the water is delivered to the high-care area to wash the produce. App. pp. 258:21-529:7. The inside tanks are in the high-care area; they recirculate some of the runoff water so that it can be used again in the processing of produce. App. pp. 14; 258:8-9; 118:21-24. Mr. McEntire testified: "[s]o water tanks are used throughout the facility but particularly in the high care area where we wash produce." App. p. 214:17-20. The water is "used to wash and sanitize the produce." *Id.*

The ALC found these water tanks exempt from use tax. App. p. 27. The ALC order noted:

> [t]hese tanks are essential to sanitize the produce and to prevent the spread of food contaminants or pollution during the cutting process by reducing the pathogens that may flow between the cutting machines, the produce and the run-off water. As such, [Petitioner]'s storage water tanks minimize the potential for the growth of microorganisms, prevent the contamination of food, and are integral and necessary to the processing of fresh produce and fall with the Machine Exemption.

In Revenue Ruling #04-7, the DOR summarized the *Springs* decision to hold that washing was an exempt function. The Revenue Ruling states at p. 7:

> In *Springs Industries, Inc. v. SCDOR*, 99-ALJ-17-0153-CC, the court held that the washing of a textile print screen was done specifically for the purpose of manufacturing a final product, that without washing the print screen would be rendered useless thereby preventing further manufacturing of the final product, and that the print screens could not be continually used without the screen washing machine. In addition, the print screen washing machine was located close to the production line machinery. As such, the court further held that the print screen washing machine was integral and necessary to the manufacturing process, was not a maintenance or repair machine, and was, therefore, exempt...

S.C. Regs. § 117-302.5(C)(8) also holds that "[t]anks which are a part of the chain of processing operations" are exempt. *See also Monroe v. Livingston*, 251 S.C. 214, 161 S.E. 2d 243 (1968) (machines used for "spraying, cleaning, candling, grading and packaging the eggs" were exempt).

h. Bar Code Scanners, Black Ink Aerosol Cans, Mobile Computer Stands

The Department again contends Petitioner failed to preserve its argument regarding the taxation of bar code scanners, black ink aerosol cans, and mobile computer scans. However, the Petitioner addressed each of these items by reference to the ALC Order, which expressly both summarized the testimony provided with respect to each of these items and described the role each played in the manufacturing process. *See* Petitioner's Brief at 15-17. Petitioner also identified the substantial evidence which the Court of Appeals disregarded in concluding this equipment was not exempt with explicit citations to the record. *See id.*

Additionally, in response to the Department's Brief, the Petitioner uses black ink aerosol cans and bar code scanners to trace the produce backwards one-step to the grower-shipper and forward one-step to the customer's distribution center. App. pp. 205:22-206:2; 220:25-221:4. This trace-back system is required by federal law. App. p. 205:24. Petitioner scans raw produce when it enters the facility, when the raw produce goes into processing, when it then goes into the finished goods area, and lastly when the produce goes from the finished goods section onto the refrigerated delivery trucks. App. p. 206:2-9, 11. The ink goes across a jet ink sprayer to spray a "use-through code" and a "lot code" onto a finished case of produce in the pack-out and repack areas of the Petitioner's facility. App. p. 220:10-16. In basic terms, the black ink aerosol cans label finished cases. App. p. 220:2-7. "The Lot Codes assist in the FDA trace-back process." App. p. 11.

Petitioner also uses a computer program to track its produce through the processing stages. App. pp. 236:24-237:1. Petitioner places computers on mobile computer stands in various parts of the facility so the employees can more easily track the process as the produce moves through the facility. App. p. 237:1-9. "The mobile computer stands are used by quality technicians, food safety technicians, and production operators to assist in the scanning and tracking of produce as it moves through the facility. While the stands themselves are not explicitly required by law, the critical care checkpoints at which the stands are used are required." App. p. 11.

These machines are a federal requirement so that the produce can be tracked (1) back to the farm, and (2) forward to the customer in the event contamination is subsequently found in the produce. Mr. McEntire testified that the need for a trace-back arises when a food-borne illness results in sickness or death and the FDA needs to determine the source of the illness. App. pp. 206:12-17; 220:23-221:15.

In S.C. Regs. § 117-302.1(e) the Department states that "plates attached by the manufacturer to his product for identification purposes" is covered by the machine exclusion. Presumably the vast majority of such plates are not required by federal law (for food safety purposes.) The Regulation also exempts "[r]ecording instruments attached to manufacturing machines." S.C. Regs. § 117-302.5(C)(25). Therefore, based on the foregoing, the ALC correctly applied the Machine Exemption to these items because federal law requires Petitioner to track the produce not only back to the harvest point, but also during the manufacturing process and forward to the consumer, thus finding them integral and necessary to Petitioner's manufacturing process.

III. THE COURT OF APPEALS HAS CREATED A NEW, UNSUPPORTED "AS NEEDED" LIMITATION OF THE MACHINE EXEMPTION.

The Department contends the Court of Appeals merely relies on application of the terms of "integral" and "necessary," rather than creating a new requirement to qualify for the Machine Exemption. However, based on a plain reading of the Court of Appeals' Opinion, there can be no other conclusion. In applying the Machine Exemption to Petitioner's purchases of maintenance tools and generator rentals, the Court of Appeals plainly rejected the substantial testimony of Petitioner and the ALC's own findings, in concluding the Machine Exemption did not apply because the evidence demonstrated Petitioner used these items on an "as needed" basis. App. p. 1322.

To demonstrate how this is a new, unfounded standard or requirement, we must look to the ALC's characterization of the use of those maintenance tools. The ALC's Order states:

> [Petitioner] uses maintenance tools to maintain, repair, install, and uninstall equipment. In the cold, damp environment of the facility, machinery wears out so quickly that *[Petitioner] has thirty (30) fulltime employees working continuously to repair and maintain equipment.*

App. p. 13 (emphasis added). The ALC Order also states:

> [Petitioner] employs thirty (30) fulltime employees who only work to maintain, repair, install, and uninstall equipment within the facility. Because the processing of fresh produce is regulated by climate control and other environmental controls, the cold and damp conditions inside of the plant cause machinery to constantly require maintenance and repairs. Thus, general ***Maintenance Tools*** *that are used to maintain, repair, install, and uninstall exempt machines inside of the plant are used on an ongoing, continuous basis* and therefore fall within the Machine Exemption.

App. p. 23 (emphasis added). The ALC thus found Petitioner had 30 full time employees and that those employees work "continuously" to maintain Petitioner's machines.

The Court of Appeals then rejected the ALC's factual findings that 30 full time employees were working on a continuous basis on general maintenance and found:

> [The Department] argues the general maintenance tools used to maintain, repair, install, and uninstall equipment are not used on an ongoing and continuous basis and, thus, do not qualify for the machine exemption. Regulation 117-302.5(B)(1)(b) provides a machine is integral and necessary to the manufacturing process *if it is "used on an ongoing and continuous basis during the manufacturing process." The evidence demonstrates McEntire uses its maintenance tools on an "as needed" basis.* Thus, they are not tax exempt.

App. p. 1322 (emphasis added).

The Court of Appeals held that maintenance tools were used on a "as needed" basis and thus were not used on an ongoing and continuous basis. By contrast, the ALC Order explicitly found as a matter of fact such tools were used "on an ongoing, continuous basis." Read literally, the Court of Appeals' Opinion render virtually all machinery and equipment subject to sales taxes for the simple reason that every machine and equipment is used on an "as needed" basis.

In the same vein, the Court of Appeals extended this newly-constructed "as needed" standard to manufacturers operating on a seasonal basis. As a fresh food processor, Petitioner by definition works on a seasonal basis, although crops are processed on a yearly basis from California and Mexico. There are a number of fresh food processors in South Carolina, and they are vital to

South Carolina's agricultural economy. In addition to selling salads and produce to grocery stores, they sell fresh food to multiple restaurants for inclusion in their dishes. The Court of Appeals' Opinion holds that equipment used on a seasonal basis like generators is not exempt.

The ALC found that for Petitioner,

> as a manufacturer of seasonal agriculture, the **Generator Rental (20)** during certain seasons to facilitate the manufacture of tomatoes is sufficient to constitute an ongoing and continuous basis so as to qualify for the exemption. In fact, it is the rental of the generators only on an as-needed, seasonal basis that makes their use ongoing and continuous. Otherwise, owning them and letting them sit dormant during the off-season would, under the logic provided by the Department, also disqualify them from the exemption. The seasonal use of equipment to manufacture a variable crop should be considered ongoing and continuous and, as such, the generator rental is integral and necessary to the tomato manufacturing process and falls within the Machine Exemption.

App. p. 24. In other words, according to the ALC's findings of fact, *Petitioner* could not operate on an "ongoing and continuous" basis *but for* the use of these generators. By contrast, the Court of Appeals' Opinion (App. pp. 1322-23) found:

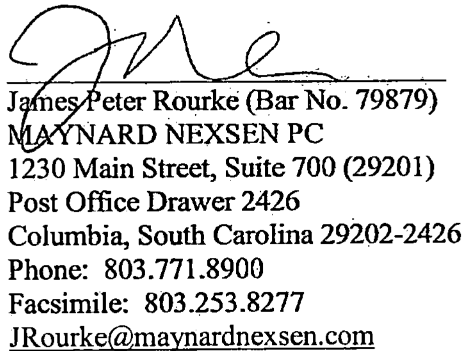
> Finally, [the Department] also argues the generator rentals are not used on an ongoing and continuous basis and, thus, do not qualify for the exemption. McEntire asserted the generators are used to speed up the ripening process and change the colors of the tomatoes and they are not used year-round because some crops do not need ripening. Because they are not used on an ongoing and continuous basis, they are not tax exempt. See Regulation 117-302.5(B)(1)(b) (providing a machine is integral and necessary to the manufacturing process if it is "used on an ongoing and continuous basis during the manufacturing process").

Read literally, the Court of Appeals' Opinion renders virtually every machine used by agricultural processors subject to sales taxes, as they are all used on a seasonal basis. Many, if not all, agricultural industries work on a seasonal basis, not just fresh food processors. Such an "as needed" limitation is not present in the Machine Exemption or any guidance produced thereto.

CONCLUSION

For the above-stated reasons, Petitioner respectfully requests that this Court reverse the Court of Appeals' Opinion and affirm the ALC Order in this matter, finding the Disputed Items qualify for exemption for sales and use tax pursuant to S.C. Code Ann. § 12-36-2120(17) and related guidance.

Respectfully Submitted,



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July 29, 2024
Columbia, South Carolina

THE STATE OF SOUTH CAROLINA
In The Supreme Court

The Honorable H.W. Funderburk, Jr., Administrative Law Judge

Case No. 17-ALJ-17-0060-CC
Appellate Case No. 2023-000973
Opinion No. 5972

McEntire Produce, Inc. .... Petitioner,

v.

South Carolina Department of Revenue, ... Respondent.

PROOF OF SERVICE

I do hereby certify that I have served on this 29th day of July, 2024 the Reply Brief by Petitioner in connection with the above-captioned matter by causing a copy of the same to be electronically mailed to Elisabeth W. Shields, Jason P. Luther and Dare P. Bailey, Attorneys for Respondent, at the below indicated addresses:

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