IN THE SUPREME COURT OF IOWA

NO. 18-0097

LOWE'S HOME CENTERS, LLC
Petitioner/Appellant

vs.

IOWA DEPARTMENT OF REVENUE AND COURTNEY M. KAY-DECKER
Respondents/Appellees

APPEAL FROM THE IOWA DISTRICT COURT FOR POLK COUNTY

THE HONORABLE LAWRENCE P. McLELLAN

POLK COUNTY NO. CVCV053336

APPELLANT'S FINAL BRIEF

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ROUTING STATEMENT

Appellant Lowe's Home Centers, LLC ("Lowe's") states that this appeal involves a substantial issue of first impression that affects the sales and use tax obligations of contractors, retailers, and customers purchasing installed real property improvements throughout Iowa. These questions involve fundamental issues of broad public importance that require prompt and final determination by this Court. Therefore, this Court should retain jurisdiction of this appeal. IOWA R. APP. P. 6.1101(2)(c), (2)(d), and (3).

This Court's ruling will necessarily impact contractors and purchasers of installed home improvements throughout Iowa. Under the Final Order, affirmed by the district court, the Department has now directed all Contractor-Retailers (and presumably all other contractors) installing home improvements in Iowa to split the transactions into two, pay tax on the installed materials, and collect additional sales tax from their customers on the labor components of their construction contracts. This directive stands in direct and irreconcilable conflict with the underlying Iowa tax statutes and the Department's own duly-promulgated Regulations interpreting those laws. The directive also conflicts with the manner in which home improvement transactions are taxed in other member states of the SST Agreement, thereby making Iowa an outlier on the issue.

STATEMENT OF THE CASE

NATURE OF THE CASE

This appeal addresses the sales tax consequences of Lowe's, (a "Contractor-Retailer") installing real property improvements into the homes of Iowa customers pursuant to written, lump-sum construction contracts ("Construction Contracts"). The home improvements at issue involved installed custom storm windows and doors, faucets, toilets, built-in dishwashers, ceiling fans, patio doors, interior and exterior doors, sinks, vanities, and garbage disposals. All installations resulted in real property receiving permanent capital improvements; none involved repair services.

The Iowa Department of Revenue (the "Department") correctly deemed Lowe's to be the general building contractor on such home improvement projects, and therefore the final user of the construction materials consumed in the installations. Simply stated, Lowe's made no retail sales of tangible personal property ("TPP") to customers subject to sales tax; rather, it sold installed real property improvements, which are not subject to sales tax in Iowa. Under Iowa law, the building contractor – Lowe's – is the party responsible for remitting sales and use tax on the cost of materials it consumes in making the improvements. This rule is embraced by nearly every state that imposes a sales tax. (*See*, *e.g.*, J.R. Hellerstein & W. Hellerstein, STATE TAXATION, ¶ 12.06[1]).

The Department, however, asserts that the homeowners who received the installed home improvements should have been separately assessed sales taxes on the incidental labor components of the construction projects. Since Lowe's did not collect this additional tax from its customers, the Department assessed Lowe's for the allegedly uncollected sales tax, plus interest (the "Assessment").

The Department insists the labor components of the Construction Contracts were separately subject to sales tax as enumerated services listed in IOWA CODE § 423.2(6) (the "Services Tax Act"). It also contends that the act of installing the home improvements was not sufficiently "large in scope" to constitute "services on or connected with new construction, reconstruction, alteration, expansion, remodeling, or the services of a general building contractor," services that are statutorily excluded from tax under IOWA CODE § 423.3(37) (the "Construction Activity Exclusion").

Lowe's contends that the Assessment is erroneous and illegal as a matter of law. Specifically, the Assessment violates Iowa law, the Department's promulgated Regulations, the state's commitments to uniformity under the Streamlined Sales and Use Tax Agreement ("SST Agreement")[1], and Lowe's

[1] Iowa, along with 22 other states and the District of Columbia, is a member of the SST Agreement. "The purpose of the Agreement is to simplify and modernize sales and use administration in order to substantially reduce the burden of tax compliance" and its goal is to promote, among other things, "uniformity in the state and local tax bases," "uniformity of major tax base definitions," and

constitutional rights to equal protection and due process. It is therefore (1) unconstitutional as applied against Lowe's; (2) inconsistent with one or more rules of the agency; (3) inconsistent with the agency's prior practices or precedents and not justified with credible reasons to indicate a fair and rational basis for the inconsistency; (4) based upon an irrational, illogical or wholly unjustifiable interpretation of the law; and (5) otherwise unreasonable, arbitrary, capricious, or an abuse of discretion. IOWA CODE §§ 17A.19(10)(a), (g), (h), (l), and (n). The district court erred in affirming the Assessment.

COURSE OF THE PROCEEDINGS

During 2007, the Department conducted a sales tax audit of Lowe's for the period January 1, 2004 through December 31, 2006 (the "Audit Period"). On January 17, 2008, the Department issued the Assessment, asserting that, in addition to the tax Lowe's already paid on the construction materials, Lowe's was separately liable for additional sales tax and interest that it should have collected from its customers on the installation labor. (Lowe's Home Centers, LLC Amended Protest, Ex. 1, Ex. 4; App. I, pp. 16, 28, 34-40). The Department claimed that this incidental work was independently taxable as enumerated repair services

(continued…)

"simplified administration of exemptions." *See Streamlined Sales Tax Governing Board, Inc.,* www.streamlinedsalestax.org/index.php?page=About-Us (last visited March 14, 2018).

under the Services Tax Act.[2] (*Id*. at App. I, pp. 16, 28, 34-40). Lowe's timely protested the Assessment on January 28, 2008. (*Id.* at App. I., pp. 16, 28, 34-40).

After several years of delay, the Department issued its final determination rejecting the protest (Lowe's Home Centers, LLC Amended Protest, Ex. 4; App. 34-40), and the matter proceeded to an appeal before Administrative Law Judge Christie J. Scase (the "ALJ"). The parties conducted discovery and submitted the matter to the ALJ for summary adjudication (Lowe's Home Centers, LLC Motion for Summary Judgment; Brief in Support of Lowe's Home Centers, LLC Motion for Summary Judgment, Lowe's Statement of Material Facts as to Which it Contends There is no Genuine Issue to be Tried; Iowa Department of Revenue's Motion for Summary Judgment; Iowa Department of Revenue's Brief in Support of Motion for Summary Judgment; Iowa Department of Revenue's Statement of Undisputed Facts; Iowa Department of Revenue's Response to Lowe's Home Centers, LLC's Statement of Undisputed Facts; Lowe's Home Centers, LLC Brief in Opposition to Iowa Department of Revenue's Motion for Summary Judgement; Iowa Department of Revenue's Reply Brief; Lowe's Home Centers, LLC Reply Brief; App. I, pp. 46-48; 49-92; 93-110; 111-113; 114-276; 277-286; 287-310; 311-346; 347-362; 363-378). The record included, among many other things,

[2] Under the Department's Regulations, however, if the installations were taxable as repair services, then the customer, and not Lowe's, would have been liable for sales tax on the entire lump sum charge. *See* 701 IAC 219.4.

deposition testimony of the Department's two designated representatives (Steve Campbell and Victoria Daniels; App. I, pp. 591-603, 604-617), unchallenged affidavit testimony from Craig J. Price, Lowe's Director of Sales and Use Tax (Affidavit and Supplemental Affidavit of Craig J. Price; App. II, pp. 7-267, 268-280), and extensive supporting documentation. On July 15, 2016, after conducting a hearing, the ALJ issued a "Proposed Order Granting Summary Judgment Affirming Department's Action" (7/15/16 Proposed Order; App. I, pp. 379-401). The ALJ agreed with the Department that (1) the installations were taxable as enumerated repair services under the Services Tax Act, and (2) the home improvements were not sufficiently large enough "in scale" to qualify as "new construction, reconstruction, alternation, expansion or remodeling of a building or structure" under the Construction Activity Exclusion. (*Id*. at 19-20; App. I, pp. 397-398).

On August 11, 2016, Lowe's appealed the Proposed Order to the Director of the Department of Revenue (the "Director")(App. I, pp. 402-435), who then conducted a hearing and, on December 13, 2016, issued her Final Order affirming the Proposed Order. (Director's Final Order; App. I, pp. 481-486). The Director, however, modified the Order to conclude that, under the definitions promulgated by the Department, the home improvement installations performed by Lowe's were ***not*** repair services. (*Id.* at 2; App I, p. 482).

Lowe's timely petitioned the Polk County District Court for judicial review of the Final Order. (Petition for Judicial Review; App. I, pp. 487-548). The district court conducted a hearing on June 30, 2017 (3/30/17 Transcript: App. I, pp. 628-632) and, on December 17, 2017, issued its Order affirming the Final Order and concluding that the Department's "application of the law to the facts with regard to the taxation of the installation contracts was not irrational, illogical or wholly unjustifiable." (Order re: Petition for Judicial Review, p. 16; App. I, p. 582).

This appeal followed. (Notice of Appeal; App. I, p. 588).

STATEMENT OF THE FACTS

Lowe's

Lowe's is a limited liability company organized under North Carolina law that operates 11 big-box, home improvement stores located throughout Iowa. (Craig Price Affidavit, ¶ 2; App. II, p. 8). Within these stores, Lowe's engages in two different types of customer transactions: (1) making retail sales of home improvement merchandise to customers; and (2) installing residential real property improvements into customer's homes pursuant to written Construction Contracts. (*Id*. at ¶ 3; App. II, p. 8.) Lowe's is licensed as a general building contractor under Iowa law (registration number C110383). (Amended Protest, ¶ 33; App. I, p. 23).

Over-the-Counter Retail Sales

When customers purchase retail merchandise at Lowe's, they select the products, take them to a checkout counter, and let the cashiers scan the barcodes to register the items into the store's computer system. The computer calculates and adds the sales tax, and the customers tender to the cashier payment and the corresponding tax, at which point the customers gain immediate possession of the items. The customers conduct these transactions "over the counter" and without written contracts. (Price Affidavit at ¶ 4; App. II, p. 8).

The Construction Contracts

When a customer engages Lowe's to install home improvements, however, he follows a different procedure. Lowe's typically begins by charging a detailing fee and assigning a subcontractor (an "Installer") to visit the customer's home and outline the scope of the proposed installation. Once there, the Installer prepares a written estimate of the anticipated quantity of construction materials and labor costs necessary to complete the project. With this information, Lowe's enters a description of the proposed home improvement into its point of sale system, which calculates the lump sum amount Lowe's will charge the customer for the completed home improvement. Lowe's prints this information on the face of a proposed Construction Contract. If the customer agrees to and executes the Contract, then Lowe's credits back the detailing fee. (*Id*. at ¶¶ 6-8, App. II, pp. 9-10).

The Construction Contracts require customers to pay the lump sum charges in full up front. Many Contracts attach schedules describing the types and estimated quantity of materials to be affixed to the customer's home, and the estimated costs of labor necessary to install the materials. Lowe's packages, sells, and performs the home improvements projects as single, consolidated, lump-sum transactions. (*Id*. at ¶ 10, Ex. A; App. II, pp. 11-12, 20).

The terms of the Construction Contracts require Lowe's to: (1) serve as the general building contractor to ensure that the installations are performed correctly; (2) complete each home improvement for the specified fixed price; and (3) absorb any excess costs if the actual labor and/or material costs necessary to complete a project exceed the amounts estimated in the Contracts. If any installation does not meet the customer's satisfaction, Lowe's arranges for the necessary remediation. (*Id*.). Lowe's is also "responsible to customer for obtaining any and all licenses and building permits which are legally required to perform the Contract," warrants "that the installation services will be performed in a good and 'workmanlike manner,'" and is responsible for the construction work "being performed in compliance with all applicable safety rules and all existing building codes, zoning ordinances and other laws." (*Id*.; App. Vol. II, pp. 13, 20).

Significantly, Lowe's retains title to all TPP and "[a]ny surplus materials upon completion of the Installation Services shall remain the property of Lowe's

and shall be returned to Lowe's by the Subcontractor." The customer does not own any TPP until after it is affixed to and incorporated into his home. (*Id.* at ¶¶ 11-13, Ex. A at 3; App. II, pp. 12-13, 20).

The Department's Regulations and Guidelines

The Regulations and Guidelines published by the Department collectively and unambiguously confirm that Contractor-Retailers like Lowe's who install permanent home improvements in Iowa must pay tax on the cost of the materials they consume in the installation process, but must ***not*** collect any sales tax on the installation labor from their customers. For example, 701 IAC 219.4, p. 4 (App. 318) instructs "dual" retailers, businesses like Lowe's that both sell merchandise over the counter and install real property improvements, as to when and how they must collect and handle sales taxes. The Regulation describes three, and only three, types of transactions that a dual retailer can provide to its customers:

(a) "A sale by a contractor-retailer of building materials, supplies and equipment which does not provide for installation of the merchandise sold is considered a retail sale and subject to sales tax."

(b) "Conversely, a sale by a contractor-retailer of building supplies, materials and equipment ***which provides for installation of the merchandise is considered a construction contract and tax shall be paid by the contractor-retailer based upon the cost of materials at the time the materials are withdrawn from inventory for use in a construction contract performed in Iowa***."

(c) "When a contractor-retailer does repair work, the contractor-retailer is acting as a retailer and not a contractor and must collect tax on the sales price charged for materials used in the repair and on the sales price charged for any labor used in the repair which is a taxable service on the entire charge if materials and labor are not separately invoiced."

(*Id*.) (emphasis added). The Regulation confirms that, in each scenario, only one tax is owed by only one taxpayer – either the customer (if it is a retail sale or a repair) or the Contractor Retailer (if it involves installation of building materials). The Regulation does not authorize either the Contractor-Retailer or the Department to arbitrarily split any of the listed transaction into two separate taxable events.

Similarly, the "Iowa Contractors Guide" published on the Department's website (*Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018); App. II, pp. 332-352) provides the following directives for Contractor-Retailers:

- Collects sales tax on the selling price when materials, supplies, and equipment are sold without installation.
- ***Performing a construction contract—does not collect sales tax from the final customer.***
- Performing a taxable service (repairs)—charges customers sales tax on labor and materials.

(*Id*. at p. 6; App. II, p. 337) (emphasis added).

The Guide specifically distinguishes the performance of a "construction contract" (Contractor-Retailer "does not collect tax from the final customer") from

the delivery of "repairs" ("a taxable service"). (*Id.*; App. II, p. 337). On the other hand, the Guide confirms that replacing built-in appliances (*e.g.*, a functional but outdated water heater, water softener, furnace or central air conditioning) with newer, more efficient built-in appliances always involves "reconstruction or remodeling" activity, services that are statutorily excluded from sales tax under the Construction Activity Exclusion. (*Id.*; App. II, p. 337).

These Regulations and Guides are written, published, and consistent with how other streamlined states that are parties to the SST Agreement treat Contractor-Retailers who install home improvements. They also answer in favor of Lowe's the very question at issue in this case. Nevertheless, the Assessment, the ALJ's Proposed Order, the Director's Final Order, and the district court's Order affirming the Final Order all inexplicably fail to follow or even mention any of these controlling Regulations and Guides.

The Evidence and Testimony Presented by Lowe's

In support of its Motion for Summary Judgment, Lowe's submitted to the ALJ, among many other things, copies of installation manuals describing the construction activities necessary to install each of the subject home improvements. Lowe's also provided unchallenged testimony that "[a]ll of the installation services at issue were intended to be 'on or connected with' the construction, reconstruction, alteration, expansion or remodeling of real property."

(Supplemental Affidavit of Craig J. Price, ¶ 5; App. II, p. 271). The Department submitted no evidence or testimony to controvert this testimony. *See, e.g.*, Deposition of Victoria Daniels at 34:9-13; App. I, p. 610; 6/30/17 Transcript at 35:21-36:3; App. I, pp. 631-632).

In affirming the Assessment, neither the ALJ nor the Director referenced or even acknowledged Craig Price's undisputed testimony. Both, however, nevertheless concluded "that the record failed to demonstrate that any of the installation contracts that were the subject of the dispute were part of projects constituting" construction, reconstruction, alteration, expansion or remodeling of real property, and thus excluded from sales tax. (Proposed Order – Granting Summary Judgment, p. 19; App. I, p. 397; Director's Final Order; App. I, pp. 481-485). And in affirming the Final Order, the district court accepted, without comment, the Director's unsupported determination "that Lowe's failed to meet its burden that these activities were subject to the exemption." (Order re: Petition for Judicial Review, p. 11; App. I, p. 577).

ARGUMENT

I. THE SERVICES TAX ACT DOES NOT IMPOSE SALES TAX ON INCIDENTAL LABOR ASSOCIATED WITH INSTALLING PERMANENT REAL PROPERTY IMPROVEMENTS.

A. STANDARD OF REVIEW

On an appeal from judicial review of an agency action, this Court's review is for correction of errors of law. IOWA CODE § 17A.19(8). "[T]he meaning of a statute is always as matter of law, and final construction and interpretation of Iowa statutory law is for this court." *Sorg v. Iowa Dep't of Revenue*, 269 N.W.2d 129, 131 (Iowa 1978). In reviewing the Department's interpretations of its own published Regulations, the Court's standard of review is *de novo*. *AOL LLC v. Iowa Dep't of Revenue*, 771 N.W.2d 404, 407-8 (Iowa 2009). While the Department has authority to promulgate rules that reasonably interpret Iowa's sales tax statutes, *Ranniger v. Iowa Dep't of Revenue & Fin.*, 746 N.W.2d 267, 268 (Iowa 2008), and such rules are themselves entitled to judicial deference, the Court is not bound by the agency's determinations, *Heartland Lysine, Inc. v. Iowa Dep't of Revenue & Fin.*, 503 N.W.2d 587, 588 (Iowa 1993), and the Department's proposed interpretations of its own promulgated rules are not entitled to ***any*** deference under IOWA CODE § 17A.19(10)(c). *See AOL*, 771 N.W.2d at 408.

Moreover, unpublished "policies," such as the Department's unilateral declaration that "in order for an installation service to constitute reconstruction, alteration, expansion, remodeling [and thereby be excluded from sales tax], it has to involve a structural change to the home or building" (Deposition of Steve Campbell at 9:7-15; 31:18-24; App. I, p. 593, 599), are similarly not entitled to judicial deference. *See The Sherwin-Williams Co. v. Iowa Dep't of Revenue*, 789

N.W.2d 417, 422 (Iowa 2010) (holding that "only an agency's 'official' interpretation of a statute is entitled to deference"); *see also Sorg*, 269 N.W.2d at 131.

B. PRESERVATION OF ISSUE FOR REVIEW

Lowe's preserved error on this issue by raising it with the district court in its Brief and at the hearing held on June 30, 2017. (*See* App. I, pp. 537-548; App. I, pp. 628-632). It further raised the issue in its Briefs and at hearings in each stage of the underlying administrative proceeding in its timely appeals of (1) the tax assessment on January 28, 2008. (App. I, p. 7-28); (2) the ALJ's adverse Proposed Order (App. I, p. 402-415); and (3) the Director of the Department of Revenue's adverse Ruling (App. I, pp. 487-501).

C. ARGUMENT

1. The Services Tax Act

While retail sales of tangible personal property are generally subject to sales tax in Iowa, the delivery of services is generally not, unless the Legislature has statutorily enumerated the specific service as taxable. The Services Tax Act enumerates 66 categories of services that are subject to sales tax in Iowa. As this Court has observed: "[t]he majority of the enumerated acts involve repair of various kinds of real and personal property." *Sorg*, 269 N.W.2d at 132. The list includes the following:

(1) alteration and garment ***repair***;
(3) vehicle ***repair***;
(8) boat ***repair***;
(11) ***carpentry***;
(12) roof, shingle, and glass ***repair***;
(15) dry cleaning;
(16) pressing, dyeing, and laundering;
(17) electrical and electronic ***repair*** and installation;
(19) farm implement ***repairs*** of all kinds;
(21) furniture, rug, carpet, upholstery ***repair*** and cleaning;
(22) fur storage and ***repair***;
(24) gun and camera ***repair***;
(26) ***household appliance***, television & radio ***repair***;
(27) janitorial & building ***maintenance*** or cleaning;
(28) jewelry and watch ***repair***;
(29) lawn care, landscaping, tree trimming & removal;
(32) machine ***repair*** of all kind;
(33) motor ***repair***;
(34) motorcycle, scooter & bicycle ***repair***;
(36) office and business machine ***repair***;
(41) ***pipe fitting and plumbing***;
(48) sewing and stitching;
(49) shoe ***repair*** and shoeshine;
(53) swimming pool cleaning and ***maintenance***;
(59) tin and sheet metal ***repair***;

(Iowa Code § 423.2(6)) (emphasis added).

The statute does not specify the scope of activities that fall within each category of enumerated repair services. Therefore, in determining whether a particular service falls within the statute's reach, the Court must strictly construe the Services Tax Act against the applying the tax to a service and liberally in favor of the taxpayer. "It must appear from the language of the statute the tax assessed against taxpayer was clearly intended." *Sorg*, 269 N.W.2d at 132 (quoting *Scott*

Cty. Conservation Bd. V. Briggs, 229 N.W.2d 126, 127 (Iowa 1975). Moreover, "[u]nder the guise of construction, an interpreting body may not extend, enlarge, or otherwise change the meaning of a statute." *Auen v. Alcoholic Beverages Div., Iowa Dep't of Commerce*, 679 N.W.2d 586, 590 (Iowa 2004).

The Department can promulgate rules to provide its interpretation of the statute, but the "adoption of administrative rules which are at variance with the statutory provisions or which amend or nullify legislative intent exceeds the Department's authority." *Sorg*, 269 N.W.2d at 131 (citing *Schmitt v. Iowa Dep't of Social Servs.*, 263 N.W.2d 739, 745 (Iowa 1978)).

Although the Services Tax Act does not define the types of activities that fall within each category of enumerated taxable services, the Department's published Regulations and Guides do, and they clearly and collectively confirm that only repair services, and not capital improvement projects, can be subject to sales tax. "A repair contemplates an existing structure or tangible personal property which has become imperfect and constitutes the restoration to a good and sound condition. A repair is not a capital improvement; that is, it does not materially add to the value or substantially prolong the useful life of the property." 701 IAC 219.13(1), p. 13.

Of the categories enumerated in the Services Tax Act, the Department identified only three that it contends were applicable to Lowe's installations: (1)

"carpentry"; (2) "electrical and electronic repair and installation"; and (3) "pipe fitting and plumbing." (Deposition of Steve Campbell at 29:13-18, 77:2-11; App. __). The Regulations, however, confirm that the capital improvements installed by Lowe's plainly fell outside the Services Tax Act's reach.

2. The Regulation Defining "Carpentry" – (701 IAC 26.12)

For example, 701 IAC 26.12, p. 6 ***expressly*** limits taxable "carpentry" services to repairs: "Persons engaged ***in the business of repairing***, as a carpenter, as the trade is known in the usual course of business, are rending, finishing or performing a service, the gross receipts from which are subject to tax." Under this official definition, carpentry services that do not relate to repairs, such as installing custom store doors or windows, are not subject to tax. The Assessment, however, simply ignored this regulatory definition.

3. The Regulation Dealing With Household Appliances – (701 IAC 26.26)

Many of the Construction Contracts at issue involved installations of "household appliances," such as built-in dishwashers and garbage disposal systems. The Department's Regulations unambiguously confirm that only ***repairs*** of existing appliances can be subject to sales tax:

> **Household appliance, television and radio repair.** Persons engaged in the business of ***repairing household appliances***, televisions sets, or radio sets, but not including installation of new parts or accessories which are not replacements, are rendering, furnishing or performing a service, the gross receipts from which are subject to tax. "Repair"

> shall include mending or renovation of existing parts of such household appliances, television sets and radio sets, as well as replacing defective parts of such articles. ***"Household appliances" shall include all mechanical devices normally used in the home***, whether or not used therein.

701 IAC 26.26, p. 11 (emphasis added).

Despite this Regulation, the Department assessed sales tax on Lowe's installations of brand-new built-in appliances, claiming that the work involved repairs and did not "constitute the activities of new construction, reconstruction, alteration, expansion or remodeling." (Iowa Department of Revenue's Brief in Support of Motion for Summary Judgment, p. 17; App. I, p. 130; Iowa Department of Revenue's Reply Brief, p. 3; App. I, p. 349). Again, the Assessment simply ignored this Regulation.

4. The Contractor-Retailer Rule – (701 IAC 219.4)

Most significantly, the Department promulgated an array of rules, collectively titled "Sales and Use Tax on Construction Activities," that provide detailed instructions to contractors as to how to handle sales tax in Iowa. 701 IAC 219.4, pp. 4-5 (App. II, pp. 318-319). Among these is the "Contractor-Retailer Rule," which is directed at "Contractors, Subcontractors or Builders who are Retailers." Subpart (b) of this Rule provides that "a sale by a contractor-retailer of building supplies, materials and equipment which provides for installation of the merchandise is considered a construction contract and tax shall be paid by the

contractor-retailer based upon the cost of materials at the time the materials are withdrawn from inventory for use in a construction contract performed in Iowa." (*Id*. at 4; App. II, p. 318).

It is undisputed that Lowe's fully complied with this directive. (Deposition of Steve Campbell at 49:5-8; 55:2-8; App. I, p. 601, 602). The Contractor-Retailer Rule does not mention any separate obligation to collect additional sales tax from customers.

5. The "Iowa Contractors Guide"

Similarly, the Department publishes its "Iowa Contractors Guide" on its website to provide specific sales and use tax instructions to contractors. *Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018). (App. II, pp. 332-352). The Guide broadly defines a "construction contract" as one that "involves changing tangible, personal, or moveable property into real estate" and a "construction contractor" as including a "contractor retailer." (*Id*.). The Guide also confirms that a "construction contractor" is the "consumer of building materials and supplies purchased for use in construction contracts" and therefore "responsible for paying sales tax at the time the purchases are made or directly to the Department." (*Id*.).

When the Department agreed that Lowe's correctly remitted use tax on the materials it consumed in performing the Construction Contracts, it conceded that

Lowe's was a "construction contractor" performing a "construction contract." Moreover, the ALJ expressly found that Lowe's was acting as a general building contractor when it installed the home improvements and, as such, had correctly remitted use tax on the cost of its materials:

> When a homeowner contracts with a contractor for a home improvement, the homeowner is not responsible for payment of sales tax on the sale of taxable personal property used for the project. Rather, the building contractor is deemed the consumer or final user of tangible personal property that the contractor buys and uses to complete the project.

(Proposed Order – Granting Summary Judgment, p. 10; App. I, p. 388). Since the Department adopted this finding in its Final Order, it is now the law of this case that Lowe's, when installing real property improvements into its customers' homes pursuant to Construction Contracts, was a "Contractor-Retailer" performing a "Construction Contract" and providing the "services of a general building contractor," all as unambiguously defined in the Regulations.

The Contractors Guide ***expressly*** instructs Contractor-Retailers that any installation labor they provide pursuant to a "Construction Contract" ***must be excluded from sales tax*** – the Contractor-Retailer "***does not collect sales tax from the final customer***." *Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018). (App. II, pp. 332-352). The Department's directive on this point simply cannot be clearer.

Yet, in concluding that Lowe's should have nevertheless collected sales tax from its final customer on its general construction activities, the ALJ, the Director, and the district court all collectively failed to acknowledge that: (1) 701 IAC 26.12 expressly limits the carpentry services subject to tax to "repairs"; (2) 701 IAC 26.26 similarly limits the tax relating to "Household Appliances" to repairs; (3) the Contractor-Retailer Rule, 701 IAC 219.4, exists and answers the overarching issue in favor of Lowe's; or (4) the Iowa Contractor's Guide does so as well.

6. The Predominant Service Rule -- (701 IAC 26.1)

Finally, yet another Regulation provides that "if the predominant service being performed is a nontaxable service," such as installing a permanent capital improvement to real property, "then the entire fee charged for the transaction is not subject to Iowa tax." 701 IAC 26.1(2), p. 1. The Iowa Tax Review Committee explained this "Predominant Service Rule" in a 1976 published ruling which addressed a taxpayer's installation of an air conditioning system:

> Some enumerated services may be involved with the installation of the air conditioning equipment such as electrical installation and pipe fitting and plumbing services. ***However, these enumerated services were incidental to the overall installation of the air conditioning equipment. It has been the Department's position that, where a named service is incidental to a service not specifically enumerated, the entire service is not subject to tax.*** Therefore, it is the position of the Committee that the installation of air conditioning systems, whether a new installation or a replacement, is exempt from the sales tax.

(Iowa Tax Review Committee's 1976 Ruling of Brief in Opposition, p. 3; App. II, 355). The Department has not since promulgated any regulation to alter or limit this ruling.

According to the district court: "Reviews of the requirements for installation demonstrated that services associated with carpentry, electrical and electronic installation and plumbing are needed." (Order re Petition for Judicial Review, p. 12; App. I, p. 578.) While that may be true, that labor was incidental to the overall installations of the permanent real property improvements, which in Iowa were not subject to sales tax. The homeowners were not purchasing carpentry or pipefitting repair services from a "repairperson"; they were buying brand-new, installed home improvements from a "construction contractor." As Lowe's testified: "***All of the installation services at issue were intended to be 'on or connected with' the construction, reconstruction, alteration, expansion or remodeling of real property***." (Supplemental Affidavit of Craig Price ¶ 5; App. II, p. 271). Under the Predominant Service Rule, the incidental labor portions of the Construction Contracts were not subject to sales tax.

The language of the Services Tax Act, coupled with the consistent directives of the Regulations interpreting that Act – *e.g.*, the definitions of taxable carpentry and home appliance repair services, the Contractor Retailer Rule, the Iowa Contractors Guide, and the Predominant Service Rule – collectively confirm the

Legislature's intent in enacting the statute: The enumerated carpentry, electrical and pipefitting services subject to sales tax in Iowa do not include incidental labor directed toward making permanent capital improvements to real property pursuant to construction contracts.

7. The Evolving Justifications for the Assessment

Although the Director ultimately concluded in her Final Order that the services at issue were not performed in the context of "repair" as that term is used in the Department's rules (Director's Final Order, p. 2; App. I, p. 482), the Department initially insisted that the "labor charges at issue all pertain to repairs to residences." (Iowa Department of Revenue's Motion for Summary Judgment, p. 2; App. I, p. 112). In the Proposed Order, the ALJ agreed with this characterization and upheld the Assessment by concluding, as a matter of law, that the installation services were all enumerated repair services:

> To assist in distinguishing construction projects on which enumerated services are exempt from sales tax from projects that will not support the exemption, Rule 219.13 essentially classifies enumerated building trade services into two categories: capital improvements and repairs; with "repairs" defined to include not only mending, restoring or maintaining an item, but also replacing an item.
>
> * * *
>
> Whether the installed sales contracts at issue involve repairs, as that term is defined within rule 219.13, is not a matter of fact but a question of law. Repair is defined in rule 219.13(1) as being "synonymous with mend, restore, maintain, replace, and service." The nonexclusive list of examples within the rule makes clear that the

> replacement of a defective window, appliance, or door, or damaged roof shingles, is a repair.

(Proposed Order – Granting Summary Judgment, pp. 19-20; App. I, pp. 397-398).

But in the Department's Final Order, the Director rejected this entire analysis and concluded, in light of the applicable law and undisputed facts of record, that the installation services at issue could ***not*** be deemed repairs:

> The Administrative Law Judge determined that the services performed were connected to "repairs" as defined in Iowa Administrative Code rule 701-219.13(1) because they amounted to replacing tangible personal property . . . The Director disagrees with this interpretation of the legal term "repair." In order to be a repair, the item being replaced must be defective, damaged, or in some way not in sound condition. Iowa Admin. Code r. 701-219.13(1)(423) ("A repair contemplates an existing structure or tangible personal property which has become imperfect and constitutes the restoration to a good and sound condition.") ***There is no evidence in the record that the items being replaced were defective, damaged, or in unsound condition. . . The Director concludes that the services at issue were not performed in the context of "repair" as that term is defined in the Department's rules***.

(Director's Final Order, p. 2; App. I, p. 482) (emphasis added).

As a matter of law, this conclusion effectively and properly removed all of the installations from the reach of the Services Tax Act, as interpreted by the Department in its Regulations. The Department has repeatedly acknowledged that the only activities that can be performed "on or connected with" a building or structure "***are either repairs or new construction, reconstruction, alteration, expansion, or remodeling***." (Iowa Department of Revenue's Reply Brief, p. 3;

App. I, p. 349). By definition, if "the services at issue were not performed in the context of 'repair' as that term is defined in the Department's rules" (*id*.), then they were necessarily "new construction, reconstruction, alteration, expansion or remodeling." Nevertheless, the Director added, without further explanation, that "the sales of the services at issue are subject to tax." (*Id*.).

8. The District Court's Order

In affirming the Final Order, the district court concluded:

> The director concurred in the ALJ's ultimate conclusion to assess the tax except the director found that the installation contracts did not involve repairs. In reaching this conclusion the director noted that rule 701-219.13 provided that taxes on enumerated services could not only be assessed to repairs but also to installation work that is not a construction activity. The director determined that simply because the TPP became part of the real property after installation was not enough to constitute the activities of new construction, reconstruction, alteration, expansion, or remodeling. As did the ALJ, the director determined that this exemption required a "project larger in scale than the replacement of windows, doors, or a built-in appliance."

(Order re: Petition for Judicial Review, p. 11; App. I, p. 577).

Separately, the district court accepted the Department's bottom line conclusion that 701 IAC 219.13 – the very Regulation cited by the Director to conclude that sales tax could be assess on "installation work that is not a construction activity" – "essentially classifies enumerated building trade services into two categories: capital improvements and repairs." (*Id.* at 10; App. I, p. 576). Again, this conclusion should, as a matter of law, determine the outcome in favor

of Lowe's. While the Regulation does ***not*** suggest that installations of real property improvements can ever be subject to sales tax, it does segregate ***all*** activity relating to buildings and structures into only two categories: either repairs (and thus taxable) or capital improvements (and therefore not taxable). The Department repeatedly acknowledges that, under the Regulation, the only activities that can be performed "on or connected with" a building or structure "are either repairs or new construction, reconstruction, alteration, expansion, or remodeling." (Iowa Department of Revenue's Reply Brief, p. 3; App. I, p. 349). This bright-line distinction determines whether the activities conducted on structures are subject to sales tax, and the Regulation, viewed as a whole, fully supports this construction.

By accepting the Department's contrary interpretation of its own Regulations, the district court erred.

This Court's decision in *AOL*, 771 N.W.2d at 404, is particularly on point here. In that case, this Court rejected as "illogical, irrational, and wholly unjustifiable" the Department's assessment of taxes on AOL's sales of communication services, because "the department's administrative rule required that both points of communication occur within the state in order for sales tax to be assessed[.]" *Id*. at 407, 409. At the time of the dispute, IOWA CODE § 422.43(1) imposed a sales tax on "the gross receipts from the sales, furnishing, or service of . . . communication service . . . when sold at retail in the state to consumers or users

. . .” To enforce the statute, the Department promulgated 701 IAC 18.20 which, among other things, defined “[c]ommunication service provided in this state” as occurring “only if both the points of origination and termination of the communication are within the borders of Iowa.” 701 IAC 18.20(1)(b).

In 2001, the Department assessed sales tax on AOL’s services. On appeal, the ALJ ruled against the assessment, concluding that under the Department’s own regulation AOL’s services were “an untaxable interstate service.” *AOL, LLC, 771 N.W.2d at 407*. The Department appealed the ALJ’s decision to its director, who reversed the proposed decision. AOL then filed a petition for judicial review, and the district court overturned the agency’s decision, finding it, in light of the Department’s regulatory definitions, to be a “wholly unjustifiable application of law to fact.” *Id.* As this Court noted: “[b]ecause the department’s administrative rule required that both points of communication occur within the state in order for sales tax to be assessed, the district court concluded that AOL services were not subject to the tax.” *Id*. The Iowa Court of Appeals subsequently affirmed the district court’s decision. *Id.* at 410.

At the final appeal to this Court, the inquiry involved “the proper interpretation of the department’s rule” and “whether AOL, under the undisputed facts, provided taxable communication services in this state within the scope of the

department's administrative rules." *Id*. at 407-8. In addressing the inquiry, this Court noted as follows:

> AOL does not challenge the general proposition that the director has broad authority to promulgate rules that the director finds consistent with the governing statute. Indeed, AOL does not make any claim that the applicable rules in this case are invalid. Instead, AOL argues that broad authority to *promulgate* rules consistent with the statute is not the same as the issue presented in this case, namely, whether the director is vested with authority to *interpret* the rules. As a result, AOL argues that the director's interpretation of the rules is not entitled to deference under IOWA CODE section 17A.19(10)(c) (Supp. 1999).

Id. at 408.

This Court agreed that it should apply the administrative rule's plain meaning "without engaging in the legal jujitsu employed by the department to escape it." *Id*. at 409. In rejecting the Department's arguments to the contrary, this Court held:

> The very purpose of putting the definitions at the beginning of a statute, contract, or rule is to establish the framework for the proper interpretation of subsequent provisions. When an agency elects to be its own lexicographer, persons are entitled to rely upon the established definitions . . . There is simply no "play in the joints" of the rule sufficient to allow the department to escape the rule's plain meaning and overall structure.

Id. at 409.

Similarly, the Department's Regulations here unambiguously establish that activities relating to a building or structure can only be repairs, and thus taxable, or capital improvements, and not taxable. "When an agency elects to be its own

lexicographer, persons are entitled to rely upon the established definitions." *Id*. Under the Regulations, there can be no "third" category of "installations" of permanent fixtures to structures that are neither repairs nor capital improvements, but that are still somehow within the reach of the Services Tax Act but simultaneously outside the reach of the Construction Activity Exclusion.

To the contrary, the Department's published rules make clear that, when a Contractor-Retailer affixes TPP to real property pursuant to a construction contract, he "***does not collect sales tax from the final customer***." *Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018). This Court should apply the plain meaning of these administrative rules to this case "without engaging in the legal jujitsu employed by the Department to escape it." *AOL*, 771 N.W.2d at 409.

II. THE DISTRICT COURT ERRED IN AFFIRMING THE DEPARTMENT'S CONCLUSION THAT PERMANENT CAPITAL IMPROVEMENT INSTALLATIONS AND LOWE'S SERVICES AS A GENERAL BUILDING CONTRACTOR FALL OUTSIDE THE CONSTRUCTION ACTIVITY EXCLUSION.

A. STANDARD OF REVIEW

In reviewing the Department's interpretations of its own published Regulations, the Court's standard of review is *de novo*. *AOL*, 771 N.W.2d at 407-8.

B. PRESERVATION OF ISSUE FOR REVIEW

Lowe's preserved error on this issue by raising it with the district court in its Brief and at the hearing held on June 30, 2017. (App. I, pp. 537-548; App. I, pp.

628-632). It further raised the issue in its Briefs and at hearings in each stage of the underlying administrative proceeding in its timely appeals of (1) the tax assessment on January 28, 2008. (App. I, p.7-28); (2) the ALJ's adverse Proposed Order (App. I, p. 416-17); and (3) the Director of the Department of Revenue's adverse Ruling (App. I, pp. 497-504).

C. ARGUMENT

1. The Construction Activity Exclusion

IOWA CODE § 423.3(37) statutorily prohibits the Department from imposing ***any*** tax on the "sales price of services on or connected with new construction, reconstruction, alteration, expansion, remodeling, or the services of a general building contractor, architect, or engineer" (collectively, "Construction Activity"). Properly construed and read together, the Services Tax Act and the Construction Activity Exclusion collectively confirm that labor associated with installing capital improvements to real property is not and cannot be subject to sales tax in Iowa.[3]

Therefore, even if the Court somehow deems the incidental installation labor to be taxable repairs enumerated in the Services Tax Act, the Construction Activity

[3] The Department's web publication styled "Iowa Sales and Use Tax: Taxable Services" lists the enumerated taxable services, then states as an "Exception" that "[w]hen services are rendered on or connected with new construction, reconstruction, alteration, expansion, or remodeling of a building or structure, they are exempt from sales and use tax.' It then clarifies that only "[r]epair services remain taxable." (https://tax.iowa.gov/iowa-sales-and-use-tax-taxable-services).

Exclusion expressly prohibits the Department from assessing tax on the Construction Activity inherent in the Construction Contracts. Although the testimony of record expressly confirmed that Lowe's home improvement activities fell within this prohibition (Supplemental Affidavit of Craig Price ¶ 4; App. II, pp. 270-271), the Department nevertheless concluded that "construction, reconstruction, alteration, expansion, and remodeling each describe a project larger in scale than the replacement of windows, doors, or built-in appliances." (Director's Final Order, p. 3; App. I, p. 483). This alleged "scale", however, is undefined, subjective, exceedingly vague, and appears nowhere in any Iowa law or regulation. Indeed, the Department is unable to articulate precisely how "large in scale" ***any*** home improvement project must be in order to qualify as Construction Activity under the Department's ruling (*See, e.g.*, Deposition of Steve Campbell at 35-37; App. I, p. 600).

2. The Regulation describing Construction Activity – (701 IAC 219)

The Construction Activity Exclusion statute prohibits any tax being imposed on "services on or connected with" any one of six separate categories of activity: (1) new construction; (2) reconstruction; (3) alteration; (4) expansion; (5) remodeling; or (6) the services of a general building contractor, architect, or engineer." While the statute does not define what types of home improvement work falls within any of the six statutory categories of Construction Activity, 701

IAC 219 does so by example. The Department purports to rely on this Regulation to support its exceedingly narrow interpretation of what constitutes Construction Activity.

Among other examples, the Regulation, at 701 IAC 219.3, specifies that replacing non-defective fixtures and appliances (such as "the replacement of windows, doors, or built-in appliances") are capital improvements. Among other not very "large in scale" examples of Construction Activity excluded from tax, the Regulation lists: (1) "replacing kitchen cabinets with some modification"; (2) "paneling existing walls"; (3) "laying a new floor over an existing floor"; and (4) "replacing an entire water heater, water softener, furnace or central air conditioning unit." (*Id.)*. None of these installation activities involves "taking out part of a wall" (Deposition of Steve Campbell at 37:3-10; App. I, p. 600) or making other "structural changes" to buildings. To the contrary, they are entirely consistent with the types of home improvements Lowe's installed. And the Regulation confirms that "[i]n all the examples, the contractor is responsible for paying tax to any supplier on materials" and "***there would be no tax on any enumerated services***." (701 IAC 219, p. 14; App. II, p. 328).

Again, by the Department's own admission, the Regulation provides that the only activities that can be performed "on or connected with" a building or structure "are either repairs or new construction, reconstruction, alteration, expansion, or

remodeling." (Iowa Department of Revenue's Reply Brief, p. 3; App. I, p. 349). There is no "third" category of taxable installations. The Regulation also distinguishes between a "contractor," who does not collect sales tax from customers, and a "retailer of repair services" who does, and it is undisputed that Lowe's was a contractor and not a "retailer of repair services." (*See* Attorney General's comments in Transcript of 10/11/16 Proceeding, pp. 35-38; App. I, pp. 624-627).

To further clarify the point, the Regulation provides a "nonexclusive list of activities and items" which "are generally associated with new construction, reconstruction, alteration or expansion of a building or structure" and therefore should always be deemed exempt from tax under the Construction Activity Exclusion:

- Awnings and venetian blinds ***which become attached to real property***;
- Counters, lockers (***installed as distinguished from portable units***), and prefabricated cabinets;
- Drapery installation;
- Electric conduit work and items relating thereto;
- Floor covering which is ***permanently installed***;
- Furnaces, heating boilers and heating units;
- Glass and glazing work;
- ***Lighting fixtures***;
- ***Lumber and carpenter works***;
- ***Millwork installation***;
- ***Piping valves and pipe fitting work;***
- ***Plumbing work***;
- ***Water heater and softener installation.***

701 IAC 219.8 (App. II, pp. 323-324) (emphasis added).

All of these examples of exempt Construction Activities involve installations of capital improvements similar or identical to those installed by Lowe's. Indeed, the Department has never explained how or why these examples of installations are all exempt from sales tax, while Lowe's virtually identical installations fell outside the Construction Activity Exclusion.

To further confirm that installing permanent capital improvements to real property is always a Construction Activity excluded from tax, the Regulation includes a nonexclusive "list of property which, under normal conditions, becomes a part of realty" and therefore exempt:

> b. ***Built-in household items*** such as kitchen cabinets, ***dishwashers, sinks (including faucets), fans, garbage disposals*** and incinerators.
>
> c. Buildings and ***structural and other improvements to buildings***, including awnings, canopies, foundations for machinery, floors (including computer room floors), walls, ***general wiring and lighting facilities***, roofs, stairways, stair lifts, sprinkler systems, ***storm doors and windows***, door controls, air curtains, loading platforms, central air-conditioning units, building elevators, sanitation and ***plumbing systems***, decks, and heating, cooling and ventilation systems.

701 IAC 219.11(2), p. 12 (*Id*.; *App. II, p. 326)* (emphasis added). Again, virtually all of Lowe's installations fell within this published list of exempt construction activities.

3. The Department's "Policy"

It is undisputed that the home improvements installed by Lowe's: (1) were not repairs; (2) resulted in fixtures being permanently attached to and incorporated into customer homes[4];and (3) were capital improvements made to real property. (Deposition of Steve Campbell at 11:3-18, 34:7-35:20, App. 594, 600). All of the improvements were installed by Lowe's in its capacity as a "construction contractor" pursuant to "Construction Contracts," as those terms are defined in the Regulations. Indeed, the Regulations cannot be clearer: a construction contractor's installation of permanent capital improvements to real property is always exempt from sales tax under the Construction Activity Exclusion.

Lowe's acknowledges that these published Regulations and Guides are entitled to judicial deference. But the Department's unpublished "policies," such as its unilateral declaration that "in order for an installation to constitute reconstruction, alteration, expansion, remodeling, it has to involve a structural change to the home or building" (Deposition of Steve Campbell at 9:7-15; 31:18-24; App. I, pp. 593, 599) are not. This is particularly true when the so-called policy is (1) not promulgated pursuant to the Iowa Administrative Procedures Act (IOWA CODE § 17A.3-4); (2) facially vague and arbitrary; (3) inconsistent with the

[4] *See* 701 IAC 19.10 which items as examples of permanent fixtures dishwashers, sinks, faucets, shower doors, tubs, storm doors, toilets, vanities and custom doors – virtually every type of home improvement for which the Department has assessed sales tax.

underlying tax statutes; and (4) in direct conflict with the Department's own published Regulations.

The policy also impermissibly seeks to alter the enabling tax statutes by (1) expanding the Services Tax Act far beyond its intended reach, and (2) narrowing the scope of the Construction Activity Exclusion to the point of meaninglessness. Since the Department does not and cannot specify precisely how "large in scale" a project must be to be considered a Construction Activity, Contractor-Retailers like Lowe's, indeed all contractors doing business in Iowa, are now at a loss as to how to comply with the vague and subjective policy.

This Court has held that the Department cannot rely on unpublished policies to alter the meaning of a tax statute. "A court construing a statute to ascertain legislative intent must not only consider the language used, but must also take account of the object sought to be accomplished or the problems sought to be remedied and arrive at a construction that will best effect its purpose." *Kelly-Springfield Tire Co. v. Bd. of Tax Revenue*, 414 N.W.2d 113, 115 (Iowa 1987). In the *Kelly-Springfield* case, the Department tried to justify its assessment based on the application of an unpublished policy. It argued that "its longstanding interpretation of the statute should be given some weight." In reversing the assessment, this Court held as follows:

> Although the interpretation of the statute proposed by IDOR in the present case may have been the department's position for some time,

> ***it should be noted that it has issued no published rule or directive codifying that position***. As we have stated in another revenue case involving statutory interpretation, "the meaning of a statute is always a matter of law, and final construction and interpretation is for this court."

Id. at 116 (*quoting Sorg*, 269 N.W.2d at 131) (emphasis added).

In its Final Order, the Department concluded that "construction, reconstruction, alteration, expansion, and remodeling each describe a project larger in scale than the replacement of windows, doors, or built-in appliances." (Director's Final Order, p. 3; App. I, p. 483). But this conclusion directly conflicts with the specific, nonexclusive examples of Construction Activity listed in the Department's own rules, which include installations of replacement fixtures and appliances. These listed examples are no larger "in scale" than the improvements installed by Lowe's and none involves making a "structural change" to a building.

Moreover, the Department's vague "structural change" policy is impossible to implement. How can a contractor-retailer determine, with any sense of predictability, whether installing all new built-in appliances into a kitchen constitutes enough of a "structural change" to fall outside this undefined third category? If installations of replacement appliances such as water heaters, water softeners, and heating and air conditioning units are, by regulation, expressly deemed to be "structural changes" to a building and excluded from sales tax, then why aren't the installations of built-in dishwashers, garbage disposals, toilets, sinks

and custom windows and doors similarly excluded? What is the point of distinction? Both sets of installations constitute permanent capital improvements made to a building, and neither set involves repairs.

In order for a tax distinction to be reasonable, it must be defined, clear, capable of being understood and followed, and consistent with the underlying statute. *See Midwest Auto. III, L.L.C. v. Iowa Dep't of Transp.*, 646 N.W.2d 417, 426 (Iowa 2002). The Department's policy, however, is undefined, internally contradictory, arbitrary, inconsistent with the specific examples listed in its rules, and purports to alter the underlying statutes. As a result, the policy cannot be followed or enforced with any degree of certainty or predictability.

4. Lowe's Services As A General Building Contractor

Separately, the Construction Activity Exclusion prohibits the Department from assessing sales tax on "the services of a general building contractor," and the Department concedes that: (1) the Legislature imposed "no limits of any kind" on this exclusion, and (2) the Department has promulgated no regulations or guidance of any kind to impose conditions on this statutory bar. (Deposition of Victoria Daniels at 26:5-29:7; App. I, p. 609). Indeed, according to the Department, "if a general building contractor is performing the services of a general building contractor, those services are exempt" from sales tax." (Deposition of Steve Campbell at 77:7-12; App. I, p. 603). And, as noted, the Proposed Order, which the Department affirmed, expressly acknowledged that Lowe's, when performing

Installation Contracts, was "performing the services of a general building contractor."

The Department nevertheless imposed sales tax directly on Lowe's services as a general building contractor. The Assessment simply ignored the exclusion applicable to contractor services. In the Final Order, the Department for the first time tried to justify its position via a circular argument – the exclusion for contractor services applies only if the project on which the contractor worked was itself large enough in scale to constitute Construction Activity. (Director's Final Order, App. I, pp. 481-486). In other words, the Department considers the contractor service exclusion to be duplicative of the other five statutory categories of Construction Activities; indeed, the Department treats all six categories the same. (Deposition of Steve Campbell at 20:16-24; App. I, p. 596). Whether the activity is remodeling, new construction, or the services of a general building contractor, under the Department's stated justification, ***all*** must involve the same undefined "large in scale" amount of "structural change" to a building. (*Id.*).

By ignoring the exclusion applicable to "the services of a general building contractor," the Department acted beyond the authority delegated to it and in violation of its own Regulations, and it made an erroneous application of the law to the undisputed facts of this case. In affirming the Department's Final Order, the district court erred.

III. THE DISTRICT COURT ERRED IN UPHOLDING THE DEPARTMENT'S ARBITRARY BIFURCATION OF LOWE'S HOME IMPROVEMENT TRANSACTIONS INTO TWO SEPARATE COMPONENTS.

A. STANDARD OF REVIEW

Again, in reviewing the Department's interpretations of its own published Regulations, the Court's standard of review is *de novo*. *AOL*, 771 N.W.2d at 407-8.

B. PRESERVATION OF ISSUE FOR REVIEW

Lowe's preserved error on this issue by raising it with the district court in its Brief and at the hearing held on June 30, 2017. (App. I, pp. 537-548; App. I, pp. 628-632). It further raised the issue in its Briefs and at hearings in each stage of the underlying administrative proceeding in its timely appeals of (1) the tax assessment on January 28, 2008. (App. I, p. 7-28); (2) the ALJ's adverse Proposed Order (App. I, p. 433); and (3) the Director of the Department of Revenue's adverse Ruling (App. I, pp. 487-504).

C. ARGUMENT

Even though Lowe's sold each home improvement project for a single fixed charge, the Department arbitrarily split the Construction Contracts into two separate components, each subject to an independent sales tax (one tax on the TPP component and another on the labor component) assessed against two different taxpayers (the contractor as to the TPP and the customer as to the labor). This conclusion is unauthorized by the Services Tax Act and directly conflicts with the Department's Regulations.

Sales taxes "are collected from the purchaser by the seller and are imposed on a transaction-by-transaction basis." J.R. Hellerstein and W. Hellerstein, STATE TAXATION ¶ 12.01, INTRODUCTION TO THE AMERICAN RETAIL SALES TAX (3d ed. 2000). The sales tax "is a discrete charge, apart from the price of an item, that is paid by the consumer and collected by the vendor." *Id.* There is no statute or regulation in Iowa that authorizes the Department to bifurcate a unitary construction project into two separate taxable events chargeable to two separate taxpayers.

As set out in the Regulations, there can only be three types of transaction that a Contractor-Retailer like Lowe's can perform – (1) an over-the-counter retail sale of TPP (customer owes sales tax on entire transaction); (2) the installation of TPP pursuant to a Construction Contract (Contractor-Retailer owes use tax on cost of installed TPP); and (3) a repair of TPP (customer owes sales tax on entire transaction). (701 IAC 219.4, pp. 3-4; App. II, pp. 318-320). In each scenario, only one tax is owed by only one taxpayer – either the customer (if it's a retail sale or a repair) or the Contractor Retailer (if it involves installation of building materials). The Regulations do not authorize the splitting of unitary transactions into two separately taxable events.

Under 701 IAC 219.4, if Lowe's was performing repair work to a customer's home, as the ALJ initially concluded, then the customer would have

owed sales tax on the ***entire*** charge, including the building supplies and materials. Lowe's would not have been deemed a contractor and would not have been liable for self-assessing tax on the cost of its materials. Alternatively, if Lowe's was installing the building supplies and materials as part of a "construction contract," then the Regulation provides that Lowe's would pay tax "based on the cost of materials at the time the materials are withdrawn from inventory for use in a construction contract performed in Iowa." And under the terms of the Iowa Contractors Guide, a contractor-retailer "[p]erforming a construction contract – ***does not collect sales tax from the final customer***." *Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018) (App. II, pp. 332-352). Under these published rules, there can be only one transaction, and it cannot be bifurcated.

Moreover, there is no mechanism available to contractors to allow them to comply with the record keeping requirements associated with such bifurcations. Indeed, this is why the Iowa Legislature, when it enumerated certain repair services for taxation, enacted the corresponding Construction Activity Exclusion to clarify that contractors who install home improvements (and pay tax on the TPP they consume in the process) are never separately obligated to collect additional sales tax from their customers. The service component is not subject to sales tax and, by holding otherwise, the district court erred.

IV. THE ASSESSMENT IS CONTRARY TO THE HOLDINGS IN OTHER STREAMLINED SALES TAX STATES.

A. STANDARD OF REVIEW

In reviewing the Department's interpretations of its own published Regulations, the Court's standard of review is *de novo*. *AOL*, 771 N.W.2d at 407-8.

B. PRESERVATION OF ISSUE FOR REVIEW

Lowe's preserved error on this issue by raising it with the district court in its Brief and at the hearing held on June 30, 2017. (App. I, pp. 537-548; App. I, pp. 628-632). It further raised the issue in its Briefs and at hearings in each stage of the underlying administrative proceeding in its timely appeals of (1) the tax assessment on January 28, 2008. (App. I, p. 7-28); (2) the ALJ's adverse Proposed Order (App. I, p. 433); and (3) the Director of the Department of Revenue's adverse Ruling (App. I, pp. 484, 487-502).

C. ARGUMENT

Iowa is a member of the Streamlined Sales and Use Tax Agreement (the "SST Agreement"). "The purpose of the Agreement is to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance" and its goal is to promote, among other things, "uniformity in the state and local tax bases," "uniformity of major tax base definitions," and "simplified administration of exemptions."[5]

[5] (http://www.streamlinedsalestax.org/index.php?page=About-Us).

Lowe's has confronted various permutations of this same installed fixtures controversy in other states that, like Iowa, are members of the SST Agreement, including Oklahoma, Indiana and Kansas. In each of these jurisdictions, the state's department of revenue initially claimed that Lowe's, when performing Construction Contracts for home improvements like those at issue in this case, erred was wrong in self-assessing and paying tax on its cost of materials. Each state assessed Lowe's for additional sales tax and Lowe's challenged each assessment. And in each case, the assessment was reversed and Lowe's was found to have acted correctly and in accordance with the applicable laws. (Affidavit of Craig Price ¶ 16, Exs. C-F; App. II, p. 15; pp. 65-129).

Oklahoma took the position that a retailer can never be a contractor. Lowe's argued that, under Oklahoma law, it was acting as a contractor when it sold installed home improvements to customers pursuant to Construction Contracts and was therefore the final user and consumer of the installed TPP. After the parties litigated the controversy, the administrative hearing officer issued his "Findings, Conclusions and Recommendations," ruling in favor of Lowe's on all claims. By Order dated February 26, 2015, the Oklahoma Tax Commission formally adopted the ALJ's findings and conclusions. (*In the Matter of the Sales Tax and Use Tax Protest of Lowe's Home Centers, LLC A/K/A Lowe's Home Centers, Inc*., Okla. Tax Commission Order, Case No. P-09-195-H (Okla. Tax Commission February

26, 2015), *aff'd In the Matter of the Sales Tax and Use Tax Protest of Lowe's Home Centers, LLC A/K/A Lowe's Home Centers, Inc.*, A.L.J. Findings, Conclusions and Recommendations, Case No. P-09-195-H (Okla. Tax Commission July 7, 2014)). (App. II, 358-409).

Indiana similarly argued that Lowe's was not acting as a contractor when it sold installed home improvements pursuant to Construction Contracts. This dispute was also litigated and, on December 19, 2014, the Indiana Tax Court similarly ruled in favor of Lowe's on all issues. The Indiana Supreme Court subsequently denied review of the Tax Court's decision. (Affidavit of Craig Price ¶ 18, Ex. D; App. II, p. 16; 119-125).

Most recently, Kansas had argued that, when Lowe's installed built-in appliances at customer homes, it was acting not as a contractor but rather as a retailer of the installed appliance and the related labor. It assessed Lowe's for additional tax on the TPP's deemed mark up and the installation labor. The Kansas Tax Code, like the Iowa Code, prohibits the imposition of taxes on services "performed in connection with the original construction, reconstruction, restoration, remodeling, renovation, repair or replacement of a residence." On June 29, 2015, the Kansas Board of Tax Appeals ruled that "the Built-In transactions at issue all involved improvements to residential properties and that the Taxpayer, in undertaking these installations, was acting as a contractor and not a retailer." (*In*

the Matter of the Appeal of Lowe's Home Centers, L.L.C., f/k/a Lowe's Home Centers, Inc., from an Order of the Division of Taxation on Assessment of Retailers' Sales Tax, Summary Decision pg. 1, Docket No. 2014-34-DT, (Kan. B.T.A June 29, 2015), *aff'd In the Matter of the Appeal of Lowe's Home Centers, L.L.C., f/k/a Lowe's Home Centers, Inc., from an Order of the Division of Taxation on Assessment of Retailers' Sales Tax*, Kan. B.T.A Order, Docket No. 2014-34-DT (Kan. B.T.A January 21, 2016)). (App. 410-426). The Board concluded that all of the installation services were made in connection with remodeling, renovation, repair and/or replacement of a residence, and that "the Taxpayer properly and correctly self-assessed use tax on the cost of materials used and consumed in performing these installation contracts." (*Id*.). On April 14, 2017, the Kansas Court of Appeals affirmed the Board's decision. (*In the Matter of the Appeal of Lowe's Home Centers, L.L.C., f/k/a Lowe's Home Centers, Inc., from an Order of the Division of Taxation on Assessment of Retailers' Sales Tax*, Case No. 115,254 (Kan. Ct. App. April 14, 2017)). (App. 427-475).

In this case, the ALJ acknowledged that "[t]he issue in the Kansas case – whether the state could collect sales tax on the cost of installation of labor charged by Lowe's under the installation sales contract – was virtually the same as the issue here." (Proposed Order – Granting Summary Judgment, p. 21; App. I, p. 399). She nevertheless tried to distinguish the case:

> The Kansas Board of Tax Appeals held that the items at issue (a variety of built-in appliances and fixtures) were installed as permanent fixtures to residences in connection with reconstruction, restoration, remodeling, renovation, repair or replacement and installation labor was exempt from sales tax. Notably, the Kansas exemption expressly applied to services rendered in connection with repair or replacement, the precise type of services at issue her. As detailed above, the exemption created by Iowa Code section 423.3(37), as interpreted through administrative rules, does not apply to repair and replacement services.

Id.

Since the Director in her Final Order subsequently ruled that the installations performed by Lowe's did not constitute "repair or replacement services" under its administrative rules, the ALJ's attempt to distinguish the Kansas case is no longer viable. Among the SST states, Iowa is a complete outlier on this issue. Its position undermines the SST goals of uniformity and simplification.

V. THE DEPARTMENT'S FINAL ORDER VIOLATED LOWE'S CONSTITUTIONAL DUE PROCESS AND EQUAL PROTECTION RIGHTS.

A. STANDARD OF REVIEW

Substantial grounds for reversal exist if the final agency action is unconstitutional as applied against the taxpayer or based on a provision of law that is unconstitutional as applied against the taxpayer. IOWA CODE § 17A.19(10)(a). In addressing a constitutional issue, the Court must make an independent evaluation based on the totality of the circumstances, which is the equivalent of *de novo* review. *State v. Nail*, 743 N.W.2d 535 (Iowa 2007); *Office of Consumer Advocate*

v. Iowa St. Commerce Comm'n, 465 N.W.2d 280, 281 (Iowa 1991); *War Eagle Village Apts. v. Plummer*, 775 N.W.2d 714, 717 (Iowa 2009).

B. PRESERVATION OF ISSUE FOR REVIEW

Lowe's first raised the issue of due process in its Amended Protest ¶¶ 39-45 (App. I, pp. 24-25). It preserved it equal protection claim in its dispositive briefing to the ALJ, after the Department appeared to change is initial justification for the Assessment. (Proposed Order p. 7; App. I., p. 385).

C. ARGUMENT

As noted, the Department's Regulations expressly provide that (1) "a sale by a contractor-retailer of building supplies, materials and equipment which provides for installation of the merchandise is considered a construction contract and tax shall be paid by the contractor-retailer based upon the cost of materials at the time the materials are withdrawn from inventory for use in a construction contract performed in Iowa" (701 IAC 219, p. 4) and (2) a contractor-retailer "performing a construction contract . . . does not collect sales tax from the final customer." *Iowa Dep't of Revenue*, Iowa Contractors Guide, https://tax.iowa.gov/iowa-contractors-guide (last visited March 14, 2018). Presumably, the Department consistently applies these Regulations to all contractors and contractor-retailers doing business in Iowa.

But the Department has inexplicably ignored these Regulations in making the Assessment against Lowe's. Moreover, the Department has presented no evidence to indicate that it has ever applied to any other contractors its unpublished "policy" of requiring a home improvement to involve a "structural change" or be sufficiently "large in scope" to qualify as Construction Activity and excluded from sales tax. The record therefore indicates that, in making the Assessment against Lowe's, the Department ignored Regulations that it applies to other contractors performing the same types of Construction Activity in Iowa. (Deposition of Victoria Daniels at 40:23-41:3; App. I, p. 611). In other words, the Department has arbitrarily imposed on Lowe's a different and greater tax burden than it imposes on other contractors making similar home improvements pursuant to construction contracts.

Due Process

Due process is designed to ensure fundamental fairness in interactions between individuals and the state. Among other things, the Due Process Clause prohibits the enforcement of vague laws or policies under the "void-for-vagueness doctrine." The doctrine has three general underpinnings: (1) the policy "cannot be so vague that it does not give persons of ordinary understanding fair notice that certain conduct is prohibited[;]" (2) the policy provides "those clothed with authority sufficient to prevent the exercise of power in an arbitrary and

discriminatory fashion[;]" and (3) the policy "cannot sweep so broadly as to prohibit substantial amounts of constitutionally-protected activities[.]" *Nail*, 743 N.W.2d at 539. By assessing Lowe's based on an exceptionally vague policy that the Department neither promulgated nor published, and which directly conflicts with its own Regulations, the Department violated Lowe's constitutional rights to due process.

When interpreting laws, this Court "necessarily operate[s] on the objective assumption that the legislature strives to create asymmetrical and harmonious systems of laws. *Id*. at 541. The *in pari material* approach to construing the law requires that the Court look at the applicable laws and regulations as a whole, with their "highly detailed, interconnecting provisions." *Id*. at 540. Reading the Services Tax Act and the Construction Activities Exclusion as a whole, together with all of their "highly-detailed" published Regulations and the SST Agreement, there was simply no authority for the Department to have assessed Lowe's for sales tax that it did not collect from its customers related to incidental installation labor. The Department's so-called policy, which stands in stark contrast to these published laws and rules, violates Lowe's due process rights.

Equal Protection

"The equal protection clause … protects the individual from state action which selects him out for discriminatory treatment by subjecting him to taxes not

imposed on others of the same class." *Allegheny Pittsburgh Coal Co. v. Cty. Comm'n of Webster Cty., W. Va.*, 488 U.S. 336, 344 (1989). In *Allegheny Pittsburgh*, the West Virginia legislature enacted a statute which provided that all property should be taxed at a rate uniform throughout the state according to its estimated market value. Although the West Virginia legislature had not drawn a distinction in the statute between recently sold property and property which had not been recently sold, a county tax assessor valued recently sold property on the basis of its recent purchase price, but assessed neighboring property which had not been recently sold under another method. 488 U.S. at 338. The U.S. Supreme Court held that the distinction drawn by the assessor, on its own initiative, resulted in disparate treatment of properties within the same class, which violated the petitioners' equal protection rights:

> But West Virginia has not drawn such a distinction. Its Constitution and laws provide that all property of the kind held by petitioners shall be taxed at a rate uniform throughout the State according to its estimated market value. … We are not advised of any West Virginia statute or practice which authorizes individual counties of the State to fashion their own substantive assessment policies independently of state statute. *See Salsburg v. Maryland*, 346 U.S. 545, 74 S.Ct. 280, 98 L.Ed. 281 (1954). The Webster County assessor has, apparently on her own initiative, applied the tax laws of West Virginia in the manner heretofore described, with the resulting disparity in assessed value of similar property.

Id. at 345.

The U.S. and Iowa Constitutions both guarantee that Lowe's shall not "be deprived of life, liberty, or property, without due process of law" (Iowa Const. Art. I, Sec. 9; U.S. Const., Amend. V) and shall enjoy equal protection under the law. (Iowa Const. Art. I, Sec. 6; U.S. Const., Amend. XIV.) By fabricating an arbitrary and unpublished "structural change" requirement that directly conflicts with its published Regulations, without following the requirements of the Iowa Administrative Procedure Act, and by imposing it on Lowe's so as to subject it to a higher tax burden than other contractors, the Department has violated Lowe's constitutional rights to due process and equal protection.

CONCLUSION

For the reasons set out herein, Lowe's respectfully asks the Court to (i) reverse and vacate the district court's Order, (ii) reject the Department's application of sales tax to the labor components of Lowe's home improvement projects, and (iii) enter an order abating and vacating the Assessment in its entirety.

Dated and respectfully submitted this 16th day of March, 2018.

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