

**OHIO BOARD OF TAX APPEALS**

Duramed Pharmaceuticals, Inc.	)	CASE NO. 2002-V-164
	)	
Appellant,	)	(FRANCHISE TAX)
	)	
vs.	)	DECISION AND ORDER
	)	
Thomas M. Zaino,	)	
Tax Commissioner of Ohio,	)	
	)	
Appellee.	)	

APPEARANCES:

For the Appellant	-	Taft, Stettinius & Hollister LLP Stephen M. Nechemias 425 Walnut Street, Suite 1800 Cincinnati, OH 45202-3957
For the Appellee	-	Jim Petro Attorney General of Ohio Richard C. Farrin Assistant Attorney General State Office Tower 30 East Broad Street, 16th Floor Columbus, Ohio 43266-0410

Entered March 7, 2003

Mr. Johnson, Ms. Jackson, and Ms. Margulies concur.

The above-captioned matter comes to be considered by the Board of Tax Appeals upon a notice of appeal filed by appellant Duramed Pharmaceuticals, Inc. (hereinafter "Duramed") concerning a final determination of the Tax Commissioner denying a portion of its 1997 corporate franchise tax refund request. Duramed asserts that its purchase of certain machinery and equipment during the qualifying period under R.C. 5733.33(A)(4) entitles it to a refund.

This matter is considered by the Board of Tax Appeals upon the notice of appeal, the statutory transcript (“S.T.”), and the testimony and other evidence adduced at the hearing (“R.”). The appellant has also provided written legal argument.

At hearing before this board, appellant presented the testimony of Mr. Timothy J. Holt, senior vice-president of finance and administration, treasurer and chief financial officer of Duramed during the period of time at issue in this case. (R at 6)<sup>1</sup> Duramed is a pharmaceutical company that develops, manufactures, and markets prescription pharmaceutical products. (R. at. 8)

In its application for an Ohio franchise tax refund claim, Duramed sought credit for investment in qualified machinery and equipment under R.C. 5733.33 for a total of \$4,877,499.39 in purchases of equipment and machinery made in calendar year 1996. (S.T. at 10) The Tax Commissioner allowed the credit (and corresponding refund) for a portion of the equipment and machinery purchases claimed, but denied a large portion of the credit attributable to machinery valued at \$4,000,000 acquired by Duramed from Ortho-McNeil Pharmaceutical Corporation (“Ortho-McNeil”). (S.T. at 2) In a letter from the Department of Taxation cited in his final determination, the Tax Commissioner determined that the machinery was not entitled to credit under R.C. 5733.33(A)(4) because it was “placed into service in the second quarter of 1995” and was “purchased, leased, and placed in service prior to the qualifying period beginning July 1, 1995.” (S.T. at 2)

In its notice of appeal, Duramed claims that the machinery was purchased within the qualifying period under R.C. 5733.33(A)(4) and therefore qualifies for the

credit for purchase of new manufacturing machinery and equipment as provided by R.C. 5733.33.

Initially, we note that the findings of the Tax Commissioner are presumptively valid. *Alcan Aluminum Corp. v. Limbach* (1989), 42 Ohio St.3d 121. It is incumbent upon a taxpayer challenging a finding of the Tax Commissioner to rebut the presumption and establish a right to the relief requested. *Belgrade Gardens, Inc. v. Kosydar* (1974), 38 Ohio St.2d 135; *Ohio Fast Freight v. Porterfield* (1972), 29 Ohio St.2d 69; *National Tube v. Glander* (1952), 157 Ohio St. 407. The taxpayer is assigned the burden of showing in what manner and to what extent the Tax Commissioner's determination is in error. *Federated Department Stores v. Lindley* (1983), 5 Ohio St.3d 213. It is with these authorities in mind that we turn to the merits of the instant appeal.

R.C. 5733.33(B)(1) provides, in relevant part:

“[A] nonrefundable credit is allowed against the tax imposed by section 5733.042 of the Revised Code for a taxpayer that purchases new manufacturing machinery and equipment during the qualifying period, provided that the new manufacturing machinery and equipment are installed in this state no later than December 31, 2006.”

The prefatory language of R.C. 5733.33(A) provides definitions for the relevant terms contained above:

“(2) ‘New manufacturing machinery and equipment’ means manufacturing machinery and equipment, the original use in this state of which commences with the taxpayer or with a partnership of which the taxpayer is a partner. \*\*\*”

“\*\*\*”

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<sup>1</sup> Subsequent to the tax years at issue, Duramed was acquired by another entity in 2001. Mr. Holt's current position is “special transitional employee.” (R at 6)

“(4) ‘Qualifying Period’ means the period that begins July 1, 1995, and ends December 31, 2005.”

The issue before this board is whether the property at issue is ‘new manufacturing machinery and equipment’ as statutorily defined, and if so, whether it was acquired by Duramed within the qualifying period.

The evidence provided by Duramed indicates that the \$4,000,000 in manufacturing equipment at issue is used to produce a conjugated estrogen hormone replacement drug, used for the treatment of symptoms related to menopause. (R. at 9)

According to the testimony of Mr. Holt, the United States Food and Drug Administration (FDA) released new guidelines in 1991 for the approval of generic conjugated estrogen products. (R. at 10) In 1994, Duramed submitted a product application to the FDA. In anticipation of a favorable approval from the FDA, Duramed sought the assistance of Ortho-McNeil, a division of Johnson and Johnson Inc., to obtain financing, marketing assistance, and manufacturing equipment used to produce the product for sale. (R. at 11, 50)

The record before this board includes the June 2, 1994 marketing services agreement and distribution agreement between Duramed and Ortho-McNeil that details the rights and responsibilities of both parties to the production, marketing, and distribution of a conjugated estrogen product in both a brand-name and generic form.<sup>2</sup> (S.T. at 52 and 73) Mr. Holt testified that in 1994 Duramed and Ortho-McNeil reached an agreement whereby Duramed would receive the necessary capital and equipment to

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<sup>2</sup> Throughout the agreements and other exhibits before this board, the conjugated estrogen product is referred to as the “CE Product” or “Cenestin.”

expand its facilities to produce the estrogen product and Ortho-McNeil would acquire the opportunity to market the new product:

“So we reached an agreement whereby they [Ortho-McNeil] were given marketing rights for the product, and in exchange for that Duramed received \$2 million in cash, they [Duramed] received the use of manufacturing equipment to ultimately make the product, once it was approved, and Ortho-McNeil provided a loan guaranteed in order for the company [Duramed] to be able to get the funding required to do the facility expansion.” (R. at 11, explanations added.)

Mr. Holt further testified as to his understanding that the agreement specified that if the product was not approved by the FDA by June 30, 1996, then Ortho-McNeil had the option to take the manufacturing equipment back or require Duramed to purchase it at fair market value. (R. at 12) Duramed ultimately argues that although it took possession of the machinery acquired by Ortho-McNeil in late 1994 (before the qualifying period provided in R.C. 5733.33(A)(4)), said equipment was not purchased by Duramed until September 24, 1997. (R. at 21)

Our review of the marketing agreement and the distribution agreement between Duramed and Ortho-McNeil fails to disclose any reference to the machinery and equipment at issue, nor any purchase provision. (See S.T. at 52 and 73)

Mr. Holt further identified a letter agreement<sup>3</sup> between Duramed and Ortho-McNeil that was not contained in the record before the Tax Commissioner.<sup>4</sup> The letter is dated June 2, 1994, signed by both parties, and is appended with an Exhibit C,

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<sup>3</sup> Said exhibit is incomplete, in that it contains the first two pages, followed by a signature page marked as “Page 11,” followed by Exhibit C. Although it is unknown what other exhibits are identified in the eight missing pages, the first two pages of the agreement before us contain references to Exhibits A and D, and the attached Exhibit C contains a reference to Exhibit G. (See Appellant’s Exhibit 1)

<sup>4</sup> The statutory transcript does contain a copy of Exhibit C, “Model Terms for Lease of Equipment” and Exhibit D, “Terms Related to Johnson and Johnson Guarantee.” (S.T. at 91, 92)

which is referenced in the letter agreement. (Appellant’s Exhibit 1) Beyond Mr. Holt’s testimony regarding his understanding of the agreement between Duramed and Ortho-McNeil, said letter agreement specifically details (albeit incompletely, see footnote 2, supra) the agreement between the parties with regard to the acquisition, placement and transfer of the manufacturing equipment, as well as the exchange of financial support referenced by Mr. Holt. Of relevance, section 2 provides:

“2. Ortho either directly or through an Affiliate shall purchase and lease to Duramed, on the terms set forth in Exhibit C hereto, certain equipment to be used by Duramed for manufacture of the CE product, and Ortho will guarantee (or cause an Affiliate satisfactory to the lending bank to guarantee) on the terms set forth in Exhibit D a bank borrowing in the amount of \$5.5 million to be used for the construction of an addition to Duramed’s plant to be used for the manufacture of the CE Product. Duramed will provide a detailed list of such equipment, and the specifications thereof to Ortho, as such information becomes known to Duramed, and the cost of such equipment (including without limitation, freight insurance and taxes) shall not exceed \$4 million.”

Exhibit C to the letter agreement is titled: “Model Terms for Lease of Equipment.” It provides:

“In general, the Standard Master Lease terms and Conditions of Johnson & Johnson Finance Corporation, as previously supplied to Duramed, will apply.

“Additional Terms

“Lease payments quarterly in arrears shall be set at \$250 per year accruing from the date substantially all equipment required for production of the CE Product shall have been delivered and shall be operational, and shall be payable within 10 days after receipt of an invoice therefore.

“Duramed shall have an option to purchase the equipment at an aggregate price of \$1,000 as follows:

“Exercisable at a price of \$250 for 25% of the equipment (the identity of the equipment to be purchased to be determined by Ortho) at and after the end of each consecutive 12-month period of supply by Duramed of the Branded Product to customers in amounts at least equal to orders solicited through the efforts of Ortho;

“Duramed will receive a credit against buy-out price in an amount of not more than \$250 per such 12-month period based on rent payments previously made.

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“In the event that: (i) Ortho (or affiliate) is required to pay on the guarantee provided for in Exhibit G of the Letter Agreement, (ii) a default by Duramed of any Sections 3, 7.2, 7.3, 7.4, 7.5, 7.8, 7.11 or 10 of the Letter agreement has occurred and is continuing, or (iii) an event which would permit the termination of the Marketing Services Agreement pursuant to Sections 5.2 and 5.3 thereof has occurred and is continuing, Ortho may, at its option, either reclaim the equipment or require Duramed to purchase the equipment. If Ortho requires Duramed to purchase the equipment, Duramed shall pay the price of such equipment on the basis of equal quarterly payments over a three year period based upon the fair market value of the equipment at the time of termination and the prime rate of interest in effect at such time.”

The equipment was installed in late 1994 and was first used to produce the conjugated estrogen product in the first half of 1995. (R. at 19)

At hearing, Mr. Holt identified personal property tax returns and Duramed’s annual reports on form 10-K for tax years 1994, 1995, 1996, and 1997. Said reports indicate Duramed’s treatment of the \$4,000,000 of equipment at issue before and after the execution of the purchase agreement. The evidence shows that Duramed did not report the equipment and machinery at issue on its Ohio personal

property tax returns until the year ending December 1996 (Appellant's Exhibit 6, 1997 return). The evidence further demonstrates that Duramed first listed the equipment and machinery on its United States Securities and Exchange Commission form 10K/A year-end report in the fourth quarter of 1996. (Appellant's Exhibit 7)

The September 24, 1997 purchase agreement is included in the record before the Tax Commissioner. (S.T. at 44) Within the recitals of the purchase agreement, the manufacturing equipment at issue is listed in Exhibit A to the agreement.

Duramed argues<sup>5</sup> that because the FDA had not approved its new product application prior to Duramed's purchase in 1997, the equipment was incapable of use and therefore, not 'used in business.' Duramed argues that pursuant to the Ohio Department of Taxation's information releases on September 22, 1995 and May 7, 1996, the state advised that in construing franchise tax credits under R.C. 5733.33, the department would follow both statutory and case law relating to personal property to determine whether the taxpayer is a manufacturer and/or whether the property is used in manufacturing. Duramed relies upon a number of Ohio Supreme Court cases holding that certain property not physically capable of use should not be taxed as personal property because it is not 'used in business.' See *United Telephone Co. of Ohio v. Tracy* (1996), 84 Ohio St.3d 560, holding that unused and damaged wires are not used in business; however, wires temporarily taken out of service are still used in business; *Gannett Satellite Info. Network, Inc. v. Limbach* (1989), 45 Ohio St.3d 145, inoperable

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<sup>5</sup> This argument does not appear to have been raised in the proceedings before the Tax Commissioner; however, we will nevertheless consider it given it falls within a broad reading of the issues raised by Duramed in its notice of appeal.

machinery in the process of being removed is not used in business; *Dayton Press, Inc. v. Limbach* (1989), 42 Ohio St.3d 101, equipment and machinery being held for disposal was not used in business; *Hatchadorian v. Lindley* (1986), 21 Ohio St.3d 66, coaxial cable tubes that had never been placed in service and were incapable of use were not used in business; and *The BOC Group, Inc. v. Limbach* (June 30, 1989), BTA No. 1985-G-679, unreported, where we held that equipment disassembled, sold, removed, and placed in storage (after appellant's product was not granted governmental approval to manufacture) was not used in business.

Given the facts before us, it is not necessary for this board to reach Duramed's argument concerning the lack of governmental approval.

The record indicates that the Tax Commissioner's denial of Duramed's application is premised upon the existence of a lease regarding the equipment at issue.<sup>6</sup> Based on the plain language of the statute, we fail to see that the existence of a lease would operate to defeat Duramed's application for the credit, given it is apparent that the equipment was first used in Ohio by Duramed.

Within the department's information release, dated September 22, 1995, the state provided definitions and interpretations relative to R.C. 5733.33(A). Specifically, it provides:

“Purchase. The term ‘purchase’ as used in the new law has the same meaning as in IRC section 179(d)(2)\*\*\*.

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“If for federal income tax purposes or if generally accepted accounting principles a ‘lease’ of qualifying equipment is

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<sup>6</sup> Before this board, Mr. Holt denied knowledge of any lease or rental payment between Duramed and Ortho-McNeil. (R. at 12, 32, 64, 68)

considered a purchase of the equipment, the lease is also considered a purchase for purposes of the credit.”

There is nothing in the record before us to suggest that Duramed’s alleged lease of the subject property would amount to a purchase for federal income tax purposes or under generally accepted accounting principles.

We find R.C. 5733.33, which grants the credit, to be clear and unambiguous. It may be applied to the facts of the instant case without interpretation. *Basic Distrib. Corp. v. Ohio Dept. of Taxation*, 94 Ohio St.3d 287, 291, 2002-Ohio-794. We find that the allowance of the credit prescribed by R.C. 5733.33(B)(1) is determined upon Duramed’s purchase of new manufacturing machinery and equipment during the qualifying period which commenced July 1, 1995. However one may construe the relationship between Ortho-McNeil and Duramed, the evidence is uncontroverted that Duramed’s obligation to purchase under the agreement with Ortho-McNeil arose on September 24, 1997. The evidence also establishes that the original use of the machinery and equipment in Ohio was by Duramed in 1994. The definition of “new machinery” under R.C. 5733.33(A)(2) is unambiguous and requires only that the original use in Ohio is by Duramed, and such original use is not restricted or limited to the qualifying period. We also conclude that the legislative purpose in granting the credit has been served since it arises from the subsequent purchase and use of the machinery and equipment by Duramed in Ohio during the qualifying period.

For the foregoing reasons, we find that Duramed is entitled to the credit which it seeks. Accordingly, it is the decision and order of the Board of Tax Appeals

that the final determination of the Tax Commissioner is hereby reversed and the matter remanded for further proceedings consistent with the foregoing decision.

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