

STATE OF ALABAMA,  
DEPARTMENT OF REVENUE,

vs.

JAMES RIVER PENNINGTON, INC.  
Route 114 Naheola Mills  
HC No. 66, Box 315  
Pennington, AL 36916-9499,

Taxpayer.

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STATE OF ALABAMA  
DEPARTMENT OF REVENUE  
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 92-292

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed James River Pennington, Inc. ("Taxpayer") for State sales tax for the period May 1989 through April 1989, State use tax for the period April 1989 through March 1990, and Choctaw County use tax for the period April 1989 through April 1990. The Taxpayer timely appealed to the Administrative Law Division. George E. Rogers, Paul Gay, Allan E. Stinchfield and K. E. Scarasbrick represented the Taxpayer. Assistant counsel Duncan Crow represented the Department.

The Taxpayer owns and operates a large papermill in Choctaw County, Alabama. The issue in this case is whether equipment and materials purchased and used by the Taxpayer on a construction project at the mill during the period in issue were exempt from sales and use tax pursuant to the sales and use tax pollution control exemptions at Code of Ala. 1975, §§40-23-4(16) and 40-23-62(18), respectively.

The Taxpayer's papermill was constructed in approximately 1958 and has operated continuously since that time. The last major renovation at the mill prior to the project in question was in 1984.

The paper industry discovered in 1985 that trace amounts of dioxin existed in both the liquid effluents ("sludge") and the pulp produced by papermills. Dioxin is a dangerous chemical pollutant that is regulated by the Environmental Protection Agency ("EPA") concerning dioxin in water, and the Federal Drug Administration ("FDA") concerning dioxin in food-contact paper products. Dioxin is formed during the pulp bleaching process when elemental chlorine gas commonly used in the bleaching process reacts with certain chemicals in the unbleached pulp.

The dioxin level in the sludge emitted from the Taxpayer's mill during the mid-1980's exceeded the recommended maximum level of .013 parts per quadrillion previously established by the EPA.

Alabama had not established a maximum level for dioxin in water at that time, but was required by the 1987 Clean Water Act to eventually adopt either the strict EPA standard or some other defensible standard. The FDA was also studying the problem of dioxin in food-contact paper products in the late 1980's, but had not yet set a maximum level for dioxin in pulp. Not knowing what maximum levels Alabama and the FDA would establish, the Taxpayer decided in 1989 to take affirmative action to reduce dioxin to a non-detectible level in both the sludge and the pulp at its mill.

Dioxin is caused by the use of chlorine in the bleaching process. The amount created is so small that once formed it cannot be removed with existing technology. Consequently, dioxin can only be eliminated by substituting chlorine dioxide for chlorine in the bleaching process so that dioxin is not formed in the first place.

The Taxpayer thus committed to making the necessary changes in its bleaching system through the chlorine dioxide generator and bleach plant modification project ("project"). It is the equipment and materials used on that project that are in issue in this case.

The Taxpayer concedes that the project increased the pulp quality and production capacity of the mill. However, the Taxpayer argues that the equipment and materials used on the project should still be exempt from sales and use tax because the primary impetus behind the project was pollution control.

The Department argues that the equipment, materials, etc. used on the project should not be exempt because they are part of and necessary to the Taxpayer's production process.

The Taxpayer completed a "Capital Appropriations Request" (Taxpayer Exhibit 1) concerning the project in March 1989. That document describes the equipment and plant modifications necessary for completing the project, and the reasons for and expected benefits from the project. Excerpts from Exhibit 1 are set out below.

A March 21, 1989 letter on page 2 reads in part as follows:

. . . This project is designed to reduce dioxin levels in Naheola's bleached pulp to non-detectable levels. Elimination of the hypochlorite bleaching stage will eliminate formation of chloroforms in the effluent and enhance pulp quality. Naheola sanitary products and bleached board utilized in food service and food packaging products make the mill particularly sensitive to the dioxin issue.

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All elements of this project will be engineered with future pulping expansion plans in mind. Capacities and process capabilities will accommodate 1800 bleached pulp tons per day or will be readily expandable to that production rate. The alternative of modifying the existing plant to current capacities was evaluated for capital comparison. This option would require 36.0 MM.

The argument could be made that the project as it is being submitted includes approximately 15.0MM incremental investment to achieve a future production of 1800 ADTPD.

The "Capital Appropriations Request" on page 5 states in part as follows:

. . . A non-detect level of dioxins in pulp is the main goal of this project, and every effort is being made to move as fast as feasible.

The "Summary of Economic Benefits" on page 6 reads as follows:

There are cost savings to be realized with high substitution of chlorine dioxide by reducing chemical usage, but it is very site specific and cannot be quantified at this time. The primary impetus for the project is the reduction of dioxins in our products to a non-detect level. The elimination of hypochlorite in the bleaching process will improve the strength and quality of pulp and eliminate formation of chloroforms in the effluent.

The "Executive Summary" beginning on page 7 states in part as follows:

There is within James River, and all other bleached pulp mills in the United States, a strong need to reduce dioxin to a non-detect level in all products. This is an especially high priority at Naheola in view of the food contact Paperboard Packaging and Dixie base stock produced from Naheola pulp.

Recent research and some industrial experience has shown that dioxin can be reduced/eliminated by significantly reducing elemental chlorine in the first bleaching stage.

The most cost-effective way to accomplish this is by increasing chlorine dioxide in the first stage to a 50% - 70% substitutional level.

An increase in pulp quality and strength can also be accomplished at this time by eliminating the hypochlorite from the bleaching processing.

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This project has many benefits from an environmental standpoint quality improvements and also addresses a production increase. The chlorine dioxide generator and bleach plant modifications were originally incorporated in the overall chemical recovery-pulping expansion at Naheola. Due to the high priority need to reduce the dioxin content in our products to a non-detect level, this project requires moving ahead as quickly as possible.

Installation of the chlorine dioxide generator and modifications to use high substitution in the first stage will require about \$20 million of this capital. It is, however, prudent to seize the opportunity to eliminate hypo chlorite altogether for improved quality and address the planned production increase at the same time.

Finally, the "Qualitative Engineering Assessment" on pages 9-17 of Exhibit 1 describe in detail the technical aspects of the project.

The pollution control exemptions in issue apply to property "acquired primarily" or "placed in operation primarily" for pollution control purposes. See, Code of Ala. 1975, §§40-23-4(16) and 40-23-62(18), respectively. If property is acquired primarily for pollution control purposes, the exemption is not lost because the property may also be used in the production of goods or services. On the other hand, property is not exempt if it is acquired primarily for the production of goods or services, even though it may also serve to control pollution.<sup>1</sup> In other words,

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<sup>1</sup> The exemption also does not apply to equipment or a facility used for pollution control if the taxpayer's primary business activity is pollution control. In that case, the taxpayer's primary motive for acquiring the equipment or facility is to make a profit, not pollution control. See, Chemical Waste Management, Inc. v. State, 512 So.2d 115 (hazardous waste facility

the primary reason why the property is purchased is controlling.

Under the "acquired primarily" test, the same property may be exempt in some instances and taxable in others. For example, if a business purchased equipment necessary to its production process either to get started in business or to replace worn-out or obsolete equipment, the exemption would not apply even if the equipment also served to control pollution. However, if the equipment, although used in the production of goods or services, was purchased primarily because it better controlled pollution, then the exemption would apply. The equipment would be exempt

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taxable because the taxpayer acquired it to make a profit); See also, Admin. Docket No. U.91-144 (exemption denied to equipment used by company engaged in wastewater disposal business); Admin. Docket No. S.90-257 (exemption denied to equipment used by company engaged in asbestos removal business) and Admin. Docket No. U.88-107 (exemption denied to containers, trucks, etc. used by company engaged in residential and commercial solid waste disposal business).

because it would not have been acquired "but for" the pollution control motive.

Whether property is acquired primarily for pollution control purposes is a question of fact that must be decided on a case-by-case basis.

The project clearly allowed the Taxpayer to increase and enhance pulp strength and quality and also expand the pulp production capability of the mill. However, the Taxpayer's primary reason for undertaking the project was to reduce pollution by eliminating dioxin in its bleaching process. Consequently, all equipment and materials necessary to convert the Taxpayer's bleaching process to a non-detect level of dioxin was acquired primarily for pollution control purposes and thus is exempt from sales and use tax.

However, it is not clear whether all of the property in issue was necessary or used primarily to convert the Taxpayer's bleaching system to a non-detect level of dioxin. If some of the property was included primarily to increase the capacity of the mill or for some other reason not necessary for reducing dioxin, those items would not be exempt.

Frankly, I do not sufficiently understand the technical aspects of the project to be able to determine what equipment and materials were necessary to change the bleaching system, and what equipment and materials, if any, were included primarily to increase production capacity, enhance quality, or for some other purpose unrelated to pollution control.

Consequently, the Taxpayer is directed to submit a written report

to the Administrative Law Division explaining why the different equipment purchased on the project was necessary or included in the project. The report should be submitted by September 23, 1994. The Department will be allowed to respond. A subsequent hearing will be scheduled if deemed necessary, after which a Final Order will be entered.

Entered on August 24, 1994.

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BILL THOMPSON  
Chief Administrative Law Judge