

KYKENKEE, INC.  
ALABAMA  
P.O. Box 297  
Vance, AL 35490,  
DIVISION

§ STATE OF  
DEPARTMENT OF REVENUE  
§ ADMINISTRATIVE LAW

618 Taxpayer,

§ DOCKET NO. S. 01-

v.

§

STATE OF ALABAMA  
DEPARTMENT OF REVENUE.

§

### **OPINION AND PRELIMINARY ORDER**

The Revenue Department assessed Kykenkee, Inc. (“Taxpayer”) for State and local use tax for January 1997 through December 1999. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 5, 2002. Assistant Counsel Wade Hope represented the Department. Blake Madison represented the Taxpayer.

### **ISSUE**

The issue in this case is whether two handling or storage bins used by the Taxpayer in its sawmill business were subject to State and local use tax at the reduced 1½ percent “machine” rate levied at Code of Ala. 1975, §40-23-61(b). The reduced rate applies generally to “machinery which is used in mining, quarrying, compounding, processing, or manufacturing tangible personal property, and the parts of such machines, attachments and replacements therefor . . . .”

### **FACTS**

The Taxpayer operates a sawmill in Tuscaloosa County, Alabama. The Taxpayer uses large saws to cut raw logs into individual boards. The sawing

process produces sawdust and wood chips, which fall onto a movable conveyor system directly under and attached to the saw superstructure. The conveyor system removes the sawdust and chips from the cutting area. The sawdust is sifted from the chips, carried by the conveyor system outside the saw building, and dumped into a 22-foot bin. The conveyor superstructure that carries the sawdust to the bin is welded to the bin. A separate conveyor inside the bin spreads the sawdust evenly throughout the bin.

The conveyor system also separates the larger wood pieces and funnels them through a chipper, where they are reduced in size. The chips are then carried by the conveyor system outside the saw building and dumped into a second bin that is approximately 44-feet long. Again, the conveyor superstructure that carries the chips to the bin is welded to the bin. A separate internal conveyor inside the chip bin spreads the chips evenly throughout the bin.

The Taxpayer uses most of the sawdust for fuel in its drying kilns. The remainder is sold. The Taxpayer also sells the chips to paper companies and other customers. The Taxpayer derives approximately 30 percent of its revenue from the sale of chips and sawdust.

The removal of the sawdust and chips from the sawing area is necessary for the smooth, uninterrupted operation of the mill. If any part of the conveyor system is not working, including the internal conveyors in the two bins, the entire mill shuts down until the problem is fixed. The Taxpayer is also required to dump the sawdust and chips into the closed bins because the Alabama Department of Environmental Management (ADEM) prohibits the open dumping of sawdust and chips.

The Taxpayer purchased the two bins in issue outside of Alabama during the audit period. It reported and paid Alabama and local use tax on the bins at

the reduced 1½ percent “machine” rate levied at §40-23-61(b). The Department audited the Taxpayer and assessed the bins at the general 4 percent rate.<sup>1</sup> The Taxpayer appealed.

### **ANALYSIS**

Sales and use taxes are viewed by the general public as the simplest taxes to understand. They can, however, be the most difficult to administer. This case again illustrates the in-depth analysis required to interpret a use tax statute that is simple in concept - a reduced tax rate on machines used in manufacturing, processing, etc. - but difficult in application.

Section 40-23-61(b) levies a 1½ percent use tax on machines “used in mining, quarrying, compounding, processing, and manufacturing of tangible personal property. . . .” The reduced rate also applies to “the parts of such machines, attachments, and replacements thereof, which are made or manufactured for use on or in the operation of such machines and which are necessary to the operation of such machines and are customarily so used.” Section 40-23-61(b).

The Department argues that the bins in issue do not qualify for the reduced rate because they are used for storage only, and are not “a machine that is necessary to the manufacturing or processing of the lumber . . . .” (T. 6). The Department concedes that the conveyor system qualifies as a “machine” pursuant to Dept. Reg. 810-6-2-.88 as an attachment to the saw mechanism. It claims, however, that the bins are “an attachment to an attachment” to manufacturing equipment, and thus not eligible for the reduced rate. (T. 17). In short, the Department claims that the conveyor system that qualifies for the reduced rate ends somewhere short of the two bins.

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<sup>1</sup>The Department made other audit adjustments that are not disputed.

The Taxpayer contends that the reduced rate applies because the bins are attached to and are an integral and necessary part of the conveyor system. In a close case, I agree with the Taxpayer.

The Alabama Supreme Court has addressed the sales and use tax machine rate provisions on numerous occasions.<sup>2</sup> That Court has broadly construed the provisions to include (1) lumber used to make flasks to hold sand in place during the casting of stoves and furnaces, *State v. Taylor*, 80 So.2d 618 (Ala. 1954); (2) sand used to make molds for casting pipe and steel shot used to remove the sand after the casting process, *State v. Newbury Mfg. Co., Inc.*, 93 So.2d 400 (Ala. 1957); (3) barge unloader equipment that was part of a coal-conveying belt system used in the production of electricity, *Alabama Power Co. v. State*, 103 So.2d 780 (Ala. 1958); (4) paper bags used to shape and hold briquets in a furnace during the production process, *State v. Calumet & Hecla, Inc.*, 206 So.2d 354 (Ala. 1968); and (5) explosive materials used to remove or loosen coal in a coal mining operation, *Robertson & Assoc. (Ala.) v. Boswell*, 361 So.2d 1070 (Ala. 1978). See also, *Overseas Hardwood Co., Inc. v. State of Alabama*, S. 00-664 (Admin. Law Div. 10/1/01) (stacking sticks used to separate lumber in the drying process entitled to the reduced rate); and *NTN Bower Corp. v. State of Alabama*, S. 01-237 (Admin. Law Div. 10/1/01) (coolant and lubricant necessary and essential to the production of roller bearings entitled to the reduced rate).

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<sup>2</sup>The sales tax machine rate levy at Code of Ala. 1975, §40-23-2(3) is identical in substance to the use tax provision in issue. Before 1959, machines used in manufacturing, processing, etc. were exempt from sales and use tax. Code of Ala. 1940, Title 51, §751(p) (sales tax) and §789(p) (use tax). The Legislature imposed a reduced 1½ percent levy on such machines in 1959. Acts 1959, 2nd Exec. Sess., No. 100, p. 298, §2 (sales tax); and Acts 1959, 2nd Exec. Sess., No. 99, p. 295, §1 (use tax).

On the other hand, the Supreme Court rejected the application of the machine rate concerning (1) an ash disposal system used to clear ashes from furnaces used in the production process and overhead cranes used to inspect, maintain, and repair plant machinery, *Alabama Power, supra*; (2) saw sharpeners, grinders, etc. used to repair and maintain saws used in the manufacturing process, *State v. Selma Foundry and Machine Co.*, 160 So.2d 1 (Ala. 1964); and (3) gravel used as a roadbed over which coal was moved from a coal mine, *Robertson & Assoc., supra*. See also, *Ona Corp. v. State of Alabama*, U. 90-315 (Admin. Law Div. 2/10/95) (coolant used only to maintain cutting tools not entitled to the reduced rate).

The general rule of law established by the above cases is that the function of the property in the process is controlling, not the material of which it is composed. If the property performs an integral function in the manufacture, processing, etc. of the end product, the reduced rate applies. But if the material, although necessary in the overall process, serves only as an aid in enabling a machine or its parts to operate, the reduced rate does not apply.

The conveyor system in issue is somewhat analogous to the ash disposal system in *Alabama Power*. Alabama Power Company produced electricity by burning coal in steam boilers. The boilers left an ash residue, which was removed by a hydraulic pump disposal system.

The Supreme Court found that although the disposal system performed an essential function and was necessary to the continued operation of the plant, it was not part of the production process. "The Court concludes that the essential function of the hydraulic ash disposal system is not production, but is rather maintenance of the plant machinery and premises free of accumulation of waste material, and that the assessment of use tax upon its component parts was proper." *Alabama Power*, 103 So.2d at 782.

The conveyor system in issue performs a function similar to the hydraulic removal system in *Alabama Power* in that it removes sawdust and chip residue from the cutting area. That would suggest that the conveyor is not entitled to the reduced rate. There is, however, one important factual difference. The hydraulic system in *Alabama Power* was independent of the boilers. In this case, the conveyor system is attached to and a part of the saw superstructure. Consequently, the Department concedes that the conveyor system, although by itself not entitled to the reduced rate, is taxable at the reduced machine rate as a qualifying attachment pursuant to Dept. Reg. 810-6-2-.88.<sup>3</sup> As indicated, however, the Department argues that the bins are only an attachment to the conveyor system, and thus sufficiently removed from the sawing process to be not entitled to the special rate. I disagree.

The bins by themselves do not qualify for the machine rate. But they are physically attached to and a part of the conveyor system, which does qualify. The bins are also a

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<sup>3</sup>Regulation 810-6-2-.88 is entitled "Sawdust Removal Equipment," and provides that equipment used in removing sawdust from saws in sawmills is subject to the machine rate, but only if the equipment is attached to and part of the sawing mechanism.

necessary and required part of the conveyor system because ADEM does not allow the open dumping of chips and sawdust. If the conveyor system qualifies for the reduced rate as an attachment to a machine, as conceded by the Department, then the bins, as an integral part of the conveyor system, also qualify for the reduced rate as a part of a qualifying attachment. See, Dept. Reg. 810-6-2-.88(3).

The above finding is supported by the rule of statutory construction that a tax levy must be strictly construed for the taxpayer and against the Department. *Calumet & Hecla*, 206 So.2d at 357. While §40-23-61(b) is technically a levy statute, in substance it allows a partial exemption from the 4 percent general use tax rate, and thus arguably should be construed for the Department, like other exemption statutes. *State v. Chesebrough-Ponds, Inc.*, 441 So.2d 598 (Ala. 1983). However, the Alabama Supreme Court certainly was aware of the nature of the statute in 1968 when it ruled in *Calumet & Hecla* that the statute should be construed for the taxpayer. See also, *Boswell v. Abex Corp.*, 317 So.2d 314 (Ala.Civ.App. 1975).

The Department is directed to recompute the final assessments in issue by removing the bins from the audit. A Final Order will then be entered for the adjusted amount due.

This Opinion and Preliminary Order is not an appealable Order. The Final Order, when entered, may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered May 7, 2002.

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BILL THOMPSON  
Chief Administrative Law Judge

bt:dr

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