ALEXANDER CITY CASTING CO., INC. P.O. Box 1900 Alexander City, AL 35011-1900,	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	DOCKET NO. S. 99-467
v.	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	

FINAL ORDER

The Revenue Department denied a refund of sales tax requested by Alexander City Casting Company, Inc. (ATaxpayer@) for January 1996 through April 1999. The Taxpayer appealed to the Administrative Law Division pursuant to Code of Ala. 1975, '40-2A-7(c)(5)a. A hearing was conducted on December 8, 1999. Cathy Lay and Glover Kerlin represented the Taxpayer. Assistant Counsel Wade Hope represented the Department.

ISSUE

The Taxpayer manufactures aluminum castings at its facility in Alexander City, Alabama. The Taxpayer uses a coating substance in the production of the aluminum castings. Code of Ala. 1975, '40-23-1(a)(9)b. defines a non-taxable Awholesale sale@ to include the sale of tangible personal property that becomes an Aingredient or component part@ of a product manufactured for sale. The issue in this case is whether the coating used by the Taxpayer in its casting process becomes an ingredient or component part of the finished casting within the scope of the above statute.

FACTS

The Taxpayer produces castings using a lost-foam process, as follows:

The Taxpayer processes polystyrene beads into styrofoam molds. Two or more molds are glued together in the shape or pattern of the product the Taxpayer wishes to produce. The pattern is coated with a mixture of mica and silica (Acoating@). The coated pattern is immersed or packed in sand, except for a small opening at the top. Hot aluminum is poured through the opening. The hot metal displaces the foam and forms a casting in the shape of the foam pattern. The coating remains on the surface of the casting, and to a small degree is mixed with the metal. After the casting cools, the Taxpayer removes approximately 95 to 99 percent of the coating from the finished casting, as requested by the customer for cosmetic reasons.

The coating serves two functions. First, it provides a bonded interface or barrier that prevents the sand from adhering to or mixing with the metal during the casting process. Second, the coating regulates the flow of the metal into the pattern, which reduces defects in the casting.

Use of the coating is required and essential to the lost-foam process. The Taxpayer does not intend for the coating to remain in the finished casting, nor does the coating serve a purpose in or add a necessary ingredient to the finished product.

The Taxpayer, as a direct pay permit holder, is allowed to purchase all tangible property tax-free.[1] The Taxpayer subsequently reports and pays sales (or use) tax on its

[1]See, Department Reg. 810-6-4-.14 and Code of Ala. 1975, '40-23-31.

cost of those items used for a taxable purpose.

The Department audited the Taxpayer and initially assessed the Taxpayer on its purchase price of the styrofoam, glue, and coating used in the production process. The Department later deleted the styrofoam and glue from the audit, but not the coating. The Taxpayer paid the sales tax on the coating, and petitioned for a refund. The Department denied the refund. The Taxpayer appealed.

ANALYSIS

A history of the Alabama sales tax Aingredient or component part@ provision, and the cases interpreting that provision, is necessary to understand this case.

Before 1981, '40-23-1(a)(9)b. defined Awholesale sale@ to include the Asale of tangible personal property or products, . . . to a manufacturer or compounder which enter into and become an ingredient or component part of the tangible personal property or products which such manufacturer or compounder manufactures or compounds for sale, . . .@

The first case involving the ingredient or component part provision was State v. Southern Kraft Corp., 8 So.2d 886 (1942). The issue in Southern Kraft was whether salt cake, sulfur, lime, starch, hydrate of lime, and chlorine used in the manufacture of Kraft paper became an ingredient or component part of the paper. The materials were necessary in the manufacturing process, but a small portion also remained as a necessary ingredient in the finished paper. The Alabama Supreme Court concluded that the ingredient or component part statute applied, holding that any materials Awhich are used with the intent and do in fact become a substantial ingredient or component part of the

finished product, are non-taxable.@ Southern Kraft, 8 So.2d at 889.

The Alabama Supreme Court cited Southern Kraft with approval in State v. U.S. Steel Corp., 206 So.2d 358 (1968). In U.S. Steel, the taxpayer used oxygen in the manufacture of steel. Less than one percent of the oxygen also remained in the finished steel. The Court held that the ingredient or component part provision applied because some of the oxygen remained as a necessary ingredient in the steel.

Next, in Boswell v. Abex Corp., 317 So.2d 314 (1975), the Alabama Court of Civil Appeals held that carbon electrodes used in the manufacture of steel wheels could be purchased at wholesale because the carbon became a necessary ingredient in the steel. The Court, citing Southern Kraft and U.S. Steel, held that the ingredient or component part provision applied even though the carbon electrodes also supplied heat in the production process.

In Robertson & Associates (Ala.), Inc. v. Boswell, 361 So.2d 1070 (1978), the Alabama Supreme Court held for the first time that the materials in issue did not become an ingredient or component part. At issue was whether ammonium nitrate used as an explosive in the taxpayer=s mining operation became an ingredient or component part of the finished product, i.e. the mined coal. Even though small traces became imbedded in the coal, the Court held that the ammonium nitrate did not become an ingredient or component part of the coal as contemplated by the statute. In so holding, the Court stated that Athe test is whether the manufacturer (here the mine operator) used the material (the explosive) with the intent and purpose of making it an ingredient or component part of the mined coal; or, conversely, was its presence in the finished product merely incidental to

its primary function.@ Robertson & Associates (Ala.), Inc, 361 So.2d at 1073.

In Boswell v. General Oils, Inc., 368 So.2d 27 (1978), the taxpayer used fuel oil to power its machinery. The fuel oil contained sulphur, which entered into and became a necessary ingredient in the taxpayer=s finished products. The Court held that the ingredient or component part provision applied because the taxpayer intended that part of the oil remain in the finished product.

After General Oils, the Alabama Legislature amended the sales tax ingredient or component part provision by Act 81-596. The amendment made two substantial changes. First, it eliminated the requirement that the manufacturer must intend for the material to remain in the finished product. Second, it specified that the provision did not encompass Acapital equipment, machinery, tools, or product@ used in the production of the finished product, except those materials essential for the reaction process that came in direct contact with the finished product.

Two cases involving the ingredient and component part issue have been decided since 1981, State v. Alabama Metallurgical Corp., 446 So.2d 41 (1984), and Stauffer Chemical v. State, Dept. of Revenue, 628 So.2d 897 (1993). Those cases both involved the use tax provision at Code of Ala. 1975, '40-23-60(4)b. That use tax statute was identical to the sales tax ingredient or component part provision before 1981. However, the use tax statute was not amended with the sales tax statute in 1981. Consequently, in both cases the Court applied the pre-1981 General Oils Aintent@ test. In Alabama Metallurgical, the Court held that carbon electrodes qualified as an ingredient or component part because the taxpayer intended for the carbon to remain in the final

product. In Stauffer Chemical, the Court held that the ingredient and component part provision did not apply because the taxpayer did not intend for the materials in issue to remain in the final product.

The Alabama Legislature again amended the sales tax ingredient or component part provision by Act 97-648.[2] The 1997 amendment retained the provision that the manufacturer=s Aintent@ was not a factor to be considered. It also removed the provision that machinery, products, etc. used in the production process did not qualify as an ingredient or component part. Instead, it added that the ingredient or component part provision did not apply to Acapital equipment, machinery, tools, or product@ that can be depreciated for Alabama income tax purposes.

The effective date of Act 97-648 was May 29, 1997. The period in issue in this case is January 1996 through April 1999. However, Section 3 of Act 97-648 specified that the Act was retroactive to Aall years for which a preliminary assessment of tax could be made under '40-2A-7.@ The retroactive provision makes Act 97-648 applicable to the entire period in issue.

Because the 1997 Act applies, it is irrelevant that the coating in issue is used in the

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[2]Act 97-648 also amended the use tax provision, '40-23-60(4)b. The Alabama sales tax and use tax ingredient or component part provisions are now identical.

production process, and thus would not have qualified as an ingredient or component part under the pre-1997 version of the statute. The coating also is not excluded per se under the current statute because it cannot be depreciated for Alabama income tax purposes.

How should the current statute be interpreted? Other than removing intent as a factor and specifying that depreciable equipment does not qualify, the current version of '40-23-1(a)(9)b. is in substance identical to the pre-1981 statute. Consequently, the last Supreme Court opinion interpreting the pre-1981 statute, Robertson and Associates, should control.

As discussed, Robertson and Associates held that the test was Awhether the manufacturer . . . used the material . . . with the intent and purpose of making it an ingredient or component part of the (finished product); or, conversely, was its presence in the finished product merely incidental to its primary function.@ Robertson & Associates, 361 So.2d at 1073. While both the 1981 and 1997 amendments to '40-23-1(a)(9)b. eliminated intent as a factor, the remainder of the Robertson & Associates test is still valid. That is, material does not become an ingredient or component part within the scope of the statute if its presence in the finished product is not necessary and is only incidental to its primary function.

In Robertson & Associates, the Supreme Court noted that the oxygen in U.S. Steel and the carbon electrodes in Abex provided necessary ingredients to the finished products. It then found that the ammonium nitrate in issue was not a necessary ingredient, but rather was only incidentally in the coal, and thus did not qualify as an ingredient or component part.

In addition to U.S. Steel and Abex, in every other Alabama case in which the ingredient or component part provision was held to apply, the materials in issue provided a necessary ingredient in the finished product. In Southern Kraft, the materials in issue provided necessary ingredients in the finished Kraft paper. In General Oils, the fuel oil contributed sulfur necessary for the production of the finished products. In Alabama Metallurgical, the carbon electrodes supplied carbon as a necessary ingredient in the finished product. Only in Robertson & Associates did the material in issue not provide a necessary ingredient in the finished product. The Supreme Court thus concluded that the ingredient or component part provision did not apply.

Likewise, the coating in issue does not provide a necessary ingredient in the finished castings. The sole function and purpose of the coating is to aid in the manufacturing process. The presence of the coating on or in the finished casting is only incidental to that function. Indeed, the Taxpayer attempts to remove as much of the coating from the finished casting as practicable for cosmetic reasons. Requiring the Taxpayer to pay tax on the coating will not result in double taxation because the Taxpayer is not reselling the coating to its customers. Rather, the coating should be taxed at the reduced 1 **2** percent Amachine@ rate levied at Code of Ala. 1975, '40-23-2(3).

The above holding complies with the purpose of the ingredient and component part provision. Manufacturers are allowed to purchase the ingredient or component parts of a final product tax-free to prevent double taxation.[3] The rationale is that the value of all

[3]In that respect, the ingredient and component part provision is akin to the sale for resale exemption. See R. Pomp & O. Oldman, State and Local Taxation '7-50 (3rd Ed. 1998). For an overview of how other states view the ingredient and component part issue,

component parts will be included in the finished product, and that sales (or use) tax will be collected on that total value when the finished product is sold at retail. On the other hand, materials used in the manufacturing process are taxed when purchased by the manufacturer because the value of those materials is not included in the finished product.

The hard question arises when a material is necessary to the manufacturing process and also remains in the finished product. In those cases, the test in Alabama for determining whether the materials can be purchased tax-free is whether the materials become a Asubstantial ingredient or component part of the finished product . . .@ Southern Kraft, 8 So.2d at 889, 890, or whether the material=s Apresence in the finished product (is) merely incidental to its primary function@ Robertson & Associates, 361 So.2d at 1073.

The coating in issue does not add value to the casting, and thus does not become a Asubstantial@ part of the casting. Rather, its presence on or in the casting is only incidental to its use in the manufacturing process. As in Robertson & Associates, to allow the Taxpayer to purchase the coating at wholesale would result in the Taxpayer avoiding tax on the coating altogether.

The Department=s denial of the refund in issue is affirmed.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, '40-2A-9(g).

Entered February 25, 2000.

BILL THOMPSON

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see J. Hellerstein & W. Hellerstein, State Taxation &14.03 (3rd Ed. 1999).

Chief Administrative Law Judge

BT:dr
cc: J. Wade Hope, Esq.
Glover Kerlin
Ginger Buchanan