WAYNE FARMS LLC D/B/A DUTCH QUALITY HOUSE C/O CHARTWELL ADVISORY GROUP 800 CORPORATE CIRCLE, SUITE 103 HARRISBURG, PA 17110,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 06-797
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER DENYING TAXPAYER'S APPLICATION FOR REHEARING

This appeal involves a denied refund of State sales tax requested by the above Taxpayer for July 2002 through November 2003. A Final Order was entered on June 18, 2007 granting the Taxpayer a reduced refund of $18,533.13.

The Taxpayer timely applied for a rehearing, and a hearing was conducted on September 13, 2007. Jim Malone and Steve Deviney represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

The Taxpayer processes chickens at a facility in Alabama. It uses carbon dioxide at two points in the process. First, immediately after the chicken is cooked, carbon dioxide is sprayed on to cool the chicken. The chicken is then cut into pieces. Carbon dioxide is sprayed on a second time during packaging to freeze and preserve the chicken.

The Taxpayer paid sales tax on the carbon dioxide it used during the period in question. It subsequently petitioned for a refund of the tax because, according to the Taxpayer, the carbon dioxide becomes a nontaxable ingredient and component part of the chicken. See, Code of Ala. 1975, §40-23-1(a)(9)b. It further claims that even if the ingredient or component part provision does not apply, the second spray of carbon dioxide

used to freeze and preserve the chicken is still exempt as packaging pursuant to Code of Ala. 1975, §40-23-4(a)(20).

The Department initially denied the refund in full. The Taxpayer appealed. The Department subsequently determined that the second spray of carbon dioxide was exempt pursuant to §40-23-4(a)(20) because it was sprayed into and became a part of the packaging of the chicken. The Administrative Law Division consequently entered a Final Order on June 18, 2007 that partially granted the Taxpayer's refund request concerning the second spray of carbon dioxide.

The Taxpayer argues on rehearing that all of the carbon dioxide is nontaxable because it remains in and becomes an ingredient part of the chicken.

The Department disagrees that the first spray of carbon dioxide remains in the chicken. Rather, the Department's examiner testified that she was told by the Taxpayer's plant manager that the first spray dissipates during the process.

Section 40-23-1(a)(9)b. defines "wholesale sale" in part as the sale of tangible personal property that becomes an ingredient or component part of a product manufactured for sale. The Administrative Law Division addressed the sales tax ingredient and component part provision in *Alexander City Casting Co., Inc. v. State of Alabama*, S. 99-467 (Admin. Law Div. 2/25/2000). The issue in that case was whether a coating substance used in the production of aluminum castings became a non-taxable ingredient or component part of the castings within the purview of §40-23-1(a)(9)b. The Administrative Law Division held as follows:

> A history of the Alabama sales tax "ingredient 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 "wholesale sale" to include the "sale 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 "which 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 "the 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 "capital 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* "intent" 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. (footnote omitted) The 1997 amendment retained the provision that the manufacturer's "intent" 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 "capital 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 "all 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 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 "whether 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 ½ percent "machine" rate levied at Code of Ala. 1975, §40-23-2(3).
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> 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. (footnote omitted) The rationale is that the value of all 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 "substantial ingredient or component part of the finished product . . ." *Southern Kraft*, 8 So.2d at 889, 890, or whether the material's "presence in the finished product (is) merely incidental to its primary function" *Robertson & Associates*, 361 So.2d at 1073.
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> The coating in issue does not add value to the casting, and thus does not become a "substantial" 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.

Alexander City Casting at 3 – 9.

The only issue addressed by the parties in their post-hearing briefs is whether the carbon dioxide first injected into the chicken to cool it down remains in the chicken. The Taxpayer contends that it does, and offers various letters and scientific articles in support of that claim.

The Department argues that the documentary evidence offered by the Taxpayer is

inadmissible because the Department did not have the opportunity to cross-examine the authors. It asserts that the Taxpayer has offered no admissible evidence supporting its position, and consequently, that the Taxpayer has failed to carry its burden of proving that the first shot of carbon dioxide is nontaxable.

Whether the first shot of carbon dioxide remains in the chicken need not be decided because even if it does, to be nontaxable it must still serve a substantial function in the finished product. The provision does not apply if the material's "presence in the finished product (is) merely incidental to its primary function." *Robertson & Associates*, 361 So.2d at 1073.

In its statement of facts in its post-hearing brief, the Taxpayer asserts that "[as] part of its operation, cooked food passes through a Cryogenic Freezing Tunnel on a continuous conveyor belt. Jets of high velocity carbon dioxide gas are sprayed into the freezing unit. Carbon dioxide is absorbed by the food and results in almost instantaneous freezing." Taxpayer's post-hearing brief at 2. The above statement presumably refers to the so-called second shot of carbon dioxide that is injected during packaging and freezes and preserves the chicken during and after shipping. As indicated, the Department concedes that that carbon dioxide is exempt.

The evidence indicates, however, that the only purpose for the first shot of carbon dioxide is to cool the chicken so it can be efficiently cut into pieces. That carbon dioxide may or may not remain in the chicken, but even if it does, its function is to cool the chicken, and its subsequent "presence in the (chicken) is merely incidental to" that function. *Robertson & Associates*, 361 So.2d at 1073. There is no evidence that the first shot of

carbon dioxide serves any other purpose than to cool the chicken. Consequently, that portion of the carbon dioxide is taxable pursuant to the rationale of *Robertson & Associates*.

The Taxpayer argues that the Administrative Law Division has previously held that carbon dioxide used in processing chicken is nontaxable as an ingredient or component part. That issue was previously addressed in *Keystone Foods, LLC v. State of Alabama*, S. 02-546 (Admin. Law Div. Amended F.O. 11/12/2003). The Department (and Etowah County) agreed in that case that the carbon dioxide in issue was nontaxable. (The Administrative Law Division did not make a substantive ruling on the issue.)

A review of *Keystone Foods* shows, however, that only the second shot of carbon dioxide was in issue. Keystone's petition for refund specified that it was seeking a refund concerning "the final stage of (the) process that uses CO2 and nitrogen which provides the cryogenic freeze of the product." As pointed out by the Department at the September 13 hearing, there was no mention in *Keystone* concerning the first shot of carbon dioxide that is applied to cool the chicken. Consequently, that ruling is not precedential.

The Taxpayer's application for rehearing is denied. The June 18, 2007 Final Order is affirmed.

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

Entered January 14, 2008.

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BILL THOMPSON

Chief Administrative Law Judge

bt:dr
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