

OVERSEAS HARDWOODS CO., INC.
P.O. Box 11501
Mobile, AL 3661-0501,

STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayer,

DOCKET NO. S. 00-664

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed Overseas Hardwood Company, Inc. (ATaxpayer@) for sales tax for July 1996 through June 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 June 22, 2001. Tom Sharp represented the Taxpayer. Assistant Counsel Duncan Crow represented the Department.

ISSUE

The Taxpayers sells kiln sticks or stacking sticks (Asticks@) at retail to various customers in Alabama, including sawmills. The customers use the sticks in the process of converting raw wood into finished, marketable lumber. The issue in this case is whether the sticks are subject to sales tax at the reduced 12 percent Amachine@rate levied at Code of Ala. 1975, ' 40-23-2(3). The reduced rate applies to Amachines used in mining, quarrying, compounding, processing, and manufacturing of tangible personal property...@

FACTS

The Taxpayer sells wood products to various industrial customers in Alabama. Among the products sold by the Taxpayer are the sticks in issue. The sticks are made of hardwood, with dimensions that vary from 6 to 8 feet in length, and 1 inch or less in width and height.

The sticks are used by the Taxpayer's customers in the process of drying green hardwood and softwood, including pine. Green lumber boards have a high moisture content, and must be dried to an ideal equilibrium moisture content (AEMC®). If the boards are not properly dried, they cannot be marketed as finished lumber because the high moisture content causes stains, rot, and an unacceptable amount of shrinkage.

The process for converting pine logs into marketable lumber products, and the function sticks perform in that process, is as follows:

Pine logs are cut into green boards of various dimensions. The raw boards are approximately 50 percent water. They are run through a planer machine to smooth the edges, and then stacked in uniform bundles. In stacking the boards, sticks are placed below each layer at specific intervals to create uniform air spaces between the boards. Placing the sticks at appropriate intervals in the bundle prevents fungus and rot, and allows the boards to dry at a uniform rate.

When a sufficient number of bundles are gathered, they are placed in a kiln and treated at temperatures above 212° F. The uniform air passages created by the sticks allow the boards to dry at a uniform rate in the kiln.

The bundles are subsequently removed from the kiln and placed in a shed, where the boards continue to dry to their ideal EMC. The boards are unbundled, dressed in a planer machine, and then sold or used by the Taxpayer's customer. The sticks are subsequently reused by the customer for the same purpose.

The process for drying hardwood is the same as the above process for pine, except that hardwood is sometimes air dried in bundles using sticks before it is kiln dried. Hardwood

is also kiln dried for longer periods at lower temperatures. The sticks perform the same function in processing both hardwood and pine lumber. Use of the sticks is essential and necessary for the processing of the raw lumber into marketable form.

ANALYSIS

Section 40-23-2(3) levies a reduced 12 percent sales tax on the retail sale of Amachines used in mining, quarrying, compounding, processing, and manufacturing of tangible personal property. . . .@The Alabama Supreme Court has addressed the issue in numerous cases.

In *State v. Taylor*, 80 So.2d 618 (Ala. 1954), the taxpayer manufactured stoves and furnaces. It purchased lumber to make flasks, which were used to hold sand in place in a mold during the casting process. The Court held that the flasks, and the lumber used to make the flasks, were Amachines@ within the purview of the statute, and thus exempt from tax.¹ In so holding, the Court acknowledged that a machine does not necessarily have to apply physical force or involve motion; but rather, may have Aonly passive or motionless functions to perform

¹The reduced 12 percent Amachine@rate was enacted in 1959. See, Acts 1959, 2nd Exec. Sess., No. 100, p. 298, ' 2. Before that time, such machines were exempt from sales tax. See, Code 1940, Title 51, ' 755(p).

in the manufacturing. @ *Taylor*, 80 So.2d at 623, quoting *Gulf Oil Corp. v. City of Philadelphia*, 53 A.2d 250 (Pa. 1947).

The Supreme Court next addressed the issue in *State v. Newbury Manufacturing Co., Inc.*, 93 So.2d 400 (Ala. 1957). In *Newbury*, the taxpayer manufactured cast iron pipe fittings. The Court held that sand used to make cores and molds for casting the pipe and steel shot used to remove the sand after the casting process were both exempt. The Court stated as follows:

The term Amachines, attachments and replacements@in this connection have been given a broad meaning. (cites omitted.) Their status is not controlled by the material of which they are composed, but by the office they serve in the process. If the article in question performs an integral function in the procedure by which the tangible person (sic) property is produced, we think it is a part and parcel of the machinery used in its production. It is not controlled by the fact that in its use it wears out its valuable properties in that connection. Many parts of machinery wear out and have to be replaced.

On the other hand, if a product, such as grease or fuel is useful only as an aid, though vital in enabling the machine or some part of it to operate, but not itself performing a distinct function in the operation, it does not come within the exception.

The Asand@ and Asteel shot@here in question have an independent function in the operation. That is not simply as an aid to some other part in the performance of its service. The question is not controlled by whether it is necessary to the operation of a machine--grease and fuel are that, but they perform no specific function in the operation. It is sometimes said to depend upon whether the article has a *direct* part in the processing program. (cites omitted.)

Newbury, 93 So.2d at 402.

In *Alabama Power Co. v. State*, 103 So.2d 780 (Ala. 1958), the Court held that pump parts and attachments used for the disposal of residue from furnaces were not exempt because Athe essential function of the hydraulic ash disposal system is not production, but is

rather maintenance of the plant machinery. . . .@ *Alabama Power Company*, 103 So.2d at 782.

Likewise, the Court held that overhead cranes used to inspect, maintain and repair the plant machinery also were not exempt.

Six years later, in *State v. Selma Foundry and Machine Co.*, 160 So.2d 1 (Ala. 1964), the Court applied the rationale of *Alabama Power Company* in holding that saw sharpeners, grinders, and other equipment used to repair and maintain saws used in the manufacturing process were not exempt.²

In 1968, the Court addressed the issue of whether paper bags used in the production of magnesium ingots were subject to the reduced rate. The bags functioned to hold and shape briquettes in a furnace during the production process. The Court held that the reduced rate applied because the paper bags were an integral, essential, and functional part of the machinery and procedure by which the magnesium metal (tangible personal property) was produced.@ *State v. Calumet and Hecla, Inc.*, 206 So.2d 354, 358 (Ala. 1968).

Finally, in *Robertson and Associates (Ala.) v. Boswell*, 361 So.2d 1070 (Ala. 1978), the Court held that gravel used as a roadbed over which coal was hauled from the mine was not entitled to the reduced rate. Rather, the Court held that the gravel served only as an aid that allowed the coal-carrying trucks to operate.

The rule of law established in the above cases is that if property is used in the manufacturing, processing, etc. of tangible personal property, and serves a direct, integral,

²Although *Selma Foundry* was decided in 1964, after the 12 percent rate was enacted in 1959, the period involved was in the early 1950s. Consequently, the pre-1959 exemption statute still applied.

and necessary function in the process, the reduced machine rate applies. If, however, the property does not serve a direct function in the process, but rather only serves to maintain, repair, or aid the machinery used in the process, the reduced rate does not apply.

It is undisputed that the sticks in issue perform an integral and necessary function in the processing of green lumber. They create uniform air passages that allow the lumber to dry to its ideal EMC. If not properly dried through the use of sticks, the lumber would not be marketable. The sticks thus qualify for the reduced 12 percent rate at '40-23-2(3). The above finding is supported by the rule of statutory construction that a tax levy statute must be construed for the taxpayer and against the Department. *Calumet and Hecla*, 206 So.2d at 357.³

The Department argues that the sticks are not machines within the purview of the statute because they serve merely as an aid in the drying process, rather than serving a function independent of the kiln. Dept. brief at 3. I disagree.

The kiln provides the heat that causes the boards to dry, but the sticks serve a function independent of the kiln by creating uniform air passages that expose all parts of the boards to uniform heat. Without the sticks, the boards would not uniformly dry, and would be

³Technically, '40-23-2(3) is a levy statute. But in substance, it allows machines to be taxed at a reduced rate, and thus is in the nature of an exclusion or exemption from tax, which should be construed against the taxpayer. However, the Supreme Court certainly was aware of the above in 1968, when it held in *Calumet and Hecla* that the statute should be construed for the taxpayer.

unmarketable. They also serve that independent and necessary function when used to dry bundled lumber outside of a kiln.

The Department also cites *Robertson and Associates* and *Ona Corporation v. State*, U. 90-315 (Admin. Law Div. O.P.O. 2/10/95), in support of its case.

As discussed, the Supreme Court held in *Robertson* that gravel used as a roadbed over which coal was transported was not subject to the reduced rate because it served only as an aid to the coal-carrying trucks, and did not perform a direct, integral function in the processing of the coal. In *Ona*, the taxpayer used cutting tools to manufacture engine parts. It pumped coolant onto the cutting tools, which prolonged the effect life of the tools. The Administrative Law Division held that the coolant was not taxable at the reduced rate because it only served to maintain the cutting tools.⁴

The Department is comparing the sticks in issue with the gravel in *Robertson* and the coolant in *Ona* by arguing that the sticks do nothing independent of the kiln, and do not in themselves cause a change in the lumber being dried. @ Dept. brief at 5.

As indicated, however, the sticks serve a direct and necessary function in the drying

⁴The reduced rate did not apply to the coolant in *Ona* because there was no evidence the coolant performed a necessary, integral function in the manufacture of the engine parts. It only served to prolong the useful life of the cutting tools. However, in *NTN Bower Corp. v. State of Alabama*, S. 01-237 (Admin. Law Div. 10/2/01), which was decided in conjunction with this case, coolant used in the manufacture of roller bearings was found to be a machine @ subject to the reduced rate. The coolant cooled and thereby prevented damage to the bearing parts, and thus served an integral and necessary function in the manufacturing process. The fact that coolant was found to be subject to the reduced rate in *NTN Bower*, but not in *Ona*, illustrates that the tax status of property is not controlled by the material of which they are composed, but by the office they serve in the process. @ *Newbury*, 93 So.2d at 402.

process, which is independent of the function served by the kiln. The fact that sticks are also used to dry lumber outside of a kiln aptly illustrates that point. The sticks qualify as machines the same as the wood flasks in *Taylor*, the sand in *Newbury*, and the paper bags in *Calumet and Hecla*. They do not move or apply force in the drying process, but like the flasks, sand, and bags in the above cases, they serve a direct, integral, and necessary function in the processing of the finished product.

The final assessment in issue is dismissed.

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

Entered October 1, 2001.