NTN BOWER CORPORATION 7078 North Bower Road McComb, IL 61455-2511,	'	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	'	DOCKET NO. S. 01-237
v.	'	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	'	

OPINION AND PRELIMINARY ORDER

The Revenue Department assessed NTN Bower Corporation (ATaxpayer@) for State and local use tax for January 1997 through November 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 August 28, 2001 in Birmingham, Alabama. William Bryant and Allison Craft represented the Taxpayer. Assistant Counsel Margaret McNeill represented the Department.

ISSUES

The primary issue in this case is whether coolant and lubricant used by the Taxpayer in its manufacturing process in Alabama should be taxed at the reduced 1 **2** percent Amachine@ rate levied at Code of Ala. 1975, '40-23-61(b). The reduced rate applies to Amachines used in mining, quarrying, compounding, processing, and manufacturing of tangible personal property, ...@ A minor issue is whether the Department correctly credited a payment by the Taxpayer for uncontested tax due.

FACTS

The Taxpayer operates a plant in Hamilton, Alabama, at which it manufactures tapered roller bearings used in trucks, agricultural machinery, and industrial equipment. The finished bearing assemblies are comprised of several parts, some of which are machined, heat

treated to a specific hardness, and then ground to extremely exact tolerances.

Friction in the grinding process causes the surface of the part being ground to heat to above 1,500° F. Such heat may damage or Aburn@ the part, making it unusable. To prevent such damage, the Taxpayer floods the grinding area with coolant.[1] The coolant dissipates the heat evenly over the surface of the part, and prevents the part from being damaged. The coolant is necessary and essential to the grinding process because otherwise the part would be damaged and could not be used.

The Taxpayer uses approximately 6 percent of the total coolant that it purchases in its machine shop. The Taxpayer concedes that the sole function of the coolant used in the machine shop is to maintain the machines, and thus should be taxed at the general 4 percent rate.

The finished bearing assembly includes a retainer, which holds the roller bearings in place. The Taxpayer manufactures or forms the retainer by stamping a solid piece of metal. Defects or Aburrs@ in the retainer may occur in the stamping process due to the direct contact of the metal stamping machine and the metal part. To prevent such defects, the Taxpayer adds a coating lubricant to the surface of the metal part. The lubricant interposes between the

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[1]The coolant used in the grinding process consists of 5.5 percent base coolant concentrate, and 94.5 percent water.

part and the stamping tool to minimize contact, and thereby lessen the risk of defects. The lubricant is necessary and essential to the stamping process because otherwise the part would be damaged and could not be used.

The Department audited the Taxpayer for use tax for the subject period. The Taxpayer did not contest a portion of the audit adjustments, and remitted to the Department auditor the uncontested tax due of $1,701.85.[2] The auditor forwarded the payment to the Sales and Use Tax Division in Montgomery, where it was applied to accrued interest.

The Taxpayer paid tax on the coolant and lubricant in issue at the reduced 1 **2** percent Amachine@ rate. The Department determined that the coolant and lubricant was taxable at the general 4 percent rate, and assessed the Taxpayer accordingly. Of the total tax assessed, 82.4 percent relates to the coolant, and 17.6 percent to the lubricant. As indicated, the Taxpayer concedes the coolant used in the machine shop, which was 6 percent of the total coolant, is taxable at the general 4 percent rate. That represents 4.944 percent (6 percent of 82.4 percent) of the contested tax.

The Taxpayer claims that the coolant and lubricant should be taxed at the reduced rate

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[2]The uncontested State tax was $2,161. However, the Taxpayer was owed a local tax refund of $459.15. Consequently, the Taxpayer remitted the net uncontested liability of $1,701.85.

because they perform direct, essential, and necessary functions in the manufacture of the bearing assemblies.

The Department argues that the coolant and lubricant is not subject to the reduced rate based on the Administrative Law Division=s holding in *Ona Corporation v. State of Alabama*, U. 90-315 (Admin. Law Div. O.P.O. 2/10/95). As discussed below, the Administrative Law Division held in *Ona* that coolant used to cool and maintain cutting tools was not subject to the reduced rate. The Department=s claim that the coolant is used to maintain the grinding tools is supported by the testimony of a Department supervisor that a machine operator at the Taxpayer=s facility told him that if the coolant was not used, it Awould bust the hell out of the grinding wheel.@ (T. at 73).

ANALYSIS

The sales tax Amachine@ rate statute was addressed by the Administrative Law Division in *Overseas Hardwood, Inc. v. State of Alabama*, S. 00-664 (Admin. Law Div. 10/1/01), which was decided in conjunction with this case. The sales tax Amachine@ rate statute at Code of Ala. 1975, '40-23-2(3) is identical to the use tax statute in issue at '40-23-61(b). Consequently, the discussion in *Overseas Hardwood* of the applicable case law on the subject applies equally to this case.

> Section 40-23-2(3) levies a reduced 1**2** percent sales tax on the retail sale of Amachinery which is used in mining, quarrying, compounding, processing, or manufacturing tangible personal property. . @ The Alabama Supreme Court has addressed the issue in numerous cases.
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> 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. (footnote omitted.) 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 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.
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> 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.
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> 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.
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> 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. (footnote omitted.)
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> 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 Athe 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).
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> 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 vehicles to operate.
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> 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 an integral and necessary function in the process, the reduced Amachine@ 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.

Overseas Hardwood at 3-5.

The coolant and lubricant in issue perform essential and necessary functions in the manufacture of the roller bearing assemblies. But for the coolant, the parts would be heat damaged in the grinding process, and could not be used. But for the lubricant, the retainers would be damaged in the stamping process, and could not be used. Consequently, the coolant and lubricant qualify for the reduced 1 **2** percent use tax levied at **'** 40-23-61(b). 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]

This case can be distinguished from *Ona*. In *Ona*, the coolant served only to cool and thereby prolong the useful life of the cutting tools. There was no evidence that the coolant prevented damage to the engine parts being manufactured, or otherwise performed a necessary and integral function in the manufacturing process.

In this case, however, the coolant performs a direct and needed function in the manufacturing process by preventing heat damage in the parts being manufactured. The fact that the reduced rate did not apply in *Ona*, but does apply in this case, is based on the different functions served by the coolant in the two cases. ATheir status is not controlled by the

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[3]Technically, '40-23-2(3) is a levy statute. But in substance, it allows Amachines@ 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.

material of which they are composed, but by the office that they served in the process.@ *State v. Newbury Manufacturing Co., Inc.*, 93 So.2d 400, 402 (Ala. 1957).

The Department claims that the coolant functioned, at least in part, to cool the Taxpayer=s cutting tools, the same as the coolant in *Ona*. That claim is based on the testimony of a Department supervisor that one of the Taxpayer=s machine operators told him that if the coolant was not used, the grinding tool would be damaged. However, while that hearsay testimony was admissible for the purpose of establishing why the Department decided to tax the coolant at the 4 percent rate, it cannot be relied on to prove the truth of the statement asserted. Rather, two witnesses testified for the Taxpayer that the grinding wheel would not be damaged or otherwise harmed if the coolant was not used. (T. at 29, 50.)

Even if the coolant did in some respects prolong the useful life of the grinding tools, the reduced rate would still apply because the coolant clearly also performed an essential and necessary function in the manufacturing process. The Alabama Supreme Court has recognized that if property is used as a machine in the manufacturing process, the reduced rate applies Ain spite of the fact that it is used occasionally for something other than the process of manufacturing.@ *State v. Calumet and Hecla Consol. Copper Co.*, 66 So.2d 726, 730 (Ala. 1953). See also, *State of Alabama v. Phifer Wire Products, Inc.*, U. 85-179 (Admin. Law Div. 5/21/86) (machine used to test wire that was essential and required in the manufacturer of wire products was subject to the reduced rate, even though it was used on occasion for non-manufacturing purposes).

Concerning how the $1,701.85 payment should have been applied, the Department

agreed at the August 28 hearing that it should be applied to the uncontested tax due, as intended by the Taxpayer.

The Department should recompute the Taxpayer=s State and local use tax liabilities by taxing only the coolant used in the machine shop at the 4 percent rate. The Department should notify the Administrative Law Division of the adjusted tax and interest due. A Final Order will then be entered.

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

red October 1, 2001.