IPSCO STEEL (ALABAMA), INC. 12400 HIGHWAY 43 AXIS, AL 36505,	§	STATE OF ALABAMA ALABAMA TAX TRIBUNAL
Taxpayer,	§	DOCKET NOS. S. 07-370 S. 10-269 S. 11-564
v.	§	S. 12-1435
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

SECOND OPINION AND PRELIMINARY ORDER

These consolidated appeals involve denied sales and use tax refund petitions filed by the above Taxpayer concerning various periods from August 2001 through June 2014. An Opinion and Preliminary Order was entered on February 23, 2017. The Tribunal ruled in the Order that work rolls used by the Taxpayer in the production of steel products became an ingredient or component part of the steel, and thus should have been purchased by the Taxpayer tax-free at wholesale pursuant to the use tax "ingredient or component part" provision at Code of Ala. 1975, §40-23-60(4). That statute defines a "wholesale sale" to include the following:

> A sale of tangible personal property or products, including iron ore, and including the furnished container and label of such 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 the manufacturer or compounder manufactures or compounds for sale, whether or not such tangible personal property or product used in manufacturing or compounding a finished product is used with the intent that it becomes a component of the finished product; provided, however, that it is the intent of this section that no sale of capital equipment, machinery, tools, or product shall be included in the term "wholesale sale." The term "capital equipment, machinery, tools, or product" shall mean property that is subject to depreciation allowances for Alabama income tax purposes.

The Tribunal found that because miniscule parts of the work rolls became a part of the manufactured steel, and because the rolls were not depreciable, they qualified for the

§40-23-60(4) wholesale provision.[1]

Revenue Discovery Systems ("RDS"), as an authorized agent for various counties and municipalities in Alabama, requested permission to file an amicus curiae brief on the "ingredient or component part" issue. The request was granted. The Taxpayer also filed a brief on the issue.

Alabama's appellate courts addressed the sales and use tax ingredient or component part provisions, §§40-23-1(a)(9)b. and 40-23-60(4)b., in a series of cases from 1942 until 1993. The Department's Administrative Law Division, now the Tax Tribunal, has also addressed the issue on numerous occasions. Some of those cases are discussed below.

The first case on the issue was *State v. Southern Craft Corp.*, 8 So.2d 887 (Ala. 1942). Southern Craft purchased various items for use in its manufacturing process. The Alabama Supreme Court held that because part of the items remained in the final product and were necessary in the process, they could be purchased at wholesale as ingredient or component parts. In so doing, the Court explained that "the legislative intent (of the ingredient or component part statute) apparently is that the use of tangible personal property by a manufacturer in manufacturing articles of tangible personal property, for sale, 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 Craft*, 8 So.2d at 889.

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[1] The Tribunal also held that railcar brackets used to secure steel being transported on railcars were not "containers," pursuant to the §40-23-1(a)(9)b. wholesale provision; and that coiler rolls were not purchased at wholesale as ingredient or component parts because they had a useful life of over one year, and thus came within the depreciable capital equipment exception in §40-23-60(4).

In *State v. United States Steel Corp.*, 206 So.2d 358 (Ala. 1968), the taxpayer manufactured steel and injected oxygen into the molten metal during the process. The oxygen helped to control the carbon content in the steel, and some of the oxygen remained in the finished steel products. The Court found that because the oxygen was essential to the manufacture of steel and a portion of the oxygen remained in the steel, the ingredient or component part provision applied – ". . .there is an abundance of evidence that the lance oxygen is essential to the manufacture (of the taxpayer's steel), that a portion of the oxygen remains in the steel . . . and that the oxygen component was beneficial and desirable in the steel. . . ." *United States Steel*, 206 So.2d at 363.

In *Boswell v. Abex Corp.*, 317 So.2d 314 (Ala. Civ. App. 1975), the issue was whether carbon electrodes used in the manufacture of railroad car wheels qualified as ingredient or component parts. The Court held that they were. "Abex purchased the carbon electrodes for the dual purpose of providing heat for its furnaces and carbon as an ingredient or component part of the finished steel railroad wheels which it produced. The Alabama Legislature in (§40-23-60(4)b.) defined those sales transactions as wholesale ones because the carbon became an ingredient or component part of the finished product." *Abex*, 317 So.2d at 317.

In *Robertson and Assoc. (Alabama) Inc. v. Boswell*, 361 So.2d 1070 (Ala. 1978), the Alabama Supreme Court for the first time rejected a taxpayer's claim that a disputed item did not become an ingredient or component part. The taxpayer in the case mined coal and purchased ammonium nitrate for use as an explosive. Tiny particles of the substance remained in the mined coal.

The Court first opined that the purpose for the ingredient or component part provision is to avoid double taxation. The Court then stated that "the test is whether the manufacturer (here the mine operator) used the materials (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 and Assoc.*, 361 So.2d at 1073. Applying that test, the Court ruled that the ammonium nitrate did not become an ingredient or component part of the coal.

> Merely because, as an incident of proximity, microscopic particles of water vapor (moisture) and "other gases" from the explosive are chemically traceable in the mined coal does not meet the test of "wholesale sales" as that term is defined by the statute. To allow the purchase of these explosive materials to be classified as "wholesale sales" contravenes the legislative intent to prevent double taxation; instead, such interpretation avoids the tax altogether.

Robertson and Assoc., 361 So.2d at 1074.

The Court of Civil Appeals decided *Boswell v. General Oils, Inc.*, 368 So.2d 27 (Ala. Civ. App. 1978), later in 1978. The issue was whether fuel oil used to make paper products became an ingredient or component part of the products. The fuel oil served a dual purpose in that it supplied energy in the manufacturing process, and was also used as a chemical contributor of sulphur in the process. Applying the *Robertson* rationale, the Court held that "the test . . . is twofold: If any part of a product purchased by a manufacturer is intended to remain and does remain in the manufacturer's finished product (the ingredient or component part provision applies, and) the purchase is at wholesale, and therefore tax free." *General Oils*, 368 So.2d at 29.

In all of the above cases, the Courts found that the ingredient or component part provision applied only if the manufacturer/processor intended for the materials in issue to become a part of the finished product, i.e., the materials were necessary in the manufacturing process. The Legislature amended the sales tax ingredient or component part provision, §40-23-1(a)(9)b., by Act 81-596 in 1981. As amended, the section now specifies that the provision applies if the materials become a part of the manufactured product "whether or not such tangible personal property or product . . . is used with the intent that it become a component of the finished product; . . . ."

The Legislature did not also amend the use tax ingredient or component part statute at §40-23-60(4)b. in 1981 to include the above language. The Court of Civil Appeals thus held in *State v. Alabama Metallurgical Corp.*, 446 So.2d 41 (Ala. Civ. App. 1984), that the intent of the manufacturer in making the materials a part of the finished product was still relevant for use tax purposes. The Court also later recognized in *Stauffer Chemical v. State, Dept. of Revenue*, 628 So.2d 897 (Ala. Civ. App. 1993), that the 1981 amendment applied only to sales tax, and that for use tax purposes, intent was still a factor.

The Alabama Legislature amended the use tax ingredient or component part provision at §40-23-60(4)b. by Act 97-648 in 1997 to remove the manufacturer's intent as a factor in deciding if the provision applied. The sales and use tax ingredient or component part provisions are thus now identical.

Alabama's appellate courts have not addressed the sales tax provision at §40-23-1(a)(9), as amended in 1981, or the use tax provision at §40-23-60(4)b., as amended in 1997. The Department's Administrative Law Division, now the Tax Tribunal, has, however,

addressed those statutes, as amended.

In February 2000, the Division held in *Alexander City Casting Co. v. State of Alabama*, Docket S. 99-467 (Admin. Law Div. 2/25/2000), that a coating substance used by the taxpayer in the production of aluminum casting did not qualify as an ingredient or component part of the casting pursuant to §40-23-1(a)(9)b., as amended in 1981, even though some of the coating remained in the finished product. In so holding, the Division recognized that the 1981 amendment removed intent as a factor, but otherwise held that "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 & Associates*, should control." *Alexander City Casting* at 7. Applying the *Robertson* test, the Division found that the coating was not an ingredient or component part because "its presence in or on the casting is only incidental to its use in the manufacturing process." *Alexander City Casting* at 9.

In *Carlisle Engineered Products, Inc. v. State of Alabama*, Docket U. 99-524 (Admin. Law Div. 4/17/2000), the Division addressed the issue of whether molds, barrels, and screws used in the manufacture of plastic automobile parts became ingredient or component parts of the finished products. The parties agreed that microscopic pieces of the molds, barrels, and screws became a part of the finished products, and also that the microscopic pieces were not an intended or necessary ingredient in the finished products. Citing its recent holding in *Alexander City Casting*, the Division held that the pieces of "the molds, barrels, and screws are only incidentally mixed with the plastic, and are not a substantial or necessary ingredient in the finished parts," and thus did not constitute

ingredient or component parts for use tax purposes pursuant to §40-23-60(4)b.

On rehearing, the Division reversed itself and held that by eliminating intent as a factor in determining if the sales and use tax ingredient or component part provisions applied, the Legislature could have only intended that an item that only incidentally and unintentionally remained in the final product could still become an ingredient or component part pursuant to §§40-23-1(a)(9)b. and 40-23-60(4)b.

> A machine or other product used in manufacturing that only incidentally becomes a part of the final product should not qualify as an exempt component part because the machine or product is not being resold. (footnote omitted) If manufacturers are allowed to purchase such machines and other products tax-free, sales or use tax will never be paid on the item. "To allow the purchase of (property that only incidentally becomes part of the final product) to be classified as 'wholesale sales' contravenes the legislative intent to prevent double taxation; instead, such interpretation avoids the tax altogether." *Robertson and Associates*, 361 So.2d at 1074. (footnote omitted)
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> However, after *Robertson and Associates*, the 1981 Legislature amended the sales tax ingredient or component part provision at §40-23-1(a)(9)b. to include the following language - ". . . whether or not such tangible personal property or product used in manufacturing or compounding a finished product is used with the intent that it becomes a component of the finished product; . . ." The use tax ingredient or component part provision in issue in this case, Code of Ala. 1975, §40-23-60(4)b., was not amended in 1981. However, the sales tax and the use tax statutes were both amended by Act 97-648 in 1997. They are now identical, and include the language quoted above. The 1997 amendment applied to all open years. Consequently, the 1997 version of §40-23-62(4)b. applies to the entire period in issue in this case.
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> How should the above quoted phrase be construed? I initially held that the phrase only eliminated intent as a factor, and that the remainder of the *Robertson and Associates* test was 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." *Carlisle Engineered Products, Inc. v. State of Alabama*, S. 99-524 (Admin. Law Div. Final Order 4/17/00), at 9, quoting *Alexander City Casting Company, Inc. v. State of Alabama*, S. 99-467 (Admin. Law Div.

2/25/00), at 6.

> I now concede that my initial holding was wrong. First, the phrase refers to "such tangible personal property (that becomes an ingredient or component part) . . . used in manufacturing . . . a finished product." The phrase thus envisions that a machine used in manufacturing may also become an ingredient or component part. (footnote omitted) Second, if property becomes a substantial and necessary ingredient, I can think of no instance in which the manufacturer would not intend that it remain in the finished product. Consequently, by specifying that property may become an ingredient or component part, even if the manufacturer did not intend that it remain in the final product, the Legislature could only have intended that property that does not become a substantial and necessary ingredient and only incidentally remains in the final product still qualifies as an exempt ingredient or component part.
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> The statute as written emasculates Alabama's sales and use tax system because it allows manufacturers to escape tax on otherwise taxable machines, supplies, etc. used in manufacturing. The molds, barrels, and screws in issue are used exclusively for manufacturing, and only microscopic shards of the machines incidentally enter into the final product. It cannot reasonably be argued that the machines are being resold as component parts of the small plastic parts sold by the Taxpayer. Yet the Taxpayer is being allowed to purchase and use the machines tax-free, and thus escape tax on the machines altogether. But an objective analysis of the statute as written leads to that conclusion. The statute contains a nonsensical "loophole," but the Taxpayer is correct that it can only be fixed by the Legislature, if it so desires.

Carlisle Engineered Products, Order on Rehearing at 2 – 5.

Finally, in *Wayne Farms, LLC v. State of Alabama*, Docket S. 06-797 (Admin. Law Div. 1/14/2008), the Division held that carbon dioxide sprayed into chickens to cool the chickens during processing did not qualify as an ingredient or component part of the chicken.

Unfortunately, in deciding *Wayne Farms*, the Division apparently overlooked its prior holding on rehearing in *Carlisle Engineered Products*, and instead relied on *Robertson and Associates* and *Alexander City Casting*. *Wayne Farms* was thus incorrectly decided. The

rationale in the *Carlisle Engineered Products* Order on Rehearing is the better reasoned view. Consequently, because intent is no longer a factor and miniscule parts of the work rolls remained in the manufactured steel, the ingredient or component part provision applies, and the Taxpayer is due a refund of the tax previously paid on the work rolls.[2]

RDS, in its excellent amicus curiae brief, argues that the primary purpose of the sales and use tax ingredient or component part provisions is to avoid double taxation. It concedes that intent is no longer a factor, but that the test is still that an item or material does not become an ingredient or component part if its "presence in the finished product (is) merely incidental to its primary function," citing *Wayne Farms* and *Robertson*. Amicus Curiae Brief at 5.

I agree that when the Legislature amended the ingredient or component part provisions to exclude intent as a factor, it likely did not foresee that the provisions would be construed to allow manufacturers to purchase machines used in manufacturing tax-free because miniscule parts of the machines wear off and incidentally remain in the final product. As stated in *Carlisle Engineered Products* – "It cannot reasonably be argued that the (molds, barrels, and screws) are being resold as component parts of the small plastic parts sold by the Taxpayer." *Carlisle Engineered Products* Order on Rehearing at 5. Likewise, it cannot reasonably be argued that the Taxpayer is reselling the work rolls in

[2] Code of Ala. 1975, §40-2B-2(l)(7) provides that the Tribunal shall follow its prior interpretation of a statute, unless the Tribunal provides a satisfactory reason for reversing prior precedent. The Administrative Law Division's reasoning in the *Carlisle Engineered Products* Order on Rehearing satisfactorily explains why the holding in *Alexander City Casting* and the original *Carlisle Engineered Products* opinion were incorrect and should not be followed, and also why the *Wayne Farms* opinion is incorrect and should not be followed in this case.

issue to its customers with the finished steel products.

Notwithstanding the above, however, the specific language in the statute must govern. *Ex parte Madison County, Alabama*, 406 So.2d 398 (1981). By removing intent as a factor, the Legislature in substance created an unintended loophole in the law, but the loophole can only be closed by the Legislature. As stated in *Carlisle Engineered Products* – "The statute contains a nonsensical 'loophole,' but the Taxpayer is correct that it can only be fixed by the Legislature, if it so desires." *Carlisle Engineered Products*, Order on Rehearing at 5.

The Revenue Department appealed the *Carlisle Engineered Products* Order on Rehearing to the Tuscaloosa County Circuit Court. That Court affirmed the Administrative Law Division's ruling. I agree with and adopt the following part of that Court's Order.

> The Department contends that the requirement set forth in *Robertson and Associates (Ala.), Inc. v. Boswell*, 361 So.2d 1070 (Ala. 1978), that the property become a "substantial and necessary ingredient," applies in order to qualify for the statutory exemption. It should be noted that the *Boswell* decision was rendered prior to the change in the statute discussed above. Therefore, it is important to determine the impact of the statutory change on the decision in *Boswell*.
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> First, the language providing the exclusion in the statute refers to "such tangible personal property (that becomes an ingredient or component part) . . . used in manufacturing . . ., a finished product." If property becomes a substantial and necessary ingredient, as the Department now contends is required under *Boswell*, one would be hard pressed to think of an instance in which the manufacturer would not then *intend* that it remain in the finished product. Consequently, by specifying that property may become an ingredient or component part, even if the manufacturer did not intend that it remain in the final product, the Legislature could only have intended that property that does not become a substantial and necessary ingredient and therefore only incidentally remains in the final product still qualifies as an exempt ingredient or component part.

> An objective analysis of the statute as now written leads to the conclusion that the requirement set forth in *Boswell*, and now proposed by the Department, that the property must be substantial and necessary ingredient to qualify for the exclusion is no longer the law in Alabama after the Alabama Legislature's changes to the statute to specifically remove the requirement that the property in question must be intended to be in the finished product. While there are certainly policy arguments as to the appropriateness of such a provision in Alabama sales and use tax law, *Carlisle* is correct in its contention that such arguments are only appropriate before the Legislature, if it so desires to consider the issue. This Court is bound by the language of the statute and *Carlisle* has satisfied not only those requirements in the statute, but those in the Department's regulation as well.

As directed in the February 23, 2017 Opinion and Preliminary Order, the Department should notify the Tribunal of the refund due on the work rolls. A Final Order will then be entered in the case.

This Second 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, §40-2B-2(m).

Entered April 25, 2017.

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BILL THOMPSON
Chief Tax Tribunal Judge

bt:dr
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