

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

440.0395

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
G--- S--- P--- COMPANY) No. SR --- XX XXXXXX-010
INC.)
)
Petitioner)

The above-entitled matter came on regularly for hearing on Thursday, August 7, 1986 in San Bernardino, California before Robert H. Anderson.

Appearing for Petitioners:

Mr. R--- H---
Attorney at Law

H---, F--- & B---

Mr. F--- W. L---
Vice President Research

Mr. E--- V. T---, Jr.
Western Region Controller

Mr. E--- A. S---
Senior Scientist
T---, Inc. (V---
Division)

Appearing for the Board:

Mr. Ted Esau
Auditor
Arcadia District (Covina)

Protest

Petitioner was audited for the period from July 1, 1982 through June 30, 1985, and a notice of determination was issued on January 15, 1986.

On January 21, 1986, petitioner filed a petition for redetermination indicating a protest of three chemicals audited as taxable. A copy of the petition is in the petition file.

Petitioner subsequently requested reconsideration of a fourth chemical previously conceded, based on tax counsel opinion 440.3680 in Business Taxes Law guide. The chemicals protested are as follows:

	<u>Measure of Tax</u>
1. Liquid sodium bisulfite	\$423,564
2. Sulfur dioxide	\$245,256
3. Sodium tripoly phosphate	\$ 78,240
4. Sodium hydrosulfite (V-Brite)	\$168,000

In addition, petitioner contends that sodium borohydrite, a chemical purchased from M--- T--- - V--- Division, tax paid, should be exempt, and credit for tax paid in the amount of \$229,512 should be given.

Contentions

Petitioner's contentions are set forth in detail in this petition for redetermination and they include arguments why the chemicals should be exempt. The arguments include references to tax counsel opinion 440.0400 in Business Taxes Law Guide and analogies between chemicals taxed and chemicals exempted. Each chemical and the contentions will be covered in detail under our analysis and conclusions.

Summary

Petitioner is a corporation and wholly owned subsidiary of M--- G---, Inc. of ---, Virginia.

The firm is engaged in the manufacture and sale of "newsprint", an industry term for paper recycled using newspaper and a de-inking process to recover wood pulp in the newspapers.

Petitioner was issued a seller's permit on September 21, 1966 and has undergone prior audits, the last of which covered a period through the second quarter of 1982. This audit covers a period from July 1, 1982 through June 30, 1985.

Generally, petitioner contends that the chemicals deemed taxable manufacturing aids are a part of the newsprint petitioner manufactures and they should be deemed components of newsprint purchased for resale rather than consumed.

The auditor used tax counsel opinion 440.0400 in Business Taxes Law Guide as a guide in making conclusions as to whether audited chemicals purchased ex-tax for resale were taxable manufacturing aids. Thus, in our analysis, we will be making reference to annotation 440.0400 along with two other tax counsel opinions relating to wood pulp products.

Old newspapers are the source of fiber in the manufacture of newsprint. We understand that there are at least two other kinds of fiber or pulp: (1) Kraft pulp which is a chemical pulp, and (2) Virgin wood pulp from trees which has never been processed into any kind of paper. Sometimes the pulp produced by petitioner is called "mechanical" pulp.

Newspapers go through a "pulping" step or process which has been compared to going through a food blender. This reportedly consists of a mass composed of 5% paper and 95% water. Paper, water, and chemicals are used to separate the ink (de-ink) from the newspapers; there is a screening process that removes various materials such as metals, staples, plastics, sticky material from glue, etc. Then there is a washing process to clean the fibers and a brightening step or process. Finally, the washed pulp goes to a paper machine (paper mill) and ends up as a roll of paper called "newsprint".

Petitioner is reportedly the only firm in California that produces newsprint although there are about nine or ten other similar firms in other states. This controversy involves five different chemicals used in the process of manufacturing newsprint

Analysis and Conclusions

Regulation 1525 (Property Used in Manufacturing) (18 Cal. Admin. Code 1525) provides in part as follows:

“(a) Tax applies to the sale of tangible personal property to persons who purchase it for the purpose of use in manufacturing, producing or processing tangible personal property, and not for the purpose of physically incorporating it into the manufactured article to be sold. (Underline added).

“(b) Tax does not apply to sales of tangible personal property to persons who purchase it for the purpose of incorporating it into the manufactured article to be sold....”

The foregoing will be a guideline in analyzing the functions of the chemicals. The fact that a chemical may incidentally remain in the end product does not dictate that it may be purchased for resale where there is a use (consumption) of it in processing pulp reclaimed from newspapers. We are concerned with the primary purpose of introducing a given chemical in the pulp.

Kaiser Steel Corp. v. State Board of Equalization (1979) 24 Cal.3d 191, upholds the primary purpose test and provides that in determining whether a sale is taxable or exempt as a sale for resale, the California courts have consistently looked to the primary purpose of the purchase. If the property is purchased as an aid in the manufacturing process, it is taxable despite the fact that some portion remains in the finished product.

We are also going to consider some tax counsel opinions that have been in the tax services for over twenty years. It is our opinion that Kaiser Steel Corp., supra, requires another look at portions of annotation 440.0400. The "primary purpose" test in the 1979 California Supreme Court Kaiser decision may have overruled some portions of the reasoning in the 1965 tax counsel annotated opinion.

This analysis and conclusion will contain references to tax counsel opinion 440.0400, Business Taxes Law Guide (hereinafter annotation 440.0400) since the audited liability was made with annotation 440.0400 as a guideline. The annotation is dated March 10, 1965 which means it has been a guideline for over twenty years. The annotation contains names of chemicals used in the production of paper products; the first part contains a one through ten (1-10) list description of chemicals and their use which are deemed manufacturing aids and taxable. The second part contains a one through three (1-3) list description of chemicals and their use which are deemed not to be manufacturing aids, but which become a necessary and desirable component of the paper product being produced.

We are concerned with four chemicals which were purchased ex-tax for resale and which were disallowed by the auditor using annotation 440.0400 as a guideline or authority. A fifth chemical is one purchased tax-paid from M--- T---, Inc., V--- Division. This chemical was of no concern to the auditor making the audit of petitioner's business because the tax had been paid on it. Petitioner contends that the chemical purchased from M--- T--- should be in a class of chemicals that, when used in producing newsprint, should be exempt rather than a taxable manufacturing aid.

The audited chemicals, in order of discussion, are:

1. Sulphur dioxide.
2. Liquid sodium bisulfite.
3. Sodium tripoly phosphate.
4. Sodium hydrosulfite (V-Brite)
5. Sodium borohydride (purchased tax-paid from M--- T---).

Sulphur dioxide and liquid sodium bisulfite are two chemicals associated with the brightening step in the manufacture of newsprint. They are used as control chemicals in the preparation of sodium hydrosulphite solution for brightening of wood pulp. No washing of the pulp is done after introduction of these chemicals. Petitioner points out that its use of sulphur dioxide is

similar to the use of sulphur dioxide as a “control” chemical for peroxide bleaching as discussed in tax counsel opinion annotation 440.0400, item no. 3, under exempt chemicals, which reads:

“Sodium Hydroxide and Sulphur Dioxide – used to control reaction rates in peroxide bleaching of ground wood pulp. No washing of the pulp is done after introduction of these compounds and sodium and sulphur therefrom remain in the pulp and finished paper products.

Petitioner contends that if sulphur dioxide is exempt in use with peroxide, the sulphur dioxide should be exempt in use with hydrosulphite. The two processes are used for the same purpose in brightening of mechanical wood pulps, and petitioner chose to use hydrosulphite rather than peroxide. No washing is done with either process, and the “control” chemicals in both processes go along with the pulp.

Sodium bisulfite is not specifically mentioned in annotation 440.0400 under item 3 of the exempt chemicals (sodium hydroxide and sulphur dioxide). In fact, it is not discussed anywhere in the annotation 440.0400. However, petitioner points out that it should be exempt along with the exemption provided under item 3 of the exempt chemicals because it too is used as a “control” chemical in the preparation of sodium hydrosulphite solution. Thus, the same arguments apply as those for sulphur dioxide. Also, it is pointed out that the two chemicals mentioned in the item 3 (sodium hydroxide and sulphur dioxide) when reacted together, yield sodium bisulphate (the chemical audited as taxable).

At this point, we call attention to annotation 440.1840, dated July 28, 1965 issued about four months after annotation 440.0400; the author of the two opinions is the same person. This opinion provides:

“Although sodium silicate, epsom salts, trisodium phosphate and Versenes 80 are combined with hydrogen peroxide, they act as peroxide stabilizers before and during the manufacturing process and only incidentally remain in the finished product, and may not be purchased for resale.”

The foregoing appears to be a restatement (in part) of item 6 (taxable chemicals) in annotation 440.0400 which reads

“Hydrogen Peroxide, Sodium Silicate, Magnesium Sulphate, Trisodium Phosphate and Versenek 80 (Diethylenetriamine-Penta-Acetic Acid) – combined to make a bleaching solution for ground wood pulp. Hydrogen Peroxide is the active agent and the other chemicals act as stabilizers, preventing premature dissociation by pulp impurities.”

We do not know if there was meant to be a distinction between “stabilizing” and “controlling” reaction rates as referred to under no. 3 in annotation 440.0400 (exempt sodium hydroxide and

sulphur dioxide); the author is not available to explain what he meant or if there is a difference. Both appear to be a manufacturing aid function.

Another apparent inconsistency in annotation 440.0400 is item 8 of the taxable chemicals; it provides:

“Sulphuric Acid, Sodium Chlorate and Sulphur Dioxide – combined to make a chlorine dioxide compound used for bleaching ‘kraft’ pulp.”

As pointed out, “kraft” pulp is a chemical pulp, but bleaching is bleaching regardless of the kind of pulp. Most of the chemicals deemed taxable in annotation 440.0400 were introduced into the process for the chemical reactions that resulted and were primarily manufacturing aids rather than a desired and necessary component of the end product.

The discussion of the basis for exempting sodium hydroxide and sulphur dioxide used to “control” reaction rates in peroxide bleaching “ground wood pulp” or petitioner’s “mechanical” wood pulp brings up a question of whether bleaching “ground wood pulp” or petitioner’s “mechanical” wood pulp is any different; again, bleaching is bleaching. Petitioner’s pulp is not from trees directly, it is from de-inked newspapers and here there may be a distinction without a difference.

Annotation 440.0400 notes that there is no washing after introduction of the compounds (sodium hydroxide and sulphur dioxide) and the compounds remain in the pulp and paper products made therefrom. The same situation exists in petitioner’s case where sulphur dioxide and liquid sodium bisulfite is used. However, it appears that, notwithstanding the chemicals remain in the finished product, the function of the chemicals is more of a manufacturing aid than a desired necessary ingredient or component part of the newsprint or paper product produced from the ground wood pulp. The chemicals remaining in the end product may be the fortuitous result of not washing the pulp after the compounds are added. We believe that sulphur dioxide and liquid sodium bisulfite, used as “control” chemicals, are “primarily” a manufacturing or processing aid even though they are alleged to remain in the end product.

It is in this regard that we stated earlier that the 1979 California Supreme Court decision in Kaiser, supra, may have overruled some of the reasoning in annotation 440.0400. It seems clear that the Kaiser court would tax chemicals that were purchased for use as manufacturing aids and only fortuitously remain in the final product. We reach the same result here in the absence of any submitted evidence that the sulphur dioxide and liquid sodium bisulfite are desired ingredients of the newsprint. Unless such evidence is submitted after the issuance of this decision, we recommend that the Board legal staff give thought to amending annotation 440.0400 accordingly, on the authority of Kaiser.

A third chemical, sodium tripoly phosphate, picked up in the audit as taxable, is not associated with the decolorization or brightening of the pulp. Petitioner states this chemical is used as a

dispersant for ink and contaminants at the paper (mill) machine. It coats the contrary particles, keeps them from growing larger by fusing, and definitely is an additive that is found in the product resulting in a cleaner appearance and fewer paper breaks in the press rooms due to contaminants in the newsprint.

Petitioner contends that this chemical compliments the use of the "Mistron Talc" for control of pitch, stickies and other foreign substances. In petitioner's system for manufacture of newsprint from de-inked newspapers, most of the ink and contaminants are removed early in the process, but the residuals of these materials must be controlled at the paper (mill) machine to remain quality competitive with virgin newsprint. The chemical is not used by petitioner as a stabilizer for peroxide as discussed in annotation 440.0400 (item 6) because no peroxide is used in petitioner's processes.

We note that item 1 (exempt chemicals) in annotation 440.0400 is "Mistron Talc" described in the annotation as a magnesium silicate compound, which is added to wood pulp to control deposition of pitch and remains as a desirable component of finished paper. Petitioner's description of the function of sodium tripoly phosphate appears to be similar to the function of Mistron Talc. Thus, we conclude that this chemical is not consumed as a manufacturing aid, but is a desired component of newsprint and may be purchased ex-tax for resale.

The fourth chemical is sodium hydrosulfite or sometimes referred to as "V-Bright". It is associated with the brightening process and was deemed a taxable manufacturing aid per annotation 440.0400, item 2 (taxable chemicals) "Zinc Hydrosulphite and Sodium Hydrosulphite" used as bleaching agents in the process of manufacturing paper from wood pulp.

We now call attention to tax counsel opinion, annotation 440.3680 dated July 28, 1965, the same date as annotation 440.1840. The author is the same person, and research has disclosed that both annotations were from the same backup material. Annotation 440.3680 provides:

"Zinc Hydrosulphite, sodium hydrosulphite and hydrogen peroxide purchased by a paper products manufacturer for decolorizing wood pulp, combine with colored constituents of wood pulp and remain in the finished product. Accordingly, zinc hydrosulphite, sodium hydrosulphite and hydrogen peroxide are purchased for resale."

The backup material contains the following:

"We have reviewed the additional data submitted by 'K' regarding the properties and functions of sodium hydrosulfite, zinc hydrosulfite, and a hydrogen peroxide solution containing Versenex 80, sodium silicate, epsom salts and trisodium phosphate.

“It is our understanding that the hydrosulfites and peroxides are unique in their decolorizing action with respect to wood pulps. They combine with colored constituents of the pulp to make them white and they remain in the pulp material. The hydrosulfites and peroxide compounds are not washed out.

“It is further our understanding that although the sodium silicate, epsom salts, trisodium phosphate and Versenex 80 constituents of the peroxide solution remain in the pulp, their purpose is merely to stabilize the peroxide before and during its action on the pulp.

“In view of the foregoing, it appears that the sodium hydrosulfite, zinc hydrosulfite and hydrogen peroxide are purchased for the purpose of incorporation of their constituents in the finished product, but the sodium silicate, epsom salts, trisodium phosphate and Versenex 80 are purchased for use as manufacturing aids, and not for the purpose of incorporation and only incidentally remain in the finished product.

“Accordingly, it is our opinion that zinc hydrosulfite, sodium hydrosulfite and hydrogen peroxide are purchased for resale and sodium silicate, epsom salts, trisodium phosphate and Versenex 80 are purchased for consumption in the process of manufacturing pulp products.”

It is obvious that the foregoing annotation (440.3680) was intended to overrule item 2 (taxable chemicals) in annotation 440.0400 but has never been corrected; 440.3680 is dated about four months after 440.0400.

Accordingly, we have reconsidered the application of tax to audited ex-tax purchases of sodium hydrosulfite and conclude that it may be purchased ex-tax for resale. We recommend to the Board's legal staff that annotation 440.0400 be so amended.

Finally, we come to the fifth chemical, sodium borohydride, purchased ex-tax from M--- T----V-- Division. Petitioner has submitted a schedule of purchases from August 3 1982 to July 11, 1986 indicating that the tax in the amount of \$229,512 was paid to that company. Petitioner was advised that if, in fact, the chemical is exempt in the manufacture of newsprint, a claim for refund must come from M--- T--- who collected the tax and paid it to the State.

Petitioner states the chemical is used for the “generation” of sodium hydrosulfite and is the key component in this reaction. M--- T--- designed and pioneered this “generation process”, and is the sole supplier of it. Petitioner contends it is the only customer paying sales tax on this chemical. There are allegedly 10 customers in seven other states that have allegedly obtained tax exemptions because the reacted boron in the form of sodium metaborate stays with the pulp, and studies by M--- T--- have found none to be present in mill effulents. Thus, being the only

customer for the chemical in California, petitioner believes it should also be exempt from the sales tax.

The fact that other states, under their respective sales and use tax laws, found it proper to exempt the sales of sodium borohydride is not a basis for the Board of Equalization to rule likewise. In California, under the Sales and Use Tax Law, and Regulation 1525, the exemption is based on whether the chemical is a manufacturing or processing aid used by the manufacturer or is purchased primarily to become a desired and necessary component of newsprint.

Petitioner describes the function of the chemical as “used for the generation of sodium hydrosulphite, and is the key component in the reaction”. Sodium borohydride appears to be a manufacturing or processing aid rather than a necessary ingredient of newsprint. Accordingly, we conclude that it was properly purchased tax-paid, and no refund or credit should be given.

Recommendation

Redetermine after reaudit deleting from the audited taxable chemicals sodium tripoly phosphate and sodium hydrosulfite (V-Brite). No credit or refund on purchases of sodium borohydride.

Action on the recommendation to be made by Petition Unit.

Robert H. Anderson, Hearing Officer

Date