

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition	)	
for Redetermination Under the	)	DECISION AND RECOMMENDATION
Sales and Use Tax Law of:	)	
	)	
D--- G---, INC.	)	No. SY -- XX XXXXXXX-010
	)	
	)	
<u>Petitioner</u>	)	

The Appeals conference in the above-referenced matter was held by Senior Staff Counsel H. L. Cohen on February 9, 1993 in Oakland, California.

Appearing for Petitioner:

- Mr. D. G---, CPA
- Mr. I. H---, Consultant
- Mr. D. H---, Controller
- Mr. M. L---
- Mr. M. P---, CPA

Appearing for the Sales and Use Tax Department:

- Mr. B. Belshaw  
Supervising Tax Auditor  
Oakland District
- Mr. H. Wong  
Senior Tax Auditor  
Oakland District

Protested Items

The protested tax liability for the period July 1, 1987 through September 30, 1990 is measured by:

	<u>Item</u>	<u>State, Local and County</u>
H.	Consumption of Lignin and Potash purchased ex-tax, Antioch	\$ 362,623
I.	Consumption of Lignin and Potash purchased ex-tax, Long Beach	612,188
J.	Consumption of Alpha Foamer purchased ex-tax, Antioch	319,856
K.	Consumption of Alpha Foamer purchased ex-tax, Long Beach	<u>315,941</u>
	Total	\$1,610,608

#### Contention

Petitioner contends that the property in question constitutes raw materials, which become a part of the product, which it sells and can therefore be purchased for resale.

#### Summary

Petitioner is a corporation which is engaged in the manufacture and sale of gypsum wallboard and related products. It has factories located in four California cities. It began in business in its present corporate form in 1987. There has been no prior Board audit of this entity. Petitioner's predecessor, D--- G--- A---, Inc., was audited by the Board for the period through December 31, 1987.

Petitioner purchases alpha foamer, lignin and potash ex-tax. Alpha foamer is a type of soap. The auditor regarded these three materials as manufacturing aids and thus subject to tax. The auditor's conclusions were supported by Decisions and Recommendations issued previously with respect to petitioner's predecessor for the periods April 1, 1978 through June 30, 1981, and January 1, 1982 through December 31, 1984. These Decisions and Recommendations concluded that the materials were manufacturing aids. The Board upheld the recommendations in these Decisions and Recommendations in 1987.

Petitioner supplied a description of its manufacturing process. Ingredients are fed from hoppers into a mixing screw. The blended ingredients are then fed into a mixer where water and foam are added. The foam is separately prepared from the foamer prior to adding it to the mixer.

The wet foamed slurry is fed onto paper, which is the backing for the wallboard. The wet wallboard is cut the length and passed through a dryer for removal of excess water.

Petitioner states that the foamer produces thick wall bubbles in the slurry. This allows petitioner to control the density of the wallboard. The foamer also wets the paper which allows penetration of the slurry into the paper. The bubbles permit easier handling and the production of a less brittle product.

Petitioner states that lignin retards setting and also assists in the penetration of the slurry into the paper. It permits the use of less water in the slurry, thus requiring less drying of the product.

Petitioner states that potash accelerates the final setting of the gypsum.

Petitioner states that all of these materials remain in the final product which petitioner sells and all are treated as components for cost accounting purposes. Petitioner submitted statements from several experts in the field of manufacturing wallboard attesting to the necessity of these materials in the production of high quality wallboard. Petitioner cites Kaiser Steel Corporation v. State Board of Equalization (1979) 24 Cal.3d 188, Burroughs Corporation v. State Board of Equalization (1984) 153 Cal.App.3d 1152, and Safeway Stores, Inc. v. State Board of Equalization (1957) 148 Cal.App.2d 299 as support for its contention that the primary purpose test requires that the materials be regarded as having been purchased for incorporation into the product. Petitioner also cites for support Business Taxes Law Guide Annotations 440.3240 (8/28/64), 440.3360 (1/27/55), 440.2320 (2/28/66), 440.2520 (7/29/54), 440.2560 (12/16/57), 440.2640 (9/30/52), 440.2660 (12/14/54), and 440.1660 (4/30/53).

#### Analysis and Conclusions

Sales and Use Tax Regulation 1525 provides:

“(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. Examples of such property are machinery, tools, furniture, office equipment, and chemicals used as catalysts or otherwise to produce a chemical or physical reaction such as the production of heat or the removal of impurities.

“(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, as, for example, any raw material becoming an ingredient or component part of the manufactured article.”

The regulation provides that the application of the tax depends on the purpose for which property is purchased. Thus, property which is a true raw material which is intended to become part of a final product which is sold may be purchased entirely for resale even though a substantial part is lost or wasted in the manufacturing process. On the other hand, property which is purchased for the purpose of aiding in the manufacturing process may not be purchased for resale even though some part or all of it ultimately remains in the final product which is sold. The distinction may be summed up as between products which benefit the final product by being present in the final product which may be purchased for resale and products whose benefit ends during the manufacturing process which may not be purchased for resale.

The Kaiser Steel case cited above which established the primary purpose test is not exactly on point. In that case, the Board had regarded part of the aluminum purchased by Kaiser for adding to the steel manufactured by Kaiser as purchased for resale and part was regarded as having been purchased for use in processing the steel. The Board allowed that part of the aluminum which remained in the steel as having been purchased for resale because it improved the quality of the steel by its presence in the steel. That part of the aluminum which came out of the process as part of the slag was held to be taxable as a processing aid because its purpose was to remove oxygen during the manufacturing process. It was immaterial that the slag was ultimately sold because the primary purpose of this aluminum was to remove oxygen from the steel.

The Burroughs case is totally inapplicable. It deals solely with the use of manufactured components to test other manufactured components prior to the sale of both of the components in the regular course of business. The Safeway case is also inapplicable as it involves an exemption for containers.

Petitioner cites eight annotations. Six of these, 440.3240, 440.2320, 440.2520, 440.2560, 440.2640, and 440.2660, are supportive of the position that property which benefits the final product by its presence in the final product can be purchased for resale. The other two annotations, 440.1660 and 440.3360, appear to be in conflict. They will be discussed below in relation to the application of tax to the foamer.

From petitioner's description of the purposes of using lignin and potash, it is clear that their use enhances the manufacturing process so that a higher quality wallboard can be produced. Their presence in the final product does not enhance the final product. Accordingly, they are manufacturing aids and their use is subject to tax.

The application of tax to the alpha foamer is more complicated. It is my conclusion that it is the presence of bubbles in the final product that is beneficial to the final product. The foamer itself produces the bubbles and is thus beneficial in the manufacturing process but not in the finished product. However, there are two conflicting annotations on the use of soap in the manufacture of wallboard. These annotations read as follows:

“440.1660. **Soap Used in Manufacturing.** Soap used to create voids in a plastic mixture, resulting in increased insulation properties of wallboard being manufactured, is purchased for a purpose other than resale. 4/30/53.”

“440.3360. **Resin Soap.** Used in the manufacture of wall board, which remains in the finished product and is sold as a component part thereof, is exempt from tax. 1/27/55.”

The latest one states that the use of foamers is not subject to tax. Petitioner was entitled to rely on this published opinion of the Board’s staff. Accordingly, I conclude that petitioner should be relieved of liability for tax on the foamer. However, I also recommend that Annotation 440.3360 be withdrawn and that petitioner be directed to pay tax with respect to all future uses of foamers.

Recommendation

Delete Audit Items J and K from the amount subject to tax. Deny the petition in all other respects.

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H. L. Cohen, Senior Staff Counsel

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Date