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May 8, 1997

Mr. W--- F. K---
Controller
W--- - O--- L--- Co.
XXXX W--- - O--- Road
--- ---, California XXXXX

Re: SR --- XX-XXXXXX

Dear Mr. K---:

This is in response to your letter dated April 29, 1997 in which you ask how tax applies with respect to an item added to your lumber during the manufacturing process. You explain:

“We are a sawmill and must dip our limber with a liquid fungicide (an anti-‘bluing’ agent). This prevents the discoloration of the surface of the board. The lumber is then sold for resale.

“We have two kinds of lumber:

- “1) Rough lumber that carries the fungicide on it to our resale customer.
- “2) Surfaced lumber. This lumber has been planed and the fungicide has been removed.

“However, the removed fungicide still exists, and is now attached to the shavings that result from the planing operation. The shavings are then sold for resale also.”

The basic rule is that raw material may be purchased extax for resale when the material will be incorporated into an item manufactured for resale, provided the material becomes a component part of the manufactured item and its presence serves a beneficial purpose. However,

property purchased for use in the manufacturing process may not be purchased for resale even if some portion of such property remains in the manufactured item that is sold. (Reg. 1525.) Thus, if the property in question does not remain in the finished product, tax applies. If the property remains in the finished item that will be sold, further analysis is required to determine whether the presence of the property in the finished item serves a beneficial purpose which was the reason for its incorporation, or if instead the property's presence in the finished product is incidental to its use in the manufacturing process.

We have considered the application of tax to the use of "anti-blue stain" in the processing of lumber. Annotation 440.3160 states:

"Chemicals for the treatment of lumber are considered to be sold for resale to purchasers who apply them to lumber to be sold, if substantially all of the chemicals remain in the lumber and are resold with the lumber. 9/21/52.

"Anti blue stain materials which form a coating on lumber, the major part of which coating remains on the lumber at the time of sale, is regarded as purchased for resale and the sale of the materials are thus exempt from tax. 6/30/54.

"Anti blue stain solutions may be purchased for resale when they are used for dipping lumber which is to be sold. 9/13/54."

Annotation 440.1380 states:

"Purchase of Melsan, Lignasan, Wyandotte Noxtane and Permatox, used as an anti-blue stain for lumber are sales for resale, provided, the purchaser who applies such stains does not plane the lumber subsequent to such application and sells the lumber unplanned. If, however, the applier planes the lumber after application of the stain and before sale of the lumber, the stain is thus removed and the sale of the stains to the applier is taxable. 7/18/56."

Since I am not familiar with the terminology of your industry, I am unable to ascertain from your letter whether the fungicide you describe as an anti-bluing agent is a chemical coming within the annotations quoted above, or if instead must be analyzed as would a fungicide used as a manufacturing aid. A good example of the type of analysis that would be required under such circumstances is set forth in Business Taxes Law Guide Annotation 440.0626, which considered the application of tax to the use of CIPC, a potato sprout inhibitor which is applied to potatoes after they have been harvested to prohibit sprouting while in storage:

"If the chemical is used during storage to prevent potatoes from sprouting, with the inhibition of sprouting to continue after the treatment even though the CIPC is

physically removed after treatment, the CIPC cannot be purchased for resale and sales tax would apply to the sale of the chemical. The chemical in this situation would be considered used as a catalyst or to produce a chemical or physical reaction....

“On the other hand, if the CIPC must be physically present on the potatoes at the time of sale in order to continue inhibiting sprout growth and if this is the grower's reason for applying the chemical, then the growers may issue a resale certificate to their vendors. 7/19/95.”

An example of such an analysis specifically to fungicides is Business Taxes Law Guide Annotation 440.0700, in which we considered the application of tax to the use of fungicides by packing companies in the preparation of fruits and vegetables for sale:

“Borax is used primarily as a fungicide to destroy fungus spores which have accumulated on the fruit prior to its arrival at the packing house. While some borax remains on the fruit to protect it after its departure from the packing house, most of the borax performs the function of removing existing spores and during the process goes off into a bath rather than permanently becoming a part of the fruit The sale of borax to the packing house constitutes a taxable retail sale. 9/26/52.”

As noted above, I am not sure whether the chemical in question comes within annotations 440.3160 and 440.1380.¹ If the chemical is covered by those annotations, you may purchase the chemical for resale when applied to rough lumber which includes the chemical when sold. If the chemical does not come within these annotations, then a determination would be necessary as to the reason for the fungicide's remaining on the lumber that is sold. If the fungicide is used to destroy fungus on the lumber and performs that function upon application to the lumber (being left on the lumber that is sold, for example, because of the expense of planing off the fungicide), you would not be regarded as purchasing the fungicide for resale and would owe tax on your use. On the other hand, if the fungicide continues to kill fungus as long as it remains on the lumber and your customers seek that continued protection when purchasing the rough lumber, you would be regarded as purchasing the fungicide for resale. This would be true even though you obtain the ancillary benefit of the fungicide's protection prior to the sale.

With respect to your second scenario, you clearly are not purchasing the fungicide for resale as part of the surfaced lumber since no fungicide is contained in that lumber. Thus, even if the property in question is Melsan, Lignasan, Wyandotte Noxtane, or Permatox and thus covered by annotation 440.1380, quoted above, it would come not come within the first

¹Using the type of analysis described in annotations 440.0626 and 440.0700, we have already determined that such chemicals may be purchased for resale.

sentence. Instead, it appears that it would be covered by the second sentence of the annotation, except that the shavings are then sold. This situation seems similar to that involved in the case of *Kaiser Steel Corporation v. State Board of Equalization* (1979) 24 Cal.3d 188. Kaiser manufactured steel and purchased certain property for use in that process. Impurities were removed from the molten metal by adding these materials during the manufacturing process so that they would combine with the impurities to form slag. The slag was a by-product of the manufacturing process and had little value compared to the steel the manufacturing process produced. However, the slag did have some value and was sold by Kaiser, who then argued that it purchased the subject materials for resale in the slag.

The California Supreme Court held that “if property is purchased as an aid in the manufacturing process, it is taxable despite the fact that some portion remains in the finished product or that an incidental waste or by-product results.” (24 Cal.3d 193.) The court noted the differential values in the products produced, explaining that “[g]iven the economics of steel versus slag production, the resale of the slag is ... collateral to the production of steel It is ... incidental to Kaiser’s business” (24 Cal.3d 195.) The court then stated that “[i]t is settled law that the eventual resale of personal property by a person who purchases such property for use will not prevent the original sale of such property from being a retail sale subject to tax.” (24 Cal.3d 197.) Thus, the fact that Kaiser was able to sell the slag was not determinative since Kaiser’s primary purpose for purchasing the subject property was not to incorporate it into slag that would be sold, but instead was for use in manufacturing steel which produced slag as a by-product. The court upheld the tax.

It appears that the fungicide is applied to protect the lumber during the manufacturing process, and that the primary purpose of that process is to produce the surfaced lumber. It appears that, although the primary purpose of the process is to produce surfaced lumber, the by-product of that process, the shavings, can be sold. I assume that the sale of the shavings is collateral to the production of the surfaced lumber as slag is collateral to the production of steel and is incidental to your business of manufacturing and selling surfaced lumber as the sale of slag was incidental to Kaiser’s business. As such, you would be regarded as having made a taxable use of the fungicide in the manufacturing process of the surfaced lumber.

In summary, it appears that you might not owe use tax with respect to the fungicide incorporated into the lumber in scenario one, and that you do owe use tax with respect to your use of the fungicide in scenario two. However, as noted above, we do not have sufficient information to provide you a definitive answer. I hope the information provided above is sufficient to answer your questions. However, if you have further questions, feel free to write again. If you do so, it would be helpful if you would specifically identify the property in question, and discuss how it compares to the anti-blue stains covered by the annotations discussed above, describing with specificity the manner and purpose of the chemical’s use in the manufacturing process and the reason for its remaining on the property sold.

Mr. W--- F. K---

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May 8, 1997
475.0057

Sincerely,

David H. Levine
Supervising Tax Counsel

DHL/cmm

cc: Sacramento District Administrator (KH)
Ms. Joan Armenta-Roberts (MIC:78)