



<u>Item</u>	<u>State, Local And County</u>
Purchases subject to use tax	\$1,010,272

Taxpayer's Contentions

1. Since petitioner has withdrawn its petition for redetermination, the determination cannot now be increased.
2. The chemicals which are the subject of the proposed increase were purchased for resale and resold prior to use.
3. The amount of the proposed increase is overstated.

Summary

Petitioner is a corporation which was engaged in the business of manufacturing and selling gypsum, gypsum wallboard, and paper. An audit of the account for the period July 1, 1973, through December 31, 1978, disallowed claimed sales for resale. The determination reflecting the audited liability was petitioned.

A preliminary hearing was held on the petition in Oakland before Hearing Officer William Low. At that hearing, the audit staff orally stated that petitioner might be liable for additional tax on manufacturing aids purchased ex-tax but used prior to resale. The staff indicated its intention to ascertain the amount of such tax by further review of petitioner's records.

On April 19, 1982, petitioner sent a letter to the Board's headquarter's staff to withdraw its petition for redetermination. This letter was received by the headquarter's staff on April 21, 1982.

Under cover letter of June 1, 1982, the Decision and Recommendation of Hearing Officer Low was mailed to petitioner. In his Decision and Recommendation, Mr. Low directed the audit staff to make a reaudit to determine the amount of the additional tax with respect to manufacturing aids.

On July 9, 1982, the headquarter's staff sent a letter to petitioner notifying petitioner of a proposed increase in the determination. The increase is for use tax on certain chemicals which petitioner purchased ex-tax under resale certificates or from out-of-state vendors. The chemicals include lignosite (lignins), potassium sulfate and "retarders" which petitioner utilizes<sup>1</sup> in the production of gypsum, particularly gypsum for wallboard. Also included are soda ash, caustic soda (sodium hydroxide) and defoamers which petitioner utilizes in producing paper.

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<sup>1</sup> Although petitioner is apparently no longer engaged in this business, we sue the present tense for convenience.

We first discuss the chemicals utilized to produce gypsum. The basic component of gypsum is calcium sulfate. Water is added to the calcium sulfate so that two molecules of water bind with each molecule of calcium sulfate, producing the hydrate molecule of gypsum. The chemicals in question are added to the gypsum during the manufacturing process for the following reasons.

Lignosite. Since gypsum is a hydrate of calcium sulfate and water, it is important that two and only two molecules of water bond to each molecule of calcium sulfate. Lignosite is a diffusing agent which is added to the slurry of calcium sulfate and water to ensure that the water will spread evenly throughout the mixture. When added to the slurry, the lignosite bonds with water molecules to form ionized water-lignin molecules. The ionized molecules apparently surround the calcium sulfate particles and thereby impart a negative charge to each of the particles. The result is that each particle repels every other particle, ensuring adequate diffusion of the water and proper bonding to the calcium sulfate.

According to testimony at the preliminary hearing, when the water-lignin molecules bind to the calcium sulfate molecules, the lignosite "enters into the crystalline structure of the hydrate, forming a totally separate and distinct crystalline structure." This allegation is supported by the declaration of C--- D. L---, which states that lignosite "remains locked in the crystal structure" of the gypsum. However, it is contradicted by the declaration of R. L. S---, which states that the "core crystal matrix" of gypsum manufactured in recent years is essentially unchanged from gypsum manufactured before lignosite was used.

In any event, the utilization of lignosite in the manufacture of gypsum produces demonstrable beneficial effects on the finished product. First, because water is more evenly diffused throughout the slurry, the gypsum contains fewer pockets of unhydrated or partially hydrated calcium sulfate. Wallboard produced from such gypsum is therefore stronger and much less likely to bow or sag. It also appears that gypsum made with lignosite contains smaller and more evenly distributed air pockets than gypsum produced without lignosite. This also contributes to the strength of gypsum wallboard, since nails driven into the wallboard are less likely to hit air pockets and produce cracks.

The more even diffusion of water throughout the slurry also has other benefits. For example, it is possible to use less water during the manufacturing process while still ensuring that each molecule of calcium sulfate becomes fully hydrated. This makes it easier to remove excess water by drying at the end of the manufacturing process. Also, less excess moisture remains in the finished wallboard, reducing its weight and consequently lowering shipping costs.

Furthermore, when producing gypsum for special purposes (such as water-resistant wallboard) petitioner adds additional chemicals to the slurry. In these cases, the lignosite acts not only to disperse the water more evenly, but also to disperse the additional chemicals more uniformly.

Finally, it appears that lignosite remains in the finished wallboard and that its physical presence there has some benefit. According to testimony at the preliminary hearing, other chemicals could be used as dispersants during the manufacturing process. However, such other chemicals have a tendency to leach out of the wallboard over the course of time. This creates weak spots in the wallboard. Since the lignosite does not leach out, using lignosite makes the wallboard stronger than it would otherwise be.

Retarders and potassium sulfate. Once the calcium sulfate is fully hydrated into gypsum, the next step in producing wallboard is to dry the mixture. In the drying process, it is important that all parts of the gypsum dry at the same rate. If some parts dry prematurely, the result is stress lines in the gypsum which weaken the wallboard.

In order to control the rate of drying, petitioner adds "retarders" and potassium sulfate to the gypsum. The retarders are added first, and their function is to prevent the gypsum from drying so that no part dries prematurely. At the proper time, petitioner then adds the potassium sulfate. This chemical causes the gypsum to dry almost immediately, thereby producing a uniform "snap set."

According to petitioner, in addition to producing a snap set, the potassium sulfate also causes the development of a gypsum crystal which has a smaller surface to volume ratio. This is beneficial in products where waterproofing agents are added, since the waterproofing agents have less area to cover and are therefore more effective.

It appears that the retarders and potassium sulfate remain in the finished gypsum. According to petitioner, the potassium sulfate actually enters into the crystalline structure of the gypsum. However, it does not appear that the physical presence of the retarders or potassium sulfate in the finished gypsum has any beneficial effect.

Other chemicals. The chemicals utilized in the paper-making process are described in petitioner's brief as follows. Soda ash is used at the "dry end" of the process to soften the liner of the paper. Caustic soda is introduced directly into the paper mix and remains in the finished paper. It contributes to Ph control, makes the paper more stable and improves its bonding qualities. Defoamer facilitates better formation of the paper product and remains in the product.

#### Analysis and Conclusions

1. Revenue and Taxation Code section 6561 authorizes persons against whom determinations have been issued to file petitions for redetermination. A determination becomes final if a petition for redetermination is not filed within 30 days from the date of the determination. Section 6564 of the Code provides that the decision of the board on the petition for redetermination becomes final 30 days after notice thereof is served on the petitioner. Section 6563 provides:

“The board may decrease or increase the amount of the determination before it becomes final, but the amount may be increased only if a claim for the increase is asserted by the board at or before the [board] hearing.”

Petitioner points out that it originally petitioned for redetermination of sales tax with regard to disallowed sales for resale, while the proposed increase deals with use tax on alleged manufacturing aids. However, there is nothing in the statutes to limit the subject matter of an increase. Accordingly, we conclude that the difference in subject matter does not preclude increasing the determination in question.

Petitioner’s principal contention is that no valid claim for the increase has been made. Petitioner argues that the staff’s assertions at the hearing before Mr. Low were not a valid claim because they were not in writing and not finalized. Petitioner also argues that the staff’s letter of July 9, 1982, was not a valid claim because it was issued after petitioner had already withdrawn its petition for redetermination.

We agree with petitioner that the oral statements made at the hearing before Mr. Low do not qualify as a valid claim for the increase. The issue presented, therefore, is whether the staff’s letter of July 9, 1982, is a valid claim.

Petitioner relies on the requirement of section 6563 that a claim for increase must be asserted at or before the board-hearing. Petitioner contends that, once it withdrew its petition for redetermination, a board hearing could no longer be scheduled on the petition. Therefore, petitioner concludes, the staff’s letter was not issued “before the hearing.” We disagree.

First, there is nothing in the Sales and Use Tax Law” which expressly authorizes or expressly prohibits withdrawal of a petition for redetermination. As a matter of administrative practice, however, the board does not allow petitions to be withdrawn. For every petition which is filed, a notice of redetermination is ultimately issued by the board even if the taxpayer has indicated a desire not to pursue the matter any further. No petition for redetermination is simply dropped without a redetermination by the board.

There are sound statutory reasons for this administrative practice. Under section 6561, once a petition has been timely filed, the original determination does not become final. Under section 6564, the decision of the board on the petition becomes final only after notice of redetermination is issued. If the board allowed petitions to be withdrawn without redetermination, the original determination would therefore never become final and could never be collected. Clearly this is not a result intended by the Legislature.

Petitioner cites the board’s pamphlet Number 17, “Appeals Procedure”, which states on page 10: “Of course, if you prevail or change your mind at any of the above steps, it will not be necessary to go further.” However, this statement does not authorize the withdrawal of a petition. It simply advises taxpayers that they need not continue to participate in the redetermination process unless they desire to do so.

Since petitioner could not withdraw its petition, we construe petitioner's attempt to do so as merely a waiver of attendance at any future hearings. (We do not mean to imply that petitioner will be bound by this waiver. If petitioner wishes to have a board hearing on this matter, one will of course be granted.)

Second, waiver of attendance at the board hearing does not prohibit the board from asserting a valid claim for increase or from increasing a determination. 'Section 6563 provides that the board may increase a determination at any time before it becomes final, provided only that a claim for the increase is asserted at or before the board hearing. As we read this section, the occurrence of a board hearing is merely a limiting factor and not a condition precedent to asserting an increase. That is, if a board hearing is held, the claim for increase must be asserted at or before the hearing. However, if a board hearing is not held, the claim for increase may be asserted and the determination may be increased at any time before the determination becomes final.

Our reading of section 6563 is supported by the language of section 6562. Under section 6562, there can be petitions for redetermination where no board hearing is held because the taxpayer did not request one. To hold that a determination could be increased when the taxpayer has requested a board hearing, but could not be increased when the taxpayer has not requested a board hearing, would create an illogical distinction not contemplated by the Legislature.

To sum up, although petitioner attempted to withdraw its petition, a redetermination has not been issued and the matter has not become final. Furthermore, a board hearing has not as yet been held. Accordingly, we conclude the staff's letter of July 9, 1982, is a timely claim for increase.

Revenue and Taxation Code section 6051 imposes a tax on all retail sales. Section 6007 of the Code defines the term "retail sale" as "a sale for any purpose other than resale in the regular course of business in the form of tangible personal property." Sections 6094 and 6244 provide that if property is purchased ex-tax but used prior to resale, the use tax applies.

The issue here is whether petitioner's purchases of certain chemicals were taxable retail sales or exempt sales for resale. Stated another way, the issue is whether petitioner used the chemicals prior to resale.

In Kaiser Steel Corp. v. State Board of Equalization, 24 Cal.3d 188, the California Supreme Court analyzed this area of the law extensively. The Court stated that "in determining whether a sale is taxable as a retail sale or exempt as a sale for resale, the California courts have consistently looked to the primary intent of the purchaser or the primary purpose of the purchase." (24 Cal.3d at 192.) The Court explained 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. Conversely, if the property is purchased for incorporation as a component of the finished product, it is not taxable despite the fact that some portion may be lost or otherwise dissipated in the manufacturing process.” (24 Cal.3d at 193.)

The Court’s analysis was based in part on Sales and Use Tax Regulation 1525, which provides:

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

“(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....”

In determining the primary purpose of a manufacturer’s purchase of chemicals, the fact that the chemicals have a beneficial effect on the manufacturer’s finished product is not determinative. Any chemical utilized by a manufacturer during the manufacturing process, regardless of whether it is purchased for used as a manufacturing aid or for incorporation into the final product, will necessarily have some beneficial effect on the final product. Otherwise the manufacturer would not utilize the chemical at all. In order to prove that the primary purpose is incorporation into the finished product for resale, therefore, it must be shown not only that the chemical has beneficial effects, but also that such effects result from the physical presence of the chemical in the finished product and not merely from use of the chemical in the manufacturing process.

For the same reason, proof that a chemical remains in the finished product is also not determinative. If the physical presence of the chemical in the finished product has little or no beneficial effect, there is no basis for concluding that the chemical was purchased for the primary purpose of resale as a component of the finished product. On the other hand, if use of the chemical during the manufacturing process brings about the chemical or physical reactions which benefit the finished product, it is reasonable to conclude that the chemical was purchased for the primary purpose of causing such reactions during the manufacturing process even though the chemical happens to remain in the finished product.

In this case, petitioner points out that adding lignosite during the gypsum manufacturing process has a number of beneficial effects. For example, when lignosite is used, the resulting wallboard is much stronger and lighter than it would otherwise be. With one exception, however, the benefits of lignosite result entirely from its use as a diffusing agent during the manufacturing process.

There is only one benefit derived from the physical presence of the lignosite in the finished wallboard. Since the lignosite does not leach out, it does not leave empty spaces which would weaken the wallboard. It is clear, however, that petitioner does not purchase lignosite primarily as a filler for the wallboard. Rather, petitioner purchases lignosite as a diffusing agent, and the fact that it remains in the finished product is merely an added benefit. Accordingly, we conclude that petitioner purchases lignosite for the primary purpose of use during the manufacturing process, and not for the primary purpose of resale as a part of the finished product. We also conclude that petitioner uses the lignosite as a diffusing agent in the manufacturing process prior to resale.

This analysis also applies to the retarders and the potassium sulfate. Both of these chemicals are used to produce chemical or physical reactions during the manufacturing process. The retarders are used to delay drying, and the potassium sulfate is used to produce a snap set. Although the retarders and potassium sulfate remain in the finished gypsum, their physical presence does not appear to have any beneficial effect whatsoever. Accordingly, we conclude that petitioner purchases these chemicals primarily for use in the manufacturing process and not for resale. We also conclude that petitioner uses these chemicals during the manufacturing process prior to resale.

With respect to the chemicals used in the paper-making process, the description of the chemicals in petitioner's brief suggests that the tax applies. However, the record does not contain sufficient information for us to make a definite decision. We suggest that petitioner submit a description of the paper-making process, focusing on the chemicals in question, within 60 days from the date this report is mailed.

Petitioner relies on a number of sales and use tax annotations. Except for Annotation 440.0400 (3/10/65), none of these annotations deal with the specific chemicals involved herein. However, petitioner contends that they establish a general principle which is applicable here: Where the added product in question remains in the end product in substantial amount and where the end product has desirable characteristics as the result of the addition of that product, the purchase and use of that product constitutes a nontaxable purchase.

We disagree with petitioner's analysis of these annotations. Annotations 440.0400 (3/10/65), 440.0420 (10/29/64) and 440.3480 (11/10/64) deal in part with chemicals which remain "as a desirable component" of the finished product or become a "component" of the finished product. Annotations 440.2920 (3/22/55) and 440.2940 (8/5/64) discuss glues which remain in the finished product as bonding agents. Annotation 440.2820 (6/15/61) discusses metallic flux which imparts "desirable alloys" to the finished product. Annotations 440.3460 (1/24/66), 440.3360 (1/27/55), 440.2480 (1/3/57), and 440.2000 (2/10/67) deal with various types of property which remain in the finished product and impart a desired characteristic to the finished product. In our view, these annotations hold that if the physical presence of a chemical in the finished product imparts a desired characteristic to the finished product, it may be assumed that the manufacturer's primary purpose in purchasing the chemical was incorporation into the finished product. The annotations do not discuss chemicals whose physical presence in the finished product was of little or no benefit to the finished product.



The remaining annotations cited by petitioner are 440.2980 (1/4/55), 440.3100 (10/20/67), 440.3180 (7/20/67), 440.3100 (10/20/67), 440.2150 (1/26/73), 440.3680 (7/28/65), and the portion of Annotation 440.0400 (3/10/65) dealing with sodium hydroxide and sulphur dioxide. These annotations do not describe the reasons why the particular chemicals were found to be exempt. Presumably there was evidence to show not only that the chemicals remained in the finished product, but also that the physical presence of the chemicals in the finished product produced some desirable results. Presumably the evidence was strong enough to warrant a finding that the chemicals were purchased, not for the beneficial reactions they caused in the manufacturing process, but rather for the benefits which their physical presence produced in the final product. Accordingly, we do not view these annotations as conflicting with the result reached herein.

3. Finally, petitioner contends that the proposed increase is overstated because it fails to account for purchase fluctuations, inflation, freight charges and a number of other items. Petitioner has not calculated the amount of the alleged overstatement, preferring to wait for a decision on whether the chemicals are taxable. Petitioner should calculate the amounts and submit evidence supporting any claimed reductions to the audit staff within the 60 days allowed above.

#### Recommendation

Hold the record open for 60 days so petitioner may submit additional evidence. Reaudit in accordance with the Decision and Recommendation of Hearing Officer Low and the claim for increase dated July 9, 1982, and adjust as warranted by such additional evidence.

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James E. Mahler, Hearing Officer

6/28/83

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Date