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# Louisiana's Retail Sales Tax and the Reprocessing Exclusion

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the effect of denying the defendant the use of probative evidence. Where this evidence is crucial to the defendant's case, this denial may constitute a violation of the defendant's constitutional right to present a defense. Finally, even if a court feels it must exclude the use of the inference, it should not exclude calling a witness to invoke a privilege on the stand when it is intended for another purpose.

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LOUISIANA'S RETAIL SALES TAX AND THE REPROCESSING EXCLUSION

Defendant taxpayer purchased five million dollars worth of graphite blades which it used in its manufacturing process for the production of chlorine. The Louisiana Collector of Revenue sued to collect the sales tax which he alleged was due on the purchase. Defendant claimed that no sales tax was due because the purchase did not constitute a retail sale under subsection 301(10) of title 47 of the Louisiana Revised Statutes, which excludes "sales of materials for further processing into articles of tangible personal property for sale at retail." The supreme court, reversing the decision of the court of appeal,[1] and reinstating the decision of the trial court,[2] *held* that the exclusion under subsection 301(10) does not apply where the inclusion of the material purchased in the end product results from an unintentional inefficiency of the manufacturing process, is of no benefit to the end product, and is an impurity rather than an integral part of the finished product. *Traigle v. PPG Industries, Inc.*, 332 So.2d 777 (La. 1976).

Pursuant to constitutional authorization,[3] the Louisiana legislature passed the present general Louisiana sales and use tax in 1948 which levied a tax on retail sales.[4] In conjunction with this sales/use tax, the

1. Traigle v. PPG Indus., Inc., 315 So. 2d 859 (La. App. 3d Cir. 1975). The court of appeal had held that the graphite was exempt from the sales tax by its mere presence in the end product regardless of whether it was beneficial to the end product.

2. Doc. No. 100,147 (14th Jud'l Dist. Ct., January 3, 1975).

3. La. Const. art. X, § 1 (1921). *See also* LA. CONST. art. VII, § 1.

4. LA. R.S. 47:302 (1950) provides in part: "(A) There is hereby levied a tax upon the sale at retail, the use, the consumption, the distribution, and the storage for use or consumption in this state, of each item or article of tangible personal property, as defined herein, the levy of said tax to be as follows: (1) At the rate of two per centum (2%) of the sales price of each item or article of tangible personal

legislature defined the term "retail sale," or "sale at retail" in subsection 301(10).[5] This statutory definition includes as taxable incidents sales to consumers or any person for any purpose other than for resale in the form of tangible personal property; the statute specifically states, however, that there is no taxable incident where goods are purchased "*for further processing into articles of tangible personal property.*"[6]

To deal with the administrative problem of interpreting which transactions would be construed to be "sales of materials for further processing into articles of tangible personal property," especially in light of the many instances of goods purchased to be used in the various manufacturing processes conducted in the state, the Collector of Revenue, pursuant to his general rule-making authority,[7] promulgated article 2-37 of the Department of Revenue Rules and Regulations which interpreted the statutory definition of retail sale as it applies to sales to manufacturers and producers.[8] That regulation exempted from the tax sales of raw materials to manufacturers and producers "*which become a recognizable, integral*

property when sold at retail in this state; the tax to be computed on gross sales for the purpose of remitting the amount of tax due the state, and to include each and every retail sale. (2) At the rate of two per centum (2%) of the cost price of each item or article of tangible personal property when the same is not sold but is used, consumed, distributed, or stored for use or consumption in this state; provided there shall be no duplication of the tax."

5. *Id.* § 301(10) (1950) provides: " 'Retail sale,' or 'sale at retail', means a sale to a consumer or to any person for any purpose other than for resale in the form of tangible personal property, and shall mean and include all such transactions as the collector, upon investigation, finds to be in lieu of sales; provided that sales for resale must be made in strict compliance with the rules and regulations. Any dealer making a sale for resale, which is not in strict compliance with the rules and regulations, shall himself be liable for and pay the tax.

The term 'sale at retail' does not include sales of materials for further processing into articles of tangible personal property for sale at retail, nor does it include an isolated or occasional sale of tangible personal property by a person not engaged in such business."

6. *Id.* (emphasis added).

7. *Id.* § 1511 (1950), *as amended* by La. Acts 1958, No. 168, § 1.

8. DEPARTMENT OF REVENUE, RULES AND REGULATIONS PROMULGATED IN CONNECTION WITH LOUISIANA'S GENERAL SALES TAX 29 (May 1, 1961) [hereinafter cited as RULES & REGULATIONS]. Article 2-37 provides that: "The gross receipts or gross proceeds derived from sales of raw materials to manufacturers and producers to be used in fabricating or producing finished articles of tangible personal property for resale, and which becomes (sic) a recognizable, integral part of such finished articles, are not subject to the tax imposed under the Sales Tax Act. The proceeds derived from subsequent sales of such finished articles of tangible personal property to consumers or users, are subject to the tax."

*part''* of finished articles of tangible personal property produced for resale.[9]

The only recorded jurisprudential interpretation of the pertinent language of subsection 301(10) prior to the instant case was in *L.A. Frey & Sons v. Lafayette Parish School Board.*[10] Actually, the tax law at issue in the *Frey* case was a Lafayette Parish retail sales tax ordinance; however, the language of the ordinance excluding ''sales of materials for further processing into articles of tangible personal property for sale at retail'' was identical to the language of subsection 301(10) which was at issue in the instant case.[11] The issue in the *Frey* case was whether the sales tax could be collected on the taxpayer's purchases of sawdust which it burned for smoke to cure meat products. The Third Circuit's discussion of this issue was extremely brief; the court simply stated that since the sawdust was used ''for the processing of meat,'' it was exempt from the sales tax.[12] Unfortunately, the court gave no indication of the reasoning by which it reached this conclusion, nor did it attempt to establish a clear rule which could be applied to subsequent cases.

In the instant case, the defendant taxpayer purchased graphite (carbon) blades to be used as conductors of electricity in the electrolytic process by which it produces chlorine.[13] In this process the graphite blades deteriorate and are periodically replaced. About sixty percent of the carbon is transformed into carbon oxides which are contained in the chlorine gas produced by the electrolytic process. The remaining forty percent of the carbon remains in the chamber in which the electrolytic process takes place and is discarded as waste. The supreme court, as well as the trial and appellate courts, concluded that the carbon oxides found in the chlorine product were useless waste materials which would be removed from the product were it economically feasible to do so.[14] The final

9. *Id.* (emphasis added). Article 2-37 was in effect from the time of its adoption in 1949 until October, 1973, and was in effect during the entire taxable period at issue in the instant case. The Department of Revenue based its tax assessment on the purchase price of the graphite that PPG bought during the period from January 1, 1968 through August 31, 1972.

10. 262 So. 2d 132 (La. App. 3d Cir. 1972).

11. *Id.* at 137.

12. *Id.*

13. The taxpayer produces chlorine by passing an electrical charge through a salt water brine, called the electrolyte, from an anode, or positive electrode, to a cathode, or negative electrode. The graphite blades in question are imbedded in lead to form the anode, and the cathode is constructed from asbestos and a steel screen. The passage of electricity through salt water breaks the water down into chlorine, hydrogen, and caustic soda, all of which are marketable.

14. 332 So. 2d 777, 780 (La. 1976).

chlorine product contained approximately one to two percent by volume of the carbon gases.

The taxpayer argued that the sales tax did not apply to the graphite it purchased because the graphite was "processed into" the final manufactured product.[15] The Collector argued that the graphite was used by the taxpayer as an ultimate consumer. The supreme court recognized that the taxpayer's interpretation of the statute was tenable, but concluded that the more reasonable interpretation was that the substance purchased should not be excluded from the sales tax as a material purchased for processing into the finished product when in fact the purpose for which it was bought was not for incorporation into the manufactured product but rather only for use in the process of producing the manufactured product for sale.[16] In reaching this conclusion the court was influenced by the fact that the presence of the carbon in the chlorine resulted from an unintended, although unavoidable, inefficiency of the manufacturing process, and that the carbon was not beneficial to the product sold and was an impurity rather than an integral part of the finished product.[17] The court thus made it clear that the reprocessing exclusion does not apply to a material simply by virtue of its presence in the end product, for this fact alone is not sufficient to show that the material was purchased for the "purpose" of processing "into" the final product.[18]

It is noteworthy that Justice Tate, writing for the court, used a purely exegetical approach in reaching the decision and indicated that he did not employ traditional rules of statutory interpretation or question the extent of the Collector's rule-making authority or the effect of rules passed pursuant to this authority.[19] Likewise, the court made absolutely no mention of how subsection 301(10) compares with various other statutory devices which can be employed to differentiate "retail sales" from "sales for resale";[20]

15. See the text at note 6, *supra*. To this end the taxpayer argued strenuously that the reasoning of *L.A. Frey & Sons v. Lafayette Parish School Bd.*, 262 So. 2d 132 (La. App. 3d Cir. 1972), should be applied. In *Frey* the court concluded that the sawdust was used "for the processing of" the meat and was therefore exempt from the tax.

16. 332 So. 2d at 781.

17. *Id.*

18. *Id. But see id.* at 783. Justice Marcus, concurring in part and dissenting in part, argued that since sixty percent of the graphite purchased by PPG was found in the final manufactured product, this was sufficient to show that this portion of the graphite had been purchased for further "processing into" the final product and should be excluded from taxation. Justice Marcus would have ruled that only the remaining forty percent should be subject to taxation.

19. *Id.* at 781.

20. For a thorough treatment of this topic, see Redlich, *Sales Tax and the*

nor did it mention the interpretation by the courts of other states of similar wording in tax statutes,[21] or the decision by the Third Circuit in *Frey*.[22]

Further, the court did not specifically address the dispute between the trial court and the appeal court as to whether it is reasonable to interpret subsection 301(10) as requiring that the material purchased be of some benefit to the end product to qualify for the exemption. The trial court had stated that such an interpretation is implicit in the statutory definition,[23] but the court of appeal reversed this holding, stating that the trial court erred in relying upon a regulation adopted by the Department of Revenue subsequent to the taxable period at issue in employing the "benefit" test.[24] The supreme court indicated that it was influenced by the fact that the carbon was of no benefit to the end product[25] and agreed with the trial court that the "benefit" test is reasonably implied by the language of article 2-37 which required that the substance be an "integral" part of the finished article,[26] but the court did not clearly state whether subsection 301(10) *requires* that the purchased material be of benefit to the manufactured product to qualify for the exclusion.

Some insight as to the factors that may have influenced the court may be gained through statements in dicta that if it were in doubt and regarded the statutory definition as ambiguous,[27] the court would have found persuasive the administrative construction given to the statute by the Department of Revenue in its rules.[28] The court's discussion regarding the

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*Resale Exemption in the Manufacture and/or Distribution of Personal Property*, 9 TAX L. REV. 435 (1954). Redlich states that Louisiana employs the "component part" test which permits an exemption for the sale of all materials which become a component part of the manufactured product; this test involves an actual physical examination of the item produced. *Id.* at 437 n.6.

21. For cases supporting the Collector's arguments, see Luer Packing Co. v. State Bd. of Equalization, 224 P.2d 744 (Cal. 1950); Blackmon v. Atlantic Steel Co., 130 Ga. App. 492, 203 S.E.2d 710 (1973); Smith Oil & Ref. Co. v. Department of Fin., 371 Ill. 405, 21 N.E.2d 292 (1939); Union Portland Cement Co. v. State Tax Comm'n, 110 Utah 135, 170 P.2d 164 (1946), *modified*, 110 Utah 152, 176 P.2d 879 (1974) (the modification did not affect the proposition for which the case is cited). For cases supporting the taxpayer's arguments, see State of Alabama v. United States Steel Corp., 281 Ala. 553, 206 So. 2d 358 (1968); State of Alabama v. Southern Kraft Corp., 243 Ala. 223, 8 So. 2d 886 (1942).

22. 262 So. 2d 132 (La. App. 3d Cir. 1972). See the text at notes 11-13, *supra*.

23. *See* 315 So. 2d at 861-62 (court of appeal cites the trial court at Tr. 242.)

24. *Id.* at 861 n.1.

25. 332 So. 2d at 781.

26. *Id.* at n.4.

27. The court stated clearly that it was not in doubt and did not find the statute ambiguous. *Id.* at 781.

28. The court also discussed briefly in dicta the taxpayer's arguments that the

weight to be given the administrative construction of a statute may be an indication of the manner in which the court will handle future problems in interpreting tax statutes. The court recognized and agreed with the taxpayer's argument that it is well established in Louisiana jurisprudence that an administrative construction will not be considered where it is contrary to or inconsistent with the statute.[29] The court made no statement as to whether the Department of Revenue's regulation interpreting subsection 301(10), which was in effect during the taxable period at issue in the instant case,[30] was contrary to or inconsistent with the statute as was argued by the taxpayer;[31] the implication is that the court did not think it was. The court did declare that where a statute is ambiguous, a long-settled contemporaneous construction by those charged with administering the statute should be given substantial and often decisive weight in its interpretation.[32]

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court should apply general rules of statutory interpretation such as where there is reasonable doubt as to the meaning of a tax statute, the doubt is ordinarily resolved in favor of the taxpayer. The court dismissed this argument stating that the rule applied only in the absence of other guides to legislative intent, citing *United Gas Corp. v. Fontenot,* 241 La. 564, 129 So. 2d 776 (1961); and 3 J. SUTHERLAND, STATUTORY CONSTRUCTION § 66.01 at 179 (4th ed. 1974). 332 So. 2d at 782. Further, the court pointed out that this principle is qualified by the corollary tenet that claims of exemption from a tax are strictly construed against the person claiming the exemption. In support of the latter rule, the court cited *Roberts v. City of Baton Rouge,* 236 La. 521, 108 So. 2d 111 (1958), and the decisions therein cited and 3 J. SUTHERLAND, STATUTORY CONSTRUCTION § 66.09 at 207 (4th ed. 1974), 332 So. 2d at 782.

29. No cases were cited by the court to support this contention, but there are numerous Louisiana cases which have so held; likewise this rule is enacted in LA. R.S. 47:1511 (1950), *as amended by* La. Acts 1958, No. 168, § 1. *See* United Gas Corp. v. Fontenot, 241 La. 564, 129 So. 2d 776 (1961); and State v. Standard Oil Co. of La., 188 La. 978, 178 So. 601 (1937) (both of which the taxpayer argued were controlling). *See also* Liquidation of Canal Bank & Trust Co., 211 La. 803, 30 So. 2d 841 (1947); State v. U-Drive It Car Co., 79 So. 2d 590 (La. App. Orl. Cir. 1955).

30. RULES & REGULATIONS art. 2-37, *supra* note 9, at 29.

31. The taxpayer argued also that the sole rule-making authority of the Collector is to make rules and regulations for proper administration and enforcement of tax statutes. In support of this contention the taxpayer cited *Collector v. Mossler Acceptance Co.*, 139 So. 2d 263 (La. App. 1st Cir. 1962).

32. 332 So. 2d at 782. In support of this rule the court cited *Roberts v. City of Baton Rouge,* 236 La. 521, 108 So. 2d 111 (1958), and *Esso Standard Oil Co. v. Crescent River Port Pilots Ass'n,* 235 La. 937, 106 So. 2d 316 (1958). Other cases supporting this rule are *C. E. Hester v. Louisiana Tax Comm'n,* 227 La. 1022, 81 So. 2d 381 (1955); *State v. U-Drive It Car Co.*, 79 So. 2d 590 (La. App. Orl. Cir. 1955). There must be ambiguity for this rule to apply. *See* Roberts v. City of Baton Rouge, 236 La. 521, 108 So. 2d 111 (1958); Esso Standard Oil Co. v. Crescent River Port Pilots Ass'n, 235 La. 937, 106 So. 2d 316 (1958); State v. J. Watts Kearny and

This expression by the court may have future importance in interpreting subsection 301(10) since the Department of Revenue's regulation interpreting that statute was changed substantially in October, 1973.[33] The new regulation provides that the subsection 301(10) reprocessing exclusion applies only to materials purchased which become a recognizable and identifiable component which is of some benefit to the end product.[34] The new regulation specifically states that the mere fact that a material becomes a recognizable component of the end product because the cost of removal was prohibitive does not qualify it for the exclusion. The language which requires that the material be of "some benefit to the end product" is particularly interesting, for while it is at least arguably not within the Collector's power to so define the terms of the statute,[35] this is the construction that the Collector argued should be given to the statute in the instant case, and the court in *PPG* based its decision to disallow exemption of the graphite from taxation at least in part on the fact that graphite "was of no benefit to the product sold."[36]

It appears that the "benefit" test will control future cases with similar fact situations whether the court's opinion in the present case is interpreted to mean that subsection 301(10) requires that the "benefit" test be ap-

Sons, 181 La. 554, 160 So. 77 (1934); Curet v. Hiern, 95 So. 2d 699 (La. App. Orl. Cir. 1957).

33. This change took place after the taxable period at issue but before the supreme court's decision in the instant case.

34. STATE OF LOUISIANA, DEPARTMENT OF REVENUE, SALES TAX LAW AND REGULATIONS (October 1, 1973) [hereinafter cited as REGULATIONS]. The applicable portion of this regulation is as follows: "Sales of materials for further processing into articles of tangible personal property for subsequent sale at retail do not constitute retail sales. This exemption does not cover materials which are used in any process by which tangible personal property is produced, but only those materials which themselves are further processed into tangible personal property. Whether materials are further processed or simply used in the processing activity will depend entirely upon an analysis of the end product. Although any particular material may be fully used, consumed, absorbed, dissipated or otherwise completely disappear during processing, if it does not become a recognizable and identifiable component which is of some benefit to the end product, it is not exempt under this provision. The fact that a material remained as a recognizable component of an end product by accident because the cost of removal from the end product was prohibitive, or for any other reason, if it does not benefit the property by its presence, it was not 'material for further processing' and the sale is not exempt under this provision."

35. It was argued both by the taxpayer and by Justice Marcus in his dissent that such a construction is in conflict with the statute and is therefore not within the Collector's power.

36. 332 So. 2d at 781 & n.4.

plied, or whether the court's opinion merely sanctions the administrative requirement of the "benefit" test as a permissible interpretation of the statute.[37] Although the court made no specific statement as to how this test is to be applied, the implication is that a determination as to whether a product was purchased "for further processing" will be based on an analysis of the end product to ascertain whether the material purchased benefits the end product itself.[38] In this regard "benefit" would seem to include actual physical benefit, such as making the product stronger or imparting to it some desirable physical or chemical property, as well as economic benefit in that it makes the product more valuable so that the producer can demand a higher price for it. The "benefit" test could also logically include purely aesthetic benefit to the product.

The court's decision in the instant case is certain to have an effect on the Department of Revenue's administration of subsection 301(10) as applied to other taxpayer manufacturers in the state.[39] The decision in this case creates a significant burden for taxpayers claiming exemptions from tax statutes in that the court indicates the close scrutiny with which it will consider such claims. If the court adheres to the "benefit" test in future cases, as is expected, the cases in which exemptions are allowed will be clearly proscribed.

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37. REGULATIONS, *supra* note 34, at art. 47:301(10).

38. This conclusion is drawn from language used by the court in the instant case which indicated that the graphite was not exempt because it was "of no benefit *to the product sold*," as well as from the court's focus on the words "integral part" in RULES & REGULATIONS, *supra* note 8, at art. 2-37; to determine whether the material purchases becomes an integral part of the end product would require an inspection of the end product. 332 So. 2d 777, 781 (emphasis added). Similarly, the newly adopted REGULATIONS. *supra* note 34, at art. 47:301 (10) clearly contemplates inspection of the end product to determine benefit.

39. In its brief to the supreme court, the Department of Revenue enumerated several products used in manufacturing processes which would be affected by the court's decision in the instant case. Brief for Relator at 11, Traigle v. PPG Indus., Inc., 332 So. 2d 777 (La. 1976). Some of these were: 1. Acids, abrasives and solvents used in cleaning metals prior to fabrication by a manufacturer; 2. Chemicals used in pulping and bleaching by the paper industry; 3. Carbon black used in processing granulated sugar; 4. Chemicals used by the photography industry to develop films; 5. Caustic used by canners of sweet potatoes to peel the potatoes; 6. Liquid oxygen used in quick freezing of shrimp and seafoods; 7. Chemicals and solvents consumed by refinishers of used furniture; 8. Embalming fluids, cosmetics and morgue supplies used by morticians; 9. Chemicals for preparation of mounting skins, heads, etc. used by taxidermists; 10. Silicate of soda used for the purpose of cleaning and reclaiming fuel oil.