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LOUISIANA SUPREME COURT ADDRESSES FURTHER PROCESSING EXCLUSION FOR LOUISIANA STATE AND LOCAL SALES/USE TAXES

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In a case of major importance to manufacturers in Louisiana, the Louisiana Supreme Court held that purchases by International Paper, Inc. ("IP") of three chemicals (sodium chlorate, elemental oxygen and hydrogen peroxide) used in the manufacturing process of white paper were excluded from Louisiana sales and use taxes under the "further processing exclusion." *International Paper, Inc. v. Cynthia Bridges, Secretary, Department of Revenue, State of Louisiana*, No. 07-C-1151 (La. 1/16/08) (hereinafter referred to as "*International Paper*"). The Court recognized the well-established, three-part test for applying the further processing exclusion. The exclusion applies when the raw materials (1) become recognizable and identifiable components of the end products, (2) are beneficial to the end products, and (3) are material for further processing and, as such, are purchased with the purpose of inclusion in the end products. The Court rejected the notions that the raw materials themselves must be present in the end products and that the further processing of the raw materials must be the *primary* purpose for purchasing the raw materials.

This case will have a significant impact on the application of the further processing exclusion for both state and local sales/use tax purposes. Businesses that could rely on the further processing exclusion should evaluate their raw material purchases to determine whether those purchases may be excluded from state and local sales/use taxes. Taxpayers may also have refund opportunities. In either event, taxpayers should be fully prepared to spend the time and money necessary to prove that the raw material purchases fall squarely within the Court's three-part test for applying the exclusion.

IP is a manufacturer of a variety of paper products. At its manufacturing facility in Bastrop, Louisiana, IP manufactures light-weight grades of paper for sale to its customers. The manufacturing process begins with raw timber and wood chips. The raw timber and wood chips are composed of fiber. The fiber is composed of a number of elements including polymers, lignin, cellulose and hemicellulose. The timber and wood chips are converted into pulp using the Kraft process.

Approximately 85% of the lignin is removed from the timber and wood chips during the Kraft process. After the Kraft process, the lignin remaining in the pulp causes it to be brown and unsuitable for certain grades of paper. In order to remove

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the brown color from the pulp, IP uses a “short sequence bleaching process” designed to remove most of the remaining lignin and to bleach whatever lignin remains in the pulp.

The short sequence bleaching process involves two stages. First, the pulp is mixed with chlorine dioxide, which is created by the sodium chlorate, for the purpose of removing 50%–75% of the remaining lignin from the pulp material. Some oxidation occurs at this stage of the process. Next, the hydrogen peroxide and elemental oxygen materials are added to the pulp to whiten the remaining lignin. Further oxidation occurs at this second stage of the process. The short sequence bleaching process causes oxygen atoms to be bonded to the remaining lignin.

The case began at the Louisiana Board of Tax Appeals, which held that the materials at issue were excluded from sales/use tax pursuant to the further processing exclusion. As such, the Board ordered that the sales/use taxes at issue be refunded to IP. On appeal, the Fourth Judicial District Court upheld the Board’s decision. The Louisiana Department of Revenue (the “Department”) then appealed the decision to the Louisiana Second Circuit Court of Appeal, which reversed the Board’s decision. IP’s writ application was granted by the Louisiana Supreme Court.

The issue before the Louisiana Supreme Court was whether IP’s purchases of sodium chlorate, elemental oxygen, and hydrogen peroxide fell within the further processing exclusion contained in La. R.S. 47:301(10)(c)(i)(aa).¹ The Department argued that none of the materials purchases were excluded because all of the materials themselves did not end up in the finished products and none of the materials were purchased for the *primary* purpose of further processing them into the finished products. IP, on the other hand, argued that each of the materials was excluded from sales/use taxes because the purchases satisfied the long-standing, three-part test in the Department’s own regulations, La. Admin. Code, Title 61, Part I, § 4301, *Retail Sale or Sale at Retail* (d)(2006)(“LAC 61:I.4301”). The Court quoted from the Board’s decision regarding the application of the three-part test as follows:

The Secretary’s regulation, LAC 61:I.4301(10) and the case law provides that in order to be “material for further processing,” as contemplated by the above statute, the raw materials or their component molecular parts must meet three criteria: (1) they must be of *benefit* to the end product; (2) they must be a *recognizable and identifiable* component of the end product; and (3) they must have been purchased for the *purpose of re-processing* into the end product. [cite omitted].

The Court began its decision by reviewing prior decisions of the Court regarding the further processing exclusion, *i.e.*, *Traigle v. PPG Industries, Inc.*, 332 So. 2d

¹ This exclusion applies for both state and local sales/use taxes.

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777 (La. 1976), and *Vulcan Foundry, Inc. v. McNamara*, 414 So. 2d 1193 (La. 1982). The Court noted that the *Traigle* Court “recognized that the ‘further processing exclusion’ applied to those raw materials *purposefully* incorporated within the final products (*i.e.*, not incidentally/accidentally incorporated within the final products), such that said incorporation resulted in the raw materials providing *integral* and *beneficial* parts to the final products produced.” The Court in *International Paper* noted that the *Traigle* Court “recognized the significance of the DOR’s administrative rule with regard to the proper interpretation of the ‘further processing exclusion.’”

Turning to the *Vulcan* decision, the Court noted that although the *Vulcan* Court determined that the carbon (obtained from the coke) became an identifiable and beneficial component of the final products, the presence of the carbon in the final products was merely incidental to the manufacturing process. Therefore, the *Vulcan* Court concluded that purchases of the carbon were not excluded from sales/use taxes.

The Second Circuit Court of Appeal in *International Paper* added a fourth part to the test for applying the further processing exclusion. The Second Circuit described the application of the exclusion as follows:

In order for the reprocessing exception to apply, four requirements must be met: (1) *the material itself must be processed into tangible personal property for sale at retail*; (2) the material must become a *recognizable, integral part of the end product*; (3) the presence of the material as component of the end product *must be of benefit to the end product*; and (4) the *primary purpose for the purchase of the material must be to process it into the end product*.

The Louisiana Supreme Court agreed with the lower court that the further processing exclusion applies to raw materials that become recognizable and integral parts of the end products and that are beneficial to the end products. The Court disagreed, however, with other aspects of the lower court’s decision. Specifically, the Court held that based on the law and jurisprudence there is no requirement “that the raw materials *themselves* (*i.e.*, the exact chemical/physical compositions of the raw materials) must appear in the end products” Further, the Court held that there is no primary purpose component of the test.

Having reached these conclusions, the Court reaffirmed the long-recognized, three-part test as follows:

From this rule [LAC 61:I.4301], we recognize that raw materials “further processed” into end products are excluded from the sales and use tax provisions when: (1) the raw materials become *recognizable* and *identifiable components* of the end products; (2) the raw materials are *beneficial* to the end products; and (3) the raw materials are *material for further processing*,

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and as such, are purchased with the *purpose of inclusion* in the end products.

The Court reiterated its conclusion that there is nothing in the statutes, regulations, or jurisprudence that supports the Department's position that the materials themselves must be present in the finished product. Instead, citing *Vulcan*, the Court noted that the law does not require "that the chemical/physical composition(s) of raw materials incorporated into end products remain the same after their incorporation into the final products."

The Court also rejected the "primary purpose" portion of the test that the lower court added to its analysis. The Court held that purchases of raw materials are excluded from sales/use tax pursuant to the further processing exclusion if the raw materials are purchased for the purpose of incorporation into the end products.

The Court concluded its opinion by noting that the Board's findings of facts regarding the particular raw materials at issue were not manifestly erroneous. The Board found that although there were somewhat conflicting expert opinions as to how oxygen ended up in the bleached pulp (the end product), both experts testified that oxygen from the raw materials ended up in the bleached pulp. The Court held that "[t]hus, the Board's conclusion that the raw materials became incorporated within the end products is reasonable in light of the evidence adduced at the hearing in this matter, as the evidence suggested that the oxygen derived from the raw materials became a recognizable, identifiable, and integral part of the white paper products produced." The Court also found that the evidence established that the presence of the oxygen in the end products was beneficial and necessary to the production of those products and that IP purchased the raw materials specifically to achieve the desired production of white paper products.

The Court's decision provides clarity to the application of the further processing exclusion for both Louisiana state and local tax purposes. The long-established, three-part test was confirmed by the Court. In addition, the Court rejected the Department's arguments that the raw materials themselves, and not just components or elements thereof, must be further processed into the end products. Finally, the Court rejected the notion that there is a primary purpose test applicable to the further processing exclusion. Instead, if the taxpayer can prove that its raw material purchases satisfy the established three-part test, then the purpose aspect of the exclusion should be satisfied and there should be no need to establish that one purpose has to "trump" another purpose.

There are at least two practical "take-aways" from the Court's decision. First, taxpayers who rely on the further processing exclusion must be prepared to spend the time and money to establish the facts necessary to meet the three-part test. This effort generally will require the use of expert witnesses to establish the multitude of technical facts necessary to meet the three-part test. This aspect is critical and must not be taken lightly by any taxpayer. Second, taxpayers should evaluate

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their particular situations and determine whether their purchases of raw materials are eligible for exclusion from sales/use taxes pursuant to the further processing exclusion. This evaluation should focus on whether the taxpayer should be paying state and local sales/use taxes on raw material purchases in the future and whether the taxpayer may have overpaid state and local sales/use taxes in the past. Taxpayers should evaluate their particular situations and, if necessary, take steps to preserve and pursue and available refund claims.

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Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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