

The Dannon Company, Inc.)	CASE NO. 97-M-233
)	
Appellant,)	(USE TAX)
)	
vs.)	DECISION AND ORDER
)	
Roger W. Tracy,))	
Tax Commissioner of Ohio,)	Motion for Reconsideration
)	Filed - Sept. 11, 1998
Appellee.)	Denied - Oct. 9, 1998

APPEARANCES:

For the Appellant-	Steven A. Dimengo Buckingham, Doolittle & Burroughs 50 S. Main Street Akron, Ohio 44309
For the Appellee-	Betty D. Montgomery Attorney General of Ohio By: Janyce C. Katz Assistant Attorney General State Office Tower 30 East Broad Street 16th Floor Columbus, Ohio 43266-0410

Entered September 11, 1998

Mr. Johnson, Ms. Jackson and Mr. Manoranjan concur.

This cause and matter comes to be considered by the Board of Tax Appeals upon a Notice of Appeal filed herein on February 28, 1997. This appeal is from a final order of the Tax Commissioner, appellee herein, dated January 31, 1997. Through that order, the Commissioner affirmed a use tax assessment previously levied against appellant after conditionally modifying the penalties imposed.

Appellant, Dannon Company, Inc. ("Dannon"), is a multi-national corporation with a manufacturing location, the subject of this appeal, in Minster, Ohio. Dannon's local facility produces

three types of yogurt in various flavors. The Commissioner conducted an audit of Dannon's purchases for the period of July 1, 1990, through December 31, 1993. The assessment issued as a result of that audit was reviewed through the Commissioner's appeal process.

Dannon's objections to the audit and its allegations of error on appeal relate to the purchase, installation of, supplies for, and fuel necessary to operate its "Clean-in-Place" or "CIP" system. The purchase of this system, more fully described later in this opinion, and the purchase of the chemicals and natural gas necessary to operate the system, were assessed by the Commissioner as items upon which use tax should have been paid.

Appellant disagrees with the Commissioner's conclusions and, through its Notice of Appeal to this Board, identifies the following as error:

"FIRST: The Tax Commissioner erred in assessing tax on costs, *** associated with the CIP system which were not subject to tax since the Taxpayer used the CIP system primarily in its manufacturing operation to produce tangible personal property for sale. See ORC Sec. 5739.01 (B)(3)(a) and (b), 5739.01(E)(9)¹ (exemption for property used primarily in a manufacturing operation) and 5739.011.

¹ As will be discussed later in this opinion, the manufacturing exception was subject to a major revamping through Am. Sub. H.B. 531, effective July 1, 1990. When originally enacted, R.C. 5739.01(E)(10) contained the exception from sales tax for items used "primarily in a manufacturing operation". The subsection was later renumbered as R.C. 5739.01(E)(9). Am. Sub. H.B. 904, effective Jan. 1, 1993. We mention this change only because it occurred during the audit period.

"Second: The Tax Commissioner erred in assessing tax on costs associated with the Taxpayer's purchase of the CIP equipment from APV Crepaco, Inc. which were not subject to tax since the Taxpayer used such property directly in the production of tangible personal property for sale by manufacturing. See ORC Sec. 5739.01(E)(2) (in effect prior to July 1, 1990), 5741.02(C) and Ohio Administrative Code Rule 5703-9-21 (in effect prior to July 1, 1990). The sale of such property occurred before July 1, 1990. See ORC Sec. 5739.01(B)(1). The costs included in this specification of error include the cost of the CIP property as well as installation and repair expenses associated therewith which were not taxable pursuant to ORC Sec. 5739.01(B) (3)(a) and (b).

"THIRD: The Tax Commissioner erred in assessing tax on costs incurred to modify non-CIP production equipment to adapt to the CIP system. The costs consist of capital, installation and repair costs and miscellaneous parts. All of these costs were exempt from tax pursuant to ORC Sec. 5739.01(E)(9) and 5739.011 since the equipment was primarily used in the Taxpayer's manufacturing process.

"FOURTH: The Tax Commissioner erred in assessing tax on the cost of natural gas used by non-CIP production equipment. Such natural gas purchases were exempt from tax since the equipment was used primarily in the Taxpayer's manufacturing operation to produce tangible personal property for sale. See ORC Sec. 5739.01 (B)(3)(a) and (b), 5739.01(E)(9) (exemption for property used primarily in a manufacturing operation) and 5739.011.

"FIFTH: All of the Taxpayer's purchases were erroneously assessed pursuant to ORC Sec. 5739.01(B) and 5739.02(B).

"SIXTH: The Determination of the Tax Commissioner is not based on evidence and is contrary to law."

The matter is considered by the Board of Tax Appeals upon the Notice of Appeal, the Statutory Transcript certified to this

Board by the Tax Commissioner, the testimony and other evidence presented at hearing, and the legal argument provided by counsel. At hearing, Dannon presented the testimony of two witnesses, Mr. Jon B. Meyer, a twenty-four year employee holding various positions with the company, and Mr. Peter O'Grady, a tax manager. Mr. Meyer described how yogurt is made and generally explained the use of the items ultimately assessed by the Commissioner. Mr. O'Grady related Dannon's specific claims of error directly to the assessment detail papers.

Dannon processes three types of yogurt at the Minster plant, traditional, blended and light. The yogurt is produced by taking unprocessed milk, adding dry ingredients necessary for the formulation of the different products, and then subjecting the milk to a number of processing stages, adding various ingredients during the process and ending with a marketable product.

Initially, dry ingredients necessary for the formulation of an individual type of yogurt are added and mixed in the milk/blend tank. After the dry ingredients are sufficiently incorporated, the mixture is released to one of several tanks for processing. The processing steps are type specific. For example, blended yogurt and light yogurt are processed by pasteurizing, homogenizing, and then fermenting in large vats. For these two types of yogurt, yogurt culture, live bacteria necessary for the creation of yogurt, is added in the fermentation tanks. Traditional yogurt, on the other hand, is pasteurized and homogenized in large tanks, but yogurt culture is not added until

the processed milk blend is placed in the cup from which it is sold.

The equipment in issue in this appeal, the sanitization system, operates throughout the Minster plant environment, with the exception of the coolers holding the final packaged product. There are actually three CIP systems in place, one running through the milk blend area, one through the processing area, and one in the filler area. Each CIP system disseminates chemicals which kill off unwanted bacteria. The chemicals do not interact with the actual product, but are run in lines and tanks in an alternating manner with the product. In other words, based upon a schedule created by Dannon in accordance with the product currently being produced, CIP chemicals will enter lines and tanks after one product batch but before another.

Even though the yogurt processing equipment is a closed system, bacteria phages exist within it. Bacteria phages are minuscule parasites which attack yogurt culture and destroy the bacteria which must grow in order to gel the milk-product into a saleable consistency. The purpose of the CIP sanitization system is to remove these unwanted bacteria and other organic materials from the equipment and lines so yogurt can be produced.

Testimony at hearing indicated that, because of the high heat and the caustic nature of the chemicals used, the CIP equipment actually decreases the life expectancy of the manufacturing equipment. Further, the sanitization process is separate from a planned preventative maintenance program conducted by Dannon employees.

Cross-examination of appellant's witness revealed that CIP systems are not new concepts, but have been used in dairy systems for twenty to thirty years. Generally, the CIP systems used in dairies remove dirt and contamination from processing lines and equipment, assuring product quality and taste. However, milk and dairy products can be processed without such systems. In contrast, because yogurt contains live bacteria which are easily affected by other organic material, without a CIP system, not only will quality and taste be affected, the intended product will not be produced.

The Commissioner assessed capital purchases relating to the CIP systems as well as the purchase of chemicals and natural gas used within those systems. Dannon claims that the CIP systems and supplies are subject to an exception from use taxation. As a preliminary matter, R.C. 5739.02 levies an excise tax upon all retail sales made in Ohio. A similar use tax is imposed by R.C. 5741.02. If a transaction is not subject to sales tax, then it is also not subject to use tax if purchased outside the state and used within. R.C. 5741.02(C). Therefore, as is common in such cases, a discussion of the relevant sales tax provisions follows.

Dannon claims that the CIP system is excepted from tax under R.C. 5739.01(E)(9). That section provides:

"For the purpose of providing revenues with which to meet the needs of the state ***, for the purpose of securing a thorough and efficient system of common schools *** and for the purpose of affording revenues in addition to those from general property taxes, *** an excise tax is hereby levied on each retail sale made in this state."

"(E) 'Retail sale' and 'sales at retail' include all sales except those in which the purpose of the consumer is:

" ***

"(9) To use the thing transferred, as described in section 5739.011 *** of the Revised Code, primarily in a manufacturing operation to produce tangible personal property for sale;"

As identified in above, an exception from the general rule that all retail sales of tangible personal property are taxable exists for items falling within what has historically been known as the "manufacturing exception". Items and equipment used to manufacture other items of tangible personal property intended to be sold are generally not subject to tax.

While the manufacturing exception has historically been a part of the state's taxing scheme, the General Assembly, through Am. H.B. 531, eff. July 1, 1990, attempted to clarify the categories of purchases upon which sales tax should be imposed and those which should not be subject to tax. The prior statute excepted from taxation items purchased for "direct use in manufacturing". The "direct use" language was replaced with an exception for items used "primarily in a manufacturing operation". Compare former R.C. 5739.01(E)(2) with current 5739.01(E)(9). At the same time and in an effort to more clearly delineate the parameters of the manufacturing exception, R.C. 5739.011 was enacted. That provision categorizes purchases by use and then classifies the use as either taxable or non-taxable. As is pertinent to this appeal, R.C. 5739.011 provides:

"(B) For purposes of division (E)(9) of section 5739.01 of the Revised Code, the 'thing transferred' includes, but is not limited to, any of the following:

"(4) Machinery, equipment, and other tangible personal property used during the manufacturing operation that control, physically support, produce power for, lubricate, or are otherwise necessary for the functioning of production machinery and equipment and the continuation of the manufacturing operation;

Appellant also argues that its system meets the exception provided in R.C. 5739.011(C)(5), which requires purchases of property and equipment used in environmental control to be subject to tax, but carves an exception for "machinery, equipment and other tangible personal property that totally regulates the environment in a special and limited area of the manufacturing facility where the regulation is essential for production to occur."

While the appellant claims its CIP system purchases meet the requirements of either of the above cited sections, the Commissioner claims that the system is specifically excluded by virtue of R.C. 5739.011(C)(9). That section provides:

"(C) For purposes of division (E)(9) of section 5739.01 of the Revised Code, the 'thing transferred' does not include any of the following:

"(9) Machinery, equipment, and other tangible personal property used to clean, repair, or maintain real or personal property in the manufacturing facility;"

We first acknowledge the standards by which we review the Commissioner's determinations. The Tax Commissioner is accorded a presumption that his findings are correct. Alcan Aluminum Corp. v. Limbach (1989), 42 Ohio St.3d 121. It is incumbent upon a taxpayer challenging a finding of the Tax Commissioner to rebut that presumption and establish a right to the relief requested. Belgrade Gardens v. Kosydar (1974), 38 Ohio St.2d 135: Midwest Transfer Co. v. Porterfield (1968), 13 Ohio St.2d 138.

Moreover, the taxpayer is assigned the burden of showing in which manner and to what extent the Tax Commissioner's determination is in error. Federated Dept. Stores, Inc. v. Lindley (1983), 5 Ohio St.3d 213. In addition, every sale or use is presumed to be taxable and exemptions or exceptions from taxation are to be strictly construed. National Tube Co. v. Glander (1952), 157 Ohio St. 407.

Prior to considering the issue as framed by the appellant, it is necessary to return to R.C. 5739.01(C)(9) and determine what constitutes the "manufacturing operation" in the Minster plant. R.C. 5739.01(E)(9) limits exception to only those items (more fully described in R.C. 5739.011) which are used within a "manufacturing operation." If an otherwise non-taxable item is purchased for use outside the "manufacturing operation" it is nevertheless subject to tax.

Under the "direct use" standard of former R.C. 5739.01(E)(2), the initial inquiry in determining whether an item was subject to tax was whether the item was used during the manufacturing or processing activity. Youngstown Bldg. Material &

Fuel Co. v. Bowers (1958), 167 Ohio St. 363; Southwestern Portland Cement Co. v. Limbach (1988), 35 Ohio St.3d 196. This inquiry required consideration of the starting point and ending of the conversion process. Ball Corp. v. Limbach (1992), 62 Ohio St.3d 474. This standard has now been codified in R.C. 5739.02(S) which provides:

"'Manufacturing operation' means a process in which materials are changed, converted or transformed into a different state or form from which they previously existed and includes refining materials, assembling parts, and preparing raw materials and parts by mixing, measuring, blending or otherwise committing such materials or parts to the manufacturing process. 'Manufacturing operation' does not include packaging."

Therefore, we must first consider the manufacturing process as a whole in order to identify the beginning point and ending point of the manufacturing operation. If the CIP equipment or supplies in issue are not used within the manufacturing operation, the purchases must be found to be taxable regardless of the equipment's specific use.

At hearing, appellant presented Exhibit "W". This exhibit identifies each assessment by line item and relates each line item to one of the three CIP systems, the "blended milk" system, the "central CIP", and the "filler" system. For capital purchases, the categories are further refined by identifying the exact point at which the item is ultimately used. The evidence presented supports a finding that the majority of the capital purchases assessed are

associated with the central CIP, that CIP system attached to the processing equipment. (Exhibit "W")

The total capital purchases assessed equals approximately \$2,172,998. Capital purchases allocated to the "blended milk" equipment equals approximately \$71,648 and purchases allocated to the "filler" system equals approximately \$367,521. The remaining purchases, or approximately \$1,733,829, are attributed to the "central CIP" system. Of this amount, \$1,491,559 is allocated to the purchase and installation of a new sanitization system attached to processing equipment devoted to the manufacture of blended yogurt. We identify this purchase because there is an independent claim that it should not be subject to tax².

With respect to the starting point of the yogurt-making process, testimony at hearing indicated that, during the audit period, raw milk was purchased from local dairies and received into milk blend tanks. Additives were then introduced and incorporated in the milk blend tanks. (H.R. p. 30) Testimony further indicated that milk was received in a continuous process. As R.C. 5739.01(S) defines the manufacturing operation as including the point where

² Appellant asserts that the contract for the purchase of the new blended yogurt CIP system was executed and a payment was made prior to July 1, 1990, the starting date of the audit. Evidence adduced at hearing related to the original negotiations, the contract executed for the purchase of the system and authorization for payment of the twenty per cent downpayment. The evidence does support a finding that a proposal was agreed upon and an initial downpayment was made prior to the audit period. However, as this Board concludes that the capital purchases relating to the central CIP system are not subject to tax, we need not make a finding as to whether the purchase of this particular CIP system was properly assessed when certain steps were completed prior to the audit period, but full consummation of the contract was made within.

materials are mixed, measured, and blended, we find that the manufacturing operation begins in the milk blend tanks. Equipment or intake lines prior to that point are prior to the beginning of the manufacturing process, and therefore are subject to tax.

While not discussed at hearing, it appears from the record that the milk blend area contains both batching tanks and storage tanks. (S.T. p. 19) As it appears that the storage tanks merely receive milk and the measuring and mixing takes place in the batching tanks, we find that the manufacturing operation begins in the batching tanks.

We make these findings because it appears that some of the assessed CIP equipment was purchased and installed on "milk reclaim" storage tanks located in the milk blend area. (Exh. "W") No specific testimony connected the assessments specifically to these milk reclaim tanks. The schematic included within the Statutory Transcript places these reclaim storage tanks with the storage tanks. (S.T. p. 19). As we have no specific testimony placing these tanks within the manufacturing process, we find that such tanks are preliminary to the manufacturing operation, and thus, the CIP capital costs attributed to such tanks are properly assessed.

We next consider the end of the manufacturing process. Testimony at hearing revealed that yogurt cultures are added to blended and light yogurt in large vats where a fermentation process occurs and yogurt is created. After fermentation, the blended and light yogurts are cooled and moved into surge tanks. From the surge tanks, blended and light yogurt is pumped to the fillers,

which fill individual cups in various sizes. Then, blended and light cups of yogurt move to coolers. In contrast, traditional yogurt is pasteurized and homogenized in large vats. The milk blend is then reheated and placed into holding tanks. From the holding tanks, the yogurt is moved, through the filler process, to cups. Yogurt culture is added directly to the cups.

Because the processing steps are dissimilar, this Board finds that the manufacturing operation ends at different times. The Board finds that, for traditional yogurt, the manufacturing operation ends after the filler process. However, for blended and light yogurt, the manufacturing process ends when the yogurt is placed in the surge tanks, as no further processing occurs after that point.

Exhibit "W" identifies certain assessments related to the filler CIP. The "culture injection system" and the "REMY C line" both appear related to the manufacture of traditional yogurt. As the manufacture of traditional yogurt does not end until after the filling process, the use of the CIP equipment must be considered in order to determine the taxability of these items. However, no testimony or other evidence was presented concerning the "ECO 2000 blended" (which we deduce is related to filling blended yogurt), the "new 6 oz. line", the "plasti-conversion to blended" (which, again we deduce is related to blended yogurt), the "KIDS", or the "cheese processing/filling modification". Therefore, this Board finds that such assessments are proper as they identify equipment used after the manufacturing operation has ended.

The bulk of the capital asset assessment relates to the central CIP system. The central CIP system is attached to processing equipment, i.e., the pasteurizers, homogenizers, fermentation tanks, coolers and surge tanks, reheaters, and buffers. The Board finds that such equipment is clearly within the manufacturing operation, and thus, the use of the CIP equipment must be reviewed so that its taxability may be determined.

With respect to such equipment, the Commissioner contends that the very name of the "Clean-in-Place" system sufficiently describes its use and R.C. 5739.011(C)(9) categorizes that use as taxable. Appellant argues, on the other hand, that R.C. 5739.011(C)(9) is ambiguous and therefore in need of interpretation. Dannon argues that the terms "clean, maintain and repair" should be read to give force to the legislative intention to tax equipment and supplies used only for general cleaning, maintenance and repair, to "keep equipment operable and prolong the life thereof." (Appellant's brief, p. 10) Dannon then argues that even the Commissioner believes some equipment which serves a cleaning function is not to be taxed under R.C. 5739.011(C)(9).

Dannon suggests that Example 49 of Ohio Adm. Code 5703-9-21 lends support to its claim that the Commissioner believes not all items and equipment purchased for use in cleaning are subject to tax. The scenario provided in Example 49 is of a manufacturer of automotive parts who paints parts as part of its manufacturing process. The painting is performed in atmospherically controlled paint booths. The back of the booth contains a water spray system which flushes extra paint from the booth to keep the booth clean

and to standardize painting conditions. In this example, the water spray is recognized as not taxable "as it is necessary for the continuation of the manufacturing operation."

Dannon argues that there is no difference between its CIP system and the water spray. Both control a limited area of the manufacturing operation; both control production equipment; both are necessary for manufacturing to occur continuously. Thus, Dannon claims, its CIP systems should also be excepted from tax.

In making this determination, we first consider the central CIP equipment, that equipment attached to processing equipment and lines, and the filler CIP equipment dedicated to the traditional yogurt process. While the words "clean, repair or maintain" encompass a cleaning function, it is our considered opinion that the CIP systems do much more. When an item of tangible personal property serves two purposes, one taxable and one non-taxable, a consideration of the primary purpose of such item is warranted. The Mead Corp. v. Glander (1950), 153 Ohio St. 539. Primacy is determined upon the need for the item purchased, its usefulness and value to the product being manufactured. Ace Steel Baling v. Porterfield (1969), 19 Ohio St.2d 137. In the present matter, we conclude that, without the CIP system, processing yogurt is virtually impossible. We are convinced that live bacteria require special handling and care, which includes control of competing organisms. Therefore, this Board finds that the primary purpose of the equipment is to control the environment necessary for processing yogurt.

We acknowledge that we have previously found CIP equipment to fulfill a maintenance function. Under the prior law items purchased for cleaning purposes were taxable, but items purchased for maintenance purposes were not subject to tax. Former Ohio Adm. Code 5703-9-21(M) In Reiter Dairy, Inc. v. Limbach (Jan. 15, 1993), B.T.A. No. 90-Z-503, unreported, this Board found certain chemicals used within a CIP system not subject to tax because the CIP system served a maintenance function throughout the dairy. While purchases of tangible personal property used to maintain equipment and personalty are now subject to tax, we find the earlier case factually distinguishable. The CIP system previously under consideration acted upon equipment processing milk and ice cream. Testimony at hearing indicated that both milk and ice cream could be manufactured without the CIP systems in place at dairies. The CIP systems in dairies served a bacterial removal purpose, but solely for the purpose of quality control.

The CIP systems currently under consideration play a much greater role in the manufacturing process. As stated above, yogurt cannot be created if unwanted bacteria are present. Therefore, the sanitization function necessary to yogurt processing is distinct from the maintenance function served by CIP equipment in dairies.

We now consider the filler system. The plant utilizes one filler system, made up of a number of components, for all three yogurt processes. We have found that certain components of this system are part of the manufacturing operation when processing traditional yogurt. However, other components of the system are used both as a part of the manufacturing operation (traditional

yogurt container filling) and after the manufacturing operation has ceased (blended and light yogurt container filling).

With regard to any remaining components of the filler CIP system common to all three processes, we again consider the equipment based upon a primary use test. Evidence adduced at hearing indicated that the manufacture of blended and light yogurt account for 60 per cent of the plant's manufactured product; traditional yogurt accounts for the remaining 40 per cent. While the primary purpose test is not solely a measurement of time, in this instance we conclude that the filler system is used to a greater extent in filling light and blended yogurt containers. As manufacturing has concluded prior to the filler system for blended and light yogurt, this Board is therefore compelled to conclude that the primary purpose of the remaining components of the filler system, and therefore the CIP system attached thereto, is of a taxable nature. Therefore, all CIP purchases relating to the filler system, except for the components attached to the traditional yogurt filler, are properly assessed.

The assessment for repairs was based upon a test sampling of appellant's repair expenses. As this Board has concluded that the central CIP should not be assessed, pursuant to R.C. 5739.01(B)(3)(a), assessments on repairs of that system, also are improper. The assessment on the CIP systems included in the blended milk tanks and fillers, are proper, as no testimony relating to their individual use has been provided. The assessment for chemicals and natural gas should, similarly, be adjusted to account for the exception granted to the central CIP system.

Further, as chemicals and natural gas are fungibles, a percentage of the purchases relating to the filler system should also be excepted. See B.F. Goodrich v. Lindley (1979), 58 Ohio St.2d 364.

Considering the appellant's notice of appeal, the record, statutes and case law, the Board of Tax Appeals finds that the Tax Commissioner erred in concluding that certain purchases, repairs and supplies used in Dannon's CIP systems should be subject to tax. The assessment is modified in accordance with this decision and order, and affirmed as modified.