

UT 03-1

Tax Type: Use Tax

Issue: Machinery & Equipment Exemption – Manufacturing

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

ABC, INC.)	Docket No.	00-ST-0000
Taxpayer)	IBT No.	0000-0000
v.)		
THE DEPARTMENT OF REVENUE)	John E. White,	
OF THE STATE OF ILLINOIS)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: John Rendelman and John Daly, Feirich, Mager, Green & Ryan, appeared for ABC, Inc.; John Alshuler, Special Assistant Attorney General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter involves amended returns that ABC, Inc. (“ABC”) filed to claim refunds of a portion of the Illinois use tax it previously paid to the Illinois Department of Revenue (“Department”) as measured by its cost price of coal purchased for use in Illinois. The purchases took place during the periods beginning on May 1, 1992 and continuing through November 30, 1999. The Department denied ABC’s claims, after which ABC protested them and asked for a hearing.

The parties agreed that the issue at hearing was whether ABC was entitled to a refund for the comparative percentage of use tax paid regarding the coal it purchased that is equal to the percentage of fly ash that remained after ABC burned the coal to produce electricity. I have reviewed the evidence adduced at hearing, and I am including in this

recommendation findings of facts and conclusions of law. I recommend that the issue be resolved in favor of the Department.

Findings of Fact:

1. ABC is a corporation that is engaged in the business of producing electricity. Hearing Transcript (“Tr.”) pp. 106-110, 169 (testimony of John Doe, ABC’s president).
2. ABC purchases coal from various sellers. Taxpayer Exs. 16-18, *passim* (see schedules attached to taxpayer’s amended returns/claims for credit showing purchases of coal from different vendors).
3. ABC burns coal at its steam station, or steam plant, which is located in Anywhere, Illinois. Tr. p. 106 (Doe). The burned coal produces steam that drives a turbine and produces electricity. *Id.* (“Basically [the plant] convert[s] coal and thermal energy into mechanical energy into electrical energy.”).
4. ABC is a privately owned wholesaler of electricity, and is not a public utility. Tr. pp. 106-07 (Doe).
5. During the early 1990’s, the provisions of the Clean Air Act of 1990 required ABC to choose between either installing scrubbers at its Anywhere steam plant or purchasing different types of coal to burn to produce electricity there. Tr. pp. 98-104 (Doe).
6. ABC decided to switch the type of coal it purchased. Tr. p. 99 (Doe). ABC made this choice because installing scrubbers would be more expensive, and because, by switching the coal it used to produce electricity, ABC could also make

- additional revenues by selling some of the ash remaining after it burned the different type of coal. Tr. pp. 99-106 (Doe).
7. Whenever coal is burned, two different kinds of ash, fly ash and bottom ash, remain as a residue of the combustion process. Taxpayer Ex. 2 (Expert's report), p. 1 (Introduction); Tr. pp. 72-73 (testimony of Expert Witness ("Expert"), ABC's opinion witness). Thus, fly ash and bottom ash both remained as residue after ABC burned the coal it purchased and consumed at its Anywhere plant. Tr. pp. 73 (Expert), 143 (Doe); Taxpayer Ex. 2, p. 1.
 8. Fly ash is dry particulate matter that rises with flue gasses and is collected by electrostatic precipitators. Taxpayer Ex. 2, p. 1. Fly ashes are formed from the mineral matter in coal and consist mainly of glassy spherical particles as well as residues of hematite and magnite, char, and some crystalline phase formed during cooling. *Id.*; Taxpayer Ex. 3D (photo of class C fly ash).
 9. Bottom ash consists of larger, fused particles of fly ash that fall to the bottom of the combustion chamber of a boiler. Taxpayer Ex. 2, pp. 1, 11 (Figure 1, showing a schematic diagram of a fossil fuel power plant); Taxpayer Ex. 3C (photo of class C bottom ash).
 10. Fly ash is a pozzolan, which means it is a material that, in the presence of water, will combine an activator, such a lime, Portland cement or kiln dust, to produce a cementitious material. Taxpayer Ex. 2, p. 6 (Fly Ash as an Engineering Material). "Cementitious" means having the ability to bind. Tr. pp. 69-70 (Expert).
 11. The American Society for Testing and Materials ("ASTM") has issued standards for ash that include classes "C" and "F" ash. Taxpayer Ex. 2, p. 6. Class C ash

- can be composed of either fly ash or bottom ash, or a combination of both. Taxpayer Exs. 3C-3D (respectively, photos of class C bottom and fly ash); Tr. pp. 32-34 (Expert).
12. The ASTM's standard 618 addresses class C (for "cementitious") fly ash, which is appropriate for use as an additive of Portland cement concrete for use in a variety of construction projects, including buildings, bridges, dams, structural fill as well as other construction uses. Taxpayer Ex. 2, pp. 6, 11-12.
 13. ASTM standard 618 is also recognized by the American Association of State Highway Transportation Officials ("AASHTO") which issues standards for construction materials that may be used on transportation projects. Taxpayer Ex. 4a (AASHTO and ASTM Standards M-295 and C-618, respectively).
 14. Whether fly ash meets the different standards set by the ASTM or by the AASHTO depends on the type of coal burned, variations in the combustion process, and the manner in which fly ash is handled after the combustion process. Taxpayer Ex. 2, pp. 1, 7-11; Tr. pp. 75-77 (Expert). Fly ash residue of the class C type is obtained from the combustion of only lignite or sub-bituminous coal, and it must have sufficient quantities of pozzolan and lime. Taxpayer Ex. 2, pp. 1, 7-11; Tr. pp. 37-38 (Expert).
 15. One of the most important characteristics of coal ash is its "loss on ignition" or "LOI," which measures the amount of unburned coal remaining in ash. Taxpayer Ex. 2, p. 7. LOI is expressed as a percentage of the total mass, in weight, of coal remaining in a given amount of ash sampled. *Id.*; Taxpayer Ex. 12, *passim* (reports showing LOI % of ABC's fly ash samples tested after the claim period).

- No evidence in this record shows what the LOI was for the fly ash remaining after ABC burned coal during the claim period.
16. Prior to and during the time period at issue, ABC purchased and installed machinery, equipment and other improvements to its Anywhere plant which helped ABC ensure, among other things, that the fly ash remaining after it burned coal would be marketable class C fly ash. Taxpayer Exs. 8-9; Tr. pp. 110-25, 143-47, 150-56 (Doe), 177-190 (testimony of Supervisor (“Supervisor”), a supervising engineer in ABC’s technical services department). Among the types of machinery and equipment ABC purchased were burners for its boilers, vacuums, pumps and other types of material handling equipment that, together, automatically collected and transported fly ash from the precipitators to a location ABC personnel referred to as the ash farm. Tr. pp. 110-25, 143-47, 150-56 (Doe), 177-190 (Supervisor).
 17. In 1992, ABC incorporated a wholly owned subsidiary, XYZ, Inc., which handled the business of selling the marketable fly ash remaining after ABC burned coal to produce electricity. Tr. p. 99 (Doe).
 18. ABC typically burned coal with a 4.5 or 4.6 percent ash content, although it purchased, blended and burned different coals with different ash contents. Tr. p. 162 (Doe); Taxpayer Exs. 16-18 (amended returns); *see also* Combs v. Hawk Contracting, Inc., 543 F.Supp. 825, 827 (D.C.Pa. 1982) (defining “ash content”).
 19. ABC realizes approximately 6% of its after tax profit from selling fly ash and approximately 94% of its after tax profit from selling electricity. Tr. p. 169 (Doe).

Conclusions of Law

Illinois' Use Tax Act ("UTA") imposes a tax on the privilege of using in Illinois tangible personal property (hereinafter, "goods") purchased at retail from a retailer. 35 ILCS 105/3. Section 2 of the UTA contains the Illinois General Assembly's definition of "use," and it provides, in pertinent part:

"Use" means the exercise by any person of any right or power over tangible personal property incident to the ownership of that property, except that it does not include the sale of such property in any form as tangible personal property in the regular course of business to the extent that such property is not first subjected to a use for which it was purchased, and does not include the use of such property by its owner for demonstration purposes: Provided that the property purchased is deemed to be purchased for the purpose of resale, despite first being used, to the extent to which it is resold as an ingredient of an intentionally produced product or by-product of manufacturing. ***

35 ILCS 105/2.

As an initial point, the Department asserts that § 2 sets forth an "exemption from use tax ... for property 'deemed to be purchased for the purpose of resale, despite first being used, to the extent to which it is resold as an ingredient of an intentionally produced product or by-product of manufacturing.'" Department of Revenue's Post-Trial Responsive Brief ("Department's Response"), p. 1. This matter, however, does not involve an exemption from use tax. Rather, it involves a question of whether and to what extent ABC used the coal it purchased by reselling it as an ingredient of an intentionally produced product or by-product of manufacturing.

ABC Did Not Merely Use The Coal, It Consumed It

ABC focuses its arguments on the undisputed fact that it sells the class C fly ash that remains from its combustion of coal, and on the efforts it undertook to ensure that the

ash produced from burning coal qualifies as class C fly ash. Post-Trial Supporting Memorandum (“ABC’s Brief”), *passim*. The Department responds that the ash remaining after ABC burned coal is not an intentionally produced product or by-product of manufacturing because ABC is not a manufacturer, either in the ordinary sense of the word, or as the word “manufacturing” is used in § 2 of the UTA. *E.g.*, Department’s Response, pp. 1-2.

Within § 2’s definition of the uses that are subject to tax, the General Assembly also described those uses that are not subject to tax. The first nontaxable use is the act of selling purchased goods in the regular course of the purchaser’s business, but only to the extent the goods have not already been used for the purpose for which they were purchased. 35 ILCS 105/2. The second nontaxable use is the act of reselling purchased goods — despite having been used by the purchaser — “to the extent [the goods] are resold as an ingredient of an intentionally produced product or by-product of manufacturing.” *Id.* The legislature clearly intended the first nontaxable use to be the exercise of rights and Doe over goods purchased by retailers or wholesalers. The second nontaxable use extends to acts exercised by persons who purchase and use goods when manufacturing other goods for sale to others, but only to the extent the purchased goods are, in fact, part of the goods that are resold to others.

The difference between these two nontaxable uses is that, in the first, the retailer or wholesaler’s post-purchase use of goods for the purpose for which they were purchased constitutes the exercise of the privilege on which tax is assessed. 35 ILCS 105/2-3. Thus, even if a retailer/wholesaler sells goods it has first subjected to the use for which they were purchased, its prior use of the goods constitutes the exercise of the

privilege that subjects the retailer/wholesaler to tax. *E.g.*, Howard Worthington, Inc. v. Department of Revenue, 96 Ill. App. 3d 1132, 421 N.E.2d 1030 (2d Dist. 1981). Not so with goods purchased by manufacturers, “to the extent [the goods are] resold as an ingredient of an intentionally produced product or by-product of manufacturing.” 35 ILCS 105/2; Granite City Steel Co. v. Department of Revenue, 30 Ill. 2d 552, 557, 198 N.E.2d 507, 511 (1964). This view of the types of nontaxable uses in § 2 reflects the legislature’s intent that tax not be assessed on transactions involving goods as they move through the chain of commerce, but only with regard to those transactions that involve a sale of goods to the ultimate consumer. Container Corp. of America v. Wagner, 293 Ill. App. 3d 1089, 1093, 689 N.E.2d 259, (1st Dist. 1997); *see also* Granite City Steel Co., 30 Ill. 2d at 557, 198 N.E.2d at 511 (describing the nontaxable uses discussed here as being “designed to avoid double taxation”).

I agree with the Department’s argument that ABC is not exercising rights and Doe over the coal it purchased here as a manufacturer using the goods that it incorporates into tangible personal property that it sells to others. Rather than being a manufacturer of fly ash, ABC has found a profitable market for some of the waste remaining after it completely consumed the coal while conducting a business that does not constitute manufacturing. *See* Tr. pp. 106, 169 (Doe).

A manufacturer’s use of goods as an ingredient in property it makes for sale to others is to be contrasted with a non-manufacturer’s consumption of goods. Granite City Steel Co., 30 Ill. 2d at 557, 198 N.E.2d at 511. The complimentary retailers’ occupation tax (“ROT”) is measurable by the gross receipts a retailer realizes from selling goods to others for use *or* consumption in Illinois. 35 ILCS 120/1, 2. The General Assembly’s

description of nontaxable uses in § 2 of the UTA include a manufacturer's "use" of goods, but that description of nontaxable uses says nothing about goods that are "consumed" by others (35 ILCS 105/2), and longstanding Illinois law is clear that the two words have different meanings.

The burning of fuel, in fact, is one of the defining examples the Illinois supreme court cited, in Revzan v. Nudelman, 370 Ill. 180, 18 N.E.2d 219 (1938), when it held that the statutory phrase "consumption," as used in the Retailers Occupation Tax Act's ("ROTA['s]") definition of "sale at retail," means "destruction by use." Revzan involved the Department's assessment of ROT to a person who sold heels and other goods to shoe repairmen. The seller contested the assessment, arguing that its sales were not for use and consumption by the repairmen, but for future sale to the repairmen's customers, the ultimate consumers. *Id.*¹ Specifically, the court wrote:

Webster's Unabridged Dictionary defines 'consume' as to use up; expend, waste, exhaust. It defines 'consumption' as the use of economic goods resulting in the diminution or destruction of their utilities. 'Consumption may consist in the active use of goods in such a manner as to accomplish their direct and immediate destruction, as in eating food, wearing clothes or burning fuel,' is given as an example. Under the rules of statutory construction, the term 'consumption' must be interpreted in its usual and popular meaning, i. e., destruction by use. ***

Revzan, 370 Ill. at 184, 18 N.E.2d at 222.

The General Assembly defined the word "use" differently than the Revzan court did, once it passed the UTA in 1955, but both the original and the various amendments to the statutory definition of "use" heed the Revzan court's interpretation of

¹ Revzan was decided more than 20 years before the Illinois General Assembly passed the Service Occupation Tax Act in 1961.

the word consumption. Again, § 2 of the UTA includes different kinds of acts and exercises over goods that constitute nontaxable uses. Nothing within that section, however, evinces a legislative intent that a person other than a manufacturer can consume purchased goods and still have such a use deemed not taxable. In short, the consumption of goods purchased at retail from a retailer — i.e., a use that destroys or completely dissipates the purchased goods — will always be a taxable use of those goods, unless and to the extent that the goods are resold as an ingredient of an intentionally produced product or by-product of manufacturing. *See, e.g., Granite City Steel Co.*, 30 Ill. 2d at 557, 198 N.E.2d at 511; *Container Corp. of America*, 293 Ill. App. 3d at 1093, 689 N.E.2d at 262.

There is no question that ABC consumed the coal here. On that point, the Illinois supreme court's decision in *Farrand Coal Co. v. Halpin*, 10 Ill. 2d 507, 513, 140 N.E.2d 698, 701 (1957) is instructive. The issue in that case was whether someone that sold coal to a electrical utility company was selling tangible personal property for use or consumption and not for resale, and therefore, subject to ROT. *Id.* The court held:

It seems patently clear that plaintiff is engaged in the business of selling coal to utilities. Such coal constitutes tangible personal property within the popular meaning of that term as used in the act in question. The coal is used by the utility to generate electrical energy. Such use is by the burning or combustion of the coal. **When burned, the coal is gone except for the ash residue. It is difficult to perceive how there could be a more complete use or consumption of the coal within the meaning of the act.** Clearly plaintiff coal company has sold tangible personal property to the utility for use or consumption.

Farrand Coal Co., 10 Ill. 2d at 513, 140 N.E.2d at 701 (emphasis added).

Nor do I have to rely on a fifty-year old court decision to conclude that ABC actually consumed the coal it burned to produce electricity here. The evidence offered at hearing showed that ABC changed its burners and made other changes to its equipment to make sure the coal it purchased is completely burned up, for thermal efficiency purposes, and so that the resulting ash had as little unburned coal in it as practicable. Tr. pp. 150-51, 153-54 (Doe). That is to say, if the coal ABC purchased is not completely consumed in the combustion process, ABC derives less heat energy from the fuel. Tr. p. 154 (Doe). Further, the presence of unburned coal in ash makes it darker and heavier, and thus, more likely to be unsaleable bottom ash. Taxpayer Ex. 2, p. 7 (LOI); Tr. pp. 153-54 (Doe). Thus, by its very nature, fly ash has less trace amounts of unburned coal in it than the bottom ash regarding which ABC does not request a refund. Taxpayer Ex. 2, p. 7; Tr. p. 154 (Doe). The evidence adduced at hearing supports a conclusion that ABC made every practicable effort to ensure that its combustion process consumed all of the coal it purchased and burned in Illinois.

ABC's argument, in fact, is reminiscent of Farrand Coal's argument under the ROTA's complimentary definition of sale at retail. There, the taxpayer argued that it was not selling coal for use and consumption, but was instead selling energy in the form of coal to an electric company, who used that energy to create electricity, which it then sold to others. Farrand Coal Co., 10 Ill. 2d at 508-09, 140 N.E.2d at 699. Here, ABC argues that it did not consume the coal that it burned at its Anywhere Illinois plant, but that it was merely making a nontaxable "use" of the coal by making it an ingredient in the fly ash that it manufactures and sells to others. Both arguments attempt to avoid taxability

by fundamentally recharacterizing the nature and purpose of the purchaser's use of goods that were, in fact, purchased at retail and consumed by the purchaser in Illinois.

To conclude that, by burning coal, ABC is really "manufacturing" ash, would pervert both the ordinary understanding of "manufacturing" as used in UTA § 2, and the legislature's intent that, while some uses of property may not be subject to tax under § 2, consumptive uses by persons who are not manufacturers will always be subject to tax. As ABC's opinion witness acknowledged at hearing, he knew of no business that burned coal simply to produce fly ash (Tr. pp. 80-81 (Expert)), and prior to being hired in this case, he had never before used the phrase, "manufacturing fly ash." Tr. p. 92 (Expert).

The Ash Remaining After ABC Burns Coal Is Not An Intentionally Produced Product Or By-Product Of Manufacturing

ABC is not entitled to a refund because the ash remaining after ABC burns coal is not an intentionally produced product or by-product of manufacturing. As already discussed, the statutes that comprise what is commonly referred to as Illinois sales tax laws treats sales or purchases to or by manufacturers and retailers, differently than those made to or by other persons. 35 ILCS 105/2; 35 ILCS 120/1 (definition of "sale at retail"). Manufacturers, and persons who sell certain goods to them, are, for example, the beneficiaries of tax exemptions for goods sold as manufacturing machinery and equipment that are primarily used in a manufacturing process. 35 ILCS 105/3-50; 35 ILCS 120/2-45. Additionally, manufacturers receive tax credits for purchases of goods qualifying for the manufacturing and assembly exemption. 35 ILCS 105/3-85. Thus, a decision that someone is a manufacturer, or that some given activity constitutes a manufacturing process, brings with it significant tax ramifications. See Andrews v. Foxworthy, 71 Ill. 2d 13, 21, 373 N.E.2d 1332, 1335 (1978) (statutory provision's

language must be read consistent with nature and objects of the Act, and with an understanding of the consequences that would result from construing it one way or another); *see also* Munroe v. Brower Realty & Management Co., 206 Ill. App. 3d 699, 706, 565 N.E.2d 32, 37 (1st Dist. 1990) (language of statute must be read in light of purpose to be served, and those words must be read to reach common-sense result).

Section 2 of the UTA, moreover, does not provide that a person's purchase and use of goods will be not taxable to the extent the goods are resold as an intentionally produced product or by-product of any business, or of any process. Rather, the statutory phrase is, "to the extent to which [the goods are] resold *as an ingredient of an intentionally produced product or by-product of manufacturing.*" 35 ILCS 105/2 (emphasis added). The object that the phrase "intentionally produced product or by-product" modifies is "manufacturing." *See* Armour Pharmaceutical Co. v. Department of Revenue, 321 Ill. App. 3d 662, 666, 748 N.E.2d 265, 266 (1st Dist. 2001) (§ 2's phrase "by-product of manufacturing" means a product other than the principal product of manufacturing). There is no reason to think the Illinois General Assembly did not mean what it clearly wrote.

There are, I am sure, many persons that burn solid fuel during some part of a manufacturing process. In some of those manufacturing processes, part of the solid fuel may become an ingredient of goods that the manufacturer is in the business of manufacturing, or an ingredient of goods that are by-products of its manufacturing process. In all of the Illinois cases in which such uses were held to be nontaxable, however, the purchaser was indisputably engaged in the business of manufacturing goods for sale to others. So, for example, in Granite City Steel Co., the Illinois supreme court

described how a steel maker's use of coke was not subject tax, to the extent it became an ingredient of the pig iron Granite City was engaged in the business of manufacturing:

*** One important and indispensable function performed by the coke, whether purchased by the plaintiff or converted from coal which the plaintiff purchased, was to supply the heat necessary in the production of pig iron. It is our opinion that all of the coke so utilized, which did not become an ingredient of the finished pig iron, was used within the meaning of the statute. (See *Farrand Coal Co. v. Halpin*, 10 Ill.2d 507, 140 N.E.2d 698; *Franklin County Coal Co. v. Ames*, 359 Ill. 178, 194 N.E. 268.) We conclude therefore that the Department properly excluded from its assessment only that coke which became an ingredient of the finished pig iron which was subsequently sold.

Granite City Steel Co., 30 Ill. 2d at 559-60, 198 N.E.2d at 512; *see also id.* at 552, 198 N.E.2d at 508 (Granite City was engaged in the business of manufacturing pig iron and steel). Other reported Illinois cases are in accord that, where a person purchases goods for a dual purpose — use and consumption — the nontaxable use applies only to the extent the goods are, in fact, included as an ingredient in the products or by-products of manufacturing. *E.g.*, Columbia Quarry Co. v. Department of Revenue, 40 Ill. 2d 47, 49, 51, 237 N.E.2d 525, 526-27 (1968) (limestone sold to steel manufacturer that burned it to “flux-off impurities,” where part of the limestone became an ingredient of slag that was produced and resold as a by-product of purchaser's manufacturing process, was not taxable to the extent it became an ingredient in the slag); Armour Pharmaceutical Co. v. Department of Revenue, 321 Ill. App. 3d 662, 664, 748 N.E.2d 265, 267 (1st Dist. 2001) (alcohol used in process of manufacturing pharmaceutical products not taxable to the extent manufacturer recycled and resold it after use).

Here, in contrast, ABC burns solid fuel, coal, for a non-manufacturing purpose, to produce heat to boil water to make steam that turns turbines that produces electricity. Tr. p. 106 (Doe). ABC is an electric company (Tr. p. 169 (Doe)), and the only tangible personal property it purports to be manufacturing is part of the ash remaining after it burns coal in Illinois to produce electricity. Illinois law has consistently held that producers of electricity are not retailers or manufacturers, and that they should not be treated as retailers or manufacturers for taxation purposes. Farrand Coal Co., 10 Ill. 2d at 507, 512-13, 140 N.E.2d at 701; People ex rel. Mercer v. Wyanet Electric Light Co., 306 Ill. 377, 381-82, 137 N.E. 834 (1923) (electric companies are neither manufacturing nor mercantile companies for purposes of having their capital stock assessed locally instead of by the State). Thus, ABC is not a manufacturer, and its business operations do not constitute manufacturing. To my knowledge, moreover, no Illinois court has ever held that a non-manufacturer's consumptive use of goods like coal is nontaxable under § 2 of the UTA. *See* Colorcraft Corp., Inc. v. Department of Revenue, 112 Ill. 2d 473, 493 N.E.2d 1066 (1986) (person engaged in photo finishing business was not manufacturing tangible personal property for sale to others, and the machinery and equipment exemption was not applicable to its use of machinery and equipment in that business).

Conclusion:

I recommend that the Director finalize the Department's prior denials of ABC's amended sales and use tax returns.

3/18/03
Date

John E. White, Administrative Law Judge