

**STATE BOARD OF EQUALIZATION**

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 324-3828

September 14, 1990

Mr. J--- D. S---
---, ---, --- & ---
Attorneys and Counselors at Law
XXXX --- ---, Suite XXX
---, CA XXXXX

FR -- XX-XXXXXXX

Dear Mr. S---:

Senior Staff Counsel John Abbott has sent your letter of July 19, 1990, enclosing your previous letter of May 21, 1990, to me for reply. First of all, I apologize for the delay. Your May 21 letter went to the Board's old address and was routed to the Evaluation and Planning Section of the Audit Unit. Since they saw it as an exemption request, they set it aside for review. Evaluation and Planning sent it to the legal staff, and it arrived at the same time as your follow-up letter.

You have requested an opinion regarding the application of sales and use tax to the purchase of certain heavy gauge bagging material by your client, C--- B--- S---, Inc. (hereinafter "CBS"). Certain of the questions you ask also indicate that you also want to know the sales and use tax consequences of your client's use of the material in its business.

I. FACTUAL BACKGROUND

In your letter, you set forth your client's activities as follows:

"...CBS, a California corporation, is engaged in the principal business activity of providing 'custom bagging services' of agricultural products for unrelated third parties. In connection with the performance of its services, CBS uses a product known as AGRI-PAC, described as a heavy gauge bagging material, which is purchased from L--- Corporation.

"The 'custom bagging service' performed by our client is fairly unique. In essence, it is a service which packages or 'bags' various agricultural products for later use in connection with the feeding of livestock. The bagging material is fastened at one end and through the use of custom equipment the created bag is filled with various agricultural products including alfalfa, corn, cottonseed, barley, wheat, and orange peel. The other end of the bagging material is then fastened creating the 'bag.' Normally, the bag is filled to a capacity of approximately 250 tons.

"The contents of the bag are later used in the feeding of livestock and generally are not transported from the location filled but rather left at that location for later use by the owner. At the time of use, which is normally a 60-90 day period, the owner opens one end of the bag to access the agricultural products for feeding purposes. Loaders are then used to remove the contents of the bag and place them in feed wagons...."

During our telephone conversation of August 29, 1990, you kindly supplied further information. You indicated that CBS's service was one process. CBS's machine forms the bag, the farmer dumps in the agricultural products, and CBS's machine then fills and seals the bag, which you said resembles an overgrown garbage bag. To gain access to the contents, the farmer slices open and unloads the bag. The farmer then disposes of the used bag. The bagging material is not reusable. The bag is not affixed to the ground. CBS does not buy agricultural products and bring it to the farm but fills the bag with agricultural material supplied by the farmer. It also does not use its equipment to load agricultural material into anyone else's containers. You were apparently unable to obtain figures showing what portion of CBS's total charge represents the bagging material.

II. OPINION

A. Sales and Use Tax Generally

In California, except where specifically exempted by statute, Revenue and Taxation Code Section 6051 imposes an excise tax, computed as a percentage of gross receipts, upon all retailers for the privilege of selling tangible personal property at retail in this state. (Unless otherwise noted, all statutory references are to the Revenue and Taxation Code.) The definition of "gross receipts" includes the "cost of material used, labor or service cost, interest paid, losses or any other expense." (§ 6012(a)(2).) "[I]t shall be presumed that all gross receipts are subject to tax until the contrary is established. The burden of proving that a sale of tangible personal property is not a sale at retail is upon the person who makes the sale...." (§ 6091.)

B. Exemptions

Certain exemptions may apply to your client's case. When a retailer purchases tangible personal property for the purpose of resale, he may make his purchase free of sales tax by giving his seller a resale certificate. (§ 6091.) As noted in your letter, Section 6364 exempt from sales or use tax the gross receipts from sales of and the storage, use, or other consumption in this state of nonreturnable containers when sold without the contents to persons who place the contents in the container and sell the contents together with the container (§ 6394(a)); and, of containers when sold with the contents if the sales price of the contents is otherwise exempted from sales or use tax. (§ 6364(b).) Finally, the gross receipts from the sales of and the storage, use, or other consumption of feed for any form of animal life of a kind the products of which ordinarily constitute food for human consumption, or are to be sold in the regular course of business are also exempted from the sales or use tax. (§ 6358(b).)

C. Sales or Service?

Your letter describes CBS's operations as providing a "custom bagging service." The "service" provided consists of forming the bag from materials which CBS supplies, filling the bag, and leaving it on the farmer's land as a storage receptacle.

A service may be excluded from the measure of sales tax or may be taxed if it is incidental to the sale of tangible personal property. The distinction depends on whether the true object of the transaction is the service per se or the property produced by the service. (Culligan Water Conditioning v. St. Bd. of Equal. (1976) 17 Cal3d. 86, 96 [130 Cal.Rptr. 321, 550 P.2d 593]; 18 Cal. Admin. Code § (hereinafter "Reg." or "Regulation") 1501.) In your client's case, it appears that the true object of the transaction is the sale of bags in which the farmer stores the agricultural products, and the services of forming and filling are incidental to that object. The customer cannot obtain the bag separately; the bag is formed and filled in one process. The customer thus buys, not just a bag which is later filled, but a filled bag. Therefore, the entire gross receipts from CBS's sales of, and forming and filling, the bags are subject to sales tax unless one of the aforementioned exemptions applies. (§ 6012(a)(2) & (3).)

D. Purchase of Materials

Your specific question concerned the tax consequences of CBS's purchase of the bagging material. As noted above, the facts indicate that the true object of CBS's services is the sale of the formed and filled bag to the farmer. Thus, CBS is purchasing the bagging material for the purpose of reselling it and so may purchase it free of sales tax by giving its supplier a resale certificate. I have enclosed a copy of 18 California Administrative Code section (hereinafter "Reg.") 1668 which discusses how a resale certificate is obtained and used.

E. Does the Container Exemption Apply to CBS's Business?

As you noted, Regulation 1589(a) includes "bags" within the definition of "containers" to which the exemption found in Section 6367, discussed above, is found. Hence, to be exempt from sales tax, your client's operations must come clearly within the terms of the exemption. (H. J. Heinz Co. v. St. Bd. of Equal. (1962) 209 Cal.App.2d 1, 4 [25 Cal.Rptr. 685].) The bags are nonreturnable, so the only exemptions which could apply to their sales are the ones regarding sales to customers who fill the container and sell it and the contents to their own customers or sales when filled with contents which are themselves exempt. (§§ 6364(a) & (b).)

1. Sale of Filled Container (§ 6364(a))

To determine if this exemption applies, we must examine the ultimate use of the filled bag. "[W]e believe that the use of [the] cartons...made them subject to the tax." (Safeway Stores v. St. Bd. of Equal. (1957) 148 Cal.App.2d 299, 303 [306 P.2d 597]; See, also, Luer Pack. Co. v. St. Bd. of Equal. (1950) 101 Cal.App.2d 99, 104 [224 P.2d 744].)

The annotations which you cite also place their focus on the use the purchaser ultimately makes of the container that determines whether or not the exemption applies. (II Bus. Tax. L. Guide, Annots. 195.0330 & 195.1260.) Annotation 195.0330 states that tax does not apply to receipts from sales of bags sold to persons who gin cotton to be sold. Annotation 195.1260 ruled:

Sales tax applies to sales of wire used in baling alfalfa, unless the purchaser will sell the baled alfalfa or use the baling wire in the commercial baling of alfalfa for others. [Emphasis added.]

Annotation 195.0330 notes that its interpretation is consistent with that of 195.0060:

Bale ties sold to persons who bale hay,...are exempt from tax as nonreturnable containers if the hay is to be sold.

The legal staff has previously noted that studies have shown that bale ties were primarily used to bale hay which was to be sold. Thus, the sales of ties would be presumed to be sales for resale unless there is evidence to show that they were not used to bale hay to be sold.

Your letter indicates that the purchasers do not sell the bags with their contents but use the to store the listed agricultural products until such time as they open them to feed the livestock. Presumably, opening the bags renders them unfit for further use, and they are discarded. Since the contents are not resold but are, in fact, used by the farmer to whom the bags are sold, the exemption in Section 6364(a) does not apply. The above cited annotations are consistent with this opinion.

2. Exempt Contents (§ 6364(b).)

The threshold question is whether or not CBS's bags are "sold with the contents." The legal staff has previously considered this problem. In that case, the taxpayer ran a canning service. The customer brought the commodity to be canned to the factory and placed it in the desired size can whereupon the canner turned on the processing line which cooked, steamed, etc., the product, and sealed the can. The filled can was returned to the customer who was then billed. The legal staff determined that service to be a "processing" under Section 6006(c) and so a taxable sale. The can was thus regarded as "sold with the contents," rendering the exemption contained in Section 6364 applicable. (II Bus. Tax. L. Guide, Annot. 195.0160.)

In this case, however, CBS inserts the agricultural products into the bags and does nothing to them. The term "processing" denotes something more than mere storage. Webster's Third New International Dictionary (G. C. Merriam & Co., 1971, p. 1408) defines "processing" as "to subject to a particular method, system, or technique of preparation, handling, or other treatment desired to effect a particular result." Regulation 1526(b) defines it as "any operation which results in the creation or production of tangible personal property or which is a step in a process or series of operations resulting in the creation or production of tangible personal property." Referring to agricultural products, the Food and Agricultural Code generally requires an operation which performs some modification in form or nature to prepare the product for market (§ 64014 – milk), or preserve, or prepare for consumption (§ 42419 – fruits, nuts, or vegetables); Nye & Nission v. Weed Lumber Co. (1928) 92 Cal.App.598, 604 [268 P. 659] – eggs.) Food and Agricultural code Section 64014 specifically states that placing bulk milk in cans is not "canning" for the purpose of the definition of "processing," and, with reference to fruits, nuts, and vegetables, Food and Agricultural Code Section 42519 states that mere refrigeration is not "processing." Therefore, just stuffing the agricultural products into a bag for storage does not appear to be "processing" so as to bring CBS's operation within 6006(b).

Since CBS does nothing to the products which could be termed "processing" and so be deemed a sale, the bags are not "sold with the contents" within the meaning of Section 6364(b). The fact that the contents may be exempt under 6358(b) is not material.

Mr. J--- D. S---

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III. Conclusion

Based on the above authorities, CBS may purchase the bagging material ex tax by giving its seller a resale certificate, but sales tax applies to its entire gross receipt, including charges for materials and fabrication, from its sales of the filled bags to customers.

If you have any further questions, please do not hesitate to contact me.

Very truly yours,

John L. Waid
Tax Counsel

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(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 324-3828

February 15, 1991

Mr. S--- Y---
XXX --- --, Suite ---
---, California XXXXX

FR -- XX-XXXXXX

Dear Mr. Y---:

Following up on our telephone conversation yesterday, I have received your letter of November 20, 1990. Although I discussed the following conclusion with your over the phone, I am writing this to provide you with written advice upon which your client may rely under the terms of Revenue and Taxation Code Section 6596. (All further statutory citations are, unless otherwise cited, to the Revenue and Taxation Code.)

In your letter, you furnished the following details on the process by which your client, C--- B--- S---, Inc. (hereinafter "CBS"), forms and fills its product.

"The following steps trace the bagging process performed by CBS. For example, CBS bags alfalfa for its customers. According to my client, the alfalfa goes through the following procedural process culminating with bagging:

"1) A custom harvester utilizing a swather (a self-propelled alfalfa cutting machine) goes through and cuts and lays the growing alfalfa down in a single woodrow.

"2) Next, raking equipment comes along and rakes two freshly cut rows of alfalfa at a time into a single row.

"3) Then, the Cutter (harvester) picks up the cut alfalfa and runs it through knives that chop it into 3/8" "cut" (i.e. pieces/length).

"4) Next, the harvester blows the "cut" into a truck.

“5) The truck then hauls the load of “cut” to the Bagging Machine.

“6) The truck backs up to the Bagging Machine and slowly unloads its contents onto the Bagging Machine.

“7) A conveyor takes the load to a rotor shaft.

“8) The rotor shaft presses the feed into the bag.

“9) It takes 2-3 hours to fill up a 250 ft. long bag.

“10) Once the material is put into the bag the contents ferment (i.e. ensilage takes place) for a period of 3 weeks.

“The bagging process keeps the feed from spoiling. The fermenting process inside the bag makes the feed more edible by the cattle it is later fed to. Failure to bag alfalfa may result in either putrefying acids creating an inedible and wasted crop or a poor pack, incomplete fermentation and excess spoilage....

* * *

“The livestock that is fed the bagged material is, indeed, for human consumption.
....”

Although your account specifies that it applies to the bagging of alfalfa, I assume that a similar process takes place no matter what kind of agricultural product is bagged. In our telephone conversation of February 15, 1990, you affirmed that CBS' equipment performed the entire process outlined above.

As you remember, in my letter of September 14, 1990, to CBS' previous attorney, J--- D. S---, we concluded that CBS's product was a “container” for the purpose of the exemption from sales and use tax provided by Revenue and Taxation Code Section 6364 for the sales of containers under certain conditions. We also concluded that, since the bags were not sold to persons who would resell them in the regular course of business, they did not qualify for the exemption found in Section 6364(b) because they were not sold with exempt contents. We came to this conclusion because, based on the facts in our possession at the time, it did not appear that CBS processed the agricultural products in any way prior to stuffing them into the bag. Merely filling the bag was not a “process” so as to find that the bags were “sold with their contents.” The full statutory and regulatory authority for our conclusion is set forth in my previous letter, so, in the interest of brevity, I will not repeat it here.

The additional facts you have now supplied have caused us to re-examine our previous conclusion. In other contexts, we have considered that cutting material into lengths to prepare it for a use is a form of "processing." (See, II BTLG, Annots. 435.0660 Cutting and Threading Pipe or Shafting; and 435.0680 Cutting Brick, Lumber and Rock.) We now conclude that CBS processes the agricultural materials prior to bagging them. We further conclude that the process preserves and enhances their food quality for the livestock that will ultimately consume them, thus bringing this process squarely within Annotation 195.0160, discussed in my previous letter. As a result, we rescind our previous conclusion and determine that the bags are "sold with the contents." As the contents are feed for animal life of a kind the products of which ordinarily constitute food for human consumption, i.e., cattle, CBS' sales of its product are exempt from sales and use tax pursuant to Sections 6364(b) and 6358(a).

To summarize the conclusions contained in this and the previous letters, because CBS will resell the bagging material to its customers, it may purchase the material free of tax by giving its supplier a resale certificate for each transaction. Its charges to its customers for the materials and services used in forming and filling the bags are, in turn, exempt from tax under the above authority.

I have enclosed a copy of Regulations 1589 and 1668 for your information. I hope the above discussion has answered your question. If you need anything further, please do not hesitate to write again.

Very truly yours,

John L. Waid
Tax Counsel

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Encs.