

Borke

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

ASH GROVE CEMENT COMPANY,

) Docket 548

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Petitioner,

)

)

Dep. of Justice

v.

)

)

ORDER

SEP 05 1997

NEBRASKA DEPARTMENT OF
REVENUE and M. BERRI BALKKA, TAX
COMMISSIONER,

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)

State of Nebraska

Respondent.

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This is an appeal from a decision of the State Tax Commissioner (the Commissioner), rendered on October 2, 1996, brought under the Nebraska Administrative Procedure Act. NEB. REV. STAT. §§ 84-901 through -920 (Reissue 1994, as amended). Accordingly, review is conducted by the court, without a jury, de novo on the record presented to the Commissioner's designated hearing officer. NEB. REV. STAT. §84-917 (5) (a) (Reissue 1994). The record consists of the transcript and the bill of exceptions of the proceedings before the designated hearing officer. *Slack Nursing Home v. Department of Social Services*, 247 Neb. 452, 528 N.W.2d 285 (1995).

In reviewing the evidence, the court reaches conclusions independent of those reached by the Commissioner. Where credible evidence is in conflict on a material issue of fact, however, the court gives weight to the fact the designated hearing officer heard and observed the witnesses and accepted one version of the facts rather than another. *Deiter v. State*, 228 Neb. 368, 422 N.W.2d 560 (1988). Also, the court considers that "[a] rebuttable presumption of validity attaches to the actions of administrative agencies. The burden of proof rests with the party challenging the agency's actions." *Wagoner v. Central Platte Natural Resources District*, 247 Neb. 233, 236, 526 N.W.2d 422, 425 (1995).

FACTS

The facts are, basically, uncontroverted. Ash Grove Cement Company (Ash Grove)

is in the business of manufacturing Portland cement (the cement) and operates a cement plant on the outskirts of Louisville, Nebraska. The raw materials used to produce the cement are limestone (90% (+/- 3.0%)), clay (8% (+/- 2.0%)), sand (1.5% (+/- 1.0%)) and mill scale (.4% (+/- .1)). These are referred to as the feed stream of raw materials. Chemically, the limestone provides calcium; the clay and sand provide silica and a small amount of alumina; and the mill scale provides iron. Ash Grove mines the clay, sand and limestone at its manufacturing site and purchases the mill scale from outside sources.

The feed stream of raw materials is pulverized in a raw mill, to reduce their size. The raw mill is a long, rotating cylinder into which the raw materials are fed. The inside of the raw mill is filled 30-40% by volume with steel balls, called "grinding balls," which are between 1-3 inches in diameter. The rotating action of the mill causes the raw materials to be caught between the roller mill and the grinding balls, causing the raw materials to be pulverized into pieces small enough to be fed into a kiln. Steel particles gradually erode from the grinding balls and remain in the feed stream that is blown into the kiln. The purpose for which the grinding balls are purchased by Ash Grove is to properly grind the raw materials for the feed stream that is fed into the kiln.

The kiln is a rotating, high temperature oven, operating in excess of three thousand degrees Fahrenheit, in which the raw materials are introduced into a feed stream and chemically converted, during the thermal processing, into "clinker," which is then processed into the cement. The chemical composition of clinker is Silica (21.5% (+/- 1.0%)); Alumina (4.2% (+/- .5%)); Calcium (64% (+/- 2.0%)); and Iron Oxide (3.2% (+/- .3%)).

Ash Grove purchases kiln bricks from various vendors, to use as an insulating layer between the rotating steel kiln and the raw material feed stream introduced into the center of the kiln. The purpose of the kiln bricks is to protect the steel kiln walls from damage from the high temperatures present in the kiln, during the manufacturing process. During this process, there is a constant degradation, or wearing down, of the kiln bricks, caused by the abrasive action of the feed stream against the surface of the bricks. The portion of

the kiln bricks that wears away remains in the feed stream and becomes a part of the clinker.

Kiln bricks are approximately nine inches long, when first placed into the kiln. When a brick wears away to between 1-2 inches thick, it loses its effectiveness as a refractory and is replaced by a new brick. Generally speaking, kiln bricks are only replaced when and where needed (i.e., not all of the bricks in the kiln are replaced at the same time). The longevity of the kiln bricks is from several months to about 1-2 years, depending on their proximity to the intensity of the heat in the kiln. Worn-out kiln bricks are removed during the replacement process and placed into the raw material supply and added to the manufacturing process feed stream. Kiln bricks are not, generally, added to the raw material supply, until after they have been used as a refractory lining for the kiln.

The primary chemical composition of kiln bricks is Alumina (69-73%) and Silica (22-26%). Generally speaking, except for slight variances in the percentages of their chemical ingredients, all kiln bricks made for cement kilns are made from the same chemical substances and are chemically compatible to the cement manufactured by Ash Grove. The primary considerations in selecting one kiln brick over another are: (1) the insulating capacity of the bricks and (2) how long the bricks will last in the protection of the kiln. Additionally, it is necessary that the kiln bricks be chemically compatible with the products being manufactured.

Cement finish mills are used to grind the clinker and to mix additives into the cement manufactured by Ash Grove. A cement finish mill is a long, rotating cylinder, into which clinker and additives are fed. There are two stages in a cement finish mill, divided by a screen. Both stages are filled 30-40% by volume with steel balls, called "grinding ball," which are 1-3 inches in diameter; however, there is a difference in the number of each size ball used in the cement finish mill, when compared to the number of balls used in the raw mill.

The clinker is initially fed into the first stage of the cement finish mill by conveyor and is then blown into the second stage by air, as cement is ground into a smaller size.

In the second stage, the clinker continues to be ground to a very fine powder. When finished, it is carried out of the cement finish mill by air and into storage silos as the cement. Steel particles erode from the grinding balls and remain as filler in the cement; however, they serve no purpose other than to add a minuscule amount of weight to the overall volume of the cement produced. (The cement is sold by weight.)

The grinding balls used in the raw mill and cement finish mill processes gradually wear down to a smaller size, which diminishes their effectiveness to grind the raw materials and the clinker. The grinding balls are replaced about every other year and are sold as scrap to third parties.

The Nebraska Department of Revenue (the Department) conducted an audit of the books and records of Ash Grove, for the period June 1, 1990, through August 31, 1993, for sales and consumer's use taxes and, for the period April 1, 1990, through August 31, 1993, for retailer's use tax. As a result of the audit, the Department, on August 30, 1994, notified Ash Grove of the following deficiency determination:

Type of Tax	Tax	Interest	Penalty	Total
Sales	\$ 1,783	\$ 440	\$ 180	\$ 2,403
Consumer's Use	128,566	35,335	12,851	176,752
Retailer's Use	5,510	1,412	550	7,472
Totals	\$ 135,859	\$ 37,187	\$ 13,581	\$186,627

Ash Grove timely filed a Petition for Redetermination with the Department. In its petition, Ash Grove alleged that the Department's deficiency determination was incorrect, because ". . . use tax has been assessed on materials which become component parts of the product Ash Grove manufactures and sells (i.e., cement)." Ash Grove further alleged, in challenging the Department's assessment of a penalty, that any failure to pay sales and use taxes was ". . . not the result of fraud or intentional failure to pay, and [arose] from a good faith interpretation of Nebraska law, or upon accounting discrepancies and errors by omission . . ."

A hearing was held before a designated hearing officer. Following the hearing, the Commissioner sustained the Department's deficiency determination, including the assessment of penalties. This appeal followed.

ISSUES

1. Whether the kiln bricks used in Ash Grove's production process become an ingredient or component part of the cement.
2. Whether the grinding balls used by Ash Grove in its production process become an ingredient or component part of the cement.
3. Whether the penalty assessments levied by the Department were appropriate.

DISCUSSION

Four Nebraska court decisions provide guidance: *American Stores Packing Company v. Peters*, 203 Neb. 76, 227 N.W.2d 544 (1979) (even though a portion of the glycerine in cellulose casings stuffed with a prepared meat product was transferred to the finished meat product, the casings, which were slit, removed and discarded, served the indispensable function of a mold and did not become an ingredient or component part of the finished meat product); *Nucor Steel v. Herrington*, 212 Neb. 310, 322 N.W.2d 647 (1982) (graphite electrodes, composed solely of carbon, used in the production of steel, which were completely used up in the production process, entered into and remained as an ingredient and component part of the finished steel product, and were, therefore, exempt component parts); *Nucor Steel v. Luenberger*, 233 Neb. 863, 448 N.W. 909 (1989) (*Nucor II*) (refractory used in the steel-making process to insulate equipment used in the very high temperature processes of steel-making, which, over time, wore away and dripped into the product being produced, was not an essential element of the product being produced and, therefore, was not a component part); and *Nucor Steel v. Balka*, 2 Neb. App. 138, 507 N.W.2d 449 (1993) (mill rolls and billet guides used during the steel-making process and recycled as scrap in subsequent steel melts were not purchased for the purpose of resale and, therefore, were not exempt from taxes).

Ash Grove asserts that the kiln bricks and the grinding balls are exempt component parts of the cement it manufactures. It is uncontested that the bricks and the grinding balls break down and enter into and become a part of the final product. It is also uncontested that the materials found in the bricks and the grinding balls are composed of ingredients required in the making of the cement. As such, the bricks and the grinding balls meet the statutory and regulatory standards for component parts.

Ash Grove acknowledges that, first and foremost, the kiln bricks are used for insulation and the grinding balls are used for grinding. The fact that the bricks and the grinding balls have a dual purpose in the manufacture of the cement does not foreclose the possibility that they are exempt component parts; however, being a component part is more than simply being present in the final product, even if the final product is made of the same materials as the bricks and the grinding balls. The question to be asked is whether the introduction of the kiln bricks and the grinding balls into the cement is accidental or incidental or is the value of the cement in any way altered by the introduction of the bricks and the grinding balls.

Applying the standard of *Nucor II*, the value of the cement is in no way altered by the presence of the remains of the kiln bricks and the grinding balls. When purchased, the value of the kiln bricks is as insulation and the value of the grinding balls is as effective grinding material for the clinker. The value of the bricks as raw material and of the grinding balls as scale represent a fraction of the cost of the items purchased. Although selected to be chemically compatible with the cement and being used up completely during the manufacturing process, by either being worn away or recycled into the mixture, the worn part of the kiln bricks and the grinding balls that become a part of the cement represent an insignificant addition to the final product.

Given that the presence of kiln brick and grinding ball materials in the cement does not alter the value of the cement; that the materials from the bricks and the grinding balls are present in very small quantities, in proportion to the total ingredients; that the materials introduced by the bricks and the grinding balls are not measured during the manufacturing

process; and that the value of the kiln bricks and the grinding balls is based upon their value as insulation and grinding material, respectively, the court finds that the Commissioner's decision should be affirmed.

The request for redetermination of the tax penalty is not precluded by the stipulation of facts, which is devoted to the questions surrounding the tax exemption question and silent as to the penalty assessment question, as suggested by the Commissioner. However, given that the law in effect at the time of the audit provided reasonable notice to Ash Grove that the kiln bricks and the grinding balls were subject to sales and use taxes, the penalty assessments are, likewise, affirmed. (In 1995 the legislature passed LB 430, which specifically amended the applicable statute to include within the definition of the ingredient or component part exempt from sales tax, "refractory materials, lime, synthetic slag, mill rolls, and guides for use in steel and cement making.")

CONCLUSION

The decision of the Commissioner should be, and hereby is, affirmed, in its entirety. The costs of this action are taxed to Ash Grove.

A copy of this order is sent to counsel of record.

Dated September 3, 1997.

SO ORDERED.

BY THE COURT



Paul D. Merritt, Jr.
District Judge