

IN THE DISTRICT COURT OF LANCASTER COUNTY, NEBRASKA

LACKAWANNA LEATHER COMPANY, )

Plaintiff, )

vs. )

NEBRASKA DEPARTMENT OF )  
REVENUE, STATE OF NEBRASKA, )

Defendant. )

DOCKET 563 PAGE 281

JUDGMENT

DEPT. OF JUSTICE

SEP 17 1998

STATE OF NEBRASKA

THIS MATTER CAME on for trial on September 2, 1998, as an appeal from the determination of the Commissioner of the Department of Revenue ("Department") under the Nebraska Administrative Procedures Act, NEB. REV. STAT. §84-901, et seq. Evidence was adduced. The Court was duly advised in the premises. The court finds that judgment should be entered in favor of the Plaintiff, reversing the decision of the State Tax Commissioner.

The issue presented by this appeal is whether a solvent which is mixed with color pigment to become a paint or dye and is then applied to leather to create a finished product for sale is an ingredient or component of the finished product and thereby exempt from sales and use tax. The Defendant found that it was not. Defendant assessed a sales tax against the Plaintiff. The Plaintiff paid the tax and applied for a refund. Following a hearing the Defendant denied the refund. This appeal followed. The evidence was presented to the State Tax Commissioner on stipulated facts.

Tax exemptions are to be strictly construed. *Omaha Public Power Dist. V. Neb. Dept. Of Revenue*, 248 Neb. 518, 519, 537 N.W.2d 312, 314 (1995). The burden of establishing the right to the exemption resides with the taxpayer. *Vulcraft v. Karnes*, 229 Neb. 676, 678, 423

N.W.2d 505, 507 (1988). "In reviewing final administrative orders under the Administrative Procedure Act, the district court functions not as a trial court but as an intermediate court of appeals. See *Booker v. Nebraska State Patrol*, 239 Neb. 687, 477 N.W.2d 805 (1991)."

*Wolgamott v. Abramson*, 253 Neb. 350, 355, 570 N.W.2d 818 (1997). The District Court's review is conducted *de novo* on the record made at the agency. NEB. REV. STAT. §84-917(5)(a).

The facts of the case are fairly simple. The Plaintiff is a leather processor that takes raw hides and applies various chemical and mechanical processes to the hides to produce finished leather goods for sale. Some of these products require that the Plaintiff dye or paint the leather. Rather than purchase pre-mixed dyes and paints, the Plaintiff has elected to purchase color pigments separate from various solvents which are then combined to make the paints and dyes. Using this method, the Plaintiff is able to mix its paints or dyes to match specifications of each purchaser and is able to maintain a lower inventory. The parties have stipulated:

- a. solvent B-3472 "... acts as a carrier for other solutions applied to the leather."
- b. solvent B-3423 assists in "... even distribution of components ... and to ensure good intercoat adhesion of the paint."
- c. solvent B-3408 aids in "... even distribution of the paint and the intercoat adhesion of the paint."
- d. Cyclohexanone prevents "... water hazing due to high relative humidity ..."

The three solvents and Cyclohexanone will collectively be referred to as "solvents" hereafter.

The parties also stipulated that each of these solvents evaporates during the processing, but "a trace amount remains with the finished product." There being no dispute with respect to the facts, this appeal involves the interpretation of regulations, which are questions of law. *Inner Harbour Hospitals v. State*, 251 Neb. 793, 559 N.W.2d 487 (1997), *Southeast Rural*

*Volunteer Fire Dept. v. Nebraska Dept. of Revenue*, 251 Neb. 852, 854, 560 N.W.2d 436 (1997).

The statutory basis for the exemption claimed states that the sale of property is exempt from sales tax if it is a "sale of property which will enter into and become an ingredient or component part of property manufactured, processed, or fabricated for ultimate sale at retail."

NEB. REV. STAT. § 77-2702.13(2)(a). Pursuant to the statute, the Department of Revenue adopted the following regulation upon which this case turns.

"023.01 Property that becomes an ingredient or component part of a product manufactured, processed, assembled, or fabricated for sale by the purchaser is exempt. Property that is necessary for production but which does not become an ingredient or component part of the product sold is taxable."

"023.02 To qualify as exempt the property must meet all of the following conditions:

023.02A The property must physically or chemically enter into and remain a part of the finished product;

023.02B The property must be an essential ingredient or component of the finished product; and

023.02C The finished product must be a product that was manufactured, processed, or fabricated for sale by the purchaser of the ingredient or component part."

Department of Revenue Reg-1-023

The Defendant maintains a two-fold position. First, the solvent is simply a vehicle for transporting the dye into the leather and therefore is not an ingredient or component, but rather merely a property "that is necessary for production" (§023.01) and therefore subject to sales tax. Second, the solvent does not "physically or chemically enter into and remain a part of the finished product," (§023.02A) therefore not exempt. Defendant compares the solvent to

cellulose casings which are used to mold processed meat and are then thrown away by the consumer.<sup>1</sup> Defendant also compares the solvents to material used to insulate equipment exposed to high temperatures during steel processing. The insulating material wears away during the processing and the worn material is either sold or given away.<sup>2</sup> Defendant also likens the solvent to camera negatives, flats, and lithographic plates in the printing process which act merely as instrumentalities or utensils for conveying the image to the paper.<sup>3</sup> Guides and forms for molten steel are also claimed comparable to the solvent.<sup>4</sup>

The Plaintiff contends that the solvent is an ingredient of a component (dye or paint) of its end product - dyed or painted leather goods - and is therefore exempt even though the solvent largely evaporates during the drying process. Plaintiff also contends that since trace amounts of the solvent remain, §023.02A is satisfied. Plaintiff compares the solvent to processing oils that remain as a coating on steel bars following manufacturing.<sup>5</sup> It is compared to lime in drinking water where only trace amounts remain in the drinking water.<sup>6</sup> Plaintiff also argues that the evaporation of the solvent is no different than the evaporation of dry ice<sup>7</sup> and use of water in

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<sup>1</sup> *American Stores Packing Co. v. Peters*, 203 Neb. 76, 227 N.W.2d 544 (1979).

<sup>2</sup> *Nucor Steel v. Leuenberger*, 233 Neb. 863, 448 N.W.2d 909 (1989).

<sup>3</sup> *Interstate Printing Co. v. Dept. Of Revenue*, 236 Neb. 110, 459 N.W.2d 519 (1990).

<sup>4</sup> *Nucor Steel v. Balka*, 2 Neb.App. 138, 507 N.W.2d 449 (1993).

<sup>5</sup> *Vulcraft v. Balka*, 5 Neb. App. 85, 555 N.W.2d 344 (1996).

<sup>6</sup> *Metropolitan Utilities Dist. v. Donald S. Leuenberger*, Docket 365, Page 160, Lancaster County District Court.

<sup>7</sup> NEB. REV. RUL. 1-88-7 (not in evidence).

manufacturing<sup>3</sup> which Plaintiff claims Defendant has ruled to be exempt.

The parties' counsel have made a thorough presentation of the law in this arena. Each has legal authority to back its selected position. The Decision of the State Tax Commissioner also presents the array of cases applicable to this case. All the briefs and arguments are well presented. In the end, if the Court examines only the facts of this case, the issue turns on where, during the leather processing, the required analysis is made. If made at the point the solvent is mixed with the color pigment to form a dye or paint for the leather, the Plaintiff clearly wins. The dye or paint is clearly a component part of the end product. If the paint or dye then become the focus, even after the paint or dye has dried in the final finished product, the Plaintiff also wins. However, if the analysis focuses only on the solvent, the outcome is less clear. Once the paint or dye is applied to the leather, it begins to dry, and the solvent evaporates leaving only trace amounts of the solvent in the leather.

The solvents in this case have functions and properties significantly different from meat or steel molds, guides, or equipment insulating material. The solvents do more than merely convey the paint to the leather like lithographic plates or camera negatives. When the hide processing is completed the solvents are gone and the only trace of their existence is absorbed in the final product to be sold. The solvents are an essential part of the final product in that without their being absorbed into the hide, the paint or dye would not transfer and adhere. This analysis is also influenced by the following exchange between the Court and the attorney for the State Tax Commissioner:

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<sup>3</sup> NEB. REV. RUL. 1-88-1 (not in evidence).

"THE COURT: Would it matter to you if the solvent was added by the paint manufacturer and included in the container that was purchased by Lackawanna?

"MR. BARTEL: If they purchased -- I don't think that -- I think if you bought the paint already that was mixed together, I don't think there would be any way to distinguish it in that sense and I suppose the entire amount of the product would be exempt...."

See also Attachment A to the Claim for Overpayment. T21. Based on this exchange and the foregoing comparisons (except those not in evidence) there is no choice but to conclude the solvents are exempt. Any other conclusion would be arbitrary, capricious and inconsistent.

I am obliged to reach a decision in this case which is not arbitrary or capricious. *Norwest Corp. v. State*, 253 Neb. 574, 571 N.W.2d 628 (1997); *Wolgamott v. Abranson*, *supra*; *McGuire v. Department of Motor Vehicles*, 253 Neb. 92, 568 N.W.2d 471 (1997). I must, of course, "[accord] deference to an agency's interpretation of its own regulations, unless plainly erroneous or inconsistent. *Southwest Rural Volunteer Fire Dept. v. Neb. Dept. of Revenue*, 251 Neb. 852, 560 N.W.2d 436 (1997); *Inner Harbour Hospitals v. State*, 251 Neb. 793, 559 N.W.2d 487 (1997)" *Vinci v. Nebraska Dept. of Correctional Services*, 253 Neb. 423, 494, 571 N.W.2d 53 (1997). Concluding that the solvents are different from the color pigment or pre-mixed dye or paint would be inconsistent and arbitrary.

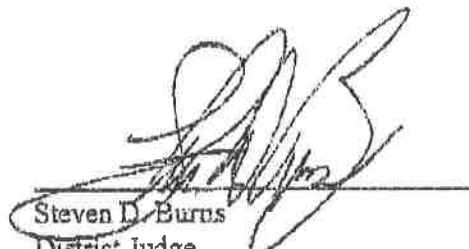
The department had the authority to deny the refund requested. The question is whether such denials are arbitrary or capricious. A decision is arbitrary when it is made in disregard of the facts or circumstances and without some basis which would lead a reasonable person to the same conclusion. *Ponderosa Ridge LLC v. Banner County*, 250 Neb. 944, 554 N.W.2d 151 (1996); *Central Platte NRD v. City of Fremont*, 250 Neb. 252, 549 N.W.2d 112 (1996). "A capricious decision is one guided by fancy rather than by judgment or settled purpose; such a

decision is apt to change suddenly; it is freakish, whimsical, humorsome. *Ponderosa Ridge LLC, supra; Central Platte NRD, supra; In re Application of Jantzen*, 245 Neb. 81, 511 N.W.2d 504 (1994).” *Southeast Rural Volunteer Fire Dept. v. Nebraska Dept. of Revenue, supra* @ 866.

The Plaintiff has established its entitlement to an exemption for those solvents which are mixed with color pigment to create paint or dye which is then applied to its final leather good products. Another conclusion would be arbitrary, capricious and inconsistent. The Decision of the State Tax Commissioner should therefore be reversed and the refund requested should be permitted.

**IT IS THEREFORE HEREBY ORDERED AND ADJUDGED** that the decision of the Director of the Department Revenue dated October 30, 1997 is reversed and the refund requested is granted.

Dated: September 16, 1998.

  
Steven D. Burns  
District Judge