**Private Letter Ruling**

|  |  |
| --- | --- |
| **Ruling Number:** | **P-2013-002** |

|  |  |
| --- | --- |
| **Tax Type:** | **Kansas Retailers' Sales Tax** |
| **Brief Description:** | **Sales of wooden and plastic pallets used to store and ship manufactured products.** |
| **Keywords:** |  |
| **Approval Date:** | **08/14/2013** |

**Body:**

Office of Policy & Research

August 14, 2013

XXXX
XXXX
XXXX

RE: Your letter dated May 28, 2013

Dear XXXX:

Thank you for your recent letter. You ask how Kansas sales tax applies to sales of wooden and plastic pallets that manufacturers buy and use to store and ship their manufactured products. A pallet is essentially a portable platform used for handling, storing, and moving manufactured goods in factories, warehouses, and retail stores, as well as for loading them onto trucks, railcars, and airplanes that haul goods in commerce. Manufactured goods are placed on top of the pallet and often are held in place with shrink wrap. A pallet consists of a raised deck with enough space beneath it to permit a forklift to lift and move the pallet and goods. The pallets typically are used by the manufacturer, shippers, wholesalers, and retailers until the manufactured goods are unpacked for use or sale.

Historically, Kansas has taxed sales of pallets to manufacturers according to whether the pallets are “to be returned to the producer, manufacturer or compounder for reuse.” *See K.S.A. 79-3602(p).* Manufacturers who bought “returnable” pallets were required to pay sales or use tax on their purchases. *K.S.A. 79-3602(p); K.S.A.79-2-3603(a)*. Manufacturers typically charged the wholesaler or retailer a “lost-pallet fee” for failing to return the pallet to them. Kansas exempts sales of “nonreturnable” packing containers that a manufacture buys and intends to use once. Kansas is not the only state that has imposed sale tax on “returnable” shipping containers that a manufacturer buys, uses, and expects to reuse to pack and ship its manufactured goods. See e.g. *Cal. Code Reg., tit. 1589 Annotation Sec. 195-0650; Fla. Admin, Code Ann, Rule 12A-1.040(6) & (16; Ind. Code 6-2.5-5-9; Ky. Acts 139.470(2)(a) & (b); Minn. Adm. Rule 8130.5500.6(c); Mo. Code Regs. 12 CSR10-103.700(3)(A); Mich. Comp. Laws Sec. 205.54(5)(j); N.C. Admin. Code Sec. 17:07B.3907; 32 Vt. Stat. Ann. Sec. 9741(16); Vt. Reg. 1.9741(a)(16) – 2 & - 5; WV Legislative Regulations Sec. 110-15-32.*

The theory for taxing returnable shipping containers is explained in *District of Columbia v. Seven-Up Wash., Inc.,*214 F.2d 197 (D.C.Cir. 1954), cert. denied, 347 U.S. 989 (1954). *D.C. v Seven-Up* concerned the taxability of soft-drink bottlers’ purchase and use of returnable bottles and returnable bottle cases. The applicable D.C. sales tax statutes excluded goods “acquired for purpose of resale” from sales tax. *Id. at 199-200 n. 9;* see *K.S.A. 79-3602(jj) (“‘Retail sale’ . . .means any sale . . . for any purpose other than for resale . . . .”)*The Court determined the bottlers did not buy the bottles and cases with the intent to resell them. Rather, “[t]he true purpose here is not to resell but to use [the returnable bottles and cases], even if this use is made possible in part through the form of resale and repurchase.” *Id. at 201.*The Court also downplayed the significance of the claim the bottlers were selling and rebuying the returnable bottles and cases. “[B]ecause the charge or deposit required for the containers is less than their cost, the true purpose of their purchase is apparent. It is to use and reuse them.” *Id.*In upholding the District of Columbia’s sales tax assessment on the bottlers’ untaxed purchases, the Court reasoned that bottlers “are not in the business of selling bottles or cases but of using them as a means of marketing their soft drinks.”

While charges to manufacturers for “returnable” pallets that are for reuse are subject to Kansas tax, charges for “nonreturnable” pallets are exempt. This is because K.S.A. 79-3602(p) declares certain packing materials used by manufacturers satisfy the definition of “ingredient or component part” for purposes of the exemption extended at K.S.A. 79-3606(m). These materials include,

(1) Containers, labels and shipping cases used in the distribution of property produced, manufactured or compounded for sale which are not to be returned to the producer, manufacturer or compounder for reuse.

(2) Containers, labels, shipping cases, paper bags, drinking straws, paper plates, paper cups, twine and wrapping paper used in the distribution and sale of property taxable under the provisions of this act by wholesalers and retailers and which is not to be returned to such wholesaler or retailer for reuse. *K.S.A. 79-3602(p). (Underlining added)*

Historically, the department treated nonreturnable pallets and any associated packing materials as satisfying the definition of “ingredient or component part” in K.S.A. 79-3602(p)(1) and, therefore, qualifying for the exemption extended at K.S.A. 79-3606(m). This treatment is accorded to pallets and packing materials because K.S.A. 79-3602(p) deems the list of “[c]ontainers, labels and shipping cases” in K.S.A. 79-3602(p)(1) is not to be viewed as “exclusive . . . or [as] a restriction upon . . . the . . . types of products included within the definition of ‘ingredient or component part.’” Compare *Com. v. Yorktowne Paper Mills, Inc.,*426 Pa. 18, 24, 231 A.2d 287, 289-90 (1967) with*Procter & Gamble Paper Products Co. v. Commonwealth,* 29 A.3d 1221, 1223 (Pa. Commw. Ct. 2011)

Because *nonreturnable* pallets and packing materials are “ingredient or component parts” which are exempt pursuant to K.S.A.79-3606(m), their sale or lease to manufacturers are exempt as “sales for resale.” Kansas extends this treatment to nonreturnable pallets and packing materials even though normally they are only delivered to final consumers who buy a fully loaded pallet of goods. More often, retailers unpack their palletized goods to be resold individually and set aside the nonreturnable pallets and shipping material for recycling. This means that the average consumer who buys goods shipped on pallets never actually takes delivery the pallets or packing material even though they qualify as “ingredient or component part[s]” of the consumer goods being purchased, pursuant to K.S.A. 79-3602(p)(1) and K.S.A. 79-3606(m).

This treatment of “returnable” and “nonreturnable” pallets has been the law in Kansas since at least 1939. See *1939 Supplement to the General Statutes of Kansas, 1935,*Sec. 79-3602(l) *(“Each sale of tangible personal property . . . made to a person engaged in the business of . . .manufacturing. . . any article . . . which becomes an ingredient or component part of the article. . . including the container, label or shipping container shall be exempt from taxation under this act.”).*This treatment was reaffirmed by the Kansas legislature in 1970 when it adopted the sweeping changes to the Kansas sales tax act that had been recommended by the Hodge Committee. See *Joint Committee on the State Tax Structure, Vol. I, Final Report and Recommendations* (January 1970).

This treatment remained in place until 2000 when the taxability of returnable pallets was indirectly addressed by 2000 HB 2011, the Kansas Integrated Manufacturing Machinery and Equipment Exemption. See *2000 Kan. Session Laws Ch. 123, K.S.A. (2011 Supp.) 79-3606(kk).*Since its enactment in 2000, K.S.A. 79-3606(kk) has provided Kansas manufacturers with a comprehensive integrated manufacturing and machinery exemption.

K.S.A. (2011 Supp.) 79-3606(kk)(3)(B) exempts a manufacturer’s purchases of equipment that is used “*(B) to transport, convey, handle or store the property undergoing manufacturing or processing at any point from the beginning of the production line through any warehousing or distribution operation of the final product that occurs at the plant or facility. . . .”*While pallets are not expressly mentioned in (kk), the Kansas Department of Revenue adopted the policy that*returnable* pallets may qualify as exempt equipment under K.S.A. 79-3606(kk)(3)(B), *quoted id.*The only caveat for this exemption is that the returnable pallets must be used for the exempt purposes more that 50% of the time. *K.S.A. 79-3606(kk)(6); K.S.A. 79-3606(kk)(2)(F).* With this treatment in mind, I will discuss the issues you raise about your client’s operations.

Your client (“taxpayer/lessor”) leases pallets to manufacturers rather than selling them outright. Each pallet is numbered for identification. In addition to entering into lease contracts with manufacturer/lessees, the taxpayer/lessor contracts with the “distributors” that take delivery of the loaded pallets from a manufacturer/lessee. After the distributor takes delivery, it stores the loaded pallet at their facility until the goods are unloading or the pallets and goods are reshipped. Once the pallets are unloaded, the distributor stores them until the distributor arranges to have an authorized collection and repair manager (“pooling manager”) take delivery of the used pallets it is storing. The pooling manager may arrange for the pick up or the distributor may be obligated to deliver the pallets to the pooling manager.

The taxpayer/lessor charges the manufacturer an initial flat “issue fee” for each pallet, plus a daily lease charge for each day the manufacturer has the pallet in its possession. The taxpayer/lessor also charges a one-time “transfer fee” to the manufacturer when the manufacturer delivers a loaded pallet to the distributor. Once the distributor receives a loaded pallet, the manufacturer/lessee has no further contractual duties to the taxpayer/lessor. Regardless of how long the distributor holds the pallet, there are no additional charges billed to the manufacturer/ lessee.

The taxpayer/lessor does not charge the distributor any daily rental charges or other fees for its use of the pallet. It only bills the distributor if a pallet is lost or damaged beyond repair. In limited circumstances, the taxpayer/lessor may charge a distributor for the transportation costs incurred for hauling the pallets to the pooling manager. The distributor is barred from transferring the pallets to anyone other than a pooling manager, the taxpayer/lessor, or their agents.

The pooling manager is responsible for securing possession of the used pallets and for inspecting and repairing them. The pooling manager then redistributes them to the taxpayer/lessor’s manufacturer/lessees. The pooling site apparently charges the taxpayer/lessor for the repair services it performs. The taxpayer/lessor retains title to the pallets at all times, and no other entity takes title to the pallets under any circumstances including when the pallet is lost or damaged.

You explain the different charges the taxpayer/lessor bills to the different entities as follows,

1. The manufacturer is initially charged an “issue fee” when the pallet is sent from Taxpayer *[your client, the taxpayer/lessor].*This fee is a one-time flat fee charged to manufacturers on a per pallet basis.

2. The manufacturer may be assessed a fuel surcharge depending on the terms of the contract.

3. The manufacturer is charged a daily rental fee based upon the number of days that a particular pallet remains in the manufacturers’ possession preceding shipment of its products to customers or distributors. This retail per diem fee ceases when the manufacturer sends it product (packaged on the pallet) to the distributor.

4. The manufacturer is also charged a one-time flat fee referred to as a “transfer fee” when a manufacturer delivers its product (on the pallet) to the distributor.

5. To the extent that a pallet received by either a manufacturer or a distributor is lost while in their respective possession (difference in pallet numbers and system balance), the corresponding manufacturer or distributor is charged a “lost equipment fee” to recoup CHEP’s costs related to locating and recovering the lost pallet or purchasing a new/replacement pallet.

6. This distributors may be charged a collection fee for a portion of CHEP’s cost for transporting the pallets to the pooling site for inspection, potential repair, and redistribution into the pool.

As has been explained, the taxpayer/lessor bills the manufacturer/lessee three charges for leasing its pallets. The taxpayer/lessor charges an “initial fee” when the pallets are delivered. It bills a second per diem lease charge based on the number of days the manufacturer has the pallet in its possession. The third fee (“transfer fee”) is charged when the manufacturer ships a loaded pallet to the distributor.

Were the pallet leases subject to Kansas sale tax, all three charges would part of the tax base for the taxable lease even though they are stated as separate line-item charges or are billed at different times. This is because all three charges, and any additional charges the taxpayer/lessor bills to the manufacturer/lessee for the pallets, are included in the tax base of the operating lease. *K.S.A. 79-3602(ll).* The three charges are included in the tax base because they are part of the total amount the lessee is obligated to pay for its lease and use of the pallets. *K.S.A. 79-3602(ll); K.A.R. 92-19-55b(d).*

K.A.R. 92-19-55b(d) makes it clear a lessor may not reduce the tax base for an operating lease by identifying and billing part of the total lease charge as separately-stated charges and then characterizes those separately-stated charges as being nontaxable charge that are not included in the tax base for the lease. This includes separate charges that the lessor bills as additions to the recurring lease installments in order to recover its expenses and costs. Typical costs and expenses that leasing businesses incur and add over and above the normal lease installment charge as a separate line item amount include, among other things: (1) additional costs of maintaining insurance coverage on the TPP it owns and leases, (2) the cost of property taxes it owes on the TPP it owns and leases; (3) the cost of maintaining and servicing the TPP it owns and leases; (4) delivery, set up, take down, and pick up charges, (5) fuel surcharges and similar charges. When it bills such line-item charges in addition to the recurring installment charges, the lessor is simply recouping the costs and expenses that are normally incurred by businesses that lease goods to consumers. Regardless of how the lessor characterizes its costs and expenses on its invoices or how it characterizes its lease installment charges, all of the costs and expenses that the lessor recovers from the lessee are taxable as part of the total amount being billed for the lease of TPP.

This treatment is appropriate because if the lessor is to continue in business, it must recover all of its costs and expenses when it invoices its lessees plus a profit. In addition, the costs and expenses that the lessor bills to the lessee as separate line-item charges typically are legal or financial obligations it incurs as the owner of the property it leases. Accordingly, the “issue fee,” “daily rental fee,” “transfer fee,” and any other fees the taxpayer/lessor bills to a lessee under an operating lease are taxable, *provided the lease is taxable*. Each of these fees is considered to be a part of the taxable lease charges, even when the fees are separately stated on an invoice given to the lessee, billed at different times on separate invoices, or billed to the lessee as a charge that is in addition to the recurring lease installment charges.

The controlling issue for the lease of the pallets is whether a manufacturer can claim exemption when it leases returnable pallets from the taxpayer/lessor. As has been discussed, the manufacturer may claim exemption for the purchase or lease of the pallets under K.S.A. (2011 Supp.) 79-3606(kk)(3)(B). To claim this exemption, the manufacturer must provide the taxpayer/lessor with a properly completed ST-201, *Integrated Production Machinery and Equipment Exemption Certificate*. This and the other Kansas exemption certificates may be downloaded from our website, www.ksrevenue.org. Publication KS.1520, *Kansas Exemption Certificates,*catalogs the exemption certificates in current use and provides instructions on their use.

As mentioned above, K.S.A. 79-3606(kk)(4) exempts equipment that is used for both exempt and nonexempt purposes provided the equipment is used for exempt purposes more than 50% of the time. Here, this is not an issue here because the manufacturer/lessees have no additional payment obligations after a distributor takes delivery of the loaded pallets. Because the time the pallets are in transit from the manufacturer to the distributor is likely a relatively short period compared to the time the manufacturer/lessee has them in its possession, the taxpayer/lessor can properly rely on the ST-201 issued by the manufacturer/lessee. The taxpayer/lessor is responsible for securing a properly completed ST-201 from the manufacturer/lessee.

Similarly, it appears the taxpayer/lessor pays the pooling manager for repairing or refurbishing the pallets it secures from the distributor. The charges billed by the pooling manager to the taxpayer/lessor are exempt as sales for resale. Lessors are allowed to claim the sale for resale exemption for labor services and parts it buys to keep its leased property in working order.*K.A.R. 92-19-55b(f).*(When repair charges are paid by the lessee, the charges are taxable.) To claim the exemption, the taxpayer/lessor is required to complete an ST-28A,*Resale Exemption Certificate,*and provide it to the pooling manager. In addition, the taxpayer/lessor should provide an ST-28A to all Kansas vendors from whom it buys lumber, nails, or other component parts for its leased pallets. The pooling manager should also provide a properly-completed ST-28A to its vendors for the materials it purchases if it refurbishes the taxpayer/lessor’s pallets.

The retail transaction here that governs sales tax levied on the final consumer is the lease agreement between the taxpayer/lessor and the manufacturer/lessee. Because this retail transaction has been determined to be exempt under (kk), the lost-equipment fees and the fees for collecting the pallets that are billed by the taxpayer/lessor are viewed as part of it receipts from a non-taxable retail transaction, rather that as separate receipts from a new retail sale that may or may not be taxable in and of itself. Accordingly, none of these charges are subject to Kansas sales or use tax.

This private letter ruling is issued pursuant to K.A.R. 92-19-59. It is based solely on the facts provided in your written request. If it is determined that undisclosed facts were material or necessary to make an accurate determination, this ruling is null and void. This ruling will be revoked in the future by the operation of law without further department action if there is a change in the statutes, administrative regulations, case law, or published revenue ruling that materially effects this private letter ruling.

Sincerely,

Thomas E. Hatten
Attorney/Policy & Research

**Date Composed: 08/20/2013 Date Modified: 08/20/2013**