

Ottawa, Monday, November 21, 1994

Appeal No. AP-93-323

IN THE MATTER OF an appeal heard on June 21, 1994,
under section 81.19 of the *Excise Tax Act*, R.S.C. 1985,
c. E-15;

AND IN THE MATTER OF a decision of the Minister of
National Revenue dated October 19, 1993, with respect to a
notice of objection served under section 81.15 of the *Excise
Tax Act*.

BETWEEN

DOMTAR INC.

Appellant

AND

THE MINISTER OF NATIONAL REVENUE

Respondent

DECISION OF THE TRIBUNAL

The appeal is allowed.

Arthur B. Trudeau

Arthur B. Trudeau
Presiding Member

Robert C. Coates, Q.C.

Robert C. Coates, Q.C.
Member

Lise Bergeron

Lise Bergeron
Member

Michel P. Granger

Michel P. Granger
Secretary

UNOFFICIAL SUMMARY

Appeal No. AP-93-323

DOMTAR INC.

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

This is an appeal under section 81.19 of the Excise Tax Act of a reassessment of the Minister of National Revenue dated April 24, 1991. In the reassessment, it was found that balers owned by the appellant were not exempt from federal sales tax under subparagraph 1(a)(i) of Part XIII of Schedule III to the Excise Tax Act as "machinery and apparatus sold to or imported by manufacturers or producers for use by them primarily and directly in ... the manufacture or production of goods." The decision confirming the reassessment was made on the basis that the appellant was neither the deemed manufacturer of baled old corrugated containers (OCC) under paragraph (b) of the definition of "manufacturer or producer" under subsection 2(1) of the Excise Tax Act nor the physical manufacturer of the baled OCC, as the balers were placed at supermarkets and department stores and operated by personnel employed by them.

HELD: *The appeal is allowed. In determining whether the balers meet the criteria for exemption from federal sales tax under the Excise Tax Act, the Tribunal felt that they ought to be considered within the broader context of making recycled linerboard as opposed to the narrow context of baling OCC, given the realities of the recycled linerboard business. In the Tribunal's opinion, the balers constitute machinery that was sold to the appellant and used by it primarily and directly in the manufacture of recycled linerboard. In the Tribunal's view, the balers are used by the appellant in the sense that they are strategically placed by the appellant in supermarkets and department stores in order to ensure the availability of a steady supply of baled OCC, which is essential to the manufacture of recycled linerboard. That the balers are located off premises and operated by personnel employed by the supermarkets and department stores does not preclude the appellant from entitlement to exemption from federal sales tax in this case.*

*Place of Hearing: Ottawa, Ontario
Date of Hearing: June 21, 1994
Date of Decision: November 21, 1994*

*Tribunal Members: Arthur B. Trudeau, Presiding Member
Robert C. Coates, Q.C., Member
Lise Bergeron, Member*

Counsel for the Tribunal: Heather A. Grant

Clerk of the Tribunal: Anne Jamieson

*Appearances: Wilfrid Lefebvre, Q.C., for the appellant
Alain Lafontaine, for the respondent*

Appeal No. AP-93-323

DOMTAR INC.

Appellant

and

THE MINISTER OF NATIONAL REVENUE

Respondent

TRIBUNAL: ARTHUR B. TRUDEAU, Presiding Member
ROBERT C. COATES, Q.C., Member
LISE BERGERON, Member

REASONS FOR DECISION

This is an appeal under section 81.19 of the *Excise Tax Act*¹ (the Act) of a reassessment of the Minister of National Revenue (the Minister) dated April 24, 1991, in which it was found that balers purchased by the appellant between October 1, 1986, and December 31, 1990, were subject to federal sales tax (FST). The reassessment was later confirmed by the Minister in a notice of decision dated October 19, 1993.

The appellant was, at all material times, in the business of processing old corrugated containers (OCC) into recycled linerboard. The goods in issue are balers purchased by the appellant and used to compress OCC into bales for use in making recycled linerboard. These balers were placed by the appellant at various supermarkets and department stores and operated by employees of these businesses in order to ensure that the appellant receives a steady supply of baled OCC required to make recycled linerboard.

The issue in this appeal is whether the balers are exempt from FST under section 51 of the Act and subparagraph 1(a)(i) of Part XIII of Schedule III to the Act as "machinery and apparatus sold to or imported by manufacturers or producers for use by them primarily and directly in ... the manufacture or production of goods."

At the hearing, the Tribunal heard the testimony of Mr. Donald Bastings, witness for the appellant, who is Production Superintendent at the appellant's recycling mill in Mississauga, Ontario. Mr. Bastings described, with the aid of photographs, the operation of the mill and the process of making 5-ply sheets of recycled linerboard. He explained that trucks transport baled OCC from supermarkets and department stores to the mill for processing 24 hours a day, 7 days a week. These bales weigh, on average, between 800 and 2,000 lbs. According to Mr. Bastings, the mill requires a steady supply of bales in order for the mill to operate at full capacity on a 24-hour basis. Approximately 400 t of baled OCC are processed in the mill each day. When the bales arrive, they are either processed directly or stockpiled until required. Mr. Bastings described how the bales are introduced into large vats for pulping using conveyors, after which the resulting "mush" is taken through various cleaning processes and other steps in order to remove contaminants and excess water. At subsequent stages, the fibres are fluffed up so that they can interlock and form 5-ply sheets of linerboard. The linerboard is taken through a series

1. R.S.C. 1985, c. E-15.

of presses and dryers and finally rolled onto spools, where the edges of the rolls are trimmed and the rolls themselves cut into various widths according to customer specifications.

Mr. Bastings testified that the mill was specifically designed to operate using baled OCC. He explained that it is important to maintain certain levels of fibre consistency during processing, which is dependent upon prescribed ratios of OCC to water. Mr. Bastings stated that the requisite levels of fibre consistency can only be achieved through a large and steady volume of baled OCC being introduced into the machines. He explained that baled OCC sink faster in the vats for pulping than do loose OCC and, therefore, allows for a greater amount of OCC to be processed. Mr. Bastings also testified that the mill has insufficient storage capacity for reserve levels of loose OCC to adequately supply the machines with the volume of OCC required for full production.

Mr. Robert Loeffler was also called as a witness for the appellant. Mr. Loeffler works in the appellant's recycling division and occupies the position of Supervisor of Administration. Mr. Loeffler testified primarily in respect of the operation of the balers and the contractual arrangements into which Domtar Inc. and various supermarkets and department stores enter. The primary purpose of these contracts is to ensure that the appellant receives a steady supply of baled OCC. Pursuant to the terms of the contracts, the appellant installs the balers at the premises of the supermarkets and department stores. The appellant undertakes the training of personnel employed by the supermarkets and department stores to ensure the proper and safe operation of the balers. Supervisors of the baler operators are further trained by the appellant in the removal of contaminants from the OCC prior to baling in order to ensure that the composition of the bales meets the appellant's needs. The appellant is responsible for the maintenance of the balers, while the supermarkets and department stores provide the electrical power, oil and lubricants, as well as the twine or wire required to tie up the bales. While the balers remain, at all times, the property of the appellant, the bales are the property of the supermarkets and department stores until they are picked up by the appellant. The contracts provide that the supermarkets and department stores sell the bales exclusively to the appellant at a price set in relation to an official market board report. The appellant retains the right to reject bales that contain too many contaminants, as these cannot be used in making recycled linerboard. The rejection rate averages about 3 percent.

Mr. Loeffler also testified about the benefits of the balers to the supermarkets and department stores. He explained that the balers are essential to the supermarkets and department stores because of the limited storage space that they have on site. Many of the contracts were signed when it was illegal for retailers to dispose of OCC at garbage dumps. Consequently, the arrangements with the appellant were mutually beneficial. Mr. Loeffler agreed with Mr. Bastings' point that the efficient operation of the mill is dependent upon a steady supply of bales from the supermarkets and department stores.

Counsel for the respondent called Mr. Robert D. Fels as an expert witness in the field of paper production. Mr. Fels has a degree in chemical engineering and has worked in the pulp and paper industry since 1951. Mr. Fels testified in respect of the evolution of the recycling industry. He testified that the balers compress OCC into a useable form, but that this compression does not alter the state of the fibres to any great extent. Mr. Fels generally agreed with the testimonies of Mr. Bastings and Mr. Loeffler and, in particular, that baled OCC are essential to the operation of the mill, although, in theory, loose OCC are sufficient. Mr. Fels agreed that the baling of OCC constitutes part of the process of making recycled linerboard. He testified that, even if loose OCC were picked up by the appellant for use in making recycled linerboard, the OCC would have to be baled at some point prior to introducing the OCC into the pulpers.

In argument, counsel for the appellant contended that the balers should qualify for an exemption from FST as they are "machinery and apparatus sold to or imported by manufacturers or producers for use by them primarily and directly in ... the manufacture or production of goods." Counsel noted that it is common ground between the parties that the goods in issue are machinery which was sold to the appellant. Counsel argued that, in assessing whether the balers qualify in respect of the other criteria in this provision, they ought to be considered within the context of the making of recycled linerboard, as the balers perform the first step in the process and constitute an essential component in that process. Counsel further argued that the process of making recycled linerboard clearly constitutes the manufacture or production of goods. Therefore, the balers are used in the manufacture or production of goods. Counsel relied on the decisions in *Steetley of Canada (Holdings) Limited v. The Deputy Minister of National Revenue for Customs and Excise*² and *I-XL Industries Ltd. v. The Deputy Minister of National Revenue for Customs and Excise*³ to suggest that the balers are used primarily and directly in the manufacture or production of recycled linerboard, as they are an integral and essential part of the manufacturing or production process. According to counsel, the evidence clearly shows that the balers would be required to bale loose OCC at the mill if the OCC were not baled by the supermarkets and department stores; to do otherwise would not be economically feasible. Furthermore, in relying on the decision in *Coca Cola Ltd. v. The Deputy Minister of National Revenue for Customs and Excise*,⁴ counsel submitted that the term "use" does not require that the balers be operated directly by the appellant's employees, but ought to be given a broad meaning within the context of the particular situation. Counsel argued that, in this case, the appellant's use of the balers is to make them available to the supermarkets and department stores, which feed the balers with OCC in order to supply the appellant with the bales required for the manufacture or production of recycled linerboard.

Counsel for the appellant relied on the Tribunal's decision in *Hydro-Québec v. The Minister of National Revenue*⁵ to argue that the Tribunal ought to look at the manufacturing or production operations as they are conducted, bearing in mind the realities of the situation, and not at how they could conceivably be conducted. Counsel argued that a broad application of the word "use" in this case, adopting a common sense approach, does not offend a reading of the provision. Rather, it provides sufficient ambit to cover a situation such as the one at hand.

Counsel for the respondent contended that the Tribunal ought to consider the balers within the context of the baling of OCC and not within the broader context of the making of recycled linerboard. Counsel submitted that the balers are not part of the process of making recycled linerboard, as the appellant does not operate the balers. In counsel's view, the manufacture or production of recycled linerboard does not begin until delivery of the bales to the mill. Following this line of argument, counsel contended that, in the context of baling, the balers merely compress the OCC and that this process does not constitute the manufacture or production of goods. However, even if the Tribunal finds that the making of bales constitutes the manufacture or production of goods, the appellant cannot claim to be the manufacturer or producer of the bales, as the balers are not operated by the appellant's employees, and ownership of the bales remains with the supplier until delivery. Moreover, the appellant does not meet the criteria to be considered a deemed manufacturer under the Act.

2. (1973), 6 T.B.R. 30.

3. (1973), 6 T.B.R. 106.

4. [1984] 1 F.C. 447.

5. Appeal No. 2374, December 20, 1991.

Counsel for the respondent relied on the decisions in *Arthur A. Voice Construction Co. Ltd. v. The Minister of National Revenue*,⁶ *The Deputy Minister of National Revenue for Customs and Excise v. Robertson Building Systems Limited*⁷ and *Mustang Engineering and Construction Limited v. The Minister of National Revenue*⁸ to argue that "for use by them" is a substantive condition. Moreover, in relying on the decisions in *Mustang Engineering* and *MCA (Canada) Ltd. v. The Minister of National Revenue*,⁹ counsel argued that it is a condition which requires the manufacturer or producer to physically use the machinery or apparatus for which it is requesting an exemption. Counsel contended that this condition further requires the purchaser to have the intention, at the time of purchase, to use the equipment itself in the manufacturing or production process and that, in this case, the appellant had no such intention, as it asked the vendor of the balers to ship them directly to the suppliers' premises from which it would be purchasing the baled OCC.

In response to the appellant's position that the balers are used primarily and directly by the appellant in the manufacture or production of goods, specifically recycled linerboard, counsel for the respondent argued that not only are the balers not used by the appellant but they are not used primarily and directly in the manufacture or production of goods. Counsel submitted that the baling of OCC is not the beginning of the appellant's production process for making recycled linerboard. In counsel's view, production starts when the bales are placed on the conveyor at the mill and introduced into the pulper. In support of this position, counsel referred to Excise Memorandum ET 303¹⁰ (Memorandum ET 303) which states that "[p]roduction commences at the receiving area on the manufacturer's manufacturing premises for materials utilized in the manufacture or production of goods, and ends at the finished-goods storage or warehouse area on these premises."¹¹ Consequently, the manufacture or production of recycled linerboard does not begin at the suppliers' premises, but at the mill where the bales begin being processed. Moreover, in relying on the decisions in *Esso Resources Canada Limited v. The Minister of National Revenue*¹² and *The Deputy Minister of National Revenue for Customs and Excise v. Amoco Canada Petroleum Company Ltd.*,¹³ counsel argued that the term "directly" ought to be interpreted to mean a "close nexus or connection," or "immediately," in the sense of "without any intervening medium," as opposed to collateral. In looking at the facts of this case, counsel argued that baling is not a direct element in the manufacture or production of recycled linerboard, but that the balers are merely used to bale the OCC in order to facilitate the handling and shipping of the material. Furthermore, there are intervening media or agents and other parties involved in the handling, delivery and possible return of the bales for credit.

A key issue in this appeal is whether the Tribunal ought to consider the operation of the balers within the broader context of the production of recycled linerboard or in the narrow context, specifically, the making of bales. Counsel for the appellant advanced the position that the balers ought to be considered within the context of the appellant's manufacture of recycled

6. Canadian International Trade Tribunal, Appeal Nos. AP-89-123 and AP-89-133, October 24, 1990.

7. [1980] 1 F.C. 58.

8. [1993] 1 G.T.C. 4050, Canadian International Trade Tribunal, Appeal No. AP-92-059, March 2, 1993.

9. 5 T.C.T. 1332, Canadian International Trade Tribunal, Appeal No. AP-90-123, August 11, 1992.

10. Production Equipment, Department of National Revenue, Customs and Excise, March 20, 1989.

11. *Ibid.* at 7.

12. 2 T.C.T. 1241, Canadian International Trade Tribunal, Appeal No. 2984, December 4, 1989.

13. 86 D.T.C. 6008 (F.C.A.).

linerboard and contended that the balers perform the first step in the production process. Counsel for the respondent argued that the process at issue is the baling of OCC and not the appellant's entire linerboard production operations. In counsel for the respondent's view, the appellant's production process does not start until the appellant takes delivery of the bales.

The Tribunal accepts the appellant's position on this issue. The Tribunal finds that whether the balers qualify for an exemption from FST under the Act is an issue that must be considered in the context of the entire operation of producing recycled linerboard. In the Tribunal's view, the balers perform the first step in the processing of OCC into recycled linerboard. In reaching this conclusion, the Tribunal took into account the testimonies of the appellant's witnesses, Messrs. Bastings and Loeffler, as well as the testimony of the respondent's expert witness, Mr. Fels. Mr. Bastings testified that the mill was designed to operate using baled material, not loose OCC. Moreover, all three witnesses agreed that the baling of OCC is essential to the production of recycled linerboard. In the Tribunal's view, the placement of the balers at supermarkets and department stores and the operation of the balers by their personnel are practical solutions to the unique nature of the recycled linerboard business and the sourcing of adequate volumes of bales. The Tribunal does not consider Memorandum ET 303, to which counsel for the respondent referred, to be on point. In the Tribunal's opinion, Memorandum ET 303 pertains specifically to "material-handling equipment" and does not contemplate the role of machines such as balers in the recycled linerboard business.

As indicated above, in order to be entitled to an exemption, the appellant must demonstrate that the balers meet the following criteria, specifically, that they are:

- (i) machinery and apparatus;
- (ii) sold to or imported;
- (iii) by manufacturers or producers;
- (iv) for use by them;
- (v) primarily and directly;
- (vi) in the manufacture or production of goods.

The appellant and the respondent agree that the balers are "machines" which were "sold to" the appellant. On the issue of whether making recycled linerboard constitutes the "manufacture or production" of goods, guidance can be taken from the Supreme Court of Canada's decision in *Her Majesty the Queen v. York Marble, Tile and Terrazzo Limited*.¹⁴ In that case, the Supreme Court of Canada adopted the definition of "manufacture" as "the production of articles for use from raw or prepared material by giving to these materials new forms, qualities and properties or combinations whether by hand or machinery."¹⁵ If this test is applied to the process at issue, the OCC receive new forms, new qualities and new properties through transformation into recycled linerboard by the appellant. Therefore, there is manufacture of goods. Consequently, as the appellant is the physical manufacturer of the recycled linerboard, the appellant also qualifies as a "manufacturer or producer," thus meeting criterion (iii) mentioned earlier.

14. [1968] S.C.R. 140.

15. *Minister of National Revenue v. Dominion Shuttle Company Limited* (1933), 72 Que. S.C. 15.

The key points at issue in this appeal are whether the balers are: (1) "for use by [the appellant];" (2) "primarily and directly" in the manufacture or production of goods.

The first point that will be addressed is whether the balers are "for use by [the appellant]" in the manufacture of recycled linerboard from OCC. The Tribunal believes that this provision ought to be given a broad interpretation in the context of each particular case. In the Tribunal's view, the balers are for use by the appellant in the sense that they are strategically placed by the appellant in supermarkets and department stores to ensure the availability of a steady supply of baled OCC, which is essential to the manufacture of recycled linerboard. The Tribunal does not believe that the fact that the employees of the supermarkets and department stores physically operate the balers precludes the appellant from meeting this requirement for the exemption under the Act. In reaching its conclusion on this point, the Tribunal focused on the entire production process and the contractual arrangements between the appellant and the supermarkets and department stores. The facts which the Tribunal considered important in reaching this conclusion include the following: (1) the appellant owns the balers; (2) the appellant purchased the balers in order to secure an essential and steady supply of baled OCC for use in its manufacture of recycled linerboard; (3) the appellant negotiated contracts with supermarkets and department stores, which agreed to sell the bales to the appellant exclusively in consideration for payment for the raw materials; and (4) the appellant is responsible for the maintenance of the balers and training of the employees of the supermarkets and department stores in the safe operation of the balers. Given these facts, the Tribunal concludes that the balers are for use by the appellant in the manufacture of recycled linerboard.

The second point at issue is whether the balers are used "primarily and directly" in the manufacture or production of goods. In the Tribunal's opinion, the evidence clearly shows that the balers are used primarily in the manufacture of recycled linerboard, as they perform a specific and necessary step in the production process.

In reaching its conclusion as to whether the balers are used "directly" in the manufacture of recycled linerboard, the Tribunal has taken into account the following principles enunciated in the *Amoco* case: (1) that the word "directly" should not be interpreted restrictively; (2) that there is no rational reason for the imposition of any arbitrary point of commencement of the production process in the absence of a specific statutory direction; and (3) that the word "directly" must be given meaning in view of the facts of each particular case. Furthermore, the Tribunal recognizes that, in interpreting the word "directly," the Tribunal and its predecessors have applied a number of different tests. For instance, in the *Amoco* case, the Federal Court of Appeal found the word "directly" to mean "immediately," in the sense of "without any intervening medium;" in the *Esso* case, the Tribunal asked whether there was a "close nexus or connection" between the machinery or apparatus and the production process; and in *The Deputy Minister of National Revenue for Customs and Excise v. Hydro-Québec*,¹⁶ the Federal Court of Appeal considered whether the apparatus in issue was integral and essential to the production process.

Having examined the facts, statutory language of the exemption provision and the relevant jurisprudence, the Tribunal is of the opinion that the balers satisfy all three tests set out above. In its view, the balers are an integral and essential part of the production process. Moreover, there is a close connection or nexus between the balers and the process of manufacturing recycled linerboard. As heard in oral testimony, the OCC would be required to be baled or manufactured at some point prior to the introduction of the OCC into the pulpers; otherwise, the mill would not function properly. As indicated in oral testimony, the mill was

16. Unreported, Federal Court of Appeal, File No. A-899-92, June 20, 1994.

specifically designed to operate using baled OCC, 24 hours a day, 7 days a week, and not loose OCC. The use of loose OCC would mean that a significantly lower volume of OCC could be introduced into the pulpers at a given time. If this were the case, the system would not receive a sufficient volume of OCC, thus the system would be unable to transfer the proper fibre content to the various steps that comprise the pulping process, ultimately causing problems in the production process. Furthermore, if the volume of water were reduced in order to compensate for a lower volume of OCC being introduced into the pulpers, the mill would not be a viable concern.

Furthermore, in the Tribunal's view, there is no intervening medium that precludes a finding that the balers are used directly in the production of recycled linerboard. As stated earlier, the Tribunal considers the manufacture of recycled linerboard to consist of various steps, of which the baling of OCC is the first one. The fact that the bales are transported by truck from supermarkets and department stores to the mill does not constitute an intermediate intervention for the purposes of the test set out in the *Amoco* case. The transportation of the bales to the mill does not initiate the production of goods, but constitutes a stage in the complete production process resulting in recycled linerboard.

In view of the foregoing, the Tribunal finds that the balers meet the criteria for exemption from FST under subparagraph 1(a)(i) of Part XIII of Schedule III to the Act as "machinery and apparatus sold to or imported by manufacturers or producers for use by them primarily and directly in ... the manufacture or production of goods."

Accordingly, the appeal is allowed.

Arthur B. Trudeau

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Member