

REQUEST LETTER

06-008

REPRESENTATIVE NAME
BUSINESS
ADDRESS

Dear Commissioners,

Re: Private Letter Ruling on Sales Tax Exemption for Construction of Closed Pipeline Water Delivery System

The purpose of this letter is to request an advisory ruling on the applicability of a sales tax exemption for the construction of a closed pipeline water delivery system for our client, NON PROFIT ORGANIZATION.

NON PROFIT ORGANIZATION is a Utah nonprofit mutual irrigation company. It utilizes water from the CREEK #1 and CREEK #2 Drainages to serve water for irrigation, municipal and industrial purposes in northern COUNTY. Although COMPANY 1 holds approximately 34% of NON PROFIT ORGANIZATION outstanding shares of stock so that it may take water from CREEK #1 for its electrical generation plant in the mouth of CANYON a majority of NON PROFIT ORGANIZATION shareholders are farmers who rely on NON PROFIT ORGANIZATION of over one hundred miles of irrigation canals and ditches to irrigate their farms.

Because NON PROFIT ORGANIZATION does not have a closed pipeline water delivery system it loses a substantial amount of valuable water each year due to seepage and evaporation. To remedy this problem, NON PROFIT ORGANIZATION plans to convert its canal and ditch water delivery system to a closed pipeline water delivery system. NON PROFIT ORGANIZATION expects that, by doing so, it will be able to conserve nearly 80% of the water that is currently lost.

NON PROFIT ORGANIZATION is eligible to receive federal funding from the National Resource Conservation Service and the United States Bureau of Reclamation and intends to use these funds to cover a portion of the costs of converting its system. However, NON PROFIT ORGANIZATION anticipates that the costs of such a project will far exceed the funds received from the federal government. As such, NON PROFIT ORGANIZATION would like to take every effort to reduce the total overall cost to the company and its shareholders.

We understand that the Utah Tax Code provides a sales and use tax exemption for equipment and other items used in farming operations. Specifically, section 59-12-104(19)

provides an exemption for “sales of tangible personal property used or consumed primarily and directly in farming operations, regardless of whether the tangible personal property: (A) becomes part of real estate; or (B) is installed by a: (I) farmer; (II) contractor; or (III) subcontractor.” Utah Code Ann. §59-12-104(19)(a)(2005).

As stated above, the closed pipeline water delivery system will be used primarily during the Irrigation Season to transfer water to the farms of the NON PROFIT ORGANIZATION shareholders. Additionally, during the Non-irrigation Season, the pipeline system will be used by NON PROFIT ORGANIZATION primarily for stockwatering. Under these facts, would either NON PROFIT ORGANIZATION or the contractor hired to complete the project be required to pay sales or use tax on the items purchased to install the pipeline system?

We also understand that the Utah Tax Code provides a sales and use tax exemption to certain entities that are also exempt from federal taxation under section 501(c) of the Internal Revenue Code. Specifically, section 59-12-104.1 grants a sales and use tax exemption to religious and charitable organizations. See Utah Code ann. § 59-12-104.1 (2005) (“[S]ales made to a religious or charitable institution or organization are exempt from the sales and use tax imposed by this chapter if the sale is made in the conduct of the institution’s or organization’s regular religious or charitable functions and activities.”).

Although not a charitable or religious organization, NON PROFIT ORGANIZATION does qualify for a federal tax exemption because it is a mutual irrigation company. See 26 U.S.C. §501(c)(12)(2005). Would NON PROFIT ORGANIZATION status as a 501(c) entity qualify it for a sales and use tax exemption under the Utah Code?

Lastly, we are aware of the strong public policy in the State of Utah which favors conserving precious water resources. See Piute Reservoir & Irr. Co. v. West Panguitch Irr. & Reservoir co., 367 P.2d 855, 859 (Utah 1962) Crockett, J., dissenting) (“Our decisions dealing with disputes over rights to the use of water are replete with statements about how important, and even precious, water is in this arid area, and that it is the policy of the law not only to permit, but to encourage the taking of any measures to develop, conserve, and put water resources to the best possible use and in the most economical manner feasible.”) However, we have been unable to locate a sales and use tax exemption designed to encourage water conservation. Is there any such exemption?

Thank you for taking the time to review this request. If there is any additional information that we can provide you, please let us know.

Yours truly,

Private Letter Ruling 06-008
November 20, 2006
Page 3 of 8

REPRESENTATIVE NAME
BUSINESS

Cc: Board of Directors, NON PROFIT ORGANIZATION
NAME #2 President
NAME #3, Vice President
NAME 4, Secretary

FOLLOW UP LETTER

July 17, 2006

Utah State Tax Commission
Attn: Pam Hendrickson – Commission Chair
210 North 1950 West
Salt Lake City UT 84134

Dear Ms Hendrickson

On DATE, REPRESENTATIVE NAME of BUSINESS submitted a letter to the Utah State Tax Commission on behalf of the NON PROFIT ORGANIZATION). The purpose of the letter was to request an advisory ruling o the sales tax exemption for an irrigation project that will irrigate over 20,000 agricultural acres that NON PROFIT ORGANIZATION is installing in COUNTY.

NON PROFIT ORGANIZATION would like to submit this follow-up letter in an effort to clarify our request. NON PROFIT ORGANIZATION is a Utah nonprofit mutual irrigation company. As REPRESENTATIVE NAME letter explains, we are in the process of installing a new irrigation system. After further review of REPRESENTATIVE NAME letter, the Board of Directors of NON PROFIT ORGANIZATION would like to clarify and reinforce the following points:

1. The new irrigation system will only deliver irrigation water and livestock water to farmers within our service area, as a result, its sole use will be directly tied to farming/agricultural operations.
2. NON PROFIT ORGANIZATION farmers are the only shareholders the new irrigation system will serve. These farms are primarily family owned and operated businesses.
3. Industrial and Municipal shareholders of NON PROFIT ORGANIZATION will not be served by the new irrigation system. They will continue using their water with existing systems through their own separate points of diversion.

Private Letter Ruling 06-008
November 20, 2006
Page 4 of 8

In consideration of information provided in this letter, as well as the April 6, 2006 letter submitted by NAME, NON PROFIT ORGANIZATION respectfully requests an advisory ruling that will exempt NON PROFIT ORGANIZATION and the contractors hired by us from paying sales tax when purchasing materials for this project.

Your timely response to our request would be very much appreciated. If you have any questions or there is additional information that we can provide, please let us know. Thank You.

Sincerely

NAME #2
ADDRESS

RESPONSE LETTER

November 20, 2006

NAME #5
ADDRESS

Re: Private Letter Ruling 06-008

Applicability of Sales Tax Exemptions on the Construction of an Irrigation Water Pipeline Delivery System

Dear NAME #5,

This letter is in response to a letter dated April 6, 2006 from REPRESENTATIVE NAME, requesting tax guidance. A second letter from NAME #3, dated July 17, 2006, supplemented the initial request. You requested that our ruling be sent to you directly.

This letter ruling is an interpretation and application of the tax law to the facts presented in your letter. It is not a statement of broad Tax Commission policy. If the facts of your client's situation differ from the facts described in this letter ruling, please let me know so we can assure a more accurate response to your client's circumstances.

Facts

The NON PROFIT ORGANIZATION is a Utah nonprofit mutual irrigation company. Although NON PROFIT ORGANIZATION supplies water to its customers for irrigation,

municipal and industrial purposes, it is building a new irrigation system that is reserved for use only by the company's agricultural customers for agricultural purposes. The majority of the shareholders in the irrigation company are farmers, who take water for their agricultural operations. As discussed in subsequent conversations with officials of NON PROFIT ORGANIZATION the rough breakout of shareholders is approximately 60% agricultural, 30% Industrial, and 10% municipal. The new irrigation system will operate separately at the point of diversion from the existing system that also serves municipal and industrial customers.

The current water system consists of more than a hundred miles of open canals and ditches. Consequently, the company suffers losses due to evaporation and seepage. The company has determined that a closed pipeline system could conserve as much as 80% of the water currently subject to loss.

The pipeline construction project will be funded, in part, through a grant by the United States Bureau of Reclamation. However, the federal funds will not cover the entire cost of construction. Consequently the shareholders will pay some of the costs of construction. With that in mind, the company is inquiring as to whether it is eligible for any sales tax exemptions. Specifically, the company requests a ruling as to whether this construction project qualifies for an exemption as 1) farm equipment, 2) as a charitable organization, or 3) on the basis of good public policy favoring conservation.

Analysis

Farm Equipment or Agricultural Exemption

Section 59-12-104(18)(a) of the Utah Sales and Use Tax Act provides a sales tax exemption for "purchases of tangible personal property used or consumed primarily and directly in farming operations. (Emphasis added.) Subparagraph (b) goes on to say:

amounts paid or charged for the following tangible personal property are subject to the taxes imposed by this chapter:

(i) (A) subject to Subsection (18)(b)(i)(B), the following tangible personal property if the tangible personal property is used in a manner that is incidental to farming:

- (I) machinery;
- (II) equipment

...

Because the statute makes a distinction between property used directly in farm operations from property whose use is incidental to farming operations, we must determine

exactly how the pipelines relate to farming operations. From the description provided in your letters, the closed pipeline delivery system will be used only in agricultural operations. The pipelines are used by the irrigation company to deliver water to the farms. The exemption is based on how the property is used. You identified several factors that we will use in making our determination:

1. First, although the new system is connected to an existing system that serves non-agricultural users, the specific system under construction will not be used to deliver water to non-agricultural users.
2. The company itself qualifies as a 501(c)(12) entity, under the Internal Revenue Service (IRS) code. Such entities include benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations. These organizations must use their income solely to cover losses and expenses, with any excess being returned to members or retained for future losses and expenses. They must collect at least 85% of their income from members for the sole purpose of meeting losses and expenses. Such entities are organized and operated on a mutual or cooperative basis. They are associations of persons and organizations, or both, banded together to provide a mutually desirable service approximately at cost and on a mutual basis.
3. Additionally, you have asserted, and we have not been able to find any contrasting views, that no agricultural water users have ever paid sales tax on purchases of construction materials.

As we reviewed the statute, we observed that the definition of direct use in an agricultural operation is not clear. As a result, there is some disagreement within the Commission as to whether the exemption applies to your situation. Nonetheless, we were able to reach enough of a consensus to determine that NON PROFIT ORGANIZATION qualifies for the exemption.

The primary reason for this determination includes the fact that the pipelines will deliver water directly and only to agricultural operations, and the water will only be used for such purposes. In addition, irrigation and other systems located on the farm would be exempt from sales tax since they are used directly by the farmer. We believe that the present situation is effectively an aggregation of farmers purchasing a water system to distribute water to their individual farms. We see no real distinction from an individual farmer constructing an irrigation system on his or her own land. In such a case the Commission would consider that system to be a direct part of the farming operation. Where you have a group of farmers constructing a system with separate pipelines leading to different agricultural operations, we do not find a substantive difference in principle from an individual farmer. In contrast, were an individual farmer to

construct an irrigation system that also delivered water to non-agricultural users, that system would be subject to sales tax.

Other contributing, but not dispositive, factors include the fact that NON PROFIT ORGANIZATION does not make commercial sales of water to non-shareholders, the nature of the ownership, and your unrefuted representation that irrigation companies have historically not paid any taxes in similar situations.

This exemption only applies to the purchase of construction materials for pipelines and other items used in the agricultural system, as well as to any otherwise taxable labor for the installation of personal property (labor for installation related to real property is not taxable). It does not apply to purchases of machinery or equipment used to construct the system. Nor would it apply to materials used for any part of the company's system that is not used solely for agricultural purposes.

Although we need not address other issues you raised in your letter, since we have already granted the exemption, we wish to answer your questions for purposes of information and clarification.

Charitable Exemption

With respect to your question on charitable use, Utah sales tax law recognizes an exemption for sales to a charitable organization made in the ordinary conduct of the organization's charitable business or activity. See Utah Code Ann. §§59-12-104(8) and 59-12-104.1. However, in order to qualify for this exemption, the organization must be recognized as a 501(c)(3) entity under the IRS code. See Utah Admin. Rule R-865-19S-43. In this case, the company is not a 501(c)(3) entity and its status as a 501(c)(12) entity is not sufficient to qualify it as a charitable organization under section 59-12-104(8). This distinction is clear from the IRS code. A 501(c)(3) organization includes charitable organizations. A 501(c)(12), on the other hand, is specifically defined to include mutual ditch or irrigation companies. This type of organization, although exempt from federal taxation, is not a qualified charitable organization.

Public Policy Considerations

You state that good public policy favors conservation in this case. Whether or not we agree, the Commission is bound to administer the sales tax exemptions as enacted by the Legislature. Unless there is a specific applicable exemption in the law, all taxable transactions are subject to sales tax, regardless of perceived, or even real, public policy benefits.

Ruling

The construction project described here qualifies for an exemption on the purchase of construction materials used in constructing the irrigation system. This exemption extends to contractors and sub-contractors who purchase the materials. It does not apply to the purchase of machinery and equipment used in the construction process.

We note that this ruling applies to NON PROFIT ORGANIZATION'S specific fact circumstances. It may or not be applicable to other water companies, depending on such factors as whether a company is a corporation that sells water commercially or if the construction of a water system includes non-agricultural uses.

Conclusion

We hope that this ruling addresses your concerns. Should the facts and circumstances associated with NON PROFIT ORGANIZATION situation be different from those represented in your correspondence with the Commission, or different from those stated in this letter, our position may be subject to change. If you have any further questions you would like to have addressed, please feel free to contact us.

For the Commission,

Marc B. Johnson
Commissioner

cc: REPRESENTATIVE NAME

MBJ/IR
PLR 06-008