

This private letter ruling was inadvertently not posted in 2007.

FINAL PRIVATE LETTER RULING

REQUEST LETTER

06-023

October 10, 2006

Utah State Tax Commission
ATTN: TRU
210 North 1950 West
Salt Lake City UT 84134

Re: Letter Ruling Request – Compression Services

Dear Sir or Madam:

Our Client, COMPANY 1 (“COMPANY 1”), would like clarification regarding the application of the Utah Sales and Use Tax statutes to its activities in Utah.

COMPANY 1 assembles compressors (in STATE 1) that are used in connection with natural gas exploration, production, processing and transportation. Historically, the assembled compressors are either sold to third party customers or COMPANY 1 retains ownership and the compressors are used by COMPANY 1 at customer locations to provide compression for a fee. Most of COMPANY 1’s current contractual agreements with their customers are structured such that they would be considered a “rental” or “lease” for Utah sales and use tax purposes.

COMPANY 1 is in the process of reorganizing its business. As a result of the reorganization, COMPANY 1 will have four primary entities involved in the compression business in your jurisdiction. Three of these entities will be new entities. One entity will lease compressors, COMPANY 2 (“Lease Company”), to a related entity through agreements that should be considered bare rentals. One of the purposes of Lease Company will be to streamline sales tax compliance procedures by eliminating inefficiencies in the sales/use tax self-assessment process. This is accomplished as a result of the bare rentals changing the nature of the tax form from a use tax to a sales tax in most jurisdictions.

The lessee of the compressors from Lease Company, COMPANY 3 (“Service Company”), will provide compression services to third parties. COMPANY 1 will contribute a portion of its current fleet of compressors, subject to certain liabilities, to Lease Company in a transaction that will be tax-free for federal income tax purposes. The remaining compressors will be contributed to a new entity owned by COMPANY 1, COMPANY 4. “LEASE COMPANY 2”) that will lease the compressors to COMPANY 1 for use in its compression business. This contribution will also be tax-free for federal income tax purposes. Lease Company and LEASE COMPANY 2 will be disregarded entities for federal tax purposes.

As part of the reorganization, COMPANY 1 is also changing its contracts with certain customers. The revised contracts will be used by both Service Company and COMPANY 1.

After these changes, the following contractual provisions indicate that the new service contract is properly treated as a service agreement for federal income tax purposes, rather than a lease:

- risk of loss, control, and certain other characteristics will be the responsibility of Service Company/ COMPANY 1 rather than the customer.
- the new contract does not specify a particular compressor or model of compressor that will be used to perform the service, rather the contract stipulates only that the compression services will be provided based on certain agreed upon parameters. Thus, as the contract acknowledges, the compressors are tools used by the Service Company / COMPANY 1 to perform services.
- ad valorem taxes will be the responsibility of Service company / COMPANY 1,
- Service Company / COMPANY 1 will be responsible for insurance for the compressors,
- the fee charged for compression services is substantially higher than the cost of bare rental of a compressor.
- the contracts are typically for approximately three years, or less than 15 percent of a compressor's economic life,
- Service Company / COMPANY 1 bears the risk of performance of its contractual obligation to provide compression services. Thus, to the extent that Service Company / COMPANY 1 is unable to provide compression services to its customers, the Service Company/ COMPANY 1 will suffer a reduction in the fee for compression services that it charges the customer and
- Service Company / COMPANY 1 does not own the gas at any point in the process, but Service Company / COMPANY 1 compresses the natural gas for its customers that typically sell the natural gas to third parties.

COMPANY 1 would specifically like guidance on how the changes described above affect the Utah sales and use tax treatment of Service Company's / COMPANY 1's business transaction in the state.

1. Will the Utah State Tax Commission treat the attached agreement ("Master Services Agreement") as a service agreement rather than a rental for Utah sales and use tax purposes?
2. Will there be any Utah sales or use taxes due as the result of transferring the existing compressors from COMPANY 1 to LEASE COMPANY 2 and Lease Company? Will the resale exemption apply to the transfer?

If you have any questions or need additional information related to this ruling request, please call me at PHONE NUMBER.

Best regards,

NAME 1
TITLE 1
COMPANY 5
CITY 1, STATE 1

RESPONSE LETTER

November 30, 2007

NAME 1
TITLE 1
COMPANY 5
ADDRESS 1
ADDRESS 2
CITY 1, STATE 1 ZIP CODE 1

RE: Private Letter Ruling Request – 06-023

Dear NAME 1,

We have received your letter regarding the application of the Utah Sales and Use Tax statutes to COMPANY 1 activities in Utah.

It should be noted that the ruling in this letter is not intended to be a statement of broad Tax Commission Policy. It is an interpretation of the tax law as it relates to the facts presented in your request letter and the assumptions stated in this ruling. If the facts or assumptions are not correctly described in this ruling, please let us know so we can assure a more accurate response to your circumstances.

FACTS

COMPANY 1 (COMPANY 1) assembles compressors at their facility in STATE 1. These compressors are either sold to third parties or used in COMPANY 1's compression service business. COMPANY 1 is reorganizing its business structure to create the following three new entities that will be subsidiaries of COMPANY 1:

- 1) COMPANY 2 (Lease Company), which will lease compressors to a related entity through "bare rental" agreements.
- 2) COMPANY 3(Service Company), which will lease the compressors from Lease Company and will provide compression services to third parties.
- 3) COMPANY 1 COMPANY 4. (LEASE COMPANY 2) will lease compressor to COMPANY 1 for use in its compression business.

Both Lease Company and LEASE COMPANY 2 will be disregarded entities for federal income tax purposes.

COMPANY 1 plans to transfer a portion of its current fleet of compressors to Lease Company, and to transfer the remainder to LEASE COMPANY 2. LEASE COMPANY 2 will then lease the compressors to COMPANY 1 for use in its compression business. NAME 2 is understanding of these transactions is that they will be tax free for federal income tax purposes. The entities plan to treat the new contracts as services agreements for federal tax purposes, rather than leases. You have provided a copy of the Master Services Agreement.

APPLICABLE LAW

Utah Code Section 59-12-103(1) imposes the tax on “(a) retail sales of tangible personal property within the state.”

Subsection (k) of that same section imposes tax on “amounts paid or charged for leases or rentals of tangible personal property if within this state the tangible personal property is: (i) stored; (ii) used; or (iii) otherwise consumed;”

Subsection (l) imposes tax on, “amounts paid or charged for tangible personal property if within the state the tangible personal property is: (i) stored; (ii) used; or (iii) otherwise consumed.”

Utah Code Section 59-12-102 (80) defines a "retail sale" or "sale at retail" as a sale, lease, or rental for a purpose other than:

- (a) resale;
- (b) sublease; or
- (c) subrent.

Utah Code Section 59-12-102 (82) (a) defines “sale” as “any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property or any other taxable transaction under Subsection 59-12-103(1).”

Utah Code Section 59-12-102 (82) (b)(v) states that “sale” includes “any transaction under which right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made.”

Utah Code Section 59-12-102(43) states, “(a) ‘lease’ or ‘rental’ means a transfer of possession or control of tangible personal property for: (i) (A) a fixed term; or (B) an

indeterminate term; and (ii) consideration...” Subsection (c) of this same section specifically excludes from the definition of a lease a transaction “providing tangible personal property along with an operator for a fixed period of time or an indeterminate period of time if the operator is necessary for the equipment to perform as designed.”

Utah Code Section 59-12-104(13) provides the following exemption: “(a)...the sale of tangible personal property by a person: (i) regardless of the number of transactions involving the sale of that tangible personal property by that person; and (ii) not regularly engaged in the business of selling that type of tangible personal property.”

Utah Code Section 59-12-104(23) provides an exemption from sales tax for “property stored in the state for resale.”

Utah Code Section 59-12-104(25) provides an exemption from sales tax for “property purchased for resale in this state, in the regular course of business, either in its original form or as an ingredient or component part of a manufactured or compounded product.”

ANALYSIS

Transactions between Service Company and third parties. Under Utah Code Section 59-12-102 (82)(b)(v), and §59-12-103(1)(k), the agreement to provide compressor services to third parties under the Master Services Agreement is, in substance, a taxable rental or lease of compressors subject to Utah sales and use tax. The customer agrees to provide a site for the compressor and to pay a mobilization fee for installing the compressor. Service Company agrees to install a suitable compressor and to maintain it in the necessary operating condition to meet the specifications of the contract. In other words, it ensures that the compressor it provides will perform the necessary task. The agreements are in essence agreements to lease equipment (compressors) to provide compression for a fee in connection with natural gas exploration, production, processing and transportation. The fact that no specific piece of equipment is identified is not dispositive; nor is the fact that Service Company will repair or replace the compressor if it is not performing properly. For sales tax purposes, Service Company is leasing equipment (compressors) to its customers.

For the same reasons, we believe any “compression services” performed by COMPANY 1 under the Master Service Agreement are also subject to sales tax as leases or rentals of tangible personal property.

The lease of compressors from Lease Company to Service Company. As noted above, a taxable “sale” for Utah sales tax purposes includes a lease. Because the Service Companies will be “re-leasing” the compressors to their own customers, the lease of the compressors to Service Company from Lease Company will be a “sale for resale.” Sales for

resale are specifically exempted from tax under Section 59-12-102(25). Accordingly, the lease of compressors from Lease Company to Service Company is exempt from Utah sales tax.¹

The lease of compressors by LEASE COMPANY 2 to COMPANY 1. The lease of compressors by LEASE COMPANY 2 to COMPANY 1 is an exempt sale for the same reasons that the lease of compressors by Lease Company to Service Company is exempt.

Transfers of assets on formation of LEASE COMPANY 2 and Lease Company. The transfer of the compressors from COMPANY 1 to LEASE COMPANY 2 and Lease Company constitute sales of tangible personal property as defined in Utah Code §59-12-102(82). “Sale” is defined as “any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property or any other taxable transaction under Subsection 59-12-103(1), for consideration.” COMPANY 1 is transferring its compressors to LEASE COMPANY 2 and Lease Company in exchange for an ownership interest in each subsidiary. This interest qualifies as valuable consideration.

Although transfers of property pursuant to incorporations or formations of business enterprises are typically exempt as “isolated or occasional sales, this exemption does not apply to transfers of inventory. Under Utah law, a transfer of inventory is never “isolated or occasional.” Therefore, these transfers do not qualify as isolated or occasional sales pursuant to Section 59-12-104(13) because COMPANY 1 is regularly engaged in the business of renting compressors.

However, the transfer of compressors to LEASE COMPANY 2 and Lease Company does qualify for an exemption from sales tax under the resale exemption in Section 59-12-104(25). As noted above, both LEASE COMPANY 2 and Lease Company will be leasing the compressors to their customers in taxable transactions. Accordingly, the transfer of compressors from COMPANY 1 to its subsidiaries, pursuant to the formation of those subsidiaries, is exempt from Utah sales tax.

CONCLUSION

The Master Services Agreement is not a service agreement for the purposes of Utah sales and use tax. Accordingly, both COMPANY 1 and Services must collect sales and use tax on the “services” performed for their customers under the Master Services Agreement. The lease of compressors from Lease Company to Service Company, or from LEASE COMPANY 2 to COMPANY 1, are exempt “sales for resale.” Transfers from COMPANY 1 to COMPANY 1

¹ We note that the law on “disregarded entities” is not well-developed in Utah. As a general proposition, we believe the entities in question are disregarded for federal income tax purposes only. They are still separate entities for sales tax purposes. Sales between a parent and its wholly owned subsidiary are subject to the normal sales and use tax laws. See *Institutional Laundry, Inc. v. State Tax Commission*, 706 P.2d 1066 (Utah 1985). Because the sales are exempt in any event, it is not necessary to rule on this issue in this ruling.

Lease Company and Lease Company on formation of those subsidiaries are also exempt under the resale exemption.

Our conclusion is based on the facts you presented. Should the facts be different from those represented in this letter, our opinion may change accordingly. Thank you for your inquiry into this matter.

For the Commission,

Marc B. Johnson
Commissioner

MBJ/SR/RBJ
06-023