FINAL PRIVATE LETTER RULING

REQUEST LETTER

13-002

March 11, 2013
R. Bruce Johnson
Commission Chair
Utah State Tax Commission
210 North 1950 West
Salt Lake City, UT 84134

Dear Commissioner,

COMPANY 1 ("COMPANY 1") operates an oil refinery in the city of CITY 1. The process of oil refining is a manufacturing process. Crude oil, intermediates, and other petroleum feedstocks are received at the refinery and converted into marketable products that include, but are not limited to, gasoline and diesel fuel. For use tax purposes and per Utah Code Section 59-12-104, COMPANY 1 treats the purchase of all manufacturing equipment having an economic life greater than three years to be exempt from use tax.

In order to correctly determine which refinery assets are part of the manufacturing process, COMPANY 1 Oil relies on the available information provided by the Utah State Tax Commission ("Tax Commission"), including the Utah Code, Administrative Rules, Private Letter Rulings, and general publications. Generally these resources are adequate in helping determine whether a particular asset is considered by the Tax Commission to be part of the manufacturing process.

Occasionally, COMPANY 1 purchases assets that are essential to the manufacturing process of oil refining, but whose use and/or purpose don't obviously fall within or without the legal definitions of manufacturing process as defined by the Tax Commission. COMPANY 1 respectfully requests the Tax Commission to issue a Private Letter Ruling as to whether or not these assets qualify, for use tax purposes, as "machinery and equipment" used in a manufacturing process.

Laboratory Equipment with an economic life greater than three years

Oil refineries cannot operate without access to a laboratory. Most oil refineries, including COMPANY 1, have a laboratory onsite that operates 24 hours per day. The pieces of equipment in the laboratory, such as knock engines, distillation machines, and gas chromotagraphs, are used to test the chemical characteristics of the liquids involved in the manufacturing process—from raw materials such as crude oil, to in-process materials such as intermediate process streams, to finished goods such as gasoline and diesel. This constant testing serves safety, regulatory, and quality control purposes.

The essence of refining oil is inherently dangerous as petroleum is flammable and numerous hazardous chemicals are extracted from, added to, and produced by the crude oil as it is manufactured into marketable products. In addition, hazardous chemicals are used as chemical catalysts in the refining process. As petroleums and chemicals are mixed, heated, and pressurized, it is essential that the operators of the refinery monitor quality, purity, and composition before and during all refining processes. In order for liquids to safely convey through pipes within the manufacturing process, critical chemical specifications must be met. Without a laboratory as part of the manufacturing process, the refining activity would present such a high level of danger to not only employees and refinery equipment, but also to people and property in the vicinity of the oil refinery, that it would be impossible to proceed.

The manufacturing process of oil refining is also heavily regulated by state and federal agencies. A laboratory is critical within the manufacturing process so that the processes and products meet regulatory guidelines. In order to meet regulations issued by the Environmental Protection Agency (EPA), chemical compositions and proportions must be monitored constantly so that chemicals and liquids, some of which are byproducts such as sulphur, can be properly identified, contained, stored and sold or disposed. Product specifications of fuels must meet regulatory standards defined by the American Society for Testing and Materials (ASTM) for octane, cloud point, vapor pressure, and blend composition, all of which are determined via laboratory testing. It would be impossible to manufacture in a legal manner or for finished goods to meet regulatory standards without heavy reliance on the laboratory within the manufacturing process.

COMPANY 1's laboratory is not physically connected to the manufacturing equipment via piping, therefore not every drop of liquid runs through the laboratory; instead, samples of the various pools and liquid streams are obtained by refinery operators and taken to the laboratory where the appropriate testing occurs. On a daily basis, millions of gallons of petroleum products and chemicals flow through the various pipes and units that are part of the manufacturing process at COMPANY 1's refinery. It is unnecessary, not to mention absurdly impractical, for the laboratory to test every drop of liquid that flows through the manufacturing process. Generally accepted scientific standards consider all molecules of a pool or liquid stream to be observed via the observation of a representative sample, so long as the sample is properly obtained and handled.

COMPANY 1 believes that laboratory equipment with a useful life greater than three years is an integral component of the manufacturing process in an oil refinery and meets the definition of "machinery and equipment" in Administrative Rule R865-19S-85(1)(b)(i). Without it, the manufacturing process would be dangerous and unfeasible. All inputs, process streams, and product outputs are tested in the laboratory through statistical sampling. Very few processes within the manufacturing activity proceed without involving the laboratory.

Hydrants and Nozzles used in a Fire Water System

COMPANY 1 is constructing an upgraded fire water system. This involves converting an NUMBER 1 gallon petroleum tank to properly hold water. Piping will connect the water tank to hydrants, nozzles, and hoses placed at each unit of manufacturing equipment used within the

manufacturing process. The hydrants and nozzles have an economic life greater than three years. As the manufacturing process at COMPANY 1 involves hazardous and flammable substances, it is critical that water be readily available to dilute spills and extinguish fires. The manufacturing process would be unsafe to employees and equipment if water were unavailable at all points of the process. COMPANY 1 believes that the hydrants and nozzles in question are essential to the manufacturing process and meet the definition of "machinery and equipment" in Administrative Rule R865-19S-85(1)(b)(i).

Train Engine Used Solely Within the Refinery

COMPANY 1 has purchased a train engine that operates solely on refinery-owned rail trackage and sidings. It is prohibited from using any COMPANY 2 trackage. Its purpose is to move railcars of raw material and finished products internally within the refinery property. Railcars act as a mode of storage, often for several weeks at a time, for crude oil between the time it is delivered by the railroad to the refinery and the time it is offloaded and entered into the manufacturing process. Railcars also act as a mode of storage for finished products before they are delivered to a railroad carrier for shipment. COMPANY 1 believes that the train engine meets the definition of machinery and equipment used for nonmanufacturing activities, but which qualify for the manufacturing exemption if used primarily in manufacturing activities such as the "storage of raw materials, component parts, or finished product" and the "shipment of the finished product" (see Administrative Rule R865-19S-85(3)(b) and (c)).

Conclusion

As noted above, COMPANY 1 respectfully requests the Tax Commission to issue a Private Letter Ruling as to whether or not laboratory equipment, fire water hydrants and nozzles, and the train engine (all of which have useful lives exceeding three years) qualify for use tax purposes as "machinery and equipment" used in a manufacturing process. This ruling will enable COMPANY 1 to continue calculating and remiting [*sic*] its use tax to the state of Utah with accuracy. A limited refinery tour is available to the Tax Commission if it would like to observe first-hand the assets discussed in this request or to speak directly with plant operators and engineers. Also available to the Tax Commission are various resources that may be useful such as refinery schematics, flow diagrams, itemized asset listings, and regulatory manuals. To schedule a visit, access additional information, or ask any questions about the request, please call NAME 1, TITLE 1, at PHONE NUMBER 1.

Thank You,

NAME 1
TITLE 1
COMPANY 1

RESPONSE LETTER

PRIVATE LETTER RULING 13-002

December 10, 2013

NAME 1
TITLE 1
COMPANY 1
ADDRESS 1

Re: Private Letter Ruling Request on Whether the Manufacturing Equipment Exemption, found in Utah Code § 59-12-104(14), would Exempt the Purchases of Certain Refinery Assets from Utah Sales and Use Tax

Dear NAME 1:

In your request letter, you explained that COMPANY 1 ("Company") operates an oil refinery in CITY 1, STATE 1, and you requested a ruling on the applicability of the Utah manufacturing equipment exemption found in Utah Code § 59-12-104(14) ("Exemption") to the purchases of the following refinery assets: (A) laboratory equipment with economic lives greater than three years, (B) hydrants and nozzles used in a fire water system, and (C) a train engine used solely within the refinery. Through subsequent communications, you clarified that you are not requesting the ruling on the railcars. As explained in our Analysis section, the purchases of the laboratory equipment meet the Exemption, but the purchases of the hydrants and nozzles and the train engine do not.

I. Facts

You provided the following facts through your request letter and/or subsequent communications. The Company has a SIC Code of NUMBER 2. Its raw materials primarily include crude oil, but also include partially-refined products and other chemicals that become part of the final products that are sold. The crude oil and partially-refined products arrive by rail, truck, and/or pipeline. Railcars holding raw materials arrive through the COMPANY 2 track and are then moved along the Company's private rail spur by the Company's train engine, which is manually operated by a conductor. The railcars might store crude oil for up to NUMBER OF DAYS, but typically crude oil is processed within one week.

The Company tests all raw materials before they enter the refinery system, but they are not necessarily tested immediately before they enter. For example crude oil might be tested when the railcars or trucks arrive, immediately before the crude oil is offloaded into the system, or

sometime in between. If a raw material fails a test, it will not be entered into the system. Instead, it will be returned to the vendor, resold, or, if possible, blended with one or more chemicals or products that will fix the situation. The testing of raw materials is necessary to ensure safety and prevent wear and tear on the refinery equipment. The Company uses sample testing; every drop of raw material is not directly tested. Every separate batch of raw materials, however, is tested.

After the raw crude is tested, it is offloaded into the refinery system through a rack and moved through piping into a storage tank. From this tank, it is automatically moved through additional piping to the beginning of the refining process.

In-process materials, including intermediate process streams, are also tested through sampling methods at various points in the manufacturing process to ensure safety and meet environmental regulations for air and water. If in-process materials fail a test, they will be either re-refined or diverted into an empty tank and blended with chemicals or products to fix the situation.

The refinery primarily produces gas and diesel fuel, but it also produces as finished goods partially-refined products and byproducts such as asphalt, wax, and sodium. The Company tests every batch of its finished goods to ensure they meet safety and consumer regulations. If a particular batch fails a test, it will be either re-refined or diverted into an empty tank and blended with chemicals or products to fix the situation, similar to how in-process materials are handled. The finished goods must meet the tests before they can be sold. The final testing of gasoline and diesel fuel occurs before the liquid is piped into the final storage tanks.

When the finished gasoline and diesel fuel are sold, they are moved from the final storage tanks, through racks, and into railcars or trucks for delivery to customers. The Company's train engine moves the filled railcars along the Company's rail spur back to the COMPANY 2 railroad. The gasoline and diesel fuel are not again tested while they are in the final storage tanks.

For the testing described above, the Company has a 24-hour, onsite laboratory. About 95% of the laboratory's work consists of statistical sample testing, with 20% for raw materials, 50% for in-process materials, and 25% for finished goods. This statistical sample testing follows generally accepted scientific standards. The remaining 5% of laboratory work consists of testing for research and development or diagnostic purposes. No laboratory equipment is used for purposes other than the testing explained above. Individual pieces of laboratory equipment have approximately the same ratios of use as the percentages provided above for the overall laboratory work.

For the greater safety of its employees and the surrounding community, the Company is expanding its fire water system. It is converting a storage tank to hold recycled water already used in the manufacturing process. From this tank, the recycled water will be sent through underground piping to industrial hydrants and nozzles, which will be installed next to manufacturing equipment throughout the main manufacturing areas. The expanded system will provide more water for the refinery to extinguish fires or to dilute chemical spills. The water is not drinkable and the system will only serve the main manufacturing areas of the refinery. The

Company's fire water system must meet the industry standards issued by the American Petroleum Institute, which when followed help the refinery meet OSHA and EPA safety regulations.

The Company has emphasized that its onsite laboratory and fire water system are essential to the manufacturing process, both to ensure general safety and to meet safety, environmental, and consumer protection regulations.

II. Applicable Law

Utah Code § 59-12-104(14) provides the Exemption, stating the following in part:

The following sales and uses are exempt from the taxes imposed by this chapter:
. . . .
(14) (a) . . . amounts paid or charged on or after July 1, 2006, for a purchase or lease by a manufacturing facility except for a cogeneration facility, of the following:
(i) machinery and equipment that:
(A) are used:
(I) for a manufacturing facility . . .:
(Aa) in the manufacturing process;
(Bb) to manufacture an item sold as tangible personal property; and
(Cc) beginning on July 1, 2009, in a manufacturing facility described in this Subsection (14)(a)(i)(A)(I) in the state; . . .
. . . .
. . . and
(B) have an economic life of three or more years; . . .
. . . .
(e) for purposes of this Subsection (14) and in accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission:
(i) shall by rule define the term "establishment"; and
(ii) may by rule define what constitutes:
(A) processing an item sold as tangible personal property;
(B) the production process, except for the production of real property;
(C) research and development; or
(D) a new or expanding establishment described in Subsection (14)(d) in the state; and
(f) on or before October 1, 2011, and every five years after October 1, 2011, the commission shall:
(i) review the exemptions described in this Subsection (14) and make recommendations to the Revenue and Taxation Interim Committee concerning whether the exemptions should be continued, modified, or repealed; and

(ii) include in its report:
(A) an estimate of the cost of the exemptions;
(B) the purpose and effectiveness of the exemptions; and
(C) the benefits of the exemptions to the state . . .

Utah Code § 59-12-102(64) defines manufacturing facility as follows in part:

For purposes of Section 59-12-104, "manufacturing facility" means:
(a) an establishment described in SIC Codes 2000 to 3999 of the 1987 Standard Industrial Classification Manual of the federal Executive Office of the President, Office of Management and Budget . . .
. . . .

Utah Administrative Code R865-19S-85 states the following, in part:

(1) Definitions:
. . . .
(b) "Machinery and equipment" means:
(i) electronic or mechanical devices incorporated into a manufacturing process from the initial stage where actual processing begins, through the completion of the finished end product, and including final processing, finishing, or packaging of articles sold as tangible personal property. This definition includes automated material handling and storage devices when those devices are part of the integrated continuous production cycle; and
(ii) any accessory that is essential to a continuous manufacturing process. Accessories essential to a continuous manufacturing process include:
(A) bits, jigs, molds, or devices that control the operation of machinery and equipment; and
(B) gas, water, electricity, or other similar supply lines installed for the operation of the manufacturing equipment, but only if the primary use of the supply line is for the operation of the manufacturing equipment.
. . . .
(2) The sales and use tax exemption for the purchase or lease of machinery and equipment by a manufacturing facility applies only to purchases or leases of tangible personal property used in the actual manufacturing process.
(a) The exemptions do not apply to purchases of items of tangible personal property that become part of the real property in which the manufacturing operation is conducted.
(b) Purchases of qualifying machinery and equipment are treated as purchases of tangible personal property under R865-19S-58, even if the item is affixed to real property upon installation.
(3) Machinery and equipment used for a nonmanufacturing activity qualify for the exemption if the machinery and equipment are primarily used in manufacturing activities. Examples of nonmanufacturing activities include:

(a) research and development;
(b) refrigerated or other storage of raw materials, component parts, or finished product; or
(c) shipment of the finished product.

. . . .

III. Analysis

Your request letter concerns a tax exemption. For background, statutes for tax exemptions or tax credits are generally strictly-construed against the taxpayer. See *Parson Asphalt Prods., Inc. v. State Tax Comm'n*, 617 P.2d 397, 398 (Utah 1980) ("[s]tatutes which provide for exemptions should be strictly construed, and one who so claims has the burden of showing his entitlement to the exemption"). Tax credit statutes, like tax exemptions, "are to be strictly construed against the taxpayer." *MacFarlane v. State Tax Comm'n*, 2006 UT 18, ¶11. However, the court did explain in that case, "While we recognize the general rule that statutes granting credits must be strictly construed against the taxpayer, the construction must not defeat the purposes of the statute. The best evidence of that intent is the plain language of the statute." (Citations omitted.) *See id.* at ¶19. The plain language of § 59-12-104(14)(f) shows that the Utah Legislature wants to balance the cost of the Exemption against the benefits of the Exemption to the state.

In general, the Exemption is available to companies that are manufacturing facilities. *See* § 59-12-104(14)(a). Based on the information presented, the Company is "a manufacturing facility," as defined in § 59-12-102(64), because it has a SIC code of 2911. Thus, it can claim the Exemption for purchases and leases meeting the other requirements found in § 59-12-104(14) and R865-19S-85.

Under § 59-12-104(14)(a) to qualify for the Exemption, the Company's purchases or leases must be of machinery or equipment that have an economic life of three of more years and are used in a Utah manufacturing facility in the manufacturing process to manufacture an item sold as tangible personal property. The facts presented show that the laboratory equipment, hydrants and nozzles, and train engine will have economic lives of three or more years, that they will be used in a Utah manufacturing facility, and that the manufacturing facility manufactures items sold as tangible personal property. It is less clear whether *the items presented* are used in the manufacturing process to manufacture the items sold as tangible personal property.

Section 59-12-104(14)(e) authorizes the commission to define by rule what constitutes processing an item sold as tangible personal property and the production process. The commission did so through administrative rule R865-19S-85. Under subsection (1)(b)(i) of R865-19S-85, the commission explained that the manufacturing process includes "the initial stage where actual processing begins, through the completion of the finished end product, and including final processing, finishing, or packaging of articles sold as tangible personal property" and that when automated material handling and storage devices are involved, those devices must be "part of the integrated continuous production cycle" to qualify for the exemption. In subsection (2), the commission explained that the machinery and equipment must be "used in the actual manufacturing process" and must not become part of the real property. Additionally, in

subsection (3), the commission explained that the machinery and equipment must be "primarily used for manufacturing activities" and specified activities that are not part of the manufacturing process; namely: research and development; refrigerated or other storage of raw materials, component parts, or finished product; and shipment of the finished product.

After reviewing the facts about the Company's refinery, the Company's manufacturing process begins when raw materials are entered into the refinery system, after the raw materials are received and tested. For crude oil, that raw material enters the refinery system through racks and is then stored in an initial storage tank. When the finished gasoline and diesel fuel are in the final storage tanks, the Company's manufacturing process has ended for these products. If a piece of equipment is used primarily before or after the manufacturing process described above that equipment does not qualify for the Exemption; this includes those items specifically submitted for review in this private letter ruling—A. laboratory equipment with economic lives greater than three years, B. hydrants and nozzles used in a fire water system, and C. a train engine used solely within the refinery.

IV. Conclusions

The Commission reaches the following conclusions, which are found in subsections A. though C.

A. Laboratory Equipment with Economic Lives Greater than Three Years Qualifies for the Exemption.

The Company's laboratory equipment with economic lives greater than three years qualifies for the Exemption.

The Company's laboratory equipment is "used . . . in the manufacturing process" for purposes of § 59-12-104(14)(a)(i)(A) and is "used in the actual manufacturing process" for purposes of subsection (2) of R865-19S-85 when the equipment is used to test in-process materials and finished goods. The testing results of these items affects how the refinery continues to process or rework the items tested.

However, the laboratory equipment is used for nonmanufacturing activities as well. The Company's testing of raw materials occurs *before* the manufacturing process begins and consists of 20% of the laboratory equipment's use. Additionally, the Company's testing for research and development occurs *independently from* the manufacturing process and consists of 5% of the laboratory equipment's use.

Under subsection (3) of R865-19S-85, the laboratory equipment still qualifies for the Exemption if the equipment is *primarily* used in manufacturing activities. After reviewing the facts presented, the testing of in-process materials, occurring at various points in the manufacturing process, the testing of the finished goods to qualify them to be sold are the primary uses of the laboratory equipment. These areas of testing consist of 75% of the laboratory equipment's use. Thus, the laboratory equipment qualifies for the exemption.

The conclusions found in a prior ruling, Private Letter Ruling ("PLR") 03-018, are consistent with the commission's conclusion for the Company's laboratory equipment.[1] In PLR 03-018, the Commission found that the Exemption applied to machinery and equipment used to test 100% of semiconductors and semiconductor-related products produced. Like the company in PLR 03-018 that directly tested 100% of its individual products, the Company tests every separate batch of its in-process materials and finished goods. Statistical sampling is generally accepted in the Company's industry as a method to indirectly test 100% of the liquids used and produced; thus, the Exemption should not be denied because the Company uses sample testing and does not directly test every drop of a liquid. If the Company simply tested random samples of its output as a quality control measure, as most manufacturers presumably do, the result may be different. Here, as in PLR 03-018, no batch may be shipped until it has been tested.

B. Hydrants and Nozzles Used in a Fire Water System Do Not Qualify for the Exemption.

Because the Company's fire system is installed in a refinery, the hydrants and nozzles do not become part of the underlying real property and they are not excluded from the Exemption based on subsection (2)(a) of R865-19S-85. Fire water systems in other situations, though, could be converted to real property and thus be ineligible for the Exemption.

However, the Company's fire water system equipment still does not qualify for the Exemption. The fire water system equipment serves a safety purpose for the refinery's manufacturing process but is not equipment "used in the manufacturing process" "to manufacture an item sold as tangible personal property" for purposes of § 59-12-104(14) and is not "used in the actual manufacturing process" for purposes of subsection (2) of R865-19S-85.

C. A Train Engine Used Solely Within the Refinery Does Not Qualify for the Exemption.

To qualify for the Exemption, a piece of equipment must be primarily used for manufacturing activities. However, based on the facts presented, the Company's train engine is used primarily to move raw materials and finished products. These are nonmanufacturing activities, under subsection (3) of R865-19S-85. Thus, the Company's train engine does not qualify for the Exemption.

V. Summary

We find that for the purchases of the items you presented, the purchases of the laboratory equipment meet the Exemption, but the purchases of the hydrants and nozzles and the train engine do not. For more direction on the application of the Exemption for other purchases or leases, you may contact the Technical Research Unit of the Utah State Tax Commission at 801-297-7705.

The Tax Commission's conclusions are based on the facts as you described them and the Utah law currently in effect. Should the facts be different or if the law were to change, a different

[1] PLR 03-018 is currently available at http://tax.utah.gov/commission/ruling/03-018.html.

conclusion may be warranted. If you feel we have misunderstood the facts as you have presented them, you have additional facts that may be relevant, or you have any other questions, please feel free to contact the Commission.

For the Commission,

D'Arcy Dixon Pignanelli
Commissioner

DDP/aln
13-002