

9/8/92

MINNESOTA Department of Revenue

**Appeals, Legal Services, and  
Criminal Investigation Division**

Mail Station 2220  
Phone (612) 296-1022

St. Paul, MN 55146-2220  
Fax (612) 296-8229

September 8, 1992

Michele Swanson  
Legislative Commission to Review Administrative Rules  
Room 55, State Office Building  
100 Constitution Avenue  
St. Paul, Minnesota 55155-1201

In re: **Statement of Need and Reasonableness for Capital Equipment Rule.**

Enclosed please find a copy of the Statement of Need and Reasonableness (SONAR) for the proposed rule, published today, which relates to sales and use tax exemption of capital equipment. Minnesota Statute 14.131 provides that we must send you a copy of the SONAR when it is available to the general public. While the statute gives no definite date for sending the SONAR, nor does it say that it must be sent before the proposed rule and notice of hearing are published, I agree that the best policy is to send it to you before publishing. I hope that you were not inconvenienced by waiting. Thank you for calling me with the reminder.

Sincerely,

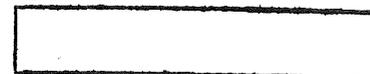


Susan E. Fremouw, Attorney  
Legal Services Section  
(612) 296-1902 Extension 128

SEF:sef:capequip:Legis.Comm. 9/8/92  
Enclosure

The Legislative Commission to  
Review Administrative Rules

SEP 10 1992



(

)

(

STATE OF MINNESOTA  
DEPARTMENT OF REVENUE

In the Matter of the Proposed  
Adoption of the Rule Relating to  
Sales and Use Tax on Capital  
Equipment.

STATEMENT OF NEED  
AND REASONABLENESS

GENERAL STATEMENT

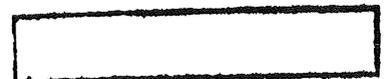
This document has been prepared as a verbatim affirmative presentation of the facts necessary to establish the statutory authority, need for, and reasonableness of the proposed rule. It is submitted pursuant to Minnesota Statutes, section 14.23 (1990) and Minnesota Rules Part 1400.0500 (1989) requiring a Statement of Need and Reasonableness.

A Notice of Intent to Solicit Outside Opinion regarding the Sales and Use Tax on Capital Equipment was published in the State Register on January 16, 1990. The notice specifically mentioned this rule and invited interested persons to submit comments or suggestions in writing to the Department by February 16, 1990. No one submitted written comments within that time. The Sales and Use Tax Committee of the Minnesota State Bar Association Tax Section submitted written comments in July 1990.

This rulemaking proceeding proposes to adopt a permanent rule relating to the Sales and Use Tax on Capital Equipment.

The Legislative Commission to  
Review Administrative Rules

SEP 10 1992



## IMPACT ON SMALL BUSINESS

The impact of this rule on small businesses has been considered. The proposed rule does not impose new filing, or payment requirements on small businesses and therefore is not expected to place any additional financial or administrative burden on small businesses.

All persons (including small businesses) currently possessing a sales tax permit were given written notification of the Department's rulemaking activities, pursuant to Minnesota Statutes, section 14.115, subd. 4 (1990). This notification was first published in the Department's January 1990 quarterly Sales Tax Newsletter which was sent to all permit holders (146,918) in late December 1989, and early January 1990. Subsequent newsletters also published the notification, for example, the April 1991 and November 1991 issues (see attached).

## SPECIAL NOTICE OF RULEMAKING

Pursuant to Minnesota Statutes, section 14.11 (1990), the proposed rule will not require the expenditure of public monies by local units of government and will not have any direct adverse effects on agricultural lands in the state.

## AUTHORITY TO ADOPT RULES

Minnesota Statutes, section 270.06 (1990) grants the Commissioner of Revenue authority to promulgate rules concerning administration and enforcement of the sales and use tax laws.

## RULE ANALYSIS

Through this rule, the commissioner seeks to clarify the scope of the sales tax exemption for capital equipment. Aside from illustrations of what constitutes a manufacturer, examples have been kept to a minimum. Because of the diverse nature of the industries that will be affected, this rule sets out broad interpretive language in an attempt to be applicable to all manufacturers, no matter what their process or product may be.

When drafting this rule, the commissioner was guided by the applicable case law governing statutory interpretation of tax exemptions. It is a well-settled principle that tax exemptions are to be strictly construed against the taxpayer, in favor of the general principle that everything is taxable unless specifically exempt. Ramaley v. City of St. Paul, 226 Minn. 406, 412, 33 N.W. 2d 19, 22-23 (1948); Abex Corp. v. Comm'r. of Taxation, 295 Minn. 445, 451-52, 207 N.W. 2d 37, 41-42 (1973). The commissioner was also guided by the statutory construction canons in Minn. Stat., chapter 645.

### Subpart 1.

This is a general introductory subpart which gives the statutory citation for the exemption and repeats the statutory definition of capital equipment. It is necessary to include the statutory language because the rule frequently refers to specific sections of this definition when interpreting the scope of the exemption.

Subpart 2.

Item A. This item defines the phrase "machinery and equipment" as it is used in the definition of capital equipment. The purpose of this definition is to give taxpayers a clear guideline to use when determining whether a purchase is capital equipment for purposes of the statute. The phrase "machinery and equipment" is interpreted to mean a single category of items, rather than attributing different meanings to the word "machinery" than are attributed to the word "equipment." It is reasonable to interpret "machinery and equipment" as single category of items. First, the term "capital equipment" uses the word "equipment." If the word "machinery" was supposed to be attributed different meaning than "equipment" then the Legislature could have written "capital equipment and machinery." Instead, the Legislature chose to use one word, "equipment," to encompass both machinery and equipment. Second, this interpretation is consistent with the cross referencing found within commonly understood definitions of "machinery" and "equipment" as used in the manufacturing context. See, e.g., Webster's Third New International Dictionary, 1986 ed., Merriam-Webster, which defines "machinery" as "the constituent parts of a machine or instrument; ..equipment, ..., or range of machines." The same dictionary defines "equipment" as "the implements (as machinery or tools) used in an operation or activity." Since machinery can include equipment, and equipment can include machinery, it is reasonable to interpret the phrase "machinery and equipment" as a single category. (For purposes of this statement, hereinafter the use of the term "equipment" means both machinery and equipment as defined in the rule.)

This rule takes the approach that capital equipment must be essential to an integrated process in order to qualify for the exemption. The language of the statute provides that "the capital equipment must be used...to manufacture...a product." The rationale for using the "essential to an integrated process" approach is that if something is not essential, then the manufacturing process can occur without it and thus that item is not "used" as required by the statute.

Many states which have a sales tax also have some type of exemption for manufacturing equipment. These exemptions typically fall into one of two categories: (1)"direct effect" test, or (2) integrated plant theory. Generally, the direct effect test is whether the equipment is used directly in manufacturing, whether it comes into physical contact with the raw material being produced, or is necessary to the operation of other equipment which is clearly used in production, and is in close physical proximity to that other equipment. States which use a "direct effect" approach may differ on the scope of the test, but it generally means used directly in production.

The second category is the "integrated plant" theory, which is currently used by several states including Kentucky and Illinois. This theory initially means a blanket exemption for any property or service used in a manufacturing plant. There are few items which would not be exempt using this theory.

This rule uses a combination of the two theories to take a middle-of-the-road approach. In other words, a piece of equipment does not need to come into direct physical contact with the raw material in order to qualify, but at the same time, there is no blanket exemption for everything used at the manufacturing facility.

It is both reasonable and necessary to take this approach. The statutory definition of capital equipment does not give clear guidance as to which theory was intended by the Legislature. The language merely refers to equipment "used...for manufacturing, fabricating,....," but does not specify how broad this should be. It is clear, however, that the integrated plant theory exceeds the scope of this definition because of the words "used...for manufacturing." If an integrated plant theory was intended, those words would be unnecessary in this definition. If a direct use test was intended, there would have been limiting language to that effect. Instead, the Legislature chose to apply the exemption to that equipment which is used in manufacturing\* and this rule's interpretation of that phrase clarifies the Legislature's intent.

\*For purposes of this statement, the term "manufacturing" includes fabricating, refining, mining, and quarrying whenever it is followed by asterisk.

The definition of the phrase "machinery and equipment" includes equipment used for research and development, design and quality control, and testing activities because they are treated as part of the production

process for purposes of the industrial production exemption found in Minn. Stat., section 297A.25, subd. 9. That exemption governs materials consumed in the production process and provides that "such production shall include, but is not limited to, research, development, design or production of any tangible personal property, manufacturing, ..., refining, ...mining, quarrying...." Given the statutory canon that the various portions of a statute relating to the same subject, or having the same general purpose, are to be read together as one law such that equal importance will be given to each, it is reasonable to conclude that the Legislature intended the same broad scope for both production and manufacturing\* exemptions. Therefore, since research, development, design, quality control, and testing are treated as part of industrial production for purposes of the "materials consumed in production" exemption, it is reasonable and necessary to also include these items as part of production for purposes of the capital equipment exemption.

This definition of the phrase "machinery and equipment" lists seven sets of examples where items do not constitute capital equipment for purposes of the exemption. This is not intended to be an exclusive list, because it is impossible to anticipate all situations which may arise; rather, it is intended to convey an idea of the types of items which are not considered capital equipment for purposes of the exemption. All of the listed items could potentially be used at a manufacturing plant, but since they are not machinery or equipment essential to an integrated process, they do not qualify as capital equipment.

Item B. This item defines materials and supplies which are necessary to construct or install the equipment. Again, to ensure consistent administration of the sales tax laws, the commissioner has looked to the industrial production exemption found in Minn. Stat., section 297A.25, subd. 9 and Minn. Rule section 8130.5500. Minn. Stat., section 297A.25, subd. 9 exempts materials used or consumed in production. Using the statute and rule for guidance, the definition of materials and supplies is limited to those items which are consumed in the construction/installation process, are not capable of reuse, or are not actually reused.

This definition is reasonable because it excludes articles such as cranes, ladders and hand tools, which are not considered "materials" for purposes of the industrial production exemption. Materials and supplies would include items such as chemicals, fuels, petroleum products, and electricity which are specifically listed as materials in the industrial production exemption statute. It is necessary to define materials and supplies in this manner, for consistency and to clarify the statutory intent.

Item C. This item defines manufacturing and also gives an example of what is not manufacturing (repair work). The definition of manufacturing is limited to those processes which result in the creation of new articles or electricity or steam, or convert unusable items into usable ones through reconstructing or rebuilding.

This definition clarifies that manufacturing means a process involving transformation of raw material from one form to another. It includes the generation of electricity and steam, since these are treated as commodities under Minn. Stat section 297A.25, and recognized as such by case law. See, e.g., Minn. Power & L. Co. v. Personal Prop. Tax 182 N.W.2d 685 (Minn. 1970) which recognized electricity as a "manufactured, marketable product."

"Manufacturing" includes the situation where an article is made and sold to be used in manufacturing another article. The manufacturer of electronic power supplies, for example, may be eligible for a capital equipment refund even though the electronic power supplies will not be sold at retail to the general public. Since another manufacturer will incorporate the supplies into television sets which they manufacture and sell to the ultimate consumer, it is reasonable that the equipment which produced the electronic power supplies is exempted as an initial step in the manufacturing process of a product sold at retail.

This definition lists over 30 examples of businesses considered to be manufacturers and over 20 examples of businesses not considered to be manufacturers. This list is not meant to be exclusive because it is impossible to anticipate all situations which may arise, but it is intended to convey an idea of the types of businesses which are considered to be manufacturers and which are not considered to be manufacturers for the purposes of the exemption.

The definition of manufacturing is both necessary and reasonable for many reasons. First, "manufacturing" needs to be defined in order to clarify the scope of the exemption. Second, the definition is reasonable because it is a narrow construction of the statutory exemption, as required under Minnesota law (see citations in introduction under Rule Analysis) and reflects the legislative intent in granting this exemption only to manufacturers, fabricators, refiners, miners, or quarriers.

Third, this definition is consistent with other sales tax provisions relating to the same subject, e.g., Minn. Stat., section 297A.25, subdivision 9. Fourth, it incorporates the elements of the commonly understood definition of manufacturing as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines "manufacturing" as "to make (as raw material) into a product suitable for use" and "to make from raw materials by hand or by machinery," and defines "manufacturer" as "one who changes the form of a commodity or who creates a new commodity," and as "an employer or workers in manufacturing, [especially] the owner or operator of a factory."

Item D. The term "fabricating" is defined here. This language incorporates the elements of the commonly understood definition of fabricating as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines fabricate as "to form by art and labor, [especially] to manufacture, produce," "to form a whole by uniting parts," and "to cause (raw materials or stock) to be manufactured."

It is reasonable to incorporate the term "manufacturing" in the definition of "fabricating," since the dictionary definition includes manufacturing.

Items E and F. The definitions of mining and quarrying clarify the scope of the statutory language which includes mining and quarrying as eligible activities under the capital equipment exemption. The quarrying definition incorporates the elements of the commonly understood definition of quarrying as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines quarrying as "the business, occupation, or act of extracting stone, marble, or slate from quarries," and "quarry" as "an open excavation ususally for obtaining building stone, slate, or limestone." Minn. Stat., section 645.16 provides that the intention of the legislature may be ascertained by considering "laws upon the same or similar subjects" Therefore, the quarrying definition also incorporates the definition found in Minnesota Rules section 7040.0100 (subp. 33) because quarriers should be familiar with the Minnesota Pollution Control Administration's (MPCA's) rules, and because it is a law upon a similar subject.

The mining definition incorporates the elements of the commonly understood definition of mining as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines mining as the process or business of making or working mines, getting ore, metal, or other natural constituents from the earth by digging, pumping, or blasting. Looking to laws upon same or similar subjects, Minnesota Rules section 7040.0100 (subp. 23) describes a mine as an excavation for

minerals; 6130.0200 (subp.8) describes the process of mining for the purpose of "mineland reclamation"; and 6131.0010 (subp.12) describes the process of peat mining for commercial purposes. It is reasonable to incorporate Minnesota Rules sections 7040.0100, 6130.0200, and 6131.0010, to the extent they relate to manufacturing\* a product to be sold at retail, because those in the business of mining should be familiar with the rules of MPCA and the DNR (Department of Natural Resources), and because it is a law upon a similar subject.

Item G The term "refining" is defined here. This language clarifies the scope of the exemption. It incorporates the elements of the commonly understood definition of refining as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines "refine" as "to reduce to a fine, unmixed, or pure state: separate from extraneous matter; free from dross or alloy (refine silver): free or cleanse from impurities (refine sugar)"; and see Webster's New World Dictionary, College Edition, which defines a "refinery" as "an establishment or plant for refining, or purifying, materials such as oil, metal, sugar, fats, etc.."

Item H. The term "facility" is defined to mean a coordinated group of fixed assets. This definition incorporates the elements of the commonly understood definition of facility as evidenced by dictionary definitions. See, e.g., Webster's Third New International Dictionary, which defines "facility" as "something (as a hospital, machinery, plumbing) that is built, constructed, installed, or established to perform some particular function or to serve or facilitate some particular end." The definition is also taken

partly from Generally Accepted Accounting Principles, or GAAP. See A Dictionary for Accountants, by Erick Kohler, 1975 edition, Prentice-Hall, Inc. Since this dictionary was in use at the time of the passage of the capital equipment statute, it is reasonable to use it for assistance in defining "facility." Also, it is appropriate to look to GAAP since virtually all accounting systems operate under GAAP, and thus taxpayers should be familiar with the concept of "facility" as here defined. Furthermore, it is reasonable to presume that the Legislature was aware that accountants would look to a GAAP definition.

The following hypothetical is an example of the "coordinated group of fixed assets" interpretation of the term "facility": A single manufacturing line is housed in two separate buildings.; one of the buildings is torn down and replaced with a new building and new equipment. All of the new equipment is replacement for the old equipment in the old building because the same product is being produced. Under this definition of facility, the new equipment would not be eligible for the refund because the new equipment is replacing equipment performing substantially the same function in an existing facility. (See subpart 4, item A, of this proposed rule.) Since the buildings are a coordinated group of fixed assets, they are considered a single facility for purposes of this rule and the capital equipment exemption. This is a necessary and reasonable interpretation of the word "facility" as used in the statute. The obvious intent of the legislature was to encourage capital expansion in Minnesota. This is evidenced by the statutory requirement of a new or expanded

facility, and the exclusion of replacement equipment and repair or replacement parts. This definition carries out that intent.

Item I. The definition of product is both necessary and reasonable for many reasons. First, "product" needs to be defined in order to clarify that the scope of the exemption is for manufacturing\* tangible personal property to be sold at retail. Second, the definition is reasonable because it is a narrow construction of the statutory exemption, as required under Minnesota law (see citations in introduction under Rule Analysis). Third, this definition is consistent with other sales tax provisions (see below) relating to the same subject.

The term "product" is defined to mean tangible personal property, electricity, or steam. Electricity and steam are included since their generation is treated as industrial production under chapter 297A. This definition is otherwise limited to tangible personal property for several reasons. First, the legislature clearly intended to limit the scope of this exemption through use of the terms manufacturing, fabricating, refining, and by later amendment, mining and quarrying. (Mining and quarrying were added in 1990.) The exemption was enacted in order to stimulate economic development, increase employment, and encourage capital expansion in Minnesota. If the legislature had intended this exemption to apply to equipment other than that which manufactures tangible personal property (aside from the generation of electricity or steam), there would be no need to limit the definition to equipment used in manufacturing. Furthermore, because the Legislature used the term "manufacturing" in

conjunction with "sold at retail," the term "product" must necessarily be restricted to tangible personal property (and electricity or steam).

Pursuant to Minn. Stat. 645.08(3), "general words are construed to be restricted in their meaning by preceding particular words." The word "product" is therefore restricted in its meaning by the preceding particular words "manufacturing"\*. The legislature failed to define the term manufacturing, so in keeping with the canon of statutory construction, Minn. Stat. 645.08(1), manufacturing is limited to the commonly accepted definition which is used in the rule. Given the "common and approved usage" of "manufacturing" as used in the rule, the "product" manufactured could only be tangible personal property.

Since the term "product" in the capital equipment definition, standing alone, is not explicit in its meaning, Minn. Stat., section 645.16 provides that the intention of the legislature may be ascertained by considering "(1) the occasion and necessity for the law; (2) the circumstances under which it was enacted," "(5) the former law, if any, including other laws upon the same or similar subjects," and "(6) the consequences of a particular interpretation."

In 1984, Minnesota offered General Motor's Saturn automobile manufacturing plant a generous package of state tax exemptions and exceptions, in an attempt to get them to build their plant in Minnesota. Minnesota manufacturers, having sustained heavy sales and use tax burdens, voiced their displeasure of the tax benefits offered to Saturn.

Concerned with the effect of negative publicity by disgruntled manufacturers, concerned with keeping these manufacturers from relocating to states with lower sales and use tax rates, and hoping to attract new industries into the state, the Legislature enacted the capital equipment refund statute. The exigencies surrounding the enactment of the statute indicate the type of businesses that the Legislature intended to benefit. Those businesses, like the Saturn Plant, the Ford Motor Plant, or Minnesota Mining & Manufacturing (3M), were manufacturers, fabricators, and refiners of tangible personal property.

Looking to "other laws upon the same or similar subjects", the Department examined the exemption for materials used in industrial production to ascertain and effectuate the intention of the Legislature. The legislature has previously provided manufacturing exemptions in the sales tax chapter, namely the one in Minn. Stat., section 297A.25, subd. 9, for materials consumed in industrial production. That exemption clearly addresses the same subject and by its terms, limits the manufacturing process to persons engaged in the production of tangible personal property. The consequence of using this interpretation is consistency in the sales tax law as it relates to manufacturers.

To qualify for the capital equipment refund, the manufactured product must "be sold at retail." The words "sold at retail" have a particular meaning given to them for purposes of sales and use tax. To ascertain and effectuate the intention of the Legislature in its use of the words "product to be sold at retail" the Department looked to Minn. Stat.

297A.01, subd. 4, which defines "retail sale" as a sale for any purpose other than resale in the regular course of business. The word "sale", under Minn. Stat., section 297A, subd. 3 of 297A.01, encompasses services such as dry cleaning clothes, rustproofing motor vehicles, grooming pets, and lawn care. It also includes the granting of admission to a place of amusement, and the furnishing for a consideration of cable television services. None of the above "sales," however, would be considered a sale of a manufactured product. The only provisions under subd. 3 that would encompass the sale of a manufactured product are subd. 3 (a), "any transfer of...tangible personal property,...and the leasing of...tangible personal property," subd. 3 (b), "the production, fabrication, printing, or processing of tangible personal property," and subd. 3(f), "the furnishing for a consideration of electricity, gas, water, or steam."

Therefore, since the definition of "product" is dependent on the term manufacturing (since the product is manufactured) in conjunction with the definition of "sales" (since the product must be sold at retail), and since a manufactured product "sold at retail" is addressed solely by subd. 3 (a),(b), and (f), "product" could only mean "tangible personal property," "electricity or steam." The consequence of using this interpretation is consistency in the sales tax law as it relates the term "retail sale." to the products of manufacturers.

The commissioner did not incorporate the decision of West Publishing Co. into the definition of product. West Publishing Co. v. Commissioner of Revenue, Minn. Tax Court, Docket No. 5346, July 11, 1990, *affirmed by equally divided Ct.*, 464 N.W.2d 512 (Minn.1991). While the effect of the Minnesota Supreme Court's split decision in West Publishing Co. was to allow West Publishing Company's refund claim for that refund period, the commissioner is not required to follow the decision for future refund claims, since there has been no definitive Supreme Court interpretation of the application of the statute to producers of "intangible" products generally.

The judgment of an equally divided court is as binding on the parties to the particular action as any other judgment, but it is not a precedent in any other case. See 3 Dunnell's Minn. Digest, Appeal and Error § 13.04 (4th ed., 1989) p. 230, citing Jordan v. Northwestern Elec. Equipment Co., 117 Minn. 209, 135 N.W. 529 (1912). For example, in Associated Dry Goods Corp. v. Commissioner of Taxation, 347 N.W.2d 36 (Minn. 1984), the Court points to its 1975 split vote (3 - 3) affirmation, without opinion, of the Tax Court's decision regarding a refund claim of the Associated Dry Goods Corp. Because the prior affirmation was on a split decision, there is no precedent for the Minnesota Supreme Court to follow when it is later presented with a similar Tax Court decision (even when the taxpayer and the issues are the same). As in Associated Dry Goods, the Minnesota Supreme Court affirmed West Publishing Co. on a 3 - 3 split vote and did not issue an opinion. Similarly, the Minnesota Supreme Court has no precedent to follow; and therefore the commissioner is not bound.

### Subpart 3.

This subpart sets out the three part statutory test which equipment must meet to qualify for the capital equipment exemption. The first requirement. The first test interprets the statutory phrase "must be used by the purchaser or lessee" (emphasis added). This subpart sets out that language and gives an example of a situation where the "user" and the "purchaser" are not the same person. In those situations, the capital equipment exemption does not apply, because of the statutory requirement that the equipment be "used by the purchaser" is not met.

This subpart and the statutory limitation are consistent with the general application of sales tax and other provisions of the sales tax law in a construction contract situation. Minn. Stat., section 297A.01, subd. 4 defines a retail sale to include "Sales of building materials, supplies and equipment to owners, contractors, subcontractors, or builders for the erection of buildings or the alteration, repair or improvement of real property...whether or not for the purpose of resale in the form of real property or otherwise." Thus it is clear under the sales/use tax law that the contractors are deemed the purchasers of these items and that they must pay sales/use tax. The building owner is not purchasing the building materials but is purchasing an improvement of real property which is not subject to sales tax. The incidence of and liability for tax rests with the contractor, not the building owner. The definition of capital equipment which requires the equipment to be "used by the purchaser" is consistent with this general principle.

This requirement is also consistent with the statutory refund provisions which require that the person applying for the refund be the one who actually paid and remitted the tax (Minn. Stat., section 289A.50). Since the building owner has not paid any sales tax (other than indirectly through price mark-up by the contractor), and is not liable to the State of Minnesota for sales tax, there is no tax to be refunded. This subpart is both necessary and reasonable because it sets out these facts in clear, understandable language and because it implements the statutory provisions for capital equipment consistent with general sales tax principles and legislative intent. It is presumed that the legislature was aware of the sales tax as it applies to contractors and improvements to real property. The fact that it failed to provide for refunds in the contractor situation evidences an intent to exempt only equipment bought and used by the purchaser. In the past, the legislature has specifically provided for contractor-situation refunds when it intended for those types of purchases to be eligible for an exemption. See Minn. Stat., section 297A.257, subd. 2a and Minn. Stat., and Section 297A.15, subd. 6. Since the legislature chose not to recognize those types of purchases with this exemption, the commissioner cannot expand the statutory exemption by rule.

The second requirement. The second requirement which equipment must meet to qualify for the capital equipment exemption is that the equipment being purchased must be used for one of the qualifying activities specified in the statute. This part also reiterates that furnishing a service does not constitute a qualifying activity, see explanation for subpart 2(c). This part clarifies the tax treatment of equipment which is

used for qualifying and nonqualifying activities, and defines when manufacturing begins and ends. This definition is reasonable because it is consistent with the definition of when manufacturing begins and ends for purposes of the industrial production exemption, see Minnesota Rule 8130.5500, subpart 1. It also clarifies that packaging is considered part of the production process.

Normally, equipment used for activities such as storage and cooling do not qualify for the exemption because those activities occur before or after the actual manufacturing process. This part clarifies that when those types of activities occur within the manufacturing process itself, the equipment can qualify.

The definition of when mining and quarrying begins and ends is set out separately from when manufacturing begins and ends, because of the unique circumstances in the mining and quarrying industries. This definition is consistent with the one used for mining, in Minnesota Rule 8130.5500, subpart 1.

The third requirement. The third requirement which equipment must meet to qualify for the capital equipment exemption is that the equipment be used in the physical expansion of an existing facility or in a new facility. Physical expansion is interpreted to mean new construction, conversion of nonproduction area, or adding new equipment to an existing production line. No percentages have been included in this rule for purposes of defining what qualifies as an expansion, notwithstanding the

fact that the statutory exemption for capital equipment in distressed counties (Minn. Stat., section 297A.257, subd. 2) specifically provides that the purchase of capital equipment qualifies as an expansion of an existing facility when production is increased by 20 percent or more in a distressed county situation. Since the statutory exemption for capital equipment in distressed counties was enacted after the general capital equipment statute, the Legislature could have amended the general capital equipment exemption to parallel the 20 per cent rule for what is an "expansion" in the distressed county provisions. The Legislature, however, chose not to. The commissioner cannot change by rule what the legislature has addressed in the statute.

The "new" facility requirement is interpreted to mean new to the purchaser, and the re-opening of a shut down facility, as well as actual new bricks and mortar construction. Treating previously shut down facilities as new facilities implements the statutory intent to stimulate economic development. The 12-month restriction is reasonable and necessary to prevent sales of on-going or seasonal businesses from qualifying as new facilities. Seasonal or on-going businesses closed for the season are actually existing facilities. As such, their sale will not stimulate economic development, increase employment, or encourage capital expansion in Minnesota.

This subpart is necessary because taxpayers frequently have questions about what is required to qualify for the capital equipment exemption. Therefore, it is important to clearly define the three statutory

requirements and the Department's interpretation of those requirements.

Subpart 4.

This subpart deals with the three restrictions contained within the statutory definition of capital equipment. It is the Department's interpretation of this definition that if a piece of equipment falls within one of these three restrictions, it is fully taxable, even though it may otherwise qualify as capital equipment (used by the purchaser for manufacturing a product in a new/physically expanded facility).

Item A. This item clarifies the statutory restriction involving the replacement of equipment performing substantially the same function in an existing facility. Equipment purchased for this purpose is not eligible for refund. Under this proposed rule, the Department will examine the product being produced, and the functioning of the equipment, when looking at the issue of "substantially the same function." This means that when a piece of replacement equipment produces the same or similar product as the previous equipment, the new equipment does not qualify. When a piece of equipment performs substantially the same function, it will not qualify even though it is faster or more technologically advanced than the previous equipment.

Some states have sales tax exemptions for replacement equipment which performs faster or has increased production. However, in almost all cases, the exemption is explicit in the language of the exempting statute. Minnesota's statute does not contain any allowances for replacement

equipment in an existing facility. This interpretation is necessary and reasonable because it supports the legislative intent to stimulate expansion and economic development. Most replacement equipment inevitably will be able to function faster and increase output over the old equipment. The statutory language would be rendered meaningless if the department interpreted it to include the conjecture that increased production by the new equipment means that the new equipment is not performing substantially the same function as the old equipment. Therefore, to give meaning to the restriction on replacement equipment, speed and increased output cannot be taken into account.

Item B. This item interprets the statutory restriction relating to repair or replacement parts. This rule clarifies the tax treatment of situations where replacement parts are purchased along with the original equipment. These parts are not eligible for a refund because the statute does not condition this restriction on when the replacement part was purchased. The mere fact that it is a replacement part makes it ineligible, by the plain language of the statute. This item also clarifies the distinction between repair and replacement parts. "Replacement" parts includes accessories or upgrades which replace existing accessory parts on a piece of equipment.

Item C. This item interprets the statutory restriction relating to equipment used to receive or store raw materials. Just-in-time inventory systems and flow-through tanks are specifically addressed because taxpayers frequently question whether such systems are exempt or not.

#### Subpart 5. Refund Procedure.

This subpart outlines the refund procedure for capital equipment. It is necessary to describe the refund procedure because of the unique manner in which this exemption is administered. Most exemptions occur at the time of the sale, and no tax is ever paid. Here, the tax is paid as if there were no exemption, and the tax is refunded only upon application by the purchaser. This procedure is mandated by Minn. Stat., section 297.15, subd. 5.

#### Subpart 6. Leases.

This subpart clarifies the tax treatment of a lease of capital equipment. Under Minn. Stat., section 297A.01, subd. 3(a), a lease is considered a purchase for purposes of charging sales tax. Thus sales tax paid on a lease of capital equipment is eligible for the refund if the equipment qualifies under the statute. This item clarifies that the tax must actually be paid before a refund claim can be made. It is necessary to state this in the rule because taxpayers frequently attempt to claim a refund of the tax due on all of the lease payments at the time the lease is signed, even though some or all of the sales tax has not been paid, and will be paid over the term of the lease. Obviously, the tax cannot be refunded until it has been remitted to the state.

Subpart 7. Research, Development and Design.

This subpart clarifies that research, development, and design are part of the manufacturing process. Again, the Department has looked to the provisions of the industrial production exemption for guidance. Since these items are treated as part of the manufacturing process for purposes of that exemption, they are also treated as part of the process here, in order to ensure consistency in the sale tax treatment of manufacturing industries. Persons engaged purely in research and development, however, are not considered manufacturers. To be considered a manufacturer, there also must be a product for sale at retail. The reason for this requirement is that research, development, and design are not normally treated as part of the production process; that is why the legislature specifically mentioned them in the industrial production exemption. While allowing an exemption for equipment used in research, development, and design as part of the production process, it is necessary and reasonable to limit the qualification of research, development, and design equipment to those situations where the equipment is used by a person actually manufacturing a product. This limitation is consistent with the statutory language "capital equipment must be used...for manufacturing...a product to be sold at retail."

This item is reasonable because it ensures consistency in the administration of the sales tax and carries out the legislative intent behind the exemption.

Subpart 8. Use Tax.

This subpart clarifies that use tax on out-of-state purchases is due immediately when the equipment is put to use here, and is due on in-state purchases (where the sales tax was not paid) the month following the purchase. This item is necessary and reasonable because taxpayers frequently do not understand that the use tax is due even though the equipment has not been fully paid for.

Subpart 9. Effective Date.

This provision is needed to notify all taxpayers when the rule is effective and can be relied on.

