MINNESOTA Department of Revenue

June 12, 1995

Maryanne V. Hruby, Director
Legislative Commission to Review Administrative Rules
55 State Office Building
St. Paul, Minnesota 55155-1201

Dear Ms. Hruby:

Enclosed is a copy of the Statement of Need and Reasonableness for the Department of Revenue's proposed rules relating to Sales and Use Tax on Capital Equipment and Replacement Capital Equipment, required to be submitted to your commission pursuant to Minnesota Statutes, section 14.131. The Notice of Hearing on the Proposed Rules will be published in the June 12th edition of the *State Register*.

Please contact me if you have any questions.

Sincerely,

Linda J. Geier, Attorney
Appeals & Legal Services Division
296-1902, ext. 116

Enclosure

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 and Replacement
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 (1992), and Minnesota Rules Part 1400.0500 (1993) 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 July 18, 1994. This notice specifically mentioned this rule and invited interested persons to submit comments or suggestions in writing or verbally by telephone or in person to the Department of Revenue by August 15, 1994. Thirteen verbal comments and two written comments were received within that time. An additional 14 verbal comments and three written comments were received before or after the comment period.

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

AGENCY TESTIMONY

The department will be represented at the hearing scheduled for July 18-19, 1995 by Mr. Greg Heck (who will do a presentation on the history of capital equipment) and by Ms. Mary Blackburn (who will do a presentation on the highlights of the proposed rule).

IMPACT ON SMALL BUSINESS

The impact of this rule on small business 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. Minnesota Statutes, section 14.115, subdivision 2, outlines the criteria that an agency must consider when proposing a new rule that may impact on small businesses. Each of those items were considered, as listed below.

"The establishment of less stringent compliance or reporting requirements for small businesses." Since the inception of the capital equipment rule in 1984, the filing requirements have been the same for all business, and require that each business must fully document the refund amounts requested, and provide evidence of payment of the tax. Prior to July 1, 1994, the department required all businesses to submit a detailed schedule of the amounts claimed; a detailed description of the property purchased and how it will be used in production; a description of the taxpayer's business activities; copies of invoices, purchases orders, and credit memos relating to the claim; copies of the entire lease(s) involved with the claim including all schedules; copies of use tax accrual sheets; and copies of canceled checks showing payment. As of July 1, 1994, the department no longer requires copies of canceled checks or copies of purchase orders. In addition, copies of invoices relating to items being claimed for the replacement capital equipment reduction are also not required.

"The establishment of less stringent schedules or deadlines for compliance or reporting requirements for small businesses." The filing requirements are set by statute for all taxpayers, and not by the department. Each refund request must be filed either within two years of payment of the tax to the commissioner or within three and one-half years of the date the tax was due to be reported to the commissioner, whichever period is longer. Should a taxpayer (who has not previously filed a capital equipment claim) become aware of the capital equipment exemption, the department will allow the taxpayer to file a protective claim in excess of $1.00 to protect any statutory periods that may expire while the taxpayer gathers the documentation required to support the refund. The taxpayer will be sent a letter requesting the supporting documentation within 60 days, and advising the taxpayer that, under statute, interest on the refund amount will not begin to accrue until all supporting documentation has been received by the department. The letter further states that if the information has not been received within 60 days, the department may deny the refund request, and which time the taxpayer will lose the protected periods. The department makes this option available to any business, regardless of size, who contacts us because they may lose statutory periods while preparing the necessary supporting documentation.

"The consolidation or simplification of compliance or reporting requirements for small business." As with subitem (a), the filing requirements for all business were made less stringent beginning July 1, 1994. Due to the limitation of two claims for capital equipment and/or replacement capital equipment per year, as provided for in statute, all businesses are allowed to file multiple tax types (sales, use, city or county) on one claim. Each claim may cover the full period refundable under statute, multiple purchases, and both capital equipment and/or replacement capital equipment purchases.

"The establishment of performance standards for small businesses to replace design or operational standards required in the rule." This item does not apply to the rule that is being proposed.

"The exemption of small businesses from any or all requirements of the rule." The proposed rule follows statutory language and restrictions, and is the same for all businesses. Any restriction or requirement found in the statute applies equally to all taxpayers. It is one of the goals of this department that all taxpayers are to be treated fairly and equally under the provisions of the tax laws that are administered, unless otherwise provided for by statute.

Pursuant to Minnesota Statutes, section 14.115, subdivision 4 (b) (1992), a news release was sent on June 12, 1995 to newspapers in the state. In addition, a copy of the news release was also sent to organizations and associations which represent small business interests.

SPECIAL NOTICE OF RULE MAKING

Pursuant to Minnesota Statutes, section 14.11 (1992), the proposed rule will not require the expenditure of public moneys by local units of government and will not have any adverse effects on agricultural lands in the state.

AUTHORITY TO ADOPT RULES

Minnesota Statutes, section 270.06, clause 14 (1994), grants the Commissioner of Revenue the 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 and the rate reduction for replacement capital equipment. 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. To provide for additional clarity for areas that may be potentially confusing due to the broad interpretation necessary, numerous examples have been provided that are general in nature so as to be applied to a majority of the manufacturers involved.

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, as shown in Ramaley v. City of St. Paul, 226 Minn. 406, 412, 33 N.W. 2d 19, 22-23 (1948) and Abex Corp. v. Commissioner 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 Minnesota Statutes, chapter 645.

Subpart 1. General Information.

This is a general introductory subpart which gives the statutory citation for the capital equipment exemption and the replacement capital equipment reduction. It is necessary to include these cites because the rule relates to specific sections of these statutes when interpreting the scope of the exemption or reduction.

It is also reasonable to include a separate statement indicating that items which do not qualify as capital equipment may qualify as replacement capital equipment as Subparts

3 and 4 specifically define what is, and is not, capital equipment. Even though an item does not qualify as capital equipment, it may still qualify for the replacement capital equipment reduction as in the example of accessories to existing capital equipment.

In addition, it is also reasonable to include a separate statement which clarifies that a retail sale includes more than just sales to the ultimate consumer (such as between a retailer and their customer) since many individuals would not consider a sale between manufacturers to also be included within the definition of a retail sale. This provision is consistent with the definition of a retail sale as found under Minnesota Statutes, section 297A.01, subdivision 4.

Subpart 2. Definitions.

Item A. This item defines the term "accessories" as it is used in the definition of capital equipment and replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivisions 16 and 20 (1994). It is necessary to define this term to give taxpayers a guideline to use to determine whether a purchase/lease qualifies as capital equipment or replacement capital equipment.

This definition is reasonable since it is consistent with commonly understood definitions, as evidenced by dictionary definitions. See *Black's Law Dictionary, Deluxe Centennial Edition, 1990 ed.* which defines an accessory as "anything which is joined to another thing ... or which accompanies it, or is connected with it as an incident, or as a subordinate, or which belongs to or with it: ... aiding or contributing in a secondary way or assisting in or contributing to as a subordinate", and see *Webster's Third New International Dictionary, unabridged, 1986 ed.* which defines an accessory to include "a thing of secondary or subordinate importance (as in achieving a purpose or an effect): ... an object or device that is not essential in itself but that adds to the beauty, convenience, or

effectiveness of something else: ... aiding or contributing in a secondary or subordinate way: ... supplementary or secondary to something of greater or primary importance."

Second, it is reasonable to define "accessories" in this manner as Minnesota Statute, section 297A.01, subdivision 16(b) (1994) excludes subsequent types of purchases/leases from qualifying as capital equipment. By including the phrase "capital equipment does not include ... accessories .. whether purchased before or after ... equipment placed into service", in Minnesota Statute, section 297A.01, subdivision 16 (1994), the legislature clearly did not intend to include any subsequent purchases of accessories to qualify as capital equipment. It is also necessary and reasonable to define this term so as to provide taxpayers with a basic definition upon which to base their determinations.

While the statute specifically states that "capital equipment does not include ... accessories .. whether purchased before or after ... equipment placed into service", it further states that "accessories are treated as capital equipment only to the extent that they are part of and are essential to the operations of the machinery or equipment as initially purchased." It is reasonable, then, to include as qualifying capital equipment purchases accessories purchased prior to the qualifying capital equipment provided they are essential to the operation of the qualifying equipment or machinery.

Item B. This item defines the term "equipment" as it is used in the definition of capital equipment and replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivisions 16 and 20 (1994). While the statute specifically defines this term, it is necessary and reasonable to include the term in the rule again so that taxpayers relying only upon the rule can find a definition for the term in the rule itself without the need to go to another source.

Item C. This item defines the term "fabrication" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). While the statute specifically defines this term, it is necessary and reasonable to include the term in the rule again so that taxpayers relying only upon the rule can find a definition for the term in the rule itself without out the need to go to another source. It is also necessary and reasonable to include the example so as to provide taxpayers with a clear example of fabricating, as used in the definition.

Item D. This item defines the term "foundation" as it is used in the definition of replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 20 (1994). It is necessary and reasonable to provide this definition as all foundations do not qualify for reduction, only those used for the installation and operation of capital equipment.

Item E. This item defines the term "generation of electricity or steam" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). It is necessary and reasonable to include this definition as many utilities believe that transformers and substations qualify as capital equipment. Shortly after the comment period expired, correspondence was received from United Power Association (UPA). UPA took the position that generation of electricity is a four-step process. Step one is the initial generation of electricity at 13,800 volts at a generating station. Step two is when the electricity travels to a step-up transformer where the voltage is brought up to 230,000 volts. Step three is when the electricity comes into the transmission substation where it is brought down to 69,000 volts. Step four is where the electricity arrives at a distribution substation for delivery to UPA's cooperatives, and the voltage is brought down to 12,470 volts.

In addition, there are several appeal matters pending specifically on this issue. One of the arguments to support the appeal was that after the electricity was generated, it became tangible personal property and therefore was continuously being refined during the transmission and distribution stages

The definition is reasonable because the statute limits the capital equipment exemption for the electric utility industry to machinery and equipment used to generate electricity. Transformers and substations used in the transmission and/or distribution of electricity are not generating electricity on their own, and therefore do not qualify as capital equipment. No other industry is allowed to claim delivery equipment as the exemption is limited to equipment that is essential to the integrated production process. Delivery of the product, while essential to the business operation, is not essential to the production of that product.

It is reasonable to assume that if electricity and steam were tangible personal property, there would have been no need for the legislature to specifically provide statutory language that capital equipment exemption extended to machinery and equipment used to generate electricity or steam.

Support for the reasonableness of the definition can be found in many places, beginning with *Webster's Third New International Dictionary, unabridged, 1986 ed.* This dictionary defines "distribution" as "the act or process of distributing: ... delivery or conveyance (as of newspapers or goods) to the members of a group: ... the part of an electric supply system between bulk power sources (as generating stations or transformations stations tapped from transmission lines) and the consumers' services switches." It defines "generate" as "to originate (something material) by physical or

chemical process : PRODUCE <would ~ a tremendous amount of electricity - *Collier's Yr. Bk.*>" It defines "transmission" as "an act, process, or instance of transmitting." Last, it defines "transmitting" as "to admit the passage of : CONDUCT <glass ~s light> <metals ~ electricity> ... to cause to go or be conveyed to another person or place : SEND."

Minnesota Rules Part 4400.0200, subparts 8-10, define high voltage transmission line as "a conductor of electric energy and associated facilities" while defining a large electric power generating plant as "electric power generating equipment." The definition for large electric power facilities means "high voltage transmission lines and large electric power generating plants." Clearly, under Minnesota Rules Part 4400.0200, subparts 8-10, two separate types of activities are defined - the generation of electricity, and the distribution of that electricity. It is reasonable, therefore, to distinguish between generation, transmission, and distribution in Item E.

In addition, Minnesota Statutes, section 216B (Public Utilities) and federal regulations distinguish between equipment that generates, that transmits, and that distributes. Minnesota Statutes, section 216B.10, subdivision 1, states that if a public utility maintains its accounts in the manner prescribed by a federal agency, it shall be deemed to be in compliance with the manner prescribed by the Minnesota Public Utilities Commission. Under federal guidelines, as demonstrated in *FERC Form No 1: ANNUAL REPORT OF MAJOR ELECTRIC UTILITIES, LICENSEES AND OTHERS (ed. 12-92)*, the utilities must provide separate balance sheet classifications by plant/activity for their equipment:

- their production plant, listing the various types of production plants such as steam, nuclear, hydraulic, or other (which includes boiler equipment, engines and engine-

driven generators, turbogenerator units, reactor plant equipment, water wheels and turbines, as well as miscellaneous plant equipment);

- their transmission plant (which includes transmission station equipment, towers and fixtures, poles and fixtures, overhead conductors and devices, underground conduits, underground conductors and devices);
- their distribution plant (which includes distribution station equipment, storage battery equipment, poles, towers and fixtures, overhead conductors and devices, underground conduit, underground conductors and devices, line transformers, services, meters, street lighting and signal systems);
- their general plant (which includes office furniture and equipment, transportation equipment, stores equipment, tools, shop and garage equipment, laboratory equipment, power operated equipment, and communication equipment).

Further evidence of this distinction between activities can be found in other sources. In *Federal Regulation of Energy (1983)* by William F. Fox, Jr. In chapter 30, Mr. Fox states that "electricity is one form of energy that cannot be stored," and he goes on to describe the electricity fuel cycle as "a process by which electricity generated in a power plant is moved through high voltage transmission lines and transformer substations (which are able to reduce the voltage as necessary) to local distribution points, and finally to the ultimate consumer." Minnesota Rules Part 8130.5500 (Agricultural and Industrial Production - Sales Tax Exemption) states that if the product is not placed into inventory, then the production process ends when the last process prior to beginning shipping activities has been completed. Finally, according to *Energy Law Service, Vol. 2, Monograph 5A (1979)*, the generation of electricity costs ends "with its delivery to the 'bus bar'." There is nothing in the statutes that indicate that the legislature intended to include delivery, transmission, or distribution equipment as part of the exemption provided for by Minnesota Statutes, section 297A.01, subdivision 16.

Item F. This item defines the phrase "integrated production process" as it is used in the definition of capital equipment and replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivisions 16 and 20 (1994). It is necessary to define this term since Minnesota Statutes, section 297A.01, subdivision 16 (1994), specifically excludes any equipment that is not essential to the integrated production process.

This definition is reasonable as it incorporates commonly defined terms as evidenced by dictionary definitions, see *Black's Law Dictionary, Deluxe Centennial Edition, 1990 ed.* which defines integral as a "term in ordinary usage means part of or constituent component necessary or essential to complete the whole." It also defines process as "a series of actions, motions, or occurrences; progressive act or transaction; continuous operation; method, mode, or operations, whereby a result or effect is produced; normal or actual course of procedure: ... process is mode, method, or operation whereby a result is produced; and means to prepare for market or convert into marketable form."

In addition, *Webster's Third New International Dictionary, unabridged, 1986 ed.* defines integrated as "composed of separate parts united together to form a more complete, harmonious, or coordinated entity: ... operating economically as a single coordinated physically interconnected unit or system: ... characterized by possession of sources of supply and continuous control of production and often distribution from raw materials to diversified finished products." It also defines process as "a progressive forward movement from one point to another on the way to completion: the action of passing through continuous development from a beginning to a completed end: the action of continuously going along through each of a succession of acts, events or developmental stages."

While several other states, such as California or Illinois, use broader definitions, it is necessary and reasonable to define this phrase in this manner given the statutory restrictions provided for in Minnesota's statutes. While the statute does not provide for a definition of this phrase, the legislature provided specific restrictions as to how broadly the department may interpret the phrase, as evidenced by Minnesota Statutes, section 297A.01, subdivision 16, paragraphs (c), (d), and (e) (1994). This position is supported by changes in Minnesota Statute, section 297A.01, subdivision 16 (1994) which require that the equipment and machinery must be essential to the production process, and that the equipment and machinery must be used primarily to manufacture, fabricate, mine, or refine tangible personal property to be sold ultimately at retail.

Shortly after the comment period expired, correspondence was received from persons representing Unisys Corporation. A portion of the Unisys Corporation comment asks that consideration be given to expanding the definition of the integrated production process to encompass "order entry, order processing, manufacturing, distribution, and customer service and repair." Of the activities listed, only manufacturing falls within the production process as it is currently used under Minnesota Rule Part 8130.5500. The other activities are administrative services, support operations, or distribution after production has ended.

Item G. This item defines the term "machinery" as it is used in the definition of capital equipment and replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivisions 16 and 20 (1994). It is needed to clarify the scope of the statutory exemption for "machinery." The definition is reasonable because it is a narrow construction of the statutory exemption, as required under Minnesota law. (See citations under Rule Analysis.)

The examples of what is not capital equipment within the restrictions provided by the statute are reasonable since they are clarifications of the statutory restrictions, as well as past audit practices that the department has adhered to in applying the law since the capital equipment statute became effective in 1984. All of the items listed could potentially be used at a manufacturing plant, but since they are not equipment or machinery essential to an integrated production process, they do not qualify as capital equipment. This is not intended to be an exclusive list because it is impossible to anticipate all situations that may arise, but it is intended to convey an idea of the types of purchases which are considered to not be qualifying purchases of capital equipment for the purposes of the exemption.

Item H. This item defines the term "manufacturing" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). This definition is needed to clarify the scope of the statutory definition of "manufacturing." It is reasonable to limit the definition to those processes which result in the creation of new articles of tangible personal property, or the conversion of unusable items into usable ones through reconstruction or rebuilding since it is a narrow construction of a statutory exemption. The item clarifies that manufacturing means a process involving the transformation of raw materials from one form to another.

"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 if the articles produced and sold to another manufacturer will be incorporated into an article that will ultimately be 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 inclusive because it is impossible to anticipate all situations that 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 several reasons. First, "manufacturing" needs to be further defined in order to clarify the scope of the exemption/reduction. Second, it reflects legislative intent to limit this exemption only to manufacturers, fabricators, miners, and refiners. Last, this definition is consistent with other sales tax provisions relating to industrial production such as Minnesota Statutes, section 297A.25, subdivision 9, and Minnesota Rules Part 8130.5500.

Item I. This item defines the phrase "materials and supplies" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). It is necessary and reasonable to restrict the definition in the manner provided, since the statute clearly states that the exemption is only for machinery and equipment used in an integrated production process.

Item J. This item defines the term "mining" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). While the statute specifically defines this term, this definition is needed to clarify the scope of the statutory definition. It is necessary to define the term in this manner due to the changes in Minnesota Statutes, section 297A.01, subdivision 16 in the years following 1984. Regarding "mining", the statute was amended in 1990 to specifically include mining and quarrying in the list of qualifying activities, and also stated that, for purposes of that

subdivision, mining included peat mining. The statute was amended again in 1994, and removed quarrying from the list of qualifying activities, but defined mining to mean "the extraction of minerals, ores, stone, and peat."

The definition is reasonable as it incorporates commonly defined terms as evidenced by dictionary definitions, see *Black's Law Dictionary, Deluxe Centennial Edition, 1990 ed.* which defines a mine to mean "a pit or excavation in the earth from which substances (as ores, precious stones, or coal are taken, ... to dig in the earth." It defines quarry to mean "an open excavation usu. for obtaining building stone, slate, or limestone, ... to remove fragments of rock."

Item K. This item defines the phrase "on-line data retrieval system" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). This definition is needed to further clarify the scope of the statutory definition. It is necessary to provide this definition since Minnesota Statutes, section 297A.01, subdivision 16, was changed in 1993 to add the phrase "for electronically transmitting results retrieved by a customer or an on-line computerized data retrieval system" to the list of qualifying activities.

It is reasonable to restrict the exemption to those who manufacture or refine information since the capital equipment exemption is generally available only to manufacturers, fabricators, miners, and refiners. Furthermore, it is reasonable to restrict the exemption to exclude any systems which are in any way subject to data privacy provisions because the statutory language states specifically that the exemption is limited to systems "whose cumulation of information is equally available and accessible to all its customers."

It is reasonable to use the example provided since it demonstrates an activity which would qualify for exemption. This example was needed since the department has received requests for the capital equipment exemption for such activities as stock market quotes, oil prices, tax return preparation, and land-based cellular services. In each instance, the party claiming the exemption was not engaged in manufacturing, fabricating, or refining a product as part of an on-line data retrieval system.

Item L. This item defines the term "refining" as it is used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). This definition is needed for clarification of the term "refining," including as it is used specifically for on-line data retrieval systems in Item K. This definition is necessary because it is consistent with the changes made to Minnesota Statutes, section 297A.01, subdivision 16, in 1993. It is the Department's view that the statutory changes were made to clarify the department's position when this rule was last proposed in 1992.

It was the Department's position then that the equipment must be used to manufacture, fabricate, mine, quarry, or refine tangible personal property for sale at retail. However, the legislature also added the phrase "for electronically transmitting results retrieved by a customer or an on-line computerized data retrieval system" to the list of qualifying activities. It is the Department's opinion that this language was specifically added to allow West Publishing Company to continue to claim equipment used in its WESTLAW service as provided for in West Publishing Co. v. Commissioner of Revenue, (Minn. Tax Ct. Dkt. No. 5346, July 11, 1990) aff'd without opinion by equally divided Court, 464 N.W. 2d 512 (Minn. 1991).

This clarification is reasonable because it is consistent with the findings in West Publishing Co. v. Commissioner of Revenue, (Minn. Tax Ct. Dkt. No. 5346, July 11, 1990)

aff'd without opinion by equally divided Court, 464 N.W. 2d 512 (Minn. 1991). In that decision, the court held that the equipment used for the WESTLAW service qualified for the capital equipment reduction because the taxpayer was deemed to have been manufacturing or refining a product, and because if the material had been printed as marketable published material, the same equipment along with the related printing equipment would have qualified.

Item M. This item defines the phrase "repair or replacement parts" as it is used in the definition of capital equipment and replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivisions 16 and 20 (1994). While the statute specifically references this term, it is necessary and reasonable to include the term in the rule again so that taxpayers relying only upon the rule can find a definition for the term in the rule itself without out the need to go to another source.

Item N. This item defines the phrase "special purpose buildings" as it is used in the definition of replacement capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 20 (1994). It was necessary to define this term to provide examples of the types of buildings which qualify for the replacement capital equipment reduction thereby giving guidance to taxpayers. Clearly, the legislative intent was to restrict this reduction in some manner, because building materials in general do not qualify as capital equipment. In fact, building materials are specifically listed as an exclusion from the definition of capital equipment, under Minnesota Statutes, section 297A.01, subdivision 16(c)(4) (1994).

This definition is reasonable because it restricts the rate reduction to buildings that are essential and necessary to the production process and whose primary purpose is for the production process itself. This definition is consistent with the concept of "special

purpose" property found in published California Court of Appeal opinions relating to fixtures and property taxation. (Crocker National Bank V. City and County of San Francisco (1989) Cal.3d 881; Southern Cal. Tec. Co. V. State Board (1938) 12 Cal.2d 127; Allstate Ins. Co. v. Los Angeles State Board (1984) 161 Cal.App.3d 877.) It is the Department's opinion that this definition of "special purpose" buildings was the definition intended by the legislature in using that term in the statute. General purpose buildings are defined and interpreted in this subdivision to provide contrast to special purpose buildings.

This subdivision also interprets the statute as applied to multi-use or multipurpose buildings. The subdivision sets forth a requirement that "80 percent or more" of the net floor area of a taxpayer's building be "special purpose" in order for the entire building to be considered to be special purpose for purposes of the regulation. Since the statute is silent on the application of the "special purposes" concept to multi-use properties, the Department has proposed an interpretation that will prevent the concept from being misapplied to mere sub-areas within general purpose buildings. Based upon the express language of the statute and general principles of narrow statutory construction in the case of tax exemptions, it is the Department's opinion that the legislature intended to narrowly construe and limit the replacement capital equipment reduction to "special purpose buildings" and not to extend the reduction to fractional portions of buildings that do not otherwise qualify as "special purpose."

In the Department's opinion, if the "non-special purpose" use in a multi-use building amounts to 20 percent or less of the entire floor area, the entire building can reasonably be considered to be "special purpose" for purposes of the reduction. However, any greater percentage of non-qualifying use over and above 20 percent cannot properly be considered to be de minimis for purposes of this regulation.

This subdivision also defines and interprets the following terms: "research facility used during the integrated production process" and "storage facility used during the production process." "Research facility used during the integrated production process" is defined so as to clarify that it does not include research facilities used primarily prior to or after completion of the manufacturing process. "Storage facility used during the production process" is defined so as to clarify that it includes such items as oil and gas storage tanks and grain storage bins used during the manufacturing process, but does not include any storage facility that is used primarily prior to or after completion of the manufacturing process.

Finally, this subdivision clarifies that the determination of whether a building qualifies as special purpose is to be made separate and apart from the determination of whether a foundation qualifies for the replacement capital equipment reduction. This interpretation follows from the Department's opinion that the statute's separate use of the terms "foundation" and "special purpose buildings" mandates that each be separately and respectively considered for qualification for the replacement capital equipment exemption under this subdivision.

Item O. This item defines the phrases "support operations" and "administrative purposes" as they are used in the definition of capital equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). It is necessary to define these phrases as the statute specifically excludes equipment and machinery used for this purpose from the capital equipment exemption. The definitions is reasonable because it incorporates the elements of the commonly understood definition of "support operations" and "administrative purposes" as evidenced by dictionary definitions. For the definition of "support operations", see *Black's Law Dictionary, Deluxe Centennial Edition, 1990 ed.* which defines support to mean "to furnish what is wanted; available aggregate of things

needed or demanded; anything yielded or afforded to meet a want; the act of furnishing with what is wanted." It further defines support as the "furnishing funds or means for maintenance; to maintain; to provide for; to enable to continue; to carry on: ... to provide a means of livelihood. To vindicate, to maintain, to defend, to uphold with aid or countenance."

In addition, *Webster's Third New International Dictionary, unabridged, 1986 ed.* defines support as "to give assistance to by providing supplies, serving as a reserve: ...to supply with the means of maintenance or to earn or furnish funds for maintaining: ... to maintain in condition, action, or existence." The list of activities included are reasonable as they are commonly understood to be support operations or activities.

For the definition of "administrative purposes" see *Black's Law Dictionary, Deluxe Centennial Edition, 1990 ed.* which defines administration as "management or conduct of an office or employment; the performance of executive duties of an institution, business, or the like: ... direction or oversight of any office, service, or employment"; and see *Webster's Third New International Dictionary, unabridged, 1986 ed.* which defines administration as "performance of executive duties: MANAGEMENT, DIRECTION: ... the principles, practices, and rationalized techniques employed in achieving the objectives or aims of an organization." The list of activities included are reasonable as they are commonly understood to be administration or office activities.

Subpart 3. Qualifying Capital Equipment.

This subpart sets out the three-part test which equipment must meet to qualify for the capital equipment exemption as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). While the statute mentions these requirements, it is necessary to include them in the rule to clarify the first and second requirements.

The first requirement. The first test interprets the statutory phrase "used by the purchaser or lessee," as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). This item 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 the statutory requirement that the equipment or machinery must be "used by the purchaser or lessee" is not met.

Under Minnesota Statutes, section 297A.01, subdivision 16 (1994), legislative intent is clearly shown through the inclusion of paragraph (e), which states that "the person who purchases or leases the machinery or equipment must be the one who uses it for the qualifying purpose." This item and the statutory limitation are also consistent with the general application of sales tax and other provisions of the sales tax law in a construction contract situation. Minnesota Statutes, section 297A.01, subdivision 4 (1994), 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 and use tax law that the contractors are deemed the purchasers of these items and that they must pay the sales or use tax. The building owner is not purchasing the building materials, but is purchasing an improvement to real property which is not subject to sales tax. The incidence of and liability for the tax rests with the contractor, not the building owner. The definition of capital equipment which requires the equipment to be "used by the purchaser or lessee" is consistent with this general principle. In addition, this definition is consistent with other sales tax provisions relating to the treatment of contractor purchases, such as Minnesota Rule Part 8130.1200.

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/or remitted the tax (Minnesota Statutes, section 289A.50 and section 297A.15, subdivision 5). 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 or use tax, there is no tax to be refunded to the owner. This subpart is both necessary and reasonable because it sets out these facts in clear, understandable language, and because it reconciles the statutory provisions for capital equipment with general sales tax principles and legislative intent.

The second requirement. The second test interprets the statutory phrase "used ... primarily for manufacturing, fabricating, mining, or refining tangible personal property to be sold ultimately at retail and for electronically transmitting results retrieved by a customer of an on-line computerized data retrieval system," as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). This item provides that furnishing a service does not constitute a qualifying activity. This item 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 manufacturing as set forth in Minnesota Statutes, section 297A.01, subdivision 16(d)(4) (1994), as well as the definition of when manufacturing begins and ends for the purposes of the industrial production exemption (Minnesota Rule Part 8130.5500, subpart 1). This item also clarifies that packaging of the individual product 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 production

process. This item clarifies that when those types of activities occur within the manufacturing process itself, the equipment can qualify.

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

The third requirement. This item merely states that the equipment must be "essential to the integrated production process." This item is necessary since the purpose of this subpart is to lay out the requirements necessary to qualify as capital equipment. Minnesota Statutes, section 297A.01, subdivision 16(b)(7) (1994), specifically excludes from the capital equipment refund any equipment or machinery "that is not essential to the integrated process of manufacturing, fabricating, mining, or refining."

It is important to clearly define the requirements and the department's interpretation of requirements one and two. In addition, its subitems are necessary because they state the types of activities which may qualify for the capital equipment exemption. This is necessary to ensure that taxpayers include equipment and machinery used in these activities. Taxpayers often believe the exemption is limited only to actual equipment used in direct production.

Subpart 4. Nonqualifying Capital Equipment.

This subpart deals with the first six specific restrictions contained within the statutory definition of what capital equipment does not include as found in Minnesota Statutes 1994, section 297A.01, subdivision 16 (1994). It is the department's interpretation of this definition that if a piece of equipment or machinery falls within one of these six

restrictions, it is fully taxable. This subpart does not deal with Minnesota Statutes, section 297A.01, subdivision 16(c)(7) (1994), since Subpart 3 of this rule requires that the equipment or machinery be essential to the production process in order to qualify as capital equipment.

Item A. This item is needed to clarify the statutory restriction found in Minnesota Statutes, section 297A.01, subdivision 16 (1994), regarding repair or replacement parts. It is reasonable to list these items as not eligible for a refund because the statute specifically makes them ineligible. "Replacement" parts include accessories or upgrades.

Item B. This item is needed to clarify that the statutory restriction found in Minnesota Statutes, section 297A.01, subdivision 16 (1994), involving motor vehicles by stating that, in addition to the vehicle itself, any accessories taxed under 297B are also ineligible for the capital equipment exemption.

Item C. This item is needed to clarify the statutory restriction relating to equipment and machinery used to receive or store raw materials as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). It was necessary to include the example of the temporary holding area because some taxpayers incorrectly believe that because they do not have a permanent inventory system, the temporary storage facility qualifies.

Also included within this restriction are equipment and machinery used to handle, store, transport, palletize, or otherwise prepare the completed product for shipment. This is reasonable because these types of activities occur after the integrated production process of the individual item of tangible personal property, and the definition is consistent with the definition of when production begins and ends for the purposes of the industrial production exemption, see Minnesota Rule Part 8130.5500. It is reasonable to include the restriction

for completed goods inventory in this section as both inventory activities are similar and occur outside the integrated production process.

Item D. This item is needed to clarify the statutory restriction relating to building materials as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). These items are not eligible for a refund. It is reasonable, however, to limit this restriction so as to exclude building materials used for foundations and special purpose buildings, as Minnesota Statutes, section 297A.01, subdivision 20 (1994), specifically provides for a reduction for materials purchased for these purposes.

Item E. This item restates the statutory restriction relating to equipment and machinery used for nonproduction purposes as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). Definitions of activities listed in subitem E(2) are to be found in Subpart 2, item O.

Item F. This item is needed to clarify the statutory restriction relating to farm machinery, aquaculture equipment, and replacement equipment as found in Minnesota Statutes, section 297A.01, subdivision 16 (1994). These items are not eligible for a refund because the statute specifically makes these types of materials ineligible. It was necessary and reasonable to specifically state that farm machinery includes logging equipment, as this is included in the definition of agriculture equipment, and because this issue was raised when the department previously proposed to adopt a version of this rule in 1992. It was not deemed necessary to make further clarifications of these types of machinery and equipment, as they are defined under other statutes and rules, specifically Minnesota Statutes, section 297A.01, subdivisions 15, 19, and 20, and Minnesota Rules Part 8130.5500.

Subpart 5. Replacement Capital Equipment.

Items A-C are clarifications of the statutory language as found in Minnesota Statutes, section 297A.01, subdivision 20 (1994). It is necessary to illustrate the department's position regarding software purchases (Item B) in order to provide taxpayers with a clear understanding of the treatment of software purchases as they relate to the replacement capital equipment reduction.

In addition, while the department recognizes that many of the purchases for qualifying foundations or special purpose buildings are made by contractors on behalf of manufacturers (Item C), Minnesota Statutes, section 297A.01, subdivision 16(e) (1994) specifically provides that capital equipment does not include purchases by contractors.

Item D is needed to clarify the statutory definition found in Minnesota Statutes, section 297A.01, subdivision 20 (1994), stating that replacement capital equipment is "all machinery and equipment that is replacing an existing piece of machinery or equipment that is essential to the integrated production process." This item sets forth the tests to determine if a piece of equipment or machinery is being used to replace an existing piece of equipment or machinery performing substantially the same function within an integrated production process. Equipment or machinery purchased that meets this definition qualifies for the replacement capital equipment reduction, and is therefore ineligible for the capital equipment exemption. Three examples have been included within this subpart to demonstrate the department's position.

Under this proposed rule, the department will examine the product being produced, and the function of the equipment previously used when compared to the new equipment. This is reasonable because the statute states that replacement capital equipment is defined as "machinery and equipment ... that serves fundamentally or essentially the same purpose

or function or that produces the same or similar end product as did the old equipment, even though it may increase speed, efficiency, or production capacity." It is reasonable to include a 50% test to determine whether the new equipment qualifies for the capital equipment exemption or the replacement capital equipment reduction since Minnesota Statutes, section 297A.01, subdivision 16, requires that equipment or machinery be used "primarily" in a qualifying function. If the new equipment or machinery is used 50% or more of the time to produce a new product, even if it performs the same purpose or function, the department will consider that the equipment is being used to produce a new product, and is therefore not replacing the existing equipment.

Subpart 6. Local Taxes.

This subpart is needed to outline the refund procedure for local taxes since many taxpayers will pay sales or use tax to a locality as well as to the state. It is reasonable to describe the refund procedure because under local city or county tax programs, a sale is exempt if it is fully exempt from Minnesota Sales and Use Tax. This subpart applies to the state-wide local options tax as well.

The restriction regarding the local options tax does not apply to leases signed prior to October 1, 1989. It is reasonable and necessary to allow the refund of the local options tax as this tax increase occurred after the original lease was signed. The intent of the original capital equipment exemption was to tax capital equipment at four percent. Therefore, it is reasonable to refund the additional tax paid on the lease payments to provide that the ultimate tax reported to the state for state tax is at the four percent rate.

Subpart 7. Leases.

This subpart clarifies the tax treatment of a lease of capital equipment or replacement capital equipment. Under Minnesota Statutes, section 297A.01, subdivision

3(a), a lease is considered a purchase for purposes of the imposition of sales tax. Thus sales tax paid on a lease of capital equipment or replacement capital equipment is eligible for the refund if the equipment or machinery qualifies under either the capital equipment or the replacement capital equipment statutes. This subpart clarifies that the tax must be paid before a refund can be made. It is necessary and reasonable to state this in the rule because taxpayers periodically claim a refund, at the time the lease is signed, of the total tax due on all payments to be made over the term of the lease. Obviously, the tax cannot be refunded until it has been remitted to the state. Under Minnesota Statutes, section 297A.15, subdivision 5, the tax is required to be paid prior to a refund being claimed.

In addition, this subpart states that the rate applicable at the time the lease is signed shall be the reduction rate available for the entire term of the lease. This is reasonable under Minnesota Statutes, section 297A.25, subdivision 42, since the full capital equipment exemption became effective for equipment or machinery ordered on or after October 1, 1989. If a lease for capital equipment was signed prior to that date, the equipment or machinery covered under the lease was obviously entered into prior to October 1, 1989.

Furthermore, this treatment is reasonable under Minnesota Statutes, section 297A.02, subdivision 5, since the effective date for each subsequent rate change is dependent upon the purchase date. It can be inferred from the phrases "for purchases after June 30, ... and prior to July 1" that the legislative intent was to allow a reduction based upon the date the equipment or machinery was acquired. Therefore, regardless of the number of months in the term of the lease, the equipment was clearly acquired as of a certain date. It is reasonable to assume that the legislature intended that the acquisition date be used.

This proposed treatment in consistent with the manner in which the department has historically treated qualifying capital equipment leases signed prior to October 1, 1989.

Subpart 8. Research, Development, and Design.

This subpart is needed to clarify the scope of the inclusion of equipment and machinery used for research, development, and design as capital equipment or replacement capital equipment. To qualify, they must be a part of the integrated production 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 sales tax treatment of manufacturing industries.

Persons engaged purely in research and development, however, are not considered to be 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.

It is reasonable to limit the exemption to those situations where the equipment is used for research, development, and design of a specific item of tangible personal property intended to be sold ultimately at retail. This limitation is consistent with the statutory language, "Capital equipment means machinery and equipment ... used ... for manufacturing, fabricating, mining, or refining tangible personal property to be sold ultimately at retail." Persons engaged solely in research, development, and design do not produce an item of tangible personal property, which is required by the statutory language. This subpart is also reasonable because it ensures consistency in the administration of the sales tax and carries out the legislative intent behind the exemption.

Subpart 9. Mining and Production of Taconite.

This subpart is needed to clarify the exemption and rate reduction available under Minnesota Statutes, section 297A.01, subdivision 16(f) and subdivision 20 (1994), for taxpayers involved in the taconite mining industry. Minnesota Statute, section 297A.01, subdivision 16(f) (1994) specifically states that equipment used to replace existing equipment used in the mining or production of taconite qualifies for the capital equipment exemption; and Minnesota Statutes, section 297A.01, subdivision 20 (1994), defines replacement capital equipment as equipment that serves fundamentally or substantially the same function as did the old equipment, and includes numerous other items which are not generally considered to be replacement equipment and machinery.

Not withstanding the inclusion of those replacement items for a reduction of tax, it is reasonable to not allow a capital equipment exemption for anything other than taconite replacement equipment and machinery. It is clear that the legislature intended to provide a full exemption only for replacement machinery and equipment used in this industry. At the time the industry received the exemption for replacement machinery and equipment, it also sought to gain an exemption for repair and replacement parts. The legislature did not grant an exemption for these items, and since the statutory language found in Minnesota Statutes, section 297A.01, subdivision 16(f) (1993) was not changed, it cannot be interpreted that the legislature intended to now allow the taconite mining industry to receive full exemption for the other items listed under Minnesota Statutes, section 297A.01, subdivision 20(b) (1994). It is the department's interpretation that if the legislature had intended the industry to receive full exemption on all these items, the wording under Minnesota Statutes, section 297A.01, subdivision 16(f) (1994), would have been changed to read, "Notwithstanding prior provisions of this subdivision, replacement capital equipment purchased or leased for use in the mining or production of taconite shall qualify as capital equipment."

Subpart 10. Use Tax.

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