

STATE OF MINNESOTA
DEPARTMENT OF REVENUE

In the Matter of the Proposed Adoption of
Amendments to the Rule Relating to
Agricultural and Industrial Production
(Minnesota Rule Part 8130.5500)

**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 amended 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 property used in Agricultural and Industrial Production, 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.

This rulemaking proceeding proposes to amend a rule relating to sales and use taxation of Property used in Agricultural and Industrial Production (8130.5500) and to consolidate the rule relating to Agricultural Production (8130.2000) with 8130.5500. These rules, which provide regulations for Minn. Stat., section 297A.25, subdivision 9, "materials used in production," were last amended in 1978. Since that time, the Minnesota Legislature has amended Minnesota Statutes, chapter 297A significantly. As a general statement, it is necessary to amend and consolidate these rules, among other reasons, so that they conform to the changes made in the law.

Some of the changes proposed by this set of rules involve repeal of outdated information and duplicative statutory language; grammatical changes; and form clarifications involving nonsubstantive changes. Where indicated, "form" changes are changes in writing style which clarify, modernize, or simplify the meaning of a rule but do not make a material change in the substance or effect of the rules.

Impact on Small Business

The impact of these rules on small businesses has been considered. The proposed rules do not impose new filing or payment requirements on small businesses and therefore are not expected to place any additional financial or administrative burden on small businesses.

Where possible, reporting and compliance requirements have been simplified, consolidated, made less stringent, or eliminated. In addition, all persons (including small businesses) currently possessing a sales tax permit were given direct notification of the Department's rulemaking activities, pursuant to Minnesota Statutes, section 14.115, subd. 4 (1990). This notification was published in the Department's January 1990 quarterly newsletter which was sent to all permit holders (146,918) in December 1989, and January 1990 (see attached).

Special Notice of Rulemaking

Pursuant to Minnesota Statutes, section 14.11 (1990), the proposed rules 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

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. 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 Minn. Stat., chapter 645.

Subpart 1. Agricultural and Industrial Production. The first paragraph is stricken because it largely repeats statutory language. It is replaced with a general statement which describes the exemption and gives the statutory reference to the exemption to aid the reader in understanding the basis for the rule. This change is necessary because the existing language duplicated statutory language.

The new language also makes it clear that the provisions of this rule only apply to those persons engaged in agricultural or industrial production. This is necessary because the statutory exemption is limited to items used or consumed in agricultural or industrial production of a product to be sold ultimately at retail. Persons who provide services are not considered as being engaged in agricultural or

industrial production. The service provider is not producing personal property to be sold at retail as is required by the statute.

The language regarding when the production process ends has been amended to clarify that production ends when the product is packaged. This is reasonable because the statute includes packaging materials as materials used in production. This new language is needed to clarify that packaging is part of the production process and that materials used or consumed during packaging are exempt.

The language regarding preparation, cooking, or mixing of meals is added to adopt the reasoning of the Minnesota Tax Court's decision in Southland Corporation v. Commissioner of Revenue, Minn. Tax Court Nos. 4136, 4137, and 4138 (1985). In that case, the tax court held that preparation of meals and drinks from food products did not constitute agricultural or industrial production.

The definition of when the production process for mining and quarrying begins and ends is set out separately, because of the unique circumstances in the mining and quarrying industries.

The language regarding separate detachable units is deleted because a large portion of it related to the tax treatment of these items under the law in effect from 1967 through 1973. That information is largely historical and does not assist current taxpayers in the interpretation of the existing statute. The remainder of the separate detachable unit information is moved to subpart 9, where it is set out in a more clear fashion.

Subpart 2. Exempt Materials. The list of items which are included in this exemption is stricken from the first paragraph. The list is stricken because it duplicates statutory language and therefore does not assist the reader in understanding the rule or statute. Clarifying language was added to the examples in the second paragraph. The language regarding animal life is stricken and in part moved to subpart 13, which contains a consolidation of all of the information relating to animals used or consumed in agricultural or industrial production.

Subpart 3. Subpart 3 is repealed and the information is moved to subpart 8 of this proposed rule. This change was made to organize the rule in a more logical fashion and to follow the language of the statutory exemption.

Subpart 3a. Chemicals and Fertilizers. This is a new subpart which is being added to clarify the application of this exemption to purchases of chemicals and fertilizers. Taxpayers frequently have questions in these areas, so it is necessary to cover them in this rule. The definition of "pest" is taken from Minn. Stat., section 18B.01, subd. 17. Chapter 18B contains pesticide control laws administered by the Commissioner of Agriculture. Only the applicable part of the definition from section 18B.01, subd. 17 is used; the rest of the definition does not fit with the sales tax statutory exemption.

This subpart clarifies that chemicals and fertilizers are exempt only to the extent they are used in production. This clarification is necessary to call attention to the statutory requirement of "used or consumed in ... production." Herbicides or fertilizers used on land in the Conservation Reserve Program or similar programs are now statutorily exempted. It is necessary to add such language to conform with

the 1991 change in the statute. This subpart also distinguishes between detergents or cleaning chemicals, which are generally taxable, and disinfectants, which are generally exempt. Again, the distinction is based on the fact that in one case, the chemicals are not specifically for production and in the other, they are.

Subpart 4. Subpart 4 is repealed and the information is moved to subpart 9 of this proposed rule. The information is reorganized in a simpler format which will be easier for taxpayers to understand.

Subpart 4a. Fuels, Electricity, Gas, and Steam. This is a new subpart which clarifies the exemption for fuels, electricity, gas, and steam. The first paragraph sets out the statutory exemption and notes the limiting language which excludes space heating and lighting. It is necessary to include this paragraph since it enables the reader to understand the rest of the rule. The next paragraph sets out the distinction between heating/lighting that is purely space heating/lighting, and thus taxable, and heating/lighting which is actually a necessary part of the production process. The "average temperature" and "average lighting" standards are needed because generally room temperature and light are not requirements of the production. The "average lighting" and the "average temperature" of the plant are set for the comfort of the production workers, for safety, for security, for a good working environment, but they do not effect product, nor do they make the machinery run. In some cases, however, extra wattage per square foot, or extra heating, is a special requirement of the process.

The rule sets out standards for establishing what constitutes space heating and lighting. The climate control temperature range set out in the rule was obtained

from the 1981 Thermal Environmental Conditions for Human Occupancy (ASHRAE Standard #55-81) which is the latest publication by the American Society of Heating, Refrigerating, and Air-Conditioning Engineers, Inc. (ASHRAE). Since ASHRAE is the authoritative source, publishing nationally recognized codes and standards which are followed by architects, engineers and others, it is reasonable to use such standards. It is necessary to include this information in the rule because it clarifies a previously confusing area for taxpayers and calls attention to the fact that in some situations, an exemption is available for heating and lighting purchases. The use of such standards is also reasonable because they provide a method for separating that part of energy purchases which is used solely for space heating and lighting from that which is actually used for production.

The ASHRAE standard is revised from time to time. If, upon the revision of the ASHRAE standard, the temperature ranges differ from those stated in the rule, the commissioner expects to propose an amendment to this rule.

Subpart 5. Packaging Material. This subpart is repealed and the language moved to subpart 6 in order to more logically follow the sequence of the statutory language.

Subpart 5a. Petroleum Products. This term is specifically mentioned in the statute, so it is necessary to explain its scope in this rule. The examples given are reasonable as they are of petroleum products and lubricants commonly used in agricultural and industrial production. The second paragraph of this subpart also calls the reader's attention to a related exemption, found in Minnesota Statutes, section 297A.25, subdivision 7 (for petroleum products used in the improvement of

agricultural land), which may affect those engaged in agricultural production. It is necessary and reasonable to include this paragraph, because many taxpayers mistakenly believe that the agricultural production exemption covers all aspects of agriculture, rather than just materials used or consumed in production.

Subpart 6. Packaging Materials. Much of this language was previously found in subpart 5 of the current rule. Subpart 5 is repealed, and the language is updated and moved to this subpart. This makes the rule follow the sequence of the statutory language which should make it easier for taxpayers to locate information.

This subpart deals with the scope of the packaging material exemption. The basic distinction here is whether or not something is a returnable container. This is a reasonable distinction since a returnable container is not consumed or used up in the production process, but will be reused again and again. The general rule is that if the container is returnable, it is treated as equipment and not as something used or consumed in the production process. The only exception is the one specifically mentioned in the statute, for packaging food and beverage products. This rule also makes a distinction between external packaging materials (dunnage), which are generally exempt, and items used to facilitate loading and moving, such as delivery carts. The distinction is necessary because the latter items are (1) equipment or comparable to equipment, and (2) do not physically package the product, but are used to carry the packaged product or the container which holds it.

Subpart 7. Road Building Materials. This is a new subpart which addresses the exemption of materials used in the production of road building materials. This item is specifically mentioned in the statute, so it is necessary to explain its scope in

this rule. This language was added because of several court cases, namely; Emil Olson v. Commissioner of Revenue, 293 N.W. 2d 831 (Minn., 1980); Bauerly Bros., Inc. v. Commissioner of Revenue, Minn. Tax Ct. Nos. 5017-5019, 5067, and 5233 (1990); Midwest Asphalt Corp. v. Commissioner of Revenue, Minn. Tax Ct. No. 2678 (1979) and Bituminous Roadways, Inc. v. Commissioner of Revenue, 324 N.W. 2d 799 (Minn., 1982). These cases have uniformly interpreted the statutory language to exempt only materials used to produce road building materials which will be sold at retail by the manufacturer.

Subpart 8. Taxable Equipment. This subpart contains information previously found at subpart 3, which is being repealed. It was moved so that the rule follows the sequence of the statutory language. It clarifies that machinery and equipment, etc., are not within the scope of this exemption. Some equipment may qualify for another exemption such as with capital equipment, or for a lower rate such as with farm machinery, but this particular exemption excludes machinery and equipment.

Subpart 9. Separate Detachable Units. This subpart describes the tax treatment of separate detachable units. The information is reorganized into a simpler format which will be easier for taxpayers to understand. Language is added to clarify that all three of the listed factors must be met and that a product must be produced for sale before the unit will qualify for this exemption. This is necessary because these are areas where taxpayers often have questions. The language is reasonable because it implements the statutory limitations which require all three factors and require personal property be produced for sale at retail.

Item A. Separate detachable unit. Most of this language was previously found in subpart 4(A) which is repealed under this proposed rule. The information is moved to this subpart of the rule because it more logically follows the sequence of the language in the exemption statute. Clarifying form changes are made. Items are added to the list of nonqualifying hand tools because of frequent taxpayer inquiries on these specific hand tools. Language is also added clarifying that although hand tools themselves do not qualify as materials used or consumed in production, or as separate detachable units, attachments to the hand tools may constitute exempt separate detachable units if they fall under examples outlined earlier in Item A. Allowing exemptions for attachments to hand tools is necessary to insure consistent treatment between taxpayers, whether they produce by means of machinery and equipment or by hand tools.

Item B. Used in producing a direct effect: Clarifying form changes are made in the first three paragraphs.

Subitem (1) The language on circuit board drill tapes is omitted because the example represents out-dated technology which is no longer widely used. Thus the example has little value because of its limited applicability to taxpayers.

Subitem (2). A sentence is added to the end of this list of nonqualifying items, which helps to explain why these items do not qualify as separate, detachable tools.

Item C. This first sentence is added because of a 1980 Minnesota Tax Court case, Plastics, Inc. v. Commissioner of Revenue, Minn. Tax Ct. No. 2948 (1980). In that case, the Tax Court ruled that if an item would have a useful life of less than 12 months when used under normal conditions, continuously in production, it would qualify as having a useful life of less than 12 months, even if it was not used continuously and thus lasted longer than 12 months.

The current language regarding expensing an item for federal income tax purposes is repealed with the repeal of subpart 4. This language is also repealed because of the Plastics, Inc. case. Language in the court's opinion clarified that the statute does not require expensing an item in order to show an ordinary useful life of less than 12 months.

The last two sentences are added to clarify that repair of an item alone does not constitute conclusive evidence of the end of an item's useful life.

Subpart 10. Building Materials. This is a new subpart which is added to clarify that building materials are not within the scope of this exemption. Taxpayers frequently inquire about this, so it is both necessary and reasonable to include it in this rule.

Subpart 11. Feeds. This is a new subpart which clarifies the scope of this exemption as it applies to feeds. This item is specifically mentioned in the statute, so it is necessary to explain its meaning and application in this rule. Since feed must be "used or consumed" in agricultural or industrial production by being fed to particular animals, it is necessary to state which animals are included. Inasmuch as

the legislature did not specify what animals must consume the feed to have the feed considered used or consumed in production, Minn. Stat., section 645.16 provides that the intention of the legislature may be ascertained by considering "the former law, if any, including other laws upon the same or similar subjects," and "the consequences of a particular interpretation." Looking to "other laws upon the same or similar subjects," the Department examined various definitions of animals, livestock, animal products, and food, which have general applicability and meaning in the agriculture industry, as they are predominantly found in Minnesota Statutes, chapters 17 to 42, the Agriculture chapters. It is reasonable to presume that the Legislature had the Agriculture chapters in mind when drafting those portions of the statutes relating to agricultural production, since both relate to the same or similar subjects.

Fur-bearing animals, pets, and research animals are included here because the definition of agricultural production found at Minn. Stat., section 297A.01, subd. 13 specifically includes these categories of animals. Since the definition of agricultural production is not exclusive, to clarify the scope of this exemption it is necessary to include "animals uses as a source of wool," "agricultural animals," and "farm work stock" in the definition of what feed is exempt.

The term "fur-bearing animal" is given the same definition as that found at Minn. Stat., section 17.351. Minn. Stat., section 17.352 specifically defines the product of a fur-bearing animals as an agricultural product. Also, in Chapter 17, at section 17.14, subdivision 3, "farm products" is defined to include "wool, mohair, hides, and meats." Therefore, animals used as a source of wool are included because, just like fur-bearing animals, they are raised for use in the production of a non-food product

which is recognized by Minnesota Statutes as a farm product . While most wool-bearing animals are also used for food (for example, sheep are used for meat), this language is necessary and reasonable as it serves to give consistent tax treatment for those who choose to raise their wool-bearing animals exclusively for wool as for those who choose to raise fur-bearing animals for their fur.

The definition of agricultural animals is derived mainly from the Minn. Stat., section 297A.01, subd. 15 definition of "livestock," Minn. Stat., chapter 17A, which deals with Minnesota Livestock Market Licensing, particularly section 17A.03, subd. 5, and from chapter 31, which deals with slaughtering, particularly section 31.59, subd. 3 and section 31.51, subd. 9. Part of the definition of a "pet" is taken from Minn. Stat., section 25.33, subd. 20, which defines pets for purposes of commercial feed law. The definition of "farm work stock" does not come directly from the agricultural statutes, but is modeled after regulations of other states which regulate, tax, or exempt the feed for work animals. For example, Wisconsin defines "farm work stock" as "animals, such as draft horses and mules, which are used exclusively for farming. The phrase does not include dogs, riding horses, racing horses or laboratory animals...." While no part of farm work stock becomes a product, these animals are similar to farm machinery in that they implement the production process; therefore, it is reasonable that the feed to keep these animals should be exempt just as the fuel to run the production machinery is exempt. Department of Revenue fact sheets and revenue notices have previously allowed tax exempt feed for herd dogs; to provide consistent tax treatment, it is necessary to allow a tax exemption for the feed bought for all farm work stock.

Subpart 12. Seeds. The term "seeds" is specifically mentioned in the statute, so it is necessary to explain its meaning and application in this rule. This subpart clarifies the scope of the seed exemption and distinguishes use of seeds for production (exempt), from nonproduction (taxable). As explained in subpart 3a regarding chemicals and fertilizers, seeds used on Conservation Reserve Program land or in similar programs, are statutorily exempt.

Subpart 13. Agricultural Production. This is a new subpart to this rule. It is necessary to devote one subpart solely to agricultural production because of the many unique terms and issues which are applicable only to agricultural, and not to industrial production.

Item A. The definitions of horticulture, agriculture, and floriculture are derived from the general dictionary definitions of those terms. See Websters' Third New International Dictionary Unabridged (1986). Minn. Stat., section 297A.01, subdivision 13, states that the definition of "agricultural production" is not limited to horticulture, floriculture, or the raising of the specified animals. As such, it is reasonable that the Legislature intended the exemption to apply to new and developing types of agriculture. Aquiculture is a new and developing type of agriculture. Minn. Stat., section 17.491, specifically provides that "Aquiculture is an agricultural pursuit." Aquiculture, as that term is defined in Minn. Stat., section 17.492, includes both hydroponics and commercial fishing (aquaculture). Considering that horticulture and floriculture are included under Minn. Stat. 297A.01, subdivision 13, as agricultural production, it is reasonable that hydroponics, the raising of plants in solutions other than soil, would also be included as agricultural production. Furthermore, the term "commercial fishing" is specifically

included in Minn. Stat., section 297A.25, subdivision 9. In effect, aquiculture is now recognized by the Legislature as a part of agricultural production.

Items B & C. These items addresses the taxation of animals associated with agricultural production. The general rule that animal sales are taxable, is set out and the exceptions to that rule are listed.

The purchase of breeding stock is exempt if the offspring of that particular animal will be used for an exempt purpose as outlined under this subpart, whether the offspring will be used for food, wool, fur, or in research and development of a product to be sold at retail. It is reasonable to include the breeder as "material used in production" because the breeder is used to produce animals which will be used or consumed in production. It is necessary to include language that clarifies that the exemption for breeders is not limited to situations where the product of that animal will be used for human consumption, a position previously taken by Department of Revenue fact sheets. If the taxpayer were to purchase the offspring for any exempt purpose under this subpart then the purchase of the breeder is also exempt.

The purchase of animals to be used in research and development are included because they will be used or consumed in production of a product to be sold at retail. Fur-bearing animals, and animals used as a source of wool are included for the same reasons illustrated in subpart 11 above. The language "solely as a commercial source of wool" is necessary to emphasize for taxpayers that the production of the wool "product" must be on "a scale comparable with that of a commercial producer." (See Item A in the rule, last paragraph.) This means that the animal is purchased for purposes of making a profit on the sale of the wool. If the

wool-bearing animal is purchased as a pet, or for the purpose of showing or exhibiting it, it is not being used commercially for agricultural production, and the taxpayer will not get the benefit of the "materials used in production" exemption.

It is necessary to state that the animal purchased for use in manufacturing food that will be consumed by "animals, or poultry," to clarify for taxpayers that the food is not limited to food for "human consumption," a phrase previously used by the Department of Revenue on fact sheets and revenue notices relating to agricultural production. In fact, most animals that are used for food are for human consumption, with the offal being used for animal consumption. All the same, the purchase of an animal is exempt if it or its by-products is used as food, whether or not a human consumes it. This is reasonable since the statute only requires that the resulting product be personal property sold at retail.

Item D. This item addresses the taxation of breeding fees and veterinarian services. Both are generally treated as exempt services. This item clarifies, however, that the fees for the breeding of certain racing horses are taxable pursuant to a different sales tax statute. It is necessary to call attention to this fact because some taxpayers are not aware of the special treatment for certain race horses and assume the service is exempt under the agricultural production exemption. This item also clarifies that, while the sale of liquid nitrogen to farmers in the business of agricultural production is exempt as a sale of a chemical used in the processing of an agricultural product, the sale or lease of liquid nitrogen tanks to farmers is not exempt. These tanks are equipment and as such are not exempt under the express provisions of the statute. These tanks are also not packaging materials within the exemption provided for in the statute. Furthermore, the retail

sale of the semen supplies listed are taxable since they are considered to be "implements, tools, accessories, appliances and contrivances" used in agricultural production, and as such not exempt by the express provisions of the statute.

Items E & F. These items clarify that the treatment of farm machinery is covered under a different sales tax statute. It is necessary to call attention to this fact because many taxpayers believe that the agricultural exemption covers all aspects of agricultural production, rather than just materials used or consumed in the production.

Item G. Aquaculture is defined in the Minn. Stat., section 17.47, as the culture of private aquatic life within an aquatic farm for consumption or sale. As such, aquaculture, which can be included within the heading aquiculture, is part of agricultural production. This item clarifies that the treatment of aquaculture production equipment is covered under a different sales tax statute. It is necessary to call attention to this fact because many taxpayers believe that the agricultural exemption covers all aspects of agricultural production, rather than just materials used or consumed in production.

Repealer. The subparts of Minnesota Rule 8130.5500 which are being repealed are discussed in this statement in the order that they occur in the existing rule.

Season's Greetings

The Department of Revenue, and especially the Taxpayer Information Division, wishes you a happy and prosperous New Year. We also thank you for your cooperation in collecting sales tax and filing reporting forms. Your efforts are sincerely appreciated!

New interest rates for 1990

Beginning January 1, 1990, the interest rate on delinquent sales and use taxes will be 11 percent per year. By law, the interest rate on unpaid taxes is adjusted each year according to the "adjusted prime rate charged by banks to businesses," as determined by the Board of Governors of the Federal Reserve System.

The interest rate paid on overpayments will also be 11 percent beginning January 1, 1990.

1989 sales tax law changes

Information about the 1989 sales tax law changes is included with this mailing. Please read it! Be sure to call or write us if you have any questions.

New toll-free telephone number: 1-800-657-3777

To give you better service, we have a new toll-free telephone number for business tax information (sales tax, withholding, and corporate income tax). Now you can call directly to our telephone assistance lines from anywhere within the continental United States. This number replaces the old toll-free number (1-800-652-9747).

The toll-free line for income tax information remains the same: 1-800-652-9094.

Instruction booklet revised

The sales and use tax instruction booklet, revised November 1989, has been mailed to all current permit holders and others on our mailing list. The booklet contains general information and instructions for filing sales and use tax returns. If you have not received your copy, please write or call us.

Newsletters and fact sheets

We publish the sales tax newsletter quarterly. Our purpose is to inform you of any changes in the sales tax law, and to give you helpful filing tips and other information that may be of interest to you. Our sales tax fact sheets cover specific topics. A brief list of the subjects covered during 1989 follows. If you are missing any newsletters or fact sheets and would like them mailed to you, call or write us.

Newsletter # 42—April 1989

- Campgrounds and recreational areas
- Labor charges
- Health care products
- Federal excise tax on diesel fuel

Newsletter # 43—July 1989

- 1989 law changes from the general session
- Oxygen tanks
- Massages
- Irrigation Systems
- Golf and country club memberships
- Auction sales

Newsletter # 44—October 1989

- Art and craft retailers need permits
- Sales to residents of other states or countries
- Food stamp guidelines
- Party plan sales
- Residential heating fuels
- Fabric and sewing supplies
- State agencies taxed

Fact Sheet 126—Meat Processors

Fact Sheet 127—Waste Collection and Disposal Service

Reminder—we've moved

We are no longer located at the Centennial Office Building in the Capitol Complex. We have moved almost all of our offices into one building, located across the Mississippi River from downtown St. Paul, at the intersection of Robert and Fillmore streets. The street address is 10 River Park Plaza. Visitors can use the metered parking lot at the east side of our building.