STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE MINNESOTA DEPARTMENT OF REVENUE

In the Matter of the Proposed Adoption of Permanent Rules Relating to Sales and Use Taxes on Capital Equipment

REPORT OF THE ADMINISTRATIVE LAW JUDGE

The above-captioned matter came on for hearing before Administrative Law Judge Jon L. Lunde commencing at 9:00 a.m. on October 15, 1992 at the offices of the Minnesota Department of Revenue in St. Paul, Minnesota. The Chief Administrative Law Judge extended the due date for this Report from December 14 to December 30, 1992.

This Report is part of a rulemaking proceeding held pursuant to Minn. Stat. §§ 14.131 to 14.20 to determine if the Department of Revenue (Department) has fulfilled all relevant, substantive and procedural requirements of law applicable to the adoption of rules, the proposed rules are needed and reasonable, and any proposed modifications to the rules constitute impermissible, substantial changes. Terese Koenig, Sales Tax System Manager; Susan Fremouw, Attorney; and Greg Heck, Attorney, constituted the hearing panel representing the Department.

The Minnesota Department of Revenue must wait at least five working days before taking any final action on the rules; during that period, this Report must be made available to all interested persons upon request.

Pursuant to the provisions of Minn. Stat. § 14.15, subd. 3 and 4, this Report has been submitted to the Chief Administrative Law Judge for his approval. If the Chief Administrative Law Judge approves the adverse findings of this Report, he will advise the Minnesota Department of Revenue of actions which will correct the defects and the Minnesota Department of Revenue may not adopt the rule until the Chief Administrative Law Judge determines that the defects have been corrected. However, in those instances where the Chief Administrative Law Judge identifies defects which relate to the issues of need or reasonableness, the Minnesota Department of Revenue may either adopt the Chief Administrative Law Judge's suggested actions to cure the defects or, in the alternative, if the Minnesota Department of Revenue does not elect to adopt the suggested actions, it must submit the proposed rule to the Legislative Commission to Review Administrative Rules for the Commission's advice and comment.

If the Minnesota Department of Revenue elects to adopt the suggested actions of the Chief Administrative Law Judge and makes no other changes and the Chief Administrative Law Judge determines that the defects have been

The documents were available for public inspection at the Office of Administrative Hearings from the date of filing to the date the record closed.

5. The period for submission of written comment and statements remained open through November 4, 1992, the period having been extended by order of the Administrative Law Judge to 20 calendar days following the hearing. The record closed on November 12, 1992, the fifth business day following the close of the initial comment period.

II. INTRODUCTION

6. Under Minn. Stat. § 270.06(13) the Commissioner of Revenue (Commissioner) has statutory authority to "make, publish, and distribute rules for the administration and enforcement of state tax laws." Under the statute, rules adopted by the Commissioner have the force of law. The statute authorizes the promulgation of rules relating to the sales and use tax exemption for capital equipment which have been proposed in this proceeding.

7. The rules proposed by the Department are designed to clarify the scope of the sales and use tax exemption for capital equipment contained in Minn. Stat. § 297A.25, subd. 42 (1990). The capital equipment exempt from taxation is defined in Minn. Stat. § 297A.01, subd. 16:

> Capital Equipment means machinery and equipment and the materials and supplies necessary to construct or install the machinery or equipment. To qualify under this definition capital equipment must be used by the purchaser or lessee for manufacturing, fabricating, mining, quarrying, or refining a product to be sold at retail and must be used for the establishment of a new or the physical expansion of an existing manufacturing, fabricating, mining, quarrying or refining facility in the state. For purposes of this subdivision, "mining" includes peat mining. Capital equipment does not include (1) machinery or equipment purchased or leased to replace machinery or equipment performing substantially the same function in an existing facility, (2) repair or replacement parts, or (3) machinery or equipment used to receive or store raw materials.

8. Capital equipment was first given special sales tax treatment in 1984. At that time, the sales tax on capital equipment was reduced from six to four percent. 1984 Minn. Laws, c. 502, art. 6, §§ 2 and 7. In 1985, the legislature authorized a sales and use tax exemption for capital equipment placed in service in "distressed counties." Laws 1985, 1st Sp., c. 14, art. 8, § 18; art. 9, § 75. (Minn. Stat. § 297A.257, subd. 2) In 1989, Minn. Stat. § 297A.25, subd. 42 was amended to exempt capital equipment from any sales and use tax. Laws 1989, 1st Sp. c. 1, art. 12, § 7, enacting Minn. Stat. § 297A.25, subd. 42. Although some capital equipment is exempt from tax, the taxpayer must initially pay the sales or use tax and file a timely refund claim. Minn. Stat. § 297A.15, subd. 5.

13. When drafting the rule, the Commissioner stated that she was guided by the principle that tax exemptions are to be strictly construed against the taxpayer and by the statutory cannons of construction. SONAR at 3. The Commissioner's strict construction of the statute was challenged by several persons. Martin A. Culhane, III, speaking on behalf of the Sales and Use Tax Subcommittee of the Tax Section of the Minnesota State Bar Association (Subcommittee), argued that the capital equipment statute is basically a refund or rebate statute drafted for remedial tax relief and should not be narrowly construed against taxpayers. To support his argument, he cited Color-Ad Packaging, Inc. v. Commissioner, Docket No. 4738, Minn. Tax Ct. (Sept. 18, 1987), aff'd, 438 N.W.2d 806, (Minn. 1988). In that case, the tax court held that the capital equipment statute should not be narrowly construed because it was a "rebate" statute and any doubts or ambiguities should be resolved in favor of the taxpayer. Color-Ad, supra at 12.

14. The Color-Ad, decision does not support the liberal construction advocated by the Subcommittee. Color-Ad was decided when the capital equipment statute authorized a rebate of a portion of the sales or use tax paid on qualifying machinery and equipment. In 1989, the operative statute was amended to exempt qualifying equipment from sales and use taxes. Now, the capital equipment statute is an exemption statute. The fact that the tax must be paid and refunded after examination does not change its essential nature as an exemption statute. A rebate, as noted by the Subcommittee, (Testimony Summary, Ex. 4A at 4 n.2) is "return of a part of a payment." Under current law, all of the tax is returned, not merely a part. Hence, no rebate is involved.

15. In spite of the foregoing, the Department is still required to adopt rules consistent with legislative intent. Midwestern Press, Inc. v. Commissioner of Taxation, 295 Minn. 59, 64, 203 N.W.2d 344, 348, (1972). The capital equipment exemption statute was "designed to create an incentive for, or to remove an impediment to, the acquisition of capital equipment by business units for employment in Minnesota plants" and to encourage Minnesota businesses to remain in the state. Color-Ad Packaging, Inc. v. Commissioner, 428 N.W.2d 806, 809, (Minn. 1988). The Administrative Law Judge agrees that the capital equipment statute was intended to encourage investment in new plant and productive equipment in Minnesota and to reduce the possibility that Minnesota business would relocate to other states. Subcommittee Background Materials, Ex. 4B at 6.

16. "Machinery and equipment" is generally defined in Item A. as "mechanical, electronic, or electrical devices essential to a manufacturing, fabricating, mining, quarrying, or refining process." The Department's rationale for requiring that the device be "essential" to the process "is that if something is not essential, then the manufacturing process can occur without it and thus that item is not 'used' as required by the statute." SONAR at 5. The decision to use the "essential" test was not questioned by interested persons and was shown to be necessary and reasonable because one way to determine if a device is "used" for manufacturing is to determine if the device is essential (i.e. necessary) to the taxpayer's manufacturing process.

for purposes of Minn. Stat. §§ 14.14, subd. 2, 14.05 subd. 1, and 14.50 (1990). To correct this defect the Department must amend the first three sentences of Item A. to reflect the scope of the exemption statute and the holding in United Power. One way to correct this defect is to amend the first three sentences to read:

> "Machinery and equipment" means mechanical, electronic, or electrical devices essential to a taxpayer's manufacturing, fabricating, mining, quarrying or refining process. It includes the basic device, devices essential to control, regulate or operate the basic device if directly connected with or on an integral part of the basic device, and devices reasonably necessary to carry out the purpose of the exempt device. Examples are computers used to operate exempt machinery or equipment, and hand tools that come in direct contact with a product.

22. Speaking on behalf of the Subcommittee, Frances H. Holmes, suggested: (1) that the first paragraph of the definition be amended to contrast essential devices from "machinery and equipment which is merely incidental, convenient, or remote to the process", (2) that the rule refer to computer software, not just computers, and (3) that a sentence be added specifically stating that exempt machinery and equipment "does not need to come in direct physical contact with the raw material or product in order to qualify for the exemption". In Ms. Holmes view, the rule does not reflect a middle-of-the-road position without the first and third language changes suggested.

23. The Department did not agree to Holmes' suggested language changes, but it did propose to amend the rule to address computer software. The new language, which will be added after the word "product" (p. 2, line 5) reads:

> While software is not machinery or equipment, if it is purchased before the machinery or equipment is placed into service and is essential to the process of manufacturing, fabricating, mining, quarrying, or refining a product to be sold at retail, it will be treated as an integral part of the exempt device.

The amendment satisfied the Subcommittee's concerns (T. at 54) and does not constitute a substantial change. However, the Department should amend the language to state:

> Software which is purchased before the machinery or equipment is placed into service and essential to the process of manufacturing, fabricating, mining, quarrying, or refining a product to be sold at retail shall be treated as an integral part of the exempt device.

24. The Department did not comment upon Holmes' other suggestions. However, the rule is necessary and reasonable without contrasting essential equipment with equipment that is merely "incidental, convenient, or remote." The rule is also necessary and reasonable without the other amendment Holmes proposed. Nonetheless, a clear statement that qualifying machinery and

> The fact that a particular piece of machinery or equipment may be essential to a process because its use is required either by law or practical necessity does not, of itself, mean that the equipment qualifies.

(p. 2, lines 12-15) Under the cited language, it is the Department's intention to exclude fire prevention, building maintenance, and pollution control equipment from the exemption. The exclusion of fire protection property and building maintenance property is consistent with NTA standards for identifying property which is directly used for manufacturing. Public Ex. 4. at 21. The Department's decision to exclude them is necessary and reasonable.

28. In the Department's view pollution control equipment is not essential for manufacturing a product and should not qualify without a specific legislative authorization. In addition to the exclusionary language last cited, "machinery and equipment used solely for pollution control, prevention, or abatement" are not exempt under subitem (6). The Department's position was criticized by several individuals.

29. Dale H. Busacker, addressed the issue on behalf of the Subcommittee. He stated:

> The committee submits that the fact that the manufacturing process could not legally occur without the pollution or environmental control equipment is enough justification to allow the equipment to qualify. The rule needs to recognize the fact that the pollution control and environmental control equipment is all part of the manufacturing process. Without these items of equipment, the manufacturing process could not legally occur. It is difficult for taxpayers to understand and accept the fact that the equipment which is so essential to the manufacturing process would not qualify for the refund. To take the narrower view adopted by the Department means that the direct effect test has been adopted.

Public Ex. 4A. Potlatch Corporation, like the Subcommittee, argued that legally required pollution control equipment is essential to integrated processes and should qualify. Northern States Power Company voiced a similar opinion pointing out that the air quality control system at its Sherburne County Generating Plant - Unit No. 3 cost $42 million and that the tax on the system could amount to as much as $2.7 million. The Commissioner of the Minnesota Pollution Control Agency, Charles W. Williams, characterized the Department's exclusion of pollution control equipment as archaic and unrealistic. Mr. M. D. Manssen, speaking on behalf of Minnesota Mining and Manufacturing Company, noted that pollution control equipment can be used exclusively for pollution control or may have a dual purpose of recycling and pollution control.

30. The governing statute -- § 297A.01, subd. 16 -- requires that exempt machinery or equipment be "used. . . . for manufacturing . . . .". In this context, the word "for" means "in order to bring about or further." Webster's

33. Pollution control equipment can involve substantial costs to a business, as N.S.P.'s comments demonstrate. Hence, the exempt status of such equipment from sales and use taxes would likely be a factor in a manufacturer's decision to build or expand in Minnesota. Moreover, there is a strong public policy in favor of abating pollution. This policy is reflected in a variety of state statutes including Minn. Stat. § 272.02, subds. 1(9) and 7 which exempt some pollution control equipment from taxation.

34. When the pollution control equipment also assists the manufacturing process by recycling combustible fuels, reducing the amount of by-products that must be disposed of, or otherwise improves the efficiency of the manufacturing process or the quality of the product, it is difficult to understand how such equipment is not used for manufacturing. Many pieces of machinery or equipment may have dual purposes. A piece of equipment might, for example, be designed to eliminate vibrations, thereby reducing structural damage to a building and also improving the quality of the manufactured product. On the other hand, it might simply recycle exhaust emissions thereby reducing fuel costs. Items having such dual purpose are used for manufacturing and would not be used if no manufacturing were taking place.

35. Pollution control equipment legally required of a qualifying manufacturing process is "reasonably necessary" to carry out the purpose of exempt property and should be exempted under United Power. While pollution control equipment, "viewed in isolation", is not used for manufacturing, it is an integral part of the manufacturing process and should be exempt. Id. Based upon the foregoing considerations, it is concluded that the rule disallowing an exemption for legally required pollution control equipment is inconsistent with the governing statutes and was not shown to be necessary and reasonable. This constitutes a substantive violation of law for purposes of Minn. Stat. §§ 14.14, subd. 2, 14.05, subd. 1 and 14.50 (1990). To correct this defect, the rule must be amended to recognize an exemption for pollution control equipment.

36. In addition to pollution control equipment, Mr. Busacker addressed environmental control equipment. He stated:

> It has been our understanding that the Department has taken the position in the past if the waste material from the manufacturing process is directly placed on the item that is being manufactured, the equipment needed to remove that waste material does qualify for the refund. However, equipment that is needed to prevent the waste material from being thrown on the employees or from being placed into the air and preventing the work area from being safe for employees to work in does not qualify. We submit that this is not an appropriate criteria to use as to what is included in the manufacturing process. We submit that a more appropriate test is the one used by the Ohio Board of Tax Appeals in its decision in American Woodwork Specialty Company Limbach, Ohio CCH Rptr. ¶ 401-330, July 10, 1992. In this case, the Board allowed a bag house dust collection system to qualify because the primary purpose was to protect production employees from the hazardous particles that were emitted during the job. We think that this test more appropriately defines what should be allowed as part of the manufacturing process.

42. James J. Duevel, representing Northern States Power Company (NSP), also addressed special equipment foundations, stating:

> In many cases equipment foundations are only extensions of a building's floor or foundation and maybe should not be considered exempt equipment; however, in cases involving huge pieces of ponderous equipment, i.e., turbine-generators at power plants, printing presses of publishers, etc., the foundations, which are of significant size and stature to support the huge piece of equipment, are completely separate from and are not used to support any portion of the building or structure that houses the equipment. As an example, they may provide the necessary ground clearance for the equipment to operate. In these cases, the equipment foundations are directly connected with and are an integral part of the equipment they support. For these reasons, we believe that special equipment foundations which are used primarily to support pieces of equipment rather than to give structural support to any building or structure, should be treated, for sales tax purposes, the same as the equipment they support.

Public Ex. 9 at 4-5. The Department rejected these arguments noting that there are inherent differences between property tax laws and sales tax laws and that the treatment of property under the former does not govern the treatment under the latter. Although there are differences between the manner in which similar items are treated for purposes of property taxes and sales taxes, and there is no statute requiring that they receive the same treatment in all cases, the tax treatment of foundations for property tax purposes can be considered in interpreting sales tax questions. Zimpro, Inc. v. Commissioner of Revenue, 339 N.W.2d 726, 740 (Minn. 1983).

43. The Department, in addressing the proposed exemption for foundations, stated:

> Moreover, foundations are not machinery and equipment for purposes of the capital equipment exemption. Even if they are needed to support or contain the machinery or equipment, just as the walls and roof of an exclosing structure are needed, they are not an integral part of the machinery and equipment and are not essential to the operation of the machinery or equipment. Thus, they are not essential to an integrated process, as required to qualify for the exemption.

See, Department's November 10, 1992 comment at 4.

44. The conclusion that foundations are not equipment and are not integral parts of manufacturing machinery and equipment has no factual or legal support in the record. It may well be that some equipment foundations are merely extensions of a building's floor or the basic structure of a building and give structural support to the building. It is doubtful that such foundations qualify for an exemption. However, as N.S.P. noted, some

because it narrowly construes the exemption, reflects legislative intent, incorporates the elements of the commonly understood meaning of the word "manufacturing", and is consistent with other tax laws on the same subject.

47. The word "product" is defined in Item I as "tangible personal property, electricity, or steam". The Department's definition equates products to tangible personal property because the capital equipment exemption statute limits the exemption to "manufacturing," and given the common and approved usage of that word, the Department argued that the only product that can be manufactured is tangible personal property. SONAR at 15.

48. The word "manufacturing" commonly involves the element of processing raw materials. SONAR at 15. However, it also means "to make or process (a product), especially with the use of industrial machines" or "to create, produce, or turn out in a mechanical manner." American Heritage Dictionary of the English language, 796 (1981). When raw materials are alluded to in the various definitions, the Department assumes that tangible personal property is necessarily involved. However, the words "raw material" not only mean "unprocessed natural products used in manufacturing", but also, "unprocessed data of any kind." American Heritage Dictionary of the English language, 1084 (1981).

49. The word "product" means "something produced by physical labor or intellectual effort: the result of work or thought. . ." Webster's Third New International Dictionary, 1810 (1986). The word is also defined as "anything produced by human or mechanical effort or by a natural process." American Heritage Dictionary of the English Language, supra, at 1044.

50. The proposed definition of product is also based on a narrow construction of the statute, and the statutory definitions of the words "sale", "retail sale", and "sale at retail" in Minn. Stat. § 297A.01, subds. 3 and 4. Subpart 3(a)(b) and (f) are the only sales involving manufactured products mentioned in Section 297A.01. The first two clauses refer to tangible personal property; the last clause refers to electricity and steam. Based on the language in section 297A.01, the Department argues that its definitions of "manufacturing" and "product" are appropriate.

51. Jerome A. Geis, speaking of behalf of the Subcommittee, argued that limiting the exemption to manufacturers of personal property is inconsistent with the statute and the decision in West Publishing Co. v. Commissioner of Revenue, Minn. Tax Court, Docket No. 5346 (July 11, 1990), aff'd by equally divided court, 464 N.W.2d 512 (Minn. 1991). In the West Publishing case, the court held that West was entitled to a sales tax refund for expansion of its WESTLAW service. The tax court rejected the Department's argument that the word "product" is limited to tangible personal property.

52. The Committee recognizes that the decision in West Publishing is not binding. Nonetheless, Mr. Geis argued that the tax court decision is worthy of reliance. In addition, he stated that there are so few manufacturers of intangible property, a narrow definition of the word "product" is unnecessary and some issues will need to decided in court. He said that it is inappropriate for the Department to codify its litigation position in West Publishing by rule and that it should issue, instead, a revenue notice not having the force and effect of law. Moreover, he argued that taxpayers could be mislead by the Department's erroneous interpretation and rule adoption should await an authoritative supreme court ruling on the issue.

> . . . . technological advancements have substantially changed many features of our society. The fact that a computer now processes a mechanical device and prints out materials which formerly could only be done by hand does not require that we continue to regard such items as services. This court takes judicial notice of these scientific advances. . . .

Tabulating Service Bureau, Inc. v. Commissioner of Taxation, supra, 204 N.W.2d at 444. In a Missouri case, the court concluded that a computerized information storage and retrieval service constituted "manufacturing" for purposes of a Missouri sales tax exemption statute not unlike that in Minnesota. Bridge Data Co. v. Director of Revenue, 794 S.W.2d 204 (Mo. 1990).

56. The Administrative Law Judge finds the reasoning and authority cited by the tax court in the West Publishing case persuasive. That decision, coupled with the usual definition of the words "product" and "raw material" and the purposes of the exemption statute render the Commissioner's proposed definition of the word "product" inappropriate and at variance with the statute. As such, the proposed definition constitutes as substantive violation of the law for purposes of Minn. Stat. §§ 14.14, subd. 2, 14.05, subd. 1 and 14.50 (1990). To correct this defect the definition must be amended to include both tangible and intangible products. In addition, as suggested by Mr. Opperman, the definition of the word "manufacturing" should be amended to include electronic data as a raw material. The best way to do this is to add the words "or electronic data" after the word material in Item C (p. 3, line 20).

57. 8130.2200, Subp. 3, Items A-C. This rule sets out in more detail the three tests qualifying equipment must meet. Generally speaking, the equipment must (A) be used by the purchaser or lessee, (B) be used to manufacture, fabricate, mine, quarry, or refine a product sold at retail, and (C) be used for the establishment of a new or the physical expansion of an existing facility. These items were the subject a great deal of comment, as is discussed below.

58. Item A, requiring equipment usage by the purchaser or lessee states:

> First, the machinery or equipment must be used by the purchaser or lessee. This means that the person who purchases the equipment must also be the one who uses it. Thus, purchases of equipment by a contractor who will turn over the equipment as a part of an improvement to real property will not qualify because, although the contractor has purchased equipment which will ultimately be used in manufacturing, that contractor will not use it for a qualifying purpose. When the equipment vendor only supervises or engineers the installation of the equipment without providing or arranging for the actual installation labor, the sale of equipment is treated as the sale of tangible personal property, not an improvement to real property, and the equipment can qualify for the refund. Leasing machinery or equipment to another person does not constitute "use" as required

61. Based on the language of the statute the Department concluded that under the sales tax laws contractors who turn over equipment as part of an improvement to real estate are deemed the purchasers of the equipment and must pay the sales or use tax. In the Department's view, the building owner is not purchasing the materials but is merely purchasing an improvement of real property and the incidents of and liability for sales tax rests with the contractor and not the building owner. In addition, the Department noted that under Minn. Stat. § 289A.50, the person applying for the sales tax refund must be the person who actually pays the tax. Because the building owner has not directly paid any sales tax and is not liable for a sales tax, there is no tax to be refunded to the building owner. Also, because the legislature failed to provide for refunds in the contractor situation, the Department concluded that it intended to exempt only equipment actually bought and used by a purchaser. The Department noted that the legislature has specifically provided for refunds in similar contexts when it intended to make contractor purchases eligible for an exemption, citing Minn. Stat. §§ 297A.257, subd. 2(a) (repealed) and 297A.15, subd. 6.

62. Potlatch Corporation stated that Item A is inconsistent with customary business practices and the legislature's intentions. Its representatives stated:

> Under the Department of Revenue's proposed rule, only business owners who purchase machinery and equipment themselves, and then separately install it themselves or through a separate contractor, can qualify for the capital equipment exemption. In a typical situation involving a large construction project, it is unlikely that the business owner will separately contract for the installation of qualifying equipment. Rather, in such large projects, contractors will be involved in the purchase and the installation of the equipment.
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> Clearly, it was the Legislature's intent to provide an incentive to expand business in Minnesota through the capital equipment exemption. Furthermore, it not unusual, and quite typical in large projects, that a contractor by involved in every phase of the construction and installation of a facility. It would be difficult to believe that the legislature did not intend that in those cases where a true expansion was occurring, that the capital equipment exemption should be denied merely by virtue of the way that the contract is structured.
>
> We propose that the terms "user" and "purchaser" be broadly construed to include business owners who make their capital equipment and machinery improvements by using contractors. In doing so, we believe that legislative intent would be met in providing an incentive for businesses to either locate or remain in the state.

Public Ex. 10 at 5-6. The Minnesota Chamber of Commerce made similar arguments noting:

> for tax exempt entities to avoid the dilemma by allowing for a cost plus contract which appoints the contractor the agent of the buyer for the purpose of buying the materials. * * * Through this "agency" interpretation, the exempt entity can achieve the benefit of the exemption.

Public Ex. 4A.

66. The Department does not propose to adopt the Subcommittee's second alternative. It believes that the amendment would cause more problems than it resolves and that the legislature would have addressed contractor purchases in the statute if it intended to exempt them because it specifically did so in other legislation, including Minn. Stat. § 297A.257 (now repealed). T. at 73-74.

67. Minn. Stat. § 297A.257, subd. 2 exempted capital equipment placed in service in distressed counties from sales and use taxes. Furthermore, under subdivision 2a, the legislature specifically provided that construction materials and supplies were exempt from sales and use taxes "regardless of whether purchased by the owner or a contractor, subcontractor, or a builder" if certain conditions were met. When the legislature enacted the capital equipment exemption in 1989 (Laws 1989, 1st Sp., c. 1, art. 12, § 7) it did not repeal the distressed county provisions. The latter were not repealed until 1991 (Laws 1991, c. 291, art. 8, § 30). While both statutes were in effect, the legislature must have intended that contractor purchases in distressed counties receive special attention. When the distressed county provisions were finally repealed in 1991, the legislature certainly could have amended the general capital equipment exemption statute to address contractor purchases. The Department believes that the legislature's failure to act indicates that it did not intend to exempt such purchases.

68. The Subcommittee argued, however, the little weight can be attached to the legislature's failure to adopt a law on the subject and that the legislature must have known that the Department exempted agent purchases for tax exempt entities and assumed it would do so in the context of the capital equipment exemption. The Subcommittee's arguments were not persuasive. Since a rebate of sales taxes paid for the purchase of capital equipment was first authorized, the Department has always interpreted the relevant statute so as to exclude contractor purchasers. Hence, when a total exemption was enacted, the legislature must have known that contractor purchases would not be covered under the Department's interpretations. There is no reason to believe that the legislature assumed that the Department would include contractor purchases under the exemption when it had not done so in the past. Also, there is no reason to believe that the legislature anticipated that the Department would adopt a rule exempting contractor purchases because it did so for tax exempt entities. The treatment of tax exempt entities and tax exempt purchases could likely be different because different considerations are involved. Moreover, if the legislature had assumed that the Department would exempt contractor purchases from sales and use taxes, it would not have specifically addressed the issue in the distressed county statute. Consequently, the Administrative Law Judge is persuaded that the Department's failure to adopt the Subcommittee's second alternative is necessary and reasonable. As a general rule, an agency cannot expand or restrict the scope of a statute or ignore

> Minn. Stat., Section 297A.01, Subd. 16 provides that capital equipment "must be used for the establishment of a new or the physical expansion of an existing. . . facility in the state." The statute also provides that capital equipment does not include, among other things, "machinery or equipment purchased or leased to replace machinery or equipment performing substantially the same function in an existing facility. . . ." [Emphasis added.] The Department of Revenue's proposed rules essentially eliminate from the statute the "substantially the same function" modifier applicable to replacement property. In the Department's Statement of Need and Reasonableness, the Department states that it "will examine the product being produced, and the functioning of the equipment, when looking at issue of 'substantially the same function.'" The Department further states that equipment will be considered to perform substantially the same function "even though it is faster or more technologically advanced than the previous equipment".
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> It is the view of the Committee that a fair reading of the statute requires that the product output of the machinery or equipment, as well as the means by which the machine manufactures the end product, provides the best indication as to whether the "function" of the machine has changed. Therefore, the Committee proposes that a 20% "bright line" test be included in the capital equipment rule in order to determine whether machinery and equipment has resulted in an expansion of an existing facility or is merely replacement property.

Public Ex. 4A.

72. To implement the Subcommittee's proposal it suggested that Item C be amended by adding a new subitem (5) to read as follows:

> substitution of a new piece of machinery or equipment when the production capacity of such piece of machinery or equipment is at least twenty percent (20%) greater than that of the piece of machinery or equipment previously used in an existing facility.

The Subcommittee's proposal was supported by Northern States Power Company, and Minnesota Mining and Manufacturing Company (3M) who stated that a 20 percent increase in production should be one factor considered in determining whether a piece of equipment performs "substantially the same function". The Iron Mining Association of Minnesota, on the other hand, argued against using a 20 percent test. In its view, the adoption of a minimum requirement would be arbitrary and would penalize taxpayers who upgrade their facility to increase productivity but fall short of the 20 percent requirement.

73. The bright line test advocated by the Subcommittee and other parties had its genesis in Northern States Power Company v. Commissioner of Revenue, Minn. Tax Ct., Docket No. 5554 (September 9, 1992), 1992 W.L. 218356 in which the tax court held that the 20% (bright line) test in Minn. Stat. § 297A.257,

interpreted it to include the conjecture that increased production by the new equipment means that the new equipment is not performing substantially the same function as the old equipment. Therefore, to give meaning to the restriction on replacement equipment, speed and increased output cannot be taken into account.

77. Based on the usual meaning of the words "physical expansion", the Administrative Law Judge is persuaded that the physical expansion of a facility does not include the purchase of any machinery and equipment that merely increases productivity. The words "physical expansion" mean a physical enlargement (making something bigger), not increased productivity. There is an inherent difference between physically enlarging a facility and increasing its output. Consequently, the Administrative Law Judge is persuaded that the Department's interpretation is necessary, reasonable, and consistent with plain language of the governing statutes.

78. Assuming, for the sake of argument, that the words "physical expansion" are ambiguous, the Administrative Law Judge is persuaded that they do not encompass increased productivity. There as several reasons for this conclusion. First, the exemption statute does not mention increased productivity, but many similar statutes do. Moreover, no legislative history was provided to support recognition of increased productivity as a physical expansion. Second, under Minn. Stat. § 645.16(5)[4] it is significant that when the distressed county statute was repealed the legislature did not amend the exemption statutes to require recognition of increased productivity as a physical expansion. If the legislature had intended to make increased productivity a physical expansion, it would have amended the capital equipment exemption statutes when the distressed county statute was repealed. It didn't. Third, recognition of increased productivity is not necessarily consistent with the purposes of the exemption statute because replacement equipment may generally be more efficient and productive. It appears that the legislature wanted physical evidence of an expansion in order for the tax exemption to be available. That does not mean that increased productivity is an irrelevant consideration, but only that the facility must be physically expanded. This may limit the availability of an exemption, but it is consistent with the words used by the legislature. Fourth, the Department's construction is entitled to some consideration.

79. As a general rule, an agency's construction of a statute is entitled to some consideration. Minn. Stat. § 645.16(8). If the agency's construction is long-standing the courts generally give it great respect. See, e.g., Bremer v. Commissioner of Taxation, 246 Minn. 446, 75 N.W.2d 470 (1956); Gale v. Commissioner of Taxation, 228 Minn. 345, 37 N.W.2d 711 (1949). In contested cases, an administrative law judge cannot defer to an agency staff's interpretation when it has not been adopted by the Commissioner. Mapleton Community Home v. Minnesota Department of Human Services, 391 N.W.2d 798 (Minn. 1986). The courts have not addressed the degree of consideration

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4/ The statute provides that in interpreting a law, the former law and other laws on the same or similar subjects can be considered.

> Machinery and equipment are considered to be performing substantially the same function even though they may increase plant production or capacity, or are capable of performing faster or more efficiently than the machinery or equipment which they replaced.

84. The Subcommittee disagrees with the Department's conclusion that the increased output of machinery or equipment cannot be considered in determining if new machinery and equipment perform substantially the same function. N.S.P. also objected to the rule stating, in part:

> . . . N.S.P. believes that the above portions of the rule provide an inappropriately narrow interpretation of the statute which is not consistent with the legislature's intent regarding both new facilities and physical expansions to existing facilities. It is our contention that new facilities are created and should qualify for the exemption, even though they may involve replacement equipment in an existing facility if the new equipment either produces a new product or provides for making a same or similar product but uses a different or more efficient manufacturing process. It is also our contention that physical expansions of existing facilities that involve machinery or equipment which substantially increase production capacity, even though the new machinery or equipment fundamentally or essentially serves the same purpose as did the old equipment, should also qualify for the capital equipment refund.
>
> * * *
>
> Finally, we suggest that the portion of the proposed rule that provides for disqualification of equipment because the same or similar product is being produced, be deleted. In addition to the definition changes suggested above which make this disqualifier inappropriate, our further basis for this contention is that nowhere in the statute does it state that if the same or similar product is being produced that the equipment doesn't qualify. Additionally, we point out that the Commissioner of Revenue (Commissioner) argued this very point (that equipment is disqualified if the same or similar product is being produced) in Northern States Power Company vs. Commissioner of Revenue, Docket No. 5554 (Minn. Tax Court dated September 9, 1992) and the court also found no basis for the Commissioner's position. . . .

Public Ex. 9, at 2-3. Commissioner Gillette also argued that increased output should be considered in determining whether an expansion has occurred. He said:

86. Mr. Menssen, speaking for 3M, stated:

> In 3M's case, the vast majority of expansion that takes place in Minnesota would fall under Subp. 4 Nonqualifying Equipment. This would include on of 3M's largest plants in Minnesota where 3M has invested over $150 million equipment since the Capital Equipment refund was enacted, and has increased production capacity of this facility by over 4 times. The vast majority of these expenditures would be disqualified under Subp. 4. 3M strongly feels that the upgrade and replacement of equipment that increases volume by over 20% should qualify for the Capital Equipment refund.
>
> The following tests should be added to Subp. 3. Qualifying Equipment, in determining whether a piece of equipment performs substantially the same function:
>
> > (1) Does the equipment increase production of the old equipment by more than 20%?
> >
> > (2) Does the equipment produce a product that could not have been produced on the existing equipment?
> >
> > (3) Does the equipment improve the quality of the product in such a way that it meets new demands in the marketplace?
> >
> > (4) Does the equipment perform tests or procedures that could not be performed on the old equipment?
>
> 3M feels that a "yes" answer to any one of these questions would involve equipment not performing substantially the same function and therefore qualify for the refund.
>
> * * *
>
> 3M would also like to note that we have attempted over the past 3-4 years to work with the Department of Revenue so they could understand the type of expansion that existing manufacturers undergo to remain competitive in a global economy. We have attempted to let them know the positive impact this legislation has had in determining where to upgrade a facility. We have given the Revenue Department a tour of one of our facilities to explain why we feel upgrades of equipment need to be included in the Capital Equipment refund. . . .

Public Ex. 1 at 1-2

87. Kelvin Johnson, President of the Printing Industry of Minnesota, was highly critical of the example the Department used of equipment which performs a substantially similar function. He argued that when a 2-color printing

indicate "purpose, intention, tendency, result, or end." Webster's Third New International Dictionary, supra, at 2401. Based on these definitions, the Administrative Law Judge is persuaded that machinery and equipment which is purchased to replace machinery and equipment that is obsolete, malfunctioning, inefficient, or worn out is not exempt if the new machinery and equipment performs substantially the same function. However, equipment purchased for expansion purposes is eligible if a physical expansion occurs. To the extent that the Department believes some other interpretation is appropriate, its interpretation is not accepted or approved. The rule could be read as leaving this issue (what is a replacement) to a case-by-case determination because the meaning of the word "replace" is not specifically defined. The Department can formulate policy on a case-by-case basis and is not required to adopt rules. Bunge Corp. v. Commissioner of Revenue, 305 N.W.2d 779 (Minn. 1982).

91. The exemption statute does not exclude all replacement equipment. It only excludes from the exemption equipment which performs substantially the same function. Hence, the legislature must have intended to exempt some replacement equipment or treat some equipment substitutions as an expansion rather than a replacement. Although the rule is not clear on this point, it apparently is not the Department's intention to differentiate between new machinery purchased for expansion purposes from machinery purchased for replacement purposes. This may be due to the fact it is difficult to distinguish between the two types of purchases because it is unlikely that a manufacturer would, for example, replace one machine with another identical model. It is more likely that the new model purchased will contain features the old model did not have and incorporate new technologies. The new equipment might likely be more efficient, more versatile, and more productive. It does not follow, however, that all new machinery and equipment purchases must be disqualified from the exemption in the manner the Department proposes. The exemption statutes do not state that replacement equipment is not exempt if the same or a similar product is produced and does not limit the exemption to equipment designed and purchased to produce a different product.

92. The word "function" is elastic and indefinite. 37 C.J.S., function, at 1397. It can be said, for example, that the function of a printing press is to manufacture a product, to print, or to print 1,000 pages hourly in three colors. The Department's interpretation is that machinery and equipment perform substantially the same function if the same or similar product is being produced or the machinery and equipment serve fundamentally or essentially the same purpose and that more versatile, speedier, or more efficient equipment is not, for those reasons, considered to be performing a different function. The Department's interpretation is inconsistent with the purposes of the exemption statutes and is an unreasonably narrow interpretation of the language used. The legislature intended to tax equipment purchased to replace similar equipment due to obsolescence, ordinary wear and tear, or damage. It also must have recognized that no mere replacement could be identical due to technological changes that naturally occur through time. However, there is no indication that the legislature intended to exclude "replacements" designed to enlarge a manufacturing operation and not merely replace outdated equipment. Because a "physical expansion" is a prerequisite to the exemption, machinery and equipment purchases that expand output or the type of products that can be produced or significantly change them in some material qualitative way should qualify for the exemption at some point. Under subpart 4A, such purchases never qualify. The Administrative Law Judge is persuaded, therefore, that subpart 4A is at

sentence in Item B in inconsistent with the exemption statutes. This constitutes a substantive violation of law for purposes of Minn. Stat. §§ 14.14, subd. 2, 14.05 subd. 2 and 14.50 (1992). To correct this defect, the second sentence must be deleted.

95. The problem with Item B, as written, is that it does not recognize a distinction between a replacement and an expansion. A facility may be upgraded and modernized as part of a physical expansion of the facility and in order increase output, the types of products produced, or the qualities of those products, and not merely because existing parts are old, worn out, obsolete, or defective. The rule has to make some distinction between these two types of purchases. West argued that a percentage standard should be adopted here under which replacement parts that do not increase plant productivity or capacity by more that 20% would not qualify as replacement parts. The Department could adopt some kind of prima facie standard under this rule like it can for Item A.

96. As noted by West, recognizing the differences between replacements and expansions is consistent with the underlying legislation and will eliminate the incentive to retain fully depreciated and no longer needed equipment solely to qualify for refund. Also, by removing the incentive to keep obsolete machinery, older equipment and machinery will flow more readily into the secondary market where it will be available for smaller companies and start-up businesses. Public Ex. 7, at 12.

97. 9130.2200, Subp. 5. This rule contains refund procedures taxpayers must follow. The Minnesota Society of Certified Public Accountants specifically addressed refund procedures. Charles M. Bartley, Chair of the Society's State Tax Subcommittee stated:

> First, we are concerned that the unreasonably narrow approach taken by the Department of Revenue has limited the group of taxpayers able to utilize this sales tax refund rule to those with the staff and resources to litigate their requests for refund in the courts. The average businessperson in Minnesota is confused by the requirements and the paperwork and is unable to expend the necessary time and money to overcome the Department's interpretations of the law. We would like to see equitable parameters established so the benefits of this law, as intended by the legislature, are realizable by all eligible taxpayers. . . Ease of compliance should also be the goal in this issue as well. Sound tax policy is the ability of all qualified taxpayers to avail oneself of the benefits, as well as the obligations.

Although the following capital equipment exemption rules are complex and the procedures somewhat burdensome, the rule proposed by the Department is consistent with underlying statutes and was shown to be necessary and reasonable.

98. 8130.200, subp. 6. This subpart of the rule pertains to leases of machinery and equipment eligible for a sales tax exemption. The proposed rule states, in part, as follows:

Subcommittee and the amendments were shown to be necessary and reasonable. Moreover, the language changes do not constitute a substantial change for purposes of Minn. Stat. § 14.15, subd. 3 (1990) and Minn. Rules, pt. 1400.1100 (1991).

101. All provisions of the rule not specifically discussed in this Report were shown to be necessary and reasonable and may be adopted by Department. In addition, all modifications to the rules not specifically discussed in this Report were shown to be necessary and reasonable and none of those changes involved a substantial change in the rules for purposes of Minn. Stat. § 14.15, subd. 3 (1990) and Minn. Rules, pt. 1400.1100 (1991).

Based upon the foregoing Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. That the Department of Revenue gave proper notice of the hearing in this matter.

2. That the Department of Revenue has fulfilled the procedural requirements of Minn. Stat. §§ 14.14, subds. 1, 1a and 14.14, subd. 2, and all other procedural requirements of law or rule.

3. That the Department of Revenue has demonstrated its statutory authority to adopt the proposed rules and has fulfilled all other substantive requirements of law or rule within the meaning of Minn. Stat. §§ 14.05, subd. 1, 14.15, subd. 3 and 14.50 (i)(ii), except as noted at Findings 21, 35, 40, 56, 92, and 94.

4. That the Department of Revenue has documented the need for and reasonableness of its proposed rules with an affirmative presentation of facts in the record within the meaning of Minn. Stat. §§ 14.14, subd. 2 and 14.50 (iii), except as noted at Findings 26, 35, and 45.

5. That the amendments and additions to the proposed rules which were suggested by the Department of Revenue after publication of the proposed rules in the State Register do not result in rules which are substantially different from the proposed rules as published in the State Register within the meaning of Minn. Stat. § 14.15, subd. 3, and Minn. Rule 1400.1000, Subp. 1 and 1400.1100.

6. That the Administrative Law Judge has suggested action to correct the defects cited in Conclusions 3 and 4 as noted at Findings 21, 26, 35, 40, 45, 56, 92 and 94.

7. That due to Conclusions 3, 4, and 6, this Report has been submitted to the Chief Administrative Law Judge for his approval pursuant to Minn. Stat. § 14.15, subd. 3.

8. That any Findings which might properly be termed Conclusions and any Conclusions which might properly be termed Findings are hereby adopted as such.