

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 10-23**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

The applicability of the Tennessee sales and use tax industrial machinery exemption to quality control testing equipment and materials.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

The [TAXPAYER] is a manufacturer¹ of [TYPE OF BUSINESS], with a facility in Tennessee. The Taxpayer uses equipment, materials, and supplies to test the products for quality control

¹ The Taxpayer holds an industrial machinery authorization number issued by the Department of Revenue.

purposes. The testing at the Tennessee facility is performed on samples taken throughout the manufacturing process, but the testing is performed primarily on equipment located in the laboratory.

Samples are taken, beginning in the [REDACTED INFORMATION], to determine what [REDACTED INFORMATION] exists, for what purpose it will be used (*e.g.*, [REDACTED INFORMATION], etc.), and the type of customer to whom it will be sold. The Taxpayer uses [EQUIPMENT] to prepare the samples for [TYPE OF] analysis in this process. Certain customers using the product for certain specialized purposes also require that, in addition to the [TYPE OF] analysis, the [PRODUCT] then go through secondary [PROCESSING] for the performance of [TYPE OF] analysis.

The Taxpayer also performs testing of the [PRODUCT] in the [TYPE OF EQUIPMENT PLANT], where it takes [PRODUCT] from the [PIECE OF EQUIPMENT], screens it, and performs [TYPE OF] analysis. The Taxpayer samples the product before and after the product is processed in the [PIECE OF EQUIPMENT] to confirm that carbon dioxide was removed from the [PRODUCT] during the [PRODUCTION] process. The [PIECE OF EQUIPMENT] operators perform [TYPE OF TEST] and [TYPE OF ANALYSIS] out of the [PIECE OF EQUIPMENT] to control the [PROCESS]. This testing uses [SEVERAL TYPES OF EQUIPMENT]. An auto-sampler located on the [PIECE OF EQUIPMENT] performs a laboratory analysis every four hours to test for various [REDACTED] chemical properties in the [PRODUCT].

The Taxpayer also tests the [TYPE OF] products in the [PRODUCT] [PROCESS] plant for various residues and other chemicals by doing [TYPE OF] analysis. Additionally, in the [TYPE OF PLANT] where [REDACTED INFORMATION] to form a [TYPE OF] product, the Taxpayer tests for various things such as [TYPE OF TESTS] on the [PRODUCT]. It also tests the [PRODUCT] by doing [TYPES OF] analysis.

All of the above testing makes up about seventy-five to eighty percent of all of the testing done in the Taxpayer's manufacturing plant. Additional testing is performed in the [TYPE OF] plant on the [PRODUCT USED FOR FUEL] in the processing of its products. This testing, which checks for [PARTS OF PRODUCT], is performed in the [TYPE OF EQUIPMENT]. This is done to insure that the [PRODUCT USED FOR FUEL] will [PERFORM] as expected and to confirm that the supplier is providing the proper [PRODUCT USED FOR FUEL] needed.

Final testing, performed only when certain customers require it, is done by way of [TYPE OF ANALYSIS], etc. at the facility's loading area before the product goes into the [MODE OF TRANSPORTATION] for shipping.

QUESTIONS

1. Are the equipment and repair parts for the equipment that are used in testing the Taxpayer's product exempt from the Tennessee sales and use tax?
2. Are any materials and supplies used in testing the product, when consumed within twenty-five days, exempt from the Tennessee sales and use tax?

RULINGS

1. The equipment and repair parts for the equipment that are primarily used in testing the Taxpayer's product as part of the manufacturing process, as described in the analysis below, are exempt from the Tennessee sales and use tax as industrial machinery. Equipment used primarily outside the manufacturing process is not exempt as industrial machinery.
2. Likewise, materials and supplies used in testing the product as part of the manufacturing process are exempt from Tennessee sales and use tax, if such materials and supplies come into direct contact with the product and are consumed within twenty-five days.

ANALYSIS

Under the Retailers' Sales Tax Act, TENN. CODE ANN. § 67-6-101 *et seq.*, the sale of tangible personal property is generally subject to the Tennessee sales and use tax. However, TENN. CODE ANN. § 67-6-206(a) (Supp. 2010) exempts "industrial machinery" from the sales and use tax, providing that "[a]fter June 30, 1983, no tax is due with respect to industrial machinery."² "Industrial machinery" is defined in pertinent part as "[m]achinery, apparatus and equipment with all associated parts, appurtenances and accessories, including hydraulic fluids, lubricating oils, and greases necessary for operation and maintenance, repair parts and any necessary repair or taxable installation labor therefor, that is necessary to, and primarily for, the fabrication or processing of tangible personal property for resale and consumption off the premises . . . where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one's principal business." TENN. CODE ANN. § 67-6-102(47)(A)(i) (Supp. 2010).

Additionally, TENN. CODE ANN. § 67-6-329(a)(12) (Supp. 2010) exempts industrial materials used "for future processing, manufacture or conversion into articles of tangible personal property for resale where the industrial materials . . . become a component part of the finished product or are used directly in fabricating, dislodging, or sizing." Finally, TENN. COMP. R. & REGS. 1320-5-1-40(2) (2008) ("Rule 40(2)") exempts from the Tennessee sales and use tax "[m]aterials and supplies coming in direct contact with and which are consumed within twenty-five (25) consecutive calendar days, in the processing of manufactured products."

1. *Equipment³ used for quality control testing*

² Note that the burden is on the Taxpayer to establish entitlement to an exemption from taxation. The Tennessee Supreme Court has stated that "[a]lthough the rule is well-established that taxing legislation should be liberally construed in favor of the taxpayer and strictly construed against the taxing authority, it is an equally important principle of Tennessee tax law that 'exemptions from taxation are construed against the taxpayer who must shoulder the heavy and exacting burden of proving the exemption.'" *Am. Airlines, Inc. v. Johnson*, 56 S.W.3d 502, 506 (Tenn. Ct. App. 2000) (quoting *Rogers Group, Inc. v. Huddleston*, 900 S.W.2d 34, 36 (Tenn. Ct. App. 1995)). The Tennessee Supreme Court has also stated that the burden is on the taxpayer to establish the exemption, and any well-founded doubt is sufficient to defeat a claimed exemption from taxation. *Am. Airlines*, 56 S.W.3d at 506 (citing *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196, 198 (Tenn. 1994); *United Cannery, Inc. v. King*, 696 S.W.2d 525, 527 (Tenn. 1985)).

³ Throughout this analysis, use of the term "equipment" is intended to include both the equipment itself and repair parts for such equipment.

Any testing equipment that is a necessary part of the manufacturing process and is primarily used for that purpose is exempt from the Tennessee sales and use tax as industrial machinery.

In order for the Taxpayer's equipment to be exempt from the Tennessee sales and use tax as industrial machinery as defined by TENN. CODE ANN. § 67-6-102(47)(A)(i) (Supp. 2010), four requirements must be met. First, the Taxpayer must be a manufacturer. Second, the equipment must be machinery, apparatus or equipment. Third, the equipment must be necessary to the fabrication or processing of the products sold by the Taxpayer. Fourth, the equipment must be primarily for the fabrication of the products sold by the Taxpayer.

The first two requirements are indisputably met under the facts provided in the taxpayer's ruling request. First, the Taxpayer qualifies as a manufacturer. A manufacturer is defined under TENN. CODE ANN. § 67-6-102(47)(A)(i) as "one who engages in [the] fabrication or processing [of tangible personal property for resale and consumption off the premises] as one's principal business." Manufacturing is a taxpayer's principal business if more than fifty percent of its revenues at a given location are derived from fabricating or processing tangible personal property for resale. *Tenn. Farmers' Coop. v. State ex rel. Jackson*, 736 S.W.2d 87, 91-92 (Tenn. 1987). The Taxpayer has indicated that it is principally engaged in the manufacturing of [NAME OF PRODUCTS], which are sold to others for use and consumption off the premises. Additionally, the Taxpayer holds an industrial machinery authorization number issued by the Department. The Taxpayer is therefore a manufacturer. Second, the equipment clearly comes within the meaning of "machinery, apparatus and equipment...[including] repair parts." TENN. CODE ANN. § 67-6-102(47)(A)(i).

The issue presented in this ruling request is which of the Taxpayer's equipment, if any, meets both the third and fourth requirements. That is, which equipment is both necessary to the manufacturing process and used primarily for such process. The term "necessary" is undefined by the Tennessee Code and the Tennessee courts for Tennessee sales and use tax purposes. The common meaning of the term "necessary" is "that which cannot be dispensed with; essential; indispensable; ... inherent in the situation; unavoidable from the premises ... rendering some essential and intimate service." WEBSTER'S NEW TWENTIETH CENTURY DICTIONARY (2nd ed. 1964). Thus, in order for machinery, equipment, or apparatus to be "necessary" to the manufacturing process, it must be essential to the manufacturing process as engaged in by a taxpayer.

Here, the Taxpayer uses various equipment to test and inspect its products throughout the manufacturing process. Without such testing, the Taxpayer could not successfully produce its products. For example, the production of [TYPE OF PRODUCT] requires the removal of [REDACTED INFORMATION] from [PRODUCT]; because the process is reversible, the Taxpayer must test the [PRODUCT] to ensure that the [REDACTED INFORMATION] has been eliminated. Similarly, the Taxpayer performs tests for [CONTENT]; conducts [TYPE OF] analysis to control the [PROCESS] in the [PIECE OF EQUIPMENT]; automatically tests the [TYPE OF] properties of the [PRODUCT] every four hours; and tests its [PRODUCT] for [PROPERTIES]. Because this testing is conducted as an essential part of the Taxpayer's manufacturing process, it is considered necessary to that process.

However, the Taxpayer also performs tests on the [PRODUCT] it uses for fuel in the processing of its products. This testing process, while its results are important to the manufacturing of the [TYPES OF PRODUCTS], is not actually a part of the manufacturing process itself. Therefore, the equipment used to test the [PRODUCT USED FOR FUEL] is not necessary to the manufacturing process.

The term “primarily” has been defined by the Tennessee Supreme Court for purposes of the industrial machinery exemption as “first of all; principally; or fundamentally” and as “first in rank or importance, chief, principal, basic or fundamental.” *Woods v. General Oils, Inc.*, 558 S.W.2d 433, 436 (Tenn. 1977) (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (1961); *Breen v. Indus. Acc. Bd.*, 436 P.2d 701 (Mont. 1968); *20th Century Mfg. Co. v. United States*, 444 F.2d 1109 (Ct. Cl. 1971)). The machinery, equipment, or apparatus satisfies this test if more than fifty percent of its use is in the manufacturing operation.

Accordingly, each particular piece of equipment must be examined. If it is used for a purpose that is necessary to the manufacturing process, as described above, and it is used for that purpose more than fifty percent of the time, then it is exempt as industrial machinery.

Note, however, that TENN. CODE ANN. § 67-6-102(47)(F) specifically excludes from the definition of “industrial machinery” any machinery, equipment, or apparatus that is used before the use of equipment that transports the raw materials from storage to the manufacturing process or after the use of equipment that transports the finished products from the manufacturing process to storage. Thus, equipment used primarily before delivery of the raw materials to the manufacturing process or after delivery of the finished product to storage will not come within the scope of the exemption. The Taxpayer has indicated that samples are taken from the [REDACTED] and tested prior to the [PROCESS] from the [REDACTED]. The Taxpayer further has indicated that a final testing process may occur upon the customer’s request in the loading area before the product is shipped to the customer. If the equipment used for either of these testing processes is used solely or primarily for these steps and is not used primarily during the manufacturing process, then this specific equipment is not “necessary to” or “primarily for” the manufacturing process and thus is not exempt as industrial machinery for Tennessee sales and use tax purposes.

2. *Materials and supplies used for testing that are consumed within 25 days*

Similar to the equipment discussed above, materials and supplies used in testing the product as part of the manufacturing process are exempt from the Tennessee sales and use tax, if the materials and supplies come into direct contact with the product and are consumed within twenty-five days.

TENN. CODE ANN. § 67-6-329(a)(12) (Supp. 2010) exempts industrial materials used “for future processing, manufacture or conversion into articles of tangible personal property for resale where the industrial materials . . . become a component part of the finished product or are used directly in fabricating, dislodging, or sizing.” Thus, under TENN. CODE ANN. § 67-6-329(a)(12), industrial materials that are used by the Taxpayer directly in fabrication, dislodging, or sizing processes are exempt from sales and use taxation.

TENN. COMP. R. & REGS. 1320-5-1-.40(2) (2008) (“Rule 40(2)”) further elaborates on Tenn. Code Ann. § 67-6-329(a)(12). Rule 40(2) exempts from the Tennessee sales and use tax “[m]aterials and supplies coming in direct contact with and which are consumed within twenty-five (25) consecutive calendar days, in the processing of manufactured products.” Thus, if materials are used by the Taxpayer for testing purposes in the manufacturing process and come into direct contact with the [NAMES OF PRODUCTS] and are consumed within twenty-five days, such materials will be exempt from the Tennessee sales and use tax.

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APPROVED: Charles A. Trost
Commissioner of Revenue

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