TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 99-10

IMPORTANT NOTICE: SINCE THIS RULING WAS ISSUED, THE TENNESSEE LEGISLATURE ENACTED 1999 TENNESSEE PUBLIC ACTS, CHAPTER 407. CURRENT LAW MAKES "EXEMPT WHOLESALE GENERATORS" AND "FERC [FEDERAL ENERGY REGULATORY COMMISSION] CERTIFIED WHOLESALER POWER MARKETERS," UNDER THE FEDERAL POWER ACT OF 1992, EXEMPT FROM THE GROSS RECEIPTS TAX PROVIDED IN T.C.A. SECTION 67-4-405.

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

Applicability of gross receipts taxes and sales and use taxes to the acquisition and use of natural gas in producing electricity and the sale of the electricity so produced by several related corporations and limited liability companies.

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 his detriment.

FACTS

[POWER COMPANY ONE] a [STATE OTHER THAN TENNESSEE] limited liability company duly qualified to do business in Tennessee, is an "exempt wholesale generator" of electricity as that term is defined in the Federal Power Act, 16 U.S.C.A. § 791a *et seq*. In [DATE], [POWER COMPANY ONE] entered into a lease agreement with the Industrial Development Board of the [CITY], Tennessee (the "Board"), pursuant to which a plant for the "conversion of natural gas into electricity" is to be constructed in [COUNTY, TENNESSEE]. The real and personal property comprising the plant will be owned by the Board and leased to [POWER COMPANY ONE]. The lease agreement contains a "payment in lieu of taxes" program. It also provides [POWER COMPANY ONE] with an option to purchase the real and personal property comprising the plant for a nominal amount. It is expected that the [POWER COMPANY ONE] plant will be completed and operational later this year.

[POWER COMPANY TWO], a [STATE OTHER THAN TENNESSEE] limited liability company, is an "exempt wholesale generator" of electricity as that term is defined in the Federal Power Act. [POWER COMPANY TWO] is considering the construction of a plant in [SECOND LOCATION, TENNESSEE], similar to the [POWER COMPANY ONE] plant.

[POWER MARKETER], a [STATE OTHER THAN TENNESSEE] corporation duly qualified to do business in Tennessee, is a wholesale power marketer that is registered with the Federal Energy Regulatory Commission.

[POWER INVESTOR], a [STATE OTHER THAN TENNESSEE] corporation, owns 100 percent of the equity interest in [POWER COMPANY ONE], in [POWER COMPANY TWO], and also in [POWER MARKETER].

(This ruling is requested on behalf of [POWER COMPANY ONE], [POWER COMPANY TWO], [POWER MARKETER] and [POWER INVESTOR] (collectively, the "Taxpayers."))

[POWER MARKETER] will purchase natural gas outside the State of Tennessee. It will arrange with an interstate gas transmission pipeline for transportation of the purchased natural gas from outside the state to the plant in Tennessee used by either [POWER COMPANY ONE] or [POWER COMPANY TWO] for their respective operations.

Both [POWER COMPANY ONE] and [POWER COMPANY TWO] (collectively, the "Plants") will provide "energy conversion services" for [POWER MARKETER], using natural gas in the production of electricity for [POWER MARKETER]. The Plants will use natural gas owned by [POWER MARKETER] to produce electricity under what is described in the ruling request as a "tolling arrangement" with the latter. Under such arrangement, [POWER MARKETER] will retain title to the energy during its conversion

from natural gas to electricity. (Neither [POWER COMPANY ONE] nor [POWER COMPANY TWO] will acquire title to the energy in either its form as natural gas or its form as electricity.)

[POWER MARKETER] will pay the Plants a processing fee for each unit of energy converted from natural gas into electricity. Additionally, [POWER MARKETER] will pay the Plants monthly capacity payments for the right to convert energy, irrespective of whether or not the Plants provide any conversion services during that month.

[POWER MARKETER] will ultimately sell the electricity produced by the Plants through the conversion process to wholesale customers both within and without Tennessee.[1]

ISSUES

1(a) Is the gross receipts tax imposed by TENN. CODE ANN. § 67-4-406 applicable to any of the Taxpayers?

1(b) Is the gross receipts tax imposed by TENN. CODE ANN. § 67-4-405 applicable to any of the Taxpayers?

2(a) Are the business activities performed by Plants for [POWER MARKETER] taxable under the sales and use tax laws provided by TENN. CODE ANN. § 67-6-101 *et seq*.?

2(b) Are the sales of electricity by [POWER MARKETER] to its wholesalers taxable under the sales and use tax laws provided by TENN. CODE ANN. § 67-6-101 *et seq*.?

3. Are machinery, apparatus, and equipment with all associated parts, appurtenances and accessories acquired by Plants that are necessary to and used primarily for conversion of natural gas to electricity for [POWER MARKETER] exempt from sales and use tax as "industrial machinery"?

4. Is the natural gas purchased by [POWER MARKETER] for conversion into electricity taxable under the sales and use tax laws provided by TENN. CODE ANN. § 67-6-101 *et seq*.?

---

[1] In the ruling request, the Taxpayers have described the business activities performed by [POWER COMPANY ONE] and [POWER COMPANY TWO] for [POWER MARKETER] as the "conversion of natural gas into electricity" and "energy conversion services" wherein natural gas is "converted" into electricity.

It is unclear whether the words "conversion" and "converted" accurately reflect the activities that will be performed by Plants. In fact, it seems probable that Plants' business activities could be better described as the use of natural gas supplied by [POWER MARKETER] as fuel in the operation of machinery and equipment to produce electricity for [POWER MARKETER].

However, to simplify discussion of the issues presented by the Taxpayers in their ruling request, the words "conversion" and "converted" are often used in the ruling to describe Plants' use of natural gas provided by [POWER MARKETER] in the production of electricity for the latter, even if these terms do not properly describe the activities to be performed here.

RULINGS

1(a) No.

1(b) Yes. The tax applies to Plants' gross receipts obtained in the furnishing of Tennessee-produced electricity to [POWER MARKETER] for delivery to the latter at Plants' respective facilities located in Tennessee. It also applies to [POWER MARKETER'S] gross receipts obtained for distributing Tennessee-produced electricity to Tennessee wholesalers.

2(a) Yes. However, Plant's sales of electricity to [POWER MARKETER] may be exempt as sales for resale.

2(b) Yes. However, [POWER MARKETER'S] sales of electricity to wholesale customers in Tennessee may be exempt as sales for resale.

3. Yes, to the extent that such machinery, apparatus and equipment acquired by Plants is "industrial machinery," as defined in TENN. CODE ANN. § 67-6-102(13)(A). (An industrial machinery authorization would be required to obtain the tax exemption.)

4. Yes, but the natural gas is taxed at the reduced rate of 1.5% as an energy fuel under TENN. CODE ANN § 67-6-206(b)(1).

ANALYSIS

Under the facts and circumstances given, [POWER INVESTOR] would have no gross receipts tax liability or sales and use tax liability. [POWER INVESTOR] does not engage in any business activities subject to the relevant privilege taxes on gross receipts (TENN. CODE ANN. §§ 67-4-405 and 67-4-406) nor does it conduct transactions subject to the sales and use taxes (TENN. CODE ANN. § 67-6-101 *et seq.*). It merely owns a 100% interest in a corporation and in two limited liability companies that may do so.

The remainder of this Analysis will discuss potential tax implications to [POWER COMPANY ONE] and [POWER COMPANY TWO] (*i.e.*, Plants) and [POWER MARKETER].

1(a) APPLICABILITY OF TENN. CODE ANN. § 67-4-406 (GROSS RECEIPTS TAX) TO THE TAXPAYERS.

TENN. CODE ANN. § 67-4-406(a) provides as follows:

> Each public utility, other than those specifically enumerated and taxed under another section of this part, shall for the privilege of doing business pay to the

> state for state purposes an amount equal to three percent (3%) of the gross receipts in this state.

The applicability of the statute turns on the definition of "public utility" and whether a particular taxpayer's business activities can properly be classified as such under the statute. However, neither the statute itself nor any of the privilege tax statutes found in Title 67, Chapter 4, Part 4, define the phrase "public utility."

When called upon to interpret TENN. CODE ANN. § 67-4-406(a), the Department has taken the position that the Tennessee legislature intended the statute to apply to businesses providing some essential commodity or service to the general public. Thus, it has concluded that a taxpayer not making services generally available to the general public, but rather to a single vendee pursuant to a private contract, is not a "public utility" under TENN. CODE ANN. § 67-4-406(a).

In the facts presented by the Taxpayers, since the energy conversion services of both [POWER COMPANY ONE] and [POWER COMPANY TWO] are rendered pursuant to specific contracts each have with a single vendee ([POWER MARKETER]), neither Plant can be considered a "public utility" subject to the gross receipts tax imposed by TENN. CODE ANN. § 67-4-406.[2]

[POWER MARKETER] contracts with various wholesalers for the sale of electricity, a commodity commonly distributed by public utilities. However, the facts indicate no general distribution of electricity by [POWER MARKETER] to members of the general public. Since statutes imposing taxes must be strictly construed (*see* 23 Tenn. Jur. *Taxation,* 3.), [POWER MARKETER] will not be considered a "public utility" under TENN. CODE ANN. § 67-4-406 subject to the gross receipts tax imposed by that statute.

1(b) APPLICABILITY OF TENN. CODE ANN. § 67-4-405 (GROSS RECEIPTS TAX) TO THE TAXPAYERS.

(1) *[POWER MARKETER'S] transfer of natural gas to Plants.*

TENN. CODE ANN. § 67-4-405(a)(2) provides, in part, as follows:

> (2) Persons engaged in the business of manufacturing gas or of distributing manufactured gas or natural gas shall . . . pay an amount equal to one and one-half percent (1.5%) of the gross receipts derived from intrastate business in this state . . .

[2] While both [POWER COMPANY ONE] and [POWER COMPANY TWO] are "exempt wholesale generators" of electricity under applicable federal law, the *federal* exemptions would not necessarily be relevant to the determination of *state* exemption from liability for the Tennessee gross receipts tax.

This statute is a privilege tax subjecting persons engaged in three particular types of business to a 1.5% gross receipts tax: the manufacturing of gas, the distributing of manufactured gas and the distributing of natural gas.

In this case, [POWER MARKETER] engages in none of the businesses subject to the tax imposed by TENN. CODE ANN. § 67-4-405(a)(2). [POWER MARKETER] does not manufacture gas because the product it contracts with Plants to produce or manufacture is *electricity*. [POWER MARKETER] does not distribute manufactured gas because the product it sells to wholesalers is *electricity*.

Finally, even though [POWER MARKETER] distributes natural gas to Plants, [POWER MARKETER] obtains no gross receipts from such transferees for the distribution. ([POWER MARKETER'S] only gross receipts are from wholesalers for the distribution of *electricity* produced by the Plants.) Thus, in the case of [POWER MARKETER'S] original transfers of natural gas to Plants, there is no tax base upon which the gross receipts tax rate could be applied.

Therefore, TENN. CODE ANN. § 67-4-405(a)(2) does not impose a gross receipts tax upon [POWER MARKETER] for its transfer (transportation by pipeline) of natural gas to the Tennessee facilities of Plants.

(2) *Plants' provision of electricity to [POWER MARKETER]*.

TENN. CODE ANN. § 67-4-405(a)(1) provides as follows:

> Each person engaged in the business of furnishing or distributing gas, water, or electric current, whether to a dealer, consumer, municipality or other customer, shall, for the privilege of doing such business, pay to the state for state purposes an amount equal to three percent (3%) of the gross receipts derived from intrastate business in the state.

Plants produce electricity in Tennessee for [POWER MARKETER]. Though Plants never obtain title to the electricity, they maintain possession of it as soon as it is produced at their facilities. Plants subsequently provide the electricity to [POWER MARKETER] pursuant to their contract, either transmitting it to [POWER MARKETER] or simply making it available to the latter at the Plant facilities.

When Plants provide the electricity to [POWER MARKETER], an electricity wholesaler, in exchange for processing fees and monthly capacity payments, they are engaged in the business of "furnishing or distributing . . . electric current . . . to a dealer" as provided in TENN. CODE ANN. § 67-4-405(a)(1).

The facts presented in the ruling request do not indicate where deliveries of electricity by Plants to [POWER MARKETER] take place. However, absent facts suggesting that

deliveries are made outside Tennessee, the Department believes that deliveries of the Tennessee-produced electricity generated at the Plants' facilities take place at their respective facilities located in [LOCATION IN TENNESSEE].

Therefore, Plants are subject to tax on their gross receipts from their production agreements with [POWER MARKETER], because the gross receipts are derived wholly from intrastate business as provided in such statute.

(3) *[POWER MARKETER'S] sale of electricity to wholesalers.*

When [POWER MARKETER] sells electricity to a wholesaler, it engages in the business of furnishing or distributing electric current to a dealer, as provided by TENN. CODE ANN. § 67-4-405(a)(1). Thus, it is subject to a 3% gross receipts tax for the privilege of doing such business based on its gross receipts from intrastate business in Tennessee.

[POWER MARKETER'S] gross receipts for sales of electricity to wholesalers *outside* Tennessee are not subject to the tax imposed by TENN. CODE ANN. § 67-4-405. Sales to out-of-state wholesalers do not constitute wholly intrastate business and only gross receipts "derived from intrastate business in this state" are taxable pursuant to TENN. CODE ANN. § 67-4-405(a)(1) and (a)(3).

However, in the facts presented, [POWER MARKETER'S] sales of electricity to wholesalers *inside* Tennessee represent intrastate business subject to the tax since the electricity is produced in Tennessee and is sold to Tennessee businesses.

(i) *Tennessee Natural Gas Line* case.

The Tennessee Supreme Court found the gross receipts tax applicable in a similar case involving a purchaser and seller of natural gas in Tennessee. In *Tennessee Natural Gas Line, Inc. v. Atkins*, 287 S.W.2d 67 (Tenn. 1956), the Court held the taxpayer liable for the gross receipts tax on its sales of natural gas even though it purchased its natural gas from an interstate carrier, rejecting the taxpayer's argument that it operations were essentially an integral part of interstate commerce.

The Court conceded that taxpayer's purchase of natural gas was an interstate transaction. However, it stated that

> . . . the transaction with which we are now concerned is the re-sale to Dupont of natural gas which has become the sole property of the complainant. **The purchase and resale is not one continuing transaction.** (Emphasis added.) *Id.*, at 69.

Similarly, the facts presented in the ruling request indicate that [POWER MARKETER] will purchase natural gas outside Tennessee and transport it into Tennessee for processing by Plants. However, [POWER MARKETER'S] out-of-state purchase and transportation

into Tennessee of natural gas is even further removed from its business subject to the gross receipts tax (furnishing or distributing *electricity*) than was the interstate transaction of the taxpayer in the *Tennessee Natural Gas Line* case from such taxpayer's business.

(The natural gas purchased out-of-state by [POWER MARKETER] is used in the production of a new product, electricity. It is only the *latter* product, produced in Tennessee, that is marketed by [POWER MARKETER] to its Tennessee wholesalers. In the *Tennessee Natural Gas Line* case, the product purchased in the interstate transaction was simply distributed, without being used, yet such distribution alone was found by the court to be a business subject to the gross receipts tax.)

The Court, in the *Tennessee Natural Gas Line* case, also recognized a distinction for tax purposes between the local and non-local aspects of a business that is both interstate and intrastate. Citing several rulings of the United States Supreme Court, it stated the following:

> . . . (A) tax that is levied upon the **local aspects of a business that is both interstate and intrastate** does not per se impose a burden on interstate commerce. *Interstate Oil Pipe Line Co. v.Stone*,337 U.S. 662, 69 S.Ct. 1264, 93 L.Ed. 1613, and authorities cited therein. (Emphasis by the court.) *Id.*, at 70.

The facts here presented indicate that [POWER MARKETER] will engage in the business of furnishing or distributing electricity, produced for it by Plants in Tennessee, to Tennessee wholesalers. Even though [POWER MARKETER] goes outside Tennessee to obtain natural gas used in the production of the electricity, all production of electricity and sales of the electricity thus produced to Tennessee wholesalers constitute *local* aspects of a business that has both interstate and intrastate aspects. There is no burden on interstate commerce imposed by the imposition of a tax on it.

(ii) Federal law.

It is observed that [POWER COMPANY ONE] and [POWER COMPANY TWO] are each "exempt wholesale generators" of electricity as that term is defined in the Federal Power Act, 16 U.S.C.A. § 791a *et seq*. and that [POWER MARKETER] is a wholesale power marketer registered with the Federal Energy Regulatory Commission.

However, the Tennessee Supreme Court stated plainly in the *Tennessee Natural Gas Line* case that the State of Tennessee was not debarred from its right to levy a tax upon the complainant for the privilege of carrying on a business that is exclusively intrastate in character merely because the original consignor of natural gas and the complainant may be subject to the Federal Power Commission.[3] *Tennessee Natural Gas Line, Inc. v. Atkins*, 287 S.W.2d 67, at 70 (Tenn. 1956).

[3] The Federal Power Commission was abolished and its functions, personnel, property, funds, etc., were transferred to the Secretary of Energy, with the exception of certain functions, which were transferred to the

Nevertheless, federal statutory law must still be considered to determine whether Tennessee's gross receipts tax on [POWER MARKETER'S] sales of electricity to wholesalers in Tennessee is a permissible form of regulation of electric utility companies engaged in interstate commerce.

The United States Congress stated its regulatory policy over electric utility companies engaged in interstate commerce in the Federal Power Act, at 16 USCS § 824(a):

> (a) **It is hereby declared that the business of transmitting and selling electric energy for ultimate distribution to the public is affected with a public interest, and that Federal regulation of matters relating to** generation to the extent provided in this Part [16 USCS §§ 824 *et seq*.] and the Part next following [16 USCS §§ 825 *et seq*.] and of that part of such business which consists of **the transmission of electric energy in interstate commerce and the sale of such energy at wholesale in interstate commerce is necessary in the public interest, such Federal regulation, however, to extend only to those matters which are not subject to regulation by the States**. (Emphasis added.)

This statutory policy statement evidences a federal intent to regulate the transmission and sale of electricity in interstate commerce. However, federal regulation is intended to be restricted to matters not regulated by the states.

The statute cited above proceeds to provide, in applicable part, as follows:

> (b) Use or sale of electric energy in interstate commerce. (1) **The provisions of** this Part [**16 USCS §§ 824 *et seq*.**] **shall apply to the transmission of electric energy in interstate commerce and to the sale of electric energy at wholesale in interstate commerce, but . . . shall not apply to any other sale of electric energy** or deprive a State or State commission of its lawful authority now exercised over the exportation of hydroelectric energy which is transmitted across a State line. **The Commission** shall have jurisdiction over all facilities for such transmission or sale of electric energy, but **shall not have jurisdiction**, except as specifically provided in this Part [16 USCS §§ 824 *et seq*.] and the Part next following [16 USCS §§ 825 *et seq*.], **over facilities used**

Federal Energy Regulatory Commission, pursuant to the Department of Energy Organization Act (Act Aug. 4, 1977, P.L. 95-91, 91 Stat. 565), which is classified generally as 42 USCS §§ 7101 *et seq*. *See* in particular, 42 USCS §§ 7151(b), 7171(a), 7172(a), 7291, and 7293.

Therefore, the authority of the Federal Energy Regulatory Commission, derived from the Federal Power Commission's previous authority, over [POWER MARKETER] does not bar the State of Tennessee from its levy of tax on [POWER MARKETER'S] intrastate business.

> **in local distribution or only for the transmission of electric energy in intrastate commerce**, or over facilities for the transmission of electric energy consumed wholly by the transmitter . . . (Emphasis added.) 16 USCS § 824(b).

This law states the limited extent of federal regulation of electricity *sales* and plainly indicates that sales and transmissions of electric energy may have a wholly "intrastate" character not subject to federal regulation.

16 USCS § 824 proceeds to provide as follows:

> (c) Electric energy in interstate commerce. **For the purpose of** this Part [**16 USCS §§ 824 *et seq*.**]**, electric energy shall be held to be transmitted in interstate commerce if transmitted from a State and consumed at any point outside thereof**; but only insofar as such transmission takes place within the United States.
> (d) "Sale of electric energy at wholesale". **The term "sale of electric energy at wholesale" when used in this Part [16 USCS §§ 824 *et seq*.] means a sale of electric energy to any person for resale.** (Emphasis added.)

Applying the above provisions to the facts presented in the ruling request, "transmission" of electricity produced by Plants in Tennessee but transmitted by [POWER MARKETER] to wholesalers out-of-state would be considered interstate commerce under 16 USCS § 824(c). Similarly, sales of electricity by [POWER MARKETER] to wholesalers out-of-state would be deemed sales in interstate commerce under the same statute.

However, [POWER MARKETER'S] sale of Tennessee-produced electricity to wholesalers in Tennessee must be considered "sales of electric energy at wholesale" but could hardly be deemed sales in interstate commerce under the statute. Where the production and the sale or distribution of electricity is begun and completed entirely in Tennessee, the business activity subject to the Tennessee tax is a wholly intrastate activity not subject to federal regulation.

(iii) *South Central Bell* case.

The Tennessee Supreme Court's decision in *South Central Bell Telephone Company v. Celauro*, 735 S.W.2d 228 (Tenn. 1987), is cited by the Taxpayers in support of their assertion that the "proposed transaction" does not implicate the applicability of the gross receipts tax to any of the Taxpayers on the theory that the business activity (or activities) are a part of interstate commerce.

However, the Court concluded that the gross receipts tax did not apply based on the fact that the income generated by the taxpayer was for end user charges *ordered* by the

Federal Communications Commission. Thus, the income that Tennessee was attempting to tax was generated from interstate commerce. Since the business was not derived wholly from intrastate commerce, the tax did not apply. *Id.*, at 231.

In the instant case, there is no federal agency that has jurisdictional authority to order the charges made by [POWER MARKETER] for its sales of electricity to Tennessee wholesalers. [POWER MARKETER'S] sales of electricity produced in Tennessee to wholesalers in Tennessee are wholly intrastate transactions. Thus, the *South Central Bell* case is inapplicable.

(iv) TENN. CODE ANN. § 67-4-405(b).

TENN. CODE ANN. § 67-4-405(b) provides, in applicable part, that "[t]his tax does not apply to cities or other political subdivisions of the state owning and operating gas companies, water companies or power plants . . ." While the Industrial Development Board of the [CITY, TENNESSEE] will be the owner of the facilities leased to [CITY, TENNESSEE], the latter will operate the leased facilities, using the natural gas to produce electricity. Since the Board will not both own and operate the energy facilities leased by [CITY, TENNESSEE], the exemption of TENN. CODE ANN. § 67-4-405(b) is not applicable.

2(a) APPLICABILITY OF TENN. CODE ANN. § 67-6-101 *ET SEQ.*, (SALES AND USE TAXES) TO PLANTS' BUSINESS ACTIVITIES.

The ruling request suggests that [POWER COMPANY ONE] and [POWER COMPANY TWO] (hereinafter, the "Plants") will be providing services - the conversion of natural gas into electricity. It points out that only certain specified services are subject to tax under the law and that since the conversion of natural gas into electricity is not listed, no sales and use tax should apply.

However, TENN. CODE ANN. § 67-6-102(29) defines "tangible personal property" to mean and include "personal property, which may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses . . ." Electricity, the energy fuel produced by the Plants' conversion of natural gas, is a substance that fits within such classification of property under the sales and use tax statutes.

TENN. CODE ANN. § 67-6-102(25)(A) defines "sale" to mean "any transfer of title or possession, . . . in any manner or by any means whatsoever of tangible personal property for a consideration, and **includes the fabrication of tangible personal property for consumers who furnish, either directly or indirectly, the materials used in fabrication work . . .**" (Emphasis added.) Plants are producing or fabricating tangible personal property (electricity) for [POWER MARKETER] using fuel (natural gas) provided by [POWER MARKETER].

Further guidance is furnished by TENN. COMP. R. & REGS. 1320-5-1-. 41 which states that "(w)here persons contract to fabricate articles of tangible personal property from materials selected or furnished by customers, the total proceeds from the sale are subject to the Sales and Use Tax . . ."

While the natural gas is not a component part of the fabricated product (electricity), in the usual sense, Plants are producing or fabricating a new form of tangible personal property and receiving consideration for such fabrication.

Therefore, the "services" Taxpayers assert are being performed by the Plants must be deemed sales of tangible personal property and generally considered subject to the provisions of the sales and use tax law. (*See* TENN. CODE ANN. § 67-6-201, which provides that "(i)t is declared to be the legislative intent that every person is exercising a taxable privilege who: (1) Engages in the business of selling tangible personal property at retail in this state . . .")

In this case, however, [POWER MARKETER] intends to sell the electricity fabricated by Plants to other wholesalers. Sales for resale are specifically excluded from the definition found in TENN. CODE ANN. § 67-6-102(24)(A) of "retail sales."[4]

2(b) APPLICABILITY OF TENN. CODE ANN. § 67-6-101 *ET SEQ*., (SALES AND USE TAXES) TO [POWER MARKETER'S] SALES OF ELECTRICITY TO TENNESSEE WHOLESALERS.

[POWER MARKETER'S] sales of electricity to wholesalers constitute sales of "tangible personal property" as defined in TENN. CODE ANN. § 67-6-102(29), since electricity "may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses."

However, since [POWER MARKETER'S] purchasers intend to re-sell the electricity they receive from [POWER MARKETER], the latter may also take advantage of the sale for resale exclusion as described above in the Analysis, Ruling 2(a), provided it complies with applicable rules and regulations promulgated by the commissioner for such sales for resale.[5]

3. APPLICABILITY OF "INDUSTRIAL MACHINERY" EXEMPTION FROM SALES AND USE TAXES TO MACHINERY, APPARATUS AND EQUIPMENT PURCHASES OF PLANTS.

---

[4] It should be noted that TENN. CODE ANN. § 67-6-102(24)(A) provides that any sales for resale must be made in strict compliance with rules and regulations promulgated by the commissioner. A dealer making a sale for resale must obtain a resale certificate from its customer. (*See* TENN. COMP. R. & REGS. 1320-5-1-. 68.) A dealer's failure to obtain such a certificate will cause the sale to be deemed a retail sale.

[5] *I.e.*, [POWER MARKETER] must obtain a resale certificate from its customer to avoid taxation from a particular sale.

Tennessee law provides an exemption from the sales and use tax for "industrial machinery" since TENN. CODE ANN. § 67-6-206(a) states that "(a)fter June 30, 1983, no tax is due with respect to industrial machinery." Industrial machinery is defined in TENN. CODE ANN. § 67-6-102(13), and such definition provides a listing of various items that would qualify for the industrial machinery exemption.

In this case, it would appear that Plants could have a number of items that would qualify as "industrial machinery" pursuant to TENN. CODE ANN. § 67-6-102(13)[6], primarily because they are properly classified as property described in the following parts of that section:

> (A) Machinery, 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, which is necessary to, and primarily for, the fabrication or processing of tangible personal property for resale and consumption off the premises, or pollution control facilities primarily used for air pollution control or water pollution control, where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one's principal business or who engages in the fabrication or processing of materials into trusses, window units or door units for resale as part of the principal business of the sale of building supplies either within or without this state . . .
> (iv) As used in this chapter, "pollution control facilities" means any system, method, improvement, structure, device or appliance appurtenant thereto used or intended for the primary purpose of eliminating, preventing or reducing air or water pollution, or for the primary purpose of treating, pretreating, recycling or disposing of any hazardous or toxic waste, solid or liquid, when such pollutants are created as a result of fabricating or processing by one who engages in fabricating or processing as such person's principal business activity, which, if released without such treatment, pretreatment, modification or disposal, might be harmful, detrimental or offensive to the public and the public interest;
> . . . (D) Such industrial machinery necessary to and primarily for the fabrication and processing of tangible personal property for resale or used primarily for the control of air pollution or water pollution includes, but is not limited to:
> (i) Machines used for generating, producing, and distributing utility services, electricity, steam, and treated or untreated water;
> (ii) Equipment used in transporting raw materials from storage to the manufacturing process, and transporting finished goods from the end of the manufacturing process to storage; [and]
> . . . (F) Such industrial machinery necessary to and primarily for the fabrication or processing of tangible personal property for resale and

[6] The Taxpayers have not specifically listed the items they believe would qualify for tax exemption.

> consumption off the premises or used primarily for the control of air pollution or water pollution does not include machinery, apparatus and equipment used prior to or after equipment exempted by subdivision (13)(D)(ii), and does not include equipment used for maintenance or the convenience or comfort of workers . . . TENN. CODE ANN. § 67-6-102(13).

An industrial machinery authorization must first be applied for and granted by the Department of Revenue before any exemption would be allowed. (See TENN. COMP. R. & REGS. 1320-5-1-1.06.)

However, not all machinery, apparatus and equipment found within the Plants' facilities would qualify. For example, desks or floor sweepers used in the facilities operated by Plants would not qualify as "industrial machinery" because they are not "necessary to, and primarily for, the fabrication and processing of tangible personal property . . ." as required by TENN. CODE ANN. § 67-6-102(13)(A).[7]

4. APPLICABILITY OF TENN. CODE ANN. § 67-6-101 *ET SEQ.* (SALES AND USE TAXES) TO NATURAL GAS PURCHASED BY [POWER MARKETER]

a. TENN. CODE ANN. § 67-6-102.

Natural gas, like electricity, is "tangible personal property." It fits within the general category of property described in TENN. CODE ANN. § 67-6-102(29), because it is personal property that can be both weighed and measured. Additionally, since it is an energy fuel used by a manufacturer, it is specifically taxable under TENN. CODE ANN. § 67-6-206(b)(1) unless an exemption applies. Thus, the fact that natural gas constitutes "tangible personal property" under the sales and use tax laws is not subject to dispute.

---

[7] The Taxpayers have asserted that natural gas itself is "industrial machinery" under the sales and use tax law and, therefore, that [POWER MARKETER'S] purchase of natural gas is exempt from taxation. However, it is difficult to conclude that the Tennessee legislature intended for natural gas used in the manner described in the ruling request to be includible in such category so as to be exempt from sales and use tax.

The legislature amended the law defining "industrial machinery" in 1992 to specifically include "hydraulic fluids, lubricating oils, and greases necessary for the operation and maintenance" of machinery, apparatus and equipment. (See 1992 Tenn. Pub. Acts, Ch. 917, §1.) Each of these items of tangible personal property are used in connection with machinery otherwise defined in the law as "industrial machinery" and have some lasting quality even though they must be replaced more frequently than the equipment itself.

However, the natural gas used by Plants in producing electricity would be totally consumed in the production process and would not become a separately identifiable component of the electricity produced. Such an item of tangible personal property, without any lasting quality or durability, would not logically fall within the legislatively defined category of "industrial machinery." Had the legislature believed that a tax exemption was nevertheless warranted for this type of property, it would have more specifically described it, either as otherwise includible in the definition of "industrial machinery" or as a separate exemption altogether.

(A further general discussion of natural gas, and the potential for [POWER MARKETER] to purchase it tax-exempt based on the facts given, is provided below in the Analysis, Ruling 4.)

Out-of-state vendors sell the natural gas to [POWER MARKETER] and that activity obviously constitutes a taxable "sale" pursuant to TENN. CODE ANN. § 67-6-102(25). Therefore, absent an exemption, the purchase of natural gas by [POWER MARKETER] from out-of-state vendors would be subject to the sales and use tax.

The natural gas purchased by [POWER MARKETER] is purchased for the purpose of converting it to, or creating, electricity, a new product and a separately identifiable item of tangible personal property. Therefore, [POWER MARKETER'S] purchase of natural gas is not for the purpose of resale and the resale exemption does not apply.

b. *AFG Industries* and *Valley View Coal* cases

The Taxpayers assert that the natural gas used by Plants in producing electricity qualifies as "industrial machinery," believing that the natural gas constitutes "apparatus" within the definition of industrial machinery in the statute. Such assertion rests on decisions reached by the Tennessee Supreme Court, in *AFG Industries, Inc. v. Cardwell*, 835 S.W.2d 583 (Tenn. 1992), and the Davidson County Chancery Court, in *Valley View Coal, Inc. v. Huddleston*, (No. 92-3489-II).

The *Valley View Coal* decision was based on an interpretation of the Tennessee statutes then applicable to "industrial machinery." However, the statute has since been amended by the legislature to clarify the legislative intent.[8] In any event neither the old statute nor the new statute nor the *Valley View Coal* decision contain any clear indicators as to whether natural gas itself could be considered "industrial machinery."

In the *AFG Industries* case, the Supreme Court admittedly interpreted the "industrial machinery" definition in a broad sense. Nevertheless, it specifically refused to find an exemption under TENN. CODE ANN. § 67-6-206(b)(3) for another form of energy (*i.e.*, electricity) used by the taxpayer in that case. *See AFG Industries, Inc. v. Cardwell*, 835 S.W.2d 583, at 586 and 587 (Tenn. 1992).

c. TENN. CODE ANN. § 67-6-206 and tax on energy fuels.

The Tennessee legislature has afforded certain energy fuels, such as gas, electricity, fuel oil, coal and other energy fuels, a reduced tax rate of 1.5% under TENN. CODE ANN. § 67-6-206(b)(1). Therefore, as a general rule, the legislature obviously intended that these fuels be subject to tax even though a reduced tax rate was to apply.[9]

---

[8] *See* discussion of 1992 Tenn. Pub. Acts, Ch. 917, § 1, in footnote 7 above.

[9] TENN. CODE ANN. § 67-6-206(b)(3) states circumstances under which no tax is due upon energy fuel. However, these circumstances are specifically defined and narrowly limited. (*I.e.*, the energy fuel must be

d. Use tax and the *M. J. Kelley* case.

Even though Plants do not obtain title to the natural gas received from [POWER MARKETER], it is likewise clear that the Plants *use* [POWER MARKETER'S] natural gas in their production or fabrication of electricity and would be subject to the use tax if no sales tax has been paid by [POWER MARKETER].

The Tennessee Supreme Court provided important clarification concerning what the use tax is and when it applies in *Woods v. M. J. Kelley Co*., 592 S.W.2d 567 (Tenn. 1980). In its opinion, the Court stated the following:

> The use tax is a compensating tax, designed to prevent the avoidance of sales taxes and ensure that Tennessee manufacturers and merchants remain on equal competitive footing with nonresidents who enter this state to do business [Citations omitted.]. . .
> Broadly speaking, the use tax is a tax "on the enjoyment of that which was purchased, after a sale has spent its interstate character." [Citation omitted.] More specifically, the use tax is a tax on the "privilege of using, consuming, distributing or storing tangible personal property after it is brought into this State from without this State." [Citation omitted.] *Id*., at 570.

The *Plants' liability* for use tax appears to attach under two statutory sections. First, TENN. CODE ANN. § 67-6-203 imposes a use tax on the cost price of tangible personal property when the property is not sold but is used, consumed, distributed, or stored for use or consumption in this state. It is clear that Plants use tangible personal property, natural gas, in Tennessee while producing or fabricating electricity.

Second, TENN. CODE ANN. § 67-6-209 (b) makes a contractor liable for the use tax when he uses tangible personal property in the performance of his contract or to fulfill his contractual obligations, regardless of who holds title in that property. Plants will use [POWER MARKETER'S] supplied natural gas in Tennessee in performing their contracts to convert such fuel into electricity.

[POWER MARKETER'S] liability for use tax, on the other hand, would appear to attach under TENN. CODE ANN. § 67-6-210, which, among other things, makes a dealer liable for the use tax on all tangible personal property he imports, or causes to be imported, and uses in this state. [POWER MARKETER] will bring natural gas into Tennessee for use by its contractors, the Plants, in the production of electricity.[10]

---

exclusively used directly in the manufacturing process, must come into direct contact with the article being processed or manufactured, and must be fully expended in the course of such contact.)

[10] It must be noted however that only one tax would be due even though both the transferor ([POWER Marketer]) and the transferee (one of the Plants) would be subject to use tax on a particular transaction.

The court, in *M. J. Kelley*, held that an out-of-state contractor doing business in Tennessee should be liable for a use tax on materials which it caused to be delivered to a construction site in Memphis, where they were installed by labor subcontractors, pursuant to contracts with the out-of-state contractor. *Woods v. M. J. Kelley Co*., 592 S.W.2d 567 (Tenn. 1980).

The court determined that under the applicable Tennessee statute, a person who brings in materials from out-of-state to be used in this state is liable for a use tax. Liability of the taxpayer was established primarily by TENN. CODE ANN. § 67-3004 (now codified as § 67-6-209), which is addressed specifically to the application of tangible personal property by a contractor or subcontractor. However, the court concluded that the language and intent of TENN. CODE ANN. § 67-3005 (now codified as § 67-6-210), was broad enough to encompass the facts of the case. *Woods v. M. J. Kelley Co*., 592 S.W.2d 567, at 572 (Tenn. 1980).

No material distinction can be found between the facts presented in the *M. J. Kelley* case and the facts presented by Taxpayers. Thus [POWER MARKETER] is subject to use tax liability for the natural gas used in Tennessee by Plants in performing the contract to convert that substance into electricity.

The Department's rules also confirm that either [POWER MARKETER] or Plants would owe use tax in these circumstances. TENN. COMP. R. & REGS. 1320-5-1-1.01, subsection (1) provides in part that "(c)ontractors or subcontractors using tangible personal property, which has been furnished them for use and which has not been subjected to a Sales or Use Tax at the rate provided for by the Sales and Use Tax Law, and the tax due thereon has not been paid, shall pay the Use Tax provided by law, measured by the purchase price or fair market value of such property."[11]

(*See* TENN. CODE ANN. § 67-6-203(a) and § 67-6-210(a), both indicating there shall be no duplication of tax, and TENN. CODE ANN. § 67-6-209(b), suggesting that a taxpayer pay tax unless such property has previously been subjected to a sales or use tax and the tax due has already been paid.

[11] Based on their assertions in the ruling request, the Taxpayers apparently consider as one transaction the following activities: the importation of natural gas into Tennessee for conversion by Plants into electricity, the conversion process and the sale by [POWER MARKETER] of the electricity produced. If this is true, the transaction would be an interstate transaction and not subject to the sales and use tax. However, as has already been explained above in the Analysis, Ruling 1(b)(3), the Tennessee Supreme Court has rejected the notion that the simple purchase and resale of natural gas is one continuing transaction in *Tennessee Natural Gas Line, Inc. v. Atkins,* 287 S.W.2d 67, at 69 (Tenn. 1956). The purchase of natural gas, the conversion of natural gas into electricity and the sale of electricity would appear to be even more distinctive transactions than the Court found to be distinguishable for purposes of taxation in the *Tennessee Natural Gas Line* case.

Additionally, the importation of the natural gas into Tennessee and the use of it by Plants (in the electricity production process) clearly removes that property from interstate commerce for purposes of the sales and use tax laws. *See* TENN. CODE ANN. § 67-6-211 and *Woods v. M. J. Kelley Co*., 592 S.W.2d 567, at 572 (Tenn. 1980).

Thomas R. Bain, Tax Counsel

APPROVED: Ruth E. Johnson, Commissioner

DATE: March 24, 1999