PRIVATE TAXPAYER RULING LR08-003

May 20, 2008

The Department issues this private taxpayer ruling in response to your letter of December 19, 2006, as supplemented by your correspondence of February 28, 2007 and April 21, 2008, requesting a ruling on behalf of your client . . . ("Taxpayer"). Taxpayer is a miner and processor of nonmetalliferous mineral products, and requests a ruling on the applicability of Arizona transaction privilege tax under the mining classification to gross receipts derived from certain processing activities Taxpayer conducts at its Arizona facility. On January 20, 2005, the Department issued Private Taxpayer Ruling LR04-009 to Taxpayer that addressed the substantially identical issue raised in this request. Nevertheless, Taxpayer now presents additional facts and substantive arguments to warrant a reconsideration of LR04-009.

Statement of Facts:

The following facts are excerpted from your December 19 letter:

> [Taxpayer] is a privately-owned, international supplier of [Compound] filler materials. In 1997, [Taxpayer] purchased [Arizona Quarry] from [Processor]. At the time [Taxpayer] purchased the quarry, [Processor] not only owned the quarry but also owned/operated a processing plant . . . . After acquiring the [Arizona] Quarry, [Taxpayer] continued to supply [Processor]'s processing plant with mined limestone [("Raw Material")] from the quarry.
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> [Taxpayer] constructed its manufacturing plant . . . [Arizona Plant] and subsequently began operations in 2000. [Processor] then built a new processing plant . . . next door to [Taxpayer]'s facility.
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> **[Arizona] Quarry:**
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> Although [Taxpayer] owns the [Arizona] Quarry, it has contracted out the mining activities to . . . [Excavating] who is the exclusive operator of the quarry mine. [Excavating] mines [Taxpayer's Raw Material] and crushes it to a size of approximately minus 6 inch (i.e. all ore will pass through a 6"x6" screen mesh). [Taxpayer] then hires an independent, over the road, trucking company to transport the mined [Raw Material] approximately 13 miles from the quarry to [Taxpayer]'s manufacturing plant. The [Arizona] Quarry yields industrial grade [Raw Material] used by [Taxpayer] to manufacture industrial-grade [Compound] products. These are used in papers, paints, plastics, adhesives, roofing tiles, sheet rock joint cement, etc. . . .
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> [Taxpayer] still sells a majority of the [Raw Material] mined from the [Arizona] Quarry to [Processor] . . . . . Approximately 54% of the quarry's output is sold to [Processor] and shipped to its new processing facility, and approximately 46% of the quarry's output is shipped from the quarry to [Taxpayer]'s manufacturing plant.

[Taxpayer]'s Raw Materials:

The [Taxpayer] manufacturing plant manufactures pharmaceutical-grade [Compound] products, food-grade [Compound] products and industrial-grade [Compound] products. The [Raw Material] mined from the [Arizona] Quarry is lower-purity [Raw Material] and is thus used only by [Taxpayer] as a raw material in manufacturing industrial-grade [Compound] products which are used in paper, paints, plastics, adhesives, sheet rock joint cement, etc. Industrial-grade [Compound] products represent sixty percent of the output of [Taxpayer]'s manufacturing plant.

Because the [Raw Material] received from the [Arizona] Quarry is lower-purity [Raw Material] it cannot be used as a raw material in manufacturing pharmaceutical-grade or food-grade [Compound] products. Therefore, [Taxpayer] must obtain high-purity [Raw Material] from another quarry.

[Taxpayer] purchases high-purity [Raw Material] from [Related Entity] (a separate, but legally related entity) which owns and operates a high-purity limestone quarry in . . . California. [Related Entity] mines the limestone and crushes it to a size of approximately minus 6 inch. [Taxpayer] then purchases the crushed high-purity [Raw Material] from [Related Entity] and hires an independent, over the road, trucking company to transport the high-purity [Raw Material] over 350 miles distance from [California] to [the Arizona Plant]. [Title and possession to the [Raw Material] rocks (sold by [Related Entity] to [Taxpayer]) transfers while it is within the State of California (outside of Arizona).]

High-purity [Raw Material] is the required raw material for use in manufacturing pharmaceutical-grade and food-grade [Compound] products. These products are used in manufacturing certain pharmaceuticals and foods. Pharmaceutical-grade and food-grade [Compound] products represent forty percent of the output of [Taxpayer]'s manufacturing plant.

[Taxpayer]'s Manufacturing Operation:

Significant manufacturing operations are required to convert the high-purity [Raw Material] into "pharmaceutical-grade" or "food-grade" [Compound] products. [The Arizona Plant] uses the ground [Compound] method.

(A) Roller Mill Process:

[Taxpayer] takes the high-purity "minus 6 inch" [Raw Material] (raw material purchased from [Related Entity]) and runs it through a secondary roll crusher to reduce its size to minus ¾ of an inch. This smaller material then serves as feed for a roller mill which pulverizes . . . the [Raw Material] into fine powder. Air is forced through the mill and finer particles are separated from the coarse particles by a turbine-type classifier. The finer particles are subsequently separated from the air stream by a cyclone. For pharmaceutical-grade products the [Compound] is then made into a slurry by the addition of potable water. This slurry is then transferred to a holding tank.

. . . .

(B) Flotation Process:[ ]

When the particles leave the holding tank they enter the flotation process. Flotation is a widely used method for enhancing the purity of fine-grained minerals. It takes advantage of

the different physicochemical surface properties of minerals—in particular, their wettability, which can be a natural property or one artificially changed by chemical reagents. . . . By altering the hydrophobic (water-repelling) or hydrophilic (water-attracting) conditions of their surfaces, mineral particles suspended in water can be induced to adhere to air bubbles passing through a flotation cell. The air bubbles pass to the upper surface of the pulp and form a froth, which, together with the undesirable attached hydrophobic minerals, can be removed. In the [Taxpayer] process, acid insoluble materials are floated off in order to improve the purity of the finished product so that it meets U.S. Pharmacopeias (USP) specifications. During the flotation process, the froth is separated from the product slurry. The slurry subsequently flows to a holding tank until it is ready to be pumped to a filtration system where most of the water is removed.

(C) Filter Press:

The slurry is pumped into the chambers of the filter press. There, the slurry is squeezed by the both hydraulic and air pressure to force water from the solids through a filter cloth at the bottom of the chamber. Water passes through the cloth to drain piping and the solids are concentrated into a de-watered filter cake. The dewatered cake then is transferred to a hot air drying process where it passes into a rotating cage mill. The cage mill rotor breaks up the fine particle clumps. Forced hot air from a natural gas fired air heater passes through the cage mill and sweeps the fine particles up in the air stream. The hot air flow drives off the moisture. The product particles are conveyed through stainless steel ducting to a cyclone where dry product is separated from the air. The moist air is subsequently vented to atmosphere through a dust collector. . . .

(D) Screening, Metal Detection, Classification, Packaging & Final Inspection:

For pharmaceutical-grade products the end product from the filter press is then subject to ***In Line Screening, Magnets,*** and ***Metal Detection*** before being conveyed into product storage silos. For food-grade products the end product from the roller mill is then subjected to ***In Line Screening, Magnets,*** and ***Metal Detection*** before being conveyed into product storage silos. The final stage of the manufacturing process is to package the product and prepare it to be sent to [Taxpayer] customers. During this final process, sample quality control tests are performed such as ***laser refraction*** particle size analysis and detailed chemical analysis by ***spectrophotometry***. These tests are done in order to assure that [Taxpayer] products meet FDA requirements and are of the highest quality possible. End products are sold under the trade name OMYA-CAL.

Requirements and Certifications:

[Taxpayer]'s pharmaceutical-grade [Compound] meets requirements of USP 24, Japanese Excipient, European Pharmacopeia, Food Chemical Codex and California's Proposition 65 lead protocol.

[Taxpayer]'s manufacturing plant is a **cGMP** designed facility and ***ISO 9000*** certified. It is also Kosher certified and registered with the **FDA** as an Active **Pharmaceutical Ingredient manufacturer**/supplier. [ ]

Industry Treatment Of [Compound] Production:

A search for "[Compound]" on ThomasNet® . . . provides a list of "Top quality [Compound] manufacturers . . . ." This site shows that it is common in business for the production of

> [Compound] to be viewed as manufacturing. . . . [Taxpayer]'s competitors commonly refer to their production of [Compound] as "manufacturing." [ ]
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> **Industry Practice Regarding Sales Of Pharmaceutical/Food-Grade [Raw Material]:**
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> It is common for entities that own and operate a [Raw Material] quarry/mine to sell their mined limestone to other entities that manufacture pharmaceutical-grade and food-grade [Compound]. [ ]

Taxpayer submitted a sworn affidavit from its chief geologist providing the following statements:

> 2. It is common for producers of pharmaceutical grade [Raw Material] products to purchase some or all of their raw material from other companies.
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> 3. There are only three major U.S. producers of pharmaceutical grade [Compound] who sell to the food and pharmaceutical market . . . .
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> 4. All three major U.S. producers of [Compound] who sell to the food and pharmaceutical market purchase at least a significant portion of their raw material (pharmaceutical grade crushed [Raw Material]) from another company. [Company X] and [Company Y] both purchase a significant portion of their raw material (pharmaceutical grade crushed [Raw Material]) from [Company Z] . . . (a company completed unrelated to either [Company X] or [Company Y]). [Taxpayer] purchases all of its raw material (pharmaceutical grade crushed [Raw Material]) from [Related Entity].

Affidavit of . . . Chief Geologist, [Taxpayer's parent entity] (Sept. 5, 2006).

Your Issue:

Does the A.R.S. § 42-5072 mining classification impose tax on Taxpayer's sales of pharmaceutical-grade Compound, manufactured in Arizona but for which the Raw Material was purchased by Taxpayer in California from a California vendor (a related entity to Taxpayer) that mined the Raw Material from its California mine?

Your Position:

No. Paraphrasing from your December 19 request, Taxpayer provided the following arguments to support its position:

1. A.R.S. § 42-5072 is a severance tax that only taxes the "mining, quarrying or producing for sale" of nonmetalliferous mineral products *severed from land within Arizona*. It is a severance tax because:

    a. It is "the only classification that causes tax to be imposed on a transaction/activity under the retail classification – when tax is due, but if the transaction/activity qualifies for exemption under the retail classification, the transaction/activity is subject to tax under the mining

classification. See, A.R.S. § 42-5075(F). This causes the mining transaction privilege tax to be imposed on all transactions/activities that would be exempt under the retail classification – with the most relevant exemptions being exemptions for sales for resale and sales in interstate commerce (out-of-state sales)."

b. It imposes tax on the first sale of the nonmetalliferous mineral product and not the last (there is no exemption for sales for resale). All other tax classifications that impose tax on the sale of tangible personal property impose the tax on the last sale or transfer of tangible personal property (the sale to the end user or consumer – there is an exemption for sales for resale).

c. It "is the only classification that treats 'the mere transportation of the product to an out-of-state location' as a trigger for a taxable event," pursuant to A.R.S. § 42-5072(E).

2. A severance tax system, unlike other privilege tax systems, are designed to compensate the state for the depletion of its natural resources, and exemptions based on the use of the tangible personal property (*e.g.*, resale or sale outside the state) would thwart one of the main purposes and are thus "virtually nonexistent." You cite to *Geo Resources, Inc. v. Tax Commissioner of the State of North Dakota*, 288 N.W.2d 54 (N.D. 1980) as support.

3. Just as the use tax serves as a complementary tax to the transaction privilege tax under the retail classification—making sure that no products purchased for use in Arizona go untaxed—the mining classification serves as severance tax complement to the retail classification by making sure that no nonmetalliferous mineral product severed from land in the State of Arizona goes untaxed by Arizona.

4. The word "produced," as used in the mining classification (*i.e.*, "The tax base includes the value of the entire product mined, quarried or *produced* for sale, profit or commercial use in this state") should be read in a manner that is synonymous with "extracted" or "severed." Because the Raw Material Taxpayer processes in Arizona to produce pharmaceutical-grade Compound is quarried in California, the tax base does not include gross income derived from such processing activities.

Taxpayer also raised additional federal Commerce Clause arguments challenging the Department's interpretation of transaction privilege tax imposed under the mining classification.

Discussion:

In LR04-009, the Department provided as follows:

> Pursuant to A.R.S. § 42-5072(A), the mining classification is not limited to mining and quarrying activities. Rather, it also includes "*producing for sale, profit or commercial use* any nonmetalliferous mineral product" (emphasis added). Neither of the above-referenced [*State Tax Comm'n v. Wallapai Brick & Clay Prods., Inc*., 85 Ariz. 23, 330 P.2d 988, (1958)] and [*State* ex rel*. Ariz. Dep't of Revenue v. Magma Copper Co*., 138 Ariz. 332, 674 P.2d 876 (Ct. App. 1983)] opinions, in analyzing whether the activity at issue was sufficiently "disassociated" from a business otherwise subject to tax under the mining classification, found significance in the *type* of production activity conducted—indeed, both courts found that the "producing for sale, profit, or commercial use" language encompasses within the tax base for the mining classification a variety of manufacturing activities that might otherwise be exempt. *Wallapai*, 330 P.2d at 993; *Magma Copper*, 674 P.2d at 879-80. Nevertheless, in giving a "literal meaning" to the language, both courts noted that there are certain kinds of manufacturing activities performed upon mineral products that the legislature "clearly did not intend to tax, such as manufacturing of a gold watch or silver spoon." *Wallapai, id.*; *Magma Copper*, *id.* at 881.
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> The issue in *Wallapai* was whether the taxpayer's gross proceeds from sales of bricks it manufactured from raw clay it had also extracted were subject to tax as gross proceeds from its mining operation. The court concluded that, while "the court certainly does not believe that it was intended that the tax be imposed upon the manufacturing of articles *entirely disassociated* with mining operation merely because such articles are manufactured from mineral products" (emphasis added), the brick manufacturing activity of the taxpayer was not disassociated in this manner:
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> It is upon the 'business' of producing mineral products '*for sale, profit or commercial use*' that the tax is imposed. It is obvious that when the clay has been refined and the process of manufacturing bricks commences there has been no 'sale'; neither could there be any sale of the product upon which proceeds the tax could be imposed. It seems equally clear that the plaintiffs have realized no 'profit' at this point. And, it would also seem that this raw clay has no 'commercial use' as yet. The word 'commercial' comes, of course, from the word 'commerce', which according to Webster's New International Dictionary has as its primary meaning:
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> 'Business intercourse; esp., the exchange or buying and selling of commodities, and particularly, the exchange of merchandise on a large scale between different places or communities; extended trade or traffic.'
>
> The court is of the opinion that the removal of clay from the earth's surface and the fabrication thereof into finished bricks, the first marketable product produced, is a 'business' and is, as a whole, within the purview of [the taxing statute.]
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> *Wallapai*, 330 P.2d at 993, 994.

In *Magma Copper*, in determining that the taxpayer's gross receipts derived from fabricating electrolytic cathode copper into continuous cast rod was sufficiently dissociated from the taxpayer's mining operation to be nontaxable, the court prefaced by stating that it was "reluctant to embrace a generalized first marketable product theory." 674 P.2d at 882. Instead, it pointed to the facts of the case and an examination of several factors—including looking at the first marketable product—to conclude that the activity in question went beyond producing for sale, profit, or commercial use. *Id.* The court weighed the following considerations in concluding that the taxpayer's gross proceeds derived from fabricating continuous cast rod were exempt from taxation:

1. Is the manufacturing or processing activity at issue sufficiently distinct from the business's mining operation to effect separate tax treatment?

2. Does the manufacturing or processing activity at issue result in the first marketable form of the product?

3. Can the tax liability incurred through "production for sale, profit or commercial use" end at an earlier point?

Id. at 881-82.

Upon considering the facts presented by Taxpayer within the framework of *Wallapai* and *Magma Copper* decisions, the Department concludes the following:

1. Taxpayer has established that the processing activity required to produce [higher] grade [Compound] using the Vendor-mined material can be separately considered from the processing activity performed on Arizona-mined material. Nevertheless, even upon separate consideration, the processing activities are not of a nature that they would be *sufficiently* distinct for purposes of assigning liability for transaction privilege tax. Both the Arizona and Vendor ores constitute nonmetalliferous mineral products, regardless of distinctions revealed in chemical analyses that would determine their suitability for use in particular applications. The fact that *flotation*—a separation technique widely used in the mining industry to extract desirable material—is an additional step used for the Vendor ore due to more stringent purity requirements does not distinguish the Vendor ore processing as a whole vis-à-vis the processing of Arizona ore.[1] Excluding the final step of floating the Vendor ore, the preliminary processing stages of both Arizona and Vendor ores appear virtually identical, with even the same machinery being used. The processing activities furthermore all seem to be activities contemplated by the statute as "production for sale, profit or commercial use."

[1] Flotation appears to be a standard method of processing used for [Compound]. *See* [citation omitted] ("To obtain higher levels of brightness and lower abrasion characteristics, [Compound] is processed by optical sorting, flotation and/or particle-size classifying. . . . Additional processing in the form of optical sorting, flotation and/or particle-size classifying is used to provide an engineered filler suitable for the customer's application.")

2. Taxpayer has established that separate markets exist for [lower]-grade [Compound] and [higher]-grade [Compound], and that a particular ore's suitability for one of the two applications can be determined before the necessary processing activities are performed. Nevertheless, Taxpayer has failed to distinguish the raw, unprocessed [Compound] ore in this case from the raw clay at issue in *Wallapai* such that, before processing for either application, it can constitute the first marketable product. The mere fact that Taxpayer purchases [higher]-grade [Compound] ore through transactions with a related entity is not evidence of the presence of a market for the unprocessed material. The Department has also been unable to independently obtain evidence of such a market.[2] Consequently, based on the facts as presented and available to the Department, the processes Taxpayer undertakes on the Arizona ore and the Vendor ore for their respective [lower grade] and [higher grade] applications are used to create the first marketable forms of [Compound].

3. Based on the facts as provided and available to the Department, the transaction privilege tax liability does not end until the points at which the respective processing of the Arizona ore and Vendor ore are completed by Taxpayer and the [Compound] is suitable for sale. There is no indication that a *market* exists for Vendor ore that has been processed up to the stage that flotation is to be performed.

   As provided in Arizona Administrative Code ("A.A.C.") R15-5-902(A), the gross proceeds of sale or gross income derived from a sale of a nonmetalliferous mineral product by a business subject to tax under the mining classification to a purchaser that resells the product in the ordinary course of business is still subject to tax under the mining classification.

   Consequently, the Department rules that the gross proceeds of sales or gross income derived from Taxpayer's sales of [Compound] are subject to tax under the mining classification, assuming that the exemptions provided under A.R.S. § 42-5072(B) do not apply. Pursuant to A.R.S. § 42-5072(C) and as provided under A.A.C. R15-5-908, Taxpayer may deduct from its gross proceeds of sales or gross income actual freight costs incurred from shipping the finished products by separately stating them in billings to customers or maintaining books and records to separately show the actual freight costs paid to a third party.

Supplementing this quoted discussion from LR04-009 is further consideration of the scope of the A.R.S. § 42-5072 mining classification. While past mining privilege tax cases have

[2] [Compound] does not appear to be a product that has been approved for trading by the United States Commodity Futures Trading Commission. Moreover, a cursory examination of the companies listed as [Compound] suppliers in the online version of the *Thomas Register of American Manufacturers* (www.thomasregister.com) suggests that most applications require some level of processing before the [Compound] is suitable for sale.

focused on mining activities performed on the natural resources extracted at this state,[3] the purpose of the mining transaction privilege tax is to tax the value of all of the various mining activities enumerated in A.R.S. § 42-5072(A), but only to the extent that it taxes receipts from those activities performed within this state.[4]

Before 1988, exemptions that were applicable to a particular taxable business activity were scattered across multiple sections in A.R.S. Title 42. One such section, former A.R.S. § 42-1317, contained exemptions that applied to all activities subject to transaction privilege tax, including mining activities. A.R.S. § 42-1317(A)(4) exempted gross receipts derived from "[s]ales in interstate or foreign commerce when prohibited from being so taxed by the Constitution of the United States or the constitution of this state."

Laws 1988, Ch. 161, § 4, which became effective July 1, 1989, reorganized and renumbered the statutes by separating activities into tax classifications with individual statutes and assigning exemptions to each respective classification's statute. The A.R.S. § 42-1317(A)(4) interstate and foreign commerce exemption, while inserted into the new retail classification, was not similarly copied into the other tax classifications. The legislative history indicates that the Legislature intended the code reorganization to be nonsubstantive in nature purely "for purposes of clarity and order," with no change in the applicability of the tax.[5]

Ruling:

Based on the facts provided by Taxpayer, the discussion of the *Magma Copper* and *Wallapai Brick* decisions excerpted from LR04-009, and the legislative history of the A.R.S. § 42-5072 mining classification, the Department rules as follows:

1. A.R.S. § 42-5072(C) provides that the mining classification's tax base "includes the value of the entire product mined, quarried *or* produced for sale, profit or commercial use in this state, regardless of the place of sale of the product or of the fact that deliveries made be made to points without this state" (emphasis added). Despite the details Taxpayer has submitted regarding the additional steps needed to produce pharmaceutical-grade Compound over the lower-purity Compound, the additional processing does not sufficiently disassociate the activity from the scope of activities contemplated by A.R.S. § 42-5072 as "production for sale, profit or

[3] S*ee, e.g.*, *Wallapai Brick*, 85 Ariz. at 31, 330 P.2d at 993; *Magma Copper*, 138 Ariz. at 328, 674 P.2d at 882.

[4] *See* A.R.S. § 42-5072(E) (limiting applicability of the tax to the value of mining activities performed in Arizona, before products move out of the state); *Indus. Uranium Co. v. State Tax Comm'n*, 95 Ariz. 130, 131, 387 P.2d 1013, 1014 (1963); *Miami Copper Co. v. State Tax Comm'n*, 121 Ariz. 150, 155, 589 P.2d 24, 29 (Ct. App. 1978).

[5] STAFF OF ARIZ. S. COMM. ON FIN., FACT SHEET FOR H.B. 2001, 38th Leg., 2d Reg. Sess. (May 4, 1988); STAFF OF ARIZ. H. COMM. ON WAYS & MEANS, SUMMARY OF BILLS ENACTED BY THE COMM. ON WAYS & MEANS 181 (1988); *Minutes of the House Committee on Ways and Means*, 38th Leg., 2d Reg. Sess. 2 (Jan. 12, 1988).

commercial use." The Department's earlier determination as to this portion of the *Magma Copper* and *Wallapai Brick* analyses is unchanged, and the Department rules that the value of the additional processing conducted at Taxpayer's Arizona facility should fall within Taxpayer's tax base under the mining classification.

2. Because the Raw Material was extracted and partially processed in California, the value of Taxpayer's compound resulting from Taxpayer's processing in Arizona will include the value of the mining activities performed outside of the state. The scope of the mining classification includes only the value of mining activities performed within Arizona. Consequently, the Department rules that Taxpayer's tax base under the mining classification includes the value of Compound, less the value of the earlier mining activities performed outside of the state.

The Ruling subsection of LR04-009 is rescinded to the extent that it conflicts with the Department's rulings as stated above.

This private taxpayer ruling does not extend beyond the facts presented in your letters of December 19, 2006, February 28, 2007, and April 21, 2008.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determinations are subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the Department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law, or notification of a different Department position.

The determinations in this private taxpayer ruling are only applicable to the taxpayer requesting the ruling and may not be relied upon, cited, nor introduced into evidence in any proceeding by a taxpayer other than the taxpayer who has received the private taxpayer ruling.