

Under the Retailers' Occupation Tax Act, the manufacturing machinery and equipment exemption is available for machinery and equipment used primarily (over 50% of the time) in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. Machinery and equipment used to manufacture compressed natural gas can qualify for the exemption. See 86 Ill. Adm. Code 130.330. (This is a PLR.)

August 17, 2016

Dear Xxxxx:

This letter is in response to your letter dated July 10, 2015 in which you request information and the supplemental materials you submitted at our request. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

Pursuant to 2 Ill. Admin. Code 1200.110, we are requesting a Private Letter Ruling on behalf of our client, COMPANY ("COMPANY" or "taxpayer"), advising COMPANY as to the applicability of Illinois Sales and Use tax relative to the manufacturing of Compressed Natural Gas ("CNG") and the purchases of machinery and equipment used in CNG stations.

DISCLOSURES

In accordance with 2 Ill. Adm. Code 1200.110(b)(3), the subject of this request is for tax periods during which related purchases may occur, and this request is not being examined as part of an audit by the Illinois Department of Revenue ("Department").

In accordance with 2 Ill. Adm. Code 1200.110(b)(4), to the best of the knowledge of both the taxpayer and the taxpayer's representative, the Department has not previously ruled on the same or a similar issue for the taxpayer or a predecessor. In addition, the taxpayer and its representatives have not previously submitted the same or a similar issue to the Department and withdrawn it before a letter ruling was issued.

In accordance with 2 Ill. Adm. Code 1200.110(b)(8), enclosed please find an original IL-2848, Power of Attorney, authorizing this firm to submit this request on behalf of taxpayer and represent taxpayer before the Department.

FACTS

Taxpayer produces CNG by compressing natural gas obtained from a distribution pipeline, in this case a utility line. When this natural gas is obtained, it is at a level of 40 pounds per square inch ("40psi"). To be usable as CNG, it is necessary for the gas to be compressed to at least 3600 to 4500psi. The natural gas obtained from the utility line is first filtered and in some cases heavy hydrocarbons are processed out of the gas stream. It is then dried through a gas dryer, which removes water and other liquids from the gas using desiccants. Once dry, the gas next moves through a pipeline to the compressor. There are four stages within the compressor. The compressor multiplies the psi of the gas in each stage from 40psi when it enters, to 4200psi when it leaves the compressor. Within the compressor, oil is used to lubricate the pistons, which enables the compressor to run. Natural gas contains traces of other liquids that need to be extracted for the CNG to be usable. There are multiple filters through which the in-process gas is passed in the manufacturing process to remove the oil and other liquids from it. The final filter is located in the dispenser terminal.

Once the in-process gas leaves the compressor, it moves to the holding tanks system via special high pressure piping. The holding tanks system consists of three main tanks with additional filters, which continue to remove oil and other liquids from the in-process gas. A priority panel system decides which holding tank to use to dispense the CNG.

A programmable logic controller ("PLC") constantly monitors the pressure in the compressor, holding tanks, and within the pipeline. The PLC sends signals to valves to open/close the holding tanks and compressor. When the PLC shows a decrease in pressure, the compressor starts to fill a holding tank.

From the holding tank system, the in-process gas moves to a dispenser terminal. Customers purchase the gas directly from the dispensers for use in their compatible vehicles (e.g., fleet trucks, buses). The temperature controls near the dispenser monitor the ambient temperature and determine the psi levels for the CNG. When a vehicle enters the CNG station, it will obtain the CNG from the dispenser hose, similar to a gasoline dispenser at a gas station.

Example:

A car powered by CNG rather than gasoline shows a level of 200psi, and therefore nearly empty. The car would need to go to a CNG station to have its tank filled to 3600psi. When the car arrives, the compressor is off and all three holding tanks are at 4200psi level. The CNG necessary to fill this car is taken from the first holding tank. The use of the tank lowers the psi, so when additional cars arrive and fill up, the tank is now at 2400psi. This means that the car can only be filled with that tank to 2400psi, as there has to be equal or more pressure in the holding tank. Therefore, holding tank #2 is used to fill up the vehicle. When tank #2 is low, then the priority panel will switch to tank #3 to fill the remaining cars. When all three tanks are below the set threshold, a

PLC will direct the compressor to start again, and it will fill the holding tanks to regulate the pressure.

If the outside temperature is high, the temperature control adjusts the amount of CNG that is placed into the vehicle.

RULING REQUEST

The taxpayer respectfully requests the Department rule that the manufacturing of natural to compressed gas qualifies as “manufacturing” relative to Illinois manufacturing machinery and equipment exemption. Additionally, the taxpayer requests the Department rule whether the equipment, such as filters, dryer, desiccants, compressor, piping, holding tank system, PLC, temperature control and dispenser terminals, used in the creation of vehicle ready Compressed Natural Gas, qualify for the Illinois sales and use tax manufacturing machinery and equipment exemption.

AUTHORITY

Illinois imposes a tax on either the sale at retail or the use of tangible personal property. 35 ILCS §120/2 and 35 ILCS §105/3. However, there is an exemption from tax on machinery and equipment used primarily in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. 86 Ill. Admin. Code §130.330(a). Machinery and equipment is used primarily if it is used 50% or more in an exempt manner. 86 Ill. Admin. Code §130.330(d)(1).

“Machinery” is defined as “major mechanical machines or major components of such machines contributing to a manufacturing or assembling process: including, machinery and equipment used in the general maintenance or repair of such exempt machinery and equipment or for in-house manufacture of exempt machinery and equipment.” 86 Ill. Admin. Code §130.330(c)(2). “Equipment” includes “any independent device or tool separate from any machinery but essential to an integrated manufacturing or assembling process: including computers used primarily in operating exempt machinery and equipment... and any parts which require periodic replacement in the course of normal operations.” 86 Ill. Admin Code §130.330(c)(3).

The “manufacturing process” is defined as “the production of an article of tangible personal property, whether the article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property... .” 35 ILCS §105/3-50(1). In order to be considered manufacturing for sales and use tax purposes, changes that result from the process must be substantial and significant, and the process must be commonly regarded as manufacturing. 86 Ill. Admin. Code §130.330(b)(2)&(3).

The manufacturing machinery and equipment exemption will generally not apply to “the use of machinery or equipment for general ventilation, heating, cooling, climate control or general illumination, not required by the manufacturing process.” 86 Ill. Admin. Code §130.330(d)(4)(H).

Effective 1/1/2014, Illinois Retailers Occupation Tax Act exempted sales of “natural or artificial gas that is delivered to customers through pipes, pipelines, or mains.” 35 ILCS §120/2. Additionally, the manufacturing machinery and equipment exemption does not include machinery and equipment used in “the generation or treatment of natural or artificial gas for wholesale or retail sale that is delivered to customers through pipes, pipelines, or mains.” 35 ILCS §120/2-5(14).

ANALYSIS

Taxpayer’s process of drying, filtering, and compressing natural gas to create CNG changes the form, composition and use of natural gas. The natural gas obtained from a utility line must be compressed to less than 1% of its volume at standard atmospheric pressure to be usable in an internal combustible engine. CNG is significantly different in its physical properties and combustion characteristics from natural gas and therefore CNG can be used to power internal combustion engines unlike natural gas. Natural gas at a level of 40psi and CNG at a level of 4200psi differ in composition since hydrocarbons, water, oil, and other liquids are removed from the natural gas during taxpayer’s operations. Natural gas and CNG also differ in form since compression increases the pressure of the gas by reducing the volume. CNG has a much higher pressure than natural gas and a lower volume. Taxpayer’s process creates a product that is different in composition and form than natural gas and therefore qualifies as manufacturing.

Machinery and equipment used primarily in manufacturing or assembling tangible personal property qualifies for Illinois manufacturing machinery and equipment exemption. Since, the taxpayer’s product is not ultimately delivered for sale via pipes, pipelines or mains, but rather via dispenser terminals, it is believed that CNG would be taxable as tangible personal property. 35 ILCS §120/2. As the taxpayer is producing tangible personal property for ultimate sale, it is reasonable to believe the process of creating CNG is manufacturing. 35 ILCS §120/2-5(14) and 86 Ill and [sic] Admin. Code §130.330(b)(4). Taxpayer’s production process begins with the filtering of the natural gas directly from the utility line and ends with the filtering in the dispenser terminal because the removing of impurities via filtering causes a “direct and immediate physical change” to the product. 86 Ill. Admin. Code §130.330(d)(3)(A). The initial filtering marks the first change in the natural gas and the final filtering gives the gas the qualities necessary and essential for use when transferred to the CNG customer.

Filters qualify for the manufacturing exemption since their use creates a “direct and immediate physical change upon tangible personal property to be sold.” 86 Ill. Admin. Code §130.330(d)(3)(A). Filters act upon the gas by straining out certain impurities during multiple stages of the production process. The filtering of impurities is continuous and constant as it begins in the first stage of the process and does not end until the completion of the final product, thus filters are essential and an “integral part of the production flow” and therefore qualify for the manufacturing exemption. 86 Ill. Admin. Code §130.330(d)(3)(B).

Dryers use desiccants (absorbents) to remove water and other liquids from the in-house gas. The absence of water is one of the differences in composition between natural gas

and CNG resulting from the taxpayer's manufacturing process. Since dryers and desiccants are the means to remove liquids during the process they have a "direct and immediate physical change upon tangible personal property to be sold." 86 Ill. Admin. Code §130.330(d)(3)(A). Dryers and desiccants are essential and an "integral part of the production flow" and therefore qualify for the manufacturing exemption. 86 Ill. Admin. Code §130.330(d)(3)(B) & (C).

Compressors are used in the production process to increase the pressure and the psi of the in-process gas, thus changing its form. 86 Ill. Admin. Code §130.330(d)(3)(A). Compressors are an integral part of the production flow as it is essential to the tuning [sic] of natural gas to CNG and therefore qualify for the manufacturing exemption. 86 Ill. Admin. Code §130.330(d)(3)(B).

Holding tanks are used to maintain gas after compression, but prior to entry into the terminal. Piping is used to move the in-process gas during all stages of the production process. Since the production process begins with the first filtering and ends after the final filtering in the dispenser terminal, the gas is in process when placed in the tanks. 86 Ill. Admin. Code §130.330(d)(3)(D). The manufacturing process "commences with the first operation or state of production in the series and does not end until the completion of the final product in the last operation or state of production in the series." 35 ILCS §105/3-50(1). Equipment used to hold, handle, and transport in-process product is an integral part of the production flow; and therefore, the tanks system and piping between the various production processes qualify for the manufacturing exemption. 86 Ill. Admin. Code §130.330(d)(3)(C).

PLC's are directly used in the production process, as they control the operation of the manufacturing process by sending signals to valves to open and close the tanks and the compressor, effectively turning on the compressor. Equipment includes "computers used primarily in operating exempt machinery and equipment in a computer-assisted design, computer-assisted manufacturing (CAD/CAM) system; or any subunit or assembly comprising a component of any machinery or auxiliary... ." 86 Ill. Admin. Code §130.330(c)(3). Therefore, PLC's qualify as equipment for the manufacturing exemption.

At the dispenser terminals, the final stage of filtering takes place and thus constitutes the final stage of the manufacturing process. The terminals are the final means to which water and other liquids are removed from the gas prior to sale and subsequent use by vehicles. Exempt manufacturing machinery and equipment includes, "the use of machinery or equipment to effect a direct and immediate physical change upon tangible personal property to be sold." 86 Ill. Admin. Code §130.330(d)(3)(A). After the final filtering, the gas has the physical qualities for use in CNG vehicles and is subsequently transferred to the CNG customer for use at the dispenser terminals. As there is filtering of the product occurring at the dispenser terminals, the manufacturing exemption language would include this equipment.

While temperature controls are used post-manufacturing; without the use of these tools to monitor the temperature and determine the proper psi levels for customer distribution of CNG, the CNG would not be properly delivered to customers and would impact use

of the product by not properly distributing the correct amount of CNG required by vehicles. While the Department provides that “the use of machinery or equipment for general ventilation, heating, cooling, climate control or general illumination, not required by the manufacturing process” generally is not considered manufacturing, the Department has consistently recognized that machinery and equipment that maintains a precise temperature as a requirement of the industry or in order to preserve a manufactured product can qualify for the manufacturing exemption. 86 Ill. Admin. Code §130.330(d)(4)(H); Illinois General Information Letter No. ST 99-0139; Illinois General Information Letter No. ST 98-0193; Illinois General Information Letter No. ST 01-0192. Therefore, temperature controls qualify for the manufacturing exemption.

CONCLUSION

We respectfully request the Department issue a Private Letter Ruling confirming COMPANY’s process of converting natural gas to Compressed Natural Gas is manufacturing as defined in 35 ILCS §105/3-50(1) and that their purchases of equipment, such as filters, dryer, desiccants, compressor, piping, holding tank systems, PLC, and dispenser terminal used in the creation of vehicle ready Compressed Natural Gas qualify for the Illinois sales and use tax manufacturing exemption.

In the event the Department intends to either deny issuance of the requested Private Letter Ruling or issue a ruling that COMPANY’s equipment does not qualify for the manufacturing exemption, we respectfully request to be notified before the issuance of such Ruling and be given the opportunity to discuss the issues and implications of such intention with the Department as well as to withdraw this Petition for Private Letter Ruling.

Please contact me at (XXX) XXX-XXXX at your earliest convenience so that we may schedule a time to further discuss COMPANY’s situation, answer any questions, and provide additional documentation you may require.

DEPARTMENT’S RESPONSE:

The Retailers’ Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property at retail to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. Use Tax is imposed on the privilege of using in this State any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as “sales tax” in Illinois.

Retailers’ Occupation Tax, however, does not apply to sales of machinery and equipment used primarily (over 50% of the time) in the manufacturing or assembling of tangible personal property for wholesale or retail sale or lease. See 86 Ill. Adm. Code 130.330. The manufacturing process is the production of articles of tangible personal property or assembling different articles of tangible personal property by procedures commonly regarded as manufacturing, processing, fabricating, or refining which changes some existing material or materials into a material with a different form, use or name. These changes must result from the process in question and be substantial and significant. See Section 130.330(b)(2).

Machinery means major mechanical machines or major components of such machines contributing to a manufacturing or assembling process, including machinery and equipment used in the general maintenance or repair of such exempt machinery and equipment or for in-house manufacture of exempt machinery and equipment. See Section 130.330(c)(2).

Based on your descriptions of the filters, dryers, compressors, holding tanks, piping, and programmable logic controllers (PLC's) and your representations that this equipment is primarily used to manufacture compressed natural gas obtained as natural gas from a utility line, the Department is of the opinion that the equipment identified in this paragraph qualifies for the manufacturing machinery and equipment exemption. The manufacturing process begins when the natural gas obtained from the utility line is first filtered and ends when the compressed natural gas moves from the holding tanks to the dispenser terminal.

Consumable supplies, however, such as desiccants, do not qualify for the manufacturing machinery and equipment exemption. See Section 130.330(c)(3). In addition, the dispenser terminal and the associated temperature controls do not qualify for the exemption as they are not used in activities commonly regarded as manufacturing, processing, fabricating, or refining. See Section 130.330(b)(2) and (3).

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or hearing and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Chairman, Private Letter Ruling Committee

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