

TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 24-07

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

Application of Tennessee sales and use tax to contractors purchasing equipment and materials to expand a freshwater treatment facility.

SCOPE

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

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

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

FACTS

[REDACTED] (the "Utility") is the municipal utility system owned by the [TENNESSEE MUNICIPALITY] and is governed by [MUNICIPAL BOARD]. It is not separately incorporated and is established pursuant to Tenn. Code Ann. § 7-52-101 *et seq.* and Tenn. Code Ann. § 7-35-401 *et seq.* The Utility has not applied for an Industrial Machinery Authorization.

The Utility owns and operates a freshwater treatment facility in [TENNESSEE MUNICIPALITY] (the "Facility"). The Facility draws water from an area river, filters the water and chemically treats the water so that the water can be used for residential and commercial water purposes, such as drinking water, water used for other household purposes, irrigation, and commercial applications including manufacturing.

The treatment process involves adding chemical coagulants to the incoming water. The water and chemicals are then rigorously mixed to ensure proper contact between the water and coagulants. The chemically treated water is then sent to flocculation basins where it is slowly mixed to allow the coagulants to combine with particles in the water to form larger, heavier particles. After the slow mixing step, the water is then sent to sedimentation basins where the larger, heavier particles are settled out of the water and removed. After settling, the water is sent through a filtration step to remove finer, lighter particles that are too small to settle out in the sediment basins. After filtration, water is disinfected using a combination of a chemical disinfectant and ultraviolet light disinfection. After disinfection, the water is stored briefly and then pumped to the distribution system where it is sold to the Utility's customers through Utility owned water meters.

The Utility intends to enter into contracts with unrelated contractors (the "Contractors") to construct an expansion of the Facility. The Utility will own and operate the expanded Facility. In the course of expanding the Facility, Contractors will purchase materials required to construct the expansion of the Facility as well as equipment to be used in the expanded Facility. The equipment and materials will consist of 1) processing equipment, including pumps, tanks, piping, piping accessories, and related equipment necessary to process water drawn from the water source ("raw water"), and 2) concrete, reinforcing materials and other building materials necessary for the construction of the foundations and enclosures necessary for the processing equipment ("Equipment and Materials").

The piping required for the Facility expansion includes process yard piping systems, including piping required to transport preliminarily treated water to the Facility's main processing location, piping required to transport treated water to storage, and piping required to transport treated water to the distribution piping system for delivery to the Utility's residential and commercial customers.

The Facility's source of water supply is a river that is [DISTANCE AND DIRECTION FROM THE] Facility. The Utility will construct an intake structure in the river with screening to remove large and small solids from the raw water and a pump station in close proximity to the intake structure (approximately 200 feet) to facilitate drawing water from the river. Water drawn from the river at the screening structure and through the pump station will undergo preliminary treatment that is integral to the Facility's processing the water into drinking water.

The preliminary screening process that occurs at the screening structure and the pump station includes fine and coarse screening, and large particulate removal. Water quality sampling begins at

the pump station and along an approximately [LENGTH] pipe (the "Piping") that transports the preliminarily treated water to the Facility's main processing location. The Piping is used to transport water that is preliminarily processed at the intake screening structure and at the pump station. The Piping is installed underground on property with respect to which the Utility has easements that allow the Utility to install the Piping, and repair and maintain the Piping. The Utility has the authority to remove the Piping in its discretion.

The pump station will include infrastructure needed to allow for possible installation of additional chemical treatment such as a potassium permanganate system to provide pre-oxidizing organic removal to aid in the removal of PFAS (polyfluoroalkyl substances) and other potential contaminants of concern as may be necessary to meet future regulatory requirements. The chemicals will be injected at the pump station and mix with and react with the water as it is pumped. The preliminarily treated water will undergo testing for turbidity, flow, and pressure to aid in further chemical treatment processes. The Piping also will serve as a geothermal temperature moderation heat exchange contactor to aid in temperature stabilization of the preliminary treatment process. The water that has undergone preliminary treatment is transported to the Facility's main processing location through the Piping where the preliminarily treated water moves through several processes to produce drinking water.

RULINGS

1. Can the Contractors purchase the Piping exempt from sales and use tax?¹

Ruling: Yes. The Piping qualifies as industrial machinery and contractors may purchase the Piping without payment of sales tax.

2. Are Contractors required to accrue and remit use tax when the Contractors use the Piping to expand the Facility?²

Ruling: No. Contractors are not required to accrue and remit use tax on the Piping when installing the Piping to expand the facility.

ANALYSIS

TENN. CODE ANN. § 67-6-209(b) (2022) states that where a contractor or subcontractor defined as a "dealer"³ uses tangible personal property in the performance of a contract, or to fulfill a contract or

¹ The Tennessee Department of Revenue previously issued a comprehensive Revenue Ruling that addresses the components of a water treatment facility. See Tenn. Dept. of Revenue Rev. Rul. 00-46 (Nov. 17, 2000). To the extent that the Equipment and Materials are substantially similar in form and function to the items described in RR 00-46, then RR 00-46 will provide the guidance for those items.

² See footnote 1.

³ TENN. CODE ANN. § 67-6-102(23)(K) (Supp. 2023) defines a "dealer" in pertinent part as one who "uses tangible personal property, whether the title to such property is in such person or some other entity, and whether or not such other entity is required to pay a sales or use tax, in the performance of such person's contract or to fulfill such person's contract obligations, unless such property has previously been subjected to a sales or use tax, and the tax due thereon has been paid."

subcontract obligations “such contractor or subcontractor shall pay a tax at the rate prescribed by § 67-6-203 measured by the purchase price of such property.” Thus, under Tennessee law, a contractor is generally liable for the “contractor’s use tax” when the contractor uses tangible personal property in the performance of a contract, unless an exemption applies.⁴

The use tax imposed against contractors does not apply where the contractor, and the purpose for which tangible personal property is used, would be exempt from the sales and use tax. This exclusion from tax is included in TENN. CODE ANN. § 67-6-209(c) and applies when a contractor constructs an improvement to real property that is exempt as industrial machinery and when a contractor installs equipment that is exempt as industrial machinery.⁵

Whether Contractors can be authorized to purchase the Piping without paying sales tax will turn on whether the Piping qualifies as industrial machinery. Whether Contractors are required to accrue and remit use tax when the Contractors use the Piping to expand the Facility will also turn on whether the Piping qualifies as industrial machinery. Industrial machinery is exempt from sales and use tax under TENN. CODE ANN. § 67-6-206(a).⁶

“Industrial machinery” is defined in pertinent part under Tenn. Code Ann. § 67-6-102(46)(A)(i) as

[m]achinery, apparatus and equipment with all associated parts, appurtenances and accessories, including hydraulic fluids, lubricating oils, and greases necessary for operation and maintenance, repair parts and any necessary repair or taxable installation labor therefor, that is necessary to, and primarily for, the fabrication or processing of tangible personal property for resale and consumption off the premises . . . where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one’s principal business.

Therefore, in order for a purchase of tangible personal property to qualify as exempt industrial machinery, four requirements must be met. First, the use of the tangible personal property must be by, or in the case of a contractor, on behalf of, a manufacturer. A manufacturer is one who engages in such fabrication or processing for resale and consumption off the premises as one’s principal

⁴ TENN. CODE ANN. § 67-6-209(c) (2022).

⁵ See generally *Hoyer-Schlesinger-Turner Inc. v. Benson*, 479 S.W. 2d 223, 225 (Tenn. 1972) (finding that industrial machinery does not lose its identity as industrial machinery merely by its affixation to real property during the process of installation). It should be noted that Tenn. Code Ann. § 67-6-102(97)(D) deems pipes, tanks, and pipelines real property when they are installed underground or attached to a building and they are used for carrying water, among other things. While this provision clarifies how to treat pipes when they are installed for sales and use tax purposes, it does not change an items identity as industrial machinery.

⁶ There is also an industrial machinery exemption for pollution control facilities that allows for purchases made by contractors for a qualified pollution control facility to be exempt from sales and use tax. TENN. CODE ANN. §§ 67-6-102(46)(A)(i). This exemption does not apply because the freshwater treatment facility is treating water drawn from its natural environment, not treating pollution.

business.⁷ Second, the tangible personal property purchased must be machinery, apparatus or equipment. Third, the tangible personal property must be necessary to the fabrication or processing of the products sold by the manufacturer. Fourth, the tangible personal property must be primarily for the fabrication of the products sold by the manufacturer.

The first requirement is met because the Facility only processes raw water into potable water for resale. The raw water is subject to numerous chemical and physical processes that make it drinkable, and water is included in the statutory definition of tangible personal property.⁸ In analyzing the meaning of “resale” as it relates to “the fabrication or processing of tangible personal property for resale and consumption off the premises,” Tennessee courts have found that the “resale” requirement under the definition of “industrial machinery” is met when the property is transferred off the premises in a taxable transaction.⁹ A manufacturer need not make a sale for resale to a wholesaler or retailer to qualify for the industrial machinery exemption. It is sufficient that the water is sold to customers for consumption off the premises.

The second requirement is met because the Piping constitutes “machinery, apparatus, and equipment.” In the case of *Eastman Chemical Co. v. Johnson*, 151 S.W. 3d 503, 509-10 (Tenn. 2004), the Tennessee Supreme Court has interpreted the phrase “machinery, apparatus, and equipment” to include “the devices conveying the materials and components from one part of the manufacturing or fabricating process to another.” Further reinforcing that items which convey material in the manufacturing process qualify as industrial machinery, TENN. CODE ANN. § 67-6-102(D)(ii) provides that 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, qualify as industrial machinery if they are necessary to and primarily for the fabrication and processing of tangible personal property. Here, the Piping conveys preliminarily treated water from the intake structure, which is where the manufacturing process begins when the incoming raw water is filtered, to the Facility where another manufacturing process takes place. As such, the Piping constitutes “machinery, apparatus, and equipment.”

The third requirement is met because the Piping is necessary to the processing of raw water into potable water. The term “necessary” is not defined by the Tennessee Code or the Tennessee courts for Tennessee sales and use tax purposes. A common definition of “necessary” is “absolutely needed: required.”¹⁰ The Piping is absolutely needed to move raw water through the treatment system so that it can be processed into potable water. The Piping also serves as a geothermal temperature moderation heat exchange contactor to aid in temperature stabilization of the preliminary treatment process. This additional function is part of the process of turning preliminarily treated water into

⁷ *Tenn. Farmers' Coop v. State ex rel. Jackson*, 736 S.W.2d 87, 91-92 (Tenn. 1987) (holding that manufacturing is a taxpayer's principal business if more than fifty percent of its revenues at a given location are derived from fabricating or processing tangible personal property for resale).

⁸ Tenn. Code Ann. § 67-6-102(97)(A).

⁹ *See Rogers Group, Inc. v. Huddleston*, 900 S.W.2d, 34, 36 (Tenn. Ct. App. Jan. 6, 1995) (finding that “fabricating or processing for resale” focuses on the property's use or consumption off the premises, and that the transfer of the property in a taxable transaction for use and consumption off the premises is identical to a sale).

¹⁰ MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY (11th ed. 2007).

potable water. The pipes that convey potable water from the Facility to be distributed to customers are not necessary to the manufacturing process and are not included in the Piping.¹¹

The fourth requirement is met because the Piping is primarily for the processing of raw water into potable water. The term “primarily” has been defined by the Tennessee Supreme Court for purposes of the industrial machinery exemption as “first of all; principally; or fundamentally” and as “first in rank or importance, chief, principal, basic or fundamental.” *Woods v. General Oils, Inc.* 558 S.W. 2d 433, 436 (Tenn. 1977) (citing WEBSTER’S THIRD NEW INTERNATIONAL DICTIONARY (1961)). Here, the Piping is used exclusively to move raw water through the treatment and screening system and to the Facility where it can be fully processed into potable water.

Having met the requirements analyzed above, the Piping qualifies as industrial machinery exempt from Tennessee sales and use tax. The Contractors may purchase the Piping materials exempt from sales and use tax after they have applied for and received their own industrial machinery exemption authorization number on a per project basis. Additionally, the Contractors are not required to accrue and remit use tax on the Piping to expand the Facility.

APPROVED: David Gerregano
Commissioner of Revenue

DATE: August 21, 2024

¹¹ See Tenn. Dept. of Revenue Ltr. Rul. 97-38 (Sept. 5, 1997) (finding that pipes that are a major part of a distribution system do not qualify as industrial machinery).