PRIVATE TAXPAYER RULING LR04-009

January 20, 2005

The Department issues this private taxpayer ruling in response to your letter of June 7, 2004, in which you request a ruling on behalf of your client . . . ("Taxpayer") . . . on the applicability of Arizona transaction privilege tax to certain revenue attained from Taxpayer's business operations. You also submitted supplemental information to your June 7 request on July 15 and November 30, 2004, responding to the Department's request for further clarification on a substantive area.

Statement of Facts:

The following facts are excerpted from your June 7 letter:

> [Taxpayer] operates a mine and a processing facility in [Town], Arizona. In addition to materials extracted and processed from its Arizona mine that are subsequently sold to its customers, [Taxpayer] purchases [Compound] extracted from a mine owned and operated by a related corporation ("[V]endor") located outside of Arizona. Title and possession of the material transfer from [Vendor] to [Taxpayer] outside of Arizona. [Taxpayer] contracts with third parties to transport the materials to its Arizona processing facility. This facility crushes the rock obtained from [Vendor] into fine powder. The processed materials are then sold to customers that incorporate the materials in various products for resale. The majority of these customers are located outside of Arizona.

In your July 15 e-mail, you specified that your request "only addresses [Compound] purchased from the vendor noted therein."

You provided the following additional information in your November 30 letter to the Department:

> The [Compound] ore purchased by [Taxpayer] from [Vendor] is used exclusively in the manufacturing of [higher] grade products. The [higher] grade products must meet the requirements set forth in the [official compendium of standards] for [Compound] . . . and . . . the requirements set forth in the [other standard references] for [Compound].
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> The difference between the Arizona mined ore . . . and the [Vendor] ore . . . is the chemistry of the ores. The chemistry of the [Vendor] ore meets both the requirements of the [official compendium of standards] and the [other standard references] for [Compound], whereas the Arizona mined ore does not. Therefore the Arizona mined ore cannot be used to manufacture [higher] grade [Compound] products[;] it can only be used for the manufacturing of [lower] grade products.
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> Also, another difference between the [Vendor] ore and Arizona ore is in the respective processing. Though there are some common equipment used in the processing of the two respective ores, prior to the processing of the [Vendor] ore for [higher] grade products, after the equipment has been used to produce [a lower] grade product using the Arizona ore, the common equipment is purged with the [Vendor] ore for a half hour to remove all trace of the

> Arizona ore. This purge [is] performed to prevent contamination of the [higher] grade products with the Arizona ore which, if not removed[,] could cause the [higher] grade products not to meet the requirements of the [official compendium of standards] or the [other standard references].
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> When producing a [higher] grade product, the [Vendor] ore goes through a unique process called flotation, which is used to enhance the purity of the resultant product. This process is never used in the production of [lower] grade products[:] this is a process used exclusively for the processing of the [Vendor] ore for [higher] grade products.

Your Issue:

In your June 7 request, you stated that the issue is whether sales of materials processed in Arizona by Taxpayer that are acquired from an out-of-state vendor are subject to tax under the retail business classification at Arizona Revised Statutes ("A.R.S") § 42-5061 or the mining business classification at A.R.S. § 42-5072.

Your Position:

Your position is that sales of [Compound] that Taxpayer initially purchases for resale are properly subject to tax under the retail classification. Thus, Taxpayer may accept exemption certificates from its customers for materials sold to them for subsequent resale. The sales are not subject to tax under the mining classification because Taxpayer does not extract the [Compound], but rather, purchases it from an outside vendor and resells it after processing using a different method than the one used for processing materials mined at its Arizona facility.

You further assert the following:

> [Taxpayer] believes that the processing of [higher grade Compound] is sufficiently disassociated from its mining activities that take place following extracting of the [Arizona-mined Compound] as discussed in both *State Tax Commission vs. Wallapai Brick & Clay Products*, 330 P.2d 988, 993-94 (Ariz. 1958) and *Arizona Department of Revenue vs. Magma Copper Company*, 674 P.2d 876, 881-82 (Ariz. Ct. App. 1983).
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> The above referenced cases involve materials commonly extracted from Arizona mines, whereas the [Vendor] materials are being acquired from an outside vendor located outside of Arizona (property not mined in Arizona). In addition, as was the case in *Wallapai* and *Magma Copper*, different processes [are] used for sales of product for differing purposes. We believe, as the courts did in these two cases, that [Taxpayer] is in the business of manufacturing the raw material it purchases, as opposed to extracts, for the purpose of sale, in this case to . . . companies [utilizing higher grade Compound] for incorporation into products for resale.

Conclusions and Ruling:

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

Wallapai and *Magma Copper* 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.

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:

> 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.'
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> 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.]

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."

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

[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.")

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.

The conclusions in this private taxpayer ruling do not extend beyond the facts presented in your communications of June 7, July 15, and November 30, 2004.

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

[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.

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.

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