UT 00-4
Tax Type: Use Tax
Issue: Pollution Control Equipment (Exemption)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
SPRINGFIELD, ILLINOIS

"MAGNATEX POWER COMPANY", & **"GROUNDSWELL MINING CO.",** **Taxpayers** **v.** **THE DEPARTMENT OF REVENUE** **OF THE STATE OF ILLINOIS**	**No. 98-ST-0000** **IBT 0000-0000** **0000-0001** **Claims for Credit or Refund** **Barbara S. Rowe** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Lawrence J. Stark, Stone, Pogrund & Korey for "Magnatex Power Company"; Charles Hickman, Special Assistant Attorney General for the Illinois Department of Revenue.

Synopsis:

The Illinois Department of Revenue (the "Department") issued Notices of Tentative Denials of Claims for refund to "Magnatex Power Company" (“Magnatex”) and "Groundswell Mining Company" (“Groundswell”) (collectively referred to as the "Taxpayers") for periods during the taxable years 1992 through 1994. The taxpayers timely protested the notices. During the administrative proceedings, the parties agreed to waive formal hearing and submitted the case on stipulations of fact (the “Stipulation”) and supporting memoranda[1] on the issue of whether the coal "Magnatex" purchased from "Groundswell" and from out of state vendors, used to produce

[1] Taxpayers’ Brief In Support Of Claim For Credit Or Refund is cited herein as “TP Brief”; Taxpayers’ Rebuttal Brief In Support of Claim For Credit Or Refund is cited as “TP Rebuttal”; Memorandum Of The Department is cited as “Dept. Brief”; the Reply Memorandum Of The Department is cited as “Dept. Reply”.

the electrical energy necessary to operate certain pollution control systems qualified for the pollution control facilities exemption found at 35 **ILCS** 105/2a of the Use Tax Act (the "UT" or "UTA") and 35 **ILCS** 120/la of the Retailers' Occupation Tax Act (the "ROT" or the "ROTA"). After reviewing the record, it is recommended that this matter be resolved in favor of the Department.

FINDINGS OF FACT:

1. The Department's *prima facie* case, inclusive of all jurisdictional elements, was established with the stipulation that the Department issued Notices of Tentative Denial of Claim to the taxpayers regarding use tax paid to Illinois by "Magnatex" for its out of state purchases of coal for the period of January 1992 through December 1994, and for the retailers'occupation tax paid by "Groundswell" on its sales of coal to "Magnatex" during April 1992 through December 1994. Stipulation ¶ 15
2. The "facts" as stipulated, in pertinent part, read as follows:
    a. ["Magnatex"] is a utility engaged in the generation of electrical power, with its principal place of business located [in] "Someplace", Illinois. [It] maintains two coal fired power plants, known as the "Power Plant #1" and the "Power Plant #2" Stipulation ¶ 2
    b. [It] has in place at its two coal fired power plants pollution control systems which involve the use of electrostatic precipitators. At "Power Plant #2", [it] also utilizes a sulfur dioxide ($S0_2$) scrubber. Both of these pollution control systems are employed directly by ["Magnatex"] in connection with the reduction of ash and sulfur dioxide emissions into the air. Ash and sulfur dioxide have been classified as pollutants by the United States E.P.A. and Illinois E.P.A. These systems have either been certified by the United States E.P.A. and the Illinois E.P.A. as Pollution Control Systems within the meaning of the Illinois Use Tax and Retailers' Occupation Tax

Acts, or such systems are within the meaning of those statutes. Stipulation ¶ 3

c. The electrostatic precipitators employed by ["Magnatex"] are apparati that consist of hundreds of exposed metal wires and plates that are electrically charged. The electricity, which is consumed by the operation of the electrostatic precipitators, is produced by burning coal purchased by [it]. Absent the electrical charge supplied to the wires and plates, the electrostatic precipitator would not function. Stipulation ¶ 4

d. The process by which an electrostatic precipitator removes suspended ash from the escaping flue gas is as follows: as the flue gas[2] passes around the positively electrically charged metal wires, the particles of suspended ash in the flue gas become positively electrically charged and are collected on negatively charged metal plates as a result of the electrical attraction created by the charged plates. The trapped ash is thus removed from the flue gas before it is allowed to be released into the atmosphere. Stipulation ¶ 5

e. The scrubbers employed by ["Magnatex"] are necessary to remove from the flue gas the sulfur dioxide, which is the result of burning high sulfur Illinois coal. The Illinois coal which [it] purchases is high in sulfur, and when the Illinois coal is burned, one combustion byproduct is the relatively high concentrations of sulfur dioxide in the flue gas. Stipulation ¶ 6

f. For the scrubbers to operate, ["Magnatex"] purchases tons of limestone (technically known as calcium carbonate) which [it] must crush and mix with water to create a mixture capable of being sprayed into the flue gas as

[2] "Flue gas" is defined to be emissions from the burning of the coal to generate the heat necessary to create the high pressure steam which then caused the turbine to spin which causes the generator to rotate, thus creating electrical power. Stipulation ¶ 5, note

a fine mist. The mix of water and limestone is referred to as slurry. A fine mist of this slurry is sprayed into the flue gas. Once the slurry is allowed to interact with the flue gas, the slurry captures and removes from the flue gas approximately 85% of the sulfur dioxide, which would otherwise escape into the atmosphere. Stipulation ¶ 7

g. The entire process of crushing the limestone, preparing and pumping the slurry for spraying into the flue gas, and the operation of oversized induced draft fans to move the flue gas through the scrubber requires electrical energy which ["Magnatex"] generates using the coal it purchases. Stipulation ¶ 8

h. The Pollution Control Systems (hereinafter referred to as the "Systems") at all relevant times herein, in order to function, required the use of electrical energy. ["Magnatex"] purchased for the purpose of operating its Systems coal, as fuel, which was necessary to produce the electrical energy, which allows the Systems to function. Stipulation ¶ 9

i. ["Magnatex"] has been able to calculate, using standard commonly accepted formulas, the amount of coal required to generate the electrical power needed to operate the electrostatic precipitators and scrubbers. Stipulation ¶¶ 10, 11

j. Without the electrical energy generated using coal purchased by ["Magnatex"], the Systems would not function. Stipulation ¶ 12

k. ["Magnatex"] paid use tax on out of state purchases of coal and "Groundswell" paid retailers' occupation tax[3] to the Illinois Department of Revenue based on ["Magnatex"'s] purchases of coal used to generate

[3] It is unclear if "Groundswell" bore the burden of the tax or if they assessed use tax against "Magnatex" for the retailers' occupation tax at issue. In order for a taxpayer to prevail in a claim for credit action, the taxpayer must present documentary evidence that he bore the burden of the tax liability. See 35 **ILCS** 120/6 *et seq.*

electrical power necessary to run ["Magnatex's"] Systems. Stipulation ¶ 13)

l. Of the amount of such tax paid to the Department of Revenue, ["Magnatex"] filed claims for refund for $24,536.00 for the period January 1992 through December 1994 and "Groundswell" filed claims for refund in the sum of $179,544.00 for the period April 1992 through December 1994. The basis of the claims was the pollution control facilities exemption, pursuant 35 **ILCS** 105/2a of the Use Tax Act and 35 **ILCS** 120/la of the Retailers' Occupation Tax Act. If the taxpayers prevail in this matter, the amount of the refund shall be the lower of the amount claimed on the above referenced claims for refund or the amount of the tax paid on coal used to generate electricity used to operate the Systems, as set forth on Exhibits A and B attached to the stipulation. Stipulation ¶ 14

CONCLUSIONS OF LAW:

"Magnatex's" claim for refund is for use tax it paid directly to the Department on its purchases, from out of state vendors, of coal that it asserts are exempt from such tax pursuant to the UTA pollution control facilities exemption. 35 **ILCS** 105/2a "Groundswell's" claim for refund is for the retailers' occupation tax it paid to the Department on its sales to "Magnatex" of coal that it now claims are exempt from the imposition of tax pursuant to the ROTA pollution control facilities exemption. 35 **ILCS** 120/1a

Prior to a discussion of the application of the specific law concerning these exemptions to the facts herein, it is necessary to set forth the well-settled parameters of law relating to tax exemptions. In Illinois, tax exemption provisions are strictly construed against the taxpayer and in favor of the taxing body. Telco Leasing, Inc. v. Allphin, 63 Ill.2d 305 (1976) The exemption claimant has to clearly and conclusively prove entitlement to the exemption. United Airlines, Inc. v. Johnson, 84 Ill.2d 446 (1981); Chicago Bar Ass'n v. Department of Revenue, 163 Ill.2d

290 (1994). In addition, all presumptions are against the intention to exempt tangible personal property from taxation. Follett's Illinois Book & Supply Store, Inc. v. Issacs, 27 Ill.2d 600 (1963)

Both the UTA and the ROTA exempt pollution control facilities from the imposition of the respective taxes, and define "pollution control facilities" as:

> ...any system, method, construction, device or appliance appurtenant thereto sold or used or intended for the primary purpose of eliminating, preventing, or reducing air and water pollution as the term "air pollution" or "water pollution" is defined in the "Environmental Protection Act", enacted by the 76th General Assembly,[4] or for the primary purpose of treating, pretreating, modifying or disposing of any potential solid, liquid or gaseous pollutant which if released without such treatment, pretreatment, modification or disposal might be harmful, detrimental, or offensive to human, plant or animal life, or to property. 35 **ILCS** 105/2a and 35 **ILCS** 120/1a.

Pursuant to its statutory rule-making authority (35 **ILCS** 120/12), the Department promulgated a regulation, found at 86 Ill. Admin. Code ch. I, §130.335, regarding the exemptions. Although it mirrors the language of the respective statutes, it includes, in pertinent part:

> a) …This exemption includes not only the pollution control equipment itself, but also replacement parts therefor, but does not extend to chemicals used in any such equipment, to fuel used in operating any such equipment nor to any other tangible personal property which may be used in some way in connection with such equipment, but which is not an integral part of the equipment itself. . . .

At issue herein is the taxpayers' entitlement to an exemption from Illinois use tax and retailers' occupation tax paid for coal that is used “to generate the heat necessary to create the high pressure steam which then causes the turbine to spin which causes the generator to rotate, thus creating electrical power” (Stipulation ¶ 5, note, defining flue gas that is the emission resulting from the burning of coal in the process of creating "Magnatex’s" product, electricity) that was used to power pollution control devices at two of "Magnatex’s" power plants.

[4] 415 **ILCS** 5/1 *et seq.*

The parties agree that "Magnatex" is a utility whose business it is to generate electrical power. They also agree that it generates its product using coal-fired power plants. Further, there is no dispute that the electrical power it generates results from the burning of coal, that in turn, generates the heat necessary to create high pressure steam which spins a turbine that causes a generator to rotate, which creates the electrical power "Magnatex" is in business to produce. The parties also stipulate that it is the ash and sulfur in the flue gas created by the very act of the burning of coal, that are *the* pollutants that must be abated, and which necessitate the pollution control systems in the first place. Finally, the coal purchased and used by "Magnatex" to generate the electrical power that is its product is entirely fungible with the coal used to generate the electrical power necessary to the pollution control systems.[5] It is also reasonable to conclude that the electrical power that "Magnatex" uses for its pollution control systems is indistinguishable from the electrical power that it generates for sale to its customers, as there is no distinction made by the parties between the electrical power ultimately generated by the burning of coal in the coal-fired power plants and the electrical power ultimately generated by the burning of coal for the pollution control systems.

In short, the very coal that is claimed to be necessary to eliminate, prevent or reduce pollution, is the same coal that is itself creating the pollution for which the scrubbers and ash removing precipitators, (the pollution control systems at issue), are necessary. The act of burning the coal at issue, that begins the process of generating electricity for the precipitators and scrubbers, is an act that pollutes the air…which necessitates the precipitators and scrubbers…and around and around and around it goes.

The ultimate question becomes then, can the coal that <u>creates</u> pollution when burned to make "Magnatex's" saleable product also be part of a pollution control system when a portion of

[5] This is a reasonable inference drawn from Stipulation ¶¶ 10, 11 that discuss "Magnatex's" ability to calculate the amount of coal required and purchased to operate the precipitators and scrubbers at issue. If "Magnatex" were purchasing coal for no purpose other than to begin the process of generating electricity to run the pollution control facilities, no calculations would be necessary.

the electricity it produces is used to run the precipitators and scrubbers necessary to abate that very same pollution? From a perspective of logic and common sense, the answer has to be no. If plain logic is put aside, the coal at issue still does not warrant exemption from the use and retailers' occupation taxes based upon a reading of the pertinent statutes and an application of the law.

In Illinois, the pollution control tax exemption is limited by the primary purpose test. Du-Mont Ventilating Co. v. Department of Revenue, 73 Ill.2d 243, 248 (1978). That is, in order to qualify for this exemption, the "primary purpose", the function and the ultimate objective of the pollution control facility must be to eliminate, prevent, or reduce air or water pollution. XL Disposal Corporation v. Zehnder, 304 Ill. App.3d 202 (4th Dist. 1999). The primary purpose test or standard is mandated by clear statutory language, and the courts in Illinois have repeatedly applied this test.

Taxpayers argue, however, that a legal analysis in this matter does not require an inquiry into the primary purpose of the coal at issue. Rather, taxpayers state that, based upon Cilco Illinois Light Co. v. Dept. of Revenue, 117 Ill. App.3d 911 (3rd Dist. 1983) (hereinafter referred to as "Cilco"), since both systems have either been certified by the United States and the Illinois E.P.A.s as pollution control systems or are within the meaning of those statutes, the evidence is conclusive that the primary purpose of the systems is pollution control. TP Rebuttal pp. 2-3. Therefore, an analysis of the coal, used as fuel in these systems, is said to be improper. *Id*. at 3. Taxpayers are incorrect.

First, the question before me, is not whether the scrubber or the precipitator qualifies for the exemption. Rather, it is whether the coal that is burned to generate the heat needed to create the steam that causes the turbine to spin which causes the generator to rotate, thereby creating the electric power that powers these items, qualifies as an exempt part of those systems.

Further, the Cilco court did not conclude its analysis of whether a cooling pond and an electric scale were exempt from UT and ROT because both had been certified as pollution control systems by the Illinois E.P.A. It stated that "[H]aving concluded that the pollution

control facilities are exempt from the imposition of use taxes by virtue of statutory enactments, it may well be unnecessary to consider whether the cooling pond and truck scales are pollution control facilities. The Department, however, argues so strenuously that they do not qualify as such facilities we feel constrained to examine the Department's contention"[6] (*Id.* at 915) (emphasis added) and proceeded to analyze both items using the primary purpose standard. That court concluded that both the cooling pond and the electric scale qualified for exemption as pollution control facilities because they would not have been necessary but for environmental laws affecting that taxpayer. Cilco, thus premised in part its analysis of this exemption applying a subjective, "but for" test. The argument of these taxpayers follows that same path, i.e. "without the electrical energy generated using coal purchased by ["Magnatex"], the Systems would not function.

Cilco is the only case in Illinois regarding the pollution control exemption that is based in part upon a subjective purpose "but for" test. The "but for" test has specifically not been followed by subsequent courts. Shell Oil Co. v. Department of Revenue, 117 Ill. App.3d 1049 (4th Dist. 1983) (storage stacks necessary to separate low and high sulphur crude oil pursuant to EPA sulphur emissions requirements found not to be exempt as their objective, primary purpose is storage); Cilco Illinois Public Service Co. v. Department of Revenue, 158 Ill. App.3d 763, 767 (4th Dist. 1987) ("This Court continues to eschew any reliance on a subjective purpose test as a basis for determining the 'primary purpose' of alleged pollution control equipment.") Nor was the subjective, "but for" test accepted and applied by any prior court, the most notable example being Illinois Cereal Mills, Inc. v. Department of Revenue, 37 Ill. App.3d 379 (4th Dist. 1976) (gas fired boiler installed only because of EPA pollution control requirements not exempt because its objective, primary purpose was to generate heat to dry grain and to heat the plant.)

[6] In Cilco, the pollution control facilities were actually certified as such by the EPA. It is unclear pursuant to the stipulation whether the precipitators and scrubbers herein are actually likewise certified. However, the parties have stipulated that, at the very least, they qualify as such under the language of the statutes.

Illinois courts have not backed away from the requirement of an objective, primary purpose analysis when faced with equipment or other tangible personal property that was part of a pollution control system. In Du-Mont Ventilating Co. v. Department of Revenue, *supra* the court considered whether the intake part of a push-pull ventilating system was exempt as a pollution control facility, even though it was not physically connected to the exhaust side of the system. In granting the exemption, the court found that the only purpose for the intake part of the system was to clear the air as part of a pollution control system. This analysis was done even though there was no question that the exhaust part of the system was a pollution control device.

Similarly, in Wesko Plating, Inc. v. Department of Revenue, 222 Ill. App.3d 422 (1st Dist. 1991) the court looked to the objective, primary purpose of certain chemicals taxpayer used in its pollution control facilities, and granted the exemption after determining that the sole purpose of the chemicals was to eliminate pollution. Accord Columbia Quarry v. Department of Revenue, 154 Ill. App.3d 129 (5th Dist. 1987) (sole purpose of the chemical, limestone, was to act as a filter within a pollution control device)

Thus, based on the above, it is necessary that an analysis be done as to whether the objective, primary purpose of the coal is to abate pollution, even though it has a part within the functions of the pollution control facilities. For the following reasons, I determine that it is not.

First, as discussed above, the coal, as it is burned by the taxpayer as the first step in the process of generating its saleable product, electricity, actually causes the very pollution that the identified pollution control facilities are required to relieve. It matters not that burning coal causes legally impermissible amounts of ash and sulphur to be discharged into the air when it is burned by taxpayer during its process of generating its product, as opposed to the coal at issue being burned so that the pollution control devices can operate. The coal "Magnatex" purchases is fungible, and it is being used in the same process for the same purpose, that is, to generate electricity, and the pollution caused by the act of burning coal is the same in both instances. Compare Wesko Plating Inc. v. Department of Revenue, *supra* (use of chemicals for electroplating process different from the use of the chemicals in eliminating pollutants). It

thwarts the entire purpose of this pollution abatement exemption if it applies to the very tangible personal property that causes the pollution in the first instance, as that property, in fact, continues to create pollution as it is being used in the process for which taxpayers claim the exemption.

Aside from the fact that the coal at issue actually causes the pollution taxpayers argue it is eliminating, it is clear that, as used, the primary purpose of the coal at issue is to generate the same electricity as is its saleable product and it does so in the same manner. The difference is that on the one hand, the product is distributed to its customers to run their equipment, appliances, etc., and on the other hand, the product is used by "Magnatex", itself, to run its own equipment. The conclusion, using an objective, primary purpose analysis, is that the coal is used in a process to generate a fungible product, electricity. The amount of the claim, therefore, is based in toto, on ledger entries in an accounting formula not on actual distinctions in use or purpose.

In this respect, this case is similar to Illinois Cereal Mills, Inc., *supra,* wherein the court addressed whether gas fired boilers were exempt as pollution control devices. These boilers took the place of coal fired boilers to produce the steam to dry taxpayer's grain and to heat its plant. The gas-fired boilers solved the pollution problem created by the burning of coal in the coal-fired boilers. Even though the gas fired boilers solved the pollution problem, the court denied the exemption because the objective, primary purpose of the new boilers was to produce the steam necessary to dry the grain and to heat the plant, rather than to eliminate pollution. In so doing, the court stated that the statutory exemption language referred "to equipment such as precipitators, filters, and smoke stacks which have no substantial function in the manufacturing or processing of a product other than to abate the pollution caused by the plant operation." *Id*. at 381-2

In comparison, the coal at issue is a beginning step in a lengthy process whereby "Magnatex" generates the electricity that is its product. In addition to directing the finished product to its customers, it uses the same product in its own plant to run its own equipment. The coal herein, then, is fungible property that is being used to produce "Magnatex's" fungible end

product, that "Magnatex" then uses for the same purposes that its customers do, that being for the operation of its equipment. The objective, primary purpose, if not the only purpose of the coal at issue, is to produce "Magnatex's" product, electricity.

To this, taxpayers argue that based upon Beelman Truck Co. v. Cosentino, 253 Ill. App.3d 420 (5th Dist. 1993) and Westko Plating, Inc, *supra*, this exemption is so broad that all that is required is a determination, without further analysis, that the tangible personal property at issue is merely one component part in the overall system of pollution control. TP Rebuttal, p. 6. Taxpayers rely on the language of these courts out of the context of the matters at issue in the cases cited and, as a result, misapply those cases to the instant cause.

For instance, in Wesko Plating, Inc. the court addressed whether chemicals used by the taxpayer to eliminate pollutants qualified for the exemption in light of the Department regulation excluding chemicals from this exemption. Thus, when that court stated that the "broad terms ['method' and 'system'] precludes a construction of section 2a limiting its application based on the type or nature of the component part" (*id*. at 426) the court addressed the general notion of whether property was excluded from exemption because it was a chemical as opposed to a mechanical device, as suggested by the Department. In this case, I find that the coal is not exempt because its objective, *primary* purpose is not pollution control, and not because it is considered a fuel. In addition, although the chemicals in Wesko were used directly in the pollution control operation, the court still analyzed what their purpose and function was before granting the exemption. That the court felt the need to consider these elements belies taxpayers' contention that no further analysis is necessary once it is shown that tangible personal property is a part of a pollution control system.

The Beelman court affirms that the statutory language of "system, method, device or appliance" is broadly interpreted (Beelman Truck Company v. Cosentino, *supra* at 423), and it further acknowledges that the primary purpose test is required "'to determine the function and ultimate objective of the equipment alleged to be exempt, and only those facilities directly involved in the pollution abatement process are to be afforded special tax status.'" *Id*. at 423

(citations omitted). Thus, the Beelman court did not forgo long standing principles concerning the applicable standard in its decision that plastic liners placed in dump trucks and escort trucks, that followed hazard waste dump trucks carrying the liners and other safety equipment necessary in the event of a hazard waste spill, qualified for this exemption. Based upon the uncontroverted evidence before that court, presented by Beelman in its summary judgment motion, that the primary purpose of the liner and the escort trucks were for the prevention, elimination, or reduction of pollution, the court granted the exemptions. The liners clearly were a part of taxpayer's pollution control system, as were the escort trucks. Nevertheless, the court did not ignore the principle that the primary purpose of the property at issue must be determined even when it is clear that the property is a part of a system or method of pollution control. It did that by emphasizing that the Department failed to controvert the well-pleaded facts and supporting affidavits filed by Beelman as part of its motion, wherein Beelman "established that the primary purpose of the plastic liner and the escort trucks was the prevention and reduction of pollution. Thus, the trial court determined, as a matter of law, that the items were tax-exempt pollution control facilities under section 2a." *Id*. at 426-7 That is not the situation before me. Therefore, even though the coal arguably has a part, albeit extenuated, in the operation of the precipitators and the scrubbers, I must, nevertheless, apply an objective, primary purpose test in making my recommendation as to the tax exempt status of the coal at issue. As a result of the above, I conclude that neither statute nor case law mandates quite the broad reading of the statute as taxpayers propose.

The parties provide that it is "Magnatex's" business to generate electricity, and that it does so by burning coal as part of a multi-stepped process. It is a stipulated fact that the coal, when burned, creates pollution, in the form of impermissible levels of ash and sulphur that require the use of precipitators and scrubbers as pollution control facilities. The parties agree that the pollution control systems in this cause require electricity to function. While there is no quarrel that the coal at issue is used as part of the process of generating the necessary electricity to run these pollution control facilities, I conclude that the objective, primary purpose of the coal

is to generate fungible electricity that "Magnatex" either distributes to its customers for use or, as in this case, uses itself.

I also find that it is inconsistent with the purpose of the pollution control facilities exemption, which is to abate pollution, to grant exemption to the very property that causes the problem. That is exactly what occurs if the coal at issue is exempted from Illinois use and retailers' occupation taxes, as is requested here.

The parties stipulate that the coal at issue is used as fuel in these systems. Taxpayers argue that the Department's regulation excluding from this exemption fuel used in operating such systems, impermissibly restricts the exempting statutes. TP Brief, pp. 8-13. Since I am basing the recommendation that the coal at issue is not exempt from the imposition of use and retailers' occupation taxes on grounds other than regulatory exclusion, it is unnecessary to determine whether the Department regulation is within legally acceptable boundaries.

It is therefore recommended that the denials of claims for refund at issue be upheld in their entirety.

Respectfully Submitted:

Date: September 26, 2000

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Barbara S. Rowe
Administrative Law Judge