MINNESOTA · REVENUE

Report and Study on Business Production Property

A study of the functions and property tax status of various components of biofuel, beer, wine, distilled beverages, and dairy products industries.

A report to the Minnesota Legislature pursuant to Minnesota Laws 2013, Chapter 143, Article 4, Section 46

Minnesota Department of Revenue
Property Tax Division
January 31, 2014

Per Minnesota Statutes, section 3.197, any report to the Legislature must contain, at the beginning of the report, the cost of preparing the report, including any costs incurred by another agency or another level of government.

This report cost $50,000.

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January 31, 2014

To the members of the Legislature of the State of Minnesota:

I am pleased to present to you this report by the Department of Revenue on the assessment of facilities that produce biofuels, alcoholic beverages (wine, beer, and distilled beverages), and dairy products. The Department of Revenue conducted this study in consultation with representatives of affected industries and the assessing community. This study and attached report were created in response to Minnesota Laws 2013, Chapter 143, Article 4, section 46, subdivision 1.

In 1973, the Minnesota legislature determined that attached machinery and equipment for manufacturing and business is exempt from property taxes. As the economy changed and production methods have increased in size and scope, our state tax code has made strides to catch up. Over time, the exemption for machinery and equipment has evolved to exclude certain equipment that provides shelter. Those that provide shelter have been defined as real property, and therefore subject to property tax. Various court decisions and Department of Revenue guidance have further defined the scope of which components used in these industries are subject to property tax, and which are exempt. As these business operations became larger and more complex, the department has increased its outreach to help county assessors with their task of valuing these complex properties.

This report examines how these types of components used for production have been taxed and what recommendations could be made based on our findings.

As certain production facilities grow larger and more complex, the tax code should be modernized to match changes in the economy. Therefore, the department recommends that components primarily used in the production process at production facilities for biofuels, alcoholic beverages, and dairy products be defined as personal property equipment, and thus exempt from property taxes. Components primarily used for storage of a product before or after production would continue to be taxable as real property. This recommendation is summarized in the attached report.

The department, in cooperation with the affected industries, coordinated several onsite visits of breweries, a biofuel production facility, and a dairy production facility. The department found that the bins and tanks used to produce biofuels, wine, beer, distilled beverages, and dairy products were primarily used as equipment in the process of making their products. In addition, the department found many of these tanks to be replaceable and necessary in the process of producing their products. Our agency also noted that some other bins or tanks were used primarily for a storage or sheltering function, and thus taxable.

This report provides some detail about the production processes of the listed facilities, a history of the legislative, judicial, and executive guidance, and an explanation of the current assessment practices. We also provide other taxing scenarios that were discussed but not recommended.

I want to thank the legislators, industry representatives, and the assessment community for your valuable contributions to the study. I look forward to the discussion of this report's findings and recommendations.

Sincerely,

Myron Frans
Commissioner

Executive Summary

Business and production property can be either "real property" or "personal property." Under current law, all real property in Minnesota – such as land and buildings – is subject to property tax unless there is a statute that specifically exempts it. Most business personal property – such as production equipment, tools, and machinery – is exempt from property tax.

The line between real and personal property can be less clear for certain industries, including biofuels, alcoholic beverage (beer, wine, and distilled beverage), and dairy processors. That is because some of the equipment used in these industries functions like real property, serving a temperature control function or offering protection from external influences. If such equipment provides shelter or protection from the elements, it is considered taxable real property under current Minnesota statutes and case law.

The definitions and taxation of real property and personal property have changed numerous times over the years. Some of these changes were due to new or evolving industrial practices; some were due to other factors. For instance, the first ethanol plant in Minnesota was established in 1988.[1] However, state laws regarding how to tax the components used to produce ethanol were enacted three years earlier (in 1985), and could not foresee the business needs of the ethanol facilities.

Recent history

The "shelter test" in current law has proved problematic for the biofuels industry and some other industries due to the nature of their production processes.

For example, ethanol facilities have very large fermentation tanks. These large tanks are placed outdoors. Their main use is fermentation, but they also provide protection from the elements. While fermentation is a necessary part of the ethanol production process, these specific tanks have been considered taxable because of their physical characteristics.

The Minnesota Supreme Court recently upheld the practice of defining some production property as taxable real property in *Southern Minnesota Beet Sugar Coop v. County of Renville*, 2007 (737 N.W.2d 545). The Court found that tanks, bins, and silos meet the definition of taxable real property if they have walls, a roof or ceiling, and floors that provide a "shelter function."

The Court's decision in *Southern Minnesota Beet Sugar Coop* concerned those who produce biofuel products at facilities affected by this determination. They worry that production equipment that otherwise would be considered personal property – and therefore not subject to property tax – would instead be taxed as real estate. Unlike

[1] Source: "Ethanol," Minnesota Department of Agriculture, http://www.mda.state.mn.us/ethanol/

many other states, Minnesota does not have a property tax for business personal property. If not defined as real estate, these types of properties would not have to pay any property taxes on that portion considered personal property equipment.

Members of the ethanol industry first approached the Department of Revenue and Minnesota Legislature in 2012 to express their concerns. The discussion included:

- How real estate and business production property are defined for tax purposes
- Whether various equipment and components should be taxable or exempt
- Property tax assessment of their facilities and how it should better reflect the actual use(s) of their equipment and property
- How these definitions and issues might also affect other industries, such as beer, wine, distilled beverage, and dairy processors

About this report

The Legislature directed the Department of Revenue to study property tax assessment of business production property in specified industries and issue a report with recommendations for taxation or exemption of various components used in their production processes.

The Department of Revenue began this study in July 2013. First, the department met with representatives of affected industries, the assessment community, and legislative staff to determine the parameters and methods used to conduct the study.

During the summer and fall, this study group toured four industry facilities and discussed the production processes and components of each industry. These facilities were for beer, ethanol, and dairy production. (For details, see Appendix A.)

Next, the department surveyed assessors on current assessment practices related to business production property of the affected industries. (For details, see Appendix B.)

Finally, the department met again with members of the study group to discuss the shared findings of the tours, and to discuss possible outcomes from the study.

This report summarizes how certain business and production property for specific industries is and has been taxed. More specifically, it:

- Provides historical context of court decisions and Department of Revenue guidance
- Presents the perspectives of industry representatives and assessors
- Outlines the processes and components of the affected industries
- Defines current assessment practices for the industries

- Discusses three approaches for resolving the issues that were raised in the study (for details, see Recommended Guidelines, starting on page 19.)

Recommendations

After considering three approaches to resolve the issues raised in this study, the Department of Revenue recommends that the Legislature revise current law to clarify which components used in the biofuels, alcoholic beverage, and dairy industries are exempt from property tax, and which are taxable. More specifically:

- Define all components primarily used in the production process as personal property equipment, and thus exempt from property taxes.
- Define all components primarily used for storage of raw or finished materials, or a product before or after production, as real property and thus taxable.

We believe this change will provide a clearer distinction – for assessors and business property owners in these industries – between taxable real property and tax-exempt personal property. In addition, it will:

- Update our property tax laws to more accurately reflect current practices in the affected industries.
- Clarify for assessors which components used in these industries are taxable, and which are exempt.
- Makes property assessment and taxation more consistent with other similar industries that do not use these particular specialized components.

Because this proposal expands the definition of exempt personal property for the specified industries, it will decrease the property tax base in affected communities. This will shift property tax burdens from the affected industry properties to other properties in those communities.

The Department of Revenue estimates that this recommendation will decrease the property tax base by $30.1 million statewide, shifting $780,000 in taxes to other properties. The local impact of this shift will be greater in some communities than others. To mitigate this impact, the department also recommends providing transition aid to taxing jurisdictions that experience significant loss of tax base.

Ultimately, no single option is without controversy or can prevent all future disputes and appeals of property assessments. As technologies and industries change, we will continue to face decisions regarding how we define business-related real and personal property for property tax purposes. But we must be mindful that these decisions have consequences – for affected businesses and for other property owners in their communities.

Background and History

Current law (Minnesota Statutes, Section 272.03) defines real property and personal property for property taxation purposes. Under section 272.03, real property "does not include tools, implements, machinery, and equipment attached to or installed in real property for use in the business or production activity conducted thereon, regardless of size, weight or method of attachment." That exclusion however "does not apply to the exterior shell of a structure which constitutes walls, ceilings, roofs, or floors if the shell of the structure has structural, insulation, or temperature control functions or provides protection from the elements."

Therefore, if a business equipment component provides exterior protection from the elements, or constitutes walls, ceilings, roofs, or floors, then the equipment component may be considered taxable real property.

This current definition has been in place since 1985, but the so-called "shelter test" for equipment components was not always used. Additionally, this language predates the first ethanol facility's establishment in 1988.

Historically, personal property equipment was taxable (at a lower rate than real property). In the 1960s, both personal and real property of businesses were taxable, although business personal property had a separate classification rate (attached machinery was taxed at $33^{1}/_{3}$% of value; other business property was at 40% of value).

Guidelines were created to help distinguish between the two types of property, and throughout the 1960s and into the early 1970s, Department of Revenue guidance was that "Equipment that is an integrated part of the building should be included in the valuation of the building (*May 1960 Minnesota Property Tax Bulletin*)." This idea is and was common real estate appraisal theory – that anything attached to or installed in real property is part of the real property; and anything that is intended to be a permanent addition to a property is also taxable real property.

A May 1960 *Property Tax Bulletin* described:

> "*The distinguishing features of attached machinery are; one, it is not part of the building facility, but part of the production, processing or service function for which the building is being used; two, it is more or less permanently located within the structure and is an integral part of the production process that takes place within the structure.*
>
> *"Included in this classification [machinery property assessed as personal property] is tools, mobile equipment and machines not attached nor an integral part of the production process. Certain characteristics distinguish machinery assessable as personal property. It is not bolted down or affixed; it is not attached with piping or other connecting apparatus; it can be removed without damage to itself; it may be put into use without installation expenditures other than the cost of moving and assembly; its removal does*

not prevent use of other installed machines; and it is ordinarily moved from place to place as it is used."

The May 1960 guidance was echoed in later bulletins. In a February, 1964 bulletin, the department stated, "Rules to be followed in classifying equipment as personal property are as follows: it is equipment that is not bolted down or affixed, it is not attached with piping or other connecting apparatus, it can be removed without damage to itself, its removal does not affect the use of installed machines, it can ordinarily be moved from place to place as it is used."

In other words, property would be considered personal property if it was not attached to the property and could be removed without damage to itself or to the property. This statement is consistent with assessment practices for all properties. For example, a window air conditioning unit on a home is generally considered personal property because it can be removed without damage to the property or to the air conditioning unit. However, a heating, ventilating, and air conditioning (HVAC) system within a home is considered part of the real estate because it could not be easily removed without damage to the system or to the home.

In 1967, the department issued a *Property Tax Bulletin* stating that, "Tools and machinery subject to exemption… must be considered by law as personal property. Machinery attached to real estate is considered for all purpose as fixtures to the real estate. The general rule for classifying machinery as personal property is that equipment is personal property only if it meets the following rules: it is not bolted down or affixed; it is not attached with piping or other connecting apparatus; can be removed without damage to either the real estate or the item itself; its removal does not affect the use of other installed machines; and can ordinarily be moved from place to place as it is used."

This further outlined that personal property included equipment property that would be easily removable from the real estate without damage to the equipment or the structure.

Additionally, a March 1968 *Minnesota Property Tax Bulletin* echoed, "The general rule as to machinery that is part of a structure is as follows: Equipment that is an integrated part of a building is regarded as real property… This includes equipment that has been installed and is auxiliary to the purpose of the building, such as escalators, elevators, heating, ventilation and air conditioning plants, sprinkler system and plumbing and electrical installations."

In all guidance throughout the 1960s, the department's assessment guidelines typically used for determining whether an item was personal property or real estate were consistent, and did not require change.

However, the 1973 Supreme Court decision in the case *Abex Corp. v. Commissioner of Taxation* (207 N.W.2d 37) created a two-part test for determining if property type or component is taxable real property: (1) whether it is annexed to the real

estate and (2) whether there is an intent to make the property a permanent accession to the freehold. The Court determined that machinery was real property in that it was installed in a building for the remaining useful life, and was not intended to be moved elsewhere.

Subsequent to that court case decision, legislation was enacted in 1973 that changed the definition of real property and personal property for property tax purposes. Department of Revenue guidance in response to the 1973 law change was:

> "*Generally, there is a fundamental distinction between annexations which would be integrated with and of permanent benefit to the land, regardless of its future use, such as a heating furnace, water systems, drainage and sewer systems, all of which are accessory to the land and not to the business carried on, and annexation of special purpose, manufacture, or processing machinery which could be used only in a particular business or industry and not for any normal use to which the land may be devoted, and hence not part of the real property…*
>
> *"For example, heating or refrigerating equipment used to heat or cool the building is part of the real estate but special furnaces installed in part of the building for annealing purposes in order to produce a heat treated product are not real property, but are equipment for use in the production activity…*"

In *KDAL, Inc. v. County of St. Louis*, 1976, the Minnesota Supreme Court upheld the exemption of a television antenna when they determined that the television tower to support the antenna was essential to the function of the business of the taxpayer (this was referred to as the "functionality" test). The television tower therefore qualified as personal property equipment attached to real property for use in a business or production activity.

The framework and superstructure of billboards was deemed exempt in the case of *Skoglund Communications, Inc. v. County of St. Louis*, 1978. The billboard equipment, which was used for business conducted on property where signs were located, was deemed to be exempt equipment essential to the function of the business of the taxpayer. Further, it was understood by the court that the framework for the billboards could serve no other purpose.

In later court cases, in order to be "equipment" and thus exempt from tax on real property, it was determined that an item must perform functions distinct and different from functions ordinarily performed by buildings and other taxable structures. (See, e.g. *Crown CoCo, Inc. v. Commissioner of Revenue*, 1983 336 N.W.2d 272, where the Court determined that a canopy was taxable because it provided a shelter function like a building would.) This required assessors to determine whether an item performed functions "distinct and different" from functions performed by buildings, and has similarities with the "shelter test."

A "primary function" test was discussed in *Farmers Union Grain Terminal Association v. County of Winona,* 1983:

> *"If the primary function of an item is distinct and different from the functions ordinarily performed by buildings or other taxable structures such item shall not be included as real property for taxation purposes… even if it has the appearance of a building."*

In the *Farmers Union* case, the property in question was used for malting barley for the brewery industry. A steeping area was not considered exempt equipment because "The steep tanks are enclosed by a roof and walls in order to protect the grain from outside elements. The primary function of that roof and walls is no different from the functions ordinarily performed by buildings." To be exempt, the building needed to "perform functions distinct and different from the function ordinarily performed by buildings and other taxable structures." The court found property for which the "primary function… is not distinct and different from the functions ordinarily performed by buildings and other taxable structures" is taxable. The "primary function" test was new compared to the requirement that something must be "exclusively" used for something other than functions of a building.

Oil tanks were also deemed taxable structures (and not "equipment") under *Barton Enterprises, Inc. v. County of Ramsey*, 1985 (390 N.W.2d 776). The oil tanks were deemed to perform a shelter function just as other buildings and structures and that the basic function of the tanks was to contain fluids and also to shelter them from the elements.

> *"More recently we declined to limit the 'functionality test' to the primary function of a structure. Rejecting the argument that because the primary function of a greenhouse is the creation of a controlled environment suitable for growing plants, a greenhouse should be deemed 'equipment' even though it performs some sheltering functions, we held that the shelter function need not be the sole or even the primary purpose of a structure in order to permit the assessment of the structure as real property [referencing Busch v. County of Hennepin, 380 N.W.2d 813; 1986]."*

The Supreme Court effectively rejected the "primary function" analysis of the *Farmers Union* case in these decisions. Under these decisions, a structure that provides a shelter function would be taxable real property, even if it performs additional functions that are different from those of a building.

Minnesota Legislature amended statute in 1985 and the Department of Revenue has used the shelter test since then when describing the methods of determining taxable real property and exempt personal property equipment.

Current statute that was initially enacted in 1985 (M.S. 272.03, subd. 1) states:

> *"(a) For the purposes of taxation, real property includes the land itself, rails, ties, and other track materials annexed to the land, and all buildings, structures, and improvements or other fixtures on it, bridges of bridge companies, and all rights and privileges belonging or appertaining to the land, and all mines, iron ore and taconite minerals not otherwise exempt, quarries, fossils, and trees on or under it.*
>
> *(b) A building or structure shall include the building or structure itself, together with all improvements or fixtures annexed to the building or structure, which are integrated with and of permanent benefit to the building or structure, regardless of the present use of the building, and which cannot be removed without substantial damage to itself or to the building or structure.*
>
> *(c)…(iii) The exclusion provided in clause (i) does not apply to the exterior shell of a structure which constitutes walls, ceilings, roofs, or floors if the shell of the structure has structural, insulation, or temperature control functions or provides protection from the elements. Such an exterior shell is included in the definition of real property even if it also has special functions distinct from that of a building."*

Most recently, the department's advice clarifies that this language means that if a property performs a containment and shelter function – a function similar to that performed by buildings – it does not fall within the category of tools, implements, machinery, and equipment, and is considered taxable as real property. Department of Revenue guidelines for taxation or exemption of business production property are based on Minnesota Statutes, section 272.03, subdivision 1, paragraph (c) and case law.

In *Southern Minnesota Beet Sugar Coop v. County of Renville*, 2007 (737 N.W.2d 545), the Supreme Court upheld the definition of taxable real property to include tanks, bins, and silos that had walls, a roof or ceiling, and floors that provided a shelter function. The court noted that the terms "real property" and "equipment" are not mutually exclusive, and therefore property may be considered "equipment" but if that equipment has been attached to or installed in real property, has an exterior shell that provides structural, insulation, or temperature control functions, or provides protection from the elements, the exterior shell is included in the definition of real property for tax purposes. In this specific case, the court found that the involved tanks, bins, and silos had walls, a roof/ceiling, and floors. The court held that the exterior shell performed a structural function of shelter from the elements and were taxable.

Members of the ethanol industry first approached the Department of Revenue and Minnesota Legislature in 2012 to express their concerns on how the statute and department guidance were impacting their facilities. In 2013, the Legislature directed the Department of Revenue to study property tax assessment of business production property in specified industries and issue a report with recommendations for taxation or exemption of various components used in their production processes.

Legislative Requirements for Study

Because the definitions of real property and personal property have changed over time, and because the industries affected by these definitions have also changed, various industries noted that the language does not contemplate their business practices. As noted, the first ethanol plant was established in 1988, and therefore language created in 1985 could not have contemplated the business practices of the ethanol industry.

As stated earlier, members of the ethanol industry approached the Department of Revenue and Minnesota Legislature in 2012 to discuss their concerns with the definition of real estate business production property, and whether various equipment components should be considered exempt or taxable. In response, the Legislature required the Department of Revenue to conduct a study and report on the components of business production property, and make recommendations for taxation or exemption of those components. Additionally, Legislature requested the involvement of other similar production industries, including beer, wine, distilled beverage, and dairy producers, as it was noted by the ethanol industry representatives that those groups might also be affected by statutory definitions.

The department was charged with: surveying counties on the components and tax status of biofuel facilities; identifying the functions of components on the five named industries; considering the taxability of components based on size, function, and use; developing recommendations for assessment guidelines and policies; and identifying possible impacts to state and local taxes resulting in recommendations.

The language outlining the study and report requirements is found in Laws 2013, Chapter 143, Article 4, section 46:

> *"… (a) In order to facilitate a legislative review of property tax assessment procedures for facilities used in the production of biofuels, wine, beer, distilled beverages, and dairy products, and the development of standards and criteria for determining the taxable status of these facilities, the commissioner of revenue must conduct a study and report the findings of the study. The study must:*
>
> *(1) include a detailed survey of counties identifying the components and tax status of biofuel facilities;*
>
> *(2) identify the function of components in facilities of the affected industries;*
>
> *(3) consider the taxability for certain components related to size, function, and use;*
>
> *(4) develop recommendations for assessment guidelines and policies for facilities of the affected industries; and*
>
> *(5) identify possible impacts to state and local taxes resulting from study recommendations.*

(b) The commissioner shall request the involvement and participation of stakeholders, including the affected industries, the assessment community, and others identified by the commissioner.

(c) The commissioner shall report the findings to the chairs of the house of representatives and senate committees with jurisdiction over taxes, agriculture, and economic development as well as the commissioners of agriculture and employment and economic development by February 1, 2014."

In order to facilitate the study and report, the Department of Revenue included participants from the affected industries, as well as members of the assessment community. Various meetings and tours were held with the participants (a description of the participants and list of tours are in Appendix A of this report). A survey of county assessors was sent on July 24, 2013, and the answers were compiled and reviewed by the department (see Appendix B). Additionally, assessors were surveyed on the known taxability and valuation of industry components in order for the department's Property Tax Research Division to be able to estimate revenue impacts of any change in administration.

The department communicated with members of the affected industries and the assessment community to thoroughly approach all requirements for the study and report, and in order to facilitate the development of guidelines that could be used to determine the taxable or exempt status of business production equipment property.

The department learned about the production processes used for the five industries (ethanol, beer, wine, whiskey, and dairy), toured four facilities, and reflected on options for taxability based on size, function, and use. The department discussed findings with the industry representatives, and developed three possible scenarios to recommend. These three scenarios were also discussed with industry representatives. The department then determined a recommendation based on those studies and discussions.

In the next section, we will discuss what was learned about the various production components for the affected industries. Then, we will discuss current assessment practices before representing the three scenarios that were outlined as possible recommendations. Each scenario will be discussed, including concerns and possible revenue implications will be outlined.

Study

Processes and Components

The following descriptions are brief and generalized descriptions of the production processes that take place at affected industry facilities. The various components that are commonly used in the processes are identified. These descriptions are not intended to encompass all of the possible diverse production processes that may take place.

Ethanol Production

When whole kernel corn arrives at the production facility as a raw material and it is placed into **grain storage silos** until it is ready to be processed. The first component of the processing is a **hammer mill**, which is used to pulverize the corn into corn flour prior to mixing it with liquids. Mixing corn flour with liquids takes place in a **slurry mixer**. Additionally, enzymes are added to the slurry mixer to help break down the starch in the corn flour. The corn is further mixed with liquids, and enzymes used to break down the starch, in the **cook slurry tanks**. The corn flour and liquids mixture is known as "mash". After that point, steam is added to the mash by a **jet cooker**, exposing more starch for ethanol production by injecting steam. The mash is conveyed into **liquefaction tanks**, which provide time for the enzymes to convert the starch into simple sugars. **Yeast tanks** are used to propagate yeast. Yeast cells are used later in the fermentation system to produce ethanol and carbon dioxide. Ethanol is produced by the fermentation of sugar with the addition of yeast in the **ethanol fermentation tanks**. The enzymes break down the simple sugars into fermentable sugars. The fermenter is filled with mash and yeast, and the sugar is converted into ethanol and carbon dioxides. **Heat exchangers** cool the mash as it ferments, and the heat exchangers use **cooling tower water** to keep the mash at the right temperature. **Distiller tanks** strips ethanol out of the fermented mash, producing 190-proof ethanol. The 190-proof ethanol is put into a **molecular sieve**, which removes the last 5% of water, creating 200-proof anhydrous ethanol. A denaturant is added to this ethanol, making it unfit for consumption, i.e. fuel-grade ethanol. The final ethanol product is then placed into **ethanol storage tanks**, where it waits to be loaded and shipped.

The solids that remain after the ethanol has been stripped from the mash are commonly known as "whole stillage." This material is pumped into a **centrifuge grain recovery system** for further processing. The heavier solids (also known as "whole stillage") are conveyed into a **grain drying system**, while the lighter and thinner liquids (also known as "thin stillage") are pumped into an **evaporation system**. Some thin stillage is also pumped into the **slurry mixer**. The evaporation system is used to concentrate the thin stillage. The final product is corn syrup, which is pumped into a **syrup tank**, and then added to the grain drying system with the heavier liquids ("wet cake") from the centrifuge recovery system. The syrup tank is used as a holding tank to deliver a consistent amount of syrup

into the grain drying system. The grain drying system produces ethanol byproducts and co-products (e.g., carbon dioxide, corn oil, and distiller's dried grains). Distiller's dried grains with soluble (DDGS) are used typically for cattle feed. Both wet and dry distiller grains are placed in **wet/dry distillers grains storage**, where that product waits to be loaded and shipped.

Beer Production

Malting of the grains used to produce beers usually takes place in a location other than a beer brewery, and brewers receive the malted grains directly. In order to create beer, a **grain mill** crush malted barley as the first process in breaking it down into fermentable sugars. The grains are transferred into an insulated mash **lauter-tun**. This device includes a **hydrator**, and the grain inside the lauter-tun is kept hydrated and at a certain temperature. The liquid from the mash at the end of this process is placed into a **brew kettle**. The brew kettle provides even heating, and it is where hops are added. Solids are then separated from the liquids through a **whirlpool or a hop filter**. The liquids that remain are known as "wort" – the liquid sugars that will be fermented into the alcohol. The liquid wort is cooled down after the solids have been separated, via **heat exchangers**. The cooled wort is transferred into a **fermentation tank**, which may or may not be bolted to the floor. The time the wort spends in fermentation will depend upon the type of beer being created (e.g., shorter fermentation for ales and longer fermentation for lagers), and the temperature of the fermentation will also change depending on the type of beer. **Airlocks** within the fermentation tank allow carbon dioxide to leave, while keeping other air or contaminants from entering. Often, **carbon dioxide storage tanks** are used for some of the byproduct. When fermentation is complete, the beer is pumped from the tanks and filtered to remove any remaining solids. It is transferred to a final **beer tank** before bottling or kegging.

Depending on the size of the brewery and the gallons of beer produced, the tanks will vary in size. Typically, fermentation tanks will get taller rather than wider, in order to preserve temperature control functions. It is typical in Minnesota for fermentation tanks to be located in the interior of buildings (also for temperature control purposes) and will sometimes be placed into the building via openings created in the roofs of the breweries.

Wine Production

Compared to beer production, wine production requires fewer components. The fruit used for the wine is placed into **fermentation tanks**. Once wine is fermented, it is transferred into **barrels** for further maturation. In some cases, wine may be stored in **stainless steel storage tanks** instead of barrels, depending on the flavor of the wine being produced. Sometimes, a **basket press** may be used on grape skins after the wine has been drained, to further extract liquid wine from the skins.

Distilled Beverage: Whiskey Production

Distilled beverage producers in Minnesota proved difficult to contact for purposes of this report. For purposes of this study, the department contacted Phillips beverage distillers, but did not receive a response. Additionally, the department attempted to contact the Minnesota Distillers Guild, but that contact described a very small production facility (with only one tank) and no tour was held at a distiller facility.

We do know that whiskey is produced in at least one distillery in Minnesota. The process for making whiskey first involves germinating barley on a **malting floor**. This process requires that the barley be turned over regularly, and be at a constant temperature and moisture level to ensure proper malting of the barley grain. Germination is stopped when the grains are dried in a **kiln**, which also adds smoky flavor to whiskeys. Some distillers purchase barley that has already been germinated elsewhere.

The malt is ground in a **malt mill** in order to make coarse flour. This flour (called "grist") is mixed with water in a **mash tun**. The mash tun allows the sugared liquids to separate from the dry grains as well. As with beer, the sugared liquid is called "wort." Yeast is added to the wort in the **fermentation tank** to create the alcohol. The alcohol is separated from water in a **distiller**. The alcohol may be distilled more than once. In this case, the first distillation occurs in a **wash still**, and a second distillation in a **spirit still**. The final product is aged in **casks**.

Dairy Processing

When milk arrives at a processing facility, it is initially tested for a number of items in a **laboratory** (including temperature, antibiotic presence, proteins, bacteria, etc.). After testing, the milk is pumped into **storage tanks**. Milk is then pasteurized in a continuous flow process, using **heat exchangers**. **Homogenizers** and **chillers** are also regularly used in the processing of milk.

When milk is further processed into cheese, more components are required. Starter cultures are typically added in **vats** or **tanks** to start the cheese-making process. A milk-clotting enzyme is also added (called "rennet"). This product is transferred into **separator tanks**, where the liquid (whey) is separated from the milk solids (curd). Stirring, heating, and draining are all required in this process before the whey is fully drained, and take place in designated **tanks**. Salt is added to the curd before being **pressed**. Curing may happen in a **temperature-controlled room** if aging is necessary. The cheese is moved to a **storage room** before being shipped.

Current Assessment Practices

In Minnesota, all real property is considered taxable, unless exempted by the Minnesota Constitution or state law (M.S. 272.01, subd. 1). Minnesota Statutes, section 272.03, subdivision 1, paragraph (c) outlines the definitions of real and personal property for production businesses.

Because current assessment practices of business production property are based off of Minnesota Statutes and case law, the department's advice has been that if a property performs a containment and shelter function – a function similar to that performed by buildings – it does not fall within the category of tools, implements, machinery, and equipment, and is considered taxable as real property.

Minnesota does not currently tax business personal property (also called "tangible personal property"), as some other states do.[2]

Under the requirement that the commissioner of revenue study the functions and tax status of various components of properties used in the production of biofuels, wine, beer, distilled beverages, or dairy products, and to make recommendations regarding taxation of those components, the department conducted a brief survey of assessors. We asked interested assessors to provide input related to the assessment of production equipment as real or personal property for tax purposes. Fourteen counties provided information; eight counties responded that they have no such industries; one county responded with a brief sentence regarding a dairy processing facility.

Based on the survey responses, some of the common guidelines used to determine taxability included the production elements of the machinery, whether storage is provided, and the shelter test. A common theme was that if the element was necessary for production (i.e., if the final product would not be arrived at without the specific component), then that element would be exempt as equipment. If a component provided storage either before or after the processing, however, that would likely be considered taxable real estate. Most respondents did not consider size of components when considering taxation. Storage tanks and tanks that provide shelter were generally noted to be taxable.

Many responding counties noted that they believed that components used in the production process should be exempt regardless of size or shelter function.

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[2] According to the Tax Foundation & Foundation for Government Accountability calculations from U.S. Census Bureau data, the following 32 states and Washington, D.C. collect some form of business personal property taxes: Arizona, Arkansas, California, Colorado, Florida, Georgia, Idaho, Indiana, Kansas, Louisiana, Maine, Massachusetts, Mississippi, Missouri, Montana, Nebraska, Nevada, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, Wyoming, and the District of Columbia. http://taxfoundation.org/article/states-moving-away-taxes-tangible-personal-property#table2

In general, most of the counties who responded did not think that it was difficult to get information necessary to tax the various components of the related industries.

Results of the survey are included in Appendix B.

Shelter and containment functions are considered in current assessment practices, but usually without regard to the size of the component that is used for storage or containment. Additionally, components that provide shelter functions or protection from the elements are not typically studied for their purpose in the overall production process, and assessors are not often industry experts (although in some cases, industry experts make themselves available to discuss the various components located at the property).

One point of misunderstanding of current statutory guidelines, particularly to industry members, is a document produced by the Minnesota Association of Assessing Officers (MAAO). In previous years, the Department of Revenue worked along with MAAO to develop a valuation guide for grain elevators and other agricultural-related structures[3]. Eventually, the department discontinued its involvement with the manual, but MAAO continued to produce it for its members' use. In a 2009 version of the *Grain Elevator Cost Schedule,* MAAO outlined its opinions on the taxable and exempt status of various components of ethanol production facilities. Erroneously, the Department of Revenue's logo continued to be used in this version of the *Cost Schedule*, even though the department no longer assisted with its development.

Consequently, it appeared to some industry members that the department had approved these recommendations. In fact, the 2009 *Grain Elevator Cost Schedule* was neither reviewed nor approved by the Department of Revenue, and does not reflect the department's policy or guidance. The guide noted that some production property should be exempt, which the department understood to be taxable under current law. The department did attempt to clarify this to members of the industries.

[3] *Grain Elevator Cost Schedule;* Minnesota Association of Assessing Officers, 2009 revision.

Recommended Guidelines

The following scenarios were developed by the Department of Revenue and discussed with affected industries and members of the assessment community.

Any changes in statute related to the assessment of production facility components should be effective for assessment year 2015 (taxes payable 2016) at the earliest, so that assessors are able to make the changes necessary, local governments are able to plan for changes in their tax bases, and taxpayers have time to prepare – if needed – for changes in their own taxes.

Appendix D contains pictures of components of the affected industries, as well as a notation of the outcome in terms of taxability or exemption for each scenario.

Scenario 1 (Recommended) – Legislative Change Required

Revise the statutes to clarify when a component used in the biofuels, alcoholic beverage, and dairy industries is subject to property taxes, or exempt.

More specifically:

- Define all components primarily used as processing equipment in the production process of biofuels, wine, beer, distilled beverages and dairy products as personal property equipment, and thus exempt from property taxes. Much of this property is replaceable and necessary to the production process, key characteristics of business personal property.
- Define all components primarily used for storage or shelter of raw or finished materials, or a product before or after production, as real property and thus taxable. Much of this property is primarily used to store or shelter materials used in the trade or business, a key characteristic of real property.

The department recommends this scenario. While none of the scenarios presented in this report are perfect, we concluded that Scenario 1 will provide a clearer distinction – for assessors and business property owners in these industries – between taxable real property and tax-exempt personal property. This recommendation is limited to the industries that were studied including the biofuel, beer, wine, distilled beverage and dairy products industries.

We believe this option will better match property assessments in these industries to the tax code. By contrast, the other options either provide no such distinction, or rely on a subjective judgment making it more difficult to achieve fair and consistent property assessments.

External tanks or bins used only to temporarily hold materials or a finished product would likely be taxable if the item leaving storage is the same item that went in. How long the storage lasts would be irrelevant. For example, at a dairy facility where milk is stored in tanks for a short time, those tanks would be considered taxable real property because the same item (milk) goes into the tank as comes out of the tank.

This definition is similar to the guidelines set by *KDAL, Inc. v. County of St. Louis*, 1976, and *Skoglund Communications, Inc. v. County of St. Louis*, 1978.

Special purpose, manufacturing, or processing machinery which can only be used in a particular business or industry would be considered exempt personal property equipment. However, components that are normally used by other businesses or property owners would still be considered taxable real property.

For example, special furnaces used to temper metals and installed in part of a building are considered production equipment (and therefore exempt from property taxes). But heating or refrigerating equipment used to heat or cool a building is part of the real estate (and therefore taxable).

Note: It is important to clarify that this definition would only include production process equipment. Other business property (non-production) would still be taxable, as would facilities that are not production facilities. For example, adopting this scenario would not affect the tax treatment of grain silos.

Concerns

Using a "functionality test" like this for property taxation may cause issues for assessors when they must define property for industries in which they have little knowledge or expertise. Assessors have not historically been asked to identify all the production components when evaluating properties in the biofuels, alcoholic beverage, and dairy industries. They could risk making incorrect decisions or assumptions based on limited available data or information, which makes valuation decisions difficult.

Some assessors also had concerns about treating similar types of property differently based on use. For example, tanks that look similar would not be taxed the same due only to the process taking place inside them – such as storage of dairy products versus fermenting of ethanol or beer.

Finally, some items could be treated one way for sales tax purposes, but another way for property tax purposes. For example, a bin or tank may be considered production equipment when purchased (and thus exempt from sales tax), but treated as storage/real property, once installed (and thus subject to property tax). While this could confuse some industry members, Minnesota laws do not use the same specific guidelines for both sales and property taxes, which is not part of the department's recommendation.

Sales tax laws are unique and different from property tax laws because each serves a different purpose, and each is applied and collected differently. Whether or not this recommendation is adopted, there will continue to be some dissonance between sales and property taxes because they have different tax bases and rules.

Revenue Impact

By expanding the definition of (exempt) personal property, this proposal reduces the amount of taxable property in Minnesota. (That is, some property that is currently subject to property taxes would become exempt.)

Based on the limited data assessors were able to provide for this study, the department estimates that this scenario would reduce the property tax base in the biofuels, alcoholic beverage, and dairy industries by $30.1 million.[4]

This shifts an estimated $780,000 in taxes away from properties in these industries and onto other properties in the counties, cities, and towns where they reside. (When the tax base is reduced in this way, all taxable properties in a jurisdiction must pay more in property tax to make up the difference.)

These numbers represent statewide totals, but the affect will be greater in some jurisdictions, while others will not be affected at all. Some jurisdictions could lose a significant portion of their tax base under this scenario.

To mitigate these impacts, we recommend the state provide transition aid to municipalities that experience significant loss of tax base from this change. Our recommendation is that this aid be gradually reduced in later years, as Minnesota has done for similar changes in the past.[5]

Note: These estimates are based on limiting the change to the industries identified in the report. If the scope of this change is broadened, it will increase the impact beyond what we can now estimate.

[4] This estimate includes properties enrolled in the Job Opportunity Building Zone (JOBZ) tax exclusion program. There is an additional $24.2 million of value of JOBZ property in the affected industries that is currently nontaxable because of enrollment in the JOBZ program. Most of the exemptions from the JOBZ program are scheduled to expire in 2015, with some expiring in 2018. Under Scenario 1, the amount of value that becomes taxable when the JOBZ exclusion is phased out will be reduced by the $24.2 million.

[5] For example, in response to a 2007 Rule change, utility value transition aid was created to temporarily compensate jurisdictions that lost a large share of their tax base by providing aid equal to the lost tax base multiplied by the municipality's tax rate. As utility values have recovered, the aid has decreased. See Minnesota Statutes, section 477A.16.

Scenario 2 – Legislative Change Required

Revise the statutes so that the definition of taxable real property includes everything attached to or installed in the real property.
More specifically, taxable real property would include any machinery or equipment that:

- cannot be easily removed, or removed without damage, from a property;
- is integrated into a property[6]; and
- is a permanent addition to a property, not intended to be moved elsewhere[7]

Under this scenario, the following would be considered personal property, and thus exempt from property tax:

- Equipment that is not bolted down, affixed, or attached with piping
- Machinery that could be removed without damage to itself or the building
- Machinery that could be removed without preventing the use of other installed machines

This approach would essentially treat business production property the same as non-production property (such as homes) in that all pipes, vents, etc., would be taxable as part of the real estate. This would be similar to the guidelines created under *Abex Corp. v. Commissioner of Taxation*, 1973 (207 N.W.2d 37).

The following guidelines would be used to identify machinery or other items that are personal property, and thus exempt from property taxes:

- Machinery is exempt personal property if it is:
    - readily moveable;
    - able to be sold independently;
    - not intended to be a permanent fixture to the property; and
    - can be removed from a plant without damaging the item or the structure, or without having to modify the structure
- Inventory, furniture, furnishings, automobiles or other vehicles, tools, parts or spare parts are exempt personal property.

Assessors would have to use multiple criteria to determine whether a component is considered real or personal property. Whether equipment provides shelter (the

[6] This would also include normally taxable real property such as escalators, elevators, heating and air conditioning, sprinkler systems, plumbing, electrical installations, etc.
[7] In years past, Minnesota treated machinery as taxable personal property equipment (but at a separate tax rate from that of taxable real property). Bulletins issued by the Department of Revenue in the 1960s reflect this type of scenario

"shelter test" in current law) would not determine what is taxable or exempt. Equipment would be considered real property if it is attached to or installed in real property, or if it is difficult to move from a property.

For example, a fermentation tank at a large-scale ethanol facility would be considered (taxable) real property if it is integrated into the building (i.e., it makes up part of the building's walls), is not intended to be removed from the property, and is not (by common definition) "readily moveable."

This approach would not require assessors to make distinctions based on size or function of components, but it would require them to identify components they may not be currently identifying and taxing. As a result, it may require assessors to tax some components that are currently exempted.

Concerns

This scenario would require assessors to make subjective decisions about what is attached to or installed in real property versus what is readily moveable and therefore personal property. In specialized production industries – like biofuels, alcoholic beverages, and dairy products – the criteria used to determine whether something is real or personal property may not be immediately uniform throughout the state.

At present, there are even differences between members of these industries. Some industries consider a component "readily moveable" if it can be moved with a crane or without incurring expenses that are considered excessive for their industry (such as replacing a roof for $100,000 to move a component into or out of a building).

Some assessors noted it could be difficult for them to determine the contributory value of all components that would be considered real property under this scenario. This is particularly true for items they do not currently identify and value.

Industry representatives noted concerns about the property tax treatment of components that are intended to be moved regularly due to wear and tear or changes in technologies. Some of these components may be quite large and integrated into a building, but the industries would argue that these components are not intended to be "permanent" and should be considered personal property. However, assessors may be inclined – in some of those cases – to consider the components real property based on their size, use, method of attachment, etc.

Industry representatives also noted concerns that otherwise similar industries and competitors could be taxed differently under this scenario based on the size of their operations. For example, a small-scale brewer with small fermentation tanks may have those tanks exempted, while a large-scale brewer would have fermentation tanks taxed. The difference in size of the brewers' tanks for these competing industries may not be taxed similarly under this option.

Revenue Impact
By expanding the definition of (taxable) real property, this proposal increases the amount of taxable property in Minnesota. (That is, some property that is currently exempt from property taxes would become taxable.)

Based on the limited data assessors were able to provide for this study, the department estimates that this scenario would increase the property tax base in the biofuels, alcoholic beverage, and dairy industries by $3.6 million.

This shifts an estimated $100,000 of taxes onto properties in these industries and away from other properties in the taxing jurisdictions where they reside. (When the tax base is increased this way, other taxable properties in a jurisdiction pay less in property tax.)

Scenario 3 – No Legislative Change Required

Do not change the statutes, and continue to enforce current law based on existing statutes and court interpretations (status quo). More specifically:

- Equipment that has a shelter function will remain subject to property taxes.
- The "shelter test" language can be modified so it is easier to apply uniformly statewide. For example, the department could stipulate that components must be located outside any other structure to provide a structure function (and be taxable).
- Otherwise, enforce current language and legal decisions while increasing the Department of Revenue's educational and informational efforts.

This requires no legislative change; however, the department will continue its enforcement actions and the moratorium on changes to assessment practices will no longer apply.

One tax policy implication that supports taxation of certain production equipment as real property is that local support services such as fire protection for these industries are financed through the local property tax system.

Concerns
Industry representative and assessors have voiced concerns that it may be difficult to understand and administer current property tax laws and legal interpretations for these properties. Under this scenario, the department would increase its educational efforts and compliance monitoring to help assessors and ensure that all taxpayers pay their fair share of property taxes.

Due to the difficulty in administering current language, different counties may assess these properties in different ways under current law. This undercuts consistency, which is crucial to a fair property tax system.

In cases where it is known that there is a violation of statutory or judicial law, the department makes every effort to bring assessments into compliance. This means that there may be some industry components that should be taxed – but are not – and there may be tax shifting implications as corrections are made to those properties that had not previously been paying the tax.

Members of the ethanol industry in particular have concerns that current statutes and most legal precedents (case law) were established before the first ethanol facilities began operating in Minnesota – and therefore do not take into consideration the business practices of their industry.

Members of the ethanol facility added that, if current practices are maintained under this scenario, they will do whatever it takes for their production equipment to be defined as (exempt) personal property. For example, they could erect a building to enclose their large fermentation tanks so the "shelter test" would no longer apply and the tanks would no longer be (taxable) real property. As a result, this scenario could still have tax implications if the affected industries change their properties to exempt more components from tax.

Revenue Impact

This scenario would not change the definition of taxable real property or exempt personal property/equipment, nor would it substantially change the property tax base or shift taxes between different types of properties. Therefore there would be no loss of tax base or shifting of taxes between properties for purposes of estimating a revenue impact.

When estimating revenue impact, the department must assume compliance with current laws and directives. While parts of some individual properties may become taxable (or exempt) if assessment errors are corrected, there would be no loss of tax base or shifting of taxes among properties for purposes of this estimate.

Other Considerations

Size

The Department of Revenue decided against making any recommendations based on the size of a production facility or its equipment. While it is certainly possible to create property tax distinctions based on size, the department feels this would drive business decisions to create equipment just under the size threshold in order to avoid taxes.

For example, making all storage tanks below 50,000 gallons exempt from property taxes would simply encourage businesses to use tanks that store 49,999 gallons or less, so as to not be taxed. The department does not feel that type of business outcome should be driven by property tax laws.

Production Tax
Some study participants briefly discussed the possibility of a production tax for facilities in the affected industries. Taconite operations and wind energy conversion systems in Minnesota currently pay such a tax instead ("in lieu") of property taxes.

The department did not consider a production tax for purposes of this report, which focuses on assessment practices. A production tax is outside the scope of this study, and the assessment community does not have the necessary expertise to consider such a tax in detail.

If the Legislature desires further study of a production tax, the department recommends a separate review and report that also considers how these facilities would be affected.

Revenue Impacts for Any Change
The Department of Revenue will have a difficult time determining the tax base implications and revenue impact of any changes to the definition of either real or personal property. Imperfect data and unknowns make it very challenging to estimate the actual tax shift of this type of change.

Other Industries
While the recommendations in this report are limited to the ethanol, beer, wine, whiskey, and dairy industries, the department has concerns about how any law change based on this study and report could affect other industries. For example, such a change could also impact cereal and soft drink producers, among others, though it is impossible to say for certain at this time. Because of this unknown, it must be stressed that it would be very difficult to estimate the revenue impact of any change in statute.

Appendix

A: Meetings & Study Participants

Study Participants

When considering a study on business production property, members of the ethanol industry notified similar industries and asked for their involvement as well. The ethanol industry associates provided names and contact information for individuals who could represent the beer, wine, distilled beverage, and dairy industries. The department utilized this list when identifying participants. Additionally, the department involved Minnesota Senate and House of Representatives and their staff, staff from the Governor's office, and members of the assessment community.

Study participants included:

- Senator Rod Skoe, District 02, Chair of the Senate Tax Committee
- Senator Ann Rest, District 45, Chair of the Senate Tax Reform Committee
- Senator Scott Newman, District 18
- Representative Jim Davnie, District 63A, Chair of the House Property Tax Committee
- Representative Dean Urdahl, District 18A
- Myron Frans, Commissioner of Revenue
- Susan VonMosch, Assistant Commission for Tax Policy, Department of Revenue
- Paul Cumings, Legislative Liaison, Department of Revenue
- John Hagen, Director, Property Tax Division of the Department of Revenue
- Jon Klockziem, Assistant Director, Property Tax Division of the Department of Revenue
- Eric Willette, Director, Property Tax Research Division of the Department of Revenue
- Lloyd McCormick, Appraisal Supervisor, Property Tax Division of the Department of Revenue
- Andrea Fish, Appraisal Supervisor, Property Tax Division of the Department of Revenue
- Tom Reineke, Property Tax Compliance Officer, Property Tax Division of the Department of Revenue
- Harriet Sims, Attorney, Legal Services Division of the Department of Revenue
- Kyle Gustafson, Attorney, Legal Services Division of the Department of Revenue

- Lance Staricha, Attorney, Legal Services Division of the Department of Revenue
- Lonn Moe, Research Division of the Department of Revenue
- Tessa Rohl, Research Division of the Department of Revenue
- Drew Imes, State Program Administrator, Property Tax Division of the Department of Revenue
- Katy Sen, Office of Governor Mark Dayton
- Steve Hinze, Minnesota House of Representatives Research
- Andrew Biggerstaff, Minnesota House of Representatives Research
- Donovan Hurd, Minnesota Senate Taxes Committee
- Steve Peterson, Minnesota Senate Taxes Committee
- Eric Silvia, Minnesota Senate Counsel & Research
- Jack Paulson, Minnesota Senate Counsel & Research
- Ron Harnack, Minnesota Bio-fuels Association (MBA)
- Tim Rudnicki, Minnesota Bio-fuels Association
- Ray Bohn, Minnesota Bio-fuels Association
- Randall Doyal, Al-Corn Clean Fuel
- Dan Larson, Minnesota Brewers Association
- Sarah Strong-Belisle, Cook Girard Associates (FBO Surly Brewing, brewing industry)
- Daniel Schwarz, Minnesota Brewers Association (FBO Lift Bridge Brewing Company)
- Mike Jerich, Minnesota Ethanol Producers Association
- Valerie Jerich, Minnesota Ethanol Producers Association
- Stephen Baker, Ramsey County Assessor FBO Minnesota Association of Assessing Officers (MAAO)
- William Effertz, Steele County Assessor FBO Minnesota Association of Assessing Officers
- Michael Stalberger, Blue Earth County Assessor FBO Minnesota Association of Assessing Officers
- Mark Vagts, Waseca County Assessor
- Jon Maloney, Cannon River Winery
- First District Association (independent dairy cooperative)
- Ward Einess, Ward Einess Strategies (FBO Summit Brewery)
- Patrick Murray, Cooperative Network, representing the dairy industry
- David Ward, Cooperative Network, representing the dairy industry

- Ben Brown, Heartland Corn Products
- Chris Freeman, Bongaard's Creamery
- Dean Reder, Guardian Energy
- Clint Fall, First District Association (dairy)
- Kyle Marti, Schell's Brewery
- Ted Marti, Schell's Brewery
- Mark Stutrud, Summit Brewery

Meetings

The Department of Revenue engaged in ongoing discussions with all participants throughout the duration of the study and the tour. Additional formal meetings were held with the all available participants at the same time to discuss the study parameters and recommendations on July 24, 2013 and October 31, 2013.

At the initial meeting on July 24, the department discussed the history of taxation and exemption of business equipment property with the participants, and outlined the Legislative requirements for the study. This meeting then allowed for an open discussion with participants, along the following topics:

a. What do you think are the current problems and issues related to the assessment of property used in production and business?

b. What preferences do you have for how these properties should be assessed? Based on size? Function? Other criteria?

c. What are the functions of the components in the affected industries (biofuel, breweries, dairy, distilled beverages, and wine)?

d. What are your expectations for the study?

After the tours and discussions, the department outlined the three scenarios for taxation or exemption of business production equipment and invited the study participants to discuss those issues at the October 31, 2013 meeting. The department got participants' thoughts and input related to each of the three scenarios in an open-forum discussion in order to fully flesh out the three scenarios and possible benefits or negative consequences of each.

Tours

Additional tours and discussions were held on the following dates:

- August 9 at Summit Brewing Company in St. Paul, MN
- August 13 at the Heartland Corn ethanol production facility in Winthrop, MN
- September 10 at the First District Association dairy processing facility in Litchfield, MN
- October 21 at Surly Brewing Company in Minneapolis, MN

The tours were set up by Jon Klockziem, Assistant Director of the Property Tax Division at the Department of Revenue.

After each tour, the attendees briefly discussed what they saw at each facility, and how they interpreted current statute to affect the various components of the industry. Tour attendees were able to ask industry professionals questions on the various components used in the process, and how the process would function if separate components were not included in the facility. Tour groups also noted which components were used for storage of a raw material or finished product at each facility. At many tours, photographs were allowed, however there were instances where for trade secret or hygienic reasons photographs were not allowed.

After initially participating in the study, the wine industry declined to participate in the tour process. We reached out to the wine production community throughout the study, and allowed them the opportunity to provide written feedback on the report and its recommendations. We did not receive a response from the wine industry. Additionally, we were unable to contact an individual from the distilled beverages industry for purposes of this study and report, and do not have feedback from the distilled beverage industry.

B: Survey of 2012 Assessment Practices

Along with the survey of current assessment practices, the department's Property Tax Compliance Officer in charge of complex property appraisals gathered data related to the valuation and assessment practices of the affected industries. We were not able to identify the contributory value of all of the taxable components in order to provide that specific data for purposes of this report, and determining the actual tax shift is therefore difficult. The data used to estimate these numbers comes from a survey of County Assessors; using 22 identified ethanol facilities and 16 beer, wine, and dairy production facilities.

Under the requirement that the commissioner of revenue study the functions and tax status of various components of properties used in the production of biofuels, wine, beer, distilled beverages, or dairy products, and to make recommendations regarding taxation of those components, the department conducted a brief survey of assessors. We asked interested assessors to provide input related to the assessment of production equipment as real or personal property for tax purposes.

- Fourteen counties provided information;
- eight counties responded that they have no such industries;
- one county responded with a brief sentence regarding a dairy processing facility.

The responses are compiled below.

Summary

- In general, most of the counties who responded did not think that it was difficult to get information necessary to tax the various components of the related industries. Generally, these counties work directly with the businesses who own the facilities. Information is gathered through site visits, discussing the production processes with the business owners, reviewing blue prints, etc.

- Some of the common guidelines used to determine what should be taxable and what should be exempt included the production elements of the machinery, whether storage is provided, and the shelter test. A common theme was that if the element was necessary for production (i.e., if the final product would not be arrived at without the specific component), then that element would be exempt as equipment. If a component provided storage either before or after the processing, however, that would likely be considered taxable real estate.

- Most respondents did not consider size of components when considering taxation. For those who do consider size, examples include:
    - If the component is less than 5,000 gallons, then it may be exempt

- If you cannot put it on a truck and move it in one piece, it is taxable
- If it has a diameter less than ten feet and height less than 20 feet

- With the exception of Stearns County, all respondents consider shelter and containment functions when considering taxation. Storage tanks and tanks that provide shelter are generally considered taxable.

- Many counties also noted that they believed that components used in the production process should be exempt regardless of size or shelter function. This is a common theme with what was learned regarding the guidelines that are used to determine exemption: if a component is necessary to produce a product, counties are more likely to consider it exempt equipment. Not all counties agree with this, but it is a common theme.

- With the exception of Douglas County, all counties consider function and use of components when considering taxation.

- Additionally, the respondents were fairly split on whether they considered both primary and secondary functions when they reviewed these facilities and were determining exemption eligibility. Counties were also split as to whether they would or would not treat tanks *inside* a building differently than they would treat tanks *outside* of a building.

Responses

1. ***How difficult is it to get information necessary to tax the various components of the related industries?***

   It has not been difficult to get information from our ethanol plant. (Swift)

   It has not been difficult at all. The owners of the business have been very forthright with us on the size, makeup and use of the components. A clarification of the general law is necessary however. Sugar beet plants and ethanol plants are two completely different operations and they use completely different components. (Kandiyohi)

   It is fairly easy. In Renville County the working relationship is very good with the Ethanol employees and any information or access to property or information has been give without any problem. (Renville)

   Dependent on taxpayer to share information on sizes of tanks. (Brown)

   I have never had difficulty getting information. The Ethanol Plant has always been forth coming with information, sharing blueprints, willing to give tours, etc. (Chippewa)

Some cooperate, some do not. Some provide specific information (gallons, sizes) others ignore such requests. (Douglas)

Generally the individual[s] cooperate. (Stearns)

Typically very difficult. (Polk)

Somewhat. (Rock)

We believe the information is available, but we have not attempted to get complete information. (Ramsey)

It would not be difficult if any ambiguity were to be removed so we knew what data we needed to collect provided that the information has not already been gathered. We do not have these facilities in Steele County. (Steele)

We only have small-scale production wineries and an ethanol plant in the county, so we are able to work directly with the property representatives to get information on the various components. Our commercial appraiser has a pretty good relationship with the folks. On our ethanol plant, the on-site folks needed to request formal approval to share tank information from corporate counsel, but it was shared eventually. (Blue Earth)

[Tom] Reineke has made info much more readily available. (Fillmore)

I have never had any problem getting information regarding these facilities. In fact, they have been some of the most cooperative taxpayers I've had the pleasure to work with. (Jackson)

2. What guidelines do you use in deciding what should be taxable and what should be exempt?

We try to distinguish if the item is necessary for the production on the product or is providing storage for either product produced or elements used in production but those elements do not change in composition. (Swift)

We look at whether it is a storage component or an in process component. If removed from the facility would it stop the process or not affect it. (Kandiyohi)

Many – those guidelines are interpretation of statues. Property function, use, necessity for its existence for the process to occur, any process that happens in a structure/tank, how long storage takes place, and many other things are considered when making that determination. (Renville)

We value the exterior tanks because they serve to function as a shelter from the elements. (Brown)

Is it part of the process or not. If the process cannot continue with that structure in the line, I would say it would be part of the process and it should be exempt. If you can remove the tank or it can have another use and ethanol can still be created, by all means; Tax it! (Chippewa)

If used for storage of a product, prior to processing, would be more inclined to consider taxable. If part of the processing of a product, exempt as equipment. (Douglas)

Reviewing the property and discuss with the owner the purpose of the component. (Stearns)

Shelter function, size, use. (Polk)

Statute/Tax Court. (Rock)

Permanence, whether inside or outside. In the past we have generally looked as tanks on the outside more as structures and those on the inside more as equipment. (Ramsey)

Functional use, does it serve a purpose to the operation, could it be removed from the site without causing damage to the improvements or to the present use. Any tanks that we know about are taxable except or some LP tanks. (Steele)

We follow statute (MS 272.01, 272.02 and 272.03) in conjunction with the court's relevant decisions in making that determination. (Blue Earth)

Started using "shelter". (Fillmore)

It has changed over the years due to the various court cases. In the "old days" it was based on the concept I was taught by DOR in course A. If it was used for storage it was taxable. If it was used as part of a process it was exempt as machinery. Back then we were told that if the product leaving the container was different than the product that went in to the container then it was part of a process. If the same material left the container that went in to the container then it was storage. Using the ethanol plant as an example, for the tanks used to simply hold water, the material going in to the tank is water and the material coming out is water so the tank would have been taxable under the old directions. Conversely, for the fermentation tanks the products going in include ground corn, water, etc. but the product leaving the tanks is corn mash, anhydrous alcohol, etc. so a process occurred in the tank and it would have been exempt machinery. The rules have changed. Currently I rely

on the most recent court decisions handed down in the sugar beet processing cases. Under the old DOR directions farm silos were a problem the DOR never wanted to discuss. What went in wasn't the same as what came out but the DOR, contrary to the directions used for industries, contended the silos were taxable. (Jackson)

3. Do you use criteria based on the size of the components when considering taxation? If yes, what is that size determination?

No. Size [is] not [a] consideration. (Swift)

We do not. The size is determined by the need. (Kandiyohi)

Not really, however when the component becomes so small so that there is no contributory value, the component is noted with no contributory value is attached to it. (Renville)

No, but would suggest a threshold of 22,000-25,000 gallons. (Brown)

No (Chippewa)

No (Douglas)

Yes and no, if the component is small <5000 gals or if larger the use of that component. (Stearns)

Basically if you cannot put it on a truck and move it out in one piece, it is taxable. (Polk)

No (Rock)

No (Ramsey)

Diameters less than 10 feet and heights less than 20 feet most likely would not be assessed. (Steele)

Yes, to some extent this comes into consideration as the benchmark. When reviewing a property and its components, if the size is substantial enough that it is clearly not personal property, that then leads us to needing to apply 272.03 to determine if it is taxable. (Blue Earth)

Capacity. (Fillmore)

No, size is not a factor with the exception of tanks that are so small that they lose the character of real estate and are instead personal property. An example would be a portable 1,000 gallon tank used to store diesel fuel. (Jackson)

4. Do you consider <u>shelter and containment</u> when considering taxation? If yes, why?

Yes. Shelter and containment as considered as use. (Swift)

We do when it comes to buildings and storage components. When it comes to tanks, some of our exempted tanks are inside a building and the building is taxable. The tanks that are outside are pass through processing tanks. The product does not stay in them for a very long period of time, but product is processing all the time. Storage tanks outside and inside are taxable. (Kandiyohi)

Yes – it is a component that assists in determining taxation. I feel there are many other components that assist and define what components are taxable or non-taxable. (Renville)

Yes, we tax the tanks that serve the shelter function (exterior) and those that serve a storage function. (Brown)

Yes, assuming that you are talking about storage tanks. If tanks are storing a product, they are taxable. There are a few tanks that are housed partially inside and partially outside. They are sheltering and containing the product during the process. I see these tanks as being exempt, because there would be no ethanol if these tanks would be removed from the process. You are not storing a product here! The product is only here for like 72 hours I believe. MN Statute 272.03. Subd. 1 "Real property does not include tools, implements, machinery, and equipment attached to or installed in real property for use in the business or production activity conducted thereon, regardless of size, weight or method of attachment." (Chippewa)

Yes MS 272.03 Subd I (i) (Douglas)

No. (Stearns)

Yes, shelter/storage function indicates the possibility of taxable. (Polk)

Yes: Statute/Tax Court (Rock)

Yes. We consider the shelter function test in determining what's real or personal. Containment has not been something we have strongly considered but will in the future. (Ramsey)

If the component is used to prevent infiltration of fertilizers into the environment it would be exempt. These containment improvements are a public externality that is required as a form of pollution control. Shelters

for whatever purpose would be taxable irrespective of function or purpose. (Steele)

Yes, the courts have issued opinions saying these criteria make machinery/equipment property taxable as real property and the interplay of the statutes with exceptions and exclusions from exceptions support this determination. (Blue Earth)

Yes, Reineke's info he has provided and tax court results (Fillmore)

Yes. [Minnesota] Supreme Court decision. (Jackson)

5. Do you believe that components used in a <u>production</u> process are taxable or exempt regardless of size or shelter function? If yes, why?

Exempt when used in production process as defined in MN Statutes 272.03 Subd 1(c)(i). (Swift)

I believe that they are exempt when they are in the production process. I believe they are personal property regardless of size. (Kandiyohi)

Yes, but not always. There are things about the component that must be considered when determining taxability. It does not define taxable or non-taxable solely because it may be part of a production process. (Renville)

Exempt if necessary as part of the process, then we consider them to be personal property. (Brown)

No (Chippewa)

Yes. My definition of equipment is: that which is necessary to produce a product, without which it could not be produced, and serves no other purpose. (Douglas)

It has always been our understanding that if the component is used in production that they were not taxable. (Stearns)

It Depends. (Polk)

Varies: Tax Court (Rock)

Previously yes. Because production denotes a business process which is regarded as equipment. (Ramsey)

The business function/process should not be the critical aspect but rather the size and function of the component in relation to the real estate and how likely the component would be removed at the point of sale to maximize or minimize the market value of the property. (Steele)

I don't think you can make a blanket determination that production process equates to taxable or exempt. Size and shelter (and containment) come into play. Statute does mention production activity as a determinant of personal property (and therefore exemption) but it provides exceptions which makes some of those components taxable. (Blue Earth)

Yes if meets "shelter". (Fillmore)

Regardless of my personal beliefs I have to abide by the [Minnesota] Supreme Court decisions until/unless statutes are passed that invalidate the [Minnesota] Supreme Court decisions. (Jackson)

6. *Do you consider function and use of the components when considering taxation?*

Yes (Swift)

Yes (Kandiyohi)

Yes those factors are considered, but a determination cannot be made solely by the function and use. (Renville)

Yes. (Brown)

Yes (Chippewa)

No (Douglas)

Yes (Stearns)

Yes (Polk)

Yes (Rock)

Yes (Ramsey)

Does the component function in a useful/efficient way the buyers are willing to pay for? Does the market recognize the function of the component and with special use properties the component is critical to the function of the value in use. (Steele)

Yes (Blue Earth)

Yes (Fillmore)

Yes. Again, based on [Minnesota] Supreme Court decisions. (Jackson)

7. *Do you identify primary vs. secondary functions? (E.g., primary function of storage, secondary function as equipment; primary function as equipment, function as storage is secondary.)*

   No (Swift)

   No I look at primary function. (Kandiyohi)

   Yes primary functions are considered, but that doesn't determine taxability alone. (Renville)

   No, we would assign one use to the tanks, whatever the primary use is. (Brown)

   No, I guess not. When I view a property I look at what the function is at that time. I don't believe I am going to start second guessing the ethanol industry or any industry what a secondary function may or may not be. Sort of like taxing the imaginary. (Chippewa)

   No (Douglas)

   ? (Stearns)

   Yes (Polk)

   Yes (Rock)

   Yes. If we consider the primary function as storage we view it as taxable. (Ramsey)

   No (Steele)

   No. But I'm kind of unclear of what this question is asking. It seems to me function is not really a determination made by proportion like use of a property. Function can change (can be storage one day and the following day when the process starts it becomes equipment), so I suppose you could look for the predominant (most frequent) function. (Blue Earth)

   Storage as primary. (Fillmore)

   No. Using the ethanol plant again as an example, if it is a fermentation tank then my appraisal lists it as a fermentation tank. (Jackson)

8. *Would you treat tanks <u>inside</u> a building differently than you would treat tanks <u>outside</u> of a building?*

   No (Swift)

   No. If they have the same use they would be treated the same. (Kandiyohi)

   Most likely yes – there would be no "Shelter" function on a component if it were located inside. If a component is for "storage" & "containment" it would be unlikely $$ would be spent to build something over it. (Renville)

   Yes. We have found tanks inside generally are used as part of the process, while exterior tanks are generally used as storage. (Brown)

   No, if they are storage tanks, I would be taxing them. If they are part of the process, I would be exempting them. (Chippewa)

   Generally I would say a tank outside a building is providing a storage function & a tank inside a building is performing a processing function (a tank ins ide is not performing a shelter function). (Douglas)

   Not after reading the resent tax court decisions. (Stearns)

   Yes (Polk)

   No (Rock)

   We first began to assess some inside tanks in 2012. (Ramsey)

   If the tanks are contained within the taxable structure they would be exempt. The structure is constructed to contain the equipment and machinery of production, would be double taxation to value the tanks in addition to the structure that houses the tanks. (Steele)

   We would use the same standards in making the taxable/exempt determination, however a tank's location would result in a different thought process and probably relying more heavily on different portions of standards, so in that sense you could say they are treated differently. For example, an inside tank would be reviewed for what shelter and containment function it serves, but we'd also look more to insulation, temperature control etc from an interior perspective. Conversely, an outside tank would be reviewed for shelter/containment, but also protection from elements, etc. (Blue Earth)

   We had in the past but now if they fit "shelter" they will be taxable (actually waiting until moratorium is off). (Fillmore)

No. Locating a tank inside or outside a building is an engineering or budget decision. Locating a denaturant tank outside the building or inside the building makes no difference, it is still a denaturant tank. However, a tank located outside a building versus a tank with the same function located inside a building may have significantly different costs and/or value due to the construction cost and/or operating cost of the tank. (Jackson)

Other:

Counties that responded only that they do not have any such facilities: Morrison, Beltrami, Kittson, Rice, Lake of the Woods, Grant, Pipestone, Watonwan

"The only facility that we have that you may be interested in is Plainview Milk Products in the City of Plainview. They purchase milk and process it into dry dairy products. We have not been assessing any tanks that they have.
Loren Benz, Wabasha County Assessor"

C: Statements from Industry Representatives

Jan. 24, 2014

Commissioner Myron Frans
Minnesota Department of Revenue
600 Roberts St. N. / St. Paul, MN 55146

Dear Commissioner Frans:

Thank you for the opportunity to participate in the process and discussion leading to the Report and Study on Business Production Property. We appreciate the chance to comment on the report, and the effort of the department to reach out to the emerging craft brewing industry in Minnesota. We were pleased to assist the department in setting up tours of two different breweries over the interim, and hope the experience provided insights that rounded out your knowledge of the brewing process.

We support the over-arching principal that is delineated in your message to the Minnesota Legislature, which holds:
Therefore, the department recommends that components primarily used in the production process at production facilities for biofuels, alcoholic beverages, and dairy products be defined as personal property equipment, and thus exempt from property taxes. Components primarily used for storage of a product before or after production would continue to be taxable as real property.

Due to the fact that the development of technology is always moving forward and brewing techniques continue to evolve, we consider it to be positive that the report focuses on the overall production process rather than listing each individual component as exempt.

We support the *Scenerio 1 Recommendation* as the best of the three offered, and believe it addresses most of the concerns of the MNBA. We do however, have two clarifications we would like to make pertaining to the brewing process:

1) Brewing production begins when malted barley is augured from a malt silo to the grain mill for crushing before it can be broken down into fermentable sugars. The description in the draft report does not recognize the process beginning at the malt silo. We would argue the malt silo should be considered the first step in the brewing process.

2) The brewing process concludes with the carbonation process. This process takes place in carbon dioxide or "bright" tanks, and is an integral part of the brewing process.

To summarize, MNBA contends the brewing process begins with malted grains from malt silos and concludes with the carbonation process in carbon dioxide tanks, making those components part of the production process and therefore exempt from property taxes under the department's Scenerio 1 Recommendation in the report.

Thanks again for allowing us to participate in the process. We look forward to continuing to work together on this issue.

Sincerely,

Ryan Petz, President
MN Brewers Assn.
414 Sixth Ave. N.
Minneapolis, MN 55401

Commissioner Frans:

Thank you for the opportunity to provide comments on the DOR *Report and Study on Business Production Property*. Furthermore, we would like to commend DOR for its inclusionary and transparent approach to undertaking the study. John Hagen and Jon Klockziem did an admirable job of reaching out to the impacted industries and facilitating a productive and informed discussion.

We generally support the report's recommendation that reads in relevant part:

> *Define all components primarily used as processing equipment in the production process of biofuels, wine, beer, distilled beverages and dairy products as personal property, and thus exempt from property taxes.*

We concur with the report that this recommendation adheres most closely to the current tax law and practice within the brewing industry. Furthermore, the recommendation, if carefully drafted, should provide greater assessment clarity and uniformity.

However, we do have a number of concerns, comments and clarifications that warrant serious consideration.

- **Aging Tanks:** Fermentation for the brewing industry is a process that determines the flavor profile of the beer. Fermentation and ***aging*** occurs in similarly constructed tanks. However, aging should not be equated with storage. The time of aging determines the specific flavor characteristic of beer and is an essential part of the brewing process. Consequently, aging tanks should be considered personal property.

- **Brite Beer Tanks:** These tanks are unquestionably an important component of the brewing process. Most brewers carbonate their beer in brite beer tanks and these tanks also serve an important quality control function of verifying the necessary specifications of a food product prior to it being packaged. Further, it is not possible to package beer in bottles, cans or kegs without a brite beer tank. Consequently, brite beer tanks should be classified as personal property.

- **Carbon Dioxide Tanks:** These tanks should be classified as personal property. Brewers purchase carbon dioxide to purge oxygen out of the "process vessels" (this step is essential to ensure shelf life and flavor stability of beer) and to operate packaging equipment. Carbon dioxide tanks are an essential part of the brewing process and should be classified as personal property.

Finally, we believe it is worth noting that food manufacturing facilities (dairies, breweries and wineries) are subject to much higher licensing standards and fees than the biofuels industry and it is inherently problematic to compare the manufacturing processes of food manufacturers with those of the biofuels industry. They simply are not comparable.

We look forward to continuing to work with you and the DOR team to make sure the legislation achieves the intended result.

Mark Stutrud
Founder and President
Summit Brewing Company

Ted Marti
President
August Schell Brewing

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January 24, 2014
Minnesota Department of Revenue
Commissioner Myron Frans
600 North Robert Street
Mail Station 3340
St. Paul, MN 55146

Dear Commissioner Frans -

On behalf of Cooperative Network, we would like to thank you and your staff at the Department of Revenue (DOR) for the extensive work that went into preparing the *Report and Study on Business Production Property* (Report). We also appreciate the continued dialogue we have had with you, and the opportunity to coordinate a visit to First District Association's Litchfield facility that included the DOR, local legislators, legislative staff and various industry stakeholders, in an effort to learn about dairy processing. Of course, we are also grateful to First District Association's welcome and assistance.

For background purposes, Cooperative Network is the largest association of its kind in the country and serves more than 600 member-cooperatives in Minnesota and Wisconsin. We are owned by more than 3.4 million Minnesota residents and provide government relations, education and marketing services for a wide variety of sectors - including dairy cooperatives.

Dairy cooperatives play an important role in Minnesota's economy and local communities. Over 80% of the milk produced in Minnesota is marketed through a cooperative and a majority of the cheese made in Minnesota is processed by a cooperative. Cooperatives add value to the 9 billion pounds of milk produced by Minnesota's dairy farmers. Minnesota's dairy industry generates approximately $9 billion a year for the state's economy and accounts for 39,000 jobs in the agricultural sector.

Of the three recommended guidelines developed in the Report, Cooperative Network's preference is "Scenario 1" that states, *"Revise the statutes to clarify when a component used in the biofuels, alcoholic beverage, and dairy industries is subject to property taxes, or exempt."* Adoption of this scenario could provide consistency in how dairy processors are assessed for property tax purposes. As the Report cites, this scenario could potentially provide a clearer distinction for assessors and business property owners throughout the state.

As was also requested, Cooperative Network would like to verify that dairy processing was accurately described on page 16 of the report. However, we would like to suggest the two following clarifications:

1) The word *"dairy"* should be changed to *"milk"* on the first line of the "Dairy Processing" paragraph. This change would provide clarity that milk is delivered to a processing plant instead of the more general term "dairy".
2) In the last line of the first "Dairy Processing" paragraph, the word *"production"* should be changed to *"processing"*. Production of milk refers to the actual extraction of milk from a cow by a dairy farmer, whereas processing refers to the milk when it is utilized as an ingredient at a dairy processing facility.[8]

In addition, we would suggest two additional changes to provide further clarity:

1) In the second paragraph on page 3, we suggest changing "dairy producers" to "dairy processors." Dairy production refers to producing milk on the farm while dairy processing is what happens when that milk is made into another product.
2) In the middle (line 22) of page 4, we suggest changing "dairy production" to "dairy processing". Again, dairy production refers to producing milk on the farm while dairy processing is what happens when that milk is made into another product.[9]

In conclusion, Cooperative Network looks forward to collaborating with you and your staff as any forthcoming legislation is developed during the 2014 session. Lastly, we would like to thank you, your staff and project manager Jon Klockziem for all of your work, for the opportunity to participate in this process and to comment on the report. If you have any questions or need additional information, please feel free to let us know.

Patrick Murray
Director of Government & Member Relations

David Ward
Director of Government Relations & Dairy

[8] [Department of Revenue note: We made these changes in the text of the report based on their suggestions.]
[9] [Department of Revenue note: We made these changes in the text of the report based on their suggestions.]

MINNESOTA BIO-FUELS ASSOCIATION, INC.

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Minneapolis, MN 55416
MnBiofuels.org / 612.924.6495

January 24, 2014

Jon Klockziem
Assistant Director-Assessment and Classification
Property Tax Division
Minnesota Department of Revenue
600 North Robert St.
St. Paul, MN 55101

Dear Mr. Klockziem:

We have reviewed the "Report and Study on Business and Production Property" 2014 (the "Report"). On behalf of the Minnesota Bio-Fuels Association and its biofuel producers, we commend you and the Department of Revenue for involving the stakeholders and conducting a thoughtful examination of the biofuel production process as well as the components and systems that are used to create the intended final biofuel product.

The biofuel producers in Minnesota create approximately 1.1 billion gallons of ethanol annually, inject over $5 billion annually in the economy, support 12,600 jobs and provide fuel consumers with homegrown, clean, renewable biofuels. Biofuels, such as ethanol, suppress the price of gasoline by $1 to $1.69 per gallon. Ethanol also saves consumers 15 cents to $1 per gallon at the fuel dispenser while reducing greenhouse gas emissions up to 57% compared to petroleum gasoline. We believe the Scenario 1 Recommendation (Report, page 19) holds the greatest potential to help make Minnesota economically competitive with other states, strengthen the biofuel industry in Minnesota, pave the way for continued growth and offer economic, consumer and environmental benefits for years to come.

Scenario 1 (Recommended) (Report, page 19), which we support, states:

> "Define all components primarily used as processing equipment in the production process of biofuels, wine, beer, distilled beverages and dairy products as personal property equipment, and thus exempt from property taxes. Much of this property is replaceable and necessary to the production process, key characteristics of business personal property."
>
> "Define all components primarily used for storage or shelter of raw or finished materials, or a product before or after production, as real property and thus taxable. Much of this property is

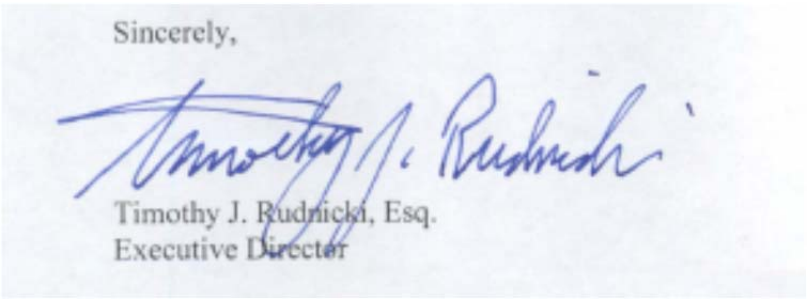
primarily used to store or shelter materials used in the trade or business, a key characteristic of real property."

While the description for the ethanol production process and its components (Report, page 14) is generally accurate, a few elements are worthy of clarification. Although some particular components are stated and described, this roster is not a comprehensive listing of process components. For example, a beer well is a common process component in the biofuels production process, but the beer well is not listed in the roster of components. On the other hand, biofuel producers may find and use other process components that have yet to be invented for use in the future. We, however, believe Recommendation 1 provides the flexibility to address changes and innovations that might be used in future biofuel production processes.

Further, please note, the reference to "com syrup" is not entirely accurate. The "syrup" at issue for biofuel production is not the com syrup that might be used in the production of sodas and other food items. "Syrup" as the term is used in the biofuel industry is Condensed Com Distillers Solubles CCDS). CCDS is a mix of ingredients that is making its way through the biofuel production process. The CCDS, or "syrup," can be added to the Distillers Dried Grains (DDG) and used in the next phase of the biofuel production process. As such, the CCDS is not the final product. This component in the process serves as an expansion tank to accommodate variable flow rates through the biological process used to create DDG and biofuels.

So long as proper statutory language is crafted to embody the elements of Recommendation 1, we believe those elements can be used to effectively distinguish between process components versus storage components for raw or finished products.

We welcome the opportunity to work with you and the Minnesota Department of Revenue to help craft language for a bill that comports with the findings and recommendations in the Report.



This position statement of MAAO is in response to the Minnesota Department of Revenue's:

"REPORT AND STUDY ON BUSINESS PRODUCTION PROPERTY"
Property Tax Division dated: January 17, 2014.

The report is a study of the functions and property tax status of various components of biofuel, beer, wine, distilled beverages, and dairy products industries. A report submitted to the Minnesota State Legislature pursuant to Minnesota Laws 2013, Chapter 143, Article 4, section 46.

MAAO is appreciative to have been included in the study group. We would like to thank legislators, industry representatives and Commissioner Frans for allowing us this opportunity. We believe that our professional expertise can provide important insights from the property tax administrator's perspective.

MAAO was represented by Michael Stalberger, Chair of Assessor Standards Committee, Blue Earth County Assessor; Stephen Baker, Past President/Strategic Planning Chair, Ramsey County Assessor; and William Effertz, Legislative Committee Chair/Executive Officer, Steele County Assessor.

As study participants, we respectfully disagree with the recommendation of the report and offer these dissenting arguments. The report of the Department of Revenue recommends that the legislature adopt what is titled "Scenario 1," whereas the current law would be changed to define all components primarily used in the production process as personal property equipment (thus exempt) while defining all components primarily used for storage of raw or finished material as real property (thus taxable).

The MAAO participants believe that "Scenario 3" would provide for the greatest level of predictability, equity and fairness to all concerned. This scenario maintains current statue and includes clear administrative direction found in Minnesota case law. This scenario is summarized as "status quo," but we feel that is slightly misleading, in that it increases the Department's role in educational and compliance efforts to help assessors and ensure that all taxpayers pay their fair share of property taxes.

Some of the concerns with "Scenario 3" are that assessment administration is not consistent around the state. This argument is valid but these interpretive inconsistencies were created before the courts rendered clear definition in their recent rulings on the subject. In recent years

assessment practices have, for the most part, come back into alignment. We feel we can best achieve statewide equity through clarification, not through wholesale change. This is best accomplished with training, instruction and collaboration. It is our belief that promulgating a new standard will likely lead to a new set of issues and will then potentially create new inconsistencies rather than eliminate the few remaining inconsistencies.

"Scenario 1" would seem to be a significant departure from existing assessment practice, from existing law, and from case law. It seems that this solution opens the door to complaints of special treatment from other industry groups and makes it likely that those groups will seek similar relief for their property, either in the initial legislation or in future legislative sessions, thus further eroding local tax bases and shifting taxes to other property types. Furthermore, special legislation for a small number of taxpayers leads to tax inequity and creates additional complexities in an already complex tax system.

Another significant concern relates to a rather fundamental change to how assessors assess property this scenario would cause. The recommendation of "Scenario 1" would require assessors to fully understand the specific business processes occurring at these specialized and highly-technical operations. Assessors would no longer assess based on the use, function, and characteristics of the property in question; rather assessors would need to add a new dimension to how that property interacts with a business process. Assessors are not industry-by-industry process experts and do not have the knowledge to competently assess property based on what components do for a process. Rather, assessors are trained in the concepts of real estate and real and personal property and how those interact with current statutes. It causes us concern that this recommendation appears to shift the definition of real property to be one that is industry-specific rather than based on the inherent real estate characteristics of the item/property in question.

We must not lose track of how important it is to our tax system to have a clearly articulated definition of taxable real property, a definition that that is well understood by property owners, tax administrators, legislators, and judges. Therefore revisions to the definition of taxable real property, if undertaken, need to be very necessary, clearly understood, well-reasoned, and must be designed to make our property tax system more fair and transparent.

An impact that is not mentioned, but we believe merits consideration, is the likelihood of a statutory change leading to new litigation, We are in a fairly settled place now and we believe that we have the language that will lead to consistency in assessment administration.

The concerns of MAAO with the recommendation of "Scenario 1" can be summarized:

- The assumed broadening of the property eligible for exemption could lead to significant loss of tax base; it may be substantial for some jurisdictions but it is hard to quantify those impacts with the limited data available to the Department.
- Newly-drafted statute has the potential to result in more confusion and lack of uniformity in administration; if there are any drafting oversights or unclear provisions, there is a high likelihood of inconsistent application statewide which undercuts fairness – as the report states – a crucial component to a fair property tax.

- The report argues that other recommendations require subjective judgment-making while Scenario 1 does not, thus making this recommendation superior; our concern is this recommendation actually removes any assessor judgment and relies solely on taxpayer information-sharing on their processes and what each piece of property does, essentially shifting the assessment to one of self-reporting by the taxpayer.
- Newly drafted law will likely result in new – and costly – litigation as the practical and administrative aspects of the law are applied at the individual county level.

In summary, MAAO feels that assessors statewide view Scenario 3 as a more appropriate solution that, with Department guidance and oversight, will lead to more uniform and consistent application with limited negative consequences such as expansion of exemption, shifting of tax burdens, changes to how real property is defined, and potential for costly litigation. Scenario 3, by improving existing practices, will best position assessors to apply the laws of the state as written and would remove any need to attempt to change them.

D: Production Process Components & Taxability Based on Recommendations

Ethanol Production Facilities

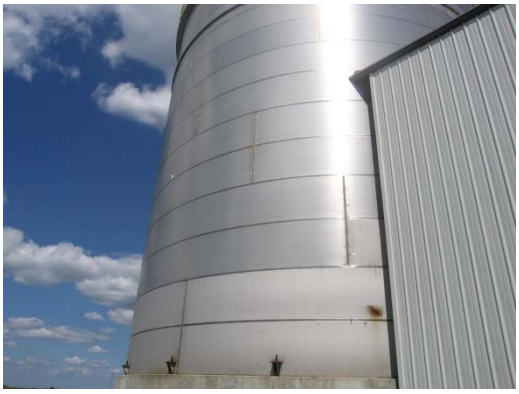
Ethanol Fermentation Tank
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Enzyme Tank & Distillation Tubes
Scenario 1: Exempt (Both)
Scenario 2: Taxable (Both)
Scenario 3: Taxable (Tank) & Exempt (Tubes)

Ethanol Enzyme Tank & Liquefaction Tank
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Corn Storage (In Back)
Scenario 1: Taxable
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Corn Storage and Mill
Scenario 1: Taxable (Storage) and Exempt (Mill)
Scenario 2: Taxable (Both)
Scenario 3: Taxable (Both)



Ethanol Fermentation Tank
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Storage (Final Product)
Scenario 1: Taxable
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Water Recovery System
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Fermentation – Mill – Water Tank
Scenario 1: Exempt – Exempt – Taxable
Scenario 2: Taxable – Taxable – Taxable
Scenario 3: Taxable – Exempt – Taxable

Ethanol Corn Storage and Ammonia Tank
Scenario 1: Taxable (both)
Scenario 2: Taxable (both)
Scenario 3: Taxable (both)

Ethanol Distillation Tanks & Tubes
Scenario 1: Exempt (both)
Scenario 2: Taxable (both)
Scenario 3: Taxable (tanks) & Exempt (tubes)

Ethanol Evaporators
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Ethanol Drum Dryer
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Exempt

Ethanol Storage Building & Corn Storage
Scenario 1: Taxable (both)
Scenario 2: Taxable (both)
Scenario 3: Taxable (both)

Ethanol Final Product Storage Tanks
Scenario 1: Taxable
Scenario 2: Taxable
Scenario 3: Taxable

Denaturant storage and DDGS storage would also be taxable in all scenarios.

Beer and Wine Production

Beer Brewery Fermentation Tanks:
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Beer Brewery Copper Brew Kettles
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Beer Brewery Experimentation Tanks
Scenario 1: Exempt
Scenario 2: Exempt
Scenario 3: Exempt

Beer Brewery Yeast Tanks
Scenario 1: Exempt
Scenario 2: Exempt
Scenario 3: Exempt

Beer Brewery Fermentation Tanks:
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Beer Brewery Fermentation Tanks:
Scenario 1: Exempt
Scenario 2: Taxable
Scenario 3: Taxable

Beer Brewery Carbon Dioxide Tank:
Scenario 1: Taxable
Scenario 2: Taxable
Scenario 3: Taxable

Winery Fermentation Tank:
Scenario 1: Exempt
Scenario 2: Exempt
Scenario 3: Exempt

E: Definitions of Terms

The *Glossary for Property Appraisal and Assessment* (International Association of Assessing Officers, 1997) provides the following definitions for terms used in this report.

Fixture

(1) Attached improvements that can be real or personal property. If attached to the realty in such a manner that it removal would damage the real property or the fixture, the fixture is **realty [real property]**. If the fixture is removable without damage, it is generally considered **personal property**.

(2) An item of equipment that, because of the way it is used, the way it is attached, or both, has become an integral part of a building or other **improvement**.

Improvement

Buildings, other structures, and attachments or annexations to land that are intended to remain so attached or annexed….

Industrial property

Generally any property used in a manufacturing activity, including a factory, wholesale bakery, dairy plant, food processing plant, mill, mine, quarry, all locally assessed utility property, and the like.

Personal property

Consists of every kind of property that is not **real property**; moveable without damage to itself or the **real estate**; subdivided into tangible and intangible.

Real estate

The physical parcel of land and all **improvements** permanently attached.

Real property

Consists of the interests, benefits, and rights inherent in the ownership of land plus anything permanently attached to the land or legally defined as immovable; the bundle of rights with which ownership of **real estate** is endowed. To the extent that "real estate" commonly includes land and any permanent **improvements**, the two terms can be understood to have the same meaning. Also called "realty."

Tangible personal property

Personal property that has a substantial physical presence beyond merely representational. It differs from **real property** in its capacity to be relocated. Common examples of tangible personal property are automobiles, boats, and jewelry.