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Cutting Edge Disputes over the Boundaries of the Manufacturing Exemption
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Introduction

- What constitutes “manufacturing” and its various aspects are extremely important, because most states offer SUT exemptions and other incentives to taxpayers engaged in manufacturing.
- **Caution**: Each state has its own unique definition of manufacturing, and an activity that will qualify in one state might not qualify in another.
- **Caution**: Exemptions are strictly construed against the taxpayer claiming them, with few exceptions.
  - Each word in each statute has a particular meaning.
- Our purpose is to bring to your attention the types of manufacturing exemption issues that should be addressed on a state by state basis, using examples of current cases/ and rulings for illustration purposes.
Tests for Defining the Use of Qualifying Machinery and Equipment

- States have varying definitions of how M&E must be used in order to qualify for their manufacturing exemptions
- Examples:
  - “Used Directly”
    - Arkansas, Missouri
  - “Used Directly or Predominantly”
    - Wyoming
  - “Necessary and Integral to”
    - Georgia
Tests for Defining the Use of Qualifying Machinery and Equipment (cont.)

- **Issues** – Under a particular state’s test, each word has significance
  - Is the M&E used during the actually manufacturing process, and when does that process begin and end?
  - Will the item qualify if it doesn’t physically touch the product being manufactured?
  - Will repair services qualify?
  - Do replacement equipment and parts qualify, and does substantially all of the M&E have to be replaced?

- **Example of strict construction:**
  - *Arkansas Administrative Hearing Decision, Dkt. Nos. 16-128; 16-183; 16-184; 16-410* (Revision Request), April 6, 2017)
Tests for Defining the Use of Qualifying Machinery and Equipment (cont.)

- What percentage of the time must the machinery and equipment be used in a qualified activity in order to qualify for the exemption?
  - **Missouri**
    - Under the “used directly” test in Missouri, the Missouri Administrative Hearing Commission recently ruled that so long as “some” of the use is a qualified use, “all” of the cost of the machinery and equipment qualifies for the manufacturing exemption.
      - *Cebridge Acquisition LP and Friendship Cable of Arkansas Inc., v. DOR*, Docket No 13-1629 RS (May 19, 2017) *(Note: the DOR did not appeal this decision)*
NAICS Codes

- Is the statutory definition tied to federal NAICS Codes, and does your activity qualify under one of the selected ones?
  - **Georgia** – “Off-site shredding” did not qualify because its NAICS classification was for document management services
  - **Utah** – provides new exemptions for automobile manufacturers (NAICS 336111) and industrial gas manufacturers (NAICS 325120)
    - S. 132 (L. 2017)
Is R&D Activity Exempt?

- The issue with R&D machinery and equipment is whether the manufacturing process has started yet
  - **Colorado** – R&D is classified as a “nonoperational activity”
    - Colorado General Information Letter, No. GIL-17-011 (May 2, 2017)
- Some states specifically include R&D in the definition of manufacturing or provide a separate exemption for it
Does Manufacturing Include Recycling?

- Some states take the position that recycling does not constitute manufacturing because the process does not involve converting new raw materials into finished products
  - **Arkansas**
    - Machinery used to reprocess excess materials trimmed from the manufacturer’s finished products for recycling is not “used directly” in manufacturing
  - **Georgia**
    - The taxpayer was determined to be a retailer, rather than a manufacturer, because its only income was generated by the sale of converted scrap
Louisiana (further processing exemption)
- The Court held that a power plant operator’s limestone purchases were excluded from SUT under the “further processing exclusion” because the use of limestone in the power generation process creates ash as a by-product that is sold at retail

Bridges v. Nelson Industrial Steam Co., No 2015-C-1439 (La. S. Ct., May 3, 2016). (Note, this case is currently on appeal)
Does Manufacturing Include Pollution Control Equipment?

- The issue is whether pollution control equipment is actually part of the manufacturing process or merely ancillary to it because it does not actually assist in the manufacture of the goods, or does it?
  - Some states provide separate exemptions for this specialty equipment
    - Example: Ala Code. § 40-23-4(a)(16)
Does Manufacturing Include Pollution Control Equipment? (cont.)

- If the equipment is required by government authorities, that might meet a “necessary” requirement
  - Canisters used to contain spent nuclear fuel rods during the manufacture of electricity qualified for South Carolina’s manufacturing exemption
    - Spent nuclear fuel is strictly regulated and inherently dangerous; building the dry storage facilities was the taxpayer’s only feasible option to comply with the regulations (the other options were either cost prohibitive or would require closing down the plant)
    - The taxpayer’s purchases of machines were necessary to comply with federal requirements to prevent or abate pollution, and were thus exempt.
Does Manufacturing Include Pollution Control Equipment? (cont.)

- **Massachusetts**
  - Pollution control equipment used to construct an electric generating unit are exempt from SUT as machinery used directly and exclusively in the integrated and synchronized system that furnishes electricity through mains, lines, or pipes.
  - Aqueous ammonia is also exempt from SUT as a material, tool, or fuel that is consumed and used in furnishing electricity through mains, lines, or pipes, if its normal useful life is less than a year, or its cost is expensed for federal income tax purposes.

Does Manufacturing Include Making Intangibles?

- Sometimes, statutes and regulations require that the product being manufactured be either TPP or taxable.
- In Missouri, there is a raging controversy over the recent decision in *IBM Corporation v. Director of Revenue*, (Mo. Sup. Ct. Docket No SC94999, April 5th, 2016)
Does Manufacturing Include Making Intangibles? (cont.)

- Prior to the *IBM* decision, for approximately 25 years, the Mo. Supreme Court held (consistently) that manipulation of data by computers into a product different from the input is “manufacturing”

- In *IBM*, however, the Court ruled that MasterCard’s equipment (purchased from IBM) and used to convert data into other products did not qualify
  - The Court:
    - Did not specifically overrule its prior decisions, but indicated that they should no longer be followed
    - Held that the generation of telephone calls no longer qualified as manufacturing, even though that issue was not before it, and even though the Court did not specifically overrule the prior case confirming the exemption
    - Did not provide prospective-only relief to IBM or similarly situated taxpayers, although it could have done so
  - Missouri has apparently abandoned Missouri’s “integrated plant” theory in favor of the more typical rule of “strict construction”
The Missouri General Assembly immediately tried to enact legislation that would abrogate *IBM*, but ran out of time
  
  - To delay things, the legislature enacted SB 83 (L. 2016), which merely precluded the DOR from enforcing the *IBM* decision until August 28, 2017 (to give the legislature additional time to consider the abrogation bills)
  
  - Unfortunately, the 2017 legislative session ended, again without any substantive legislative action to abrogate all or part of the *IBM* decision
  
  - Again, the General Assembly “kicked the football” by precluding the DOR from enforcing the IBM decision until August 28, 2018
On May 19, 2017, mere days after the 2017 General Session ended, however, the Commission handed down a decision in *Cebridge Acquisition LP and Friendship Cable of Arkansas Inc., v. DOR*, Docket No 13-1629 RS (May 19, 2017), following IBM and holding that:

- The DOR is not required to send notice to taxpayers that may be assessed in the wake of the IBM decision, because the IBM case was not unexpected
  - (even though IBM overruled the Commission in finding against the taxpayers)
- The IBM decision abrogated two prior cases holding that making telephone calls constituted manufacturing
- The Commission will apply the IBM case retroactively to periods before the IBM decision was handed down

What happens next is anyone’s guess, but bills will be pending again this year in the General Assembly to address both the “data processing” issue and the “telephone” issue
Does Manufacturing Include Custom Printing?

- **Arkansas**
  - The lease of a color digital printing press did not qualify for Arkansas’s M&E exemption because the Department opined that custom print products did not constitute “articles of commerce”
  - Under Ark. Regs. Section GR-55(F)(6), an “article of commerce” means “any property to be placed on the market for retail sale to the general public, and any product which becomes a recognizable integral part of a manufactured product in its finished and packaged form ready to be placed in the market for retail sale
  - The Department ruled that custom items produced for specific customers in response to specific orders are not articles of commerce (huh?)

- **Revenue Legal Opinion No. 20160915** (Sales Tax - Printing Machinery), January 12, 2017)
Does Manufacturing Include Generating Electricity?

- **Some States Say Yes**
  - **Missouri**
    - The generation (but not the transmission and distribution) of electricity qualifies for Missouri’s manufacturing exemptions.
    - The Missouri DOR recently ruled that concrete, nacelle, rotors, rebar, anchor bolts, and electrical conduit for incorporation into the foundations for wind turbines qualify for Missouri’s manufacturing exemptions, because the turbines cannot work without the foundation.
Some States Say No

- Illinois

See Amended Regulation 89 Ill. Admin Code Section 130.330, (effective September 23, 2016), that clarified Illinois’ position that although mining and quarrying operations qualify as manufacturing, the generation of electricity is not an exempt activity.
Does Manufacturing Include Generating Natural Gas?

- **Some States Say Yes**
  - **Mississippi**
    - Recently adopted a new Industrial Utility Exemption for Oil and Gas Exploration and Development (effective July 1, 2017)
    - This new exemption applies to start-up, expansion, or improvement of a business solely engaged in the conversion of natural sand into proppants used in oil and gas exploration and development
      - the business must hire 85 new employees averaging $65,000 and make $80 Million in new investment
Some States Say Yes (cont.)

- Mississippi (cont.)
  - The exemption would cover:
    - Component construction materials for buildings
    - M&E used in the buildings
    - Processing M&E permanently attached but not intended to be housed in a building and
    - Sales of all utilities and fuel used therein
Some States Say No

- Texas

The Texas Supreme Court held that oil and gas exploration and production equipment (casing, tubing, other well equipment, and associated services) were not eligible for the statutory exemption for “property used in manufacturing” because the equipment did not directly cause a physical change in petroleum brought to the surface from underground.

Some say that if the trial court hadn’t been overturned, the refunds generated by this case would have bankrupted the State.

- See *Southwest Royalties, Inc. v. Hegar*, No. 14-0743 (Texas Supreme Court, June 17, 2016)
Does Manufacturing Include Other Weird Stuff?

- **North Carolina (Blinded by Science?)**
  - The DOR ruled that the creation of a biologically inert fuel by pulverizing raw materials into particles with the use of compression at high temperatures constituted manufacturing
  - The process causes lignin molecules in the particles to separate from the cellulose structure, plasticize, and migrate to the surface of the particles (whatever that means)
New York – Grocery Store Bakeries

- The DTF ruled that a supermarket’s purchases of fuel & utilities to power a fuel cell used in baking, cutting, and packaging meat, slicing deli meats and cheeses to order are exempt from SUT to the extent the fuel is used directly and predominantly in the production process.

- The fuel cell meet the "directly" requirement if it creates the energy used to power equipment used in production activities, and it meets the "predominantly" requirement if more than 50% of its use powers production equipment.

- The supermarket must use an acceptable method (e.g., engineering study) to allocate the portion of energy used in production process.


- The New York Tax Tribunal held that utilities that were used to power pan washers used by a warehouse-type department to store to clean the store’s bakery did not qualify for a processing exemption.
- The taxpayer argued that the utilities were necessary to sanitize the pots, pans, etc. used to make baked goods.
- Court disagreed because the utilities did not have a “direct and exclusive” relationship to the baking production process and the utilities were used on during pre-and post- production.
- The Tribunal also disallowed exemptions for utilities used to service, maintain, or repair the production equipment.

In the Matter of the Petition of Costco Wholesale Corporation, N.Y.S. Tax Appeals Tribunal, Docket No. 825882 (March 6, 2017)
What Items Qualify as “Machinery and Equipment”? 

- Can Fluids Qualify as Equipment? 
  - Arkansas
    - Under Arkansas’s regulations, new purchases of chemical compounds can qualify as equipment for purposes of the manufacturing exemption if they are used directly in manufacturing, serve as instruments or tools, and are not fully integrated into something else.
    - However, at least one taxpayer failed to make a compelling argument.
    - The taxpayer argued that oil it purchased was necessary to operate and maintain the machine, because it was used to set up the machine for the first time.
      - That is, the machine could not be shipped with any fluids in the lathe.
    - The ALJ, however, ruled that the taxpayer failed to establish that the oil was a component part of the taxpayer’s lathe, or that it otherwise served as an instrument or tool.
What Items Qualify as “Machinery and Equipment”? (cont.)

- **Can Fluids Qualify as Equipment? (cont.)**
  - **Georgia**
    - Chemicals and gases used for quality control purposes qualified for the exemption
    - **Note**: The DOR also ruled that “booms, lifts, ladders, scaffolding, flashlights, headlamps, light towers, batteries for the various lights, ear plugs, barricade tape, chains, tags, signs, labels, and placards also met the definition of “equipment”
What Items Qualify as “Machinery and Equipment”? (cont.)

- **Can Safety Equipment Qualify as Equipment?**
  - **Georgia**
    - **Yes** – safety equipment necessary for the protection of employees qualifies, whether or not required by state law
Ohio – Ordinary Pickup Trucks Are Not Utility Equipment

- Pickup truck did not qualify for the exemption for property used directly in the rendition of a public utility service
- The BTA denied the petition for procedural flaws, but commented that the taxpayer would have lost anyway
- Only specially designed motor vehicles that have been customized for this purpose
  - Merely installing a bed cover and stainless steel “nurfbars” to transport tools, equipment, and supplies was not sufficient customization
Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process?

- **Arizona – Electricity Coops Were Denied Use Tax Refunds for Purchases of Coal/Natural Gas**
  - Between 2003 and 2010, the taxpayers used coal and natural gas to produce electricity, and claimed that these purchases were exempt because they were either:
    - Purchased for resale or
    - Incorporated into the products sold
  - The Appellate Court affirmed the lower court and held, essentially, that it was impossible for fuel that was totally consumed in making electricity to either be resold or incorporated into the electricity

Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process? (cont.)

- **Indiana – Electricity for Food Storage Warehouse Does Not Qualify for Manufacturing Exemption**
  - The taxpayer maintained “freezer warehouses” for its food manufacturing customers, who would store their products there
  - In order to qualify for the exemption, however, the M&E and utilities had to be used as an “essential and integral” part of the production process
  - The Court held that the taxpayer’s processes didn’t create anything, but rather preserved already manufactured food
  - The Court also stated that even though the food was “sold frozen”, the taxpayer was not the manufacturer who used the freezer and electricity to manufacture the frozen food

Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process? (cont.)

- **Iowa – Supplies and Replacement Parts**
  - Amended regulations (amended Iowa Admin. Code § 701-230.5, .14 through .22(423)) implement statutory modifications to sales and use tax exemptions for manufacturers
  - The amendments exempt supplies and define replacement parts and supplies, and relate to exemption of sales of the following occurring on or after July 1, 2016:
    - gases used in the manufacturing process (no sales date specified)
    - computers, machinery, equipment, replacement parts, supplies, and materials used to construct or self-construct computers, machinery, equipment, replacement parts, and supplies used for certain manufacturing purposes
    - the sale of property directly and primarily used in processing by a manufacturer
Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process? (cont.)

- **Iowa (cont’d.)**
  - the sale of property directly and primarily used by a manufacturer to maintain integrity or unique environmental conditions;
  - the sale of property directly and primarily used in R&D of new products or processes of processing;
  - for the sale of computers used in processing or storage of data or information by an insurance company, financial institution, or commercial enterprise;
  - the sale of property directly and primarily used in recycling or reprocessing of waste products;
  - the sale of pollution-control equipment used by a manufacturer;
  - the sale of fuel or electricity used in exempt property; and
  - for the sale of services for designing or installing new industrial machinery or equipment
Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process? (cont.)

- **Louisiana (Constitutional or not Constitutional?)**
  - During the 2015 Regular Session, LA Legislature issued **House Concurrent Resolution No. 8**
    - HCR8 suspended many business exemptions for steam, water, electrical power, or energy and natural gas (and related items) from 7/1/2015 – 8/5/2016
    - Excluded from the exclusion (i.e., still exempt) were:
      - Natural gas used in the direct reduced iron process
      - Electricity used by chlor-alkali facilities
      - Electricity and natural gas used by wood and paper facilities
Louisiana – HCR8 (cont.)

- The Louisiana Chemical Association and numerous other companies (collectively “LAC”) filed a petition for declaratory judgement against numerous state agencies and officials, asserting that HCR8 was unconstitutional for numerous reasons.
- On 11/1/15, the state agencies filed motions for summary judgement, based on legal/constitutional arguments, but primarily because LA needed the money to perform vital state services.
- On 1/6/16, the District Court denied the LAC motion, granted the State motion, and dismissed LAC’s claims.
Louisiana – HCR8 (cont.)

- The LAC appealed to the LA Court of Appeals, who upheld the judgements of the District Court and
- On 4/7/17, the LA Court of Appeals affirmed the District Court’s decision

- Is this outcome determinative, or what?
Does Your State Provide Exemptions for Fuel Used or Consumed in the Manufacturing Process? (cont.)

- **Mississippi – New M&E Exemption Regulations**
  - Effective May 27, 2017, the MS DOR amended MS Admin. Code Sec. 35.IV.7.03 (Manufacturers and Custom Processors), regarding sales of manufacturing machinery and machine parts
  - The following items are exempt:
    - Electricity and natural gas used in an engine and manufacturing processors
    - Raw materials, catalysts, processing chemicals, welding gases, or other industrial gases used directly in manufacturing or processing (Note: previously, sales of natural gas were not exempt)
    - The exemption for pollution control equipment by manufacturers and custom processors is expanded to all uses, when it was previously restricted to industrial uses
    - Natural gas and raw materials used for fuel which become component parts of finished products or are used directly in processing
North Carolina – Natural Gas Exemption

- Effective on January 1, 2017, the exemption for fuel and electricity sold to a manufacturer for operating a manufacturing facility changed to exclude fuel or piped natural gas that is used solely for “comfort heating” and not for use in a manufacturing process
  - L. 2016; S. 729 (c.5)
Ohio – Exemption Disallowed for General Use Utilities in a Manufacturing Facility

- A trailer manufacturer argued that natural gas to maintain its plant facilities at a fixed temperature was necessary to facilitate welding
  - The entire facility was necessary to make the trailers
- The Court agreed with the Commission and held that the taxpayer had not met its burden of proving that the gas was essential to production (Really?)
  - The Court reasoned that the taxpayer could have bolted the trailers rather than weld them, so the “entire facility” argument failed
  - Thus, the natural gas was used for quality control and was not essential to production
Did We Forget Any Other Cutting Edge Issues?

- Thank you!
- You’ve been a wonderful audience!