



2009 Annual Ohio Tax Course

Sales & Use Tax in the Manufacturing Environment

13 August 2009



The Manufacturing Exemption

Ohio Revised Code:

5739.02(B)(42)(a) - Raw Materials

- ▶ When the purpose of the consumer is to incorporate the thing transferred as a part into tangible personal property to be produced for sale by manufacturing, assembling, processing, or refining.

5739.02(B)(42)(g) - Equipment/Materials Directly used in Manufacturing

- ▶ When the purpose of the consumer is to use the thing transferred primarily in a manufacturing operation to produce tangible personal property for sale.

Definitions

Manufacturing Operation

- ▶ Process in which materials are changed into a different state from which they previously existed.
 - ▶ Includes: refining, assembling, and preparing, mixing, measuring, blending or otherwise committing such materials to the manufacturing process (does not include packaging).

Refining

- ▶ Removing or separating a desirable product from raw or contaminated materials by distillation or physical, mechanical, or chemical processes.

Assembly

- ▶ Attaching or fitting together parts to form a product (does not include packaging product).

Definitions

Manufacturing Facility

- ▶ Single location where a manufacturing operation is conducted.
 - ▶ Includes locations with multiple buildings in a contiguous area controlled by the manufacturer.

Testing

- ▶ Process to identify properties or assure the quality of a material or part.

Completed Product

- ▶ Manufactured item that is in the form as it will be sold by the manufacturer.

Continuous Manufacturing Operation

- ▶ Process in which raw materials are moved through the steps whereby manufacturing occurs.

Items Covered by Exemption

Items Exempt from Sales & Use Tax

- ▶ Production Equipment
- ▶ Materials Handling Equipment
- ▶ Consumables
- ▶ Adjuncts
- ▶ Use on Use
- ▶ Testing Equipment
- ▶ Scrap Handling
- ▶ Power and Power Producing Equipment
- ▶ Equipment Transporting Power, Water, Etc.
- ▶ Recycling Equipment
- ▶ Repair Parts

Items **Covered** by Exemption

Production Equipment

- ▶ Machinery/Equipment that act upon the product or treat the materials in preparation for the manufacturing operation.
- ▶ Machinery that changes the state of the product that is manufactured for sale.
- ▶ Equipment that treats, blends, mixes, measures, washes, agitates, filters, heats, cools, or other similar processes after the materials have been committed to the manufacturing operation and before the product is completed.

Items Covered by Exemption

Materials Handling Equipment

- ▶ Equipment that moves the product through a continuous manufacturing operation.
- ▶ Equipment that temporarily stores the product during manufacturing operation.
- ▶ Equipment used in intraplant or interplant transfers of work in progress where the transfer occurs between manufacturing facilities operated by the same person (excluding licensed vehicles).
 - ▶ Equipment used to move or transport the in-progress product between manufacturing facilities of the same manufacturer, is considered to be used in the manufacturing operation.

Items Covered by Exemption

Consumables

- ▶ Catalysts, solvents, water, acids, oil, and similar consumables that interact with the product and that are an integral part of the manufacturing operation.
 - ▶ This includes substances that do not necessarily become a component part of the product, but which usually come in contact with the product during the manufacturing process.

Items Covered by Exemption

Adjuncts

- ▶ Machinery, equipment, and other property used during the manufacturing operation that control, physically support, produce power for, lubricate, or are otherwise necessary for the functioning of production machinery and equipment and the continuation of the manufacturing operation.
- ▶ Tangible personal property that monitors in-process product or that lubricates, cools, monitors, or controls production machinery, materials handling equipment, and other equipment used in a continuous manufacturing operation.

Items Covered by Exemption

Use on Use

- ▶ Machinery, equipment, fuel, power, material, parts, and other tangible personal property used to manufacture machinery, equipment, or other tangible personal property used in manufacturing a product for sale.

Testing Equipment

- ▶ Machinery, equipment, and other tangible personal property used by a manufacturer to test raw materials or the completed product.
- ▶ Equipment and supplies used to perform testing, and the property used to physically support, control, lubricate, cool or monitor such equipment.

Items Covered by Exemption

Scrap Handling

- ▶ Machinery/Equipment used to handle or temporarily store scrap that is reused in the manufacturing operation at the same facility.

Power and Power Producing Equipment

- ▶ Electricity, coke, gas, water, steam, and similar substances used in the manufacturing operation;
 - ▶ Machinery/Equipment used to extracting those substances or make the substances suitable for use in the manufacturing operation.

Equipment Transporting Power, Water, etc.

- ▶ Machinery/Equipment used to transport or transmit electricity, coke, gas, water, steam, or similar substances used in the manufacturing operation to the manufacturing operation.

Items **Covered** by Exemption

Recycling Equipment

- ▶ Machinery/Equipment that treats, filters, cools, refines, or otherwise renders substances used in the manufacturing operation reusable,

Repair Parts

- ▶ Parts, components, and repair and installation services for items used in the manufacturing operation.

Items that are **Taxable**

Items not covered by Manufacturing Exemption

- ▶ Administrative and Inventory
- ▶ Storage
- ▶ Scrap Handling and Storage
- ▶ Storage of Consumables
- ▶ Real Estate
- ▶ Environmental Controls
- ▶ Storage of raw materials and finished goods
- ▶ Safety Equipment
- ▶ Research and Development
- ▶ Repair and Maintenance Equipment
- ▶ Vehicles

Items that are Taxable

Administrative and Inventory

- ▶ Tangible personal property used in administrative, personnel, security, inventory control, record keeping, ordering, billing, etc.

Storage

- ▶ Tangible personal property used to store raw materials prior to the commencement of manufacturing or used to handle a completed product, including storage that maintain a completed product.

Scrap Handling and Storage

- ▶ Tangible personal property used to handle or store scrap intended for disposal, sale, or other disposition.
 - ▶ Does not include scrap intended for reuse at same facility.

Items that are **Taxable**

Storage of Consumables

- ▶ Tangible personal property used to store fuel, water, solvents, acid, oil, etc. consumed in the manufacturing.

Real Estate

- ▶ Tangible personal property that is incorporated into realty.

Safety Equipment

- ▶ Tangible personal property used for the protection and safety of workers.
 - ▶ **Unless** property is attached to machinery/equipment used in a continuous manufacturing operation.

Items that are **Taxable**

Environmental Control

- ▶ Machinery/Equipment used for ventilation, dust or gas collection, humidity or temperature regulation.
- ▶ Machinery/Equipment that totally regulates the environment in a limited area of the manufacturing facility where the regulation is essential for production is **exempt**.
- ▶ *Hamilton Fixture Company v. Tracy*
 - ▶ System used to remove sawdust, wood chips and particulate matter from wood cutting machinery was upheld as taxable.

Items that are **Taxable**

Research and Development

- ▶ ORC 5739.02(B)(42)(i) provides a separate exemption for machinery/equipment used in research and development.

Repair and Maintenance Equipment

- ▶ Machinery/Equipment used to clean, repair, or maintain property in the manufacturing facility.

Vehicles

- ▶ Motor vehicles registered for use on public highways.

The Primary Use Test

Case law developed what is known as the "primary use test."

- ▶ If the primary use of a piece of equipment (i.e. 51% or more of its use) was an exempt function, the purchase of the equipment was exempt.
- ▶ 5739.011(D) codifies the primary use test.

Relevant Court Cases

Q3 Stamped Metal, Inc. v. Zaino

- ▶ Ohio Supreme Court found that a forklift used to replace stamping press dies did not qualify for exemption.
 - ▶ Forklift was not used “during” manufacturing operation. The dies were replaced between stamping activity and the press functioned without the forklift.
- ▶ Court affirmed that welding equipment (i.e., helmets and glasses) was exempt because its primary purpose was to enable the welder during the manufacturing process.

Relevant Court Cases

Appleton Papers Inc. v. Tracy

- ▶ Taxpayer contended air conditioning used to cool a room with manufacturing equipment was exempt under ORC 573 9.011 (C).
- ▶ The BTA held the taxpayer did not demonstrate the cooling was essential for production to occur, and denied the exemption claim.

Relevant Court Cases

Harsco Corporation Heckett Multiserve Division v. Tracy,

- ▶ Does the manufacturing process began at the time unprocessed molten slag is poured into slag pots?
- ▶ Board held that unprocessed slag undergoes a change when first poured into the slag pots at the furnace.
 - ▶ Board relied on testimony of taxpayer's witness.
 - ▶ Primary use of taxpayer's slag pots is to effect a gravity separation process and not for transportation.
- ▶ Slag pots and the repair expenses for slag pot carriers were exempt.

Relevant court Cases

PPG Industries, Inc. v. Tracy

- ▶ Polymer resin manufacturer entitled to exemption on purchases of equipment related to a “manifold” system that drew exact quantities of raw materials from storage tanks.
- ▶ Prior case law: manufacturing did not commence until raw materials were blended in mixing tanks.

Because raw materials were drawn into the manifold in definite amounts, the manifold was the point at which manufacturing began.

- ▶ All purchases related to the manifold system qualified for exemption.

Packaging

ORC 5739.02(B)(15)

- ▶ Sales of packages, materials for packages, and of machinery/equipment for use in packaging tangible personal property are excluded from tax.
- ▶ Packaging exemption available to persons described in 5739.02(B)(42)(a) or (g) and retailers.
 - ▶ Generally available to manufacturers and those engaged in making retail sales.

Packaging

- ▶ Ohio Supreme Court determined that packaging materials must restrict the movement of a product in more than one plane of direction.

Custom Beverage Packers v. Kosydar

- ▶ Strapping materials used on packages that restricted movement only from side to side were not exempt as packaging materials.

Packaging

Shipping Pallets are **sometimes** held exempt as packaging materials:

The Goodyear Tire and Rubber Co. v. Porterfield

- ▶ When product containers are glued or attached to pallets, they are normally held exempt.

BF Goodrich Chemical Company v. Collins

- ▶ It is required that shrink wrap go around the pallet and not just the boxes.

Packaging

In *Miles Laboratories, Inc. v. Limbach*

- ▶ Pallets held exempt as packaging material when the bags on the pallets and the pallets were covered with plastic shrink wrap.
 - ▶ Taxpayer's witnesses testified that shrink wrap surrounded the pallets and the Board found such testimony credible.

Packaging

Earlier cases were construed to exempt only equipment used to actually place a product in a package.

Southwestern Portland Cement Co. v. Lindley

- ▶ Equipment used to dampen cement bags into which cement was placed held taxable

Hawthorn Melody, Inc. et al. v. Lindley

- ▶ Conveyor systems are exempt only if they are involved in the actual packaging operation, and not if they are used to move empty cases or other items.

The Procter & Gamble Co. v. Limbach

- ▶ Totally automatic packaging system was held to be exempt as packaging equipment.
 - ▶ Although each piece of the equipment did not place products in the packages, each was part of a fully integrated system.

Packaging

Anheuser-Busch, Inc. v. Tracy

- ▶ Ohio Supreme Court affirmed BTA Appeals decision holding a blower system taxable.
 - ▶ Blower system: dries bottles before coding and labeling, and has glue rollers to apply labels, and a video jet coding machine that inks a code on the bottles.
 - ▶ Taxpayer argued the equipment was exempt under the packaging exemption.
 - ▶ The Court held the equipment in question was not an integral part of the packaging operation.
 - ▶ Not part of the package nor was it used to place beer into packages.

- ▶ **In a legislative response to this case:** Packaging exemption broadened to include labels and machinery, equipment, and supplies used to make labels or packages, to prepare packages or products for labeling, or to label packages or products. See 5739.02(B)(15).

Packaging

The Limited Stores, Inc. v. Tracy

- ▶ Clothing retailer objected to sales tax on packaging it purchased in order to ship merchandise from its distribution center to stores.
 - ▶ BTA said that the criteria requisite for exception are:
 - ▶ (1) the taxpayer must be engaged in an enterprise described in 5739.01(E)(2), and
 - ▶ (2) the item for which the exception is sought must meet the definition of "packages" contained in RC 5739.02(B)(15).
 - ▶ BTA stated that the first prong is satisfied because the taxpayer is a retailer directly engaged in selling, in spite of the commissioner's argument that the packaging in this case was not used directly for retail sales.

Sales Excluded Based on the Item Sold

Pollution Control Equipment

- ▶ Sale or use of parts to be incorporated into pollution control facility for which a pollution control certificate has been issued is not taxable.
- ▶ Air pollution control facility: Property whose purpose is eliminating or reducing the emission or ground level concentration of air contaminants such as dust, particulants, fumes, gas, mist, smoke, vapor and odorous substances.
 - ▶ Air and noise pollution control certificate applications are filed with the Tax Commissioner who seeks an opinion of the EPA.
- ▶ Water pollution control facility: Any disposal system or treatment works used primarily for the purpose of reducing, controlling, or eliminating water pollution caused by industrial waste.
 - ▶ Water pollution control certificate applications are filed with the EPA who notifies the Tax Commissioner.

Sales Excluded Based on the Item Sold

Southwestern Portland Cement Company v. Limbach

- ▶ Board held purchases used to make repairs to facilities covered by an air pollution certificate were exempt.
 - ▶ Separate applications required for additions or enlargements of previously certified air pollution control facilities.
 - ▶ Repairs do not require a certificate.

Sales Excluded Based on the Item Sold

Research and Development Exemption

- ▶ Exemption exists for qualified research and development equipment 5739.02(B)(42)(i).
- ▶ Research and development: designing, creating, or formulating new or enhanced products, equipment, or manufacturing processes, and connected scientific or technological inquiry and experimentation in the physical sciences with the goal of increasing scientific knowledge which may reveal the basis for new or enhanced products, equipment, or manufacturing processes.