



**HOUSE BILL 1030:
2016 Appropriations Act, Sec. 38.2:
Expand Taxation of Mill Machinery**

2015-2016 General Assembly

Committee:		Date:	July 27, 2016
Introduced by:		Prepared by:	Trina Griffin Staff Attorney
Analysis of:	Sec. 38.2 of S.L. 2016-94		

OVERVIEW: *Sec. 38.2 of S.L. 2016-94, as amended by Secs. 11.1 and 11.3 of S.L. 2016-123, expands the preferential tax treatment of certain machinery and equipment subject to the 1% / \$80 tax by adding provisions for the following:*

- *Parts, accessories, or attachments for equipment that is currently eligible for a company located at a ports facility. This provision became effective July 14, 2016, and applies retroactively to purchases made on or after July 1, 2013.*
- *Secondary metal recyclers, effective for purchases made on or after July 1, 2016. The equipment must be used in a process that converts ferrous or nonferrous metals or other items that have served their original purpose into new or different products for sale.*
- *Precious metal processors, effective for purchases made on or after July 1, 2016. This provision applies to a company that processes tangible personal property for the purpose of extracting precious metals regardless of whether the company owns the property being processed.*
- *Metal fabricators that derive more than \$8 million annually from the fabrication or manufacture of metal products, effective for purchases made on or after July 1, 2016. This provision applies regardless of whether the products manufactured are for sale or for the company's own use.*

CURRENT LAW: Article 5F of Chapter 105 of the General Statutes provides that mill machinery and mill machinery parts and accessories purchased by a manufacturing industry or plant, or by a contractor or subcontractor for use in the performance of a contract with a manufacturing industry, are subject to a privilege tax at the rate of 1% of the purchase price with a cap of \$80 per article. An item subject to the 1%/\$80 privilege tax is exempt from sales tax.

This preferential rate and corresponding sales and use tax exemption also apply to certain machinery and equipment purchased by the following types of companies:

- A major recycling facility.
- A research and development company in the physical, engineering, and life sciences.
- A software publishing company.
- An industrial machinery refurbishing company.
- A company located at a ports facility for waterborne commerce.
- A large manufacturing and distribution facility.

Service contracts on Article 5F items and the repair, maintenance, and installation of Article 5F items are exempt from sales and use tax.

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House Bill 1030

Page 2

BILL ANALYSIS: Section 38.2 of S.L. 2016-94, as amended by Sections 11.1 and 11.3(a) of S.L. 2016-123, expands the scope of the 1%/\$80 tax for four different types of companies.

Ports Facility. – Currently, a company located at a ports facility for waterborne commerce can purchase, at the 1%/\$80 tax rate, **machinery and equipment** that is used to unload or facilitate the unloading or processing of bulk cargo to make it suitable for delivery to and use by manufacturing facilities.

Section 38.2(a) expands the current provision by allowing that same company to purchase **parts, accessories, or attachments** used to repair, maintain, or upgrade the machinery and equipment at the 1%/\$80 rate as well. The expansion is retroactive for purchases made on or after July 1, 2013, which is when the ports provision originally became effective.

Secondary Metal Recyclers. – Under current law, some, but not all, of a secondary metal recycler's equipment is eligible for the 1%/\$80 tax. Generally speaking, equipment must be an integral part of transforming raw materials into a new and different product in order to be eligible. Equipment that only cuts or sorts, for example, is not eligible.

Section 38.2(b) provides the 1%/\$80 treatment for equipment, or attachments and repair parts for equipment, purchased by a person that gathers and obtains ferrous metals, nonferrous metals, and items that have served their original economic purpose and converts them by processes including sorting, cutting, classifying, cleaning, baling, wrapping, shredding, or shearing into a new and different product for sale consisting of prepared grades. It does not apply to motor vehicles or attachment or repair parts for motor vehicles purchased by said company.

Section 38.2(c) also exempts from sales tax fuel, piped natural gas, and electricity sold to a secondary metals recycler for use in recycling at its facility at which the primary activity is recycling.

This provision is effective for sales and purchases made on or after July 1, 2016.

Precious Metal Processors. – Under current law, equipment that is used in the manufacturing process is not eligible for the 1%/\$80 treatment if the raw materials or tangible personal property being processed is not owned by the company processing it.

Section 38.2(b) provides the 1%/\$80 treatment for equipment used by a company that is primarily engaged in processing tangible personal property for the purpose of extracting precious metals to determine the value of the precious metals for potential purchase. The company does not necessarily have to own the property being processed nor does it have to purchase the extracted metal once the property is processed.

This provision is effective for purchases made on or after July 1, 2016.

Metal Fabricators. – Under current law, equipment used to manufacture an item for a company's own use in the fulfillment of a performance contract, as distinguished from equipment used to manufacture an item for sale, is not eligible for the 1%/\$80 treatment.

Section 38.2(b) provides the 1%/\$80 treatment to a company that is engaged in the fabrication of metal work that generates in excess of \$8 million per year. The rate applies to equipment, and attachment or repair parts for said equipment, used at the establishment in the fabrication or manufacture of metal products. Under this provision, a company need not be "primarily engaged" in the fabrication of metal products, and the equipment qualifies regardless of whether it is primarily used to manufacture items for sale or for use by the company.

This provision is effective for purchases made on or after July 1, 2016.

House Bill 1030

Page 3

LEGISLATIVE HISTORY: The 1%/\$80 cap per article classification for certain machinery and equipment was enacted in 1961 as a preferential rate of sales tax, which was among other sales and use tax changes made at the same time, including the elimination of the wholesale tax, and was a means of ameliorating the fiscal impact of those changes. It is not clear why the rate of 1% with a maximum of \$80 per article was chosen; perhaps it was because that was the same preferential rate imposed on motor vehicles and airplanes in 1955 when the \$15.00 per article limitation that applied to every item sold was repealed. However, since its enactment in 1955, the rate applicable to motor vehicles and airplanes has increased, but the rate applicable to certain machinery and equipment has remained the same since 1961.

In 2001, in response to the requirement of the Streamlined Agreement that states simplify their sales tax rates, the General Assembly repealed the 1% sales tax rate and \$80 per article cap imposed on mill machinery and replaced it with a privilege excise tax having the same rate (Article 5F of Chapter 105).

Since 2001, the Article has been expanded for specific types of industries by taxing machinery and equipment at the lower rate, so long as it is capitalized for tax purposes under the Code by a company "primarily engaged" in certain kinds of business activities. This criterion is undefined, and the Department is often faced with having to make a determination whether a company is primarily engaged in the named activity. The Department has generally interpreted it to mean that over 50% of the revenues generated at the establishment are derived from the named activity. The types of businesses eligible for the 1%/\$80 rate on certain machinery and equipment are as follows:

- A major recycling facility. (2005)
- A research and development company in the physical, engineering, and life sciences. (2006)
- A software publishing company. (2007)
- An industrial machinery refurbishing company. (2008)
- A large manufacturing and distribution facility. (2011)
- A company located at a ports facility for waterborne commerce. (2013)

BACKGROUND: The original statute in Article 5F (G.S. 105-187.51) imposes the rate on a manufacturing industry or plant that purchases mill machinery or mill machinery parts and accessories. However, the statute does not specifically define a "manufacturing industry" or "mill machinery." Because the statute does not define these terms, it has raised questions as to whether a company is a manufacturer, for example, if it engages in multiple activities, only one of which may be manufacturing. It also raises questions as to whether a particular piece of equipment is "mill machinery" if it has dual purposes, only one of which is to manufacture goods. Over the years, the Department of Revenue has, through a combination of administrative rule, case law, and interpretation of the Secretary, developed guidance and criteria to determine the application of the tax. The criteria have not always been consistent or clear to taxpayers, but one aspect that has remained consistent is that the rate applies to equipment that manufactures goods for sale.

Most states provide a sales and use tax exemption for machinery and equipment used directly and exclusively in manufacturing or processing tangible personal property for sale. The exemption (or reduced rate) is intended to help eliminate taxation on business inputs where the end product that is being manufactured is ultimately taxed. However, this seemingly straightforward exemption is one of the greatest sources of complexity in sales tax law and has generated innumerable court cases in virtually all states. The exemption creates two major questions: what constitutes "manufacturing" and does equipment involved in certain activities, such as testing, research and development, repair and maintenance, storage, or transport, qualify as "equipment used in manufacturing."

House Bill 1030

Page 4

What constitutes "manufacturing"? - Manufacturing comprises so many different activities that the definition, interpretation, and application of the term varies from state to state. For example, all manufacturing probably includes some processing or fabrication, but not all fabrication or processing is manufacturing. Similar questions arise over refining, assembly, and construction. In *East Tex. Motor Freight Lines v. Frozen Foods Express*, 351 U.S. 49 (1956), the U.S. Supreme Court stated that "manufacturing implies a change...there must be a transformation; a new and different article must emerge, having a distinctive name, character, or use." In *Appeal of Clayton-Marcus Co., Inc.*, 286 N.C. 215, 223-26, 210 S.E. 2d 199, 205-07 (1974), the North Carolina Supreme Court stated that "producing a finished good not for sale but rather for one's own use is not manufacturing." However, attempts to follow this guiding principle have produced mixed results.

What constitutes "equipment used in manufacturing"? - Most states require that, in order to qualify for this exemption or preferential rate, machinery and equipment must be used directly, exclusively, primarily, or some combination thereof, in manufacturing tangible personal property for sale. Again, how those terms are defined varies from state to state. Primary use is generally defined as more than 50% of the machine or equipment's use must be in manufacturing or production. In most states, manufacturing begins when the item is withdrawn from its first point of storage and ends when the item is removed at the end of the manufacturing process and placed in finished goods storage. Most states consider the shipping and receiving areas to be outside the manufacturing process.