HOUSE BILL 81:
Expand 1%/$80 Rate for Mill Machinery

2015-2016 General Assembly

Committee:	House Finance	**Date:**	April 14, 2015
Introduced by:	Reps. Malone, Lewis, Collins, S. Martin	**Prepared by:**	Trina Griffin
Analysis of:	PCS to First Edition H81-CSSV-13		Committee Counsel

SUMMARY: The Proposed Committee Substitute for H81 would allow certain companies engaged in the fabrication of metal work to qualify for the 1%/$80 privilege tax that applies to purchases of certain machinery and equipment. The bill would also direct the Revenue Laws Study Committee to study the scope and application of the 1%/$80 tax for purchases of mill machinery and other equipment and report its findings, along with any legislative recommendations, to the 2016 Regular Session of the 2015 General Assembly.

BACKGROUND: 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 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on motor vehicles and airplanes in 1955 when the $15.00 per article limitation that applied to every item sold was repealed.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.

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."

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. Most of the disputes involving the scope of manufacturing are attempts to distinguish manufacturing from assembly, fabrication, and processing. 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 vary 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.

CURRENT LAW: 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).

The original statute in Article 5F imposes this 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 and not for the company's own use in the fulfillment of a contract.

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 also 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)
- A datacenter. (2007)
- An industrial machinery refurbishing company. (2008)
- A company located at a ports facility for waterborne commerce. (2011)

BILL ANALYSIS: Section 1 would expand the 1%/$80 tax to apply to a company that is engaged in the fabrication of metal work and that has annual gross receipts of at least $8 million dollars derived from the fabrication. The rate would apply to purchases of equipment and repair parts that are capitalized by the company for tax purposes under the Code and that are used at the establishment in the fabrication of metal products or used to create equipment for the fabrication of metal products. Under this bill, a company would not be required to be "primarily engaged" in the fabrication of metal products. Also, the equipment would qualify regardless of whether it is primarily used to manufacture items for sale. Historically, this rate has been afforded to companies that manufacture a finished product

for sale as distinguished from a company that manufactures an item for its own use in the fulfillment of a performance contract.

Section 2 of the bill would direct the Revenue Laws Study Committee to study the scope and application of the privilege tax at the rate of 1% with an $80 cap for purchases of mill machinery and other equipment and report its findings, along with any legislative recommendations, to the 2016 Regular Session of the 2015 General Assembly.

EFFECTIVE DATE: The expansion of the 1%/$80 rate would become effective July 1, 2015, and apply to purchases on or after that date. The remainder of the act would become effective when it becomes law.