

## **PA Tax Tips - Local Tax Exemptions For Manufacturing, By-Products Of Manufacturing And Industrial Establishments**

by James L. Fritz and James Welch

In the January 2011 edition of the PA Tax Law News newsletter, we offered a broad overview of the production-based exemptions under Pennsylvania's Sales & Use Tax, Capital Stock and Franchise Taxes, local Business Privilege Taxes and Real Property Tax. In our May newsletter we discussed some of the Sales and Use Tax exemptions in depth. This article focuses on a more detailed discussion of the activities qualifying under the "manufacturing" and "by-product of manufacturing" exemptions from local business privilege and mercantile taxes levied by school districts and municipalities outside of Philadelphia. This article also discusses the local real estate tax exemptions for "mills, mines, manufactories and industrial establishments."

### **Local Business Privilege and Mercantile Taxes**

The Local Tax Enabling Act ("LTEA") provides broad taxing authority to municipalities and school districts outside of Philadelphia. However, the LTEA also provides fairly broad production-based exclusions limiting local business privilege and mercantile taxes levied on gross receipts. Tax may not be collected on receipts from:

- Goods and articles manufactured in the political subdivision
- By-products of manufacture
- Minerals, timber and other natural resources produced in the political subdivision
- Farm products produced in the political subdivision
- Preparation or processing of minerals, timber, natural resources or farm products for use or market
- "Any privilege, act or transaction related to" the business of manufacturing, or to the production, preparation or processing of minerals, timber, natural resources or farm products

These exemptions may be claimed only by manufacturers, producers and farmers with respect to their own products.

The LTEA also exempts receipts from:

- Any privilege, act or transaction relating to the processing of manufacturing by-products
- Transportation, loading, unloading or dumping or storage of goods, articles, products or by-products listed above

### **“Manufacturing” Exemption**

Unlike in Pennsylvania’s Sales and Use Tax statute, “manufacturing” is not defined in the LTEA. In determining whether an activity constitutes “manufacturing” under the LTEA, the courts apply the same narrow standard that is used in the Capital Stock/Franchise Tax context. (See our discussion of the “manufacturing” prong of sales tax exclusion in our May newsletter.) As defined by case law under the local mercantile and business privilege taxes, as well as the capital stock and franchise taxes, “Manufacturing” is the application of labor and skill to material which changes the original material into something different. Whether manufacturing has taken place will depend on the existence of a substantial transformation in the form, qualities and use of the original material. Superficial changes which do not create a new identity in the material are not manufacturing.

The manufacturing exemption applies to more than receipts from outright sales. In *City of Pittsburgh v. IBM Corp.*, 391 A.2d 1126 (Pa. Cmwlth. 1978), a court held that gains from the leasing of manufactured products were exempt under the LTEA.

Following are some of the activities treated as “manufacturing” by Pennsylvania courts addressing local mercantile and business privilege taxes:

- Producing potato chips, which have “an entirely different use” from raw potatoes, oil and salt
- Production of flours by grinding, blending and processing many types of wheat

- Commercial printing involving the design, making of printing plates, printing onto paper which is folded, cut and bound
- Production of shirt boards, collar supports, ribbon reel covers and hosiery packaging inserts from cardboard through scoring, stamping, cutting and folding
- Production of apparel from material precut according to prescribed patterns and designs, where production process included sewing and fusing pieces of fabric, inserting zippers, buttons and other materials and pressing the garment
- Insertion of preprinted advertisements into a newspaper as a part of the larger process of manufacturing the newspaper

The development of film or photofinishing which results in a photo-negative for use in newspaper printing

Following are some of the activities that do not constitute “manufacturing”:

- Document reproduction through photocopying
- Commercial illustrating
- Preparing bird and small animal feed by combining, cleaning and packaging various grains, seeds and corn (However, the cracking of corn was manufacturing)
- Processing and packaging of meat (But where the processing of meat would result in other products such as soap, glue, cosmetics, or shortening, that portion of the activities was manufacturing)
- Preparation and cooking of food items
- Production of roasted coffee beans
- Addition of water and sucrose to slurry and powdered drink mixes to form fruit juice, fruit drinks and iced tea
- Preparing and publishing a newsletter, where independent contractor performed the actual printing
- Annealing and galvanizing of steel
- Rebuilding and reconditioning internal combustion engines and selling parts
- Collection of scrap metal which is separated out and resold

- Printing designs on ready-made clothing
- Cutting of leather into pieces, where no new product was produced and the cutting was for the convenience of the purchaser
- Dying and processing of cloth
- Providing cable television services

### **“By-Products of Manufacture”**

Although the general “manufacturing” exemption is limited to manufacturers, the prohibition on the taxation of “any privilege, act or transaction” involved in the processing of “by-products of manufacture” is available to persons other than the manufacturer. *Harsco Corp. v. City of Pittsburgh*, 533 A.2d 1012 (Pa. 1987). In *Harsco*, the Pennsylvania Supreme Court held that a metal recovery company engaged in processing of slag generated in steelmaking operations of a manufacturing company qualified for exemption.

The by-products of manufacturing exemption focuses on the existence of a secondary or additional product. *Metaltech v. City of Pittsburgh*, 623 A.2d 401 (Pa. Cmwlth. 1993). In *Metaltech*, the court refused to characterize the galvanizing of steel as processing a by-product of manufacturing because the process did not produce a second product. Real Property Taxes In Pennsylvania, ad valorem taxes are levied on real property by counties, school districts and municipalities. Exemptions, however, are governed by state law. These include:

- “Machinery, tools, appliances and other equipment” contained in any “mill, mine, manufactory or industrial establishment”
- Farm silos used for processing or storage of animal feed
- Farm grain bins or corn cribs used for processing or storage of animal feed
- Structures and containments used predominantly for processing and storage of animal waste
- Composting facilities incidental to farm operation
- Wind turbine generators and related appliances and equipment (including towers and foundations)

As the other exemptions are more or less self-explanatory, this discussion will focus on the so called “industrial equipment” exemption. Under this provision, the test for exemption from real property taxes requires satisfaction of two distinct elements: “1) the property at issue must constitute machinery, tools, appliances, or other equipment; and 2) the property must be contained in a mill, mine, manufactory, or industrial establishment.” *BFC Hardwoods, Inc. v. Bd. of Assessment Appeals, Crawford Cnty.*, 565 Pa. 65, 771 A.2d 759 (2001).

### **“Machinery, Tools, Appliances and Other Equipment”**

Whether an item is considered “machinery” or “equipment” will depend on whether it is an integral, as opposed to merely incidental, part of the manufacturing process. *Jones and Laughlin Tax Assessment Case*, 405 Pa. 421, 175 A.2d 856 (1961).

Therefore, it is our considered conclusion, under the statute involved, improvements, whether fast or loose, which are used directly in manufacturing the products that the establishment is intended to produce and are necessary and integral parts of the manufacturing process and are used solely for effectuating that purpose, are excluded from real estate assessment and taxation. On the other hand, improvements which benefit the land generally and which may serve various users of the land, are not in this category. Neither are structures, which are not necessary and integral parts of the manufacturing process and which are separate and apart therefrom within the exclusion. A structure used for storage, for example, is part of the realty and subject to real estate taxation.

*Id.* at 431-32. In evaluating whether an improvement is machinery or equipment, courts have applied a three part test. An improvement must be (1) “directly used to manufacture the product,” (2) “a necessary and integral part of the manufacturing process,” and (3) “used solely for effectuating that purpose.” *U.S. Steel v. Bd. of Assessment and Revision of Taxes of Bucks Cnty.*, 422 Pa. 463, 223 A.2d 92 (1966). Courts have focused on whether the “practical and economic use” of property is solely the purpose for which they were built, or if there is a benefit to the land generally.

Smokestacks, cooling towers and water intake structures had a practical and economic use of generating electricity and did not benefit the land generally, and therefore were “machinery and equipment.” *Allegheny Energy Supply Co., LLC v. Greene Cnty. Bd. Of Assessment Appeals*, 837 A.2d 665, 668 (Pa. Cmwlth. 2003).

### **“Mill, Mine, Manufactory or Industrial Establishment”**

Even if an item is machinery or equipment, it will not be excluded from tax unless it is part of a “mill,” “mine,” “manufactory” or “industrial establishment.” The meanings of “mill” and “mine” being sufficiently ascertainable, much of the courts’ interpretation has focused on what constitutes an “industrial establishment”. The primary contention among parties seeking exemption has been that while a use traditionally may not be considered manufacturing, and therefore not meet the “manufactory” standard; the inclusion of “industrial establishment” in the statute broadens the exemption.

“Industrial establishment” has been defined by the courts based on an ordinary man standard. See *North Side Laundry Co. v. Bd. Of Property Assessment, Appeals and Review*, 366 Pa. 636, 79 A.2d 419, 421 (1951). Courts have construed the additional term as expanding the exemption such that items which are taxed, and not exempted as manufacturing, in other contexts, may be exempted from real estate tax.

In *BFC Hardwoods, Inc. v. Bd. of Assessment Appeals, Crawford Cnty.*, 771 A.2d 759 (Pa. 2001), the Supreme Court held that a lumber drying business was an industrial establishment despite not being “manufacturing” for capital stock tax purposes. In BFC, the business property was comprised of office space, storage, undeveloped real estate and the kilns used to dry lumber. *Id.* at 765. The court characterized the entire parcel as making up the “industrial establishment.” *Id.* at 765. The court noted that the industrial establishment provision created a broader exclusion than under other forms of taxation.

Courts have applied the industrial establishment exemption in numerous contexts, which may or may not be exempt from other taxes under statutory “manufacturing” provisions.

- Various laundry machines were excludable as machinery and equipment used by a commercial laundry company that was an industrial establishment
- Television antenna was excludable as machinery because a television station was an industrial establishment

The industrial establishment provision, though broader than purely “manufacturing” activities, is not without limits.

- Communications towers have been held not to be part of an industrial establishment under the “ordinary man” test
- Nursery business was not an industrial establishment, but rather an agricultural establishment; therefore, a greenhouse was not excludable as equipment contained within it
- Warehouse used as storage facility was not an industrial establishment

## **Conclusion**

Production-based exclusions under Pennsylvania’s state and local tax laws can seem confusing and, at times cases may seem inconsistent. If your company is performing activities you think may qualify for an exemption which has not been claimed, please contact Jim Fritz at 717-237-5365 or [jfritz@mwn.com](mailto:jfritz@mwn.com), or another member of the McNees SALT group to discuss whether you should assert a claim to exemption (and possibly file a petition for refund).

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*Jim Fritz will be presenting on “Pennsylvania Production Exemptions” as part of a Pennsylvania Bar Institute program: “Pennsylvania Taxes – Update and Selected Topics” in Mechanicsburg (Monday, August 8th) and in Philadelphia (Tuesday, August 9th). The Philadelphia Session will be broadcast to several additional locations. He will be joined as a presenter by the Chair of the Pennsylvania Department of Revenue’s Board of Appeals, Lauren Zaccarelli, Esq., the*

*Secretary of the Board of Finance and Revenue, Jacqueline Cook, and Revenue Department  
Deputy Chief Counsel Jeff Snavelly. Further information is available at [www.pbi.org](http://www.pbi.org).*

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