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State Tax Treatment Of a 'Manufacturer'

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Many states have created special treatment for manufacturers, including tax exemptions, credits, and special income tax apportionment rules. In this edition of A Pinch of SALT, we explore the state tax treatment of manufacturers, including their relevance, definitions, and special treatment.

Introduction

Manufacturing has been woven into the fabric of our economy for centuries, although its predominance has diminished dramatically since the 1960s. In his 2012 State of the Union speech, President Obama discussed the need to "lay out a blueprint for an economy that is built to last" and said "this blueprint begins with American manufacturing." This renewed focus on manufacturing has put a spotlight on federal and state law, motivating policymakers to stimulate that sector of the U.S. economy.

Manufacturers generally require a significant amount of property in the state, employ numerous workers from all skill levels, and frequently purchase materials from local businesses. Providing incentives to manufacturers to relocate or remain in a state is especially attractive for obvious reasons, including an improved economic climate.

To attract new business investment and boost their economy, most states offer manufacturers a variety of tax incentives, including exemptions, credits, and special apportionment rules. For example, states offer credits to manufacturers to lure them into the state, while at the same time they can limit the period and amount of the benefit. Special income tax apportionment rules are also attractive for retaining businesses; however, setting a time limitation on those types of rules is challenging.[1]

Because the distinctions between manufacturing and other sectors are blurred in many cases, whether a particular taxpayer meets a state's definition of manufacturer and qualifies for that state's tax incentives is uncertain. The uncertainty is further highlighted by the difficulty of fitting today's digital goods and service economy into the traditional meaning of manufacturing.

Relevance of 'Manufacturing' for State Taxation Purposes

Categorizing a business activity as manufacturing is far from an exact science, and the determination often turns on the taxpayer's facts and circumstances. Only some states define manufacturing, and of those, many statutes are antiquated or the definitions are general and subject to interpretation.

Determining whether a taxpayer is a manufacturer or is engaged in manufacturing activities is critical to ensuring proper application of core tax

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[1]Oregon recently struggled with a related issue regarding Nike Inc.'s operation in the state. The popular shoe company requested that Oregon guarantee its single-sales-factor apportionment formula for the next 40 years in exchange for a promise to invest $150 million in the state over five years and create 500 jobs. *See* http://online.wsj.com/article/SB1000142 412788732429660457817777710769 45076.html. Oregon substantially agreed to Nike's request and passed a law that allows Nike to calculate its state taxes using a single-sales-factor apportionment formula for the next 30 years, regardless of future changes to state law, in exchange for Nike's promise to invest $150 million in the state over five years and create 500 jobs by 2016. *See* http://online.wsj.com/article/SB10001424127887323777204578189950366322648.html. The single-sales-factor apportionment formula is currently Oregon's standard formula (that is, it is not a special formula) and does not depend on whether the business is deemed engaged in manufacturing. Nike stated that it "would not consider making this capital investment in the State of Oregon but for the favorable economic development climate created by the State's use of the Single Sales Factor Method." *Id*.

provisions. The definition and scope of manufacturing is particularly significant in a handful of states, including Massachusetts and Rhode Island, that prescribe a different apportionment method for manufacturers. Manufacturer status could be either beneficial or burdensome depending on the facts and circumstances. For example, Massachusetts requires a manufacturing corporation to use a single-sales-factor apportionment formula.[2] Similarly, Rhode Island allows manufacturers to elect to double-weight the sales factor in place of the traditional three-factor formula.[3] Connecticut,[4] Kansas,[5] and Maryland[6] are examples of other states that provide a different apportionment method for manufacturers. Those apportionment formulas can prove to be beneficial in many circumstances because the manufacturer incurs no additional tax for locating in a jurisdiction. The manufacturer's apportionment formula is now weighted more heavily to the state based on its sales. The common notion is that manufacturing companies that have a large amount of property and payroll in state, and make most of their sales out of state, will benefit from those types of formulas.

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The definition of manufacturing is also important to taxpayers in determining eligibility for credits and incentives for property tax and income tax purposes. Eligibility for income tax credits is often determined by using different definitions than those for apportionment purposes. For example, South Carolina defines manufacturing in its income tax chapter for purposes of the job income tax credit and the renewable energy income tax credit; however, it does not define manufacturer for apportionment purposes.[7]

In the sales and use tax context, the definition of manufacturing is critical in deciding whether a taxpayer is eligible for a sales or use tax exemption. For example, most states provide a full or partial exemption for machinery and equipment used in manufacturing. However, each state has its own method of determining what activities constitute manufacturing. Thus, whether machinery or equipment is exempt under a given statute turns on the state's interpretation of the scope of manufacturing. For example, the Virginia tax commissioner recently determined that a taxpayer that sold packaging products did not qualify for Virginia's sales tax exemption for machinery, tools, or repair parts used in processing, manufacturing, or converting products for sale because the taxpayer did not have a manufacturing business classification under the North American Industry Classification System (NAICS) manual.[8] The tax commissioner found that although converting corrugated cardboard into self-locking boxes may be "processing," the taxpayer's primary business activity of selling packaging materials was not industrial in nature.[9]

Varying Definitions of Manufacturer or Manufacturing

The first hurdle in determining eligibility for a credit, an exemption, or an apportionment method is understanding how states define manufacturer or manufacturing for each particular tax type. Because of the lack of clarity, courts are often required to interpret the statutory definitions. Many courts have required manufacturers to have operations, processes, or activities that result in the production of a new and different article, product, or commodity.

For purposes of this article, we have grouped the statutory definitions into two general categories — those that provide a specific definition, and those that incorporate an NAICS code to determine whether one qualifies as a manufacturer. The statutes that provide a specific definition typically rely on ideas such as increased commercial value and tangible personal property, while others focus on change in form.

Massachusetts provides a specific definition for determining whether a taxpayer is a manufacturer for income tax apportionment purposes. A Massachusetts manufacturing corporation is a "corporation engaged in manufacturing."[10] To be considered as engaged in manufacturing, the corporation must be substantially engaged in transforming raw or finished physical materials by hand or machinery, and through human skill and knowledge, into a new product possessing a new name and nature, and

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[2]Mass. Gen. Laws ch. 63, section 38(*l*)(1).
[3]*See* R.I. Gen. Laws section 44-11-14.6.
[4]Conn. Gen. Stat. section 12-218(k).
[5]Kan. Stat. Ann. section 79-3279(b)(6).
[6]Md. Code Ann. Tax-Gen. section 10-402(c)(2); Md. Regs. Code section 03.04.03.10.
[7]*See* S.C. Code Ann. section 12-6-3360(L)(5); S.C. Code Ann. section 12-6-3588(B)(2).

[8]Virginia Public Document Ruling 12-119 (Va. Tax Comm'r July 25, 2012).
[9]*Id.*
[10]Mass. Gen. Laws ch. 63, section 38(*l*)(1).

adapted to a new use.[11] Illinois defines the manufacturing process for use tax purposes as "the production of an article of tangible personal property, whether the article is a finished product or an article for use in the process of manufacturing or assembling a different article of tangible personal property, by a procedure commonly regarded as manufacturing, processing, fabricating, or refining that changes some existing material into a material with a different form, use or name."[12] That statutory approach focuses on the concepts of tangible personal property and change in form.

Washington has adopted a similar definition for purposes of its business and occupation tax. Washington defines manufacturing as "all activities of a commercial or industrial nature [in which] labor or skill is applied, by hand or machinery, to materials so that . . . a new, different, or useful substance or article of tangible personal property is produced for sale or commercial or industrial use."[13] Change in form or a transformation process is evident in most, if not all, statutory definitions and is what one typically thinks of when referring to the manufacturing process.

New Mexico defines manufacturing as "combining or processing components or materials to increase their value for sale in the ordinary course of business" for purposes of qualifying for the manufacturing equipment investment credit.[14] New Mexico focuses on the increased commercial value. That concept is common among state statutes but seems to be less important than the requirement that there be a change in form and production of a new and different article.

States that look to a taxpayer's NAICS code, which is determined based on the taxpayer's primary activity, seek to apply industry standards to define manufacturing. There are three NAICS codes for manufacturing — sectors 31 through 33. The manufacturing sector as a whole "comprises establishments engaged in the mechanical, physical, or chemical transformation of materials, substances, or components into new products."[15] Under the NAICS, a wide variety of activities qualify as manufacturing. Plants, factories, or mills obviously qualify, but so do other types of establishments one may not typically consider to be manufacturing establishments, such as bakeries or custom tailors. Interestingly, the Office of Management and Budget, which publishes the NAICS definitions, acknowledges that "the boundaries of manufacturing and the other sectors of the classification system can be somewhat blurry."[16]

Rhode Island is an example of a state that incorporates the NAICS codes into its definition of manufacturing for income tax apportionment purposes. For that purpose, Rhode Island defines a manufacturer as a taxpayer whose principal business is described in sector 31, 32, or 33 of the NAICS as adopted by the OMB.[17] Similarly, Virginia refers to the manufacturing NAICS codes to determine whether a taxpayer is eligible for optional single-sales-factor income tax apportionment available only to manufacturers.[18] Virginia, however, also includes the agriculture, forestry, and fishing and hunting sector, sector 11, in its definition of manufacturing for that purpose. Georgia uses the NAICS codes in determining whether a taxpayer is eligible for the manufacturer's and telecommunications investment tax credit.[19] The statute defines manufacturing to include "those establishments classified by the [NAICS] Codes . . . that belong to Sectors 31-33."[20] Although not every state uses the same exact codes in its definition, there does seem to be a general consensus that sectors 31 through 33 should be included. Some states add codes that are deemed similar to the manufacturing codes.

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Although it appears that using NAICS codes could provide more certainty than using a statutory definition, the use of NAICS codes could be over- or underinclusive and result in outcomes unintended by state legislatures. Another potential problem with using NAICS codes is that the codes focus on the product and assigns the same code to all establishments related to those products regardless of whether manufacturing actually occurs at the establishment.

In some cases, a determination that a taxpayer is a manufacturer or engages in manufacturing activities does not end the analysis, even in states that statutorily define those terms. For example, in the

[11] Mass. Gen. Laws ch. 63, section 38(*l*)(2).

[12] 35 ILCS 105/3-50(1).

[13] Wash. Rev. Code section 82.04.120.

[14] N.M. Stat. Ann. section 7-9A-5.

[15] 2012 NAICS Definitions, sector 31-33 — Manufacturing, *available at* http://www.census.gov/eos/www/naics/index.html.

[16] *Id.*

[17] R.I. Gen. Laws section 44-11-14.6.

[18] Va. Code Ann. section 58.1-422(D).

[19] *See* Ga. Reg. section 560-7-8-.37.

[20] *Id.*

sales and use tax context, it may be necessary to determine which property used by the taxpayer would qualify for manufacturing machinery and equipment exemptions. Traditionally, machinery and equipment used in manufacturing qualifies for sales or use tax exemptions only if they have a direct and immediate effect on the physical transformation of raw material into new material.[21] Some states, however, use the "integrated plant theory" as a concept to broaden the scope of those exemptions to encompass all parts of an integrated manufacturing operation.[22] The integrated plant theory allows for additional machinery and equipment to qualify for sales or use tax exemption — including property used between manufacturing activities — as long as the property is integral or necessary to the manufacturing process, without regard to whether the machinery and equipment touch or act on the material or product. For instance, Virginia follows an integrated plant theory and statutorily defines manufacturing to include "the production line of the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished or completed for sale and conveyed to a warehouse at the production site."[23]

Problems With Special Manufacturing Treatment

In addition to the definitional issues, determining whether a taxpayer qualifies for special tax treatment offered to manufacturers becomes problematic when the taxpayer has mixed sales of services and tangible personal property. Some states look to the taxpayer's predominant business activity, but in many cases it is unclear how the predominant activity is to be determined (by sales, costs, profits, or gross revenue). Other states provide no clear guidance. That uncertainty or lack of guidance might create compliance challenges and also discourage in-state investment.

Other common problems with preferential treatment for manufacturers include defining manufacturer or manufacturing for one tax type (for example, income tax), but not another (for example, sales tax). State revenue departments and courts across the country have issued inconsistent opinions, some holding that the definitions of the terms in a different tax context (or a nontax context) should control the meaning of the terms in other tax contexts, and other courts finding to the contrary.[24]

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Similarly, courts and state tax agencies have struggled to apply those definitions to electric companies,[25] telecommunications companies,[26] and companies that provide electronic goods[27]; the results have been inconsistent. More recently, states have struggled in determining whether to include as manufacturers taxpayers that provide digital goods, services, and other intangibles. For example, the Washington attorney general has opined that providing customers with access to computer databases and Internet search engines does not constitute manufacturing for purposes of the rural county sales tax deferral program because doing so does not

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[21]*See, e.g.*, Colo. Rev. Stat. section 39-26-709(1)(a)(II); 6 Ind. Admin. Code section 6-2.5-5-3(b); N.J.S.A. section 54:32B-8.13.

[22]*See, e.g.*, Ga. Code Ann. section 48-8-3(34); Ark. Code Ann. section 26-52-402(c)(2)(A)(ii); Kan. Stat. Ann. section 79-3606(kk)(1)(A).

[23]23 Va. Admin. Code section 10-210-920(B)(2); Va. Code Ann. section 58.1-602. New York, Georgia, and Kansas are other states that have legislatively adopted the integrated plant theory.

[24]*See, e.g.*, S-D-176, S.C. Dep't of Revenue (Aug. 22, 1986) (declining to extend definition of manufacturer from other tax contexts when no definition existed for sales tax exemption purposes); *Turner Const. Co. v. Cantor*, 196 A.D. 213 (1st Dept. 1921) (holding that even though a corporation falls under the definition of a manufacturing corporation under the Bankruptcy Act, that does not dictate that the corporation is a manufacturer for purposes of the tax law); *Grant v. Zoning Hearing Board of the Township of Penn*, No. 2255 (Pa. Com. Pl. Westmoreland County July 24, 2000) (using the definition of manufacturing from a tax context in deciding a zoning ordinance issue despite recognizing that different considerations should be made).

[25]*See, e.g.*, *Public Serv. Co. v. Department of Revenue*, 2011 WL 4089971 (Colo. 2011); *United Illuminating Co. v. Groppo*, 601 A.2d 1005 (Conn. 1992).

[26]*See, e.g.*, *Southern Bell Tel. & Tel. Co. v. South Carolina Tax Comm'n*, 377 S.E.2d 358 (S.C. Ct. App. 1989); *Bell Atlantic Mobile Systems, Inc. v. Commonweath of Pennsylvania*, 799 A.2d 902 (Pa. Commw. Ct. 2002), *aff'd per curiam*, 845 A.2d 762 (2004).

[27]*Compare Random House, Inc. v. Comm'r of Revenue*, Docket no. C303502, Mass. Appellate Tax Bd. (Oct. 2, 2012) (holding that a book publisher using electronic processes was a manufacturing corporation for apportionment purposes), *and* Tex. Policy Letter Ruling 200808142L (Aug. 15, 2008) (ruling that a software developer qualified as a manufacturer), *with Schawk, Inc. v. Zehnder*, 326 Ill. App. 3d 752 (1st Dist. 2001) (finding that a graphic arts company that was in the business of providing digital imaging prepress services for the consumer products industry was not a manufacturer for purposes of the investment tax credit, but was instead a service business).

involve any production of tangible personal property.[28] The Pennsylvania Supreme Court has held that a provider of cellular telephone service is not a manufacturer entitled to an exemption from sales tax, because the provider did not change tangible personal property from its original composition into a different form or product.[29]

In contrast, the Missouri Supreme Court has found that a telephone company's purchases of machinery and equipment were exempt from use tax because they were used directly in manufacturing basic and vertical telephone services.[30] Recently, the Massachusetts Appellate Tax Board determined that a book publisher — even though it used electronic processes — was a manufacturing corporation for apportionment purposes because the processes had a substantial and physical effect on the final tangible product produced, and the publisher retained control over the exact specifications of the final product.[31] Those differing opinions illustrate the need for states to fix their outdated tax provisions to reflect today's information-based service economy and provide more certainty for taxpayers.

Conclusion

Many states have developed a complex set of tax incentives for manufacturers in their effort to attract new business to the state and stimulate their economy. Yet in today's ever-evolving economic landscape, it is not always clear what the terms "manufacturer" and "manufacturing" encompass. Thus, it is important for states to provide guidance to taxpayers other than traditional manufacturers. ✰

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[28]Wash. AGO 2007 No. 8, Nov. 21, 2007.

[29]*Bell Atlantic Mobile Systems, Inc. v. Com.*, 799 A.2d 902 (Pa. Commw. Ct. 2002), *aff'd per curiam,* 845 A.2d 762 (Pa. 2004). After *Bell Atlantic* was decided, Pennsylvania updated its statute to provide that production of mobile telecommunications services qualified as processing. Thus, cellular telephone providers are now entitled to a sales tax exemption on purchases of tangible personal property used in the provision and production of mobile telecommunications services. *See* 72 Pa. Stat. section 7201(k)(8)(D); 72 Pa. Stat. section 7201(d)(17).

[30]*Southwestern Bell Tel. Co. v. Dir. of Revenue*, 182 S.W.3d 226 (Mo. 2005).

[31]*Random House, Inc. v. Comm'r of Revenue*, Docket no. C303502, Mass. Appellate Tax Bd. (Oct. 2, 2012).