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LEGISLATION

THE MANUFACTURER'S EXEMPTION IN THE PENNSYLVANIA SALES AND USE TAX

The new Pennsylvania sales and use tax imposes a tax upon each separate sale at retail within the Commonwealth.¹ The Acts in defining a sale at retail provide an exemption for manufacturers in two categories of purchases of personal property, those items becoming an ingredient or component part of the manufactured item and those consumed in the process of manufacture.

Giving a precise meaning to exemptions similar to these in other states has been a complicated task. Tax administrators in their efforts to draw a precise line between exempt and non-exempt purchases of tangible personal property have issued voluminous regulations which have been followed by much litigation in the courts. Often the decisions and regulations have been contradictory. Therefore in an effort to make an accurate interpretation of the Pennsylvania statutory wording the first step will be to speculate as to the probable motives of our legislature in providing an exemption for our manufacturers. If this can be established, the problem of giving an interpretation to the statute effectuating these motives will be much simpler.

The first probable motive to be considered is that of avoiding multiple taxation. Tax pyramiding occurs when a consumer's article is taxed, not only when passing to the consumer in a retail sale, but also at one or more of the various stages in its production and distribution. The total tax paid by the consumer in such a case consists of the amount of taxes already imposed on the manufacturer of the article as reflected in its total cost of production and concealed in the selling price plus the tax paid at the time of the purchase of the article by the consumer at the retail sale.

A second probable motive for providing a manufacturer's exemption is the desire not to put domestic manufacturers at a competitive disadvantage with out-of-state manufacturers. If the out-of-state manufacturer pays no taxes on the items becoming a component part and used in the process of manufacturing the article, his cost of manufacture will naturally be lower than that of the manufacturer paying the tax. By creating this exemption, the legislature is quite possibly seeking to avoid this undesirable result.

¹ "The term 'sale at retail' does not include:

(o) Sales of tangible personal property (i) which is to be used in fabricating, compounding or manufacturing tangible personal property or in producing public utility service to be sold ultimately at retail, or (ii) which is to be used in the process of farming, agriculture or horticulture and which in either event becomes an ingredient or component part of the fabricated, compounded or manufactured tangible personal property or public utility product or of the product of farming, agriculture or horticulture, or is consumed in the process of fabrication, compounding, manufacturing or producing or in the process of farming, agriculture or horticulture, or (iii) which is to be used in the production or delivery of public utility service."

—Consumers Sales Tax Act, Act No. 86, Laws of 1953, as amended, 72 P. S.; C.C.H. Pa. Tax Reports ¶ 97-260.

A third possibility would be a desire on the part of the legislature to define a retail sale in a manner consistent with the economic theory that a retail sale is one to a consumer who enjoys and derives utility from the use or possession of that which he acquires and does not employ it in a business or occupation.

Fourth and finally is the possibility that the legislature simply copied the practice of other states in including a manufacturer's exemption without giving consideration to the reasons for creating such exemptions.

The first three motives considered above are logically legitimate and theoretically interrelated. Careful consideration will reveal that in order to give effect to any one of these motives *all* tangible personal property purchased by manufacturers would be exempt from a retail sales tax.

However, other states with similar exemptions have not exempted all items of tangible personal property used by manufacturers from the tax. In Ohio and Michigan the statutory wording creating the manufacturer's exemption for their sales tax is similar to the Pennsylvania statute. The Ohio statute provides for exemption of purchases of tangible personal property where the purpose of the consumer is ". . . to incorporate the thing transferred as a material or part into tangible personal property . . . , or to use or consume the thing transferred directly in the production of tangible personal property . . ." ² The Michigan statute exempts from the tax sales of tangible personal property ". . . to persons for the use or consumption in industrial processing: Provided, that the term 'industrial processing' shall not be deemed to include tangible personal property permanently affixed and becoming a structural part of the real estate." ³ Note the similarity of these exemptions to the wording of the Pennsylvania statute exempting those items of tangible personal property that ". . . becomes an ingredient or component part of the fabricated, compounded or manufactured tangible personal property . . . , or is consumed in the process of fabrication, compounding, manufacturing . . ." In all three statutes two general classes of exemption are created, one for tangible personal property that becomes a physical ingredient of the end product and one for tangible personal property which is used or consumed in the manufacturing process. The latter classification of property used or consumed in the manufacturing process has been subdivided into property that is consumed and that which is merely used. Property is classified as consumed if its normal life and usefulness is less than one year or if it is deductible as a necessary business expense for federal income tax purposes. Property which has a life longer than one year and is capitalized for federal income tax purposes is placed in the used category. Both types of property are eventually consumed or used up in the sense that they are ultimately rendered valueless by depreciation, the only difference being in the amount of time for this process to take place. However, many states (Pennsyl-

² Retail Sales Tax, Amend. House Bill No. 438, Laws of 1953, C.C.H. All State Sales Tax Reporter, v. 2, ¶ 60-301.

³ Occupational Retail Sales Tax, ch. 205, Act 167 of 1933, Compiled Laws of Michigan, 1948 as amended. Section 205.54a as amended by Act 272, Laws 1949, C.C.H., *Ibid.*, ¶ 44-042.

vania included) exempt from their sales taxes only that tangible personal property in the consumed category. Other states allow exemptions for property in both the consumed and the used category if the consumption or use takes place in the manufacturing process. For the purpose of this discussion both will be considered as the one classification of property used or consumed in the manufacturing process.

Much effort has been expended by tax administrators in Michigan and Ohio and other states in interpreting and giving effect to these exemptions. Such phrases as "consume", "component part", "industrial processing", "consumed directly in industrial processing", have been carefully analyzed and usually have been interpreted very literally in the regulations promulgated to give effect to the statutes. For example, in Ohio the regulations provide some of the following exemptions:

1. Actual production machinery which acts upon the raw material or component undergoing transformation into the completed product.
2. Maintenance tools and equipment used to maintain productivity of production machinery.
3. Materials handling equipment and transportation devices used to transport goods in production from the first production steps through the packaging of the finished product. (Sales or purchases of equipment which transports raw material to the place of processing but which transports the completed article after production has ceased, or, which disposes of scrap or waste materials are subject to the tax.)"⁴

The Michigan regulations follow in the same vein although possibly the exemption is less broad than in Ohio. After exempting items becoming an ingredient or component part the Michigan rules exclude ". . . the specific machinery and processing equipment which is exclusively designed and made for and specifically used in the manufacturing of a product to be sold at retail . . ."⁵

The criteria underlying the exemptions for those items becoming a component part of the end product is often described as the physical ingredient rule. The rationale behind this rule is self explanatory, i.e. anything becoming a physical ingredient of the product being manufactured becomes exempt. However, it was much more difficult for the tax administrators to develop a rule of thumb on which to base decisions classifying an article within or without the exemption of items used or consumed directly in the industrial process. Apparently the criteria for exempting such an item is the physical proximity of the item to the article being produced coupled with proximity in time to the period when the article to be produced is actually undergoing some sort of physical alteration or transformation. Thus, as was seen in the Ohio regulation, materials handling equipment used to move the raw material about during the time that the material was "in production" was exempt. If used, however, when the raw material was being transported to the place of "production", it would not be exempt.

⁴ Rule 39, C.C.H., *Ibid.*, ¶ 60-539.

⁵ Regulation 8, C.C.H., *Ibid.*, ¶ 44-508.

The rules promulgated and distinctions drawn by the tax administrators are all done in an effort to give effect to the legislative intent as revealed in the statutory language creating the exceptions. The courts have backed up the interpretation of the statute as reflected in these rules and regulations. But the important question arises, do the criteria adopted by the administrators and approved by the courts give effect to the motives which originally prompted the legislature to create the manufacturer's exemption? More precisely do the criteria of the physical ingredients rule and the proximity, physically and in point of time, of an item to the production of an article have a direct bearing on the desire to avoid multiple taxation and to avoid putting domestic manufacturers at a competitive disadvantage with out-of-state producers?

Many states have only the one portion of the exemption excluding items becoming a component part of the end product from the sales tax. Such items are not considered a sale at retail for they will be sold again in the same or altered form when the sale of the manufactured item occurs. The physical ingredients rule is the usual criteria for effecting this exemption. Doubtlessly the adoption of this exemption does prevent multiple taxation on the materials exempted. But the manufacturer still pays taxes on all the other items of tangible personal property consumed by him. The purpose of his total operation is to produce an article of tangible personal property. Many of the costs incurred in this total effort consist of purchases of tangible personal property which do not become an ingredient in the end product. In fact the cost of the material exempt under the physical ingredients rule may be a small and even insignificant part of the total cost of the manufactured article. If all the other items of tangible personal property are taxed, cost of production will increase accordingly, necessitating a higher price to the consumer (assuming that the manufacturer will not want to take a reduction in his profit). By paying this higher price multiple taxation will still continue to occur. The exemption will only suffice to prevent multiple taxation to the amount of the fraction of the cost of the ingredients to the total cost of all tangible personal property used by the manufacturer times the total amount of tax that would be paid without any exemption.

The physical ingredients rule is also ineffective to prevent the placing of domestic manufacturers at a competitive disadvantage to out-of-state manufacturers. A sales tax creates a competitive disadvantage because it raises the cost of production. Exempting the cost of the physical ingredients of the end product is only a partial measure. The manufacturer must still buy machinery, stationery, adding machines and thousands of other articles of personal property not coming under the classification covered by the physical ingredients rule. A tax on these items raises his cost of production, and the exemption provides only partial relief, especially if the article produced contains raw material of little value and requires a large capital investment necessitated by complicated machining or intricate manufacturing processes.

The additional exemption provided in Pennsylvania and several other states for those items of tangible personal property used or consumed in the process of manufacture can be explained as a recognition on the part of the legislatures of the incompleteness of the component part exemption to further the desired motives considered above. However, the effectiveness of this exemption to correct the inadequacy of the component part exemption has been vitiated by the very narrow interpretation of the statutory wording excluding from the tax those items of tangible personal property used or consumed in the process of manufacture. Using this restrictive literal interpretation the machine toolcutting and shaping the manufactured article is exempt, but the paper consumed in the accounting department is not exempt. The creation of manufactured personal property is impossible without both. The use of the tool and the paper are equally essential steps in the manufacturing process and contribute to the total cost, yet the tool is exempt and the paper is not. Are not both consumed in the process of manufacturing? A manufacturer by definition is engaged in manufacturing. If the paper consumed in the accounting department of a manufacturer is not consumed in the process of manufacturing, in what process is it consumed? To answer that the paper is used in the accounting process is to beg the question. The accounting process is merely a portion of the whole operation by a manufacturer who is manufacturing.

The narrow interpretation of the exemption for goods consumed in the process of manufacture is understandable and logical if the interpretation is based strictly on the words alone and not considered in the light of the purpose for which the exemption was created. Thus the word "manufacturing" in the popular sense of the word immediately raises visions of large rooms filled with clanking machinery; and the tax administrators have reflected this idea by such rules which exempt power wires used inside a factory, but not those leading into the building where the "manufacturing" is taking place.

In summary, the very presence of the exemption of personal property used or consumed in the process of manufacturing is a concession to the inadequacy of the physical ingredients exemption. That exemption did not avoid multiple taxation or cure the higher costs of production of the domestic manufacturers. Adding this second exemption does rectify the error if given a liberal interpretation consistent with well established economic cost theories. As it has been interpreted in the past, however, it fails to accomplish the desired result.

In clarifying and giving effect to the manufacturer's exemption in Pennsylvania, the Division of Sales and Use Tax of the Department of Internal Revenue has followed suit with other states by giving a strict interpretation to the statutory wording. In the regulations manufacturing has been defined as ". . . the working of raw materials or partially finished goods into products of a different character . . ."⁶ From this definition a logical division has been made between the adminis-

⁶ Commonwealth of Pennsylvania Sales and Use Tax Regulations. Effective Sept. 1, 1953. Regulation 262.

trative and non-manufacturing departments and the manufacturing departments of a manufacturing concern. The exemption from the sales tax does not apply to any articles used or consumed in any of the enumerated administrative and non-manufacturing departments. In view of the statutory language this type of interpretation and implementation of the manufacturer's exemption was the only course open to our tax administrators. It is consistent with rulings of other state tax administrators working with similar exemptions couched in similar statutory language, and these interpretations have been sanctioned by the courts.

Perhaps only partial relief was intended by the legislature when they included the manufacturer's exemption. However, it is unlikely that the legislature would purposely adopt a half-way measure. Assuming that the object of the exemption was to avoid multiple taxation and to avoid placing domestic manufacturers at a competitive disadvantage, the legislature should have used language making these objectives possible. The simplest path would have been to exempt *all* purchases of tangible personal property by manufacturers. This course would have achieved the desired result and would have avoided the vexing and insoluble problem of trying to determine precisely which of the millions of articles used by manufacturers are to come under the exemption. The loss in revenue (estimated to be between from three to twelve per cent)⁷ would be more than compensated for by the savings in administrative and litigation expenses to say nothing of the general absence of headaches for buyers and sellers throughout the state. As the statutory language stands, the tax administrators can do little more than make as clear as possible the artificial distinction between goods consumed in the process of manufacture and those not so consumed and await the inevitable flood of inquiries and suits from an understandably confused and irritated Pennsylvania industry.

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⁷ Jacoby, Neil H., "Retail Sales Taxation", C.C.H. (1938), p. 136.