

## **PA Tax Tips - Sales & Use Tax Exclusions for Manufacturing, Fabricating, Compounding, Processing and “Other Operations”**

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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. This article focuses on a more detailed discussion of the activities qualifying under the Pennsylvania Sales & Use Tax exclusions for Manufacturing, Fabricating, Compounding, Processing and “Other Operations.”

The Tax Reform Code provides a specific listing of activities qualifying as “processing” and a general definition for “manufacture.”

### **Specifically Defined “Processing”**

The Legislature has defined “processing” to include a number of somewhat narrowly proscribed activities, many of which were added after tax auditors challenged their qualification under “manufacturing” or other more broadly-defined exclusions. These activities include the Cooking, Baking or Freezing of Fruits, Vegetables, Mushrooms, Fish, Seafood, Meats, Poultry or Bakery Products and packaging for wholesale distribution; the Electroplating, Galvanizing, Enameling, Anodizing, Coloring, Finishing, Impregnating or Heat Treating of Metals or Plastics; the Production, Processing and Bottling of Non-alcoholic beverages for wholesale distribution; and twenty additional categories of activities which are listed in the January article.

### **Specifically Deemed “Manufacture”**

The statute provides that “manufacture” shall include, but not be limited to, specific activities, including publishing, printing, mining, quarrying, research and several other activities also listed in the January article.

### **Specifically Deemed Not to be “Manufacture”**

The statute also specifically indicates that “manufacture” shall not include: constructing, altering, servicing, repairing or improving real estate; repairing, servicing or installing tangible personal property; producing a commercial motion picture; and the cooking, freezing or baking of fruits, vegetables, mushrooms, fish, seafood, meats, poultry or bakery products.

## General Definition of “Manufacture”

For everyone conducting activities not specifically listed as exempt or taxable, the statute provides the following general definition of “manufacture:”

The performance of manufacturing, fabricating, compounding, processing or other operations, engaged in as a business, which place any tangible personal property in a form, composition or character different from that in which it is acquired whether for sale or use by the manufacturer...

72 P.S. § 7201(c).

## Manufacturing

The term “manufacturing” has been used as a basis for exemption in a number of other tax statutes. Since the term was not defined in those statutes, the courts developed various expressions of the meaning of the term. Generally, the courts have defined the term narrowly. As discussed below, the sales and use tax definition of “manufacture,” on the whole, provides a significantly broader result. However, it is important to remember that any activity which has already been determined to qualify as “manufacturing” under other taxes will automatically qualify as “manufacture” for sales and use tax purposes.

Following are some examples of activities held to constitute “manufacturing” under taxes other than the Sales & Use Tax:

- Producing asphalt
- Making cabinets
- Candy production
- Ready-mixing concrete
- Sewing garments (but not just embroidering garments)
- Producing coke or gas from coal
- Making skim milk or buttermilk powder, sour cream, butter, cottage cheese or ice cream
- Tanning animal skins
- Producing iron from iron ore

- Refining crude oil
- Making potato chips
- Building new engines
- Shoemaking
- Producing snow from water and compressed air

### **Fabricating**

The term “fabricating” is not defined in the sales and use tax statute or in the related Revenue Department regulations. An early sales and use tax case looked to the following dictionary definition:

To form into a whole by uniting parts; to frame; construct; build, as, to fabricate a bridge or ship; to fabricate a book, specif.: To make, shape, or prepare (a part of anything, as of a ship, bridge, automobile, etc.) according to standardized specifications, so as to be interchangeable. To construct or build up into a whole by uniting interchangeable or standardized parts, often made elsewhere; as, a fabricated ship, automobile, or the like. To form by art and labor; to manufacture; produce.

*Commonwealth v. Donovan*, 76 Dauph. 191 (1960).

The court noted several activities, previously treated as “manufacturing,” that could also be considered “fabricating:”

- Manufacturing of steam engines
- Making of aluminum awnings
- Making of gummed paper
- Making of barrels from staves, hoops and nails
- Printing and publishing of books and periodicals

In a letter ruling, the Department of Revenue characterized the cutting and pre-drilling of components and the pre-assembly of cabinetry as “fabrication” activities. Similarly, a taxpayer making various building and pole signs was referred to as a fabricator in another ruling.

As will be discussed below, the sales and use tax exclusion for “manufacture” requires only a change in “form, composition or character,” which would seem to encompass many “fabricating” activities.

## **Compounding**

Few Pennsylvania cases discuss the terms “compound” or “compounding” in a taxation context. An early case looked to a definition in Webster’s New International Dictionary, defining “compound” as:

To put together, as elements, ingredients, or parts, to form a whole; to combine; unite. To form or make up, as a composite product, by combining different elements, ingredients; or parts; as, to compound a medicine. ... To compose; to constitute.

*Commonwealth v. Donovan Co.*

In addition to the compounding of a medicine, the court noted that the making of concrete from cement, sand and crushed stone and the making of asphalt floors could be considered “compounding,” noting that such activities had previously been exempted under other taxes as “manufacturing.” The court considered the following activities, previously held to constitute “manufacturing” to “more properly” fall within the bounds of “processing” or “compounding:”

- Production of artificial gas
- Refining of crude petroleum and producing lubricating and illuminating oils
- Making condiments, drugs and dyes
- Brewing of malt liquors
- Making soft drink syrup and flavoring extracts
- Production of coke from Coal
- Producing wood alcohol, charcoal, tar and acetate of lime by burning cordwood in retorts
- Making butter and cheese
- Production of artificial gas for illumination
- Production of peanut butter

- Making potato chips
- Making gasoline
- Making ice cream, cottage cheese and butter

## Processing

One of the more confusing aspects of Pennsylvania's current sales and use tax statute is that it provides separate exclusions for tangible personal property used in "manufacture" and for that used in "processing," then defines "manufacture" to include "processing." The key is that the separate exclusion for "processing" is qualified by reference to the list of specific activities in the definition of that term set out in the statute (see discussion above). The term "processing" as used in the definition of "manufacture" includes no such qualification. The term "processing" as used in defining "manufacture," therefore, refers to the common meaning of the term.

The sales and use tax authorities speaking to the common meaning of "processing" are somewhat limited. As discussed above under "compounding," the Dauphin County Court of Common Pleas' 1960 decision in the Donovan case lists a number of activities that may have been characterized as "processing" or "compounding," but does not make clear which would be the more descriptive term. In *Commonwealth v. C.F. Manbeck, Inc.*, 45 Pa. D. & C.2d 549 (Dauph. Co. C.P. 1967) the court treated the taxpayer as a "processor" and described the company as being "engaged in the business of preparing, processing and packaging frozen poultry in sealed containers for wholesale distribution."

A better understanding of the common meaning of "processing" may be gained from an examination of the following activities which were denied the "manufacturing" exemption under other taxes but would seem to qualify as "processing:"

- Pasteurization of milk and the production of condensed and evaporated milks were merely "processing" – use of large, expensive machinery notwithstanding
- Production of smoked hams, pickled and dry pork
- Cleaning, drying, pickling, salting, smoking, boiling and baking of meat
- Milling of grain and spinning of cotton
- Extracting usable iron from steel plant slag

- Processing of unfinished cloth by dyeing, autoclaving, bulking, adjusting stretch, curing, flame retarding, heat setting, mildew proofing, imparting permanent press, water repellence and dimensional stability, and changing terry cloth to velour
- Preparation of foods by process of cutting, chopping or dicing and then blending
- Production of fruit juice, fruit drinks and iced tea by process of adding water and sucrose to a fruit juice slurry or to a powdered mix
- Cutting, pressing and folding cloth

### **“Other Operations”**

In *Commonwealth v. Sitkin's Junk Co.*, 412 Pa. 132, 194 A.2d 199 (1963), the Pennsylvania Supreme Court established beyond question that the sales and use tax exclusion for “manufacture” would be given a much broader meaning than had been given the “manufacturing” exemptions under the Capital Stock Tax and other taxes.

Sitkin purchased mixed and unsorted scrap metal. Utilizing certain machinery and equipment, Sitkin removed unusable portions and sorted the scrap. Sitkin then sometimes cut the scrap into “convenient lengths” and sometimes baled the scrap. Through Sitkin’s actions, the scrap was made useful in the production of steel and Sitkin sold it to various steel mills.

Prior to this decision, the lower court had interpreted the sales and use tax exclusion for “manufacture” to have the same basic meaning as the “manufacturing” exemptions from Capital Stock, Franchise and local mercantile taxes – requiring the production of a “new and different product.” Taking this approach, the Dauphin County Court of Common Pleas had held that Sitkin did not produce a new product. However, on review, the Pennsylvania Supreme Court noted:

By specifically defining ‘manufacture,’ the legislature indicated its intent that ‘manufacture’ be construed in accordance with the statutory language and that the construction of such word was not to be controlled by prior judicial construction of such word under prior tax statutes. By way of example, the Act provides that the finished product had to be ‘different’ from that form in which it was acquired whereas under prior judicial construction the finished product had to be both ‘new and different.’

Analyzing the statutory definition, the Court noted that, to satisfy the definition of “manufacture,” an activity must be a type of activity described in the definition, and must produce a result specified in the definition. Under the statute, the activity must be Manufacturing, Fabricating, Compounding, Processing, or “Other Operations.” Based on principles of statutory construction, the Court interpreted legislative intent to require

“other operations” to “include and embrace other types of activities not covered by the words ‘manufacturing, fabricating, compounding, processing.’” The court then cited a dictionary definition indicating that “[a]n ‘operation’ is an ‘action’ or ‘activity’ and is the ‘action of making or producing something.’”

Applying this broad definition of “other operations,” the Court held that Sitkin’s activities qualified.

### **Transformation of Form, Composition or Character**

The statutory definition further requires that the activity place tangible personal property “in a form, composition or character different from that in which it is acquired whether for sale or use by the manufacturer ....” 72 P.S. § 7201(c). In *Sitkin’s*, the Court did not dwell on the specifics of “form,” “composition” or “character” but ruled more generally that all three “change standards” of the statute were satisfied:

The court below took the position that the scrap subjected to the taxpayers’ activities remained scrap even when such activities had been completed. That may well be. However, such scrap, after and as a result of the handling and activities of the taxpayers, was in ‘a form, composition and character’ different from that scrap which had been acquired by the taxpayers. Posed in another fashion, would the Commonwealth assert that a farmer who purchased machinery to drain marsh land was subject to tax on such machinery because, after its operation upon the land, land remained where there was land before and that it was not, therefore, used directly in a farming operation? We think not. In the one case there is a different category of land while in the case at bar there is a different category of scrap; as a result of both operations that which was useless has been rendered useful and, in each instance, something different has been produced.

The key takeaway from this statement is that the change need not rise to the level of something “new” – it is sufficient if there has been some lesser degree of change. Subsequent cases have addressed the required change somewhat more specifically.

In *Commonwealth v. Air Products and Chemicals, Inc.*, 475 Pa. 318, 380 A.2d 741 (1977), the Pennsylvania Supreme Court ruled that conversion of a liquefied gas into a gasified state was a sufficient change in “form, composition or character.”

In *Commonwealth v. Goodyear Tire and Rubber Co.*, 88 Dauph. 301 (1967), the court concluded that the retreading of a tire did not produce a change in form or character, however, the vulcanization of the “green tread” attached to the worn tire carcass produced chemical and physical changes which constituted a change in “composition” as specified in the statute. The court cited a dictionary definition stating that:

Composition is the ‘formation of a whole particular arrangement or combination of parts of a unit or whole.’

However, the Commonwealth Court’s decision in *Marweg v. Commonwealth*, 513 A.2d 525 (1986), holding the production of ice not to qualify as “manufacture,” suggests that if the change is easily produced the activity may not qualify.

After *Sitkin* and its progeny, the key to qualifying for the sales and use tax exclusion for manufacture appears to depend, first, on establishing that the activity rises at least to the level of an “other operation” – a relatively low hurdle. Second, it must be shown that the result of the activity is somehow “different” in form, composition or character but the change is not so slight or so easily produced as to be viewed as superficial.

The terms “manufacturing,” “fabricating,” “compounding” and “processing” all seem more demanding than “other operations.” As a result, those terms probably add value primarily by suggesting that any activity previously characterized by one of these terms should likely qualify for exclusion from sales and use tax.

### **Examples of “Manufacture”**

Following are examples of activities which have been treated as “manufacture” for sales and use tax purposes:

- Conversion of liquid to gas
- Use of cameras, film, and other equipment to produce custom portraits
- Making pizzas
- Retreading tires (including vulcanization)
- Production of Electricity; Production of Electricity using landfill gas, natural gas, or solar panels
- Producing skin lotions and moisturizers by combining raw materials such as cocoa butter or mineral oil, heating, agitating and homogenizing
- Producing canned (not custom) software
- Spot welding steel and plating to produce metal shelving

Following are examples of activities denied exclusion for “manufacture” under the sales and use tax statute:

- Internet Service Provider's conversion of electronic signals.
- Making ice on a commercial basis
- Printing customer invoices which did not consist of "substantially similar matter"

If your company is engaged in activities seemingly like those described above as qualifying for exemption, but you have not been claiming exemption on services, materials, equipment and supplies used in those activities, we would be happy to help you determine whether you should begin claiming exemption and whether you may have potential refund claims!

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