ARC 4218C

REVENUE DEPARTMENT[701]

Adopted and Filed

Rule making related to exemptions primarily benefiting manufacturers and other persons engaged in processing

The Revenue Department hereby amends Chapter 211, "Definitions," and Chapter 230, "Exemptions Primarily Benefiting Manufacturers and Other Persons Engaged in Processing," Iowa Administrative Code.

Legal Authority for Rule Making

This rule making is adopted under the authority provided in Iowa Code section 421.17.

State or Federal Law Implemented

This rule making implements, in whole or in part, Iowa Code section 423.3 as amended by 2018 Iowa Acts, Senate File 2417.

Purpose and Summary

This rule making implements the changes to Iowa Code section 423.3(47)"d" as amended by 2018 Iowa Acts, Senate File 2417.

Iowa Code section 423.3(47) provides a sales tax exemption for the "sales price from the sale or rental of computers, machinery, equipment, replacement parts, supplies, and materials used to construct or self-construct computers, machinery, equipment, replacement parts, and supplies" if those items are, in relevant part, "directly and primarily used in processing by a manufacturer." Senate File 2417 modified definitions of "manufacturer" and "manufacturing." This rule making amends the Department's rules implementing that provision to reflect the changes in Senate File 2417, which went into effect on May 30, 2018.

Public Comment and Changes to Rule Making

Notice of Intended Action for this rule making was published in the Iowa Administrative Bulletin on November 7, 2018, as **ARC 4109C**. A public hearing was held on November 27, 2018, at 9 a.m. in the auditorium of the Wallace State Office Building, Des Moines, Iowa.

Six people attended the public hearing. Comments were received from representatives of the Iowa Association of Business and Industry (ABI) and the Iowa Taxpayers Association (ITA). The comments addressed the same issues: the exclusion of a person engaged in construction contracting from qualifying as a manufacturer, and the inclusion of a list of factors a manufacturer can use to rebut the presumption that a manufacturer's premises is primarily used to make retail sales according to the calculation set forth in the rule.

The Department received written comments from ABI and ITA mirroring the comments made at the public hearing. The Department also received written comments from LifeServe Blood Center, which voiced concern with the statutory change in 2018 Iowa Acts, Senate File 2417, excluding nonprofit organizations from qualifying as manufacturers.

The Department made four changes from the Notice in response to comments. The Department did not adopt the example proposed under the "manufacturer" subrule. The Department added some language to subparagraph 230.15(5)"c"(2) to clarify that the determination that a manufacturer's premises is primarily used to make retail sales is a presumption. The Department added subparagraph 230.15(5)"c"(3) to provide a nonexclusive list of factors manufacturers may use to rebut that presumption. The Department also added an example in subrule 230.15(5) illustrating how a manufacturer may use the factors to rebut the presumption.

In addition, references to 2018 Iowa Acts, Senate File 2417, have been removed since the amendments in the Senate File have been codified in the 2019 Iowa Code.

Adoption of Rule Making

This rule making was adopted by the Department on December 12, 2018.

Fiscal Impact

This rule making has no fiscal impact beyond the legislation it implements. According to the Legislative Services Agency's fiscal estimate for Senate File 2417, the Iowa Code changes implemented by this proposed rule making will increase General Fund revenues by $13.8 million in FY 2019, $13.9 million in FY 2020, $14.4 million in FY 2021, $14.9 million in FY 2022, $15.5 million in FY 2023, and $16.1 million in FY 2024.

Jobs Impact

After analysis and review of this rule making, no impact on jobs has been found.

Waivers

Any person who believes that the application of the discretionary provisions of this rule making would result in hardship or injustice to that person may petition the Department for a waiver of the discretionary provisions, if any, pursuant to rule 701—7.28(17A).

Review by Administrative Rules Review Committee

The Administrative Rules Review Committee, a bipartisan legislative committee which oversees rule making by executive branch agencies, may, on its own motion or on written request by any individual or group, review this rule making at its regular monthly meeting or at a special meeting. The Committee's meetings are open to the public, and interested persons may be heard as provided in Iowa Code section 17A.8(6).

Effective Date

This rule making will become effective on February 6, 2019.

The following rule-making actions are adopted:

ITEM 1. Amend rule **701—211.1(423)**, definition of "Manufacturer," as follows:

"Manufacturer" means ~~any person, firm, or corporation that purchases, receives, or holds personal property for the purpose of adding to its value by any process of manufacturing, refining, purifying, or combining of different materials or by packing of meats with an intent to sell at a gain or profit~~ the same as defined in Iowa Code section 423.3(47).

ITEM 2. Rescind and reserve subrule **230.2(1)**.

ITEM 3. Rescind subrule 230.15(4) and adopt the following **new** subrule in lieu thereof:

230.15(4) *Manufacturer.*

a. Generally. Iowa Code section 423.3(47)*"d"*(4) abrogates *The Sherwin-Williams Company v. Iowa Department of Revenue*, 789 N.W.2d 417 (Iowa 2010).

b. Definitions.

"Construction contracting" means engaging in or performing a construction contract as defined in rule 701—219.8(423).

"Manufacturer" means the same as defined in Iowa Code section 423.3(47).

"Transporting for hire" means the service of moving persons or property for consideration, including but not limited to the use of a "personal transportation service" as that term is described in Iowa Code section 423.2(6) and rule 701—26.80(422,423).

ITEM 4. Renumber subrule **230.15(5)** as **230.15(6)**.

ITEM 5. Adopt the following **new** subrule 230.15(5):

230.15(5) *Manufacturing.*

a. Activities commonly understood to be manufacturing. "Manufacturing" means the same as defined in Iowa Code section 423.3(47).

b. Premises primarily used to make retail sales.

(1) A person engaged in activities on a premises primarily used to make retail sales is not engaged in manufacturing at that premises and cannot claim this exemption for items used at that premises.

(2) The following are "premises primarily used to make retail sales":

1. Restaurants.
2. Mobile food vendors, vehicles, trailers, and other facilities used for retail sales.
3. Retail bakeries.
4. Prepared food retailers establishments.
5. Bars and taverns.
6. Racing and gaming establishments.
7. Racetracks.
8. Casinos.
9. Gas stations.
10. Convenience stores.
11. Hardware and home improvement stores.
12. Grocery stores.
13. Paint or paint supply stores.
14. Floral shops.
15. Other retail stores.

c. Rebuttable presumption. In addition to the premises listed in paragraph 230.15(5)*"b,"* a premises shall be presumed to be "primarily used to make retail sales" when more than 50 percent of the gross sales of a business and its affiliates attributable to the premises are retail sales sourced to the premises under Iowa Code section 423.15(1)*"a."*

(1) For purposes of paragraph 230.15(5)*"c"*:

"Attributable to the premises" means sales of tangible personal property at the premises or shipped from the premises to another location for sale or eventual sale.

"Premises" means any contiguous parcels, as defined in Iowa Code section 426C.1, which are owned, leased, rented, or occupied by a business or its affiliates and are operated by that business or its affiliates for a common business purpose. A "common business purpose" means the participation in any stage of manufacturing, production, or sale of a product. Whether a business is operating for a common business purpose is a fact-based determination that will depend on the individual circumstances at issue.

(2) Calculation. If a business seeking to claim this exemption makes retail sales sourced to a premises under Iowa Code section 423.15(1)*"a"* and the location is not one of those listed in paragraph 230.15(5)*"b,"* the business shall determine whether a specific premises are primarily used to make retail sales by determining the amount of retail sales sourced to the premises under Iowa Code section 423.15(1)*"a"* during the 12-month period after the date the tangible personal property claimed to be exempt is used at the premises. The calculation should be done as follows:

$$\frac{\text{Retail sales sourced to the premises}}{\text{Gross sales attributable to the premises}}$$

If the result is less than or equal to 0.5 (or 50 percent), the premises is not primarily used to make retail sales. If the result is greater than 0.5, the premises is presumed to be primarily used to make retail sales.

(3) Rebutting the presumption. If a premises is presumed to be primarily used to make retail sales under subparagraph 230.15(5)*"c"*(2), a manufacturer may prove to the department the premises is not primarily used to make retail sales by providing information regarding the following nonexclusive list of factors to support its assertion:

1. The square footage of the premises allocated to the manufacturing process.
2. The number of employees or employee work hours allocated to the manufacturing process.
3. The wages and salaries of employees working at the premises allocated to the manufacturing process.
4. The cost of operating the premises attributable to the manufacturing process.

The department's determination shall be a fact-based determination based on the information provided by a manufacturer and the individual circumstances at issue.

EXAMPLE 1: Company A owns a centralized facility where it makes widgets and distributes them to several of its own retail stores for retail sale. The retail stores are not contiguous to the centralized facility. Company A purchases a widget maker for its centralized facility and seeks to claim this exemption. Because the widgets sold are sold at the retail stores, the sales of those widgets are sourced to the retail stores where the sales occur. Therefore, none of the sales are retail sales sourced to the centralized facility. Because Company A does not make retail sales sourced to the centralized facility, the centralized facility is not primarily used to make retail sales.

EXAMPLE 2A: Company A makes widgets at its premises in Iowa, known as Location 1. Company A sells its widgets to retailers for resale and also makes some retail sales that are sourced to Location 1.

Twelve months ago, Company A purchased and put into use at Location 1 a new molding machine for making new widgets. Company A paid tax on the sales price of the molding machine at the time of purchase. During the 12-month period after Company A first used the molding machine, 2 percent of the gross sales attributable to Location 1 were from retail sales sourced to Location 1 and 98 percent of the gross sales attributable to Location 1 were from sales of widgets to retailers.

Because less than half of the sales attributable to Location 1 during the 12-month period after the molding machine was first used at Location 1 were generated from retail sales sourced to Location 1, Location 1 is not primarily used to make retail sales. Therefore, if Company A's use of the molding machine satisfies all other requirements of the exemption, Company A's activities occurring on the premises constitute manufacturing.

EXAMPLE 2B: Same facts as in Example 2A, except that Company A also owns a second, noncontiguous premises in Iowa, known as Location 2. At Location 2, Company A operates a factory that makes the same types of widgets as Location 1. Company A also makes substantial retail sales that are sourced to Location 2.

Twelve months ago, Company A purchased new molding machines for Location 1 and Location 2. Company A paid tax on the sales price of the molding machines. During this 12-month period, 2 percent of the gross sales attributable to Location 1 were retail sales sourced to Location 1 and 98 percent of the gross sales attributable to Location 1 were from sales of widgets to distributors. Also during this 12-month period, 60 percent of the gross sales attributable to Location 2 were retail sales sourced to Location 2 and 40 percent of the gross sales attributable to Location 2 were from sales of widgets to distributors.

With respect to Location 1, the outcome is the same as in Example 1A. Because less than half of the sales attributable to Location 1 during the 12-month period after the molding machine was used at Location 1 were generated from retail sales sourced to Location 1, Location 1 is not primarily used to make retail sales.

However, Location 2 is presumed to be primarily used to make retail sales because more than half of the gross sales attributable to Location 2 are from retail sales sourced to Location 2.

EXAMPLE 2C: Same facts as in Example 2B. Company A decides to purchase new molding machines for both Location 1 and Location 2. Relying on the exemption determinations for the prior year, Company A pays sales tax on the purchase price of the molding machine for Location 2 but tenders an exemption certificate for the purchase of the molding machine for Location 1 and does not pay sales tax on that transaction.

Twelve months pass since the new molding machines were used at their respective locations. At Location 1, the gross sales attributable to the premises and retail sales sourced to the premises remained the same. However, at Location 2, Company A experienced a decrease in on-site retail sales and an increase in distribution sales. Because of a shift in sales, 45 percent of the gross sales attributable to Location 2 were retail sales sourced to Location 2, and 55 percent of the gross sales attributable to Location 2 were from sales of widgets to distributors.

Therefore, this year, Location 2 is no longer presumed to be primarily used to make retail sales because in the 12 months after the machine was used at Location 2, less than half of the gross sales attributable to Location 2 were from retail sales sourced to Location 2.

EXAMPLE 3A: Company A owns a premises on which it makes baseball bats. A portion of the premises is leased to Company B, which operates a retail store on the premises that sells clothing and is not commonly understood to be a manufacturer. Company A and Company B are unaffiliated entities.

Company A is seeking to purchase several new lathes to use in its bat production. In the last year, 95 percent of Company A's gross sales attributable to the premises came from selling bats to distributors, and 5 percent of Company A's gross sales attributable to the premises were from retail sales at a small on-site location. Also in the last year, 100 percent of Company B's gross sales attributable to the premises were from on-site retail sales.

Because Company A and Company B are not affiliated in any way, none of Company B's sales are attributable to Company A. Therefore, for purposes of Company A's determining its eligibility to claim the exemption, Company A's premises are not primarily used to make retail sales because less than half of its gross sales attributable to the premises are from retail sales sourced to the premises.

EXAMPLE 3B: Same facts as in Example 3A, except that Company B is an affiliate of Company A.

The result is the same; while Company B is an affiliate of Company A, the premises are not being operated for a common business purpose because Company B is not selling any of the bats manufactured by Company A. Therefore, none of Company B's business is attributable to Company A. For purposes of Company A's determining its eligibility to claim the exemption, Company A's premises are not primarily used to make retail sales because less than half of its gross sales attributable to the premises are from retail sales sourced to the premises.

EXAMPLE 3C: Same facts as in Example 3A, except that Company B is an affiliate of Company A and instead of operating a clothing store, Company B operates a sporting goods store where it sells some of the bats manufactured by Company A.

In this case, Company B's sales are attributable to Company A because both companies use the premises for a common business purpose: the sale of baseball bats manufactured by Company A. Therefore, the gross sales attributable to the premises of both Company A and Company B must be included in Company A's gross sales attributable to the premises. The premises will be presumed to be primarily used to make retail sales if the combined retail sales by Company A and Company B that are sourced to the premises exceed 50 percent of the gross sales attributable to the premises.

EXAMPLE 4: Company A owns a premises not included in the list above at which it makes widgets. Company A sells 15 percent of its widgets by delivery to customers' homes, 30 percent to wholesalers, and the remaining 55 percent directly to customers who pick up widgets at the premises. Company A's premises is presumed to be primarily used to make retail sales.

Company A dedicates 75 percent of the square footage of the premises to the production of widgets, 20 percent to storage, and 5 percent to a loading dock. Company A employs a total of 50 people, 40 of whom work on the production floor making widgets. Company A's production staff accounts for 80 percent of its total wages and salaries paid to all employees. The cost of operating the widget production area accounts for 90 percent of Company A's total expenses. Upon claiming this exemption, Company

A provides information satisfactory to the department to demonstrate these facts. Company A qualifies for the exemption.

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EDITOR'S NOTE: For replacement pages for IAC, see IAC Supplement 1/2/19.