

January 1, 2010

To Members of the Iowa General Assembly:

On behalf of the State Industrial Processing Exemption Study Committee (the “Committee”), we are pleased to submit this report summarizing the activities of the Committee during 2009, including the development of recommended amendments to the statutes concerning specific aspects of Iowa’s industrial processing sales and use tax exemptions.

### **History of the Committee**

The Committee was originally formed by the Iowa General Assembly during 2003 as part of House File 692 in order to study and make recommendations related to Iowa’s sales and use tax industrial processing exemptions. In 2004, the Committee’s existence under State law was nullified as a result of an Iowa Supreme Court ruling that “no portion of HF 692 became law” because of an improper use of line-item veto power by then-Governor Vilsack to strike provisions unrelated to the Committee (see Rants v. Vilsack, 684 N.W. 2d 193 (Iowa 2004)). However, the members of the Committee continued to meet during 2004 and 2005 as a subcommittee of the Iowa Taxpayers Association.

During the 2005 legislative session, the Iowa General Assembly passed House File 313, which again established the Committee under state law. The Committee’s members include representatives of the manufacturing industry, the Iowa Department of Revenue, the Iowa Attorney General’s office, associations with manufacturers as members, and accounting and law firms who specialize in the area of Iowa sales and use taxes. The Committee is required to make a report to the Iowa General Assembly each year through January 1, 2013.

### **Charge of the Committee**

Under House File 313, the purpose of the Committee is to study and make recommendations regarding all of the following:

1. The current sales and use tax industrial processing exemption.
2. The corresponding administrative rules, including a review and recommendation of an administrative rules process relating to the industrial processing exemption prior to filing with the administrative rules review committee.
3. Other states' industrial processing exemptions.
4. Recommendations for change for issues including effectiveness and competitiveness.
5. Development of additional publications to improve compliance.

### **Activities of the Committee**

The Committee has worked diligently to fulfill the responsibilities assigned to it by the Iowa General Assembly as listed in House File 313. The Committee’s activities in previous years included in-depth review of the statutes and regulations related to Iowa’s industrial processing exemptions, including drafting recommended improvements to those statutes and regulations. The Committee also completed a study related to the industrial processing exemptions offered by other states, resulting in an analysis of

options for comprehensive reform of Iowa's exemptions. Please see the annual reports filed by the Committee for 2005 through 2008 for a more detailed discussion of these activities.

During 2008, the Committee determined that its efforts for 2009 would be focused on developing recommendations for improvements to Iowa's industrial processing exemption statutes related to the following issues:

1. Software used to operate manufacturing machinery and equipment;
2. Definitions of "manufacturer" and "processing;"
3. Transformers and other related equipment used to provide electricity to manufacturing machinery and equipment; and
4. Repair and replacement parts for manufacturing machinery and equipment.

These issues were selected because they are among the most frequent and troublesome areas taxpayers and the Department of Revenue face when dealing with Iowa's manufacturing machinery and equipment exemption.

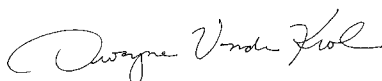
At its meeting on February 26, 2009, the Committee voted to form a subcommittee to review and draft recommended amendments to Iowa's statutes related to the four selected issues. The subcommittee was further divided into four workgroups, one for each issue. Each workgroup met several times and devoted a significant number of hours to researching, reviewing, and drafting recommended amendments to the applicable Iowa statutes. Included in this process was the review of other states' laws and regulations in order to determine how those states taxed the items at issue. These recommendations were then reviewed, revised, and approved by the subcommittee at a meeting on June 25, 2009. The subcommittee's recommendations were reviewed and discussed by the full Committee at a meeting on July 23, 2009, at which time the Committee decided to return two of the recommendations back to the subcommittee for additional work. After the applicable workgroups reviewed and drafted additional revisions to these two statutes, the subcommittee met again on August 13, 2009 and voted to move these recommendations back to the full Committee. The full Committee met on September 18, 2009 and, after making a few revisions to the subcommittee's recommendations, voted to propose that the Iowa General Assembly adopt the changes to Iowa's statutes.

The changes drafted and approved by the Committee during 2009 are described on Attachments 1 through 4, which have been numbered to correspond to each of the four issues listed above. The Committee recommends that the Iowa General Assembly adopt these changes in order to provide clarity to some of the most difficult areas of sales and use tax law, as well as to make Iowa's sales and use tax exemptions for manufacturers more competitive with the exemptions provided by other states.

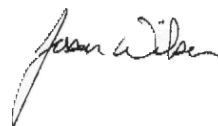
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It has been an honor for us to chair this Committee during 2009. The members of the Committee include some of Iowa's foremost experts in the area of sales and use taxes, and we thank them for the contributions they have made to this Committee's accomplishments. We look forward to continuing this good work in 2010 and beyond.

Sincerely,



Dwayne Vande Krol  
Co-Chair



Jason Wilson  
Co-Chair

## ATTACHMENT 1

The Committee recommends amending Iowa Code Sec. 423.3.47.a. as follows to exempt “process control software” used to control or operate manufacturing machinery and equipment:

**Iowa Code Sec. 423.3.47.a.** The sales price from the sale or rental of computers, machinery, and equipment, including replacement parts and process control software, and materials used to construct or self-construct computers, machinery, and equipment if such items are any of the following:

**423.3.47.a(1)** Directly and primarily used in processing by a manufacturer.

**423.3.47.a(2)** Directly and primarily used to maintain the integrity of the product or to maintain unique environmental conditions required for either the product or the computers, machinery, and equipment used in processing by a manufacturer, including test equipment used to control quality and specifications of the product.

**423.3.47.a(3)** Directly and primarily used in research and development of new products or processes of processing.

**423.3.47.a(4)** Computers used in processing or storage of data or information by an insurance company, financial institution, or commercial enterprise.

**423.3.47.a(5)** Directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.a(6)** Pollution-control equipment used by a manufacturer, including but not limited to that required or certified by an agency of this state or of the United States government.

**423.3.47.b.** The sales price from the sale of fuel used in creating heat, power, steam, or for generating electrical current, or from the sale of electricity, consumed by computers, machinery, or equipment used in an exempt manner described in paragraph "a", subparagraph (1), (2), (3), (5), or (6).

**423.3.47.c.** The sales price from the sale or rental of the following shall not be exempt from the tax imposed by this subchapter:

**423.3.47.c (1)** Hand tools.

**423.3.47.c (2)** Point-of-sale equipment and computers.

**423.3.47.c (3)** Industrial machinery, equipment, and computers, including pollution-control equipment within the scope of section 427A.1, subsection 1, paragraphs "h" and "i".

**423.3.47.c (4)** Vehicles subject to registration, except vehicles subject to registration which are directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.d.** As used in this subsection:

**423.3.47.d(1)** "Commercial enterprise" includes businesses and manufacturers conducted for profit and centers for data processing services to insurance companies, financial institutions, businesses, and manufacturers, but excludes professions and occupations and nonprofit organizations.

**423.3.47.d(2)** "Financial institution" means as defined in section 527.2.

**423.3.47.d(3)** "Insurance company" means an insurer organized or operating under chapter 508, 514, 515, 518, 518A, 519, or 520, or authorized to do business in Iowa as an insurer or an insurance producer under chapter 522B.

**423.3.47.d(4)** "Manufacturer" means as defined in section 428.20, but also includes contract manufacturers. A contract manufacturer is a manufacturer that otherwise falls within the definition of manufacturer under section 428.20, except that a contract manufacturer does not sell the tangible personal property the contract manufacturer processes on behalf of other manufacturers. A business engaged in activities subsequent to the extractive process of quarrying or mining, such as crushing, washing, sizing, or blending of aggregate materials, is a manufacturer with respect to these activities.

**423.3.47.d(5)** "Process control software" is any computer software program used directly and primarily to control, regulate or operate other machinery and equipment used in an exempt manner described in paragraph a, subparagraph (1), (2), (3), (5) or (6).

**423.3.47.d(6)(5)** "Processing" means a series of operations in which materials are manufactured, refined, purified, created, combined, or transformed by a manufacturer, ultimately into tangible personal property. Processing encompasses all activities commencing with the receipt or producing of raw materials by the manufacturer and ending at the point products are delivered for shipment or transferred from the manufacturer. Processing includes but is not limited to refinement or purification of materials; treatment of materials to change their form, context, or condition; maintenance of the quality or integrity of materials, components, or products; maintenance of environmental conditions necessary for materials, components, or products; quality control activities; and construction of packaging and shipping devices, placement into shipping containers or any type of shipping devices or medium, and the movement of materials, components, or products until shipment from the processor.

**423.3.47.d(7)(6)** "Receipt or producing of raw materials" means activities performed upon tangible personal property only. With respect to raw materials produced from or upon real estate, the receipt or producing of raw materials is deemed to occur immediately following the severance of the raw materials from the real estate.

## ATTACHMENT 2

The Committee recommends amending Iowa Code Sec. 423.3.47.a. as follows to adopt a definition of “manufacturer” for sales and use tax purposes (i.e., to remove the reference to the definition in the property tax statutes) and to provide an exemption for equipment used at a qualified, separate “manufacturing location” by taxpayers whose predominant business is not manufacturing:

**Iowa Code Sec. 423.3.47.a.** The sales price from the sale or rental of computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment if such items are any of the following:

**423.3.47.a(1)** Directly and primarily used in processing by a manufacturer or at a manufacturing location.

**423.3.47.a(2)** Directly and primarily used to maintain the integrity of the product or to maintain unique environmental conditions required for either the product or the computers, machinery, and equipment used in processing by a manufacturer or at a manufacturing location, including test equipment used to control quality and specifications of the product.

**423.3.47.a(3)** Directly and primarily used in research and development of new products or processes of processing.

**423.3.47.a(4)** Computers used in processing or storage of data or information by an insurance company, financial institution, or commercial enterprise.

**423.3.47.a(5)** Directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.a(6)** Pollution-control equipment used by a manufacturer or at a manufacturing location, including but not limited to that required or certified by an agency of this state or of the United States government.

**423.3.47.b.** The sales price from the sale of fuel used in creating heat, power, steam, or for generating electrical current, or from the sale of electricity, consumed by computers, machinery, or equipment used in an exempt manner described in paragraph "a", subparagraph (1), (2), (3), (5), or (6).

**423.3.47.c.** The sales price from the sale or rental of the following shall not be exempt from the tax imposed by this subchapter:

**423.3.47.c (1)** Hand tools.

**423.3.47.c (2)** Point-of-sale equipment and computers.

**423.3.47.c (3)** Industrial machinery, equipment, and computers, including pollution-control equipment within the scope of section 427A.1, subsection 1, paragraphs "h" and "i".

**423.3.47.c (4)** Vehicles subject to registration, except vehicles subject to registration which are directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.d.** As used in this subsection:

**423.3.47.d(1)** "Commercial enterprise" includes businesses and manufacturers conducted for profit and centers for data processing services to insurance companies, financial institutions, businesses, and manufacturers, but excludes professions and occupations and nonprofit organizations.

**423.3.47.d(2)** "Financial institution" means as defined in section 527.2.

**423.3.47.d(3)** "Insurance company" means an insurer organized or operating under chapter 508, 514, 515, 518, 518A, 519, or 520, or authorized to do business in Iowa as an insurer or an insurance producer under chapter 522B.

**423.3.47.d(4)** "Manufacturer" means ~~as defined in section 428.20 a person who purchases, receives, or holds personal property of any description for the purpose of adding to its value by a process of manufacturing, refining, purifying, combining of different materials, or by the packing of meats, with a view to selling the property for gain or profit,~~ but also includes contract manufacturers. A contract manufacturer is a manufacturer that otherwise falls within the definition of manufacturer ~~under section 428.20 above,~~ except that a contract manufacturer does not sell the tangible personal property the contract manufacturer processes on behalf of other manufacturers. A business engaged in activities subsequent to the extractive process of quarrying or mining, such as crushing, washing, sizing, or blending of aggregate materials, is a manufacturer with respect to these activities.

**423.3.47.d(4A)** "Manufacturing location" means an industrial operation at which a person purchases, receives, or holds personal property of any description for the purpose of adding to its value by a process of manufacturing, refining, purifying, combining of different materials, or by the packing of meats, with a view to selling the property for gain or profit. In order to qualify as a "manufacturing location," the industrial operation must be clearly separated from the person's retail and other operations including, but not limited to, location in a separate building, room, or other facility.

**423.3.47.d(5)** "Processing" means a series of operations in which materials are manufactured, refined, purified, created, combined, or transformed by a manufacturer, ultimately into tangible personal property. Processing encompasses all activities commencing with the receipt or producing of raw materials by the manufacturer and ending at the point products are delivered for shipment or transferred from the manufacturer. Processing includes but is not limited to refinement or purification of materials; treatment of materials to change their form, context, or condition; maintenance of the quality or integrity of materials, components, or products; maintenance of environmental conditions necessary for materials, components, or products; quality control activities; and construction of packaging and shipping devices, placement into shipping containers or any type of shipping devices or medium, and the movement of materials, components, or products until shipment from the processor.

**423.3.47.d(6)** "Receipt or producing of raw materials" means activities performed upon tangible personal property only. With respect to raw materials produced from or upon real estate, the receipt or producing of raw materials is deemed to occur immediately following the severance of the raw materials from the real estate.

## ATTACHMENT 3

The Committee recommends amending Iowa Code Sec. 423.3.47.a. as follows to exempt transformers and other equipment used to provide electricity to manufacturing machinery and equipment:

**Iowa Code Sec. 423.3.47.a.** The sales price from the sale or rental of computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment if such items are any of the following:

**423.3.47.a(1)** Directly and primarily used in processing by a manufacturer.

**423.3.47.a(2)** Directly and primarily used to maintain the integrity of the product or to maintain unique environmental conditions required for either the product or the computers, machinery, and equipment used in processing by a manufacturer, including test equipment used to control quality and specifications of the product.

**423.3.47.a(3)** Directly and primarily used in research and development of new products or processes of processing.

**423.3.47.a(4)** Computers used in processing or storage of data or information by an insurance company, financial institution, or commercial enterprise.

**423.3.47.a(5)** Directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.a(6)** Pollution-control equipment used by a manufacturer, including but not limited to that required or certified by an agency of this state or of the United States government.

**423.3.47.b.** The sales price from the sale of fuel used in creating heat, power, steam, or for generating electrical current, or from the sale of electricity, consumed by computers, machinery, or equipment used in an exempt manner described in paragraph "a", subparagraph (1), (2), (3), (5), or (6).

**423.3.47.c.** The sales price from machinery and equipment primarily used to create or transmit heat, power, steam, or to generate, transmit, or regulate electric current, when such heat, power, steam, or electric current is consumed by computers, machinery, or equipment used in an exempt manner described in paragraph "a", subparagraph (1), (2), (3), (5), or (6).

**423.3.47.de.** The sales price from the sale or rental of the following shall not be exempt from the tax imposed by this subchapter:

**423.3.47.de (1)** Hand tools.

**423.3.47.de (2)** Point-of-sale equipment and computers.

**423.3.47.de (3)** Industrial machinery, equipment, and computers, including pollution-control equipment within the scope of section 427A.1, subsection 1, paragraphs "h" and "i".

**423.3.47.de (4)** Vehicles subject to registration, except vehicles subject to registration which are directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.ed.** As used in this subsection:

**423.3.47.ed(1)** "Commercial enterprise" includes businesses and manufacturers conducted for profit and centers for data processing services to insurance companies, financial institutions, businesses, and manufacturers, but excludes professions and occupations and nonprofit organizations.

**423.3.47.ed(2)** "Financial institution" means as defined in section 527.2.

**423.3.47.ed(3)** "Insurance company" means an insurer organized or operating under chapter 508, 514, 515, 518, 518A, 519, or 520, or authorized to do business in Iowa as an insurer or an insurance producer under chapter 522B.

**423.3.47.ed(4)** "Manufacturer" means as defined in section 428.20, but also includes contract manufacturers. A contract manufacturer is a manufacturer that otherwise falls within the definition of manufacturer under section 428.20, except that a contract manufacturer does not sell the tangible personal property the contract manufacturer processes on behalf of other manufacturers. A business engaged in activities subsequent to the extractive process of quarrying or mining, such as crushing, washing, sizing, or blending of aggregate materials, is a manufacturer with respect to these activities.

**423.3.47.ed(5)** "Processing" means a series of operations in which materials are manufactured, refined, purified, created, combined, or transformed by a manufacturer, ultimately into tangible personal property. Processing encompasses all activities commencing with the receipt or producing of raw materials by the manufacturer and ending at the point products are delivered for shipment or transferred from the manufacturer. Processing includes but is not limited to refinement or purification of materials; treatment of materials to change their form, context, or condition; maintenance of the quality or integrity of materials, components, or products; maintenance of environmental conditions necessary for materials, components, or products; quality control activities; and construction of packaging and shipping devices, placement into shipping containers or any type of shipping devices or medium, and the movement of materials, components, or products until shipment from the processor.

**423.3.47.ed(6)** "Receipt or producing of raw materials" means activities performed upon tangible personal property only. With respect to raw materials produced from or upon real estate, the receipt or producing of raw materials is deemed to occur immediately following the severance of the raw materials from the real estate.



## ATTACHMENT 4

The Committee recommends amending Iowa Code Sec. 423.3.47.a. as follows to specify the definition of exempt "replacement parts" for manufacturing machinery and equipment:

**423.3.47.a.** The sales price from the sale or rental of computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment if such items are any of the following:

**423.3.47.a(1)** Directly and primarily used in processing by a manufacturer.

**423.3.47.a(2)** Directly and primarily used to maintain the integrity of the product or to maintain unique environmental conditions required for either the product or the computers, machinery, and equipment used in processing by a manufacturer, including test equipment used to control quality and specifications of the product.

**423.3.47.a(3)** Directly and primarily used in research and development of new products or processes of processing.

**423.3.47.a(4)** Computers used in processing or storage of data or information by an insurance company, financial institution, or commercial enterprise.

**423.3.47.a(5)** Directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.a(6)** Pollution-control equipment used by a manufacturer, including but not limited to that required or certified by an agency of this state or of the United States government.

**423.3.47.b.** The sales price from the sale of fuel used in creating heat, power, steam, or for generating electrical current, or from the sale of electricity, consumed by computers, machinery, or equipment used in an exempt manner described in paragraph "a", subparagraph (1), (2), (3), (5), or (6).

**423.3.47.c.** The sales price from the sale or rental of the following shall not be exempt from the tax imposed by this subchapter:

**423.3.47.c (1)** Hand tools.

**423.3.47.c (2)** Point-of-sale equipment and computers.

**423.3.47.c (3)** Industrial machinery, equipment, and computers, including pollution-control equipment within the scope of section 427A.1, subsection 1, paragraphs "h" and "i".

**423.3.47.c (4)** Vehicles subject to registration, except vehicles subject to registration which are directly and primarily used in recycling or reprocessing of waste products.

**423.3.47.d.** As used in this subsection:

**423.3.47.d(1)** "Commercial enterprise" includes businesses and manufacturers conducted for profit and centers for data processing services to insurance companies, financial institutions, businesses, and manufacturers, but excludes professions and occupations and nonprofit organizations.

**423.3.47.d(2)** "Financial institution" means as defined in section 527.2.

**423.3.47.d(3)** "Insurance company" means an insurer organized or operating under chapter 508, 514, 515, 518, 518A, 519, or 520, or authorized to do business in Iowa as an insurer or an insurance producer under chapter 522B.

**423.3.47.d(4)** "Manufacturer" means as defined in section 428.20, but also includes contract manufacturers. A contract manufacturer is a manufacturer that otherwise falls within the definition of manufacturer under section 428.20, except that a contract manufacturer does not sell the tangible personal property the contract manufacturer processes on behalf of other manufacturers. A business engaged in activities subsequent to the extractive process of quarrying or mining, such as crushing, washing, sizing, or blending of aggregate materials, is a manufacturer with respect to these activities.

**423.3.47.d(5)** "Processing" means a series of operations in which materials are manufactured, refined, purified, created, combined, or transformed by a manufacturer, ultimately into tangible personal property. Processing encompasses all activities commencing with the receipt or producing of raw materials by the manufacturer and ending at the point products are delivered for shipment or transferred from the manufacturer. Processing includes but is not limited to refinement or purification of materials; treatment of materials to change their form, context, or condition; maintenance of the quality or integrity of materials, components, or products; maintenance of environmental conditions necessary for materials, components, or products; quality control activities; and construction of packaging and shipping devices, placement into shipping containers or any type of shipping devices or medium, and the movement of materials, components, or products until shipment from the processor.

**423.3.47.d(6)** "Receipt or producing of raw materials" means activities performed upon tangible personal property only. With respect to raw materials produced from or upon real estate, the receipt or producing of raw materials is deemed to occur immediately following the severance of the raw materials from the real estate.

**423.3.47.d(7)** "Replacement part" means tangible personal property that: (1) replaces components of computers, machinery, or equipment that can be separated; (2) performs the same or similar function as the original parts; (3) is added to restore the computer, machinery, or equipment to its original operating condition; or (4) upgrades or improves the efficiency of qualified computers, machinery, or equipment.

Replacement parts do not include consumable supplies. "Consumable supplies" means tangible personal property other than computers, machinery, equipment, or raw materials that is consumed or expended during the manufacture of tangible personal property. The term "consumable supplies" includes but is not limited to oils, greases, hydraulic fluids, coolants, and lubricants.

Jigs, dies, tools, and other devices which are used in conjunction with manufacturing machinery or equipment, and which are often specially-designed for use in manufacturing specific products and thus are used interchangeably and intermittently on a particular machine, are themselves considered to be machinery or equipment, not replacement parts, and thus are not subject to the requirements of this subsection.