MANUFACTURING SALES TAX EXEMPTION RULES

The Department of Revenue filed an administrative rules Notice of Intended Action related to a manufacturing sales tax exemption in the September 2015 Iowa Administrative Bulletin (ARC 2178C). The effective date of the proposed rule change is January 1, 2016.

The existing rule and the proposed amendments implement Iowa Code sections:

- 423.3(47) - Exempting the sale or rental of computers, machinery, and equipment, including replacement parts, and materials used to construct or self-construct computers, machinery, and equipment from the sales tax.
- 423.3(48) - Exempting the furnishing of the design and installation of new industrial machinery or equipment, including electrical and electronic installation, from the sales tax.
- 423.2(1)(b) - Subjecting the sales of building materials, supplies, and equipment to owners, contractors, subcontractors, or builders for the erection of buildings or the alteration, repair, or improvement of real property to the sales tax.
- 423.2(1)(c) - Relating to the taxation of building materials, supplies, and equipment in the performance of construction contracts.

History and Background

The existing rules related to the manufacturing sales tax exemption were promulgated in response to the enactment of Iowa Code sections 423.3(47) and 423.3(48) in HF 126 (Sales and Use Tax Exemptions Act of 1997). Enactment of those two Iowa Code sections replaced an existing and similar manufacturing exemption that was originally enacted in 1985 (see SF 395, section 85, Sales and Local Option Taxes and Wine Sales Act of 1985).

Many of the terms used for the exemption are not defined in the Iowa Code and their definition, interpretation, and enforcement has been a function of Department of Revenue rules and procedures. Under the existing Department rules:

- Supplies are specifically excluded from the definition of “replacement parts.” Drill bits, grinding wheels, punches, taps, reamers, saw blades, lubricants, coolants, sanding discs, sanding belts, and air filters are listed within the rules as nonexclusive examples of supplies. The existing rule specifies that supplies are taxed.
- Replacement parts are generally required to have a longer lifespan (12 months or more). Items that do not have the required lifespan are generally defined as supplies and therefore subject to sales tax. Supplies that last 12 months or longer are generally considered machinery equipment replacement parts and not subject to sales tax.

Under the proposed rules:

- The term “equipment” is defined to include “supplies” and therefore exempt from sales tax. According to the proposed rules, the types of supplies that are to be considered equipment and therefore exempt from sales tax are items such as drill bits, grinding wheels, punches, taps, reamers, saw blades, lubricants, coolants, sanding discs, sanding belts, and air filters.
- The 12-month lifespan presumption for replacement parts is eliminated. Beginning January 1, 2016, all items that can be considered replacement parts will become tax exempt under the rule.

- Changes the categorization of certain types of property installed by a building contractor from the current category of real property, to the category of personal property. This change will allow additional construction value to be defined as manufacturing machinery and equipment and therefore exempt from the sales tax.

Fiscal Impact

If implemented, the proposed rules will extend an existing tax exemption to additional purchases made by manufacturers. Therefore, the proposed rules have a fiscal impact on State General Fund revenue and local option sales tax revenue. The Department of Revenue submitted an estimate of the annual fiscal impact of their proposed sales tax exemption rules change to the Administrative Rules Committee.

As there is no available independent source of detailed business expenditure data, the Department developed a survey for Iowa manufacturers to submit expenditure details to the Department. A total of seventeen Iowa manufacturers responded.[1] Based on the survey results, the Department extrapolated the reported purchases to all Iowa manufacturing companies.[2]

The Department calculated and reported the fiscal impact in two categories, the impact on the State General Fund (6.0% sales tax) and the impact on local option sales tax revenue (statewide average of 0.87% sales tax). The Department estimate is provided in **Table 1**.

Table 1

General Fund Revenue Reduction

Department of Revenue Projection

In Millions of Dollars

	State General Fund	Local Option Taxes	Total Tax Reduction, State and Local Taxes Combined
FY 2016	$17.2	$2.5	$19.7
FY 2017	35.1	5.1	40.2
FY 2018	35.9	5.2	41.1
FY 2019	36.8	5.3	42.1
FY 2020	37.7	5.5	43.2

The Legislative Services Agency (LSA) reviewed the Department estimate and determined that two fiscal estimate adjustments and additional explanation is necessary. The two adjustments impacting the projected fiscal impact of the rule change include the following:

[1] The U.S. Census Bureau statistics show that Iowa has 3,100 manufacturing firms. Of that number, about 2,000 firms have 20 or fewer employees and 300 have over 500 employees.

[2] For the portion of the estimate related to the change from real property to personal property, the Department estimate was developed from the reported expenditures of one manufacturing facility, scaled to cover facilities for selected manufacturing sectors in the State.

- While the rules can generally be considered an expanded tax exemption for traditional manufacturing concepts, the rule is not limited to what could be generally considered manufacturing companies. In 2013 (see SF 452, section 127, Standing Appropriations Act), the Iowa Code was amended to specifically remove any implication that a business must be a "manufacturer" in order to benefit from the processing sales tax exemptions. The business must simply be using the machinery, computers, and equipment to "manufacture" something. The Department estimate only accounts for traditional manufacturers. The LSA estimate includes other types of businesses that will benefit from the expansion of the tax exemption to additional business inputs.
- The Department utilized a future growth rate for the impact of the exemption that equaled the U.S. Gross Domestic Price (GDP) Deflator. When applied to the previous five years, this method of growth projection would significantly underestimate the growth in Iowa manufacturing over that period. For all projection years, the LSA estimate uses the average growth in Total Cost of Materials, as provided by the U.S. Census Bureau Annual Survey of Manufacturers.[3] The annual growth rate of Total Cost of Materials for Iowa manufacturers from 2008 through 2013, was 3.3%.

The LSA estimate is 17.5% higher in the first year and 22.1% higher by FY 2020 than the Department estimate. The LSA figures are provided in **Table 2**. The LSA estimate divides the impact into three categories, instead of two, as the State 6.0% sales tax rate is essentially a 5.0% State rate and a 1.0% rate dedicated to school infrastructure. For the purpose of comparing, the LSA State General Fund and School Infrastructure columns should be compared to the Department State General Fund column.

Table 2

General Fund Revenue Reduction

Legislative Services Agency Projection

In Millions of Dollars

	State General Fund	School Infrastructure	Local Option Taxes	Total Tax Reduction, State and Local Taxes Combined
FY 2016	$16.8	$3.4	$2.9	$23.1
FY 2017	34.8	7.0	6.1	47.9
FY 2018	35.9	7.2	6.3	49.4
FY 2019	37.1	7.4	6.5	51.0
FY 2020	38.3	7.7	6.7	52.7

In future fiscal years, the impact is expected to grow at a rate just above the rate of inflation.

[3] The Total Cost of Materials dataset is part of the same U.S. Census Bureau publication the Department used to extrapolate the survey response from the 17 Iowa manufacturing companies to all Iowa manufacturing companies. For 2008, the Total Cost of Materials for all Iowa manufacturers was estimated by the Census Bureau to be $62.5 billion. In 2013, the estimate was $73.6 billion.

One additional impact is possible and this impact was not estimated by the Department and cannot be estimated by the LSA. The 2012 General Assembly created a Flood Mitigation Program (see SF 2217, Flood Mitigation Act) funded through State sales tax revenue. The amount of sales tax revenue each qualified city may receive is determined by comparing the sales tax revenue generated in a given year to the sales tax generated in a base year.

For the 10 impacted cities, the sales tax base was determined without this additional sales tax exemption. It is possible that the Flood Mitigation Program funding stream for one or more of the cities benefiting from the new program could be negatively impacted by the tax base reduction that results from this rule change. It is also possible that none of the cities will be impacted.

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