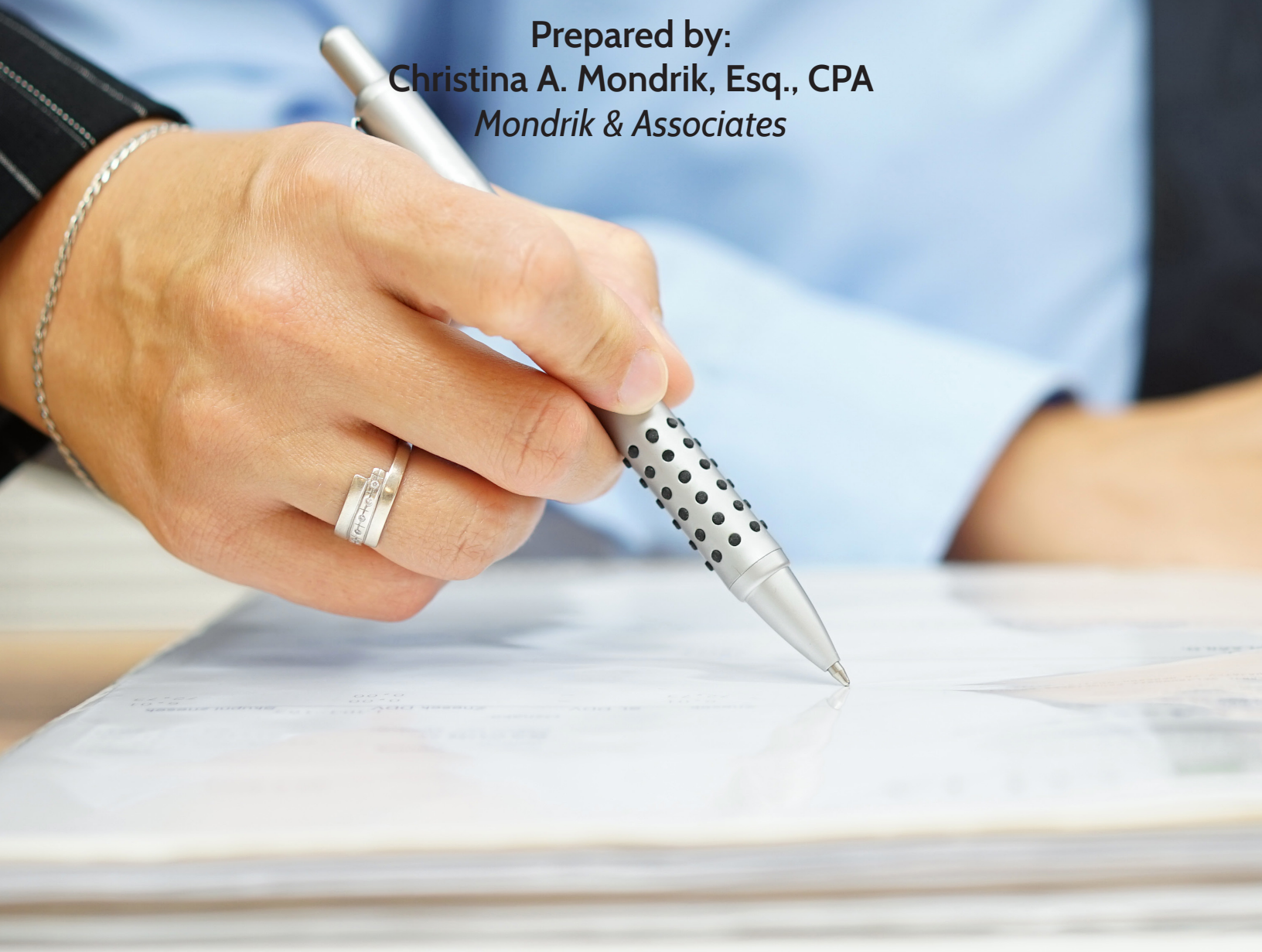


# Claiming and Preserving the Manufacturing Exemption

Prepared by:  
Christina A. Mondrik, Esq., CPA  
*Mondrik & Associates*



## INTRODUCING

Lorman's New Approach to Continuing Education

# ALL-ACCESS PASS

The All-Access Pass grants you **UNLIMITED** access to Lorman's ever-growing library of training resources:

- ☑ Unlimited Live Webinars - 120 live webinars added every month
- ☑ Unlimited OnDemand and MP3 Downloads - Over 1,500 courses available
- ☑ Videos - More than 1300 available
- ☑ Slide Decks - More than 2300 available
- ☑ White Papers
- ☑ Reports
- ☑ Articles
- ☑ ... and much more!

Join the thousands of other pass-holders that have already trusted us for their professional development by choosing the All-Access Pass.



**Get Your All-Access Pass Today!**

# SAVE 20%

Learn more: [www.lorman.com/pass/?s=special20](http://www.lorman.com/pass/?s=special20)

Use Discount Code Q7014393 and Priority Code 18536 to receive the 20% AAP discount.

\*Discount cannot be combined with any other discounts.

# Claiming and Preserving the Manufacturing Exemption

Texas law offers various exemptions from the sales and use tax. These materials focus on the manufacturing exemption. Exemptions are located in subchapter H of Chapter 151 of the Texas Tax Code. The burden of proof for exemptions generally lies with the taxpayer who is claiming the exemption. Different documentation requirements apply depending upon the type of exemption and depending on whether the taxpayer claiming the exemption is the seller or purchaser.

## Claiming Exemptions

An entity claiming an exemption may issue an exemption certificate in lieu of paying sales tax on an item

## Presumptions

All of a seller's gross receipts are presumed to be subject to the sales tax unless the buyer furnishes the seller with a properly completed exemption or resale certificate. The sale of a taxable item by a person for delivery in Texas is presumed to be a sale for storage, use or consumption in Texas unless the seller accepts an exemption or resale certificate. The purchaser has the burden to claim the exemption to which he or she may be entitled.

## Burden of Proof.

Courts have held that the purchaser bears the burden of proving the exemption. The Comptroller and the courts construe all doubts in favor of non-exemption or taxability.

## **Manufacturing Exemption**

The Texas Tax Code provides sales tax exemptions to promote industry and prevent multiple taxation of manufactured products that are sold (and thereby taxed) at retail. Generally, materials and equipment that are used or consumed in manufacturing, processing or fabricating products to be sold at retail are exempt from the sales and use tax.<sup>37</sup>

The manufacturing exemption generally applies to materials and equipment that a manufacturer purchases for use in manufacturing. In order to qualify for the exemption, the item purchased must generally make a chemical or physical change to an item manufactured for sale, or must become a component part of the product manufactured for ultimate sale. Equipment must generally make a direct modification to the product being manufactured for sale in order for it to qualify for exemption.

---

<sup>37</sup> Comptroller Rule 3.300.

Manufacturing includes each operation beginning with the first stage of production of tangible personal property and ending with the completion of tangible personal property having the physical properties, including packaging, that it has when transferred by the manufacturer.<sup>38</sup>

**First Production Stage.** The “first production stage” means the first act of production. It does not include acts in preparation for production. Before determining whether equipment or supplies are exempt, the taxpayer must first determine whether the equipment or supplies will be used while manufacturing or processing is occurring. The statutory language applies the manufacturing exemption only to “manufacturing, processing, or fabrication,” which generally requires that a chemical or physical change occur in order to bring the product being manufactured closer to being ready to sell.

**Example.** A lumber company cutting down trees to be milled into 2x4s is in the pre-production phase.

**Example.** A brewery that gathers raw materials or inventory (barley, malt grains, hops, empty bottles/cans, packaging materials, etc.) is preparing for production

**Example.** The first stage/act of production for a computer program developing company is the design and writing of the code or program.

**Example.** A diamond mining company extracting raw diamonds from the earth to be fabricated and processed into jewelry is preparing for production.

**Example.** A taxpayer mining uranium by using oxygen enriched water to extract uranium from formation (i.e. solution mining) was not performing a processing activity during the extraction phase.<sup>39</sup>

**Caution.** In the oil and gas industry, bringing oil or gas to the surface of the earth is commonly called “production.” However, for the purposes of the manufacturing exemption, it does not constitute processing, fabrication or manufacturing.<sup>40</sup>

**Manufacturing.** A manufacturer is a person engaged in manufacturing and includes processors, fabricators and custom manufacturers.<sup>41</sup> Manufacturing includes each operation beginning with the first stage in the production of tangible personal property and ending with the completion of tangible personal property having the physical properties (including packaging, if any) that it has when transferred by the manufacturer to another.<sup>42</sup>

---

<sup>38</sup> Tex. Tax Code § 151.318(d).

<sup>39</sup> Comptroller Hearing No. 102,539; SOAH Docket No. 304-10-4598.26 (2011).

<sup>40</sup> Comptroller Letter No. 9612121L.

<sup>41</sup> Comptroller Rule 3.300(a)(8).

<sup>42</sup> Comptroller Rule 3.300(a)(9)(A).

**Example.** A taxpayer's creation of necklaces and bracelets by cutting an appropriate length of chain from a spool of bulk chain, stringing the chain through a drop or pendant and then attaching fasteners or clasps to the ends of chains constituted manufacturing.<sup>43</sup>

Pre-production. Before determining whether equipment or supplies are exempt, the taxpayer must first determine whether the equipment or supplies will be used while manufacturing or processing is occurring. The statutory language applies the manufacturing exemption only to "manufacturing, processing, or fabrication," which generally requires that a chemical or physical change occur in order to bring the product being manufactured closer to being ready to sell.

**Example.** Washing and sorting tomatoes and potatoes was found not to be manufacturing because it did not result in a chemical or physical change to the tomatoes and potatoes.<sup>44</sup>

Qualifying Items. The following categories of items are exempt from sales and use tax:<sup>45</sup>

- a. Component Parts. Tangible personal property that will become an ingredient or component part of tangible personal property manufactured, processed or fabricated for ultimate sale;<sup>46</sup>

**Example.** Gears for a bicycle.

**Example.** Grinding balls that entered into and became a component part of cement.<sup>47</sup>

- b. Direct Use Equipment. Tangible personal property directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale. The use or consumption of the property must be "necessary or essential" to the manufacturing, processing or fabricating operation and the use must directly make or cause a chemical or physical change either to the preliminary, intermediate or final product being manufactured for ultimate sale.<sup>48</sup>

**Example.** A sewing machine used for manufacturing clothes.

- c. Chemicals & Catalysts. The manufacturing exemption includes chemicals, catalysts and other materials used during a manufacturing, processing or fabrication operation to produce or induce a chemical or physical change, to remove impurities or to make the product more marketable.

---

<sup>43</sup> Comptroller Hearing No. 38,620 (November 20, 2002).

<sup>44</sup> Comptroller Hearing No. 48,151 (2008).

<sup>45</sup> Texas Tax Code § 151.318

<sup>46</sup> Beginning October 1, 1997, the property must be directly used or consumed in the manufacturing, processing or fabrication of the property. Tex. H.B. 1855, 75th Leg., R.S., (1997).

<sup>47</sup> *Bullock v. Lone Star Industries*, 584 S.W.2d 386 (Tex. App.-Waco 1979).

<sup>48</sup> Tex. H.B. 1855, 75th Leg., R.S. (1997) (amending Texas Tax Code § 151.318, "Property Used in Manufacturing").



**Example.** Titanium trichloride (TiCl<sub>3</sub>), a catalyst used in blending plastics.

**Example.** Oil soluble chemicals are generally exempt in oil and gas manufacturing. However, water soluble chemicals that are injected into a well or formation do not become part of the product being produced, and consequently are not exempt under the manufacturing exemption.<sup>49</sup>

- d. Listed Support Equipment. This equipment automatically qualifies for the exemption if it is used to power, supply, support or control equipment that qualifies for exemption or to generate electricity, chilled water or steam for ultimate sale:
- actuators
  - steam production equipment and its fuel
  - in-process flow through tanks
  - cooling towers
  - generators
  - heat exchanges
  - electronic control room equipment
  - computerized control units
  - compressors
  - and hydraulic units.<sup>50</sup>
- e. Beginning October 1, 1999, the exemption extends to these items, as well:
- transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the transformers;
  - pumps; and
  - transformers located at an electric generating facility that increase the voltage of electricity generated for ultimate sale, the electrical cable that carries the electricity from the electric generating equipment to the step-up transformers and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-up transformers; and transformers that decrease the voltage of electricity generated for ultimate sale and the switches, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are related to the step-down transformers.
- f. Lubricants. The 1999 Legislation reinstated the manufacturing exemption for lubricants, chemicals, chemical compounds, gases or liquids used or consumed

---

<sup>49</sup> Comptroller Letter No. 9809836L (Gilbert Zamora, September 15, 1998).

<sup>50</sup> H.B. 1855, § 1 (75th Leg., R.S.) amending Texas Tax Code § 151.318, "Property Used in Manufacturing".

during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if their use or consumption is necessary and essential to prevent the decline, failure, lapse or deterioration of exempt manufacturing equipment.

**Example.** Lubricants used on compressor engines that are used to compress gas on gas leases.

- g. Gases. The 1999 Legislation reinstated the manufacturing exemption for gases used on the premises of a manufacturing plant to prevent contamination of raw materials or products, or to prevent a fire, explosion, or other hazardous or environmentally damaging situation at any stage in the manufacturing process or in loading or storage of the product or raw material on premises.
- h. Quality Control Process. The 1999 Legislation reinstated the manufacturing exemption for tangible personal property used or consumed during the **actual** manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to a quality control process.

**Example.** Spectrometers used to test the composition of chemicals produced for ultimate sale.

**Example.** Test and measurement software and equipment used to analyze test results during manufacturing.

**Caution.** The quality control process presents timing issues regarding when the manufacturing process begins and ends. Quality control machinery is eligible for the manufacturing exemption, but must be used during the manufacturing process.

**Example.** Barcode scanners used to verify correct components were included in the tray of parts to be assembled into the final product were not exempt equipment because they did not perform a quality control function. The scanners were most likely part of the overall control system (i.e. inventory and tracking).<sup>51</sup>

- i. Safety Clothing. The 1999 Legislation reinstated the manufacturing exemption for safety apparel or work clothing that is used during the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the manufacturing process would not be possible without the use of the apparel or clothing and the apparel or clothing is not resold to the employee.

**Examples.** Hardhats, earplugs, hairnets, safety shoes, mouth coverings, protective jumpsuits.

---

<sup>51</sup> Comptroller Hearing No. 200604619H (April 13, 2006).

- j. **Public Health.** The 1999 Legislation reinstated the manufacturing exemption for tangible personal property used or consumed in the actual manufacturing, processing or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary and essential to comply with federal, state or local laws or rules that establish requirements related to public health.

**Caution.** OSHA-required items only qualify for the manufacturing exemption if they're used in the actual manufacturing of the product for sale and they are necessary and essential to comply with regulations.<sup>52</sup>

**Example.** The Comptroller disallowed an exemption for an eye wash station that was required in the manufacturing area because it was not used in or during the actual manufacturing process.<sup>53</sup>

**Example.** Shop towels used to wipe off equipment, soak up spills, or clean up the work fall within the definition of "hand tools." Paper towels used solely by employees in the process of washing their hands in order to meet regulatory requirements do not fall within that definition because they, like the soap, are an integral part of that washing process.<sup>54</sup>

- k. **Water Conservation.** The 1999 Legislation reinstated the manufacturing exemption for tangible personal property specifically installed to:

- reduce water use and wastewater flow volumes from the manufacturing, processing, fabrication or repair operation;

**Example.** The cost of redesigning and rebuilding a machine so that it will use less water, reuse and recycle wastewater streams generated within the manufacturing, processing, fabrication or repair operation; or treat wastewater from another industrial or municipal source for the purpose of replacing existing freshwater sources in the manufacturing, processing, fabrication or repair operation.

**Note.** The pollution control exemption already covers much of this equipment. This provision extends the exemption to cover equipment that treats wastewater from a source other than the taxpayer.

**No Divergent Use.** The water conservation exemption applies only if the equipment or services are used solely for the exempt purpose.

- l. **Increased Capacity in a Petrochemical Refinery or Chemical Plant.** Labor is exempt as new construction when the repair, restoration, remodeling or

---

<sup>52</sup> See, e.g., Tax Policy News, November 2002 and Comptroller Decision No. 38,348 (Aug. 21, 2002) (deciding that an OSHA-required eyewash system didn't qualify for the manufacturing exemption because it wasn't used or consumed in the manufacturing process).

<sup>53</sup> Comptroller Hearing No. 38,388 (August 15, 2001).

<sup>54</sup> Comptroller Hearing No. 39,327 (August 30, 2000).



modification of an improvement to a manufacturing or processing production unit in a petrochemical refinery or chemical plant provides increased capacity in the production unit.<sup>55</sup>

- m. **Pollution Control Equipment.** Machinery or equipment required by law or regulation to control pollution resulting from the manufacturing process also qualifies for the exemption.<sup>56</sup>

**Example.** Pollution control equipment required by regulatory authorities in connection with particular manufacturing processes, such as fuel blending operations, is exempt. The electricity used to power the equipment is also exempt.<sup>57</sup>

**Non-Qualifying Items.** By statute, many items will not qualify for the manufacturing exemption, even if they directly touch the product or cause a chemical or physical change to the product being manufactured for sale.

- a. **Indirect Equipment.** The manufacturing sales tax exemption applies only to equipment that is directly used or consumed in manufacturing, processing or fabricating tangible personal property for ultimate sale.<sup>58</sup> The equipment must directly make or cause a chemical or physical change to the preliminary, intermediate or final product being manufactured for ultimate sale.
- b. Items that are “**one step removed**” from the manufacturing process may not be exempt since they don’t directly make or cause a physical change to the product being manufactured.

**Example.** A taxpayer manufactures cast-iron pipes using molds made from specially treated sand. The mold itself would be exempt because it directly forms steel into the proper shape for the product being manufactured. However, items used to make the mold would not be exempt. The product ultimately being manufactured is the pipe, and the items used to make the mold do not become component parts of the pipe; nor do they directly make or cause a physical change to the pipe.

Molds, dies, patterns. A manufacturer’s purchase of molds, dies, patterns, jigs, tooling,<sup>59</sup> photo engraving, and other manufacturing aids, and their raw materials or component parts, may qualify for exemption as direct use equipment.<sup>60</sup>

---

<sup>55</sup> See Comptroller Rule §3.362.

<sup>56</sup> Texas Tax Code § 151.338.

<sup>57</sup> Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

<sup>58</sup> October 1, 1997. *cf.* Sharp v. Tyler Pipe Indus., Inc., 919 S.W.2d 157 (Tex. App. – Austin 1996).

<sup>59</sup> Modifying existing dies.

<sup>60</sup> Comptroller Rule 3.300(b)(3).

**Planning Opportunity.** In the above example, the taxpayer could create a separate subsidiary to manufacture the molds. As the molds are the product manufactured by the subsidiary, any items becoming component parts of the molds, or causing a direct change to the molds, would be exempt. The sale of the molds to the parent entity would also be exempt since they directly make a physical change to the pipes, the product manufactured by the parent.

- c. **Intrplant Transportation Equipment.** This equipment is used to move, without change, products in process in the manufacturing plant. This equipment and machinery, by statute, does not qualify as manufacturing equipment. This includes equipment such as conveyor belts, pipelines, forklifts, etc.<sup>61</sup>

**Example.** Electricity used to transport product within a plant facility is taxable intraplant transportation. Equipment and electricity used to transport and load the product is also taxable.<sup>62</sup>

**Exception for Recirculation.** Piping qualifies if it is piping through which the product (or an intermediate or preliminary product that will become an ingredient or component part of the product) is recycled or circulated in a loop between the single item of manufacturing equipment and the ancillary equipment that supports only that single item of manufacturing equipment, if the single item of manufacturing equipment and the ancillary equipment operate together to perform a specific step in the manufacturing process.

**Example.** Conveyors inside a pizza oven.

**Example.** Bottling conveyors have been held to be exempt when they're part of the bottling machinery and taxable when they are not.<sup>63</sup>

- d. **Hand Tools.** Hand tools do not qualify for exemption as direct use equipment. A hand tool is an instrument that is to be used, managed, and powered by the hand (e.g., paint brush, trowel, hammer, screwdriver, files, disposable squeeze bottles for applying epoxy, gauges, calipers, shop rags). Equipment that is controlled or operated by the hand, but is moved or powered by electricity, gas, steam, or other fuel, is not a hand tool (e.g., electric drill, chain saw, jackhammer).<sup>64</sup>

**Example.** A nail gun may qualify for exemption but a hammer may not.

---

<sup>61</sup> Before October 1, 1997, equipment purchased for intraplant transportation of products may qualify for the manufacturing exemption if some physical or chemical change occurs during the transportation. *cf.* *Chevron Chemical v. Sharp*, 924 S.W. 2d 429 (Tex. App. – Austin 1996, writ denied).

<sup>62</sup> Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

<sup>63</sup> See Comptroller Letter No. 8908L0951B12 (Jo Ann Deick, August 10, 1989).

<sup>64</sup> Comptroller Rule 3.300(a)(6).

- e. **Property Repairs.** Manufacturing includes repairing or rebuilding tangible personal property for the purpose of being sold, but does not include the repair or rebuilding of property belonging to another.<sup>65</sup>
- f. **Real Property Maintenance.** The manufacturing process does not include maintaining the life of tangible personal property after it has been manufactured and the manufacturing process is complete.<sup>66</sup>
- g. **Samples.** A sample is a scale model or representative piece of a manufactured product held for sale. (e.g., cloth swatches and wallpaper books.)<sup>67</sup> Since the sole use of such samples is to demonstrate not the sample but the other items that the sample represents, the purchase of the raw materials used to make a sample are subject to sales or use tax, regardless of whether or not the sample itself may be ultimately sold.<sup>68</sup>

### *End of Manufacturing Process*

The manufacturing process concludes when the last physical or chemical change is made to the goods being manufactured for sale and they packaged and ready for marketing.

**Example.** A steel mill obtains recycled steel scrap from crushed automobiles, and places it into large furnaces that melt the steel into a molten state to form the products it sells (e.g. flat iron, angle iron, channel iron, concrete reinforcing bar and pipe). After being molded into the desired product, the manufacturer places the red hot molten products are placed on cooling beds to sufficiently reduce the temperature so further processing may occur. The purpose of the cooling bed is to control the rate of cooling to prevent internal stresses, fractures and warping. The cooling bed is exempt manufacturing equipment.

### *Containers and Packaging*

The final stage of manufacturing is packaging the items being manufactured so they are ready for sale. Depending upon the circumstances, the Comptroller's office may take different policy positions regarding what constitutes the final manufacturing stage.

**Example.** Packaging by Manufacturer with Distribution Center. Toothpaste may be sold at retail in a tube enclosed in a box. Multiple units of the boxed toothpaste are placed in cardboard boxes by the manufacturer. A label is placed on the cardboard boxes identifying the product. The manufacturer then places these labeled boxes on a pallet and covers them with shrink-wrap for shipment, either to the manufacturer's distribution center, the manufacturer's warehouse, or to the manufacturer's customer. The toothpaste manufacturer may purchase the tubes, boxes, labels, pallets, and shrink-wrap tax free. Any additional packaging necessary to transfer the product from the manufacturer's

---

<sup>65</sup> Comptroller Rule 3.300(a)(9).

<sup>66</sup> *Id.*

<sup>67</sup> Comptroller Rule 3.300(b)(4).

<sup>68</sup> *Id.*

distribution center, or from the manufacturer's warehouse to the manufacturer's customer would also be exempt from tax.<sup>69</sup>

**Example.** Pallets Rented by Manufacturer. A producer of food products with a manufacturing and a distribution center in Texas may rent pallets tax-free under the manufacturing exemption only if the pallets are leased for a period of more than one year. Pallets leased under a daily rental charge would not qualify for exemption.<sup>70</sup>

**Example.** Third Party Packaging. A third party packaging company is not a manufacturer or sub-manufacturer. The Comptroller considered a third party packaging company to owe tax on all equipment and supplies used for drumming liquid products for delivery, including charges for the drums, palletizing, banding and storage prior to shipment on the customer's behalf to the customer's clients.<sup>71</sup>

The Comptroller takes the position that third-party professional packaging services are nontaxable. The Tax Code requires service providers performing nontaxable services to pay tax on all taxable items used in performing the service. Since packaging services are nontaxable, the third-party packaging service provider must pay tax on all tangible personal property used in providing the service at the time of purchase.<sup>72</sup>

In *Combs v. Home and Garden Party, Ltd.*, the Third Court of Appeals denied a sales and use tax exemption on wrapping and packaging supplies where they were merely used to repackage items that were purchased from the manufacturer.<sup>73</sup>

Certain containers, including glass/plastic/metal bottles, cans, barrels and cylinders, which are necessary for marketing the finished product, are nontaxable or exempt.<sup>74</sup> The following are examples of nontaxable or exempt containers and packaging.

**Example.** Container sold with its contents if the contents are not subject to sales and use tax. In such case, the container would be a component part of the nontaxable item.

**Example.** Nonreusable container sold without contents to a person who fills the container and sells the container and contents together. In such case, the transaction would qualify for the resale or manufacturing exemption.

**Example.** A returnable container sold with contents or for refilling (e.g. a growler for beer<sup>75</sup> or a propane tank for a barbecue grill).

---

<sup>69</sup> Comptroller Rule 3.314(b)(1).

<sup>70</sup> Comptroller Letter No. 200110528L (Gilbert Zamora, October 5, 2001).

<sup>71</sup> Comptroller Letter No. 201001557L (Robin Corrigan, January 8, 2010).

<sup>72</sup> Comptroller Decision No. 9801144H (January 27, 1997).

<sup>73</sup> Not Reported in S.W.3d, 2010 WL 4367054, Tex. App.—Austin, no pet.).

<sup>74</sup> Tex. Tax Code § 151.322.

<sup>75</sup> Unless the beer is subject to mixed beverage gross receipts tax under Tax Code, Chapter 183.

Additional packing or wrapping supplies (wrapping paper, twine, bags, cartons, etc.) are not exempt.<sup>76</sup> Returnable containers used during manufacturing process are taxable.<sup>77</sup>

**Example.** Reusable soft drink bottles are subject to sales tax.

**Example.** Pallets and shrink wrap to bundle boxes of products for shipment to distribution centers.

Packaging supplies, including pallets, are exempt from tax only if they are “purchased by manufacturers for use as part of the completion of the manufacturing process.”<sup>78</sup>

**Example.** Bottlers are generally manufacturers and may qualify for the manufacturing exemption. Manufacturing machinery and equipment that are necessary, essential, and directly cause a chemical or physical change in the product (beverage) manufactured for sale are exempt from tax. Exempt packaging materials include bottle crowns, throwaway cartons and containers, and labels. Tax is due on wooden cases and returnable containers.<sup>79</sup>

Packaging equipment is exempt from tax when it is purchased by the manufacturer and used to package the product as it will be sold by the manufacturer. Repairs to such equipment are also exempt. Packaging equipment purchased by non-manufacturers is not exempt from tax.

**Example.** Stretch wrapper - A unit that applies film to products on a pallet. For example, a pallet of fertilizer or boxes found at a retail location like a home improvement store. The unit wraps plastic around the products and pallet to unitize the load.<sup>80</sup>

**Example.** Strapper - A unit that applies plastic bands around boxes or products. For example, an office supply’s copier paper has these plastic straps wrapped around the box.<sup>81</sup>

**Example.** Shrink wrapper - A unit that applies a temperature sensitive plastic film around the product. For example, a new video has this shrink wrap film wrapped around it. The shrink wrap must be removed prior to use.<sup>82</sup>

**Exemption for Manufacturers.** A manufacturer may purchase the stretch wrapper, strapper, and shrink wrapper tax-free for use as a part of the completion of the manufacturing process. The manufacturing process is complete when the manufacturer has packaged the tangible personal property produced as it will be sold by the manufacturer. The manufacturer also may purchase repair parts and repair labor for

---

<sup>76</sup> Tex. Tax Code § 151.322.

<sup>77</sup> Comptroller Letter No. 200002044L (Lindey Osborne, February 11, 2000).

<sup>78</sup> Comptroller Hearing No. 40,794 (2005) (citing Tex. Tax Code § 3.314(b)(1)).

<sup>79</sup> Comptroller Publication 94-139.

<sup>80</sup> Comptroller Letter No. 200012945L (Lindey Osborne, December 19, 2000).

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

qualifying manufacturing machinery and equipment tax-free by issuing a properly completed exemption certificate to the repairman.<sup>83</sup>

**No Exemption for Non-Manufacturers.** Persons other than manufacturers, such as persons who repack tangible personal property prior to sale, wholesalers, and retailers, owe tax on the purchase price, the repair parts, and repair labor for wrapping and packaging equipment.

**Exception for Sub-Manufacturers.** There is an exception where manufacturers subcontract the wrapping and packaging function to a subcontractor. The Comptroller has determined that a manufacturer that subcontracts with a person for some portion of the manufacturing process is entitled to make tax-free purchases of the qualifying taxable items used in providing the sub-contracted portion of the manufacturing process. In this situation, the subcontractor is performing the last stage of manufacturing by wrapping and packaging the product as it will be sold. Therefore, the subcontractor's purchases of wrapping and packaging equipment and repairs may be purchased tax-free.<sup>84</sup>

**Caution.** In order for this exception to apply, the third-party packager must qualify as a sub-manufacturer.<sup>85</sup> Some factors to consider may include whether the packager returns the items to the manufacturer, whether title transfers under the contract, whether the goods are repackaged and sold by the packager, etc. These characteristics distinguish between a packager that is a sub-manufacturer and qualifies for exemption and a packager that is not a sub-manufacturer and does not qualify.

#### *Exemption Available Only to Manufacturer*

In *Laredo Coca-Cola Bottling Co. v. Combs*,<sup>86</sup> the Third Court of Appeals considered whether post-mix machines qualify for the manufacturing exemption. Post mix machines combine syrup and soda to manufacture soft drinks. Specifically, the Court of Appeals considered whether Coca-Cola could qualify for exemption for purchase of post mix machinery which it placed on its customers' location under a "commitment agreement" under which no payments are required but the customers make certain commitments to purchase a specified quantity of Coca-Cola products. Coca-Cola didn't recoup the expenses associated with providing the equipment through higher charges for its other products, such as syrup, carbon dioxide or cups.<sup>87</sup>

The Comptroller contended and the Court held that the manufacturing exemption didn't apply because Coca-Cola's customers, not Coca-Cola itself, manufactured the beverages sold. Moreover, the Comptroller also contended that the transfers of the machines didn't qualify as sales for resale because there was no consideration to Coca-Cola for the machines. Rather, since there was no evidence that a customer failing to purchase the minimum requirement would lose

---

<sup>83</sup> *Id.*

<sup>84</sup> Comptroller Letter No. 200012945L (Lindey Osborne, Dec. 19, 2000).

<sup>85</sup> *See, e.g.,* Comptroller Letter No. 201001557L (Robin Corrigan, Jan. 8, 2010).

<sup>86</sup> \_\_\_ S.W.3d \_\_\_, 2010 WL 1507819 (Tex. App.—Austin 2010, pet. denied).

<sup>87</sup> *Id.* at \*2.

the machine, nor did Coca-Cola prohibit the customers from selling other beverages from other machines, there had been no consideration for the alleged “sale.”<sup>88</sup> The Court also determined that assumption of liability by Coca-Cola’s customers did constitute consideration for purposes of the resale exemption because there was no evidence in the record of Coca-Cola ever enforcing such a provision.<sup>89</sup>

Comptroller Hearing No. 44,231 considered whether a natural gas producer’s purchases qualified for the manufacturing exemption. The administrative law judge determined that compressors used to bring natural gas to the surface did not qualify for the exemption because the compressors were used before any chemical or physical changes were made to the item being manufactured for sale. The manufacturing exemption applies only to equipment used during the manufacturing process. Therefore, compressors used to extract oil and gas from the ground and to increase pressure for transportation purposes are not exempt. Compressors necessary for operating field dehydrators, heat treaters, separators and scrubbers qualify for the exemption because they are used in processing the natural gas and involve a chemical or physical change to the item being manufactured for sale. Since the compressors didn’t qualify for exemption, the administrative law judge also denied exemptions for compressor repairs and maintenance and purchases of lubricants, soap and surfactants for the compressors.<sup>90</sup>

The hearing also considered whether various oil and gas services were taxable. The invoice descriptions of the services performed were integral in the determination of whether the various services were taxable.

Comptroller Hearing No. 46,434 considered whether a cement plant operator’s purchase of a coal mill qualified for the manufacturing exemption. The coal mill mixed and crushed coal and coke into a powder that fueled a kiln. The cement plant operator used the kiln to bake aggregate materials into semi-molten clinker granules. The clinker granules were then cooled and mixed with gypsum to create cement. Since the coal mill didn’t cause a direct physical or chemical change to a component part of the product being manufactured for sale, the administrative law judge determined the coal mill purchase didn’t qualify for the exemption.

## **Divergent Use**

Divergent use means a use of a purchased item in a manner or for a purpose other than the manner or purpose that originally qualified the property for the exemption (in this case, the manufacturing exemption).<sup>91</sup>

Taxpayers are required to accrue use tax on the fair value of non-qualified use of manufacturing equipment. Prior to October 1, 2001, taxpayers could not claim a partial manufacturing exemption. The item was either exempt or it was not exempt.<sup>92</sup> Once the

---

<sup>88</sup> *Id.* at \*5.

<sup>89</sup> *Id.*

<sup>90</sup> See also Comptroller Hearing No. 43,112 (considering whether chokes, manifolds, valves and related items qualified for the manufacturing exemption).

<sup>91</sup> Tex. Tax Code § 151.3181(a)(1).

<sup>92</sup> Tex. Tax Code § 151.3181 (effective Sept. 1, 2001).



divergent use occurred, the taxpayer owed sales and use tax on the fair rental value of the equipment.

Since October 1, 2001, Texas taxes the amount of divergent use during the first four years of owning the equipment.<sup>93</sup> The tax on divergent use is payable monthly.<sup>94</sup> When applicable, a fraction of the tax that would have been due at the time of purchase is imposed based on the percentage of divergent use during that month.

*De Minimis* Exceptions. No tax is due on divergent use if the first divergent use occurs after the first four years or if divergent use during a reporting period doesn't exceed 5% of the total use of the item.

## **Taxable Service Issues for Manufacturers**

### **“Taxable Services”**

Taxable services are enumerated in Texas Tax Code § 151.0101. They include such things as amusement services; cable television services; personal services; motor vehicle parking and storage services; repair, remodeling, maintenance and restoration of certain tangible personal property; telecommunications services; credit reporting services; debt collection services; insurance services; information services; real property services; data processing services; real property repair and remodeling; security services; telephone answering services; Internet access services; and sales by transmission and distribution utilities to end-use customers whose consumption of electricity is subject to sales and use tax.

### **Repair, Remodeling, Restoration of Tangible Personal Property**

Repairs, remodeling, and restoration of tangible personal property is a taxable service. There is an exception for certain types of repairs, remodeling and restoration of computer programs that are not sold by the person performing the repairs, remodeling or restoration.

Repairs to Manufacturing Equipment: Repair, remodeling and maintenance charges relating to exempt manufacturing equipment are exempt so long as the equipment has not been incorporated into the realty such that it has lost its characterization as tangible personal property at the time the service is performed.

### **Services Related to Real Estate**

Repair and remodeling of commercial real property is a taxable service. New construction and residential repairs are nontaxable. However, contractors improving realty are considered the consumers of materials purchased for lump sum nontaxable jobs.<sup>95</sup> A taxpayer may be a manufacturer on one job, and a contractor on another. However, the taxpayer cannot be

---

<sup>93</sup> Tex. Tax Code § 151.3181 (effective Oct. 1, 2001).

<sup>94</sup> Tex. Tax Code § 151.3181(b).

<sup>95</sup> A lump sum contract, as contrasted with a separated contract, is one in which a single charge includes both labor and materials.

both a manufacturer and a contractor on the same job.<sup>96</sup> A taxpayer is considered a contractor when it installs manufactured goods such that they become part of the real estate. Manufactured goods generally become part of the realty when they're inseparable from the realty, without damage.

**Example.** The tax treatment of concrete processing equipment depends on whether a manufacturer contracts to mix and deliver concrete to a job site or contracts to incorporate the concrete into realty (i.e., builds the forms and sets/ties steel reinforcing bar, in addition to mixing and pouring the concrete). In the first case, the taxpayer is a manufacturer. In the second case, the taxpayer is a contractor.<sup>97</sup>

## Nontaxable New Construction

New construction of real estate is not subject to sales or use tax. Contracts to improve real property (or real estate) include contracts to erect, construct, alter, or repair any building or other structure, project, development, or other permanent improvement on, under the surface of, or to real property. Manufacturers may be purchasers of construction services when having a new facility built. If a manufacturer acts as a contractor for its customers it may lose its manufacturing exemption, in full or in part.

**Example.** Electrical wiring installed within building walls becomes real property. To qualify for the manufacturing exemption, the electrical wiring must: (i) be installed under a separated contract; and (ii) be a component part of exempt manufacturing equipment, electronic control-room equipment or computerized control units used to power, supply, support or control exempt manufacturing equipment. Electrical equipment that supports general plant operations is not exempt.<sup>98</sup>

New construction also includes furnishing and installing property that becomes a part of any building or other structure, project, development, or other permanent improvement on or to such real property, including tangible personal property, which after installation becomes real property by virtue of being embedded in or permanently affixed to the land or to a structure constituting realty and which property after installation is necessary to the intended usefulness of the building or other structure.

Comptroller Rule 3.357(a)(8) defines “new construction” to include “[a]ll new improvements to real property including initial finish out work to the interior or exterior of the improvement. An example would be a multiple story building which has only had its first floor finished and occupied. The initial finishing out of each additional floor prior to initial occupancy will be considered new construction. New construction also includes the addition of new footage to an existing structure.”

---

<sup>96</sup> Comptroller Letter No. 200007533L (Philip Knisley, July 26, 2000).

<sup>97</sup> See Comptroller Letter No. 200803078L (James P. Mathieson, March 25, 2008).

<sup>98</sup> Comptroller Letter No. 200002044L (Lindey Osborne, February 11, 2000).

It also includes the alteration of the land surface of real property by such means as creating roads, paving roads, creating earthen dams, and creating stock tanks. However, mining or timber operations do not, in and of themselves, constitute improvements to realty.

Charges for new construction will be nontaxable if the new construction is from the ground up, where no structure has existed before.

Charges for new construction will also be nontaxable if the work adds additional footage to an existing building or structure.

**Example.** Comptroller Letter No. 200112697L (December 31, 2001) considered the taxability of converting a movie theatre to an office building. The project included adding a second floor within an existing structure. The general contractor leveled the ground floor and constructed a second floor where one did not exist before. The usable square footage of the building increased without a change in the outside dimensions of the building. The steel structure for the second floor was totally independent of the existing structure since the existing structure couldn't handle additional loads. The taxpayer also added a separate HVAC system and restrooms for the second floor. The contract segregated the costs associated with new construction from those associated with remodeling of the first floor. The Comptroller considered the construction of the second floor inside the former theatre to be new construction. The new construction included the supports located on the first floor since they were totally independent of the existing structure and did not serve any function in the remodeling of the first floor (i.e. serve as walls for the first floor remodeling job). The Comptroller cautioned that fortifying existing walls or foundation to accept the increased load (not present in this scenario) would be considered remodeling. The Comptroller considered the modifications to the first floor to the HVAC system to also be taxable remodeling services, along with any work performed on the existing roof or walls of the theatre structure. Any additional walls or finish out (i.e. flooring, new false ceiling, etc.) were considered new construction.

However, the fact that changes must or may be made to an existing structure to accommodate or facilitate new footage and whether or not the changes will enhance the existing structure does not change remodeling to new construction.

**Example.** In addition to remodeling an existing shopping mall, the taxpayer demolished a portion of the building that consisted of floor space customers used to gain access to the retail stores, along with a storage area beneath the pedestrian walkway. They replaced the demolished structure with a new structure that housed a movie theatre on a lower level and a food service hall on a second level above the movie theatre. The new structure added additional leasable space to the mall. However, the Comptroller considers replacing or upgrading any part of an existing structure is remodeling or modification. Only a portion of the present structure was being demolished. Converting storage to "leasable space" is not necessarily addition of "new footage" to an existing structure.<sup>99</sup>

---

<sup>99</sup> Comptroller Letter No. 8902L0925C01 (Tom Soto, February 21, 1989).

Another common issue for manufacturers arises when purchasing a newly constructed manufacturing facility. Any equipment purchased by the manufacturer that may be subject to the manufacturing exemption should be separately stated in the contract. Only if the manufacturer is the consumer of a piece of manufacturing equipment may the manufacturing exemption apply. If a contractor purchases manufacturing equipment and then charges the manufacturer for it as part of the lump-sum cost of new construction, the contractor is considered the consumer of the equipment and the manufacturer loses the ability to claim an exemption.

### Special Exclusion for Petrochemical Refineries

An improvement to a manufacturing or processing production unit in a petrochemical refinery or chemical plant that provides increased capacity in the production unit is not subject to sales or use tax.<sup>100</sup>

Increased capacity means the capacity to produce additional products or services or a new product or service. Additional capacity may be measured by units per hour or units per year.

A production unit means a group of manufacturing and processing machines and ancillary equipment that together are necessary to create or produce a physical or chemical change beginning with the first processing of the raw material and ending with the finished product.

A “new product” is one that has different product properties and a different commercial application than the previous product and is not created by straining or purifying an existing product or by making cosmetic changes (e.g. adding or removing color or odor).

### **Regularly Scheduled Maintenance Exception**

Taxable repairs and remodeling do not include regularly scheduled maintenance, such as maintenance of a manufacturing plant. Maintenance means scheduled, periodic work that is necessary to sustain or support safe, efficient, continuous operations, or to prevent the decline, failure, lapse, or deterioration of operational and functional improvements to realty.

Taxable real property services do not qualify as maintenance. Maintenance also does not include work to remodel, modify, upgrade, perform major repair, or restore, even if the work is scheduled or periodic.

**Example.** Parking lot striping - Parking lot restriping may qualify as maintenance only when performed on a regularly scheduled and recurring basis. Persons claiming this exemption must be able to show by maintenance schedules or work orders that the restriping is performed to sustain or support safe, efficient, continuous operations or to keep in good working order by preventing the decline, failure, lapse, or deterioration of the improvement. Any restriping performed due

---

<sup>100</sup> See Tex. Tax Code § 151.0047 (a)(3).

to fading, cracking, etc., is done after the deterioration has occurred is therefore a taxable repair.<sup>101</sup>

**Caution.** The Comptroller has held in certain cases that merely determining that the real property must have additional work within some general time frame is not the same as regularly scheduling the work and is not maintenance.<sup>102</sup>

## Unprocessed Materials - Sand, Dirt and Gravel

Charges for sand, dirt and gravel that are dug up from the earth, without processing, and delivered to the job site are treated as charges for nontaxable delivery services. Delivery services on their own are not subject to sales or use tax. Delivery services are only taxable when provided in connection with the sale of a taxable item.

**Example.** The purchase of “unprocessed” sand and gravel is not subject to sales tax. The washing, drying, screening for size, and sorting of sand, gravel and similar materials is not processing. The sale and delivery of these unprocessed materials is not taxable.<sup>103</sup>

**Note.** Portland cement is not subject to Texas sales or use tax. It is exempt from tax under Tax Code Sec. 151.308(a)(4). The taxability of cement is governed by Chapter 181, which imposes an occupation tax on cement production.

## Processed Materials, Concrete and Other Aggregates

While it is true that merely washing gravel, dirt and sand to remove clay and silt would not be considered processing, where the facts show that characteristics of the sand, dirt or gravel are also being changed or modified during washing, the sand, dirt or gravel may be considered taxable processed materials and the manufacturing exemption may apply to equipment purchased to perform the work.<sup>104</sup>

**Example.** During the hydraulic wash process, high-powered streams of water spray a sand pile, further downsizing the sand when individual grains are freed (due to the intense water pressure) from clumps of sand grains. In addition, impurities bound to the sand grains (such as iron oxide and silica) are released during this process.

Processed materials and aggregates, such as concrete or drilling mud, are subject to sales and use tax as manufactured goods. A manufacturer processing such materials may claim an exemption for tools and equipment purchased for the purpose of making a chemical or physical change to the processed materials or aggregates being manufactured for sale.<sup>105</sup>

---

<sup>101</sup> Comptroller Letter No. 8911L0969B12 (Glenda Aguirre, November 15, 1989).

<sup>102</sup> Comptroller Letter No. 9506L1351G08 (Wade Anderson, June 13, 1995).

<sup>103</sup> Comptroller Letter No. 200002044L (Lindey Osborne, February 11, 2000).

<sup>104</sup> Comptroller Hearing No. 27,940 (1992).

<sup>105</sup> See Tex. Tax Code § 151.318(a)(1).

**Example.** Washing, drying, screening for size, and sorting of sand gravel and similar materials is not processing. Crushing or mixing is processing. Sand is also considered to be processed when it is blasted out of the ground. Sale and delivery of unprocessed materials are nontaxable services.<sup>106</sup>

**Example.** Crushing or mixing is processing.<sup>107</sup>

**Example.** Combining several materials such as sand and gravel or rock to produce a material for making concrete is processing.

**Example.** Crushing the materials or crushing a small percentage of materials and blending with the same kind of uncrushed materials is also considered processing.<sup>108</sup>

As a manufacturer, a taxpayer is a supplier (i.e., retailer) of concrete when sold to a contractor making real property improvements.<sup>109</sup> When selling to a contractor providing new construction or residential repair or remodeling services under a lump-sum contract with the property owner, the manufacturer should collect tax from the contractor on the selling price of the concrete.<sup>110</sup>

A manufacturer selling concrete to a contractor performing new construction or residential repair or remodeling under a separated contract with the property owner, or selling to a nonresidential real property repair or remodeling service provider under either a lump-sum or separated contract may accept a resale certificate in lieu of collecting tax from the purchaser. The contractor or service provider then has the responsibility of collecting tax from its customer.<sup>111</sup>

The Tax Code will treat a taxpayer as a concrete contractor if the taxpayer is making an improvement to realty (i.e., if the contract includes building the forms and setting or tying steel reinforcing bar, in addition to mixing and pouring the concrete.) A concrete contractor is not a manufacturer and may not claim manufacturing exemptions on purchases of concrete producing equipment. In that case, divergent use tax would be due on purchase of loaders, mixers and portable batch plants, as well as any other tools and equipment, at the time of purchase, or divergent use.<sup>112</sup>

A manufacturer of aggregates may qualify for exemption from sales and use tax when it purchases machinery or equipment used to produce aggregates.

**Example.** Using dynamite to blast rock out of the earth, and simultaneously start the reduction in size of large boulders into gravel is processing. The dynamite was primarily

---

<sup>106</sup> Comptroller Letter No. 9212L1233B12 (Jo Ann Dieck, December 7, 1992).

<sup>107</sup> *Id.*

<sup>108</sup> See Tex. Tax Code § 151.318(a)(1).

<sup>109</sup> See Rules 3.291 and 3.357.

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

used to reduce the size of the rocks and therefore qualified for the manufacturing exemption.<sup>113</sup>

## Ready Mix Concrete Contractors

The Comptroller amended Rule 3.291 to reflect 2007 legislation that requires ready mix concrete contractors to separately state the price of concrete from any other charges associated with the contract.<sup>114</sup> Ready mix concrete contractors are those who both (1) manufacture concrete for construction purposes and (2) incorporate concrete into realty.<sup>115</sup> The contractors are required to collect and remit tax on the higher of the invoice price or fair market value.

A ready mix concrete contractor must invoice the customer for the cost of the concrete separately from the charge for the improvement to realty contract and charge for each cubic yard of ready mixed concrete produced and consumed on the project.<sup>116</sup>

The ready mix concrete contractor may issue a resale certificate in lieu of paying tax on the purchase of taxable items, such as processed sand or gravel, used in mixing concrete. The ready mix concrete contractor must collect sales tax on the greater of the invoice price of the concrete consumed in completing the job or the fair market value of the concrete. This provision does not apply to a ready mix concrete contractor working on a public works project.<sup>117</sup>

**Example.** Subcontractor providing ready mix concrete contractor services to a general contractor under a lump-sum contract. The subcontractor would pay tax on all materials incorporated into the realty (e.g., rebar, stubbed pipes, conduit, wiring, etc.) but could issue a resale certificate for the processed materials used to produce the concrete. The subcontractor must invoice the general contractor for the cost of the concrete separately from the charge for the improvement to realty contract and charge for each cubic yard of ready mixed concrete produced and consumed on the project. Tax must be collected on the charge for the concrete.

**Example.** Subcontractor to a general contractor that enters into a separated contract with the general contractor. The subcontractor could issue a resale certificate in lieu of paying tax on the purchase of incorporated materials (e.g., rebar, stubbed pipe, conduit, wiring, etc.) and the processed materials used to produce the concrete. The subcontractor must charge tax to the general contractor on the incorporated materials and separately stated concrete charge if the general contractor is performing work under a lump-sum contract with the owner or the subcontractor may accept a valid resale or exemption certificate in lieu of collecting the tax from the general contractor.

**Example.** Subcontractor to a general contractor that enters into a separated contract with the general contractor. The subcontractor may accept a resale certificate from the general

---

<sup>113</sup> Comptroller Hearing No. 23,055 (1988).

<sup>114</sup> Tex. Tax Code § 151.056(g).

<sup>115</sup> *Id.*

<sup>116</sup> *See* Tex. Tax Code § 151.318(a)(1).

<sup>117</sup> *Id.*



contractor for the separately stated materials and concrete if the general contractor is also performing its contract under the terms of a separated contract with the owner. The general contractor would be liable for collecting tax on the separately stated materials and concrete charges from the owner or must accept a valid exemption certificate in lieu of the collecting the tax.<sup>118</sup>

**Example.** Subcontractor to a service provider performing nonresidential repair and remodeling. The subcontractor may accept a resale certificate from the service provider for all charges. The service provider is responsible for collecting tax from the owner on the total charges for the job.<sup>119</sup>

Businesses that mix and deliver concrete to a job site and pour the concrete are considered to be manufacturers exempt from sales tax on the purchase of machinery and component parts used in manufacturing the concrete. Freestanding mixers<sup>120</sup> and certain parts of portable batch plants<sup>121</sup> qualify for the manufacturing exemption. Front end loaders used to fill hoppers or move materials are non-exempt transportation equipment.<sup>122</sup>

**Delivering Concrete to a Job Site.** A taxpayer that mixes and delivers concrete to the job site and pours in a location, as directed, is considered to be a seller of concrete. As a seller of concrete, the taxpayer is a manufacturer entitled to certain manufacturing exemptions.<sup>123</sup> The taxpayer may issue a valid exemption certificate for qualifying manufacturing machinery and equipment in addition to the component ingredients used in to make the concrete.<sup>124</sup>

## **Five Percent (5%) Rule for Mixed Transactions**

If a contract includes both nontaxable new construction and taxable repairs and remodeling for a lump-sum charge, the entire charge will be presumed nontaxable new construction if the portion of the charge applicable to the remodeling is less than five percent (5%) of the overall contract. If the remodeling portion represents more than five percent (5%) of the lump-sum charge, the total contract will be presumed taxable unless the charge for the remodeling is separately stated.

A taxpayer may overcome the presumption of taxability under the five percent (5%) rule by providing bid sheets, blueprints, or other documents that break down the percentage charged for the nontaxable new construction and the taxable repairs and remodeling.

---

<sup>118</sup> See Comptroller Rule 3.291.

<sup>119</sup> See Comptroller Rule 3.357.

<sup>120</sup> Tex. Tax Code § 151.318(a)(2).

<sup>121</sup> Comptroller Rule 3.300.

<sup>122</sup> See Comptroller Letter No. 200803078L (James P. Mathieson, March 25, 2008) (loaders are excluded from the exemption by § 151.318(c)(1)).

<sup>123</sup> Tex. Tax Code § 151.318.

<sup>124</sup> Comptroller Form 01-339.

## Garbage Removal and Real Property Services

Garbage removal is a taxable real property service. Taxable real property services also include landscaping, lawn maintenance, janitorial services, pest control, and surveying services. They are taxable services regardless of whether the property is commercial or residential.

Taxable garbage removal includes the removal or collection of garbage, rubbish or other solid waste other than:

- a. Hazardous waste, as identified or listed as a hazardous waste by the administrator of the United States Environmental Protection Agency or by other appropriate federal or state agency;
- b. Industrial solid waste, as that term is defined in Health and Safety Code, Chapter 361, the “Solid Waste Disposal Act,” with the exception of industrial solid waste which meets the definition of garbage or municipal solid waste;
  - i. Industrial solid waste – solid waste resulting from or incidental to a process of industry or manufacturing, or mining or agricultural operations.<sup>125</sup>
  - ii. Garbage – solid waste that is putrescible animal and vegetable waste materials from the handling, preparation, cooking, or consumption of food, including waste materials from markets, storage facilities, and the handling and sale of produce and other food products.<sup>126</sup>
  - iii. Municipal solid waste – solid waste resulting from or incidental to municipal, community, commercial, institutional, or recreational activities, and includes garbage, rubbish, ashes, street cleanings, dead animals, abandoned automobiles, and other solid waste other than industrial solid waste.<sup>127</sup>
- c. Waste material associated with exploration, development, or production activities for oil, gas, geothermal resources, or other substances or materials regulated by the Texas Railroad Commission;<sup>128</sup>
- d. Domestic sewage or an irrigation return flow (to the extent the sewage or return flow doesn’t constitute “garbage” or “rubbish”); and
- e. Industrial discharges regulated by permit<sup>129</sup>

---

<sup>125</sup> Health and Safety Code § 361.003(16).

<sup>126</sup> Health and Safety Code § 361.003(10).

<sup>127</sup> Health and Safety Code § 361.003(20).

<sup>128</sup> Texas Natural Resources Code § 91.101.

<sup>129</sup> Texas Water Code, Chapter 26.

The taxpayer in *Southern Plastics v. Combs*,<sup>130</sup> was denied a refund of sales and use taxes paid on industrial solid waste because it was unable to distinguish the charge for industrial solid waste removal from charges to remove other waste from its facilities. Southern Plastics is a manufacturer of plastic closures, such as cups and lids, which it sells to companies that manufacture and sell beverages, personal care products and other household products. Southern Plastics also manufactures liners for the insides of some of the plastic closures. The Comptroller audited Southern Plastics and assessed tax on waste removal charges. Southern Plastics offered results of subsequent engineering studies, which showed less than one percent of the waste was from office, administrative or break room areas. However, the court held that no provision applied for allowing an after-the-fact study to allocate the waste removal charges. Therefore, the assessment was upheld and the refund was denied.<sup>131</sup>

## Industry Issues

### Semiconductor Manufacturers.

Semiconductor clean rooms are exempt.<sup>132</sup> The exemption extends to all tangible personal property without regard to whether the property is affixed to or incorporated into realty.<sup>133</sup> A semiconductor manufacturer can claim an exemption on fabrication cleanrooms and equipment. Qualifying items include all tangible personal property used in connection with the manufacturing, processing or fabrication of semiconductors in a cleanroom environment.<sup>134</sup>

**Example.** A charge for services to clean a semiconductor manufacturer's clean room is exempt.<sup>135</sup> A service performed on TPP that is exempt at the time of service is also exempt.<sup>136</sup>

A qualifying item can be affixed to or incorporated into realty, and does not have to be in the cleanroom. The exemption covers such items as integrated systems, fixtures and piping; property necessary or adapted to reduce contamination or to control airflow, temperature, humidity, chemical purity or other environmental conditions or manufacturing tolerances; and production equipment and machinery.<sup>137</sup>

Also qualifying are movable cleanroom partitions and cleanroom lighting, although the exemption does not extend to the building (or its permanent, nonremovable components) that houses the cleanroom.<sup>138</sup>

---

<sup>130</sup> 2009 WL 1896077 (Tex. App.—Austin 2009), Cause No. 03-08-00149-CV.

<sup>131</sup> Texas Water Code, Chapter 26.

<sup>132</sup> Tex. Tax Code §§ 151.318(b)(2), 151.318(q).

<sup>133</sup> Comptroller Letter No. 200011921L (Eddie Washington, November 21, 2000).

<sup>134</sup> Comptroller Publication 94-124, Specific Exemptions for Certain Manufacturers, available online at: [http://www.cpa.state.tx.us/taxinfo/taxpubs/tx94\\_124.html](http://www.cpa.state.tx.us/taxinfo/taxpubs/tx94_124.html).

<sup>135</sup> Comptroller Letter No. 200011921L (Eddie Washington, November 21, 2000).

<sup>136</sup> *Id.*

<sup>137</sup> Comptroller Publication 94-124, "Specific Exemptions for Certain Manufacturers," available online at: [http://www.cpa.state.tx.us/taxinfo/taxpubs/tx94\\_124.html](http://www.cpa.state.tx.us/taxinfo/taxpubs/tx94_124.html).

<sup>138</sup> *Id.*

In *DuPont Photomasks, Inc. v. Strayhorn*,<sup>139</sup> the Court considered whether the sales tax exemption applied to costs of cleanroom equipment resold in connection with a lease of real property. In order to manufacture sensitive electronic equipment, DuPont entered into an agreement for the construction of a sterile, controlled cleanroom and a building to house the chamber. After the building was constructed, DuPont leased the building and the cleanroom to another company. DuPont did not pay sales tax on the parts purchased for the construction of the cleanroom and claimed that it was entitled to the resale exemption. The Court determined DuPont wasn't eligible for the exemption because it did not purchase a cleanroom, but purchased various items that were assembled to make a cleanroom. Therefore, it did not purchase a cleanroom for the sole purpose of subsequently leasing it. DuPont also did not provide resale certificates to the companies that it purchased the items.

## **Exemption for Items Used to Capture, Transport and Sequester Carbon Dioxide (CO<sub>2</sub>)**

Texas law exempts from sales and use tax components of tangible personal property used in connection with an advanced clean energy project that are installed to capture, transport, inject or prepare for transportation or injection of CO<sub>2</sub> from an anthropogenic emission source. The CO<sub>2</sub> must be sequestered in Texas as part of an enhanced oil recovery project under conditions that create a reasonable expectation that at least 99% of the CO<sub>2</sub> will remain sequestered from the atmosphere for at least 1,000 years.<sup>140</sup>

## **Gas and Electricity Exemption**

Manufacturers may also qualify for the gas and electricity exemption. Documenting the exemption is a common issue in audits and administrative hearings. Gas and electricity are exempt if sold for certain exempt purchases enumerated by statute. These exempt purposes include:

- a. Residential use (including rental property which is rented for longer than a 29 day period) (except local tax)<sup>141</sup>
- b. Use in manufacturing (except restaurant use)

Manufacturers intending to qualify for a gas or electricity exemption must have a utility study performed by a qualified engineer, which states that at least 50% of the uses of electricity flowing through the exempt meter qualify for exemption.

- c. Use in agriculture (including dairy or poultry operations and pumping for farm or ranch irrigation)
- d. Use in exploring for, producing, or transporting material extracted from the earth.

---

<sup>139</sup> 219 S.W.3d 414 (Tex. App.—Austin 2007, *pet denied*).

<sup>140</sup> House Bill 469 (Effective Sept. 1, 2009).

<sup>141</sup> See, e.g. Comptroller Letter No. 9009L1069E01 (Jo Anne Dieck, Sept. 27, 1990).

- e. Use in electrical processes, such as electroplating, electrolysis and cathodic protection.
- f. Direct use in the off-wing overhaul or repair of jet turbine engines or parts for a certificated or licensed carrier of people or property
- g. Use directly in providing, under contracts with the United States government or foreign governments, defense or national security related electronics, classified intelligence data processing and handling systems, or defense-related platform modifications or upgrades.
- h. Electricity purchased by a utility provider for resale
- i. Use in timber operations (including pumping for irrigation or timber land)

Gas and electricity used during the manufacturing process is exempt from Texas sales and use tax. However, the gas and electricity must be used after the manufacturing has commenced and before the process is concluded. Once manufacturing is complete, the exemption no longer applies.

**Example.** Electricity used by a meat processing plant to cook the meat products and to quickly cool it to a specific temperature necessary for sale qualified for the manufacturing exemption.<sup>142</sup> Additional electricity needed to maintain the meat at the cooled temperature while it was held for distribution and sale did not qualify for the exemption.<sup>143</sup>

**Example.** Electricity used to maintain frozen orange juice concentrate at a consistent temperature prior to production of the final juice product was considered to be used in manufacturing and qualified for exemption.<sup>144</sup>

In contrast with the regular manufacturing exemption, manufacturing does not include restaurant use for purposes of the exemption on gas and electricity.

**Example.** Electricity and gas used in preparing food at a restaurant chain's central kitchen were not exempt from sales and use tax because the utilities were consumed in connection with preparing food for immediate consumption.<sup>145</sup>

---

<sup>142</sup> Comptroller Hearing No. 27,389 (1992).

<sup>143</sup> *Id.*

<sup>144</sup> *Texas Citrus Exchange v. Sharp*, 955 S.W.2d 164 (Tex. App.—Austin 1997).

<sup>145</sup> *See Cafeteria Operators v. Sharp*, 96 S.W.3d 460 (Tex. App.—Austin 2002). No significant food product prepared in the central kitchen was retailed for home preparation. *See also*, *Colonial Cafeteria-Arlington, Inc. v. Bullock*, 587 S.W.2d 211 (Tex. App.—Beaumont 1979) (holding that electricity consumed in processing food was not used for manufacturing).

**Planning Opportunity.** If the cafeteria business involved in the example above had formed its central kitchen as a separate legal entity, the manufacturing exemption may have applied, since the entity prepping the food would not be the same entity as the cafeteria locations cooking, heating and serving the food.

#### Special Requirements for Exempt Gas and Electricity

In addition to the usual exemption certificate requirements, an entity claiming the gas and electricity exemption must include the following:

Specific statement of exemption: e.g. “A valid and complete study has been performed which shows that (insert the actual exempt percentage) of the natural gas or electricity is for processing tangible personal property for sale in the regular course of business.”

The original seal of the registered engineer who performed the study or a signed statement including the original signatures of the business owner and engineer.

**Non-Qualifying Uses.** Non-qualifying use means the use of gas and electricity by a person engaged in selling, warehousing or distributing a commodity or performing a professional or personal service. This includes electricity or gas used in the wholesale and retail trades, hotels, office buildings, in preparing or storing food for immediate consumption and for use by persons providing taxable services.

**Taxable v. Exempt Uses.** When determining the predominant use of natural gas or electricity, utilities used to operate production machinery and for lighting, cooling and heating in the manufacturing area are considered exempt uses. Gas and electricity used to operate, lighting, cooling and heating in manufacturing support areas are considered taxable uses. Manufacturing support areas include, but are not limited to, storage, engineering, office and accounting areas, research and development and break room, eating and restroom facilities. Utilities used in an area open to the public for purposes of marketing a product ready for sale are considered taxable uses. Utilities used to operate other nonproduction machinery or equipment are taxable.

**Single Meters and “Predominant Use.”** Natural gas or electricity used for both exempt and taxable purposes under a single meter is totally exempt or totally taxable based upon the “predominant use” of the gas or electricity measured by that meter. Predominant use of gas and/or electricity for exempt purposes is required to obtain an exemption.

**Utility Study Required.** If the utilities are not separately metered, the Comptroller requires the taxpayer to have an engineer perform a utility study to establish the qualified, predominant use of the utilities. The study must list all exempt and nonexempt uses of the utilities, as well as other technical specifications. The business owner must certify that all items using natural gas or electricity are listed and the hours of use for each item are correct. The electricity or natural gas computations must be performed by a registered engineer or a person with an engineering degree from an accredited engineering college. The taxpayer must complete the utility study and have it

on file at the time the taxpayer submits the exemption certificate to the utility company. Without the study, the Comptroller presumes the exemption is invalid.

**Example.** Comptroller Rule 3.295 requires a predominant use study to include all items on a particular meter and all utility uses for each item. Limiting the analysis only to a portion of the use (e.g., refrigeration) results in an incomplete study. A taxpayer claiming exemption must present evidence that clearly brings him within the exemption.<sup>146</sup>

**No Study.** Persons obtaining a sales tax refund without a valid study will be assessed tax, penalty and interest on the full amount of the refund, if the exemption is not proved. The Comptroller may request a copy of the study for review before or after the sales tax exemption is granted. Review of the study by the Comptroller does not confirm the study's accuracy.

**What if Qualifying Use is 50% or Less?** If 50% or less of the electricity or gas flowing through a single meter constitutes a qualified (exempt use), none of the electricity or gas is exempt. However, the taxpayer may add another meter through which the qualifying use electricity or gas may flow which will then allow the exemption for the gas or electricity flowing through the second meter (assuming more than 50% of the use flowing through the second meter is qualified.) According to the Comptroller's office, this strategy is allowed.

**Non-qualifying Property.** The following items don't qualify for the manufacturing exemption:<sup>147</sup>

- Property used in the transmission or distribution of electricity;
- Transformers, cable, switched, breakers, capacitor banks, regulators, relays, reclosers, fuses, interrupters, reactors, arresters, resistors, insulators, instrument transformers and telemetry units that are not otherwise exempted; and
- Lines, conduit towers and poles.

**Caution.** The Comptroller requires a business with more than one location to have a valid utility study for each location, even if the gas and electricity use at the various locations are comparable.<sup>148</sup>

---

<sup>146</sup> Taxability Ruling 1275 (John Sharp, October 18, 1991), STAR No. 9110T1221D05.

<sup>147</sup> Tex. Tax Code § 151.318 (c)(5).

<sup>148</sup> Comptroller Hearing No. 39,602 (June 27, 2002).



The material appearing in this website is for informational purposes only and is not legal advice. Transmission of this information is not intended to create, and receipt does not constitute, an attorney-client relationship. The information provided herein is intended only as general information which may or may not reflect the most current developments. Although these materials may be prepared by professionals, they should not be used as a substitute for professional services. If legal or other professional advice is required, the services of a professional should be sought.

The opinions or viewpoints expressed herein do not necessarily reflect those of Lorman Education Services. All materials and content were prepared by persons and/or entities other than Lorman Education Services, and said other persons and/or entities are solely responsible for their content.

Any links to other websites are not intended to be referrals or endorsements of these sites. The links provided are maintained by the respective organizations, and they are solely responsible for the content of their own sites.