

January 25, 2012

To the Honorable 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 2011.

The processing and manufacturing industries are vital to the strength of Iowa's economy. Attached to this report are several amendments to Iowa's industrial processing exemption statutes that the Committee believes could play an important role in encouraging additional investment by Iowa's manufacturers. We would be pleased to assist the General Assembly to further explore the details and advantages of these proposals.

History and Charge of the Committee

The Committee was originally formed by the Iowa General Assembly in 2003 in order to study and make recommendations related to Iowa's sales and use tax industrial processing exemptions. The Committee is required to make a report to the Iowa General Assembly each year through January 1, 2013.

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.

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. A list of the current members of the Committee is attached to this letter at Attachment 1. These professionals represent 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.

Activities of the Committee

The Committee has worked diligently since 2003 to fulfill the responsibilities assigned to it by the Iowa General Assembly. 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 2010 for a more detailed discussion of these activities.

In our Annual Reports for previous years, the Committee offered a number of additional statutory amendments, including the following:

- Clarify the exemption for materials used to self-construct packaging and containers;
- An exemption for services used by manufacturers in processing or performed on machinery and equipment used in processing;
- An exemption for cutting oils, coolants, and sorbents;
- An exemption for chemicals used in processing.

- Clarify the exemption for software used to operate manufacturing machinery and equipment;
- Change the definitions of “manufacturer” and “manufacturing location;”
- Clarify the exemption for transformers and other related equipment used to provide electricity to manufacturing machinery and equipment;
- Provide a statutory definition of exempt “replacement parts” for manufacturing machinery and equipment; and
- Clarify the exemption for parts and services used to “rebuild” manufacturing machinery and equipment.

Copies of these prior-year proposals are attached to this report as Attachments 2 – 5 and 7 – 11. The Committee has also drafted proposed changes to the Iowa Department of Revenue’s current regulations related to replacement parts and repair services for manufacturing machinery and equipment. This proposal is attached as Attachment 6.

Additionally, the Committee was asked by the Association of Business and Industry to review proposed legislation, which was introduced as Senate File 2244 during the 2010 legislative session, creating an exemption for wastewater treatment or effluent treatment services provided to paper recycling mills. The Committee revised the ABI proposal to extend the exemption to all manufacturers, not just paper recycling mills. A copy of the proposal approved by the Committee is attached as Attachment 12. The Committee notes that wastewater treatment services would also be exempted by the proposed legislation described in Attachment 3, and that the proposal on Attachment 3 may represent a simpler and broader approach to the situation. However, the Committee approved the proposed legislation on Attachment 12 should the General Assembly choose to only address the more narrow issues created by wastewater treatment services.

The issues addressed above 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. In light of the importance of the manufacturing industry to Iowa’s economy, 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.

As noted above, the legislative act that created the Committee states that the Committee is only to remain in existence through January 1, 2013. We ask that the General Assembly act to extend the life of the Committee through December 31, 2015, with Committee’s final report due January 1, 2016. The Committee is hopeful that the General Assembly will be actively involved in addressing the sales and use tax issues currently facing Iowa’s manufacturers, and stands ready to serve in an advisory capacity as the General Assembly considers the legislative proposals summarized in this report.

* * * * *

It has been an honor for us to chair this Committee during 2011. We look forward to continuing this good work in 2012 and beyond.

Sincerely,



Dwayne Vande Krol
Co-Chair



Jason Wilson
Co-Chair

Attachment 1

List of Committee Members as of January 1, 2012

January 2012

INDUSTRIAL PROCESSING STUDY COMMITTEE

Dwayne Vande Krol, Co-Chair
Nyemaster, Goode, West, Hansell
& O'Brien, P.C.
700 Walnut, Suite 1600
Des Moines, IA 50309-3899
(515) 283-8195
dvandekrol@nyemaster.com

Jason Wilson, Co-Chair
Wilson Tax and Business Consulting
PO Box 1116
Ankeny, IA 50221
(515) 577-1294
jasonwilson.wtbc@gmail.com

Bruce Baker
Nyemaster, Goode, West, Hansell, and O'Brien
700 Walnut Street, Suite 1600
Des Moines, IA 50309
(515) 283-3187
bwbaker@nyemaster.com

Denton Childs
Tyson Foods, Inc.
PO Box 2020, CP131
Springdale, AR 72765
(479) 290-7093
denton.childs@tyson.com

Michael A. Eversmeyer
Vice President, Treasurer & Controller
Muscatine Foods Corporation
1600 Oregon Street, PO Box 149
Muscatine, IA 52761-0149
(563) 264-4445
mike_eversmeyer@muscatinefoods.com

John Gilliland
Senior Vice President, Government Relations
Iowa Association of Business and Industry
400 East Court Ave., Ste 100
Des Moines, IA 50309
(515) 235-0566
jgilliland@iowaabi.org

Daryl Jendras
State and Local Tax Manager
RSM McGladrey, Inc.

One South Wacker Drive, Suite 800
Chicago, IL 60606-3392
(312) 634-4544
daryl.jendras@rsmi.com

Jeffrey L. Johnson
Grant Thornton
500 US Bank Plaza
200 South Sixth Street
Minneapolis, MN 55402
(612) 677-5112
jeff.johnson@gt.com

Stephen W. Roberts
Senior Shareholder
Davis, Brown, Koehn, Shors & Roberts, PC
2500 Financial Center
Des Moines, IA 50309-3993
(515) 246-7933
steveroberts@davisbrownlaw.com

Michael C. Rubino
Director State Taxes
Deere & Company
John Deere Road
Moline, IL 61265
(309) 765-4311
rubinomichaelc@johndeere.com

Rick Smith
Cost Accountant
Clow Valve Company
902 South 2nd Street
Oskaloosa, IA 52577
(641) 673-8611
rsmith@clowvalve.com

Kimberley Vellenga
State and Local Tax Manager
McGladrey & Pullen, LLP
201 N. Harrison, Suite 300
Davenport, IA 52801-1999
(563) 888-4433
kimberley.vellenga@mcgladrey.com

Nicole Molt
President
Iowa Taxpayers Association
705 East 2nd
Des Moines, IA 50309
(515) 243-0300
nicole@iowataxpayers.org

Michael E. Belwood
Manager, North American Public Strategy
ALCOA
7850 Brookshire Ct.
Evansville, IN 47715
(812) 604-0530
mike.belwood@alcoa.com

Joel Lunde
Office of Management
State Capitol Building
Des Moines, IA 50319
(515) 281-7072
joel.lunde@iowa.gov

Marcia Mason
Assistant Attorney General
Iowa Attorney General's Office
Hoover State Office Building
Des Moines, Iowa 50319
(515) 281-5055
mmason@ag.state.ia.us

Victoria Daniels
Manager Policy/Audit Services Section
Iowa Department of Revenue
Hoover State Office Building
Des Moines, Iowa 50319
(515) 281-8450
victoria.daniels@iowa.gov

Theresa Dvorak
Technical Tax Specialist, Policy Section
Iowa Department of Revenue
Hoover State Office Building
Des Moines, Iowa 50319
(515) 281-3194
theresa.dvorak@iowa.gov

Attachment 2

Amend Iowa Code Sec. 423.3(45) as follows to exempt materials used to self-construct containers and other packaging:

The sales price from the sale of property which is a container, label, carton, pallet, packing case, wrapping paper, twine, bag, bottle, shipping case, or other similar article or receptacle sold to retailers or manufacturers for the purpose of packaging or facilitating the transportation of tangible personal property sold at retail or transferred in association with the maintenance or repair of fabric or clothing. Materials used to construct the listed items are also exempt.

Attachment 3

Add NEW Iowa Code Sec. 423.3(47)(c) as follows to exempt services used by manufacturers in processing, and services performed on certain computer, machinery, and equipment used in an exempt manner:

- c. The sales price from the sale of otherwise taxable services used by a manufacturer in processing as defined in section 423.3(47)(d)(5), or performed on or with computers, machinery, and equipment used in an exempt manner as described in paragraph “a,” subparagraphs (1), (2), (3), (5), or (6).

Attachment 4

Amend Iowa Code Sec. 423.3(51) as follows to exempt cutting fluids and similar items:

423.3.51.a The sales price of tangible personal property sold for processing. Tangible personal property is sold for processing within the meaning of this subsection only when it is intended that the property will, by means of fabrication, compounding, manufacturing, or germination, become an integral part of other tangible personal property intended to be sold ultimately at retail; or for generating electric current; or the property is a chemical, solvent, sorbent, or reagent, which is directly used and is consumed, dissipated or depleted in processing tangible personal property which is intended to be sold ultimately at retail or consumed in the maintenance or repair of fabric or clothing, and which may not become a component or integral part of the finished product. The distribution to the public of free newspapers or shoppers guides is a retail sale for purposes of the processing exemption set out in this subsection and in subsection 50.

423.3.51.b The sales price of cutting fluids, oils, coolants and lubricants that come into direct contact with tangible personal property intended to be ultimately sold at retail and which may not become a component or integral part of the product. This does not include a machine's internal oils and lubricants that relate to the machine's internal operations.

Attachment 5

Add NEW Iowa Code Sec. 423.3(47)(c) as follows to exempt chemicals used by manufacturers in processing:

- c. The sales price from the sale of a chemical, solvent, sorbent, or reagent, which is consumed, dissipated or depleted in processing used by a manufacturer in processing as defined in section 423.3(47)(d)(5).

Attachment 6

Amend Iowa Rule 701-18.58(1) as follows:

“Replacement parts.” A “replacement part” is any machinery, equipment, or computer part which is substituted for another part that has broken, has become worn out or obsolete, or is otherwise unable to perform its intended function. “Replacement parts” are those parts which materially add to the value of industrial machinery, equipment, or computers or appreciably prolong their lives or keep them in their ordinarily efficient operating condition. Excluded from the meaning of the term “replacement parts” are supplies, the use of which is necessary if machinery is to accomplish its intended function. Drill bits, grinding wheels, punches, taps, reamers, saw blades, lubricants, coolants, sanding discs, sanding belts, and air filters are nonexclusive examples of items which may be rebuttably presumed to be supplies. Sales of supplies remain taxable.

Tangible personal property with an expected useful life of 12 months or more which is used in the operation of machinery, equipment, or computers is rebuttably presumed to be a “replacement part.” Tangible personal property used in the same manner with an expected useful life of less than 12 months is rebuttably presumed to be a “supply.” The following is a non-exclusive list of factors that may be used to rebut the presumption that an item with an expected useful life of less than 12 months is a “supply.”

- a. The item is subjected to extreme levels of temperature, friction, pressure, or other similar physical or chemical stress.
- b. The item is used in an operation that runs continuously and with little downtime.
- c. The item is used in an operation that runs for more than one eight-hour shift per day.
- d. The item is covered by an original manufacturer’s warranty of 12 months or longer.

The accounting treatment for financial statement or income tax purposes shall not be the determining factor as to whether such items qualify as replacement parts.

Amend Iowa Rule 701-26.29 as follows:

Persons engaged in the business of repairing machines of all kinds are rendering, furnishing or performing a service, the gross receipts from which are subject to tax. “Machine” shall include all devices having moving parts and operated by hand, powered by a motor, engine, or other form of energy, as well as replacement parts for such devices. It is a mechanical device or combination of mechanical powers and devices used to perform some function and produce a certain effect or result. A musical instrument does not constitute a machine and therefore, musical instrument repairs are not subject to tax. Repair of supply items or other items not meeting the definition of machine or a replacement part for a machine are not taxable as machine repair. Examples of nontaxable services include, but are not limited to, the modification of tooling if no enumerated services (such as welding) are part of the modification process, and the sharpening of blades and tooling if the blades and tooling are not considered replacement parts for the machine to which they are attached. The definition and factors used in Rule 701-18.58(1) for distinguishing between a “supply” and “replacement part” in the context of the exemption for manufacturing machinery and equipment should be consulted for purposes of defining taxable “machine repair.”

Attachment 7

Amend Iowa Code Sec. 423.3.47 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.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).

Attachment 8

Amend Iowa Code Sec. 423.3.47.a. as follows to adopt a definition of “manufacturer” for sales and use tax purposes 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.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.

Attachment 9

Adopt NEW Iowa Code Sec. 423.3.47(c) as follows to exempt transformers and other equipment used to provide electricity to manufacturing machinery and equipment:

Iowa Code Sec. 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).

Attachment 10

Adopt NEW Iowa Code Sec. 423.3.47(d)(7) as follows to specify the definition of exempt “replacement parts” for manufacturing machinery and equipment:

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.

Attachment 11

Adopt NEW Iowa Code Sec. 423.3(47)(b) as follows to exempt parts and services used to rebuild manufacturing machinery and equipment:

b. Services purchased to repair or rebuild machinery or component parts of machinery that are described in section 423.3(47)(a) are exempt if the services and material to repair or rebuild the machinery or component parts of machinery exceed 75% of the cost to acquire the machinery or component parts of machinery, based on the lower of current replacement cost or original cost as adjusted for inflation.

Attachment 12

Amend Iowa Code Sec. 422.3.32.c. relating to the sales tax exemption for certain wastewater treatment or effluent treatment services as follows:

Iowa Code Sec. 422.3.32.c. The sale or furnishing of sewage service for nonresidential commercial operations, except for water treatment or effluent treatment services to a manufacturer as defined in section 423.3(47)(d)(4).