Capitalizing on Your Nontaxable Capital in Virginia

by Rita Davis

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In this viewpoint, Davis explains Virginia's machinery and tools tax, including some arguably counterintuitive ways it is applied. She writes that determining a piece of machinery's tax status requires an extensive step-by-step analysis of its role in the manufacturing process.

I. Introduction

Understanding and navigating the personal property taxes imposed on manufacturers in the commonwealth of Virginia can be challenging. For large manufacturers, tax assessments from localities can drain significant sums from an operating budget. This is especially true regarding the machinery and tools (M&T) tax. The first hint of difficulties in this area came in 1942 in *City of Roanoke v. James W. Michael's Bakery Corp*.[1] In *Michael's Bakery*, the dissent commented on the majority's ruling that a delivery truck was intangible personal property subject to state taxation, writing that "one must travel far to prove that a truck is not a truck." That hint reveals an opportunity for good tax planning — sometimes machinery is not tangible. Consequently, many tax professionals report as taxable M&T property that is not taxable by Virginia localities.

Counterintuitively, not all of a manufacturing business's equipment is subject to the M&T tax. Some machinery and equipment (known as capital) cannot be taxed by localities and is not taxed by the commonwealth. It is therefore important that a manufacturer understand the difference between M&T and capital. That, however, cannot be done without a careful examination of the applicable standards, case law, rulings from the Virginia Department of Taxation, and an evaluation of the business's manufacturing process. This article provides a practical overview of the process for evaluating whether a manufacturer's equipment is M&T or nontaxable capital.[2]

II. Legal Framework

Virginia classifies personal property as tangible[3] or intangible[4] for tax purposes. This classification governs, in large measure, whether it is subject to state or local taxation. The Constitution of Virginia segregates exclusively for local taxation tangible personal property,[5] while permitting the legislature to exempt from state and local taxation intangible personal property.[6] The legislature, in turn, separated for taxation by the state most intangible personal property.[7] The classification of personal property for tax purposes is illustrated in Figure 1.

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[1] *City of Roanoke v. James W. Michael's Bakery Corp.*, 21 S.E.2d 788, 800 (Va. 1942).

[2] Much of the analysis in this article also applies to equipment used in the mining, water well drilling, processing or reprocessing, radio or

(Footnote continued in next column.)

television broadcasting, dairy, dry cleaning, and laundry industries. This article focuses, however, on manufacturing businesses.

[3] The department defines tangible property as property that "is capable of being handled, felt or touched, and may be evaluated by its physical senses; it is property having substance or body and which is capable of being possessed or realized" and "property such as a chair or watch which may be touched or felt in contrast to a contract." PD 04-54 (Aug. 18, 2004) (quoting 63C *Am. Jur. 2d* "Property," section 9 (1997) and *Black's Law Dictionary* (1979)).

[4] In contrast, "intangible property" for sales and use tax purposes (but not for property purposes):

> consists of rights not related to physical things, but merely are relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in the courts. Intangible property may be evidenced by a document with no intrinsic value, such as a stock certificate. According to this widely accepted definition, contracts fall under the definition of "intangible property."

PD 04-54 (Aug. 18, 2004).

[5] Va. Const. Art. X, section 4; *see also* Va. Code section 58.1-3500, which provides:

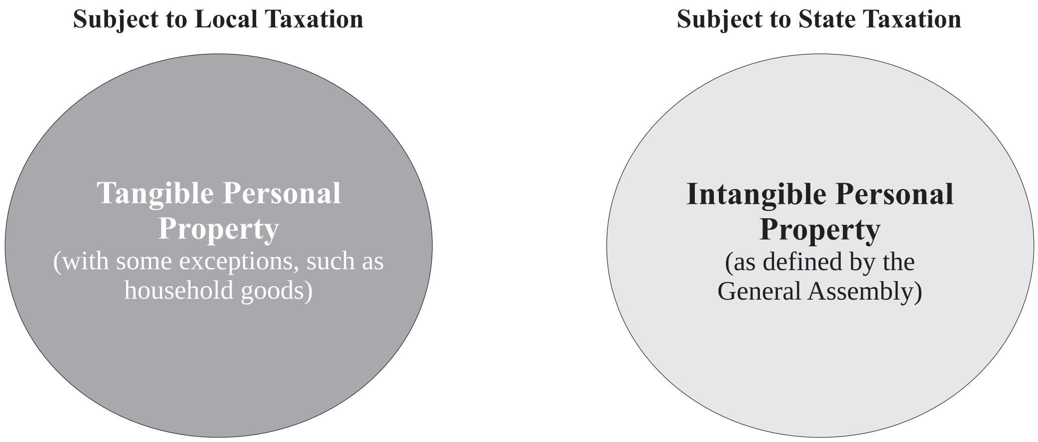
> Tangible personal property shall consist of all personal property not otherwise classified by (i) section 58.1-1100 as intangible personal property, (ii) section 58.1-3510 as merchants' capital, or (iii) section 58.1-3510.4 as short-term rental property. Such tangible personal property is hereby segregated for and made subject to local taxation only pursuant to Article X, section 4 of the Constitution of Virginia.

For a history of Virginia's classification of personal property, see *Michael's Bakery* and "Taxation of Machinery and Tools Used in a Manufacturing or Mining Business: An Analysis," 39 *U Va. L. Rev*. 249 (1953).

[6] Va. Const. Art. X, section 6(a)(5) describes it as "intangible personal property, or any class or classes thereof, as may be exempted in whole or in part by general law."

[7] Va. Code section 58.1-1100 provides that "intangible personal property, including capital of a trade or business of any person, firm or corporation . . . is hereby segregated for state taxation only."

Figure 1.



With the power to define and classify personal property not otherwise classified in the Virginia Constitution, the General Assembly declared that some personal property, despite its tangible nature, is intangible for tax purposes.[8] For instance, it classified as intangible personal property capital that is tangible personal property "used in a manufacturing business."[9] Often referred to as "manufacturer's capital," that property consists of tangible personal property (such as furniture, fixtures, office equipment, and so forth) used by manufacturers in their businesses.[10] Even though manufacturer's capital is reserved for state taxation, the commonwealth does not tax it.[11] Excluded from manufacturer's capital, also known as "capital not otherwise taxed," is M&T.[12] Only the localities can tax M&T.[13] Thus, taxation of manufacturing equipment depends on how it is classified by the General Assembly. (See Figure 2.)

III. Is Your Equipment M&T or Capital Not Otherwise Taxed?

Generally, a manufacturer has the following classes of property under Virginia tax law: real property, motor vehicles (including delivery equipment), M&T, and capital not otherwise taxed. All tangible personal property used in a manufacturing business is capital not otherwise taxed unless it is M&T, motor vehicles, or delivery trucks.[14] Thus, only

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[8]Va. Const. Art. X, section 1 ("The General Assembly may define and classify taxable subjects. Except as to classes of property herein expressly segregated for either State or local taxation"); Va. Code section 58.1-1100; *see also Michael's Bakery* (recognizing legislature's power to define and classify personal property).

[9]Va. Code section 58.1-1101 A 2 defines as intangible personal property:

> Capital which is personal property, tangible in fact, used in manufacturing (including, but not limited to, furniture, fixtures, office equipment and computer equipment used in corporate headquarters), mining, water well drilling, radio or television broadcasting, dairy, dry cleaning or laundry businesses. Machinery and tools, motor vehicles and delivery equipment of such businesses shall not be defined as intangible personal property for purposes of this chapter and shall be taxed locally as tangible personal property according to the applicable provisions of law relative to such property.

[10]*See* Va. Code section 58.1-1101 A 2.

[11]Va. Code section 58.1-1101 C provides that manufacturer's capital "shall be exempt from taxation as provided in Article X, section 6(a)(5) of the Constitution of Virginia."

[12]Va. Code section 58.1-1101 A 2.

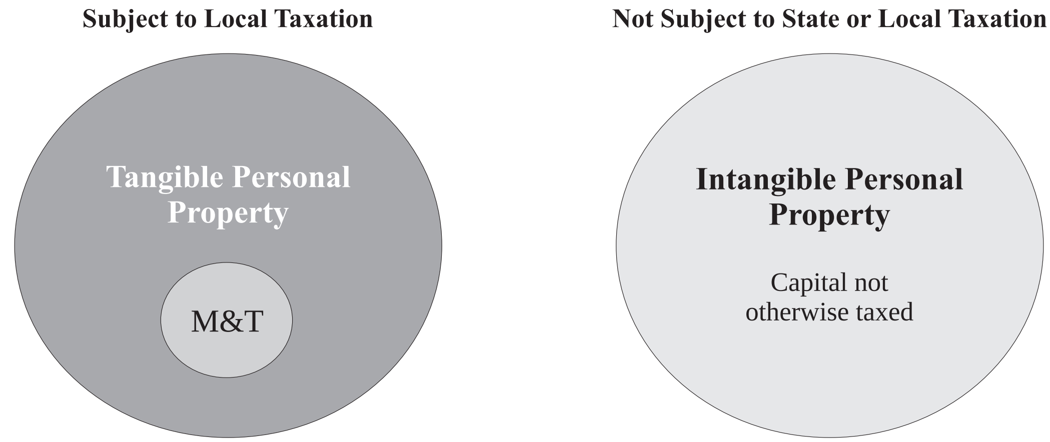
[13]Va. Code section 58.1-3507 A states in relevant part:

> Machinery and tools, except idle machinery and tools as defined in subsection D and machinery and equipment used by farm wineries as defined in section 4.1-100, used in a manufacturing, mining, water well drilling, processing or reprocessing, radio or television broadcasting, dairy, dry cleaning or laundry business shall be listed and are hereby segregated as a class of tangible personal property separate from all other classes of property and shall be subject to local taxation only.

See also Va. Code section 58.1-1101 A 2.

[14]*See, e.g.*, Va. Code section 58.1-3500, which states, "Tangible personal property shall consist of all personal property not otherwise classified by . . . section 58.1-1100 as intangible personal property."

Figure 2.



the latter three are subject to local taxation.[15] Manufacturing equipment, however, is either capital not otherwise taxed or M&T. It cannot be both.[16] In order for manufacturing equipment to be classified as M&T, it must be "actually and directly used in the manufacturing process where new materials are transformed into a substantially different product or . . . connected with the operation of machinery actually and directly used in the manufacturing process."[17] The Supreme Court of Virginia set out that standard in *The Daily Press v. City of Newport News*.[18] Under that standard, one must determine whether the equipment is:

> (a) used in the actual process of manufacturing; or
>
> (b) necessary in the particular manufacturing business and . . . used in connection with the operation of machinery which is actually and directly used in the manufacturing process.[19]

If neither (a) nor (b) applies, the equipment is capital not otherwise taxed, meaning it cannot be taxed by the locality or by the commonwealth. If either (a) or (b) applies, the equipment is M&T and subject to local taxation. Determining the answers to (a) and (b) should not be done casually — both prongs must be carefully considered.

A. A Deeper Dive

Below are issues to consider when analyzing manufacturing equipment under *The Daily Press* standard.

1. What product does the business manufacture?

In determining whether manufacturing equipment is M&T, courts consider what product the manufacturer actually makes.[20]

2. Where does the transformation process begin and end?

Determine the points in the process where the transformation of raw or new materials into that product begins and ends.

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[15] *See* Va. Code sections 58.1-3507 A and C; PD 12-181 (Nov. 13, 2012); and PD 15-7 (Jan. 8, 2015).

[16] The Supreme Court of Virginia recognized that "a single piece of property" cannot "be subject to more than one ad valorem tax apportioned according to its use." *County of Chesterfield v. BBC Brown Boveri*, 380 S.E.2d 890, 892 (Va. 1989) (citation omitted).

[17] *The Daily Press v. City of Newport News*, 576 S.E.2d at 434 (citing *City of Winchester v. American Woodmark*, 464 S.E.2d 148, 152 (Va. 1995) (stating that machinery must be actually used in the manufacturing process)). Note that Va. Code section 58.1-602 contains a definition for manufacturing. That definition, however, applies to sales and use tax. The department has advised that because the "purpose of M&T tax statutes is to establish what property may be subject to tax while the laws governing the retail sales and use tax determine which purchases are exempt from the tax," the definitions of manufacturing are not necessarily interchangeable, and manufacturing equipment "may not be treated the same under Virginia's sales and use tax rules and the M&T tax statutes." *See* PD 13-163 (May 10, 2013).

[18] 576 S.E.2d 430 (Va. 2003).

[19] *The Daily Press*, 576 S.E.2d at 433 (citation omitted).

[20] *Id.* at 310-311, 576 S.E.2d at 433-434 (holding that *The Daily Press* manufactured newspapers, and the process of transforming raw material into newspapers began in the pressroom).

3. Are there production activities that take place before the transformation process?

Manufacturing equipment used in preproduction is generally capital not otherwise taxed.[21] For instance, raw material storage kept separate from the manufacturing process is capital not otherwise taxed.[22] Also, tools used to manufacture tools actually used in the manufacturing process are capital not otherwise taxed.[23] So if tools are created during a preproduction phase and later used during the transformation process, the equipment used to manufacture those preproduction tools is not taxable. Tools used to repair equipment actually and directly used in the manufacturing process are also classified as capital not otherwise taxed.[24]

Similarly, there may be other items manufactured during a preproduction phase that are actually and directly used in the manufacture of the product for sale. Those items may be destroyed during the manufacturing process or later discarded. It has been argued that the equipment used to create those "interim objects" is not M&T. In *The Daily Press*, the Supreme Court of Virginia rejected the argument that equipment that transformed a sheet of aluminum into a press plate embossed with the format and content of the newspaper was M&T. The court found that *The Daily Press* manufactured newspapers but that the only place where raw materials were transformed into newspapers was the pressroom, where "a printing press, using ink, a water fountain solution mix, and the aluminum press plate, transforms a news print roll . . . into a newspaper."[25] Even though the press plate was made by *The Daily Press* for manufacturing the newspaper, the court declined to rule that the equipment used to create that press plate was M&T. An analogous argument may be available for equipment that manufactures similar interim objects.[26]

[21]PD 14-12 (Jan. 27, 2014) ("Machinery and tools used in a pre-production process not directly used in manufacturing are considered intangible property not subject to the M&T tax") (citing *The Daily Press*, 265 Va. at 310, 576 S.E.2d at 433; and PD 06-79 (Aug. 23, 2006)).

[22]PD 14-12 (Jan. 27, 2014).

[23]Both the Supreme Court of Virginia and the department have ruled that equipment used to manufacture the tools actually and directly used in the manufacturing process is intangible capital. *See The Daily Press*, 576 S.E.2d at 433; and PD 06-79 (Aug. 23, 2006).

[24]PD 06-79 (Aug. 23, 2006).

[25]*The Daily Press*, 576 S.E.2d at 433.

[26]It must be mentioned that the department has ruled that, at least in a precision investment casting process, machinery that manufactures casts and molds is M&T. The department ruled that *The Daily Press* standard does not say that manufacturing occurs only when it results in the final product for sale. *See* PD 15-212 (Nov. 24, 2015). It is difficult to square the department's ruling with the court's finding in *The Daily Press* that the only manufacturing occurring at the taxpayer's facility was in the pressroom where the actual newspapers were made.

4. After the transformation process ends, what is next?

Are there any post-production manufacturing activities? For example, does the product need to be tested, cleaned, polished, stamped, or packaged before it can be shipped to the purchaser? Whether equipment involved in post-production activities is capital not otherwise taxed or M&T turns on the purpose of its function. For example, equipment used to package, test, or calibrate the product for retail sale to meet industry standards, comply with government regulations, or meet product quality requirements is M&T. In contrast, equipment used to package the product for shipping is capital not otherwise taxed. The key inquiry regarding packaging equipment is whether it adds value to the finished product. If so, it is likely M&T.

Likewise, if the product must be cleaned, buffed, or polished before being sent to the customer, equipment performing that function is M&T. Equipment used to inventory finished product quantities, however, is capital not otherwise taxed. Equipment used to carry out the logistics of stocking and moving finished goods is likely to be capital not otherwise taxed. That same equipment, however, if used to move raw materials from one part of the manufacturing process to another, may be M&T. Equipment with a dual function, such as storage racking systems used to hold both raw materials to be used in the manufacturing process and finished goods, will be classified as M&T if a substantial part of its function is actually and directly used in manufacturing.[27]

5. Is all the equipment M&T?

It would be tempting to view all the equipment used during the transformation process as M&T. That, however, would be shortsighted. Even if equipment is used in the transformation process, it is not necessarily M&T. That is because there may be assets operating during the transformation process that are not actually and directly used in the transformation of raw materials into a substantially different product.

For example, pollution control equipment installed to meet environmental regulatory standards may be capital not otherwise taxed, not M&T.[28] Similarly, if the product could be made without the asset, as is the case with most pollution control equipment, there is a strong argument that the asset is not actually and directly used in the manufacturing process.[29] And therefore, the asset is not M&T.[30]

[27]PD 08-88 (June 16, 2008).

[28]*Id.*

[29]*The Daily Press*, 576 S.E.2d at 433.

[30]It is important to note, however, that the department has ruled that if the pollution control equipment functions to capture material

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Also consider whether safety equipment (such as first-aid stations), gas detection equipment, or hazardous material equipment is actually and directly used in transforming raw materials, or is necessary and integrated or built into machinery that is. If not, there is a strong argument that the equipment is not M&T.

B. Be Critical: Ask the Right Questions

When considering whether equipment operating in the manufacturing process is M&T or capital not otherwise taxed, ask the following questions[31]:

- Does the equipment actually and directly transform raw materials into the product being manufactured?
- Even if the equipment never touches the raw materials or the new product, is it used at any point directly in the process of transforming the raw materials into the product?[32]
- Does the equipment perform a function necessary to bring the product into compliance with a performance, sanitation, quality control or quality assurance standard?
- Does the equipment perform a function that adds value to the product?

If the answer to any of the above is yes, the equipment is likely M&T. If the answer to any of the above is no, ask whether the equipment is (a) necessary to the manufacturing business and (b) integrated or built into equipment that does any of the above.[33] Again, if the answer is no, the equipment is likely capital not otherwise taxed.

IV. Conclusion

The classification of manufacturing equipment depends on how it is used in the particular manufacturing business. A manufacturer should not assume that every asset operating during the manufacturing process is subject to M&T tax. Much that is tangible in fact in Virginia is intangible under law. Therefore, a manufacturer and its tax professionals should conduct a fact-intensive examination of what the manufacturing process is and each asset's function in that process. That kind of analysis could result in significant tax savings. ✰

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and recycle it for further use in the manufacturing process, the equipment is actually and directly used in the manufacturing process. *See* PD 11-110 (June 17, 2011).

[31]Be aware that property that is exempt from sales and use tax as "directly used" in manufacturing is not necessarily taxable M&T. *See, e.g.,* PD 15-214 (Nov. 24, 2015).

[32]Under the department's application of *The Daily Press* standard, machinery does not need to be actually involved in the transformation of the new material into a substantially different product or ever touch raw material. Thus, a drying complex used in the initial step of transforming carpet fibers and lab equipment used to make water and oil mixtures eventually used in the manufacture of copper rods were ruled by the department to be M&T. *See* PD 05-148 (Aug. 30, 2005); PD 04-39 (Aug. 2, 2004); and PD 15-212 (Nov. 11, 2004).

(Footnote continued in next column.)

[33]*The Daily Press*, 576 S.E.2d at 433 (citation omitted); and PD 14-12 (Jan. 27, 2014).