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Purchaser Must Be The Manufacturer Who Uses The Items To Qualify For The Texas Sales Tax Manufacturing Exemption

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The Texas Comptroller recently ruled that a taxpayer (hereafter "Taxpayer") who manufactures, markets, and distributes beverage concentrates cannot claim the Texas sales tax manufacturing exemption (or the resale exemption) for purchases of fountain drink machines, replacement parts or related repair services provided to its customers free of charge.¹

Even though (i) Taxpayer is a manufacturer, and (ii) the fountain drink machines perform manufacturing activities, the Taxpayer's purchases of the machines do not fall within the scope of the Texas sales tax manufacturing exemption. Because the Taxpayer's "customers," and not Taxpayer, use the machines to manufacture products for ultimate sale, Taxpayer's purchases cannot qualify for the manufacturing exemption. Further, Taxpayer's purchases of fountain drink machines were not treated as exempt under the sale for resale exemption since Taxpayer did not show that it received any monetary payment from its customers for use of the machines.

Background And Taxpayer's Claims

Taxpayer manufactures, markets, and distributes nonalcoholic beverage concentrates and syrups. Taxpayer provides fountain drink machines free of charge to customers who purchase Taxpayer's concentrates and syrups to make soft drinks for retail sale.

Taxpayer filed refund claims for sales tax paid on purchases of fountain drink machines and replacement parts, and for repair services performed on the machines. Taxpayer contends that the purchase of fountain drink machines subsequently provided to its customers, as well as repair and replacement parts related to those machines, qualify for the Texas sales tax manufacturing exemption. Taxpayer further contends that its purchase of repair services performed on the fountain drink machines were exempt from Texas sales tax as services performed on exempt property under Texas Tax Code § 151.3111. Alternatively, Taxpayer claims that its purchases of fountain drink machines

¹ See Texas Comptroller's Decision Nos. 43,792 and 43,793 (Sept. 12, 2005).

were exempt sales for resale. The Comptroller's Audit Division denied Taxpayer's claims.

Manufacturing Exemption Requirements

Texas Tax Code § 151.318 provides an exemption from the Texas sales and use tax for certain property "sold, leased, or rented to, or stored, used, or consumed by a manufacturer." To qualify the property must be:

tangible personal property directly used or consumed in or during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale if the use or consumption of the property is necessary or essential to the manufacturing, processing, or fabrication operation and directly makes or causes a chemical or physical change to . . . the product being manufactured, processed, or fabricated for ultimate sale²

In addition, services performed on exempt tangible personal property are exempt from Texas sales and use tax. The Texas Tax Code specifically provides:

A service that is performed on tangible personal property that, if sold, leased, or rented, at the time of the performance of the service, would be exempted under this chapter because of the nature of the property, its use, or a combination of its nature and use, is exempted from this chapter.³

In rejecting Taxpayer's claim, the Administrative Law Judge ruled that Taxpayer could not claim the manufacturing exemption since Taxpayer's customers, and not Taxpayer, actually directly used the fountain drink machines to manufacture product for ultimate sale. Even though Taxpayer is a manufacturer and the fountain drink machines perform activities that fall within the manufacturing exemption, Taxpayer could not claim the manufacturing exemption because Taxpayer did not use the machines directly in its manufacturing operation (*i.e.* Taxpayer's use of the fountain drink machines was one step removed from the actual, relevant manufacturing process).⁴

Having determined that Taxpayer's purchases of fountain drink machines did not qualify for the Texas sales tax manufacturing exemption, the Comptroller necessarily ruled that Taxpayer's purchase of repair services performed on those machines did not qualify for the exemption from sales and use tax provided by Texas Tax Code § 151.3111 for services performed on exempt property.

² See Texas Tax Code § 151.318(a)(2).

³ See Texas Tax Code § 151.3111(a).

⁴ See *also*, Texas Comptroller's Decision Nos. 39,965 (Dec. 30, 2002), 42,653 (Nov. 7, 2002), 42,656 (Nov. 7, 2002), 40,299 (Jul. 24, 2002), 40,316 (Jul. 24, 2002), and 40,317 (Jul. 24, 2002).

No Sales For Resale If Provided To Customers At No Cost

The Comptroller also rejected Taxpayer's alternative argument that its purchases of fountain drink machines were exempt sales for resale. Several previous Comptroller decisions have held that the purchase of beverage mixing machines provided by a manufacturer to its customers do not qualify as sales for resale, except when the manufacturer can show that it received some monetary compensation in return for providing the machines.⁵ Since Taxpayer failed to show that it received any monetary payment from its customers for the use of the fountain drink machines, the Comptroller rejected Taxpayer's argument that the purchase of the fountain drink machines qualified as exempt sales for resale.

Analysis and Practice Pointer

Taxpayer's purchases of fountain drink machines and repair parts failed to qualify for the Texas sales tax manufacturing exemption even though the equipment itself was qualifying manufacturing equipment.⁶ Alternative contract language could have qualified the transactions as exempt.

The specific form of the contract is frequently the difference between a taxable and exempt sale. Had Taxpayer leased the fountain drink machines to its customers (and granted an equivalent value of discount on the concentrates and syrups, rather than providing the machines free of charge), the purchase of the machines and related repair parts presumably would have been exempt from the Texas sales tax as sales for lease under Texas Tax Code § 151.302.⁷ Further, the leases should qualify for the manufacturing exemption since the property would be leased to a manufacturer (Taxpayer's customer) for direct use in the actual manufacture of soft drinks for ultimate sale.

Consider whether your contracts need a tax-efficiency review. ■

⁵ See, e.g., Comptroller's Decision No. 39,695 (Dec. 30, 2002) (purchases of post-mix machines used to produce soft drinks, and the replacement parts for those machines, are exempt from sales tax as purchases for resale when the machines were leased for a monthly rental of \$60); Comptroller's Decision No. 42,653 (Nov. 7, 2002) (purchases of post-mix machines loaned at no charge to customers that purchased syrup, CO₂, and approved trademark cups from Claimant did not qualify as sales for resale); Comptroller's Decision No. 40,299 (Jul. 24, 2002) (same).

⁶ See e.g., Comptroller Letter Ruling 200005317L (May 17, 2000) (purchase of restaurant equipment such as coffee machines and microwave ovens qualified for the Texas sales tax manufacturing exemption when purchased by a restaurant or other food service operator who directly used the equipment to make coffee or other food items for ultimate sale).

⁷ See, e.g., Comptroller's Decision No. 39,695 (Dec. 30, 2002) (purchases of post-mix machines used to produce soft drinks, and the replacement parts for those machines, are exempt from sales tax as purchases for resale when the machines were leased for a monthly rental of \$60).



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