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Point of View

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THE MANUFACTURING CORPORATION DESIGNATION UNDER MASSACHUSETTS TAX LAW

by Michael S. Schneider, Esq.

The Benefits-

There are significant state tax benefits under Massachusetts tax law available to those businesses classified as "manufacturing corporations." Manufacturing corporations are exempt from sales tax and use tax. In addition, manufacturing corporations are exempted from personal property excise tax payable to the municipalities in which they are located.

Imagine then the state tax savings available for a business that does not have to pay any use tax on the equipment, machinery and tools it uses to create goods and products. Couple those savings with the additional savings available to a business that is not forced to pay sales tax on the raw materials, components, fuel and ingredients it purchases and consumes in order to create those same goods and products. Last, consider that businesses, not responsible for sales and use tax in their manufacturing operations, are exempt from paying excise tax for their personal property. The assessor of the city or town in which that business is located does not charge a manufacturing corporation excise on its machinery, equipment and tools.

The policy behind these laws is clear: by softening the financial impact upon businesses that conduct manufacturing activities with tax exemptions and savings for those activities, the Commonwealth incubates manufacturing activities and businesses within Massachusetts. The key to those savings is classification as a "manufacturing corporation." The breath of activities considered "manufacturing" and the narrowness of "forms" of businesses eligible for the classification and eventual tax savings are notable.

Manufacturing-

Common images of manufacturing include textile mills along the Merrimack River in Lowell during the 1800s or steel foundries in Pennsylvania or automobile plants in Detroit, Michigan. If a business in Massachusetts is engaged in weaving fabric or producing automobiles it would certainly be considered to be engaged in manufacturing for state tax purposes.

Less obvious members of the class of manufacturing businesses are those engaged in activities that bring about "change wrought through the application of forces directed by the human mind, which results in the transformation of some pre-existing substance or element into something different, with a new name, nature or use." Such an open ended definition as put forth by the Supreme Judicial Court, predictably, has led to a broad proliferation of business activities included under the manufacturing umbrella.

As the following cases illustrate, "manufacturing" is not necessarily a large scale operation in terms of physical space occupied by equipment and machinery. And "manufacturing" does not necessarily result in the is creation of an entirely new product.

A few years ago Sherwin-Williams applied to the Department of Revenue for classification as a manufacturing corporation. That application was denied, and Sherwin-Williams appealed that denial to the Appellate Tax Board (ATB).

In a typical Sherwin-Williams retail store the company has a computer-assisted machine that adds tint to base paint to suit a customer's order. Other machines in those stores shake the paint sufficiently to ensure the tint thoroughly changes the color of the base paint. These machines may weigh just a few hundred pounds and take up only a few cubic feet. No large factory or mill is involved.

The ATB overruled the Department of Revenue's refusal to designate the Sherwin-Williams retail stores as manufacturing operations. The ATB found that adding tint to base paint and thoroughly mixing it did constitute manufacturing because the machines in the store took raw materials - base paint and tint - and created a new paint to suit the customer's needs. It was not conclusive for the ATB that Sherwin-Williams simply took paint and used it to create other paint. While the procedure is simple, adding tint to base paint to accommodate a customer's order is the last step in creating and bringing a product to market for sale and use.

As another ATB case shows, "manufacturing" can include activities that do not result directly in bringing products to market. In August of 2007, the ATB awarded Duracell, Inc. the coveted manufacturing corporation designation, thereby abating its sales and use tax liabilities in Massachusetts. Duracell's activities in Massachusetts are centered in Needham, but Duracell creates no batteries in Needham that it subsequently brings to market.

Duracell's Needham activities include researching new battery technology concepts, testing materials, creating prototypes of batteries and developing improved battery production techniques. While Duracell's Needham activities enhance the actual commercial production of batteries, all of Duracell's production activities and facilities are located outside of Massachusetts.

In granting Duracell manufacturing corporation designation, the ATB recounted its findings that "the battery R&D conducted at the Needham facility altered and enhanced the actual manufacturing process undertaken by Duracell at its other locations ... Given the extensive nature of the testing, substantial refinements to the raw materials and the direct and continuous impact on Duracell's entire product line and the way in which it manufactured its products ... the activities of the Needham facility..." constituted manufacturing. Duracell did not have to pay sales and use tax.

In September 2007, the ATB continued to broaden the category of activities that could qualify a business as a manufacturing corporation. In an extension of the reasoning utilized in the Duracell case, the ATB ruled that a business that did not even fabricate prototypes or models to be used as part of creating an overall product line was a manufacturing corporation. The ATB designated The First Years, Inc., a company that designs and sells infant care products, as a manufacturing corporation even though the company does not fabricate anything.

The First Years develops and sells child care related items such as bottles, toys and baby monitors. Th

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company does not fabricate the goods it sells. Third parties do. In addition, The First Years does not create the models or prototypes of the goods it sells.

The First Years' employees work with third parties to take the concept of a product to the model stage. The company then subjects the model to consumer research and product testing. The First Years uses third party independent contractors to design products, create models, fabricate molds and tooling and manufacture the end products in bulk.

The First Years' product managers work closely with third parties to create prototypes and conduct consumer testing. In addition, third parties fabricate tools and molding according to the company's exact specifications. The First Years qualifies as a manufacturing corporation because of its thorough involvement - from concept to finished product - with the third parties that fabricate its goods and tools.

Manufacturing for purposes of Massachusetts tax law, then, includes many activities that do not conjure images of heavy industry. Adding the finishing touches to a product can constitute manufacturing. A company that creates prototypes can earn manufacturing corporation status. Even a company that does not fabricate anything, but oversees production to its specifications, may qualify.

Manufacturing Corporations-

Businesses operating in Massachusetts may qualify as engaged in manufacturing if they conduct any number of activities. Only business *corporations* conducting manufacturing, however, may take advantage of the tax benefits outlined above.

The relevant statutory authority provides that "business *corporations*" "engaged in manufacturing" in Massachusetts are eligible for tax abatements for sales and use tax as well as an exemption for their personal property from local taxation. This means that a limited liability company, business trust or partnership of any sort will not be able to take advantage of significant tax savings simply due to its formal entity type.

The Massachusetts Legislature recently had the chance to extend these tax benefits to, for example, limited liability companies engaged in manufacturing. In January of 2008, Governor Patrick presented a bill entitled "An Act Improving Tax Fairness and Business Competitiveness" to the Legislature. The bill passed in July of 2008. In exalting form over substance, the Legislature failed to extend tax benefits to any business entity engaged in manufacturing other than business *corporations*. If the most beleaguered member of the American automotive industry, Chrysler, were to engage in manufacturing in Massachusetts it would not be able to take advantage of significant tax savings here. Chrysler is a limited liability company. It would not receive tax benefits from its heavy industry activities because, formally, it is not a business corporation.

Implications for Businesses Operating in Massachusetts-

The lesson then, is simple: if a business in Massachusetts fabricates goods, creates prototypes, tests products it has made or oversees production of its product line it may be engaged in manufacturing. It will only be allowed state tax benefits, however, if it has been organized as a corporation.

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