III. Identifying Tax Exemptions and Exclusions

An exemption is the grant of tax free status by a legislature or the Constitution. Exemptions occur because of the nature of the purchaser, item being sold, or the transaction.

A. Who and What is Exempt?

i. <u>Who</u>:

1. Charitable organization
2. Educational organization
3. Religious organizations
4. Federal/state government
5. Non-profit organization
   a. Some states provides that sales to nonprofit organizations are taxable unless they fall into one of the following categories (see Illinois statute below):
      i. The sale is made to the organization's members, students, patients, or inmates primarily for the purpose of the selling organization
      ii. Infrequent sales that are noncompetitive with business establishments and whose primary purpose is to solicit a donation
      iii. Occasional dinners and similar activities if held not more than twice within a one-year period.

ii. <u>State Requirements to Qualify for Exemption:</u>

1. Many states require potentially qualifying organizations to apply for exemption; that procedure permits a state to review the nonprofit organization's charter or federal

income exemption letter issued by the IRS to ensure that the organization qualifies for the state's exemption.

a. Some states do not automatically exempt organizations that are exempt under Code Section 501; instead those states impose their own substantive prerequisites.

   i. Virginia: Restricts its sales/use exemption to nonprofit, schools, colleges, and "other institutions of learning" that meet the following specific criteria: employment of professional trained faculty; enrollment and graduation of students on the basis of academic achievement; offering of prescribed courses of study; and provision of regular instruction.

   ii. Pennsylvania: The PA S.C. held that recognition as an exempt charity for federal income tax purposes does not automatically qualify an entity for the state exemption. The following five factors should be considered: (1) Is a charitable purpose advanced? (2) Is a substantial portion of the entity's services gratuitously donated? (3) Is a population that is a legitimate subject of charity being benefited? (4) Is the government relieved of some of its burden? (5) Does the entity operate free of profit motive?

iii. Texas: Exempts organizations recognized as exempt for federal income tax purposes, as long as none of the entity's net earnings benefit private shareholders and the items purchased are related to the entity's purpose.

iv. Illinois: Exempts sales to entities organized and operated exclusively for charitable, educational, or religious purposes.

1. Sales by nonprofit service enterprises, such as social, athletic or recreational organizations, patriotic organizations, civic organizations, trade and professional associations, fraternities and sororities among others, are subject to tax.
2. Sales by charitable organizations subject to tax unless: (1) sales to members for the organization's purposes; (2) noncompetitive, infrequent sales by members, the proceeds of which go to the charity, and the purchaser's intent being to make a donation to the charity; and (3) sales involving occasional dinners, social events, and activities.

v. Massachusetts: Imposes the following formal requirements for entities to receive the sales/use exemption: (1) the property purchased must be used in the conduct of the religious, charitable, educational, or scientific enterprise.

vi. New Jersey: Exempts any sale by or to Section 501(c)(3) organizations that is directly related to the organization's exempt purpose.

iii. What:

1. Common Exemptions:

a. Sale to state or municipal government

i. For sales to the state or municipal governments to be exempt from sales/use tax, many states require that the purchases be made pursuant to an official purchase order and be paid directly by the governmental unit or paid out of public funds. Sales that are not made with the required official purchase orders are not paid directly by the government and are subject to sales/use taxes.

1. Illinois- Sales of tangible personal property to federal, state, local and foreign governments are exempt from tax, provided that the government entity has been issued an active sales tax exemption number by the department.

2. Illinois- All sales by the federal government or any foreign government, or any agency or

instrumentality of any such government are exempt, provided that the sales are made by the entity in its governmental capacity.

b. Sale for Resale

   i. When tangible personal property is sold and the purchaser intends to resell the property, the sale is not a retail sale; rather, it is a sale for resale.

      1. Illinois- The taxing statutes establish a rebuttable presumption that all sales are subject to tax unless and until the party claiming a resale exemption produces evidence to the contrary.

   ii. The resale exemption is allowed because the sale does not represent the ultimate use or final consumption of the tangible personal property.

   iii. Any interim use by the buyer voids the resale purpose and nullifies any exemption; use tax applies if there is interim use of the property other than demonstration or display while the purchaser is holding it for resale.

      1. Despite interim use, Illinois provides that exempt from use tax if the property remains on the books as inventory or is otherwise available for sale during the interim use period.

iv. Ingredients: Sales of tangible personal property that is incorporated as an ingredient or constituent of goods ultimately sold at retail are deemed to be purchased for resale and are not subject to the use tax. 86 Ill. Admin. Code §130.210. However, it is important to make the distinction that even though certain property may be essential to the manufacturing process, if the property itself is used or consumed in the manufacturing process and is not otherwise incorporated into a final product which is then sold at retail, such property is not deemed to be a purchase for resale and is subject to the use tax.

c. Manufacturing Machinery and Equipment

i. Some state often grant exemptions for manufacturing machinery and equipment as an incentive for manufacturers to relocate to, expand, or remain in a state.

ii. Generally, industrial machinery and equipment used in the manufacture or processing of tangible personal property are exempt in most states from tax if certain limitations or requirements are met. Each state determines its own standards and statutory definitions or has its own judicial interpretations.

iii. To qualify, a company must typically be a "manufacturer" or be "engaged in manufacturing."

1. The definition of manufacturing was codified by the United States Supreme Court in *East Texas Motor Freight Lines, Inc. v. Frozen Foods Express*, 351 U.S. 49 (1956). It requires: (1) a transformation and (2) a new and different article must emerge, having a distinct name, character, and use.

iv. Also, most states have two requirements: (1) the machinery and equipment must be directly used in the manufacturing operation; (2) the machinery must be used exclusively – used solely by a manufacturer in manufacturing tangible person property to the exclusion of all other uses, primarily – more than 50 percent use in manufacturing or assembling, or predominant – over 50 percent of its use is directly in the production phase of the process in the production activity.

v. There are also two statutory schemes used to determine whether the machinery and equipment are exempt from sales and use tax (states use one of the two):

1. Direct Use Test – Machinery and equipment must be directly involved in the manufacture of products. There must be a direct causal relationship between the equipment and machinery and the items produced through manufacture.
2. Necessity Test – Equipment and machinery must be such an integral part of the production process that without the relevant items manufacturing would halt.

d. Agricultural Machinery

   i. Many states have special provisions exempting from sales/use tax the sale of equipment and materials to taxpayers engaged in farming, agriculture, horticulture, and floriculture.

      1. Illinois- farm chemicals and farm machinery and equipment. 35 ILCS 120/2-5.
      2. Illinois- Certain fuels used in agriculture.

e. Occasional Sale/Isolated Sale

   i. A casual, isolated, or occasional sale exemption is usually limited to taxpayers not regularly engaged in selling tangible personal property. However, in some states, the occasional sale exemption can be applied to vendors that have previously "ceased operations."

ii. Some states limit the casual, isolated, or occasional sale exemption to a specified number of sales or a specified dollar amount of sales per year. Other states such as Illinois have broader and more inclusive definitions of casual, isolated, or occasional sales.

iii. In most states, the occasional sale exemption does not apply to 1) the sale of aircraft, boats, mobile homes, or motor vehicles required to be registered or licensed; 2) the distribution or sale of inventory; 3) the distribution or sale of tangible personal property used in business; or 4) property on which tax was not paid by the seller or the original purchaser.

f. Temporary Storage Exemption

i. States that provide a temporary storage exemption allow tax-free storage of tangible personal property in the state.

ii. This exemption can be limited as to the type of items eligible for storage, such as advertising and marketing materials, or it can exempt all temporary storage of tangible personal property.

1. Illinois- The temporary storage of tangible personal property that is acquired outside Illinois that, after being brought into Illinois and stored here temporarily, is used solely outside Illinois or is physically attached to or incorporated into other tangible personal property that is used solely outside Illinois, or is altered by converting, fabricating, manufacturing, printing, processing, or shaping, and, as altered, is used solely outside Illinois. 35 ILCS § 105/3-55.

g. Rolling Stock Exemption

   i. Items (including repair and replacement parts) purchased by interstate carriers for hire to haul persons or commodities in interstate commerce qualify for the rolling stock exemption. Lessors may qualify for the exemption if items purchased will be leased for one year or more.

2. Other Exemptions- Illinois

   a. Machinery and equipment used in graphics arts production;
   b. Photoprocessing machinery and equipment;
   c. Building materials to be incorporated into buildings in enterprise zones;

d. Tangible personal property used or consumed in the manufacturing or assembling process, or in the operation of a pollution control facility qualify for the exemption where the business enterprise is located in the enterprise zone and is certified by the Department of Commerce and Community Affairs as having met certain conditions;
e. Machinery and equipment used to operate a high-impact service facility located in an enterprise zone;
f. Qualified sales of building materials to be incorporated into real estate within a river edge redevelopment zone;
g. Mandatory service charges separately stated on customers' bills for the purchase and consumption of food and beverages, to the extent the proceeds of the service charge are in fact turned over as tips or as a substitute for tips to employees.
h. Newsprint and Ink;
i. Farm chemicals;

3. Other Exemptions Offered by Various States, including Illinois:

a. Pollution Control
b. Sales on Indian Reservations
c. Motion Picture Production
d. Wholesale Sales
e. Architectural Services
f. Drugs and Medical Appliances
g. Solar Energy Equipment

h. Shipping Containers and Packaging Materials
i. Software – Canned and Custom
j. Transfers of Assets Involved in Mergers, Consolidations, Acquisitions, Liquidations, and Incorporations
k. Sales to Enterprise Zones
l. Sales to High Impact Businesses

B. How to Claim Exemptions

i. Provide documentation:

1. Exempt parties must provide documentation recording the tax free nature of the transaction.

2. The interpretation of exemptions is usually against the taxpayer.

ii. Complete Exemption Certificate:

1. Taxpayers making sales to tax-exempt entities should have a procedure in place to secure an exemption certificate prior to making the sale. To be valid, an exemption certificate should contain the following elements:

a. Reason for exemption
b. Description of item purchased
c. Exemption number if applicable
d. Signature of responsible party for exempt entity
e. Date
f. Indication of blanket coverage versus single purchase coverage

2. Visit Department of Revenue Website

a. Each state differs in its exemption certificate requirements; visit the particular state's Department of Revenue website for the appropriate forms.

3. <u>MTC Uniform Certificate</u>

a. The Multistate Tax Commission has issued a uniform certificate designed to be used when purchases are made for resale, lease, or rental or for use in manufacturing or producing. The multijurisdictional certificate permits a taxpayer that purchases goods from one vendor for wholesale, resale, or use in manufacturing or producing that are delivered into numerous states to give to the seller one exemption certificate that identifies the states where the delivered goods are exempt from sales/use tax.