



# Use-based Exemptions Requirements, Examples and Limitations

**Phil Schlesinger, Product Manager**  
Sales and Use Tax  
CCH, A Wolters Kluwer business

This page prints blank intentionally.



Generally speaking, there are three main categories of exemptions in the sales and use tax world, namely “product/service-based” exemptions (i.e. food, clothing, medical, newspapers, professional services, etc.), “entity-based” exemptions (i.e. government, charitable and religious organizations, educational institutions, etc.) and “use-based” exemptions (i.e. manufacturing, agriculture, etc.). Following the presumption of taxability theory that exists for the sale or purchase of tangible personal property in any given taxable state and locality, if a transaction is not deemed to be subject to tax in a given jurisdiction, then the particular exemption would fall into one of these three exemption categories. For purposes of this whitepaper, we will limit our focus to only use-based exemptions and address some of the associated requirements, applications, complexities and administration.

## Defining Use-based Exemptions

In its simplest form, a use-based exemption is an exemption offered in many taxing jurisdictions that involves the sale or purchase of taxable tangible personal property (and in some cases taxable services) that qualify as exempt based on some type of statutorily exempt “usage.” When ascertaining the applicability of use-based exemptions, there are four main questions that need to be addressed, namely: who, where, what and how? Who the purchaser is; where the item is being used; what the item is that is being used; and how the item is being used. The answer to these four questions will determine whether or not a use-based exemption is applicable.

The most notable type of use-based exemption would be that of machinery and equipment that is used in a manufacturing process. For purposes of illustration, if a company that is classified as a manufacturer (who) purchases a piece of machinery and equipment (what) for use in a state (where) that offers a manufacturing exemption and it is specifically used in the manufacturing process (how) that meets the state requirements for exemption qualification, then the sale or purchase of the machinery and equipment would be exempt from taxation as a manufacturing use-based exemption.

## Direct Use Requirement Relating to Use-based Exemptions

There are various requirements associated with use-based exemptions; however, the primary commonality that seems to exist among all use-based exemptions is the requirement of “direct” use, as it relates to the specific qualifying items being used in the exempt activity.

Simply stated, a qualifying item must be used directly in the activity in which the use-based exemption is applicable to. For example, with respect to manufacturing, the qualifying machinery and equipment must be used directly in the manufacturing process of converting raw material into a finished product. Conceptually, the same would apply to the other types of use-based exemptions.

Each applicable state will have its own specific definition as to what actually constitutes direct use, which could actually vary from an extremely narrow definition to a very broad definition. For example, relative again to manufacturing, a narrow definition may be limited to only machinery and equipment that has actual direct contact with the raw materials and the finished product during the process of transforming the raw material to a finished product. Conversely, a broad definition may encapsulate the other end of the spectrum extending to all machinery and equipment that is needed in some form or another, whether or not it has direct contact with raw material or the finished product. As a practical matter, most states will define direct use somewhere between the two extremes.

A few examples of items that may not be part of the definition of being used directly in the process might include items such as ventilation systems, bins, cleaning systems, testing equipment, material handling systems, and storage equipment.

In trying to consider exemption applicability relative to use-based exemptions, it's important to first understand how a specific taxing authority defines direct use for purposes of applying the exemption. Rather than making assumptions with respect to how direct use is defined, it should be thoroughly researched before proceeding to the other relevant use-based exemption requirements for the state or states that offer use-based exemptions that you are concerned about.

## Various Types of Use-based Exemptions

There are currently forty-six (46) taxable states, including the District of Columbia, as well as numerous taxable local jurisdictions in the US, many of which offer various types of used-based exemptions. In many cases, states and localities offer these special use-based types of exemptions as a major incentive for companies to come and set up shop in their state, which in turn brings jobs and other economic benefits to the state, locality and community in which they are located.

The most notable types of use-based exemptions that are offered include the following:

- 1) Manufacturing
- 2) Agricultural/farming
- 3) Research and development
- 4) Aircraft maintenance
- 5) Data processing
- 6) Pollution control
- 7) Warehouse/distribution center operations
- 8) Call center operations

## Use-based Exemption Application

For purpose of this whitepaper, we will include in our analysis the three most predominant types of use-based exemptions, namely: manufacturing, research and development, and agriculture/farming.

### 1) Manufacturing

Currently, there are thirty-seven (37) taxable states that offer some form of manufacturing use-based exemptions. Additionally, there are two states that imposed a reduced tax rate on qualifying manufacturing machinery and equipment, with two additional states that offer credit or refund opportunities associated with certain qualifying items. This leaves four states and the District of Columbia that have no sales and use tax-related use-based exemptions or credits for manufacturing.

For the states that do offer manufacturing-related use-based exemptions, manufacturing is generally defined as an operation of producing a new product, article or commodity that is different, and that has a distinctive name, character or use from raw material and that is intended to be sold either as a finished product or a component of a future finished product. Manufacturing usually includes producing, processing, compounding, mining, refining, fabricating, and in many cases, printing.

One of the difficult challenges with respect to manufacturing is defining where the manufacturing process actually starts and where it ends, for purposes of identifying which items of tangible personal property qualify and which ones do not. This of course will require a state-by-state analysis.

While differences may exist from state to state, it is interesting to note that conceptually there are more similarities than differences especially when you factor into the equation the requirement of "direct use".

In defining the scope of manufacturing, many states subscribe in some form or another to the concept of an "integrated plant theory" which essentially means that in order to qualify under a manufacturing use-based exemption, the machinery and equipment must be essential to and be an integral part of the manufacturing process. Some of the factors that are embedded into this concept include: 1) whether the item is necessary to production, 2) how close the item is to the production process, and 3) whether the item operates harmoniously with other machinery and equipment to make an integrated and synchronized system.

Some of the obvious types of machinery and equipment that would qualify under a manufacturing use-based exemption would include those that are utilized directly in the process of transforming the raw-material into a finished product. This usually includes repair and replacement parts as well. Other qualifying items include equipment that cleans and prepares raw material after entering the production line and before it ends, testing equipment that is used during production, material handling systems and other equipment operating in the actual production line, and in some cases other items that are viewed to be used in the manufacturing process even though they are utilized during pre-production or post-production activities. In most cases, computer hardware and software that is dedicated to the operation and control of the manufacturing machinery and equipment, and/or the entire process itself, will also usually qualify under a use-based exemption.

Other types of related transactions that are often included in a manufacturing exemption include installation and repair services that are associated with qualifying exempt machinery and equipment, as well as the fuels and lubricants that are used to operate the qualifying machinery and equipment. Additionally, in many cases utilities (i.e. electricity, gas, water, etc.) that are used to power and operate the qualifying machinery and equipment is also included in the exemption.



A state-by-state review will reveal items and services that are included or excluded from a state's manufacturing use-based exemption.

## **2) Research and Development**

Use-based exemptions relating to research and development activities usually come in one of two forms, either as a component part of a broad manufacturing exemption, or a separately identified research and development use-based exemption. In most cases, when research and development is deemed to be an exempt activity in a given taxing jurisdiction, it is part of the state's manufacturing use-based exemption.

Generally speaking, research and development involves the following: 1) advancing the knowledge or technology in a scientific or technical field endeavor, 2) development of a new product, 3) improvement of an existing product, and 4) design and development of a prototype. Conversely, activities usually not considered part of research and development include ordinary testing or inspection of material or products used in quality control activities, market research, efficiency surveys, management studies, or other research of non-technical activities.

For purposes of applying the research and development use-based exemption, qualifying items include various types of machinery and equipment used for research and development as well as tooling, testing devices, measuring devices, computer hardware and computer software.

## **3) Agriculture and Farming**

Most states offer use-based exemptions relating to commercial agriculture and farming operations, in some form or another, either as a full exemption or a partial exemption. Generally speaking, this kind of use-based exemption relates to the raising of crops or livestock for profit. In many cases, the exemption also extends to other commercial operations such as aquaculture, floriculture, ornamental, greenhouse operations, and in some cases, logging.

For purposes of applying the exemption, most machinery and equipment that is used specifically for agriculture and farming operations will qualify, including auxiliary equipment and replacement parts that are essential to the operation of the qualifying machinery and equipment. Examples of qualifying machinery and equipment include things such as: tractors, feeding systems, generators, balers, conveyors, pumps, skidders and irrigation equipment. Items usually not included relative to the exemption are vehicles that are required to be registered as well as machinery and equipment that is used in a manner that is only incidental to the operation.

Also, included in many taxing jurisdictions are utilities used in the agriculture and farming operations such as gas, electricity and water.

Other items that often qualify under an agriculture and farming use-based exemption include such things as: lubricants and coolants used in the qualifying machinery and equipment, sprays, insecticides, pesticides, feed, medicines, veterinarian supplies, water treatment equipment and supplies, disinfectants and other chemicals used in the exempt operation.

## Limitations

Like most exemptions there are also limitations associated with use-based exemptions. In fact, there are perhaps more limitations associated with use-based exemptions than any other type of exemption, simply because they are based on a certain type of “usage”, which also implies a certain classification of users and is usually limited to a finite number of qualifying items. Some of the limitations that are usually associated with use-based exemptions include the following:

### 1) Percentage of Actual Usage Associated with an Exempt Purpose

Taxing jurisdictions that offer use-based exemptions also stipulate the usage requirements of the applicable qualifying item, which usually include terms such as primary, majority, predominately, exclusively, and even “a preponderance of the time.” The usage percentage requirement, regardless of the term, will usually range from 51% (or more than 50%) to 100% usage. The usage percentage is very important to ascertain because some states will allow a qualifying item to be used both in a taxable use as well as an exempt use, but some states will require a qualifying item to be used exclusively in the exempt activity.

### 2) New and Expanding Operations

Some taxing authorities limit their use-based exemptions to only those items that are part of a new manufacturing operation or to those that actually expand the existing manufacturing process.

In other words, machinery and equipment that is acquired to replace a worn out piece of machinery or one that has become obsolete due to advances in technology would not qualify under some states’ exemption provisions.

### 3) Minimum Dollar Amount or Minimum Useful Life

Another limitation associated with use-based exemptions is the establishment of minimum dollar amounts and/or useful economic life. A typical range relative to a minimum dollar requirement would be \$100.00 to \$500.00, and a typical range of a minimum economic life might be from one to three years. Another version of these two “minimums” might be only items that are actually capitalized for depreciation purposes.

### 4) Industry

A typical example of this type of limitation is research and development in which the used-based exemption is limited to machinery and equipment that is used only in the research and development of prescription pharmaceuticals, defense or space industry, biotechnology industry or semiconductor industry.

### 5) Partial Exemption

There are a few jurisdictions that have limited or partial use-based exemptions as opposed to a full or 100% exemption. One example would include a 50% exemption for items that are not otherwise fully exempt under a state’s use-based exemption such as materials, tools or fuel that is used or consumed in the manufacturing process, or machinery and equipment used in the preparatory stages of manufacturing, research and development, transportation or testing. Additionally, in few cases, a partial exemption may equate to a full exemption at the state level but remain taxable at a standard local rate in localities that haven’t adopted a state’s exemption, such as localities in Colorado and Missouri.

## Exemption Certificate Requirements

Generally speaking, exemption certificate documentation is required in order to support a use-based exemption. All applicable states have their own specific requirements relative to the support of

use-based exemptions, but what is consistent across the board in all taxable states is that the “burden-of-proof” for exempt treatment usually falls on the shoulders of the licensed seller. Consequently, even if there isn’t specific statutory language spelling out the actual requirements for obtaining exemption certificate documentation relative to use-based exemptions, it should be remembered that unless there is a specific statute that exempts tangible personal property from tax, regardless of its use, or a valid exemption certificate (or other acceptable documentation) has been obtained in lieu of collecting the tax, the tangible personal property is presumed to be taxable. Therefore, it would be advantageous for a licensed seller to obtain an exemption certificate or other acceptable documentation to support the exemption. At the end of the day, the seller must be able to prove that the buyer is a qualified buyer, and the item being sold is a qualifying item, and that the actual usage of the item qualifies under the use-based exemption provision. In most cases, the receipt of a valid and properly prepared exemption certificate or some exempt-use affidavit will release the seller from the obligation of having to collect the tax.

Where things become a bit more problematic is where qualifying items are combined with non-qualifying items as part of the same transaction. For example, if a sale is made that involves five items that qualify under a use-based exemption and five items that do not qualify as exempt, does the seller have the obligation to collect the tax on the five items that don’t qualify as exempt despite the fact the seller obtained a valid exemption certificate from the customer? This is one of the difficult questions associated with the administration of use-based exemptions. Again, each state will have its own policies and requirements relative to the administration of use-based exemptions, but there are a couple things to consider if the statutes or regulations are vague on the issue.

First, the seller usually doesn’t have knowledge of the purchaser’s operational plans, or specific knowledge or expertise to ascertain which of the ten items being sold (assuming that all ten items are similar in nature) will actually be used for an exempt purpose and which ones will not.



In this scenario, unless the purchaser provides specific information contrary to its exempt use, the seller is left to assume that the exemption certificate provided by the purchaser is intended to cover all items associated with the transaction.

However, on the other hand, if the purchaser does specify which items qualify and which ones do not, or if five of the items are clearly not items that would qualify under the applicable use-based exemption, the seller should impose tax on the non-exempt items by default; otherwise, they could be creating potential tax exposure for themselves as the party with the responsibility for the collection of the tax.

Secondly, in some cases there are states that will make the purchaser fully liable for any items that don't qualify as exempt simply because the purchaser provided a valid exemption certificate to the seller in good faith, and therefore, the seller is released from the liability of collecting the tax. Additionally, from an audit and systemic standpoint, it is sometimes easier to treat the entire transaction as exempt ("all or nothing" scenario) rather than trying to figure out which particular items actually qualify and which ones do not, especially when it's not easily discernable from the available documentation. However, as a matter of administrative policy when dealing with use-based exemptions and the required exemption certificate documentation, a seller should always seek specific guidelines from the applicable taxing authority when requirements are not clearly defined in the statutes, regulations or tax authority publications.

Unlike the other two types of exemptions, namely, "product-based" and "entity-based," use-based exemptions are determined by all four decision points of a transaction, namely, who the user is, where the item is being used or consumed, what the item being used is, and how the item is being used or consumed. Based on these four decision points, it goes without saying that use-based exemptions are definitely the most complex of the three exemptions types in terms of requirements, application and administration. Additionally, use-based exemptions usually represent the highest dollar amount of tax savings for a qualifying taxpayer, but unfortunately, they also represent the greatest dollar amount of potential tax exposure if incorrectly applied. Consequently, careful consideration and review should always be exercised when dealing with use-based exemptions.

## About the Author

Phil Schlesinger has been in the sales and use tax field for 22 years and has extensive knowledge and experience in compliance, audit (internal and external), tax research, and automation, both in a corporate environment and in a consulting role. While in consulting, he prepared taxability matrixes for dozens of companies representing numerous types of industries such as software, manufacturing, services, food, medical, advertising and construction. Over his career, Phil has also been heavily involved in the design, testing and/or operation of several sales and use tax software tax calculation engines and tax return processing systems including CCH, Vertex, Taxware and AvaTax.



CCH

a Wolters Kluwer business

1-866-513-CORP (866-513-2677)  
SalesTax.com