

SJR 361: Joint Subcommittee Studying Manufacturing Needs and the Future of Manufacturing in Virginia

April 5, 2005

Richmond

The Joint Subcommittee Studying Manufacturing Needs and the Future of Manufacturing in Virginia was established by Senate Joint Resolution 64 of 2004, and was continued by the 2005 Session for a second year pursuant to SJR 361. The initial meeting of the joint subcommittee's second year was held at Wyeth Pharmaceuticals' Darbytown Road facility near Richmond.

Natural Gas and Manufacturing Competitiveness

In its first year, the joint subcommittee recommended legislation directing the Virginia Liaison Office to work with members of the State Congressional Delegation and executive agencies to develop and enact legislation or executive action that would provide an exemption to the existing moratorium on off-shore natural gas exploratory activity. As amended, the bill specifically endorsed measures such as are contained in the proposed federal State Enhanced Authority for Coastal and Offshore Resources Act (SEACOR) or similar legislation to enhance states' authority over coastal and offshore resources. The amended bill also endorsed development and production of natural gas deposits, rather than merely surveying and exploration. The bill was vetoed by Governor Warner, who stated that the measure encroaches on the role of the Governor to direct the activities of the Virginia Liaison Office and it directs the Commonwealth to advocate for federal legislation that has yet to be introduced.

In its meeting on the eve of the reconvened legislative session to address the Governor's action, the chairman reiterated the need to address the need of Virginia's manufacturing sector for natural gas. Keith Togna of Honeywell Nylon LLC's Hopewell facility, which is the largest industrial user of natural gas east of the Mississippi, reported that the facility consumes 57 million cubic feet of natural gas daily. One third of the gas consumed is used as fuel, and the balance is used as the raw material or feedstock for ammonia, which is used to make caprolactum, used in the production of nylon, and fertilizer. The cost of natural gas comprises 30 percent of the final product price.

Rising natural gas prices, which have jumped from \$2.77 per decatherm (Dth) in 1998 to \$7.22/Dth in 2005, have directly affected Honeywell's nylon business. Over the past three years, natural gas has increased \$3.26/Dth, costing the company \$72 million. Over that period, Virginia operations have experienced a 25 percent workforce reduction, which was attributed to rising energy costs and foreign competition. In an attempt to address this issue, Honeywell has completed a project whereby it purchases natural gas produced from the decomposition of waste at the Waverly landfill. The landfill methane project required construction of a 23 mile pipeline, which is the longest landfill gas pipeline in the nation. The project, implemented in January 2004, currently displaces 4 percent of the Honeywell plant's natural gas requirement and is expected to displace up to 20 percent over the next 50 to 70 years. Honeywell's project, which has received an award from the Environmental Protection Agency, is expected to allow the firm to obtain gas at a price that is about one half of the market cost.

Machinery and Tools Tax

The chairman observed that a successful future for manufacturing in Virginia will require increasing productivity, which in turn is dependent upon investment in equipment in plants. The state, therefore, should look at ways to create incentives for firms to buy machinery and tools. During the course of the meeting, some questioned whether the current system of local taxation of machinery and tools is at odds with this goal.

Brett Vassey of the Virginia Manufacturers Association presented interim findings from Ernst & Young's comparative study of tax burdens in Virginia and five other states: Alabama, Georgia, Kentucky, North Carolina, and South Carolina. In measuring the effective property tax rates on business property in these six states, revenue from real and personal property tax collections was divided by the equivalent real and personal property tax base in each state. Virginia's effective state and local property tax rate of 1.18 percent of the value of business property was second highest, exceeded only by South Carolina's 1.46 percent. Alabama, Kentucky, and North Carolina were reported to have the lowest effective business property tax rates of 0.65, 0.69, and 0.72 percent, respectively.

Ernst & Young's report also calculated the effective tax rates on purchases of electric utility services by manufacturers by dividing (i) the estimated electric utility taxes paid by manufacturers by (ii) all state and local taxes imposed on electricity sales. The calculation assumes that state and local gross receipts and excise taxes that are imposed on electric utilities are passed forward to manufacturers and other businesses and household consumers. Ernst & Young calculated that the effective tax rates on electric utility services used by manufacturers in 2003 in these six states ranged from 1.76 percent in Alabama to 0.01 percent in South Carolina, with Virginia having the second-highest effective rate at 1.61 percent. Senator Watkins questioned the analysis, noting that Virginia replaced its gross receipts tax on electric utilities with a consumption tax and corporate income tax in 1999. Mr. Vassey agreed to provide additional information regarding this issue at a later meeting.

Brad Gilks of Smurfit-Stone Container Corporation in West Point reported that from 1991 to 2004 the facility's real property tax bill has increased from less than \$360,000 to about \$380,000, an increase of about 6 percent. Over the same period, however, the local machinery and tools tax bill has jumped from \$1.3 million to over \$3.5 million. Much of the increase in tax liability was attributed to changes made by localities in the assessment ratio and depreciation rates. For example, from 1991 through 1996, assets were taxed at 10 percent of original cost; from 1997 through 2001, assets were taxed at 80 percent of cost in their first year and thereafter at percentages that declined by 20 percent each year until the fifth and subsequent years, when they were taxed at 10 percent of original cost; and in 2002 assets were assessed at 25 percent of the original cost of assets. As Smurfit-Stone Container reportedly accounts for 98 percent of the machinery and tools tax paid to King William County, concern was expressed that its changes in assessment rates were aimed at increasing the amount of tax liability on this firm.

Staff provided the joint subcommittee with an overview of statutes relating to the assessment of the local machinery and tools tax. Machinery and tools, with certain exceptions, are a separate class of tangible personal property that is subject to local taxation. The rate of tax imposed by a

locality on such machinery and tools shall not exceed the rate imposed upon the general class of tangible personal property. Machinery and tools are required to be valued by depreciated cost or a percentage or percentages of original total capitalized cost excluding capitalized interest.

Commissioners of the revenue are required to use a cost basis in valuing a particular class of property, unless the cost valuation method may not reasonably be expected to result in a determination of fair market value, as determined by the commissioner of the revenue or other assessing officer. In practice, localities use the original cost, fair market value or book value as a basis for the assessment. In addition to setting the nominal tax rate, localities use an assessment ratio which need not be 100 percent. The assessment ratio, multiplied by the nominal rate, is the effective rate paid. Typically the percentage of the basis for the assessment declines over a fixed number of years. Data on tax rates compiled by the Weldon Cooper Center for Public Service illustrates a great deal of variety in assessment ratios and assessment methodologies.

The use to which the machinery and tools are put will determine whether they are taxable as machinery and tools, as tangible personal property, or as capital. Certain tangible-in-fact equipment used in manufacturing, including 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, has been defined by the General Assembly as capital, which as intangible personal property is segregated for state taxation only. As the state does not impose an intangible personal property tax, such items of manufacturing-related equipment are exempt from property taxation altogether. As a result, machinery and tools used in manufacturing is subject to local taxation as tangible personal property, but other equipment used in manufacturing is exempt from taxation. This result follows from the broad authority of the General Assembly to define and classify taxable subjects.

The joint subcommittee indicated that further examination of the issues of the local variations in assessment procedures and ratios and of the discretion of local officials in determining whether an object is part of the manufacturing process would be appropriate. Senator Watkins noted that the advisability of increasing standardization among localities should be examined. The chairman reiterated the importance of fair and consistent policies to firms that are considering investing in expensive manufacturing machinery in Virginia.

Next Meeting

The next meeting of the joint subcommittee will be held on June 7, 2005, in Bedford County. Issues for possible review will include the status of landfill gas projects around the state, the criteria used in determining sites appropriate for liquefied natural gas offloading facilities, an update on the pending federal SEACOR legislation, and a review of previous studies and recommendations addressing the machinery and tools tax.

Chairman: The Honorable Frank W. Wagner, Chairman
Legislative Services contact: Franklin D. Munyan