

Recent Legislation and Legislative Studies Regarding the Machinery and Tools Tax

Division of Legislative Services

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I. RECENT LEGISLATION

2005 Session

- House Bill 2477 (Del. Ed Scott) requires that proposed changes in the valuation method used for machinery and tools be published by a notice appearing in a newspaper of general circulation at least 30 days prior to such change. The bill also requires that citizens be allowed to submit comments to the local commissioner of the revenue regarding the proposal during the 30-day period.

2004 Session

- House Bill 295 (Del. Ware) authorized the State Tax Commissioner to issue written opinions regarding machinery and tools tax, business tangible personal property tax, and merchant's capital tax and the administration of such taxes prior to the filing of an appeal. The bill amends § 58.1-3983.1, added in 1999, which sets out an appeals process for these local business taxes.
- House Bill 1072 (Del. Armstrong) failed; it would have changed the date by which machinery and tools tax returns must be filed each year from May 1 to March 1. The bill was stricken in the House Finance Committee.

2000 Session

- House Bill 781 (Del. J. Rust), as introduced, would have created a separate classification, for tax rate purposes, of machinery and tools used in the provision of Internet services, and localities would have been authorized to tax machinery and tools used in the provision of Internet services at rates below the machinery and tools tax rate applied to the general class of machinery and tools within such localities. The bill, as it passed, was substantially revised to create a separate classification, for tax rate purposes, for business tangible personal property used in the provision of Internet services, including Internet web-hosting services. Localities are authorized to tax such property at a rate that does not exceed the rate applicable to the general class of personal property within such localities.

1999 Session

- Senate Bill 780 (Sen. Colgan) and House Bill 2085 (Parrish) were companion bills that established an appeals and rulings process for all the machinery and tools tax and other local business taxes (business tangible personal property tax and merchant's capital tax). The process provides for appeals through the local

assessor and the state Tax Commissioner. It is similar to the appeals process established for the BPOL tax. The bill also included a second enactment clause stating that interested parties, including but not limited to the Virginia Municipal League, Virginia Association of Counties, Commissioners of the Revenue Association, Virginia Chamber of Commerce and the Virginia Manufacturers Association, shall propose recommendations to address uniform methods of valuation, rate classification and associated local revenue impacts for local business taxes to the House Finance and Senate Finance Committees by December 15, 1999.

- Senate Bill 1312 (Sen. Potts) provided that machinery and tools used in water well drilling are to be taxed in the same manner as machinery and tools used in a manufacturing, mining, radio or television broadcasting, dairy, dry cleaning or laundry business.
- House Bill 2502 (Del. Ingram) failed; it would have established a schedule for valuation of machinery and tools used in coal mining business, as follows: In year 1, assessed value is 80 percent of original cost; in year 2, 60 percent of original cost; in year 3, 40 percent of original cost; in year 4, 30 percent of original cost; and in year 5 and thereafter, 20 percent of original cost.

1998 Session

- House Bill 555 (Del. DeBoer) allowed taxpayers to deduct the amount of a locally-authorized tax exemption for certified solar energy equipment and certified recycling equipment, facilities, or devices from the amount of machinery and tools tax liability. Prior to the enactment of this measure, the amount of the tax exemption had to be deducted from the real property tax due on the real estate to which the equipment, facilities, or devices were attached. Local governments are authorized to exempt or partially exempt such property from tax.

1997 Session

- House Bill 2100 (Del.Crouch) repealed a measure that stated that machinery and tools used in food processing constituted a separate class of machinery and tools. The only other provision for a separate class of machinery and tools that existed was for machinery and tools used in semiconductor manufacturing. Any locality that had adopted a separate classification for machinery and tools used in food processing prior to July 1, 1997, was allowed to continue to tax such property at a different rate than it taxes machinery and tools generally.

1996 Session

- House Bill 496 (Del. Dickinson) made machinery and tools used in semiconductor manufacturing or food processing separate classifications of machinery and tools for local taxation. Localities were thereby authorized to tax

property in these classifications at rates or assessment ratios that are not greater than those for other machinery and tools.

II. RECENT LEGISLATIVE STUDY REPORTS

1994: House Document 75 -- Tax Department Study of Proposal to Define Manufacturers for All State and Local Taxes as Defined in the SIC Manual

House Joint Resolution 527 of the 1993 Session requested the Department of Taxation to conduct a study on the benefits of adding to Title 58.1 of the Code of Virginia, for all state and local taxes, the definition of "manufacturer" as defined by Standard Industrial Classification (SIC) codes 20 through 39.

The Department of Taxation currently uses the SIC system (as the result of a 1983 law change) for purposes of determining eligibility for the manufacturing exemption from the sales and use tax. Also, at least one locality uses the SIC codes as a tool for managing and administrating local license tax classification.

The Tax Department's report observed that there is no definition of manufacturing or manufacturer in statutes pertaining to local taxes. A working common law definition has developed through numerous Virginia Supreme Court decisions. As a result, a business may be considered a manufacturer by the Tax Department for state tax purposes but not by a locality for local tax purposes, and vice versa.

The report acknowledged that classification as a manufacturer often provides a business with significant local tax benefits, including exemptions from the local business license (BPOL) tax and, in some localities, a lower tax rate on machinery and tools. The resolution anticipates that a uniform definition will enhance Virginia's business environment by reducing uncertainty.

In its discussion of the machinery and tools tax, the report notes that localities are responsible for classifying taxpayers as manufacturers and determining which property is eligible for segregated tax treatment of machinery and tools. This segregated classification and taxable treatment of machinery and tools, under which localities may set a tax rate for the machinery and tools of manufacturers that is lower than the rate imposed on the general class of tangible personal property, is not generally available to processors. As a result, machinery and tools used by processors may be taxed by a locality at a rate which is often higher than the rate levied on a manufacturer's machinery and tools.

Personal property (other than machinery and tools, motor vehicles, and delivery equipment) used in manufacturing (as well as in mining, broadcasting, dairy, and laundry businesses) is classified as intangible personal property and thus is exempt from taxation. As a result, office equipment used in manufacturing is exempt from local taxation, but the same equipment used in processing would not be exempt. While this is an incentive for corporate headquarters and administrative facilities, it may be a disincentive for attracting manufacturing plants (because a manufacturer's machinery and tools are not totally exempt).

The primary benefits of an SIC code approach appear to be:

- Increased uniformity in classification among all localities. Local tax administrators are concerned with the lack of certainty in their classification of businesses as manufacturers, which has administrative and revenue considerations.
- Increased uniformity in defining a manufacturer for all state and local taxes.
- Increased certainty as to classification. Industry and economic development groups are sensitive to the lack of uniformity in classification among localities.

The report identifies several relevant concerns with the proposal:

1. Secondary Criteria. The issue of eligibility for a tax preference is not resolved by determining whether a business is a "manufacturer." If a business is a manufacturer, a second inquiry is required to determine if property is "used in manufacturing." Being a manufacturer is not enough by itself to qualify for each tax preference. For example, a manufacturer's office equipment must be used in manufacturing to qualify as intangible personal property. These "secondary" requirements would not necessarily be removed if a business is determined to be a manufacturer based on the SIC codes. If secondary requirements remain, there will still be variations among localities based on judgments of local tax officials as to how closely related property must be to a manufacturing process to be deemed "used in manufacturing." As long as there is any room for judgment in the interpretation of a law and its application to a specific set of facts, there will be differences. Adoption of definitions based on SIC codes will not eliminate all disputes; for example, the SIC code depends on an evaluation of an establishment's primary activity, and "primary" is susceptible to different interpretations. Moreover, if the secondary requirements remain applicable to tax preferences, there would be room for further nonuniform treatment.

2. Activities in Other Locations. Some local tax officials consider only the activities of the business within the locality, and others look at its worldwide activities. If a business facility where no manufacturing occurs is deemed to be a manufacturer, its tangible personal property and gross receipts may escape local taxation even though the actual manufacturing activity occurs outside the locality's jurisdiction. The Tax Department recognized that Commissioners of Revenue do not have the authority to examine activities at facilities outside their locality. However, it may no longer be realistic to expect an entire manufacturing process to occur in one locality or that activity in a single facility, seen in isolation, will be readily identifiable as a part of a manufacturing process.

3. Potential Loss of Local Revenue. SIC codes relating to manufacturing include many types of businesses that would not currently be classified as manufacturers, e.g., processors. For example, in Prentice v. City of Richmond, a poultry processor was held not to be a manufacturer, despite the fact that poultry processing is classified as manufacturing under SIC code 2015. Because the SIC includes many businesses that localities generally classify as nonmanufacturers, VML and VACO opposed the use of SIC codes in this manner.

4. Currently-advantaged Businesses May No Longer be "Manufacturers." Some businesses currently classified as manufacturers would no longer be, under the SIC codes. For

example, photofinishing is classified as a business service in SIC code 73, but in some localities it has been classified as manufacturing.

5. Misclassification of Businesses. Businesses may misclassify themselves, i.e., choose an incorrect SIC code in order to escape local taxation. Also, since each establishment, rather than the business as a whole, is classified according to its primary activity, in localities where the classification is determined based on the overall nature of its manufacturing business, a headquarters or administrative facility would be classified as a nonmanufacturing facility, thus losing its eligibility for classification as intangible personal property.

The report finds that a business with identical activities in different localities may have its activities classified differently in those localities. Using an SIC-based definition will increase uniformity in classification among all localities. However, other issues, such as whether equipment is "machinery and tools" used in manufacturing, will not be resolved by an SIC-based definition or other uniform definition of "manufacturer." While all of the interested parties in the study share some of the same concerns, the bottom line issue of revenue loss for local governments may render it impossible to obtain immediate resolution -- either in the form of an SIC-based classification system or some other uniform definition of "manufacturer."

The report concludes that recommendation for or against adoption of an SIC-based classification is premature. Other mechanisms are in place, to allow the interested parties to further explore the issue.

1995: House Document 69 -- Local Revenue Resources

House Joint Resolution 160, adopted by the 1994 Session, established a joint subcommittee to examine local revenue resources. The resolution directed the subcommittee to identify and examine all local taxes and fees, review the equity of each tax and fee assessed, determine whether changes are needed in the tax structure relative to Virginia's changing economy, and recommend possible alternatives for replacement or consolidation of local taxes and fees. The study was chaired by Delegate Hull.

With respect to the machinery and tools tax, the report notes that while localities are required to assess tangible personal property at fair market value, localities are authorized to assess each class of tangible personal property according to a different method so long as the method used is uniform within each class.

Appendix D of the report noted that the machinery and tools tax accounted for 2.0 percent of the revenue of cities, and 1.6 percent of the revenue of counties (with one county not taxing machinery and tools).

Much of the group's work addressed proposals to eliminate the BPOL tax. Other topics discussed included a piggy-back income tax, increasing the sales tax, taxing services currently exempt from the sales tax, adequacy of the county, city and town structure for current fiscal conditions, equal taxing authority for cities and counties, local corporate income tax, local option

gasoline tax, lowered real property taxes, taxing authority for local school boards, incentives for revenue sharing, and return of lottery proceeds to localities.

In the discussion of the possible imposition of new taxes, there was an underlying assumption that new taxes would be added only if current taxes were eliminated, and no current taxes would be eliminated without providing a replacement source of revenue. The subcommittee did not reach any conclusions or make any recommendations, other than to continue to study the issues. Many items were raised that need further examination. By authority of HJR 487 (1995), which established the Commission on State and Local Government Responsibility and Taxing Authority, the study of this topic was continued and extended to the broader issues of state and local government responsibility and taxing authority.

1996: House Document 62 -- Beyer Commission, Part I

House Joint Resolution 487 (1995) created the Commission on State and Local Government Responsibility and Taxing Authority to study the state and local tax system and the service delivery system. The commission was chaired in its first year by former Lieutenant Governor Don Beyer. The commission issued an interim report in March 1996.

The business, professional and occupational license (BPOL) tax was the focus of much of the commission's work. Though the machinery and tools tax was not discussed expressly in the report, VMA representative Carol Wampler proposed the implementation of a uniform appeals procedure for local taxes, which would encompass such tax.

To address the separate themes of the efficiency of service delivery and the equity of state and local taxes, the commission established a Services Task Force and a Revenues Task Force, which began work in November 1995. The commission was continued by House Joint Resolution 108 (1996), and again by House Joint Resolution 532 (1997). The commission also recommended supporting the concepts and principles embodied in BPOL uniform ordinance legislation, which was originally introduced during the 1995 General Assembly Session. The BPOL uniform ordinance bill was enacted in 1996.

1998: House Document 88 -- Beyer Commission, Part II

The Commission on State and Local Government Responsibility and Taxing Authority met a total of ten times in various locations throughout the Commonwealth during 1996 and 1997 pursuant to House Joint Resolution 108 (1996) and House Joint Resolution 532 (1997).

In 1996, a special drafting subcommittee prepared proposals that, among other things, would provide for state assumption of authority to levy a BPOL tax and remove it from local control, simultaneous to the assumption of education, social services, and health services. In the face of opposition from localities, no action was taken on the proposals and it recommended only that the study be continued for a third year. The commission did not issue an interim report following its work in 1996.

In 1997, the commission examined six topics: (i) the personal property tax on automobiles, trucks, and motorcycles, (ii) a state earned income tax credit, (iii) local taxing authority, (iv) local assessment practices, (v) the funding obligations of the Commonwealth, and (vi) the need for a permanent tax commission. At the commission's August 1997 meeting, the Commissioners of the Revenue Association explained the assessment methods for the machinery and tools tax. The testimony showed that there are varying values, pricing guides and assessment ratios utilized throughout the Commonwealth. The lack of uniformity in assessment methods is similar to that which existed with the BPOL tax prior to its reform. The Commissioners of the Revenue Association undertook to work on recommendations regarding uniformity in this area for presentation to the commission at its December meeting. There is no record of the Association presenting such recommendations. The commission included in its findings and recommendations a general statement on local assessment practices supporting "the adoption of more uniform statewide assessment procedures for personal and real property that is based on a uniform fair market value methodology and including better training for local assessors and a simpler, more user-friendly process for taxpayers who appeal assessments.

1999: Report Pursuant to House Bill 2085

House Bill 2085 established an appeals process for local business taxes (including machinery and tools tax, business tangible personal property tax, and merchant's capital tax). During the Session, interested parties could not reach an agreement on issues involving uniform methods of valuation and rate classification. In an effort to assist the parties in reaching a consensus on these issues, HB 2085 was amended to include a second enactment clause, which directed the VML, VACO, Commissioners of Revenue Association, Virginia Chamber of Commerce, and VMA) were directed to propose recommendations to address uniform methods of valuation, rate classification and associated local revenue impacts for local business taxes to the House Finance and Senate Finance Committees by December 15, 1999.

The organizations met in July and October 1999. On December 30, 1999, counsel to the House and Senate Finance Committees submitted a report to their Chairmen the following:

After careful thought and deliberation, it was determined that a statewide uniform method of valuation was not in anyone's best interest -- neither the taxpayers' nor the localities'. Therefore, the interested parties' recommendation is to leave alone the current method of valuation with regard to local business taxes.

Issues that the parties discussed at their meetings included (i) defining "manufacturing" in the Code of Virginia; (ii) addressing what happens when new facts about an assessment are determined, as the basis for an appeal; (iii) ensuring that assessment procedures satisfy both the fair market value and uniformity requirements of the Constitution in a revenue-neutral manner; and (iv) addressing the term "fair market value."

The parties also identified a problem with classification in §§ 58.1-3503 A (17), which relates to the general classifications of tangible personal property for valuation purposes, and 58.1-3506 (24), which addresses other classifications of tangible personal property for taxation. The group proposed legislation to correct a conflict between these two sections, to clarify that a

locality may tax certain business tangible personal property at a rate below the rate generally applicable to all tangible personal property situated in the locality. In response, House Bill 684, which made property described in subdivision A 17 of § 58.1-3503 fit in the class of business tangible personal property set out in subdivision A 24 of § 58.1-3506, was enacted in the 2000 Session.

The parties also agreed that standardized procedures should be developed for the appeal and administration of local business tax assessments. The report noted that the Commissioners of the Revenue Association developed standardized appeal procedures and agreed to encourage all localities to adopt the procedures.

2001: Senate Document 38 -- Commission on the Condition and Future of Virginia's Cities/ Advisory Commission on Intergovernmental Relations

The 1998 Session passed House Joint Resolution 432, which established the Commission on the Condition and Future of Virginia's Cities, chaired by former Speaker Moss. The Commission was requested to conduct a comprehensive two-year examination of the condition and needs of Virginia's cities, and develop and recommend appropriate and feasible alternatives to ameliorate the problems to ensure the future of the Commonwealth. The Commission established three subcommittees, one of which was charged with examining Finances and Fiscal Issues. Information was provided regarding changes in the sources of local taxes over time, including changes, on a year-by-year basis, in sources of city tax revenue and county tax revenue, from 1986 to 1997. Similar information was provided regarding sources of state tax revenue.

In 1998 the commission focused primarily on identifying the problems faced by the Commonwealth's urban areas. However, the commission also saw some of its interim recommendations adopted during the 1999 Session, including the creation of a commission to study the Commonwealth's state and local tax structure.

In 1999, the commission's work focused on finding solutions to the service and structural priority issues identified in 1998. Issues related to tax structure were referred to the commission studying the Commonwealth's state and local tax structure. The Commission on the Condition and Future of Virginia's Cities developed 35 specific recommendations, of which 11 dealt with aspects of state and local tax structure and were referred to the Commission on Virginia's State and Local Tax Structure for the 21st Century.

The Advisory Commission on Intergovernmental Relations was directed, by Senate Joint Resolution 218 (2000), to study the other 24 recommendations and make additional recommendations for measures to alleviate the social and economic problems confronting Virginia's urban localities. Its conclusions are found in Senate Document 38 of 2001; none relate specifically to the machinery and tools tax.

2001: House Document 22 -- Morris Commission

House Joint Resolution 578 of the 1999 Session established the Commission on Virginia's State and Local Tax Structure for the 21st Century, which is referred to by the name of its chairman, Dr. Thomas Morris of Emory and Henry College. The Morris Commission, comprised of 14 citizen members, was staffed primarily by Mich Wilkinson of the Weldon Cooper Center for Public Service. The Morris Commission's establishment was a recommendation of the Commission on the Condition and Future of Virginia Cities.

The Morris Commission was requested to consider 11 specific proposals referred to it by the Cities Commission, dated February 17, 2000. None of the 11 proposals addressed the machinery and tools tax. The 11 recommendations offered by the Morris Commission following its two-year study included increases in state support for local school divisions, state assumption of operational costs for the provision of mandated health, welfare and other services, and returning a portion of state income tax collections to localities, revising state income tax rates, brackets, and exemptions. There was no discussion of machinery and tools tax in either the text of its report or in its recommendations.

2001: Report of the Governor's Commission on Government Finance Reform for the 21st Century -- Bliley Commission

The Commission on Government Finance Reform for the 21st Century was established in June 2001 by Governor Gilmore's Executive Order 75 (01). The commission did not address the machinery and tools tax directly.

2003: House Document 26 -- Study of Virginia's State Tax Code

House Joint Resolution 685 and Senate Joint Resolution 387 of the 2001 Session established a joint subcommittee to study and revise Virginia's State Tax Code. The joint subcommittee was directed to examine the report and recommendations of the Commission on Virginia's State and Local Tax Structure for the 21st Century. Its other specific mandates included clarifying the definition of "manufacturer" for purposes of the business, professional, and occupational license tax, and evaluating the appropriateness of the merchant's capital tax and the business, professional and occupational license tax. Senator Hanger and Delegate McDonnell co-chaired the study.

House Joint Resolution 60 (2002) added four members and continued the joint subcommittee for a second year, with a directive to complete its work by November 2002. A report detailing its work in 2001 and 2002 was presented by the Joint Subcommittee to the 2003 Session as House Document 26. Its principal recommendation was to continue the study for one more year, with a final report in December 2003.

The resolution recited, among other things, that "the property tax assessment process, including consideration of administrative and judicial challenges by taxpayers, is a complex process that varies in administration from jurisdiction to jurisdiction." One of its recommendations submitted in 2002 called for revising the property tax appeals process to

clarify procedures and the standard of proof for taxpayers. The report indicates that the testimony on this issue focused exclusively on real property tax appeals (See, e.g., Appendix J).

The Commission's Task Force #2 considered a proposal, raised at its June 26, 2002, meeting by the Chamber of Commerce, Retail Alliance, Colony Condominium, and Retail Merchants Association, to eliminate the BPOL, machinery and tools, and merchant's capital taxes and replace the \$640 million total of lost revenue with an increase in the corporate income tax. Each 1% increase in the corporate income tax would raise \$60 million. The Task Force #2 deferred action on the proposal pending a recommendation of the BPOL Work Group. It was estimated that the cost of repealing the machinery and tools tax would be \$203.4 million in the 2002-2003 biennium and \$211.6 million in the 2003-2004 biennium. No action was taken on this proposal.

The Commission's Task Force #1 was presented with a proposal to amend the Constitution to abolish all personal property taxation. Though directed primarily at the tax relief program for personal automobiles, staff calculated the cost of repealing all authorization to levy ad valorem taxes on personalty of all types, including machinery and tools. There is no record of any action being taken with respect to the proposal.

The 2003 Session adopted Senate Joint Resolution 347, which recited that because of the (i) sheer complexity and interconnection of tax policy issues and the voluminous documents and proposals that were submitted to the joint subcommittee, not all of which have been fully analyzed; (ii) lack of consensus among stakeholder task forces on key issues such as revenue sharing, equalization of taxing authority, and local business license tax reform, which caused the joint subcommittee to agree to extend the study for a third year on major restructuring issues; and (iii) pressing nature of the Commonwealth's fiscal situation, which has diverted legislative and executive attention from tax restructuring, these issues and others pertaining to Virginia's State Tax Code and the Streamlined Sales Tax Project Agreement should be examined simultaneously. The work of the Joint Subcommittee was therefore continued as part of the new Commission. The Commission, chaired by Senator Hanger, met five times in 2003, and concluded its work without making legislative recommendations. The Commission did not submit a final report.

Earlier Studies

A summary of recommendations for legislative action from studies from 1984 through 1997, with a description of any action taken with respect to each recommendation, is attached.