Tax Commission

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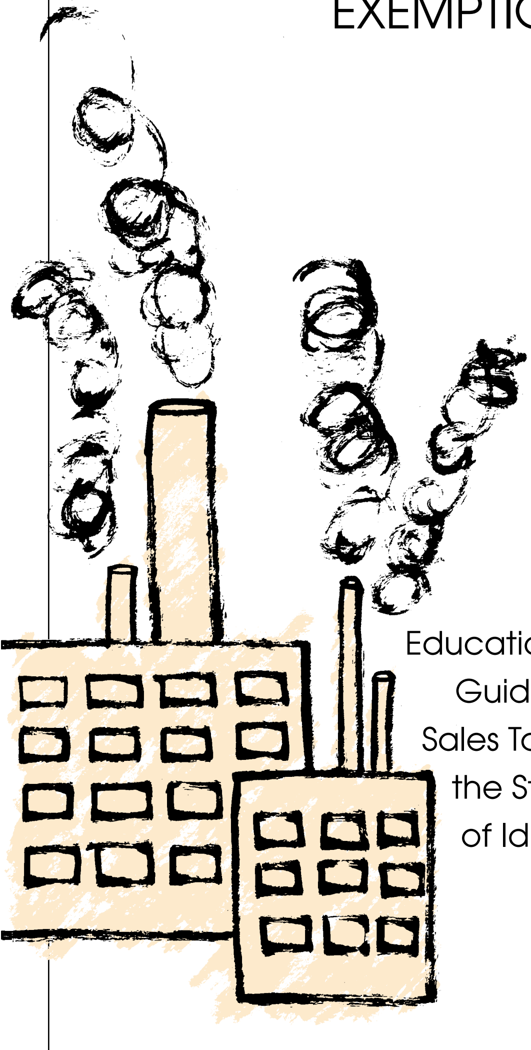
THE PRODUCTION EXEMPTION



An Educational Guide to Sales Tax in the State of Idaho

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This brochure is intended to explain what items are taxable or nontaxable under the production exemption. While it covers a wide range of producers and manufacturers, there are separate brochures available on Mining, Farming and Lumber Manufacturing.

This information is based on the sales tax laws and rules in effect on July 1, 2001.

WHAT IS THE PRODUCTION EXEMPTION?

The production exemption eliminates sales tax on purchases of materials and supplies used directly in the production process by farmers, manufacturers and other producers.

The exemption also applies to purchases of certain kinds of production equipment. This equipment must be "directly" and "primarily" used in the production process. If it is used only in an incidental manner, the equipment is not exempt.

The distinction between "direct" and "primary" use versus "incidental" use is one of the main sources of confusion about the production exemption. However, the law is much clearer regarding some types of property, such as licensed motor vehicles and inexpensive hand tools. These items do not qualify for the production exemption.

WHO QUALIFIES?

The production exemption applies to a business (or segment of a business) that spends the majority of its time producing a product that will be resold. A "segment of a business" is a division or branch with its own identity and separate accounting records.

In order to qualify for an exemption, the business (or segment of a business) must:

- Be engaged in one of these activities:
  - Farming
  - Mining
  - Ranching
  - Fabricating
  - Manufacturing
  - Processing
- Be "primarily" devoted to producing a product for resale. This means that more than 50% of its activities must involve production.
- Own the goods being manufactured, processed, etc. The production exemption does not apply to service-oriented businesses, with the exception of custom farming and contract mining.

The production exemption is granted only to businesses. It does not apply to individuals who buy supplies for a hobby or other non-business activity.

WHO DOES NOT QUALIFY?

Businesses do not qualify for the production exemption if they:

1. Do not produce a product for ultimate sale at retail, or are primarily engaged in retailing.
   Examples:
   - Service-oriented businesses, such as:
     dry cleaners
     horse trainers and racers
   - Retail stores, such as:
     drugstores
     restaurants
     clothing stores
2. Are not involved in production more than 50% of the time.
   Example: A shop spends 40% of its time manufacturing and 60% doing repairs. Manufacturing is an exempt activity, but repairing someone else's property is not. This means the shop does not qualify for the production exemption, since only 40% of its work is eligible. However, the same shop *can* qualify for the exemption on its manufacturing activities by creating a separate operation for them and maintaining separate assets, income, expenses, employees and accounting records.
   Example: A sand and gravel company crushes gravel both for road-building activities and to sell at its retail yard (without setting it in place). If more than 50% of the gravel it crushes is sold at retail by the sand and gravel company, the crushing equipment qualifies for the production exemption. However, if the company uses more than 50% of the crushed gravel to perform its own contracts, then the crushing equipment and any repair parts are taxable when they are purchased.
3. Are specifically excluded from the production exemption by law.
   - Utility companies
   - Producers of heating materials
   - Publishers of tax-exempt literature
   - Liquor producers

WHAT PURCHASES ARE EXEMPT?

The production exemption allows tax-free purchases of:

1. Raw materials that become part of a final product.

   Examples:
   - Metals purchased by a metal fabricator
   - Logs purchased by a lumber mill
   - Potatoes purchased by a french fry producer
   - Feed purchased by a cattle rancher
2. Chemicals and catalysts that affect a product by:
   - ■ Causing a physical change.

   Example: Welding gases used by a fabricator to mold and join the product he is fabricating.
   - ■ Removing impurities.

   Examples:
   - Chemicals used by a potato processor to remove impurities from the potatoes.
   - Chemicals used to refine metallic ores.
   - Chemicals used to strip oil and impurities from electronic parts.
   - ■ Making the product more marketable.

   Example: Electroplating equipment and chemicals used to chrome plate metal products.
3. Equipment or other tangible personal property which is primarily and directly used in the production process and is necessary or essential to the operation.

   The key words are:
   - ■ Tangible personal property—It must be (and remain) tangible personal property; the exemption does not apply to items that will become part of real property (such as fence posts or building materials).
   - ■ Primarily—More than 50% of its use must be in the production process.
   - ■ Directly—Its function must be a direct part of the production process.

   Example: A computer is used directly in a manufacturing plant if it operates the manufacturing equipment, but not if it is used to keep records for the manufacturer.
   - ■ Necessary or essential—It must be required for the production process.

An item must meet all four of the conditions above in order to qualify for the production exemption.

Example: A piece of equipment is used directly in the production process and is necessary, but only 45% of its equipment hours are devoted to the process. Because the equipment is **not** "primarily" (more than 50%) used in the production process, it meets only three of the four requirements and is not eligible for the exemption.

4. Safety equipment and supplies, if they are:
   - Used directly in the production process, and
   - Required to meet safety standards set by a state or federal agency.

   Examples: Required hard hats, protective clothing, gloves and fire extinguishers.

WHAT PURCHASES ARE TAXABLE?

Some items do not qualify for the production exemption. Sales tax applies to the following purchases:

1. Hand tools with a unit price of $100 or less, *regardless of how they are used:*

   Examples:
   - A hammer used by a metal fabricator
   - Tweezers used by a microchip manufacturer
2. Equipment and supplies for any of the following:
   - Office
   - Selling or distribution activities
   - Janitorial purposes (except clean-in-place equipment and chemicals used by a food processor)
   - Research or development
   - Transportation activities
3. Equipment and supplies used for maintenance or repair;
4. Real property or items that will become improvements or fixtures to real property, such as:
   - Rebar
   - Fence posts
   - Gates
   - Road gravel and culverts
   - Foundations for production equipment
5. Safety equipment and supplies that are not required by a state or federal agency, or are required but are not used directly in a production activity;

   Examples:
   - A first aid kit in the office
   - A fire extinguisher in the shipping area
6. Licensed motor vehicles, licensed trailers, recreation-related vehicles and aircraft, or any related parts and supplies.

   NOTE: Heavy trucks and trailers used in interstate commerce may qualify for an exemption. See Brochure #41—Transportation.

WHAT IF THE USE OF AN ITEM CHANGES?

If an item is purchased tax exempt for use in a production process and later is put to a use that does not qualify for the production exemption, tax applies to the value of the item at the time it no longer qualifies for the exemption.

Example: A fabricator buys a forklift that will be used to move raw goods from one fabrication process to another until the product is completed. This forklift qualifies for the exemption as it is "directly" used during the fabrication process. After two years, the fabricator decides to move the forklift into the finished goods warehouse to load trucks. This activity does not qualify for the exemption, so the forklift is subject to tax on its fair market value at the time it ceases to qualify.

The law does not allow credit for tax paid on a piece of equipment bought for use in a non-exempt activity and later moved to an exempt one. If the forklift in the above example is purchased for use in the shipping warehouse, tax applies to the purchase price. When it is moved from shipping (a taxable activity) to the fabricating line (a nontaxable activity), no credit can be claimed for the tax paid.

HOW DOES A BUYER CLAIM THE EXEMPTION?

Businesses that qualify for the production exemption may claim it in one of two ways:

1. Give the seller a completed form ST-101, Sales Tax Resale or Exemption Certificate. Once on file with the seller, this form is valid for all future exempt sales.
2. Fill in a "Production Exemption" claim printed or stamped on the seller's invoice or on your purchase order. If you do this for each exempt purchase, you do not have to give your suppliers a form ST-101.

Read Brochure #5 for more information on exemption claim forms.

DOES TAX APPLY TO SALES BY A PRODUCTION COMPANY?

If a production company sells products or any items to the final consumer, the company must charge tax.

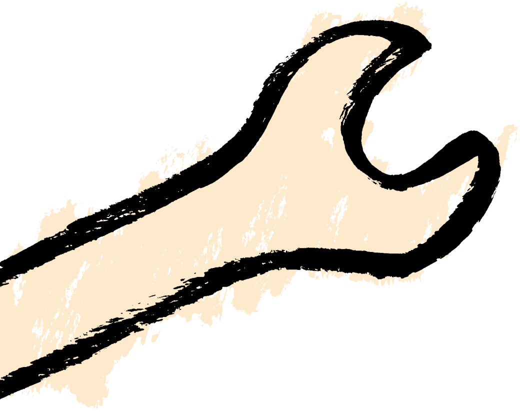
Examples:

- Retail sales of finished goods to employees or others
- Sales of promotional items, such as hats, jackets, etc.

The production company must document all nontaxed sales of its products in Idaho. Customers must complete form ST-101 for the production company's records.

FOR MORE INFORMATION, READ:

Brochure #2	Use Tax
Brochure #4	Retailers
Brochure #5	Retailers & Wholesalers: Making Exempt Sales
Rule 79	Production Exemption
Rule 128	Certificates for Resale and Other Exemption Claims



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