



SC REVENUE RULING #91-13

SUBJECT: Machine Shop Activities
(Sales and Use Tax)

TAX ANALYST: Steve C. Hallman

EFFECTIVE DATE: With respect to machines used by machine shops to produce tools and supplies for the machine shops' own use, the effective date is December 1, 1991.

With respect to all other issues, this ruling applies to all open periods under the statute.

REFERENCE: S.C. Code Ann. Section 12-36-110 (Supp. 1990)
S.C. Code Ann. Section 12-36-120(2) and (3) (Supp. 1990)
S.C. Code Ann. Section 12-36-910(A) (Supp. 1990)
S.C. Code Ann. Section 12-36-1310(A) (Supp. 1990)
S.C. Code Ann. Section 12-36-2120(17) and (19) (Supp. 1990)
Regulation 117-174.110
Regulation 117-174.123
Regulation 117-174.130

AUTHORITY: S.C. Code Ann. Section 12-4-320 (Enacted June, 1991)
SC Revenue Procedure #87-3

SCOPE: A Revenue Ruling is the Commission's official interpretation of how tax law is to be applied to a specific set of facts. A Revenue Ruling is public information and remains a permanent document until superseded by a Regulation or is rescinded by a subsequent Revenue Ruling.

Questions:

1. Are sales to, or purchases by, machine shops of tangible personal property which becomes an ingredient or a component part of the product being manufactured, or is "used directly" in manufacturing the product, excluded from the sales and use tax pursuant to Code Section 12-36-120(2) and (3)?

2. Are sales to, or purchases by, machine shops of machines and electricity exempt from the sales and use tax pursuant to Code Section 12-36-2120(17) and (19)?

Facts:

Machine shops are facilities where power-driven tools are used for making, finishing, or repairing machines or machine parts. Some manufacturers own and operate machine shops, while other machine shops are independently owned and operated. In many instances, machine shops custom make or fabricate parts or attachments for a manufacturer's machinery. Where machine shops engage in such activities, it has not been clear whether the machine shops are considered as manufacturers for sales and use tax purposes. More specifically, there has been uncertainty as to whether machine shops qualify for the exclusions from the sales and use tax found at Code Sections 12-36-120(2) and (3) when purchasing ingredients or component parts of a product being manufactured, or tangible personal property "used directly" in manufacturing a product. Further, there has been uncertainty as to whether machine shops qualify for the exemptions from the sales and use tax found at Code Section 12-36-2120(17) and (19) for machines and electricity used in manufacturing tangible personal property.

Discussion:

Code Section 12-36-910(A) states:

A sales tax, equal to five percent of the gross proceeds of sales, is imposed upon every person engaged or continuing within this State in the business of selling tangible personal property at retail.

Code Section 12-36-1310(A) reads:

A use tax is imposed on the storage, use, or other consumption in this State of tangible personal property purchased at retail for storage, use, or other consumption in this State, at the rate of five percent of the sales price of the property, regardless of whether the retailer is or is not engaged in business in this State.

The terms "sale at retail" and "retail sale" are defined at Code Section 12-36-110, in part, as "all sales of tangible personal property except those defined as wholesale sales."

Code Section 12-36-120 provides, in part:

"Wholesale sale" and "sale at wholesale" mean a sale of:

* * * *

- (2) tangible personal property to a manufacturer or compounder as an ingredient or component part of the tangible personal property or products manufactured or compounded for sale;

- (3) tangible personal property used directly in manufacturing, compounding, or processing tangible personal property into products for sale;...

In summary, for the sales or use tax to be imposed, there must be a retail sale of tangible personal property. Wholesale sales of tangible personal property are excluded from taxation. Wholesale sales include sales of tangible personal property to a manufacturer which become an ingredient or component part of products manufactured for sale or which are "used directly" in manufacturing tangible personal property for sale. The term "used directly" as found in the statute is defined in Regulation 117-174.30(b) to mean:

... that the materials or products so used come in direct contact with and contribute to bring about some chemical or physical change in the ingredient or component properties during the period in which the fabricating, converting or processing takes place. It is not necessary that such materials or products be used up or entirely consumed, provided there is a compliance with the requirements set forth herein.

In addition to the aforementioned exclusions, Code Section 12-36-2120 exempts from the sales and use tax purchases of:

- (17) machines used in manufacturing, processing, compounding, mining, or quarrying tangible personal property for sale. "Machines" include the parts of machines, attachments, and replacements used, or manufactured for use, on or in the operation of the machines and which are necessary to the operation of the machines and are customarily so used. This exemption does not include automobiles or trucks;

* * * *

- (19) electricity used by manufacturers, miners, or quarries to manufacture, mine, or quarry tangible personal property for sale.

Therefore, purchases of machines and electricity used to manufacture tangible personal property for sale are exempt from the sales and use taxes.

Regulation 117-174.123 states, in pertinent part:

Manufacturers or compounders are entitled to purchase at wholesale free of the sales or use tax, materials used by them in the building of machines for the purpose of manufacturing or compounding tangible personal property for sale.

It should be noted that only those materials are exempt to manufacturers or compounders which are used by them in building machines for the purpose of manufacturing or compounding tangible personal property for sale....

In Southern Equipment Sales Company, Inc. v. South Carolina Tax Commission, Court of Common Pleas of Richland County, unpublished order dated July 27, 1962, the court considered whether a secondary and casual use of a machine by a construction contractor who occasionally sold asphalt produced by the machine would come within the exemption for machines used in

manufacturing tangible personal property. The court concluded the exemption was applicable when a machine is used in the manufacture, processing or compounding of tangible personal property for sale and that incidental sales of asphalt by the contractor to others would not bring its machine within the exemption.

More recently, the Court of Appeals of South Carolina, in Hercules Contractors and Engineers, Inc. v. South Carolina Tax Commission, 280 S.C. 426, 313 S.E.2d 300, 308, 309 (1984), deliberated whether building materials were exempt from sales and use taxes when used to construct a machine to abate pollution caused by the operation of manufacturing machines even though the pollution abatement machine was not used exclusively for that purpose. In reaching its conclusion the court reviewed an exemption found at Code Section 12-35-550(17) that has been repealed and recodified at Code Section 12-36-2120(17). Their finding states, in part:

...The exemption of section [12-36-2120(17)] extends to the sale of machines used in the manufacture of tangible personal property. It does not provide that the manufacturing use has to be exclusive. Neither does it require that the manufacturing use must be the primary use to which the facility [pollution abatement machine] is devoted....At the same time, it would not be reasonable to hold that the legislature intended only a minimum use by a manufacturer be sufficient to make a machine tax exempt.... The Burlington facility [pollution abatement facility], ...is substantially used in the manufacture of tangible personal property for sale, and this was the purpose for which it was built. We therefore hold that the materials used in its construction are exempt from sales or use taxes....(emphasis added)

In summary, a machine must be substantially used in manufacturing tangible personal property for sale in order to qualify for the exemption at Code Section 12-36-2120(17). In addition, materials used to construct a machine which qualifies for the exemption are not subject to the tax.

Regulation 117-174.110, entitled "Machine Shops", states:

Property manufactured or fabricated by machine shops and custom foundries is subject to the sales tax, except when sold for resale purposes or when exempted by one of the exemptions found in the sales tax law.

In doing repair work the machine shop operator consumes the materials which lose their identity in the repairing process, such as paint, solder, babbitt and lumber. He is also considered to be the consumer of such items as cotter keys, nails, washers, stove bolts and nuts, bits of metal, and sheets of metal used in patching or reinforcing. The receipts from the use of these materials are not subject to the sales tax. The sales or use tax is due by the machinist at the time of purchase from his suppliers.

Where the machinist in making repairs, fabricates or manufactures a recognizable part or attachment for the article being repaired (as contrasted to patching, mending, or reinforcing weakened parts) no deduction is permissible for labor or any other expenses which are a part of fabricating or manufacturing the part or attachment. He may, however,

if making separate agreements to sell the manufactured or fabricated part and to install the same, remit tax only on the sales price of the fabricated part or attachment, provided his books and invoices show clearly a separation between the sales price of the fabricated part or attachment and the labor and service of installation.

Pursuant to the language contained in the above regulation, a machine shop may function as a manufacturer of tangible personal property.

Regulation 117-174.130, entitled "Machine Shop Machinery", reads:

Machines used for maintenance purposes do not come within the machine exemption. Machines used to produce tools and supplies for the use or consumption of the manufacturer do come within the machine exemption. Machines customarily used for both maintenance and manufacturing of tangible personal property will normally be considered to come within the machine exemption, except where manufacturing is an occasional, incidental or inconsequential part of the use of the machine.

Note: Nothing contained herein shall be construed to exempt from the tax materials from which a manufacturer fabricates tools for his own use, or machinery which will be placed to a taxable use. (emphasis added)

The foregoing regulation conflicts with the statute in that the regulation would allow a machine shop to purchase tax-free machines used to produce tools and supplies for its own use, while Code Section 12-36-2120(17) limits the exemption from sales and use tax to machines used in manufacturing tangible personal property for sale.

To quote from 68 Am.Jur.2d, Sales and Use Taxes, §143:

... An administrative rule or regulation is invalid to the extent that it is in conflict with or at variance with the taxing statute as construed by the court; and it is null and void if it purports to extend coverage of the statute being administered, or to enlarge an exemption or confer an exemption not conferred by the statute....

The above rule was followed by the South Carolina Supreme Court, in Society of Professional Journalists v. Sexton, 283 S.C. 563, 324 S.E.2d 313, 315 (1984), when the Court ruled, "Although a regulation has the force of law, it must fall when it alters or adds to a statute." Therefore, the above emphasized sentence in Regulation 117-174.130 is invalid as it is in conflict with Code Section 12-36-2120(17). However, the remainder of the regulation is valid.

Conclusions:

1. Sales to, or purchases by, machine shops of tangible personal property which becomes an ingredient or component part of the product being manufactured for sale, or "used directly" in manufacturing the product for sale, are excluded from the sales and use tax pursuant to Code Section 12-36-120(2) and (3). To qualify for the exclusions, the machine shops must manufacture tangible personal property for sale on a regular and continuous basis, and these activities must be a substantial part of the machine shops' total business activities.

Further, if a machine shop owned by a manufacturer only fabricates tangible personal property for use by the manufacturer (and not for resale), then tangible personal property purchased by the machine shop to fabricate an item that will be "used directly" in manufacturing tangible personal property for sale is not subject to the sales and use tax pursuant to Code Section 12-36-120(3).

2. Sales to, or purchases by, machine shops of machines and electricity are exempt from the sales and use tax pursuant to Code Section 12-36-2120(17) and (19) provided the machine shops manufacture tangible personal property for sale on a regular and continuous basis, and these activities are a substantial part of the machine shops' total business activities.

Also, tangible personal property purchased by machine shops and used to fabricate parts for exempt manufacturing machines are not subject to the sales and use tax pursuant to Code Section 12-36-2120(17).

Effective December 1, 1991, machine shops not substantially engaged in manufacturing tangible personal property for sale may not purchase machines free of the tax. For example, if a machine shop's activities consist solely of producing tools, supplies, or machine parts for its own use, machines may not be purchased for, or by, the machine shop free of the tax.

SOUTH CAROLINA TAX COMMISSION

s/S. Hunter Howard Jr.
S. Hunter Howard, Jr., Chairman

s/A. Crawford Clarkson Jr.
A. Crawford Clarkson, Jr., Commissioner

s/T. R. McConnell
T. R. McConnell, Commissioner

Columbia, South Carolina
September 4, 1991