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SC TECHNICAL ADVICE MEMORANDUM #94-3 (TAX)

TO: ABC, Inc.

SUBJECT: Computer System
(Sales and Use Tax)

DATE: December 6, 1994

SCOPE: This Technical Advice Memorandum is Policy's official advisory opinion of how laws administered by the Department of Revenue are to be applied to a specific audit of a particular person. It may only be relied upon by the person to whom it is issued and only for the transaction or transactions to which it relates. This Technical Advice Memorandum has no precedential value.

Question:

Is the following machinery and equipment used in the local area network ("LAN") of ABC, Inc. exempt as machines used in manufacturing tangible personal property for sale under Code Section 12-36-2120(17)?

1. Digital photography equipment used to input information (diagrams and pictures) into a database.
2. The computer used to manipulate the photographs created by the digital photography equipment and join them with detailed engineering specifications and a parts list.
3. The file server of the local area network.
4. Computers located at employee workstations along the valve assembly line.
5. Laser pens attached to the workstation computers.

Conclusion:

The digital photography equipment, the computer used to manipulate the photographs, the file server of the local area network, the computers located at employee workstations along the valve assembly line, and the laser pens attached to these workstation computers are all exempt as machines used by ABC, Inc. in manufacturing tangible personal property for sale under Code Section 12-36-2120(17).

Facts:

ABC, Inc. ("ABC") is in the business of manufacturing and rebuilding automotive transmissions and their respective components in Summerville, South Carolina.

ABC uses an internally developed mixed model production system to manufacture automobile transmissions. Due to large variations between transmission types, the system must be flexible enough to permit the manufacture of ABC's entire product line. ABC has developed this flexible mixed model production technology and is currently attempting to market it as the TEST system.

TEST is an interactive mixed model production system utilizing technicians, fixed assembly workstations, and local area network ("LAN") based computers to control and direct the activities of the technicians in assembling mixed model products. A mixed model production system allows ABC to manufacture different products on the same assembly line instead of manufacturing one product and then re-tooling the line to manufacture another product.

The computer system directs the first technicians as to what model of product is to be constructed. The technician, based upon the computer instructions, sets up a bar-coded colored bin to contain the components and uses a laser pen to read the bar-code. The technician then sends the bin down the roller pin table to the next station. The next technicians read the bar-code with the laser pen and the LAN computer provides the technician with written text and pictures describing the component or components the technician is to attach and the proper procedures (i.e. angle, torque) that should be used. The color coded bin proceeds through the various workstations and components are added to the product until it is finished. The TEST system controls and directs the assembly steps necessary to assemble the complex and widely varying configuration of products that ABC manufactures.

The TEST system consists of several components.

- * **Digital photography equipment** is utilized to input information (diagrams and pictures) into the database. The digital photographs are then manipulated by computer.
- * **One computer** is used exclusively to manipulate the digital photographs and combine them with detailed engineering specifications and a parts list.
- * The information is stored in a **file server computer**.
- * With the information in the file server computer, pertinent instructions are available to each technician through **computers located at each workstation** on the valve assembly line. The line technicians also have the ability to enter problems or questions into the computer to be addressed by engineers each day.
- * **A laser pen located at each workstation** is used by the technician to read the bar-code so the proper information needed by the technician to assemble the product will be displayed on the workstation computer.

Presently, the TEST system is only used along the valve assembly line portion of ABC's operation in South Carolina.

Discussion:

Code Section 12-36-2120(17) exempts from sales and use tax:

...the gross proceeds of sales of...machines used in ... manufacturing...tangible personal property for sale. 'Machines' include the parts of machines, attachments, and replacements used...in the operation of the machines and which are necessary to the operation of the machines...

Regulation 117-174.120 provides an interpretation of the term "machines" and reads, in part:

The terms "...parts of such machines" are restricted to the following: (a) they must be used or manufactured for use, on or in the operation of such machines; (b) necessary to the operation of such machines and (c) customarily so used. These restrictions are interpreted to mean that the part or attachment must be purchased in the form in which it will be used by the manufacturer without any fabrication or alteration by him, except the usual and customary minor adjustment (except as stated at 117-174.123) and that it is a standard part or attachment customarily used and, further, that the machine or machinery on which it is used would not do the work for which it was designed if it were not used.

This, of course, exempts all parts and attachments without which the machine would do no work, and, in addition, it exempts parts and attachments designed to increase the efficiency of the machine.

The law, therefore, provides that machines, their parts and attachments, subject to certain restrictions, that are used by in manufacturing tangible personal property for sale qualify for the exemption found in Code Section 12-36-2120(17). However, as a general rule, tax exemption statutes are strictly construed against the taxpayer. Owen Industrial Products, Inc. v. Sharpe, 274 SC 193, 262 SE 2d 33 (1980), Hollingsworth on Wheels, Inc. v. Greenville County Treasurer et al, 276 SC 314, 278 SE 2d 340 (1981). This rule of strict construction simply means that constitutional and statutory language will not be strained or liberally construed in the taxpayer's favor. York County Fair Association v. SC Tax Commission, 249 SC 337, 154 SE 2d 361 (1967).

In order to determine whether machines and attachments are used in manufacturing tangible personal property for sale, it is essential to ascertain the points at which manufacturing begins and ends. American Law Reports Annotated 2d suggests the following in making this determination and reads:

While the determination of whether the use is a taxable one or not appears to depend largely upon the peculiarities of the taxpayer's operations, so as to be essentially a question of fact in each case, it seems that the tax will be imposed where the transportation or storage is clearly of raw materials prior to the start of manufacturing or processing, or of the completed product after such operations have clearly terminated, but that the handling and storage intermediate to the various manufacturing or processing operations may be regarded as a part of those operations, and so free from the tax. Annot., 30 A. L. R. 2d 1449 (1953).

Furthermore, in the case of Hercules Contractors and Engineers, Inc. v. South Carolina Tax Commission, S.C., 313 S.E. 2d. 300 (1984) the Court of Appeals of South Carolina held:

Alabama, whose statutory exemption is similar to our own, does not require a machine to have moving parts if it is an integral part of the manufacturing process.

* * * *

The test for determining what is machinery and equipment, first formulated in *[In re Borough of Aliquippa] Jones and Laughlin*, 405 Pa. [421] at 431, 175 A. 2d [856] at 861, provides:

"Improvements, whether fast or loose, which (1) are used directly in manufacturing the products that the establishment is intended to produce; (2) are necessary and integral parts of the manufacturing process; and (3) are used solely for effectuating that purpose are excluded from real estate assessment and taxation. On the other hand ... improvements which benefit the land generally and may serve various users of the land are subject to taxation."

Commonwealth v. Philadelphia Electric Company, 472 Pa. 530, 372 A. 2d 815 at 820 (1977). Thus, a particular "structure" may or may not constitute a machine for tax purposes, depending not upon its form but upon its use. (Emphasis added.)

While the Hercules case primarily concerned the application of the machine exemption to the determination as to whether a "structure" affixed to realty was a machine, it does state that a machine's use and its relationship to the manufacturing process are important considerations in determining whether or not it is exempt. Machines that are used directly in manufacturing tangible personal property for sale and are a necessary and integral parts of the manufacturing process are exempt from sales and use taxes.

Finally, where the words of a statute are clear there is no room for construction and such terms must be given their literal meaning. Duke Power Co. v. South Carolina Tax Commission, 292 S.C. 64, 354 S.E.2d 902 (1987).

Based on the above, the following can be concluded with respect to the TEST system at ABC, Inc.:

1. The digital photography equipment, the computers used to manipulate these photographs and store them in the system, the LAN computers that are located at each workstation and the file server to these computers are "machines used in ... manufacturing...tangible personal property for sale" and are therefore exempt from the sales and use tax.
2. The laser pens located at each workstation are attachments to the workstation computers, the "machines used in ... manufacturing...tangible personal property for sale", and are therefore exempt from the sales and use tax.