



Window on State Government

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Natural Gas & Electricity

If the taxpayer is a manufacturer and has claimed exemption on natural gas or electricity, a predominant usage study must be made available to the auditor for review. If the study is found to be invalid, the non-taxed billings should be scheduled as well as any amounts refunded to the taxpayer during the audit period by either the utility company or the Comptroller. Even if the refunded amount applies to periods outside of the audit period, the total refunded amount should be scheduled. If the refund is after the audit period, a subsequent audit should be generated.

A predominant usage study is not needed when 100% of the natural gas or electricity on a meter is used in an exempt manner. However, the exemption certificate should state the specific use. (8903L0926E05)

Many times, a taxpayer is paying tax at the beginning of an audit period but not at the end of the audit period or vice versa. Without reviewing the actual utility bills as well as the utility expense accounts for any unusual debit entries for various periods throughout the audit, the auditor will not notice this change.

A study must contain the following essential elements:

- A list of every item that uses electricity separated by processing items and non-processing items;
- A detailed description of what each such item does;
- If a piece of equipment has both a processing and a non-processing function, it should be included in both lists with appropriate hours listed for each function;
- Identification of all heating and air conditioning in terms of type (gas or electric) and size (tons for air conditioning, BTUs for heating);
- Amperage, voltage (or kilowatt rating) and hours of operation for each piece of equipment;
- Any cycling equipment must reflect real "on" hours with a separately stated duty factor. CA variance from 50 percent must be proven out for all cycling equipment and certified by a registered engineer or a person with an engineering degree from an accredited engineering college;
- Hours per day and days per week the location is open to the public;
- Hours the location is occupied by employees prior to opening and after closing to the public;
- Copies of the last twelve months' electricity bills; and
- Certification of both the engineer and the owner must appear on the face of the study.

(9302091P and 9612056L)

Any changes in equipment, business activities, or square footage being served by the utility meter should be taken into account by the study.

The auditor should perform the following steps when verifying a utility study:

- Obtain a depreciation schedule from the taxpayer and cross-reference the listed equipment to equipment on the study and observed during a tour at the taxpayer's location. Any changes in the depreciation schedule throughout the audit period should be noted.
- Review the study for reasonable hours for each piece of equipment.
- Identify pieces of equipment that may have a dual purpose. For example, if a lathe is used to manufacture items for resale but is also used to repair tangible personal property belonging to another, the study should identify the repair hours as taxable use. Likewise, any lighting, heating, or cooling hours should also be split for taxable and non-taxable use. In other words, if processing is not actually occurring, hours for lighting should not be classified as exempt. (200002085L)

Examples:

- Taxpayer submitted a study showing 1,200 hours per year for manufacturing equipment. However, the study showed approximately 3,600 hours per year for lighting used in the manufacturing area and classified all of these as exempt. The lighting hours should have approximated the hours for the manufacturing equipment for exempt usage and also should have been allocated to a taxable usage category when processing was not occurring.
- A bakery produces donuts sold for immediate consumption and not sold for immediate consumption. If the utility study showed that 80% of the electricity was used to produce donuts and that 3,000 donuts were sold for immediate consumption and 7,000 were not sold for immediate consumption, the exemption certificate should be accepted based on the following multiplication. $80\% \times 7000/10,000 = 56\%$. Therefore, 56% of the electricity used would be **exempt**. (9504197L)
- Verify the amperage and voltage (or kilowatt rating) listed in the study by reviewing the decal or plate typically located on the equipment, by reviewing purchase invoices or owner's manuals for the equipment specifications, or searching the internet for the maker of the equipment which may provide detailed information.

Example:

Electricity used for storing produce or maintaining an already marketable product is taxable. (200101051H)

Wrapping & Packaging

The manufacturing process is complete when the manufacturer has packaged the tangible personal property being produced, as it will be sold.

Therefore, manufacturers or sub-manufacturers performing the wrapping & packaging function may purchase tax-free any wrapping & packaging equipment, repair parts and repair labor for qualifying equipment, and packaging supplies.

Exempt wrapping, packing, and packaging supplies that are used to further the sale of a product include non-returnable containers, wrapping paper, wrapping twine, bags, boxes, cartons, crates, crating material, pallets, tape, rope, rubber bands, metal bands, labels, tags, staples, glue, mailing tubes, excelsior, straw, cardboard fillers, separators, shredded paper, ice, dry ice, cotton batting, shirt boards, and hay lath.

Exempt Examples:

- Artwork for shipping containers that can also be used to display the product shipped in the container (9911914L)
- Packaging supplies (containers, bags, labels, etc.) used to package cheese sliced or grated (9904382L)
- Returnable reels/pallets purchased by manufacturer (200108400L)
- Instruction guides included with the product (9910825L)
- Stretch wrapper that applies to film to products on a pallet, strapper that applies plastic bands around boxes or products, and a shrink wrapper that applies a temperature sensitive plastic film around the product (200012945L)

Taxable Examples:

- Artwork for a promotional display only (9911914L)
- Packaging supplies used by a grocer's cheese department that is merely cutting large wheels of cheese and repackaging (9904382L)
- Returnable water bottles purchased by a manufacturer and used to package water are taxable (200007631H)
- Advertising material included with the product by the manufacturer (200010807L)

Tangible Personal Property verses Improvement to Realty

When installing or repairing qualifying equipment classified as tangible personal property (TPP), the manufacturing exemption is applicable for parts and labor regardless of how billed (lump-sum or separated). However, when installing or repairing manufacturing equipment classified as an improvement to realty, the manufacturing exemption is applicable for separated qualifying parts only; thus, the billing becomes an issue.

Most large manufacturing plants maintain an inventory of spare parts/equipment (stores) to eliminate any interruption in the manufacturing process due to repairs of non-functioning equipment. This inventory may consist of newly purchased parts/equipment or repaired parts/equipment. When repairs are performed for manufacturing equipment that has been incorporated into realty, the manufacturer has two options: (1) the repaired manufacturing equipment may be reinstalled into realty or (2) placed into inventory. If the manufacturer chooses to reinstall the equipment into realty, the repair parts will be exempt, but the labor will be taxable. If the manufacturer chooses to place the repaired equipment into inventory, both the repair parts and repair labor will be exempt since the equipment loses its identity as real property.

Remember two important points:

- (1) Repair labor by the manufacturer's employees is not taxable.
- (2) The manufacturer is responsible for documenting whether the repaired equipment was reinstalled into realty or placed into inventory.

The following chart summarizes the taxability status of qualifying manufacturing equipment based on different billing types:

Type	Parts/equipment	Labor
TPP-Initial Installation-Lump Sum	Exempt	Exempt
TPP-Initial Installation-Separated	Exempt	Exempt
TPP-Repair-Lump Sum	Exempt	Exempt
TPP-Repair-Separated	Exempt	Exempt
Improvement to Realty-New Construction-Lump Sum	Tax owed by contractor at time of purchase	Exempt
Improvement to Realty-New Construction-Separated	Exempt	Exempt
Improvement to Realty-Repair/Remodel-Lump Sum	Taxable unless exempt qualifying manufacturing equipment is separately stated or documentary evidence is provided establishing a percentage of the total charge relating to exempt equipment	Taxable
Improvement to Realty-Repair/Remodel-Separated	Exempt	Taxable

Examples:

- A repair to a built-in oven (improvement to realty) under a lump-sum billing is taxable unless the manufacturing equipment is separately stated or documentary evidence is provided establishing a percentage of the total charge relating to exempt equipment.
- A repair to a built-in oven (improvement to realty) under a separated billing--parts are exempt, but the labor is taxable.
- Repair parts and labor for pollution control equipment classified as TPP are exempt.
- A repair to a pump that is reinstalled as real property--parts are exempt, but the labor is taxable.
- A repair to a pump that was manufacturing equipment incorporated into realty is put into inventory spare parts (stores) instead of being reinstalled as real property, so the pump loses its identity as real property, and both the parts and labor are exempt.

(200108408L, 200007520L, 9710931L, 9601931L, and 9606L1415G10)

Separated and lump-sum contracts to improve realty

A contractor who incorporates into realty any equipment or materials that qualify for exemption may accept an exemption certificate in lieu of tax from the manufacturer for the separately stated exempt materials sold under a separated contract. Taxable materials, such as foundation materials and items that are noted under 3.300(c) must be separately stated from qualifying equipment, or a single charge for qualifying and non-qualifying materials will be presumed taxable. When nonresidential repair, remodeling, or restoration of realty is performed, qualifying equipment should be separately stated from both non-qualifying materials and taxable labor. A lump-sum charge to repair, remodel, or restore nonresidential realty is presumed taxable. The presumption may be overcome by the service provider at the time the transaction occurs by separately stating to the customer a reasonable charge for the taxable services. However, if the charge for the qualifying manufacturing equipment is not separately stated at the time of the transaction, the service provider or the purchaser may later establish for the comptroller, through documentary evidence, the percentage of the total charge that relates to exempt qualifying manufacturing equipment. Examples of acceptable documentation include purchase invoices, bid sheets, or schedules of values. A lump-sum charge to perform new construction is not taxable. The contractor is the consumer of all the goods that the contractor uses in the performance of a lump sum new construction contract, and neither the contractor nor the manufacturer may claim an exemption on otherwise qualifying manufacturing equipment.

(200105245L and 9103L1153D10)

Divergent Use

As noted in the Sales section of this manual, certain activities will cause a divergent use of otherwise exempt property. A common situation occurs when a taxpayer is both a manufacturer and a contractor or repairman/remodeler; when acting as a contractor or repairman/remodeler, tax is due on the divergent use of the manufacturing equipment.

January 01, 1995 - September 30, 2001

Divergent use will be assessed on either the fair market rental value (fmrv) or on the full purchase price of the tangible personal property. The fmrv is the price a third party would charge for the rental of the property.

In order to stop accruing tax for divergent use, tax has to be paid on the original purchase price of the property. A reduction in tax is not allowed for tax accrued on the property's fair market rental value for divergent uses. If a fair market rental value cannot be determined, tax is owed on the original purchase price. The statute specifically excludes from the exemption, property that is not used in the actual manufacturing process.

October 01, 2001 and after

There will be no tax on the divergent use of equipment that is four years or older. The count for four years starts running from the date of purchase. Any taxable use of property that does not exceed 5% of the total use for a month is not subject to tax. The tax is due on the percentage of taxable use in a month times 1/48 of the cost of the property.

Section 151.3181 of the tax code specifies the following procedure for calculation of divergent use for a month:

Tax = 1/48 of purchase price X divergent use percentage X tax rate applicable at purchase

Divergent use percentage is measured either in hours or by outputs:

$$\frac{\text{total divergent use hours of operations in a month}}{\text{total hours of operations of the property during the month}}$$

OR

$$\frac{\text{total output during divergent use in a month}}{\text{total output during the entire month}}$$

A manufacturer who purchases non-capitalized equipment repair parts or consumables for equipment that are routinely used in both exempt and nonexempt manners may elect to pay tax on the repair parts or consumables by applying the divergent use percentage of the equipment as provided by paragraph (2)(B) of this subsection for the month in which the purchase of the repairs part or consumable was made.

A manufacturer who purchases repair labor for equipment may owe tax if the qualifying exempt equipment is used in both exempt and nonexempt manners. If the qualifying equipment was being used in an exempt manner at the time the repair was needed, no tax is due for divergent use of the repair. If qualifying equipment was being used in a nonexempt manner at the time the repair was needed, tax is due on the purchase price of the repair. If a manufacturer cannot determine whether the equipment was being used either in an exempt or nonexempt manner at the time of repair, the manufacturer may pay tax by applying to the purchase price of the repair the divergent use percentage for the month in which the purchase was made.

(9603030L, 9706494L, 200110533L, 200111621L, and 200112735L)

Newspapers/Publications

A person who is engaged in printing or imprinting tangible personal property for sale or production of a publication for the dissemination of news of a general character and of a general interest that is **printed on newsprint** and distributed to the general public daily, weekly, or at some

other short interval, free of charge, may purchase tax free, in addition to other items that are exempted under this section, the following pre-press machinery, equipment, and supply items that are necessary and essential to and used in connection with the printing process:

- Computers
- Cameras
- Film
- Film developing chemicals
- Veloxes
- Plate-making machinery
- Plate metal
- Litho negatives
- Color separation negatives
- Proofs of color negatives
- Production art work
- Typesetting or composition proofs

The bulleted items above are specifically listed in Section 151.318(t) of the Tax Code. Section 151.319(e)(4) of the Tax Code states in part that equipment or supplies used in gathering information is taxable; however, Section 151.318(t) is more specific. Therefore, computers used to access the Internet to gather information, for example, would **not** be taxable.

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