QUESTIONS OF BUSINESS AND PERSONAL PROPERTY CLASSIFICATION

WINERIES, BREWERIES, NANO-BREWERIES, MICRO-BREWERIES, DISTILLERIES, BLENDING BUSINESSES, and MOONSHINE

Overview

This presentation is intended to provide some guidance to Commissioners and deputies who must make determinations on BPOL and personal property classifications for wineries, breweries and distilleries.

The commercial production of wine, beer, spirits, ciders and other products is fundamentally a manufacturing process, traditionally in an industrial setting. In recent decades across Virginia, the production setting is more diverse. We are seeing craft-, micro-, nano-, and combinations with other business activities. Tap rooms, restaurants, event spaces, brew your own; you name it. If it hasn't popped up yet, it will. Changes in technology and market behavior will likely present more challenges in the future.

These industries are evolving, but changes in law tend to occur more slowly. The proper application of current statutes is sometimes difficult to make. It is hoped the material in this presentation will provide revenue officers with the tools to better apply current law.

Is the production of wine, beer, liquor (including moonshine) actually manufacturing for the purpose of local taxation?

Yes, when the production of those products is the substantive activity of the business.

Such classification should not be an issue for those businesses that are solely engaged in the production of wine (<u>and not located on a farm</u>*), beer, or liquor.

What constitutes a manufacturer is not addressed in property tax law.

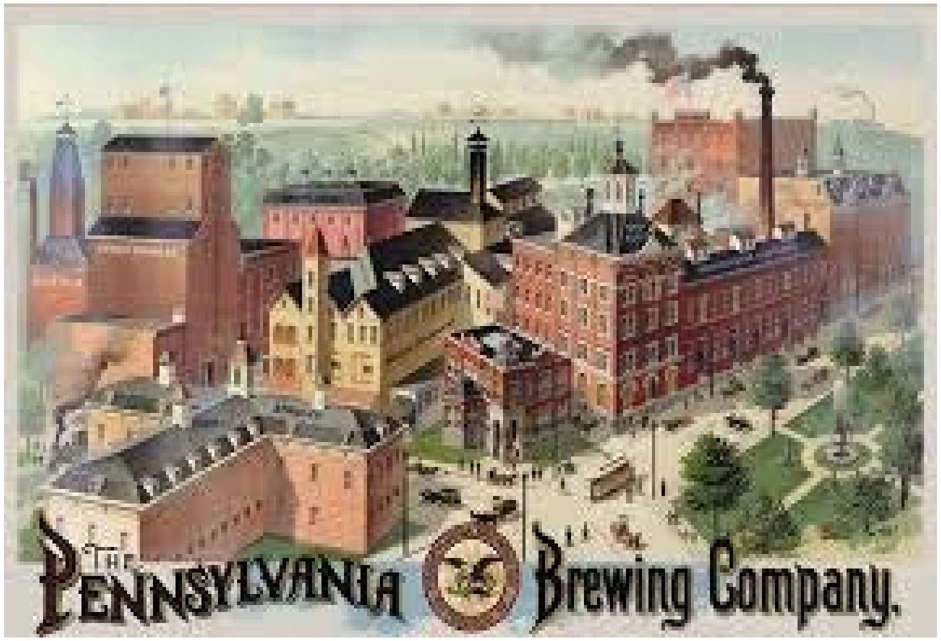
However, the subject is addressed in Virginia Tax Administrative Code **23VAC10 500-520** and **23VAC10-210-920**, and though applicable to BPOL and Retail Sales and Use Tax respectively, provide for distinctions that can be made between manufacturing and processing, and what tests to apply in making the distinction.

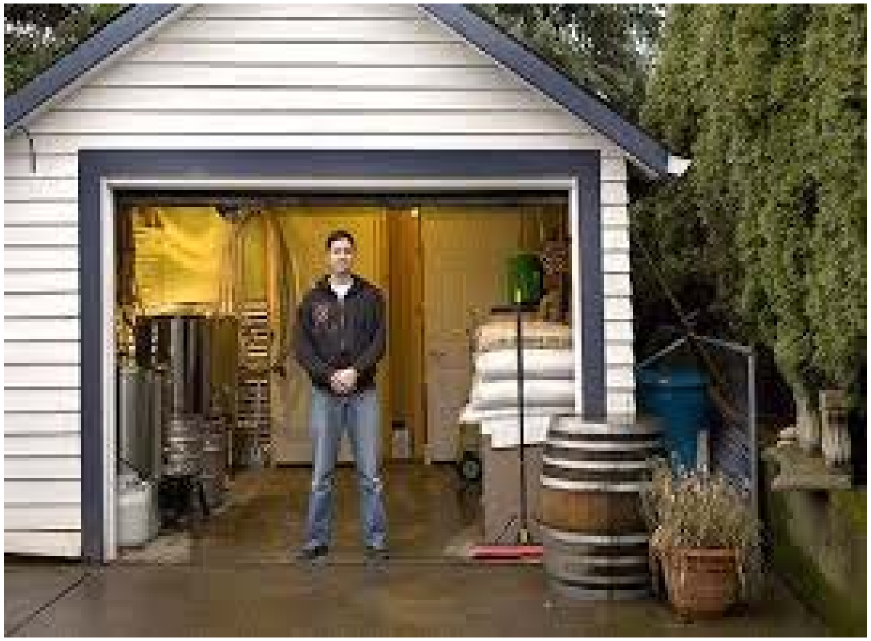
* To be discussed later in the presentation

Is the production of wine, beer, liquor (including moonshine) actually manufacturing for the purpose of local taxation?

Please note:

The determination of whether an operation is industrial in nature shall be made without regard to plant size, finished product inventory size, degree of mechanization, amount of capital investment, number of employees or other factors relating principally to size.





Manufacturing – Defined
Virginia Tax Administrative Code

23VAC10-500-520: BPOL Tax

The *Code of Virginia* does not define the term "manufacturer" for purposes of the local business license tax. The courts, however, have developed a liberally applied test involving three essential elements in determining when a person is a manufacturer:

1. The original material
2. A process whereby the original material is changed; and
3. A resulting product which, by reason of being subjected to processing, is different from the original material

23VAC10-210-920: Retail Sales and Use Tax Paragraph B, Definitions:

1. **Industrial manufacturer and industrial processor**.

Industrial **manufacturers** include establishments engaged in the mechanical or chemical transformation of materials or substances into new products

Industrial **processors** include establishments engaged in the treatment of materials, substances, or other products in such a manner as to render such products more useful or marketable. Products need not undergo a change in state or form in order for an establishment to be classified as an industrial processor.

Manufacturing – Process? Business?

At this point it may be useful to clarify the term "manufacturing" for the purposes of this presentation. Manufacturing can be thought of as a process, but also as a classification of business activity.

As we proceed, the classification of a business activity as manufacturing will be discussed. A business that is substantively a manufacturer is exempt from BPOL. Non production personal property, tangible in fact, associated with manufacturing is capital, and subject to classification as intangible personal property **(§58.1-1101)**. Manufacturing business classification has broad taxation implications, which are beyond the scope of this presentation.

Equipment and machinery used in the manufacturing "process", with few exceptions, is to be classified as Machinery & Tools, a class of tangible personal property subject to local taxation **(§58.1 – 3507)**.

If manufacturing, where is the line between production equipment and equipment not part of the manufacturing process such as:

- ***A) Bottling equipment***
- ***B) Computer/printer to produce labels for labeling product***
- ***C) Shelving to store product (barrels)***
- ***D) Holding tanks: production equipment or storage?***
- ***E) Office furniture, computers and peripherals.***

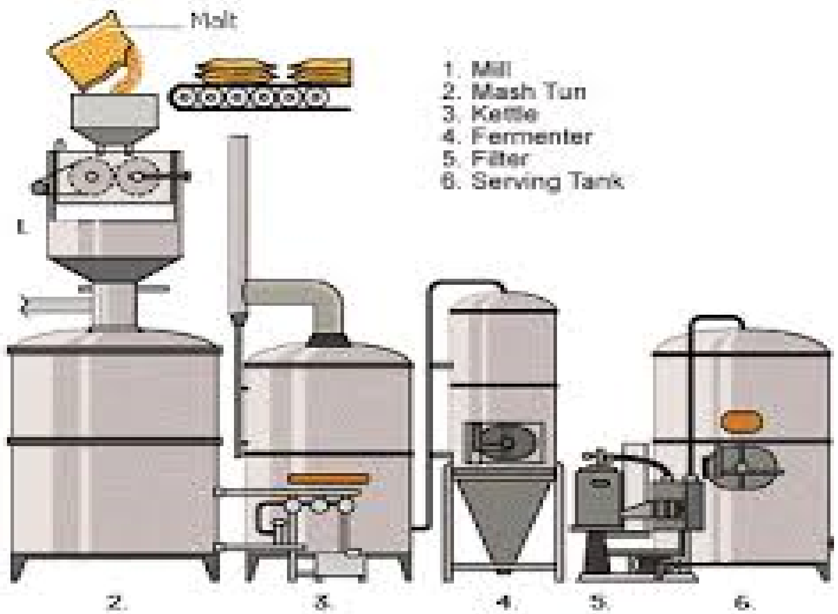
Production – A, B, C, D ***Not part of Production – E***

23VAC10-210-920: Retail Sales and Use Tax discusses the concept of "used directly", which refers to those activities that are an integral part of the production of a product, including all steps of an integrated manufacturing process, but not including incidental activities such as general maintenance, management, and administration.

The manufacturing process can be thought of as beginning with the handling and storage of raw materials at the plant site and continuing through the last step of production where products are finished or completed for sale and conveyed to a warehouse at the same plant site, and also includes production line testing and quality control.

Production equipment and equipment not part of the manufacturing process

Production



Non-Production

When is the production of wine, beer, liquor (including moonshine) <u>not</u> manufacturing for the purpose of local taxation?

Administrative Code **23VAC10-210-920** also makes reference to businesses classified or substantially similar to other businesses classified in codes 20 through 39 of the Standard Industrial Classification Manual published by the U.S. Department of Commerce (now reported under the U S Department of Labor), which includes wineries, breweries, and distilleries as their primary business to be manufacturers.

Still, questions may arise when a manufacturer is engaged in more than one type of business activity. For example, a business may manufacture a product, but may also be involved in wholesaling, retailing, or other business activities.

Manufacturing?

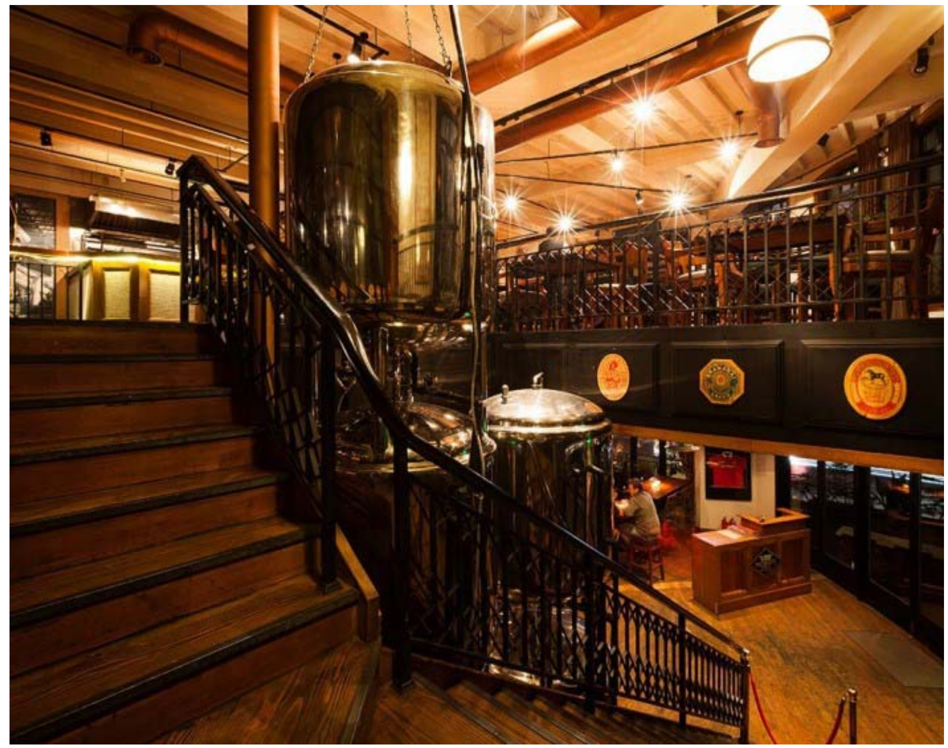
"A business engaged in manufacturing does not lose its status as a manufacturer merely because it conducts some non-manufacturing activities. When one is engaged in both manufacturing and non-manufacturing activities, it can still be classified as a manufacturer if its manufacturing activity constitutes a substantial portion of its overall activities…" **23VAC10-500-520**

"Establishments which manufacture or process tangible personal property as an incidental part of a retail or service business are generally deemed to be engaged in nonindustrial activities. Establishments of this type include retailers such as restaurants, caterers, meat and fish markets, and candy, nut, and confectionery stores which process food products primarily for direct sale on the premises to consumers. Such non-industrial establishments also include individuals engaged primarily in providing personal services such as photographers, artists, tailors, and seamstresses." **23VAC10-210-920**

Manufacturing?

Restaurant or Brewery?

Brewery or Restaurant?



The substantive business activity - Manufacturing?

The question then becomes *"what is the substantive business activity?"* and what metrics apply… on what basis is the determination made that the substantive business activity is manufacturing, and eligible for manufacturer classification? Such a determination impacts business license tax (manufacturers are exempted) and personal property classification and taxation:

- Tangible personal property (**§ 58.1-3503**, etc)
  - … Equipment and machinery used by **farm wineries** * as defined in **§ 4.1-100** in the production of wine… (**§58.1-3505**)
- Intangible personal property (**§ 58.1-1101**)
- Merchants' capital (**§58.1-3509**)
- Machinery and tools (**§58.1-3507**)

* To be discussed later in the presentation

The substantive business activity - Manufacturing?

The Virginia Supreme Court has used the BPOL test set out in **23VAC10-210-520** to determine whether a business engaged in manufacturing loses its status as a manufacturer for purposes of the business license tax, ***County of Chesterfield v. BBC Brown Boveri, Inc, 238 Va. 64 380 SE2d 890***. In this case the Court ruled that that the substantive business activity was manufacturing, upholding the Attorney General Opinion advising that the company is a manufacturer if its manufacturing activity constitutes a substantial portion of its business activity, in which case the lower tax rate for machinery and tools would be imposed.

The Attorney General had also opined that the term substantial is not susceptible of being reduced to mathematical precision, is not synonymous with preponderance, and is properly defined as not incidental or inconsequential.

The substantive business activity - Manufacturing?

Furthermore, the Court cited the factors that a court may consider in determining whether the manufacturing component of a multipurpose business makes a substantial contribution to the entire business, which include:

- The manufacturing component's financial receipts,
- Its proportion of the total corporate income,
- The percentage it comprises of the total capital investment,
- The number of employees working in the manufacturing component as compared with the total number of employees, or
- The ratio of manufacturing activities to the entire business

(***Fernandes Super Markets, Inc.*, 371 Mass. At 32223, 357 N.E.2d at 299**).

BPOL and personal property tax implications for other business activities will be discussed later in the presentation under the topic of farm wineries and other business activities.

Farm Winery = Manufacturing?

A farm winery is a unique entity, specifically defined in law, which requires careful analysis of applicable statutes when considering questions of classification and taxation. At minimum, a farm winery will have a producing vineyard, orchard, or similar growing, area and with facilities for fermenting and bottling wine on the premises.

There may be some support for the premise that the business of a farm winery, as defined in the Code of Virginia, is manufacturing.

Title **§ 4.1-100** of the *Code of Virginia*, *Definitions*, defines Farm Winery as an establishment located on a farm that "***manufactures*** *wine*". The definition goes on to say "*As used in this definition, the terms "owner" and "lessee" shall include a cooperative formed by an association of individuals for the purpose of* ***manufacturing*** *wine*.

Farm Winery = Manufacturing?

A farm winery is a unique entity, specifically defined in law.
The process is manufacturing, the business classification is farm winery.

Farm Winery - Business License

As defined, it is not unreasonable to consider a farm winery as being a manufacturing business. But, for business license purposes, does it matter? Both the business of selling farm products and manufacturing are exempted from BPOL.

§ 58.1-3703. Counties, cities and towns may impose local license taxes and fees; limitation of authority.

C. No county, city, or town shall impose a license fee or levy any license tax:

2. For selling farm or domestic products or nursery products, ornamental or otherwise, or for the planting of nursery products, as an incident to the sale thereof, outside of the regular market houses and sheds of such county, city or town, provided such products are grown or produced by the person offering them for sale;

4. On a manufacturer for the privilege of manufacturing and selling goods, wares and merchandise at wholesale at the place of manufacture;

If a Farm Winery, and the locality does not exempt equipment used in the production of wine under §58.1-3505, considering §58.1-3507 excepts machinery and equipment used by farm wineries from classification for machinery and tools tax, how would a locality tax a farm winery?

As noted earlier farm wineries are a unique entity, defined in law, and also referenced in property tax law. **§58.1-3503** identifies farm machinery as a class of tangible personal property. When directed to **§58.1-3505** from **§58.1-3503**, the provisions of **§ 58.1-3505** apply to certain farm equipment, and specifically include equipment and machinery used by farm wineries in the production of wine. In **§58.1 – 3507** an exception from classification as Machinery and Tools is made for equipment and machinery used by farm wineries in the production of wine.

So, how is farm winery equipment and machinery to be taxed? One line of thought is that if you presume a farm winery is a manufacturing business, the equipment and machinery, excepted from Machinery & Tools classification, would be subject to **§58.1-1101**, and classified as intangible personal property.

Farm Winery – Personal Property Classification
Farm Winery Machinery & Equipment - Tangible or Intangible ?

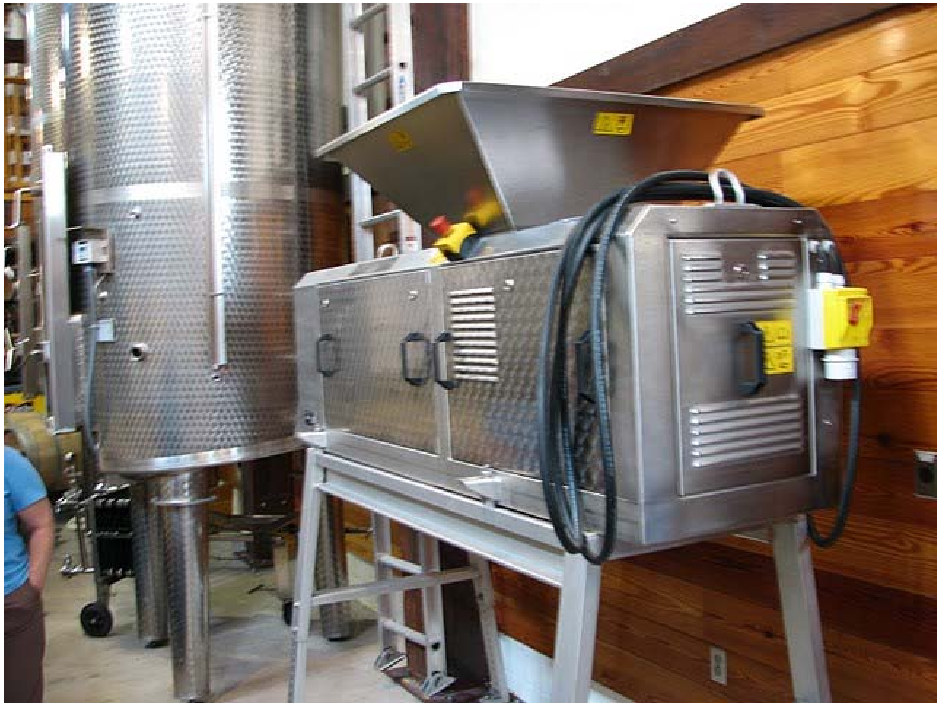
However, the General Assembly sought to provide clear guidance as to how farm wineries should be treated for personal property tax purposes when it enacted legislation in 1984 (**Senate Bill 126, Chapter 160**), and this legislation remains in effect today. The legislation did two things:

- Changed the classification of equipment and machinery used by farm wineries from "machinery and tools," subject to the machinery and tools tax **(§ 58.1-3507**), to "farm machinery," which is separately classified **(§ 58.1-3503**) and which localities may exempt or subject to a different rate **(§ 58.1-3505**).

- Classified wine in the hands of a winery as an agricultural product that is exempt from property taxation. Prior to this law, wine produced by farm wineries was treated as inventory of a manufacturer, and thus subject to the state intangible personal property tax. (**See PD 85-111**).

Farm Winery – Personal Property Classification
Farm Winery Machinery & Equipment - Tangible or Intangible ?

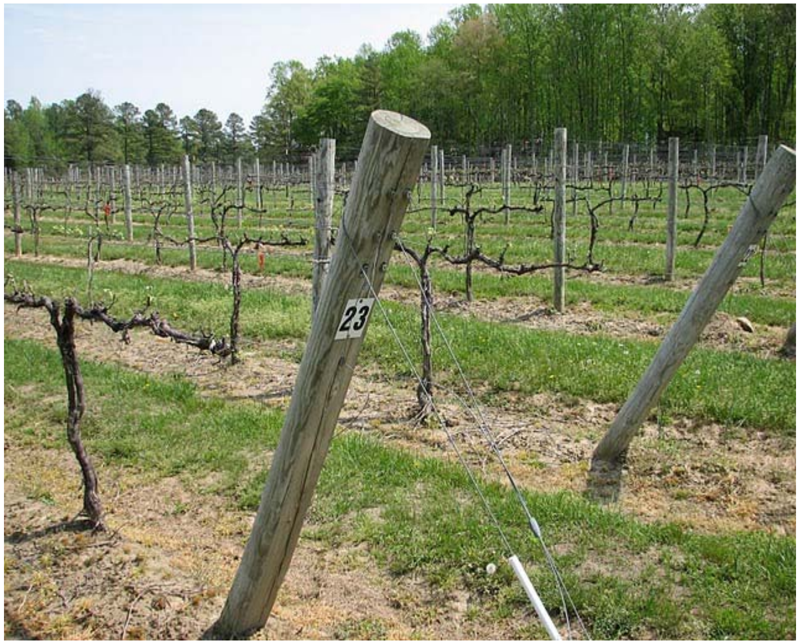
It can be understood from a reading of statute that equipment and machinery used by qualifying farm wineries is to be included in the classification of farm machinery under **§58.1-3503** and **§58.1 3505**.



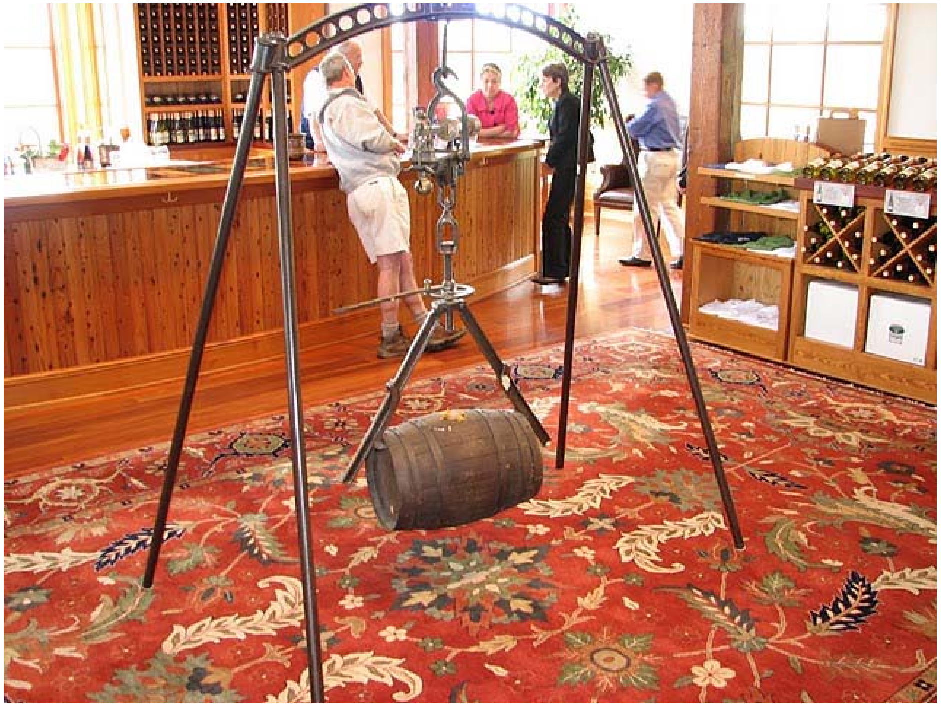
If not exempted, or a different rate assigned pursuant to the provisions of **§58.1-3505,** the locality would impose the tax at the rate applicable to the general class of tangible personal property.

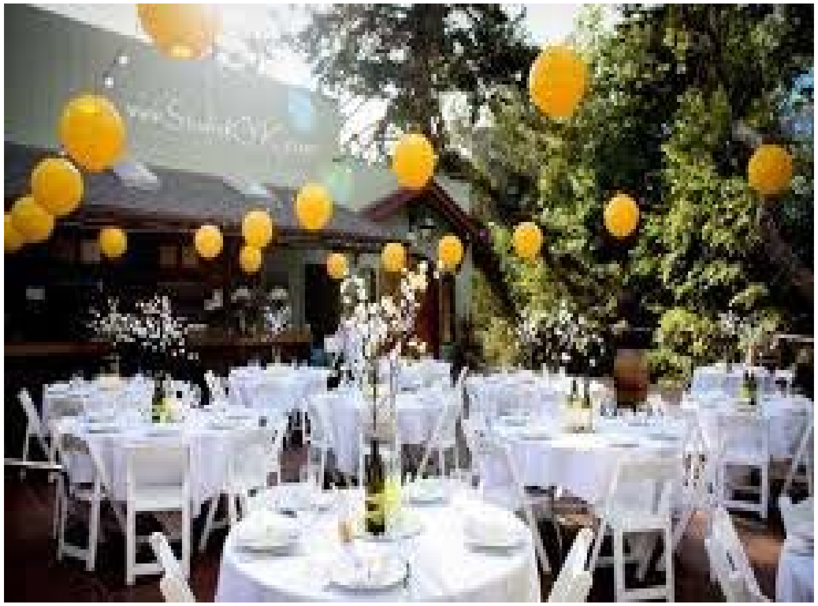
The farm winery and other business activities

The definition of a farm winery limits one to an *establishment located on a farm, having a producing vineyard, orchard, or similar growing area, and with facilities for fermenting and bottling wine on the premises where the owner or lessee manufactures wine*. As previously stated, the business activity of the farm winery is exempted from BPOL. However, it is not unusual to have on premises and in addition to the farm winery such different and separate business activities as tasting rooms, gift shops, restaurants, and even lodgings.



The farm winery and other business activities





The farm winery and other business activities

Though specific to manufacturing, the Virginia Supreme Court has provided some guidance for making distinctions between business activities for BPOL and personal property tax purposes. In the case of ***Coca –Cola Bottling Co. of Roanoke, Inc. v. County of Boutetourt, 259 Va. 559***, the Court held that manufacturing an article is essentially different from selling an article after it has been manufactured. As such, property "used in manufacturing" that is classified as "intangible personal property" under *Va. Code* ***§ 58.1-1101*** does not include equipment that is used for selling the property. The Court found that if a taxpayer is engaged in more than one business, the taxpayer "shall pay the tax provided by law on each branch of . . . its business" citing: ***§ 58.1-5****. Persons, etc., engaged in more than one business.*
When any person, firm or corporation is engaged in more than one business which is made by law subject to taxation, such person, firm or corporation shall pay the tax provided by law on each branch of his, their or its business.

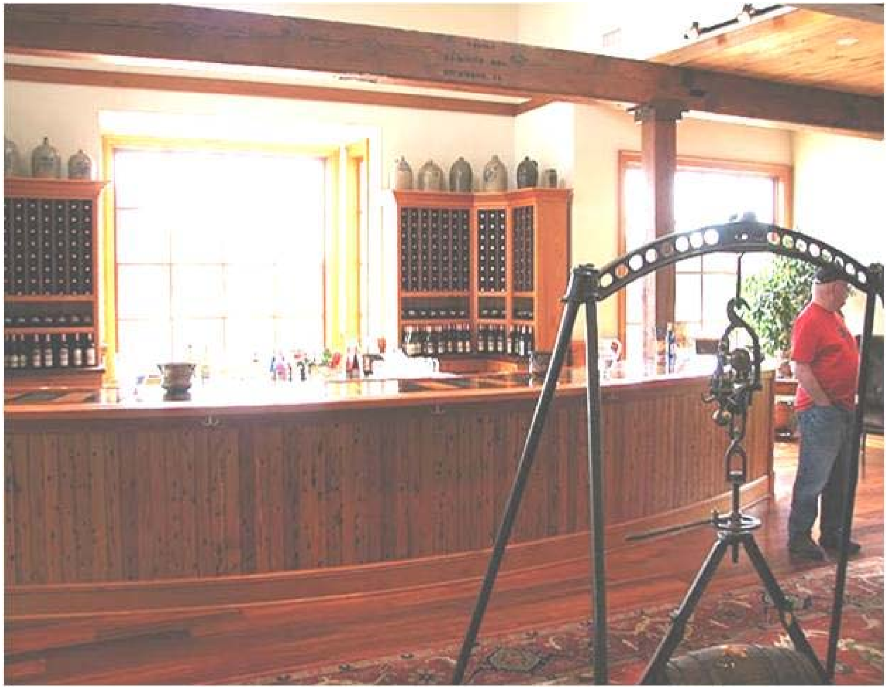
The farm winery and other business activities

The ***Coca-Cola*** ruling also included the following:

Whether a taxpayer's activities are considered as two separate businesses for tax purposes, however, is not determined by the formal structure of the taxpayer's functions or the taxpayer's relation to its franchiser. Rather, that issue is determined by the manner in which the taxpayer actually conducts its business. See Caffee v. City of Portsmouth, 203 Va. 928, 93031, 128 S.E.2d 421, 42223 (1962) (retail and wholesale sales in salesroom portion of bakery's manufacturing plant constitute a separate sales business for local license tax purposes).

The farm winery and other business activities

When taken together, the *Coca Cola* case, the *Caffee v. City of Portsmouth* case discussed earlier, and the provisions of **§ 58.1-5,** there is strong support for applying BPOL and tangible personal property classifications to other activities that would be viewed as separate businesses, pursuant to statutes applicable to those businesses.



Are nano-breweries, micro-breweries, blending businesses (blend multiple ready-made beers/wines/liquors to generate a different beer or liquor) considered manufacturers?

Generally speaking:

Nano-breweries, micro-breweries – can be considered **manufacturing**, assuming full brewery process that is the substantive component of the business

Blending businesses – can be considered a **processor**, not manufacturing

Refer to Virginia Tax Administrative Code, **23VAC10-210-920**: Retail Sales and Use Tax, Paragraph B, Definitions, which has been previously discussed.

Can a locality exempt equipment used in the production of beer/moonshine/liquor by a 'FARM' (grows some of the ingredients used) producer – if the locality exempts 'Farm' equipment under §58.1-3505

No, statute makes the distinction that farm machinery specifically includes equipment and machinery used by **farm wineries** in the production of wine as eligible for exemption under **§58.1- 3505**.

Farm Breweries or Farm Distilleries are not defined or included in statute.

Machinery and equipment used in the production of brewery or distillery products are not included as an exception in **§58.1- 3507**, and therefore would be classified as Machinery and Tools. If the breweries and distilleries are classified as manufacturing, the other personal property would be classified as intangible personal property, in accordance with **§58.1- 1101**.

Lickinghole Creek Craft Brewery in Goochland County is an example of a Virginia farm brewery. The entire ingredient chain for producing beer is on the 221-acre farm, including the water from on-site wells, the hops, barley, spices, and vegetables. See http://www.lickingholecreek.com/

In Summary

- The production of wine, brew, and spirits is fundamentally a manufacturing process
- The distinction between manufacturing as a process, the M&T classification of personal property used in manufacturing, and manufacturing as a business classification, with intangible personal property classification implications
- What constitutes a manufacturer is not addressed in property tax law.
- Relying on current statutes, court rulings considered to be applicable, and Virginia Tax Administrative Code **23VAC10 500-520** and **23VAC10-210-920**, though they apply to BPOL and Retail Sales and Use Tax respectively
- Manufacturers: establishments engaged in the mechanical or chemical transformation of materials or substances into new products
- Production equipment and machinery is integral to the production of a product
- Manufacturer business classification applies if its manufacturing activity constitutes a substantial portion of its overall activities

In Summary

- Determination of substantive business activity impacts business license tax and personal property classification and taxation
- Substantial is not susceptible of being reduced to mathematical precision, is not synonymous with preponderance, and is properly defined as not incidental or inconsequential
- A farm winery is a unique business classification entity, specifically defined in law, and having a producing vineyard, orchard, or similar growing, area and with facilities for fermenting and bottling wine on the premises.
- A farm winery is engaged in both the business of selling farm products and manufacturing, which are activities exempted from BPOL
- A farm winery employs manufacturing process to the production of wine, but is a unique entity for personal property classification. If equipment and machinery used in the production of wine is not exempted from tax, or a different rate applied, under **§58.1-3505**, the locality would impose the tax at the rate applicable to the general class of tangible personal property pursuant to **§58.1-3503**

In Summary

- **§ 58.1-5**. Persons, etc., engaged in more than one business. When any person, firm or corporation is engaged in more than one business which is made by law subject to taxation, such person, firm or corporation shall pay the tax provided by law on each branch of his, their or its business.

- Generally speaking:

  Nano-breweries, micro-breweries – can be considered manufacturing,

  Blending businesses – can be considered a processor

- Farm Breweries or Farm Distilleries are not defined or included in statute,

- Machinery and equipment used in the production of brewery or distillery products are not included as an exception in **§58.1- 3507**, and therefore could be classified as Machinery and Tools, nor are they eligible for exemption under **§58.1- 3505.**