

TAXATION: LICENSE TAXES — REVIEW OF LOCAL TAXES.

Decision whether company that assembles materials is manufacturer is question of fact to be resolved by commissioner of revenue analyzing such factors as type of materials being assembled, complexity of process, and product resulting from assembly. Locality is not liable for payment of interest on refund of erroneously assessed BPOL taxes for license years prior to January 1, 1997.

The Honorable Ray A. Conner
Commissioner of the Revenue for the City of Chesapeake
June 7, 1999

You ask whether an assembly plant doing business in the City of Chesapeake is a manufacturer under § 58.1-3703(C)(4) of the *Code of Virginia*.

Section 58.1-3703(C)(4) prohibits a locality from assessing a business, professional and occupational license ("BPOL") tax "[o]n a manufacturer for the privilege of manufacturing and selling goods, wares and merchandise at wholesale at the place of manufacture." The BPOL statutes do not define the term "manufacturer," and the question often arises regarding whether the activity of a business constitutes manufacturing for purposes of the § 58.1-3703(C)(4) exemption.

Whether a business is engaged in manufacturing is a question of fact to be resolved on a case-by-case basis by the commissioner of the revenue.¹ You provide the following facts regarding the assembly plant in Chesapeake. The plant is a national company headquartered in Michigan. The plant produces automotive seating for Ford pickup trucks according to specifications provided by the Ford Motor Company. The Chesapeake plant obtains parts and materials from subsidiary suppliers and independent manufacturers. Various types of mechanical equipment are used to assemble the seating components. The seats are transferred from one workstation to the next by conveyor belt or similar device until the process is complete. The seats are then ironed, cleaned, wrapped and shipped to the Ford Motor Company's plant in Norfolk. Quality engineers at the Chesapeake plant devise and implement operational tests on the seats. A plant production engineer assists with design of the seats in conjunction with the principal design services performed at the Michigan headquarters.

You state that it is your view that the company engages in an assembly process and that, because there is no transformation of the character of the original materials, the company is not a manufacturer for purposes of § 58.1-3703(C)(4). You believe this view to be consistent with the definition of "manufacturer" that the Supreme Court of Virginia has traditionally applied. You question, however, whether the BPOL guidelines issued by the Department of Taxation² and a recent advisory opinion of the State Tax Commissioner³ expand the term "manufacturer" beyond its meaning as interpreted by the Supreme Court.

The Supreme Court has held that manufacturing contains three components: (1) a raw or original material; (2) a process whereby the material is changed; and (3) a resulting product that is different in character from the original material.⁴ Although the Court has applied this test to various types of business activities,⁵ I am aware of no case in which the Court has considered directly whether the assembly of parts into a finished product constitutes manufacturing.

Moreover, while numerous prior opinions of the Attorney General also consider whether a particular business is engaged in manufacturing under the tax statutes,⁶ only one opinion applies the manufacturing test to an assembly process.⁷ The opinion considers whether the assembly of precut furniture kits constitutes manufacturing and concludes that the assembly is not manufacturing.⁸ The opinion notes that the original kit, without assembly, would be usable by

consumers and that the company's assembly for the consumer merely enhances the item, i.e., the furniture kit, without changing its character.⁹

Appendix B of the BPOL guidelines provides the following guidance on whether the assembly of products is manufacturing:

The assembly of purchased components may or may not constitute manufacturing. Routine assembly generally is not manufacturing. For example, if components are sold separately and assembly is offered as an option to the purchaser, the assembly is a service (which may or may not be ancillary to the sale of the component, or de minimis). When evaluating the facts and circumstances to determine if a business is engaged in manufacturing, factors which suggest that assembly is not a separate service but part of a manufacturing process include, but are not limited to, any one or more of the following:

- (i) The assembly process is complex and uses numerous parts.
- (ii) After assembly the components cannot be recognized without previous knowledge.
- (iii) The components are not readily usable for any purpose other than incorporation into the finished product.^[10]

In a 1998 advisory opinion, the Tax Commissioner applied these guidelines to a company that assembled component parts into a computer and advised that the company was engaged in manufacturing.¹¹ The Commissioner considered both the complexity of the assembly process and the essential difference between the original material and the resulting product.¹²

An argument can be made that the assembly of materials lacks the "processing" component necessary for manufacturing to occur.¹³ No Virginia cases expressly so hold. Moreover, the Court has held that the manufacturing exemption is to be liberally construed in furtherance of the state's public policy of encouraging manufacturing in the Commonwealth.¹⁴ Accordingly, it is my view that such a narrow interpretation should not be adopted unless clearly directed by the Court's rulings.

The Court has held that (1) the pasteurization of milk is not manufacturing because it does not alter the substantial form and character of raw milk;¹⁵ (2) the slaughtering and cleaning of chickens is not manufacturing because it does not transform the chickens into a different product¹⁶ and (3) the crushing and grading of sand and gravel is not manufacturing because neither the sand nor rock is changed into a product of substantially different character.¹⁷ The primary focus of the analysis in each of these cases is whether, through subjecting materials to a process, a product results that is different from the original materials. While each case concluded that the process did not result in the transformation of one product into a substantially different product, I do not believe that the cases direct a conclusion that the assembly of original materials into a different product cannot be deemed manufacturing or that, in order for such assembly to constitute manufacturing, the original materials must themselves undergo a transformation in character. Accordingly, it is my opinion that, in light of the Court's liberal construction mandate, neither the BPOL guidelines nor the Commissioner's advisory opinion are in conflict with Supreme Court rulings interpreting the term "manufacturer."¹⁸

Whether a company engaged in the assembly of materials is or is not a manufacturer remains a question of fact and will depend on an analysis of such factors as the type of materials being

assembled, the complexity of the process, and the product resulting from the assembly. It is my opinion that the facts you provide in your letter would support a conclusion that the company is engaged in manufacturing for purposes of § 58.1-3703(C)(4). The final decision, however, must be made by you as the commissioner of the revenue upon consideration of all of the facts.¹⁹

You ask also whether, should the company be entitled to a refund for the BPOL taxes paid for the years 1995 through 1998, the city must add interest to the refund for tax years preceding January 1, 1997. Amendments to the BPOL statutes adopted at the 1996 Session of the General Assembly include the addition of § 58.1-3703.1.²⁰ The amendments to the BPOL taxes are effective generally for license years beginning on and after January 1, 1997.²¹

Section 58.1-3703.1(A)(2) contains the provisions regarding the due dates for payment of the license tax and the imposition of penalties and interest. Section 58.1-3703.1(A)(2)(e) provides that "[i]nterest shall be paid on the refund of any BPOL tax from the date of payment or due date, whichever is later, whether attributable to an amended return or other reason." It is clear under this provision that, for license years beginning on and after January 1, 1997, the locality must pay interest on the refund of any erroneously assessed license taxes.

Section 58.1-3703.1(B)(2) provides, however, that "[t]he provisions of this section relating to penalties, interest, and administrative and judicial review of an assessment shall be applicable to assessments made on and after January 1, 1997, even if for an earlier license year." If the language "assessments made" applies not only to assessments made by the tax officials but also to a taxpayer's request for a refund, it would appear that a locality would be liable for the payment of interest on the refund of taxes assessed for license years prior to 1997.²² It is my opinion, however, that the amendments to the BPOL statutes do not indicate that the legislature intended this conclusion.

The Supreme Court of Virginia has repeatedly held that, "[i]n the absence of statutory authority allowing payment of interest, it is not recoverable from the government upon refund of taxes erroneously assessed, collected and ordered refunded."²³ Likewise, § 58.1-3991 requires a locality that chooses to pay interest on the refund of erroneously assessed taxes to adopt an ordinance so providing. Assuming for purposes of this opinion that the city has not adopted such an ordinance or elected to have the BPOL amendments apply to an earlier tax year,²⁴ interest may be paid on the refund of BPOL taxes paid or due before January 1, 1997, only if authorized by § 58.1-3703.1(B)(2).

In my opinion, § 58.1-3703.1(B)(2) does not indicate a clear legislative intent to impose retroactive interest payment liability on local governments. The imposition of such retroactive liability results only if the legislature intended the language "assessments made" in § 58.1-3703.1(B)(2) to include a taxpayer's request for a refund or filing of an amended return. Moreover, the effect of this broadened interpretation would be to impose interest payment liability on a local government for a period during which there was no statutory authority for the payment. Absent a clearer indication of legislative intent, it is my opinion that a locality is not liable for the payment of interest on the refund of the BPOL taxes for years prior to 1997.

¹See Op. Va. Att'y Gen.: 1995 at 254, 256; 1993 at 231, 233.

²The present guidelines were issued in 1997. See Department of Taxation, Guidelines for Local Business, Professional and Occupational License Taxes (Jan. 1, 1997) [hereinafter BPOL guidelines]. "After July 1, 2001, the [BPOL] guidelines shall be subject to the Administrative Process Act and accorded the weight of a regulation under § 58.1-205." Section 58.1-3701. The

present Guidelines are issued "for the use of local governments in administering the taxes imposed" under the BPOL statutory scheme. *Id.*

³Section 58.1-3701 authorizes the Tax Commissioner to issue advisory written opinions in specific cases to interpret the BPOL statutes and guidelines.

⁴*Prentice v. City of Richmond*, 197 Va. 724, 729-30, 90 S.E.2d 839, 843 (1956).

⁵See *Solite Corp. v. King George County*, 220 Va. 661, 261 S.E.2d 535 (1980) (quarrying, crushing, washing and grading to remove impurities, and segregating sand and gravel into various grades, does not constitute manufacturing); *Prentice v. City of Richmond*, 197 Va. at 730-31, 90 S.E.2d at 843-44 (chicken processing operation is not manufacturing); *Commonwealth v. Meyer*, 180 Va. 466, 23 S.E.2d 353 (1942) (process by which hog on hoof becomes hams, shoulders, sausage and other articles of commerce fit for consumption is manufacturing); *Richmond v. Dairy Co.*, 156 Va. 63, 157 S.E. 728 (1931) (pasteurization of milk and production of buttermilk are not manufacturing).

⁶See, e.g., *Op. Va. Att'y Gen.*: 1996 at 214 (embroidering images on tee shirts and converting them into outerwear may constitute manufacturing); 1995 at 257 (transforming water into fruit-flavored liquid drink is manufacturing); *id.* at 254 (process of electroplating items is not manufacturing); 1993 at 231 (seafood processor who transforms unusable product into usable product is manufacturer); 1991 at 248 (business primarily providing software development is not engaged in manufacturing); 1985-1986 at 287 (removing tack from fiber and rewinding fiber on cone is not manufacturing); 1984-1985 at 399, 400 (grading and packing herbs is not manufacturing unless raw material consists of plants that are dried, crushed, graded and packaged); *id.* at 356 (processing 15 products into cement-related products is blending together of ingredients and is not manufacturing).

⁷See 1996 *Op. Va. Att'y Gen.* 212 (assembly of precut furniture kits).

⁸The opinion reasons that the assembly is not manufacturing because (1) it does not involve a raw material that is changed in any manner; (2) there is no substantial transformation into a new or different product; and (3) the finished product is not different from the original raw materials. 1996 *Op. Va. Att'y Gen.*, *supra*, at 213.

⁹*Id.*

¹⁰BPOL guidelines app. B, *supra* note 2, at 2-3.

¹¹See 2 Va. Tax Rep. (CCH) ¶ 203-890, *Comm'r Rul.* 98-154 (Oct. 16, 1998).

¹²The Commissioner also noted that, in considering similar facts, the Circuit Court of Fairfax County had ruled that such computer assembly constituted manufacturing. See *id.* at 15,398-99 (citing *Fairfax County v. DataComp Corp.*, 36 Va. Cir. 60 (1995)).

¹³See *Solite Corp. v. King George County*, 220 Va. at 665, 261 S.E.2d at 537 (blending together of various ingredients, absent transformation into substantially different product, is not manufacturing). In *State Tax Commissioner v. Flow Research Animals*, 221 Va. 817, 820, 273 S.E.2d 811, 813 (1981), and *Commonwealth v. Orange-Madison Cooperative Farm Service*, 220 Va. 655, 658, 261 S.E.2d 532, 534 (1980), the Court defined "processing" as subjecting a product to a treatment rendering the product more marketable or usable. These cases deal with the exemption from the retail sales and use tax for equipment used in industrial processing and have limited relevance to questions regarding the manufacturing exemption.

¹⁴ See *County of Chesterfield v. BBC Brown Boveri*, 238 Va. 64, 69, 380 S.E.2d 890, 893 (1989).

¹⁵ See *Richmond v. Dairy Co.*, 156 Va. at 75, 157 S.E. at 732.

¹⁶ See *Prentice v. City of Richmond*, 197 Va. at 730-31, 90 S.E.2d at 843-44.

¹⁷ See *Solite Corp. v. King George County*, 220 Va. at 665, 261 S.E.2d at 537-38.

¹⁸ A prior opinion considering the BPOL guidelines recognizes that constructions placed on the law by agencies charged with administrative duties in connection with the law are entitled to great weight, especially when the agency has been charged by the General Assembly with construing individual statutes that constitute part of a complex statutory scheme. See 1997 Op. Va. Att'y Gen. 176, 179.

¹⁹ Should you determine that only a portion of the company's activities constitute manufacturing, the business would be classified as a manufacturer if such activities are substantial in comparison to the company's remaining activities. See *County of Chesterfield v. BBC Brown Boveri*, 238 Va. at 70-72, 380 S.E.2d at 893-94. To be considered substantial, the manufacturing activities must not be "*de minimis*, merely trivial, or only incidental to its principal business." *Id.* at 71, 380 S.E.2d at 893-94.

²⁰ See 1996 Va. Acts: ch. 715, at 1233, 1234-35, 1238-41; ch. 720 at 1247, 1248-49, 1251-55 (adding §§ 58.1-3700.1, 58.1-3703.1).

²¹ See *id.* cl. 3, 4, at 1244, 1258.

²² The Department of Taxation has concluded in several advisory opinions that a taxpayer's request for a refund constitutes an assessment and that, therefore, interest would be due on any refund paid pursuant to a taxpayer's request for a refund made on or after January 1, 1997, even if the request is for taxes paid for a year prior to January 1, 1997. See 2 Va. Tax Rep. (CCH) ¶ 203-382, Comm'r Rul. 97-129 (Mar. 19, 1997); see *id.* ¶ 203-524, Comm'r Rul. 97-273, at 14,916 (June 16, 1997). Section 58.1-3700.1 defines "assessment" generally to include not only assessments by the assessing official but also self-assessments by the taxpayer.

²³ *Railway Express v. Com'wealth*, 196 Va. 1069, 1072, 87 S.E.2d 188, 190 (1955); see also *Board of Sup. v. FCS Building Association*, 254 Va. 464, 466, 492 S.E.2d 634, 636 (1997); *City of Winchester v. American Woodmark*, 250 Va. 451, 460, 464 S.E.2d 148, 153 (1995).

²⁴ See 1996 Va. Acts chs. 715, 720, cl. 4, *supra* note 20, at 1244, 1258.