

**DEPARTMENT OF TAXATION
2016 Fiscal Impact Statement**

1. **Patron** R. Steven Landes
3. **Committee** Passed House and Senate
4. **Title** Retail Sales and Use Tax; Exempts Items
Used in Commercial Beer Production

2. **Bill Number** HB 859
House of Origin:
 Introduced
 Substitute
 Engrossed
- Second House:**
 In Committee
 Substitute
 X **Enrolled**

5. Summary/Purpose:

This bill would provide an exemption from the Retail Sales and Use Tax for certain items, if the preponderance of their use is in the manufacture of beer by qualifying licensed brewers. The exemption would apply to: 1) machinery, tools, equipment and repair and replacement parts, fuel, power, energy or supplies; 2) materials for future processing, manufacturing or conversion into beer, where the materials either enter into the production of or become a component part of the beer; and 3) materials for future use for packaging the beer for shipment or sale. The exemption would apply only if the eligible tangible personal property is used in the manufacture of beer by brewers holding brewery licenses or limited brewery licenses issued by the Alcoholic Beverage Control Board under subsections 1 and 2 of *Va. Code* § 4.1-208.

Current law provides an exemption from the retail sales and use tax for machinery, tools, repair parts, fuel, power, energy supplies, and other specified types of tangible personal property when used or consumed by an industrial manufacturer or processor of products for sale or resale. In order for the exemption to apply, the production must be industrial in nature.

The effective date of this bill is not specified.

6. **Budget amendment necessary:** No.
7. **Fiscal Impact Estimates are:** Not available. (See Line 8.)
8. **Fiscal implications:**

Administrative Costs Impact

The Department considers implementation of this bill as “routine” and does not require additional funding.

Revenue Impact

The exemption proposed in this bill would result in an unknown minimal revenue loss. The proposed legislation would render existing brewpubs, farm breweries, and other non-industrial microbreweries that do not satisfy the Department's facts and circumstances test for industrial manufacturing exempt from the sales and use tax. The bill would also impact planned farm breweries, microbreweries and brewpubs. Of the approximately 130 breweries in Virginia, six percent are large or regional breweries that are deemed "industrial in nature" and are entitled to the sales and use tax exemption under current law. While the Department must look closely at the facts and circumstances surrounding the business operations for the remaining farm breweries and microbreweries, brewpubs, and similar facilities, typically, the Department has denied the exemption only when on-site beer sales accounted for more than half of total beer sales. Because the Department cannot determine how many existing non-qualifying breweries or planned breweries will purchase qualifying tangible personal property, the revenue impact of this bill is not known. However, as the volume of tax assessments on these operations has decreased in recent years, and as several of these assessments were abated, the proposed expansion in this bill is expected to result in a minimal revenue loss that can be absorbed without the need for a budget amendment.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Industrial Manufacturers, Generally

Virginia law provides a broad exemption from the Retail Sales and Use Tax for certain tangible personal property when used or consumed by an industrial manufacturer or processor of products for sale or resale. The exemption extends to:

- Industrial materials for future processing, manufacturing, refining or conversion into tangible personal property for resale, where the materials enter into the production of or become a component part of the finished product;
- Industrial materials coated upon or impregnated into the product being processed, manufactured, refined or converted for resale;
- Machinery or tools, and their repair and replacement parts, fuel, power, energy or supplies used directly in processing, manufacturing, refining, mining or converting products for sale or resale; and
- Materials containers, labels, sacks, cans, boxes, drums or bags for future use for packaging tangible personal property for shipment or sale.

The exemption applies only to those items for direct use in producing products for sale or resale. Other production items and items of tangible personal property used indirectly in production activities are deemed subject to the tax. If an otherwise exempt item of

tangible personal property is put to use in two different activities, one of which is an immediate part of the industrial production process and the other of which is not, the sales and use tax applies in full when the preponderance of the item's use (fifty percent or more) is in non-exempt activities. The item is totally exempt from tax if the preponderance of its use is in exempt production activities.

The manufacturing exemption is limited to processes deemed "industrial in nature," which include those businesses classified in codes 10 through 14 and 20 through 39 published in the Standard Industrial Classification ("SIC") Manual. Plants, factories, or mills, and other operations where production activities generally are carried on for the wholesale market, rather than for direct sale to domestic consumers are considered "industrial in nature." Furthermore, the determination of whether an operation is 'industrial in nature' must be made without regard to factors relating principally to size, such as the size of the plant or the finished product inventory, the capital investment amount, the degree of mechanization, or the number of employees.

Exemption for Packaging Materials

Current law provides an exemption from the Retail Sales and Use Tax for materials that will become a part of the finished product that will be sold, regardless of whether the purchaser is deemed an industrial manufacturer. To the extent that items, such as bottles, containers, boxes, etc., are used to package products for sale, and become the property of the purchaser subsequent to the sale, they are also exempt from the tax.

Manufacturers of Beer

Historically, breweries in Virginia operated under a traditional wholesale model. As such, their operations were deemed industrial manufacturing and purchases of machinery and equipment used in their brewing operations were exempt from the sales and use tax. With the evolution of the craft beer industry and the emergence of several new marketing models, such as brew pubs or breweries with tasting rooms, the clear distinction between manufacturing and retail operations began to blur.

Because the Standard Industrial Classification Manual classifies beer manufacturing facilities under SIC Code 2082, most beer brewers are "industrial manufacturers" for purposes of the manufacturing exemption. Establishments engaged in the sale of prepared foods and drinks for immediate consumption, however, are classified under SIC Code 5812, and are deemed "nonindustrial." When brewpubs and similar restaurants brew beer on the premises in connection with their retail operations, the Department of Taxation must employ a "facts and circumstances" analysis to determine whether the industrial activity is secondary to the operation of the retail business. While the primary focus is the percentage of on-premise versus off-premise consumption, the Department also considers additional facts, such as the size of the operation, the location where each activity occurs, and the percentage of floor space and number of transactions attributable to each aspect of the business.

Brewery and Limited Brewery Licenses

Virginia law authorizes the Alcoholic Beverage Control Board to grant various beer licenses. Specifically, under Va. Code § 4.1-208(1), the Board may grant brewery licenses authorizing a licensee to manufacture, and subsequently sell or deliver manufactured beer in closed containers to licensed wholesalers, certain licensed retailers, and persons outside Virginia for resale outside Virginia. Additionally, brewery licensees may make retail sales of their own brands of beer from their breweries for on-premises consumption or in closed containers for off-premise consumption. The brewery license also authorizes its licensees to operate facilities solely to show patrons how beer is manufactured and to offer samples of its products.

Code of Virginia § 4.1-208(2) permits the ABC Board to grant limited brewery licenses to breweries located on agriculturally-zoned Virginia farms that manufacture no more than 15,000 barrels of beer per calendar year. The farm must be owned or leased by the brewery or its owner, and agricultural products used by the brewery in the beer manufacturing must be grown on the farm in order for a limited brewer's license to be issued.

Proposal

This bill would provide an exemption from the Retail Sales and Use Tax for certain items, if the preponderance of their use is in the manufacture of beer by qualifying licensed brewers. The exemption would apply to: 1) machinery, tools, equipment and repair and replacement parts, fuel, power, energy or supplies; 2) materials for future processing, manufacturing or conversion into beer, where the materials either enter into the production of or become a component part of the beer; and 3) materials for future use for packaging the beer for shipment or sale. The exemption would apply only if the eligible tangible personal property is used in the manufacture of beer by brewers holding brewery licenses or limited brewery licenses issued by the Alcoholic Beverage Control Board under subsections 1 and 2 of Va. Code § 4.1-208.

The bill would eliminate the need for the Department's facts and circumstances analysis for those beer brewers operating tasting rooms or brewpubs that make on-premises sales of beer or are otherwise engaged in retail operations. Additionally, the bill would explicitly exempt breweries located on agriculturally-zoned Virginia farms on their purchases of machinery, tools equipment, and other eligible tangible personal property if the preponderance of the item's use is in the manufacture of beer.

The effective date of this bill is not specified.

cc : Secretary of Finance

Date: 3/11/2016 KP
DLAS File Name: HB859FER161