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## H.B. 635: "Use on Use" Sales Tax Exemption Reenacted

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## H.B. 635: "USE ON USE" SALES TAX EXEMPTION REENACTED

### I. INTRODUCTION

In May of 1978, the 112th General Assembly enacted House Bill 635, amending section 5739.02 of the Ohio Revised Code. The bill added subsection (B)(25), a "use on use" exemption from the sales tax.<sup>1</sup> The ultimate effect of this exemption is to relieve certain sales from the sales tax.

A discussion of sales tax exemptions requires an understanding of the terminology used. "Sales", as used in chapter 5739 (sales tax), "includes all transactions by which title or possession, or both, of tangible personal property, is or is to be transferred."<sup>2</sup> Section 5739.02 states that a sales tax shall be levied on all retail sales made in the state. "Retail sales", encompassing a narrower group of transactions than "sales", is statutorily defined as:

including all sales *except* those in which the purpose of the consumer is:

- (2) To incorporate the thing transferred as a material or part, into tangible personal property to be produced for sale by manufacturing . . . or to use or consume the thing transferred directly in the production of tangible personal property for sale by manufacturing . . . .<sup>3</sup>

This exception is known as the "direct use" sales tax exception. Because the definition of retail sale excludes the direct use transaction, no sales tax is imposed. These two definitions appear in the definitional section of the sales tax chapter.<sup>4</sup>

The general sales tax levying provision, section 5739.02, lists numerous exemptions from the sales tax. The newest exemption, added by House Bill 635, exempts from sales tax any

sale to persons engaged in manufacturing . . . of tangible personal property for use or consumption *directly* in the production by manufacturing . . . of other tangible personal property for use or consumption *directly* in the production of tangible personal property for sale by manufacturing . . . and of material and parts for incorporation into any such tangible personal property for use or consumption in production.<sup>5</sup>

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1. OHIO REV. CODE ANN. § 5739.02(B)(25) (Page Supp. 1978). For a short history of the Ohio sales tax law from its inception in 1934 through 1952 see 13 OHIO ST. L.J. 114 (1952).

2. OHIO REV. CODE ANN. § 5739.01(B) (Page Supp. 1978).

3. *Id.* § 5739.01 (E)(2) (emphasis added).

4. *Id.* § 5739.01.

5. *Id.* § 5739.02(B)(25) (emphasis added); this exemption also applies to the processing, assembling, and refining of tangible personal property.

This is known as the "use on use" exemption because the sales of material which will be directly used in the production of a product, which will later be used to produce a product for sale, are now exempt from any sales tax. Note the close similarity of language between the direct use exception and the use on use exemption. An example may clarify the distinction between the two exemptions. The sale of metal to an auto maker to build a fender press is use on use transaction. The fender press is used to produce the final product for sale—the fender. The sale of steel to produce the fender itself would also be exempt from sales tax under the direct use exception; the steel is directly consumed in the manufacturing of a product for sale. If the auto maker were to buy the fender press rather than build it, the purchase of the press would be exempt from sales tax by virtue of the direct use exception. The press would be directly used in the manufacturing of a product for sale. There appears to be no sound justification for exempting the purchase of a machine used to produce a product for retail sale, but taxing the purchase of materials used to build a machine for the same purpose. The use on use exemption removes one artificial economic cost from the decision whether to purchase or build items used to produce products for retail sale.

The addition of the use on use exemption to the direct use exception will have a beneficial impact on manufacturers of products which are, in turn, used directly to produce final products for sale.<sup>6</sup> The use on use exemption extends the number of manufacturing purchases which are not subject to the sales tax. It will further eliminate some of the tax burden of operating within the state, thus stimulating present industry and possibly helping to attract new industry to the state.<sup>7</sup> The net result would be creation of more jobs, which would ultimately produce more income for the state.<sup>8</sup>

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6. NATIONAL TAX ASSOCIATION, 1974 PROCEEDINGS OF THE 67TH ANNUAL CONFERENCE ON TAXATION 466 (1975); *see also* TAX INSTITUTE OF AMERICA, STATE AND LOCAL TAXES ON BUSINESS (1965). The importance of the use on use exemption can be gauged by the Ohio Legislative Budget Office's estimate of revenue loss because of the exemption. The Budget Office's fiscal note on the bill estimated annual revenue loss from the use on use exemption at between eleven and twenty three million dollars as compared to approximately \$230 million annually for the direct use exemption. Ohio Legislative Budget Office, Fiscal Note on House Bill 635, April 6, 1978.

7. *See generally* J. DUE, SALES TAXATION (1957).

8. Transactions subject to the direct use exception or the use on use exemption would also be exempt from the use tax, chapter 5741. The use tax is levied on goods purchased outside the state and brought into the state for use, while the sales tax is levied on sales made within the state. Transactions qualifying for either the direct use exception or the use on use exemption are "sales" within the statutory definition of "sale" but are not subject to the sales tax by virtue of being exempted. Section 5741.02(C)(2) states that the use tax does not apply to "tangible personal property, the

It is unclear what sales are covered by the exemption due to the ambiguity of the statutory language. It is helpful, therefore, to draw an analogy from the direct use exception to the use on use exemption. A significant amount of case law interpreting the application of the direct use exception can be utilized in applying the use on use exemption. This extension is justifiable because both exemptions use similar statutory language; both are applicable only to the manufacturing process,<sup>9</sup> and both have the same end—relieving certain sales from the sales tax.

## II. ANALYSIS

Section 5739.02(B)(25) is a reenactment of the use on use sales tax exemption which was in effect from 1962 to 1967.<sup>10</sup> The previous exemption generated very little litigation regarding its scope. The only decisions which considered the exemption were not rendered until after the exemption was repealed. Collection of sales tax on use on use transactions was difficult collected only through Tax Department audits.<sup>11</sup> Because the exemption uses the exact words of the previous statute, it can be argued that the legislature was satisfied with the prior operation of the law and intended it to be utilized in the same manner.

Although statutory interpretation is scarce, the Ohio Supreme Court has indicated at least one situation which would qualify for the use on use exemption from sales tax. *Canton Malleable Iron Co. v. Porterfield*<sup>12</sup> was decided in 1972 after repeal of the use on use exemption which left only the direct use exception in effect. The taxpayer was a manufacturer of iron castings, the production of which requires molds. Wanting to increase productivity, the taxpayer installed a system to manufacture the molds rather than purchasing them. The taxpayer claimed a direct use exception from the sales tax for the replacement parts for the system. The court stated that the molds were

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acquisition of which, if made in Ohio, would be a sale [but] not subject to the [sales] tax." Thus, items purchased outside the state, which if bought in Ohio would be exempt from the sales tax, are made exempt from the use tax. See also J. DUE, STATE SALES TAX ADMINISTRATION (1963).

9. Both the direct use and the use on use exemptions apply to the processing, assembling, and refining of tangible personal property.

10. OHIO REV. CODE ANN. § 5739.02(B)(17) (Baldwin 1964). The legislative history fails to reveal why the use on use exemption was repealed. A possible explanation was the desire to increase state revenues, because the bill which repealed the exemption also included a rate increase for both the sales and use taxes.

11. Ohio Legislative Budget Office, Fiscal Note on House Bill 635, April 6, 1978.

12. 30 Ohio St. 2d 163, 283 N.E.2d 434 (1972); see also R.R. Donnelley & Sons Co. v. Porterfield, 30 Ohio St.2d 219, 284 N.E.2d 171 (1972), which concerned a transaction that occurred between 1965 and 1967 that could possibly have qualified for the use on use exemption; however, the taxpayer failed to claim the exemption.

clearly exempt from taxation by virtue of the direct use exception but the system to make the molds was not exempt. The Tax Commissioner conceded, and the court agreed, that the system and replacement parts would have been exempt under the old use on use sales tax exemption. The system was directly used in the production of property (the molds) for use directly in the production of property for sale (the iron castings). Nevertheless, the court found that the mold making system was not directly used in the manufacturing of property for sale because it was the iron castings that the taxpayer produced for sale, not the molds.

Both the use on use and the direct use exemptions use the terms "directly" and "manufacturing". Because the terms were not statutorily defined, the courts had the responsibility of interpreting these terms and of devising a formula for the application of the statute under the direct use exception.<sup>13</sup> In 1967 the legislature enacted a definition of "manufacturing" which significantly aided the courts in dealing with the direct use exception.<sup>14</sup>

"Directly," however, is still in the arena for judicial interpretation. The leading test for defining "directly," under the direct use exception, was enunciated in *Youngstown Building Material and Fuel Co. v. Bowers*.<sup>15</sup>

In determining whether tangible personal property is used or consumed directly in the production of tangible personal property for sale by manufacturing . . . and, therefore, whether its sale or use is exempted from [sales tax], the test is not whether such property is essential to the operation of an integrated plant; the test to be applied being, when does the actual manufacturing . . . activity begin and end, and is the property used or consumed during and in the manufacturing . . . period.<sup>16</sup>

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13. *Mead Corp. v. Glander*, 153 Ohio St. 539, 93 N.E.2d 19 (1950). Ohio is considered to have had substantial influence in the definition and interpretation of the production exemption, which is the direct use exception. NATIONAL TAX ASSOCIATION, 1974 PROCEEDINGS OF THE 67TH ANNUAL CONFERENCE ON TAXATION 466 (1975).

14. "Manufacturing" or "processing" means the transformation or conversion of material or things into a different state or form from that in which they originally existed and, for the purpose of the exceptions contained in division (E)(2) of this section, includes the adjuncts used during and in, and necessary to carry on and continue, production to complete a product at the same location after such transforming or converting has commenced.  
OHIO REV. CODE ANN. § 5739.01(S) (Page Supp. 1978).

15. 167 Ohio St. 363, 149 N.E.2d 1 (1958). The court held that the bins which held cement and gravel above the hopper which mixed them were not directly used in the production of cement. *See also* *Ohio Stove Co. v. Bowers*, 171 Ohio St. 484, 172 N.E.2d 295 (1961).

16. 167 Ohio St. at 363, 149 N.E.2d at 1.

Extending this definition to the use on use exemption, it would require that an item be directly used in the production of a product which will be directly used in the production of a product for sale.

The judicially developed test for the direct use exception will help in interpreting and applying the use on use exemption. The test must merely be moved one step away from the requirement of being used directly in the production of a product for sale.<sup>17</sup> Now it must be determined when the actual manufacturing activity of an item which is to be used in the production of a product for sale begins and ends, and whether the item is used or consumed during this initial manufacturing activity.

The purpose for which the purchased item is to be used determines whether the direct use exception is applicable.<sup>18</sup> If the buyer uses or incorporates the material into the final product for sale, the direct use exception applies. Similarly, under the use on use exemption, if the buyer uses the item to produce property which in turn will be directly used to produce the final product for sale, the buyer is exempted from paying sales tax on the purchase of those items.

In *Interlake, Inc. v. Kosydar*,<sup>19</sup> the taxpayer, a manufacturer of merchant pig iron, claimed a direct use sales tax exception on equipment used to produce coke. The coke was then used to produce the pig iron. The court denied the application of the direct use exception because the tangible personal property for sale was the pig iron, not the coke. The majority reasoned that the manufacturing of pig iron begins when the raw materials—iron ore, coke and limestone—are combined to produce the pig iron. The coking equipment is used in a process which is preliminary to the manufacturing of pig iron, and thus not used directly in the production of tangible personal property for sale.

Under the use on use exemption, however, the coking equipment would be exempt. It is directly used to produce a product (the coke) which is directly used to produce a product for sale (the pig iron). Applying the test from *Youngstown Building*, the manufacturing of the coke begins when coal is transformed into coke, and the coking equipment is used during this manufacturing period. Consequently, the

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17. *Youngstown Building Material and Fuel Co. v. Bowers*, 167 Ohio St. 363, 149 N.E.2d 1 (1958).

18. *But see Interlake, Inc. v. Kosydar*, 42 Ohio St. 2d 457, 330 N.E.2d 444 (1975) (Brown, J. dissenting), which distinguished between machinery used to produce machinery that is used to produce a product for sale, and machinery used to produce a product used to produce a product for sale. The former was considered a use on use transaction while the latter was considered a direct use transaction.

19. 42 Ohio St. 2d 457, 330 N.E.2d 444 (1975).

manufacturing of coke should qualify for the use on use sales tax exemption.

In contrast with *Interlake* is *Semac Industries v. Collins*,<sup>20</sup> which dealt with the issue whether a fork lift used for transporting logs from trucks to the mill was eligible for the direct use sales tax exception. The court found that the fork lift was not used directly but was merely used in a preliminary operation to the manufacturing. The fork lift would probably also fail to qualify for the use on use exemption because it does not manufacture tangible personal property, it merely moves a product used in manufacturing. The logs are not transformed or converted into a different state by being moved.<sup>21</sup> Therefore, there is no production of a product.

As a matter of policy, the court will not break up single machines nor systems into component parts and distinguish between those used directly and those that are not so used.<sup>22</sup> In cases dealing with the direct use exception, the court "attempt[s] to alleviate the ambiguity inherent in the word 'directly' by endeavoring to make each decision consistent with previous decisions even if the results seem to represent the drawing of artificial boundaries and lines."<sup>23</sup> Because of the similarity between the direct use exception and the use on use exemption, the policy developed under the direct use exception should be carried over to the use on use exemption.

The use on use exemption considerably broadens the number of transactions qualifying for sales tax exemption. Now a manufacturer may maintain an "integrated plant," which itself produces many of the products used in manufacturing its final product. Consequently, the manufacturer may qualify many of the purchases made for the manufacturing process for sales tax exemption. For example, the foundry operator in *Canton Malleable*<sup>24</sup> who produces iron castings and also the molds to make the castings would be able to claim an exemption from sales tax on materials bought for the castings and the molds. The test for "directly" should merely be removed one step away from the manufacturing activity which produces the final product for sale to the step which produces the final product for sale to the step which produces to be used in the final manufacturing. Although the "integrated plant" rationale was rejected as the test for "directly" under

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20. 48 Ohio St. 2d 4, 354 N.E.2d 922 (1976).

21. OHIO REV. CODE ANN. § 5739.01(S) (Page Supp. 1978) defines manufacturing and processing as including transformation or conversion into a different state.

22. Timken Co. v. Kosydar, 52 Ohio St. 2d 131, 369 N.E.2d 1211 (1977).

23. *Id.* at 133, 369 N.E.2d at 1214.

24. 30 Ohio St. 2d 163, 283 N.E.2d 434 (1972); see note 12 and accompanying text *supra*.

the direct use exception, the use on use exemption expands the exemption to include much integrated plant activity.<sup>25</sup>

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Code Section Affected: § 5739.02.

Effective Date: August 16, 1978.

Sponsors: Tablack (H); O'Shaughnessy (S).

Committees: Committee on Ways and Means (H & S).

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25. As of this writing, no regulations have been issued for the use on use exemption by the Tax Commissioner.

