This Week in State Tax (TWIST)

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Tennessee: Taxpayer Not Required to Create New Product to Qualify for the Industrial Machinery Exemption

The Tennessee Court of Appeals recently affirmed a chancery court's conclusion that a taxpayer qualified for an industrial machinery sales tax exemption. The taxpayer at issue rented hygienically clean textiles to its customers for a single use, after which the textiles were retrieved by the taxpayer to be sanitized so they could be rented out again. The taxpayer's sanitizing process required it to submerge textiles into highly specific chemicals to remove soils from the textiles. At issue was whether the taxpayer was entitled to the state's industrial machinery sales and use tax exemption for equipment used at its Tennessee facilities. "Industrial machinery" means "[m]achinery, apparatus and equipment with all associated parts . . . that is necessary to, and primarily for, the fabrication or processing of tangible personal property for resale and consumption off the premises . . . by one who engages in such fabrication or processing as one's principal business." After originally granting the certificates of exemption, the Department of Revenue reversed course and determined the taxpayer did not qualify. A hearing was held on the issue, and the ALJ determined that the taxpayer was not "processing" tangible personal property because it did not transform materials into a different state or form than their original existence. In other words, the textiles (e.g., linens, uniforms, towels, etc.) were in the same form before the sterilization process as they were afterwards. Although the taxpayer's activities created a marketable product because the textiles could not be leased in soiled or unsterile conditions, they did not create a new and different substantive product. After a chancery court issued a decision in favor of the taxpayer, the Department appealed.

The sole dispute on appeal was whether the taxpayer's operations constituted processing, which was not a defined term in Tennessee law. However, in an earlier case, *Beare Co. v. Tennessee Department of Revenue*, the Tennessee Supreme Court had attempted to define the term. While not directly on point, the court noted that nothing in the *Beare* decision indicated that the change in state or form could not be to a state or form the textile had been in at some point in the past. All that was required was that each time the articles or materials were submitted to a taxpayer's operations, they must have been in a state or form different than the state or form in which they were after undergoing the process. The court found support for this interpretation in an Ohio case in which laundering operations were considered processing because they changed the state of textiles and made them marketable. Although there were also cases reaching the opposite conclusion from other jurisdictions, the court noted that Tennessee's industrial machinery exemption did not require the creation of entirely or substantially new products. Rather, as highlighted in *Beare*, the focus was on the change in the state or form of materials during processing. The court determined that the taxpayer's sanitization process—wherein contaminants were removed, and the textiles were transformed into hygienically-clean and absorbent textiles that were fit for consumption—undisputedly changed the state of the textiles. As such, the court concluded that the taxpayer qualified for the industrial machinery exemption. Please contact Justin Stringfield with questions on *Alsco, Inc. v. Tennessee Dep't of Revenue*.