



Businesses Face NAICS Classification Risks and Opportunities in State Tax and Incentive Systems

States increasingly borrow North American Industry Classification System (NAICS) code classifications to determine the scope of when a business is subject to tax or eligible for an exemption or incentive. While this generally provides more certainty than a state simply making its own definitions, the trend poses risks for taxpayers because a classification claimed in one context may be used against the taxpayer in another context. It also can limit administrators' ability to use incentives and exemptions to further policy goals.

Taxpayers should evaluate their NAICS positions on a holistic basis and consider consistency, risks and opportunities. Leaving NAICS codes to be determined at whim by whomever is filling out a form poses substantial risks to a business.

Background on NAICS codes. The NAICS is a system of six-digit codes that was developed by the United States Office of Management and Budget ("OMB"), working with its Canadian and Mexican counterparts. NAICS was designed for purposes of gathering and analyzing economic

data, not for purposes of tax or incentives policy: "Its purposes are (1) to facilitate the collection, tabulation, presentation, and analysis of data relating to establishments, and (2) to promote uniformity and comparability in the presentation of statistical data describing the economy."¹

The NAICS replaced its predecessor Standard Industrial Classification (SIC) system beginning in 1997. NAICS codes are structured hierarchically so that a shorter code refers to a broader statistical grouping:

- Sector: 2-digit code
- Subsector: 3-digit code
- Industry Group: 4-digit code
- NAICS Industry: 5-digit code
- National Industry: 6-digit code²

Codes typically are updated every five years (2002, 2007, 2012, etc.), in conjunction with the United States Economic Census cycle. Codes may be split, combined, or changed to better reflect the evolving economy.

NAICS takes a supply-side, production-driven approach to classification, using the "establishment" as the reporting unit. This means that NAICS is designed not based on a demand-driven

analysis of what commodities or services are sold by a business, but rather classifying based on the type of production process undertaken to produce the product or service.³

Additionally, the classification is by "establishment," which is generally a single physical location where business is conducted or where services or industrial operations are performed.⁴ A business enterprise thus can have multiple establishments with different NAICS codes.

Although the NAICS was expressly designed for statistical use, it was recognized that the classification system would likely "also be used for nonstatistical purposes (e.g., administrative, regulatory, or taxation)"⁵ The OMB recommended that any adoption of NAICS codes for such nonstatistical purposes should also grant discretion to the administrator to modify classifications where appropriate.⁶

Numerous federal, state, and local agencies use NAICS codes. In some instances NAICS is simply used for statistical purposes, but in many cases the classifications have real-world effects in terms of how laws and regulations apply to businesses—as is the case for many state and local taxes and incentives.

Use of NAICS codes in state tax and incentive systems. The ready-made NAICS definitions are a natural fit for state tax and incentive systems, where definitional and classification issues can be the

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subject of considerable ambiguity and controversy. Borrowing of NAICS codes makes it easier to quickly draft targeted legislation. Accordingly, NAICS classifications are being adopted by states looking for classifications for tax and incentive purposes in a variety of contexts.

For incentives, NAICS codes particularly make sense: NAICS classifications are designed to classify production activities at specific establishments, allowing states to specifically designate the types of activities the state seeks to incentivize.

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States can enumerate specific sectors or codes that can be eligible for an incentive.⁷ Indeed, sometimes the NAICS code appears to have been used to narrow the incentive qualification criteria to a specific project.⁸ NAICS codes also can be used to preclude less desirable industries from qualifying.⁹

For taxes, NAICS classifications are used to determine taxability, particularly

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in the case of sales taxes on enumerated services.¹⁰ They also can be used to determine the applicable rate, as exemplified by the recently enacted Nevada commerce tax that relies almost completely on NAICS classifications to determine the rate of tax on a business.¹¹

For income or business activity taxes, the NAICS code may determine the apportionment formula¹² or sourcing rule that a business uses.¹³ NAICS codes also frequently are used to define the scope of sales tax exemptions, allowing targeting of highly specific industries such as aircraft

manufacturing,¹⁴ web search portals,¹⁵ video production,¹⁶ and mining.¹⁷

Some of these uses of NAICS are a better fit than others. In general, the nature of NAICS as a production-driven classification for a single establishment means that codes are well-suited to classifying projects for incentive eligibility or to providing targeted sales tax exemptions for certain production processes.

Classifying the sales or income of an overall business raises more questions, because NAICS is not designed for enterprise-level determinations of business sectors, particularly for vertically integrated businesses. Classification of innovative business models, especially rapidly evolving technology businesses, also is often an area of uncertainty. Business should be careful however not to overstep plausible readings of NAICS code definitions: courts tend to read them literally and consider the plain meaning of the NAICS wording.¹⁸

From a technical perspective, states typically adopt NAICS definitions by referencing a specific version (1997, 2002, 2007, etc.). The NAICS structure does not tend to change much from version to version, but there are some differences.

Unlike conformity to the Internal Revenue Code, states do not often update their definitions to conform to the most recent version of the NAICS. Indeed, some states still have references to SIC codes in their



¹ 1997 North American Industry Classification System—1987 Standard Industrial Classification Replacement, 62 Fed. Reg. 17,288 (Apr. 9, 1997).

² United States Census Bureau, Economic Census, NAICS Structure, available at http://www.census.gov/econ/census/help/naics_other_classification_systems/naics_structure.html (accessed Nov. 15, 2015); see also 62 Fed. Reg. at 17,291.

³ 62 Fed. Reg. at 17,289; see generally, Economic Classification Policy Committee, Issues Paper No. 1: Conceptual Issues, 58 Fed. Reg. 16,991 (Mar. 31, 1993).

⁴ United States Census Bureau, North American Industry Classification System, Frequently Asked Questions (FAQs), no. 5, available at <https://www.census.gov/eos/www/naics/faqs/faqs.html#q2> (accessed Nov. 15, 2015).

⁵ 62 Fed. Reg. at 17,294.

⁶ *Id.*

⁷ See, e.g., Ala. Code § 40-9B-3 (using NAICS codes to define “headquarters facility” and “[i]ndustrial or research enterprise”).

⁸ See, e.g., Ark. Code Ann. § 26-51-311(b)(1) (using NAICS code 333611 (turbine and turbine generator set units manufacturing) for income tax exemption targeted to windmill blade manufacturer).

⁹ See, e.g., Cal. Rev. & Tax. Code § 23626(b)(11)(C) (excluding from the new employment credit: temporary help services (code 561320), retail trade services (sector 44-45), food services (codes

711110, 722511, 722513, 722514 and 722515) and casinos and bars (codes 713210, 721120 and 722410)).

¹⁰ See, e.g., R.I. Gen. Laws Ann. § 44-18-73(b)(1)-(3) (taxing NAICS codes 485310 (taxi dispatchers), 485320 (limousine services), 485510 (charter bus service), 485999 (other transit and ground passenger transportation) and 812910 (pet care services)); Fla. Stat. § 212.05(1)(i)1 (taxing NAICS codes 561611, 561612, 561613 and 561621 (detective, burglar protection and other protection services), and 561710 and 561720 (nonresidential cleaning and pest control)).

¹¹ See 2015 Nev. S.B. 483 (enacted Jun. 9, 2015), § 24-48. (It appears that the commerce tax will be codified as chapter 363C of the Nevada Revised Statutes.) See also S.F. Bus. & Tax Reg. § 953.1-953.7 (similarly using NAICS classifications to determine applicable tax rates).

¹² See Utah Code Ann. § 59-7-302(1)(k) (denying sales factor weighted taxpayer (single sales factor) status to NAICS sectors 21 (mining), 31-33 (manufacturing), 48-49 (transportation and warehousing), 51 (information, excepting subsector 519, other information services) or 52 (finance and insurance)).

¹³ See Fla. Stat. § 220.15(5)(b)1 (providing special exception from f.o.b. sale sourcing rule for code 311412 (frozen fruit, juice and vegetable manufacturing)).

¹⁴ Utah Code Ann. § 59-12-104(5)(a)(i)(A)(II) (NAICS codes 336411 or 336412).

¹⁵ Utah Code Ann. § 59-12-104(14)(d) (NAICS code 518112).

¹⁶ Utah Code Ann. § 59-12-104(54)(c) (NAICS codes 512110 or 51219).

¹⁷ Utah Code Ann. § 59-12-104(14)(c) (NAICS subsector 212 as well as codes 213113, 213114 and 213115); Ga. Code Ann. § 48-8-3.2(a)(10)(A) (including sector 21 in definition of “manufacturer”).

¹⁸ See, e.g., *A. Schulman, Inc. v. Wilkins*, Ohio Bd. Tax. App. No. 2004-B-370 (Sept. 22, 2006) (rejecting argument that taxpayer made “intermediate” goods qualifying for plastics product manufacturing, NAICS industry 3261, instead of plastics material and resin manufacturing, NAICS code 325211), *appeal denied on procedural grounds*, 116 Ohio St. 3d 105 (2006), *cross-appeal of other issue granted*, *A. Schulman, Inc. v. Levin*, 116 Ohio St. 3d 105 (2007).

¹⁹ See *Graceland College Ctr. for Prof'l Dev. & Lifelong Learning v. S.D. Dep't of Revenue*, 2002 SD 145 ¶ 7 (S.D. 2002) (where statute specified a SIC code, noting that “[a]pplication of the NAICS Manual would in effect create tax exemptions not granted by our legislature”).

²⁰ See *supra* note 6 and accompanying text.

²¹ *Dep't of Revenue v. Bill Davis Racing*, 684 S.E.2d 914 (N.C. Ct. App. 2009).

²² 684 S.E.2d at 921.

²³ See 62 Fed. Reg. at 17,295-337.



laws—definitions that are at least 20 years old. Differences, particularly between NAICS and SIC, can have significant impacts.¹⁹

Additionally, despite OMB's recommendation to the contrary,²⁰ states generally do not enact language giving tax or incentive administrators discretion to modify NAICS definitions if necessary. This can severely limit their discretion in situations where policy considerations call for adjustments to literal application of NAICS codes.

Strategic consistency in reporting NAICS codes. The widespread use of NAICS codes and their nature as a self-reported classification presents businesses with both risk and opportunity. The downside is that a business that does not track NAICS code classifications could find inconsistent NAICS code claims used against it in a dispute.

If a central issue in a controversy is NAICS classification, one can expect opposing coun-

sel to request identification of the NAICS codes that a business has reported to other agencies. For example, in *Department of Revenue v. Bill Davis Racing*,²¹ reporting to the Internal Revenue Service of the wrong NAICS code (711210, spectator sports) was a fact used against an auto racing business that claimed credits as a manufacturer of motor vehicles under SIC code 3711 (equivalent to a NAICS code in subsector 336).²²

Companies all too often use inconsistent NAICS codes in their reporting. It sometimes seems as though little thought has gone into the NAICS code, which is simply determined by the judgment of whomever happens to be completing a given form or registration. As long as this is just a question of statistical reporting, such inconsistency is of little import. Once NAICS codes start to matter to a company, however, it needs an integrated NAICS code and SIC code position tailored to overall circumstances.

For example, it may be the case that claiming an exemption under a NAICS code in one jurisdiction will raise the risk of being taxed under that NAICS code in another jurisdiction, such that the incentive is not worth claiming. Additionally, in many instances classification is ambiguous and a business has considerable leeway in choosing the optimal NAICS code from an overall perspective. As some agencies still use SIC codes, relevant SIC codes should also be considered, particularly since there is guidance tying SIC codes to corresponding NAICS codes.²³

At minimum this type of NAICS analysis should be done across tax functions. Better yet is to include legal and compliance input into the process so as to arrive at a business-wide approach to NAICS classification that is consistent and well thought-out. NAICS codes reported to other agencies like the Census Bureau, the Occupational Health and Safety Administration (OSHA), or a state environmental regulator should be considered together with those used for tax and incentive purposes.

A systematic consideration of NAICS positions also can identify principled ways to use different NAICS codes in different contexts. The exact wording by which a state adopts NAICS classifications in a given context is critical in this type of analysis.

The state may be looking to the activity in a specific establishment, in the state as a whole, or on a nationwide basis, each of which could be different. If considering statewide or national activity, the classification may be on a separate entity basis or may consider an overall combined group. These variables can provide justification for the principled use of different NAICS codes in different contexts.

With states increasingly tying their tax and incentive programs to NAICS classifications, businesses need to consider their overall NAICS position. In a dispute over classification, a state will likely request information about NAICS codes that a business has reported to other jurisdictions and agencies. Inconsistent positions can be used to undermine the business's case. On the other hand it will be difficult for the state to dislodge a prepared business's principled NAICS position that is grounded in the wording of the NAICS code definition and that has been used consistently with other agencies. ■

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