

Cite as Det No. 13-0034, 32 WTD 220 (2013)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 13-0034
)	
)	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .
)	Docket No. . . .

[1] RULE 13601; RCW 82.08.0265: SALES TAX – M&E EXEMPTION – DUAL PURPOSE – MAJORITY USE TEST. A wood products manufacturer that uses machinery that both fabricates new saw blades from saw blade blanks and sharpens old saw blades must satisfy the “majority use” test before the machinery is eligible for the M&E sales tax exemption.

[2] RCW 82.32A.020: PRIOR WRITTEN INSTRUCTIONS. The taxpayer had the right to rely on the holding of a previous determination issued to the taxpayer.

Weaver, A.L.J. – A taxpayer engaged in manufacturing wood products requests a correction of use tax assessed on five equipment purchases in 2007, claiming that the purchased equipment qualifies for the machinery and equipment (“M&E”) exemption. Taxpayer’s petition is granted primarily on the basis of [prior written instructions], but, in the future, Taxpayer’s equipment must satisfy the majority use test to qualify for the M&E exemption.¹

ISSUE

1. Whether, under RCW 82.08.02565, machinery and equipment used to fabricate saw blades are “used directly” in the manufacturing of timber products for purposes of the M&E exemption.
2. Whether, under RCW 82.32A.020(2), a taxpayer has a right to rely on an earlier determination characterizing the “sharpening” of saw blades as “re-manufacture.”

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

[Taxpayer] operates . . . saw mills in Washington State and [in another state]. Taxpayer is engaged in the business of manufacturing wood products in . . . Washington. The majority of Taxpayer's customers are either . . . home improvement stores or . . . building contractors.

Taxpayer's manufacturing operation requires the use of saws, both band and circular. Taxpayer's manufacturing operation is designed to maximize the amount of usable lumber that it can get out of each log that enters its facility. To accomplish this end, Taxpayer designed its own custom saw blade specifications to be used in its manufacturing operation. The types of saw blades used by Taxpayer are not available from any other source and must be fabricated. Taxpayer states that it did not wish to provide its saw technology to an outside manufacturer, so it fabricates the custom saw blades itself.

Taxpayer constructed two saw shops, one [at its saw mill in] Washington and one in [the saw mill in another state], in which it manufactures the saws used in its manufacturing operation. The saw shops obtain tempered blanks (which are unusable in their blank form) and then run the blanks through automated equipment that grinds the tooth profile, applies special tips, grinds the tips to form, and then sharpens the saw blades until they meet Taxpayer's custom specifications. In 2007, Taxpayer purchased certain machinery and equipment to fabricate and sharpen the customized saw blades. These machines have dual uses and are used both to fabricate custom saw blades as well as to sharpen dulled blades.

The Audit Division of the Department of Revenue ("Department") audited Taxpayer's books and records for the period January 1, 2007 through March 31, 2011. On December 28, 2011, the Audit Division issued an assessment against Taxpayer in the amount of \$. . . , of which \$. . . was use tax/deferred sales tax, and \$. . . was interest. The use tax assessment was based on the purchase of five separate machines by Taxpayer in 2007.

Those five [types of] machines at issue are the following:

1. . . . Sharpener

The . . . Sharpener is a circular and band saw sharpener. Taxpayer purchased this piece of equipment for \$. . . , and put it into service [in] 2007.

2. One [Side Grinding Machine]

The . . . side grinding machine [is] used to produce customized saw blades. It enables carbide-tipped circular saw blades to be fabricated to specifications set by the user. It can be used as a stand-alone unit or can be used in combination with automatic loaders for saw blade production. Taxpayer purchased this equipment for \$. . . , and put it into service [in] 2007.

3. Two [Handling Systems]

The . . . handling system [is] for automating the process of grinding customized saw blades. The . . . handling system is connected with grinding machines by means of a data input system. The saw blades to be machined are stacked on a loading carriage and are then fed by the handling system. . . . Taxpayer purchased these pieces of equipment for \$. . . and put them into service [in] 2007.

4. [An additional] Side Grinder . . .

The . . . side grinder another side grinding machine used to produce customized saw blades. Taxpayer purchased this equipment for \$. . . and put it into service [in], 2007.

5. Two [additional Handling Systems]

As stated above the . . . handling system [is] for automating the process of grinding customized saw blades. Taxpayer purchased these pieces of equipment for \$. . . and put them into service on . . . , 2007.

Taxpayer filed a timely appeal of the use tax assessment.

ANALYSIS

[1] All sales of tangible personal property to consumers in the state of Washington, including successive retail sales of the same property, are subject to retail sales tax, unless there is a specific exemption. RCW 82.08.020; 82.04.050. In general, the use tax applies upon the use within Washington of any tangible personal property the sale or acquisition of which has not been subjected to the Washington retail sales tax. It complements the retail sales tax by imposing a tax of like amount. WAC 458-20-178 (“Rule 178”); RCW 82.12.020; RCW 82.12.0252.

RCW 82.08.02565 provides a sales tax exemption for sales to a manufacturer or processor for hire of machinery and equipment (“M&E”) used directly in a manufacturing operation. RCW 82.12.02565 provides a similar exemption from the use tax. These exemptions, like all tax exemptions in Washington, are strictly construed in favor of application of the tax and against the person claiming the exemption. *Yakima Fruit Growers Ass’n v. Henneford*, 187 Wash. 252, 258, 60 P.2d 62 (1936); *All-State Constr. Co. v. Gordon*, 70 Wn.2d 657, 425 P.2d 16 (1967). However, the policy of strict construction of exemption provisions does not mean they will be read so narrowly that the legislative purpose and intent in enacting the provisions are undermined. *Cherry v. Metro Seattle*, 116 Wn.2d 794, 808 P.2d 746 (1991).

The M&E retail sales tax exemption in RCW 82.08.02565², reads as follows:

- (1) (a) The tax levied by RCW 82.08.020 shall not apply to sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation, to sales to a person engaged in testing

² RCW 82.12.02565 provides a corresponding use tax exemption.

for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation, or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment.

RCW 82.08.02565(1). RCW 82.08.02565(2) additionally provides, in parts pertinent to this discussion:

(2) For purposes of this section and RCW 82.12.02565³:

(a) “Machinery and equipment” means industrial fixtures, devices . . . and tangible personal property that becomes an ingredient or component thereof . . .

(b) “Machinery and equipment” does not include:

. . . .

(ii) Property with a useful life of less than one year;

(c) Machinery and equipment is “used directly” in a manufacturing operation, testing operation, or research and development operation if the machinery and equipment:

. . . .

(vi) Produces another item of tangible personal property for use in the manufacturing operation . . .

(d) “Manufacturer” means a person that qualifies as a manufacturer under RCW 82.04.110

(f) “Manufacturing operation” means the manufacturing of articles, substances or commodities for sale as tangible personal property. A manufacturing operation begins at the point where the raw materials enter the manufacturing site and ends at the point where the processed material leaves the manufacturing site

RCW 82.08.02565(2). Therefore, the M&E exemption has four distinct requirements:

1. The purchaser/user must be a “manufacturer” or “processor for hire”;
2. The purchased/used item must meet the definition of “machinery and equipment”; and
3. The item must be “used directly” . . .
4. in a “manufacturing operation.”

Det. No. 04-092, 24 WTD 092 (2004).

In this case, Taxpayer is a “manufacturer,” because it manufactures timber products for sale. *See* RCW 82.04.110(1); RCW 82.08.02565(2)(d). It is uncontested that the five [types] of machinery

³ RCW 82.12.02565 provides the use tax exemption that corresponds to the sales tax exemption in RCW 82.08.02565.

at issue meet the definition of “machinery and equipment,” as they are devices that have useful lives over a year. *See* RCW 82.08.02565(2)(a), (b).⁴ Taxpayer is certainly engaged in a “manufacturing operation”⁵ as it processes the raw logs that enter its manufacturing site into timber products that it sells to its customers as tangible personal property. RCW 82.08.02565(2)(f).⁶

Therefore, the only question remaining is whether the machinery at issue was “used directly” in a manufacturing operation. In this case, Taxpayer claims the new machinery is used to actually fabricate new proprietary saw blades from saw blade blanks which it then incorporates into its manufacturing operation. Therefore, when Taxpayer uses the machines to fabricate new blades from saw blade blanks, it “[p]roduces another item of tangible personal property for use in the manufacturing operation . . .” RCW 82.08.02565(2)(c)(vi). Because the machines produce items of tangible personal property [new saw blades] that are used in a manufacturing operation, the machinery is “used directly” in a manufacturing operation. *Id.*

However, Taxpayer concedes that its equipment may have a dual use, when it is used both for fabricating new blades and for sharpening old blades. In highlighting this “dual use,” Taxpayer correctly recognizes there is a distinction between equipment used to “produce” tangible personal property used in a manufacturing operation and equipment used to repair or maintain tangible personal property that was already in use. When Taxpayer’s equipment is used to sharpen old blades, it does not “produce another item of tangible personal property;” rather, it restores old saw blades to proper working order. *See* RCW 82.08.02565(2)(c)(vi). Because the sharpening of old blades does not “produce” items of tangible personal property, machinery used to sharpen is not “used directly” in a manufacturing operation. *Id.*

In 2000, the Department adopted WAC 458-20-13601 (“Rule 13601”), in part to address how to determine whether “dual use” equipment is eligible for the M&E exemption. The methodology adopted in the rule is the “majority use threshold.” Rule 13601(9). Rule 13601(9) reads as follows:

(a) Machinery and equipment both used directly in a qualifying operation and used in a nonqualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. Examples of situations in which an item of machinery and equipment is used for qualifying and nonqualifying purposes include: The use of

⁴ The issue whether the saw blades themselves qualify as machinery and equipment is not before us on this appeal; however, it is clear that they would not qualify as M&E, because their useful life is less than a year. *See* Det. No. 03-0261, 23 WTD 177 (2004).

⁵ [The saw shops by themselves would not be considered a “manufacturing operation” because Taxpayer does not manufacture the saw blades “for sale as tangible personal property.” *See* RCW 82.08.02565(2)(f). However, because the Washington saw shop is located at Taxpayer’s Washington saw mill where timber products are produced for sale, the M&E at issue is used in a “manufacturing operation.”]

⁶ As Taxpayer was instructed in the earlier determination (Det. No. 97-163), manufacturers who make items for commercial or industrial use must pay both manufacturing B&O tax and use tax on the value of the items being manufactured, which do not otherwise qualify for an exemption (the blades with a useful life of less than a year would not qualify for an M&E use tax exemption, as discussed above). WAC 458-20-134(3), (4).

machinery and equipment in manufacturing and repair activities . . . Majority use can be expressed as a percentage, with the minimum required amount of qualifying use being greater than fifty percent compared to overall use. To determine whether the majority use requirement has been satisfied, the person claiming the exemption must maintain records documenting the measurement used to substantiate a claim for exemption or, if time, value, or volume is not the basis for measurement, be able to establish by demonstrating through practice or routine that the requirement is satisfied

Rule 13601(9)(a) (emphasis added). In this case, the use of the equipment to fabricate or produce new saw blades is a qualifying use, because the equipment is used directly in a manufacturing operation. However, the use of the equipment to sharpen old blades is a nonqualifying use, because it does not produce another item of tangible personal property. In such situations, taxpayers are required to keep records sufficient to substantiate a claim for exemption under the majority use threshold. *Id.*

Having articulated the proper application of the majority use test, we now note that Taxpayer has a right to rely on our previous determination (Det. No. 97-163), which held that Taxpayer's saw blade sharpening equipment qualifies for the M&E exemption because the sharpening activity constitutes the "re-manufacture" of saw blades. *See* RCW 82.32A.020(2). The Taxpayer Rights and Responsibilities are codified in chapter 82.32A RCW, and state:

The right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment.

RCW 82.32A.020(2). We disagree with the holding in Det. No. 97-163 that the use of the equipment to sharpen old blades constitutes "re-manufacture" of the saw blades. As stated above, the statute says that M&E used to "produce" another item of tangible personal property is "used directly" in a manufacturing operation. RCW 82.08.02565(2)(c)(vii). When machinery is used to produce "new" saw blades, it qualifies as equipment used directly in a manufacturing operation. *Id.* However, when machinery is used to sharpen old blades, it does not "produce another item of tangible personal property" and therefore does not qualify for the M&E exemption. *See id.*

In this matter, we affirm the holding in the earlier determination, insofar as we agree that the machinery used by Taxpayer to fabricate sharp usable saw blades "produces another item of tangible personal property for use in the manufacturing operation." *See* RCW 82.08.02565(2)(c)(vii). However, because equipment used to sharpen old blades does not produce a new item of tangible personal property, equipment used for sharpening old blades does not qualify for the M&E exemption. *See id.*

To the extent that Taxpayer purchases equipment that has a "dual use," meaning that the equipment both fabricates new saw blades and sharpens old blades, the issue whether such equipment is subject to the M&E exemption depends on whether Taxpayer can prove that the use of the equipment satisfies the "majority use" test. Rule 13601(9)(a). To the extent that the

distinction between the qualifying activity of producing new saw blades and the nonqualifying activity of sharpening old blades is a change from the holding in the previous determination issued to Taxpayer (Det. No. 97-163), the instructions in that earlier determination are overruled and Taxpayer is instructed that the M&E exemption will no longer apply to “dual purpose” M&E that does not meet the “majority use” test.

Because Taxpayer has a right to rely on the holding of our earlier determination, we grant Taxpayer’s petition. However, the holding in Det. No. 97-163 is partially overruled by this determination and Taxpayer is instructed to report in the future in accordance with the holding of this determination.

DECISION AND DISPOSITION

Taxpayer’s petition is granted. The assessment is canceled.

Dated this 8th day of February 2013.