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BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 19-0049
)	
... )	Registration No. . . .
)	

RCW 82.08.02565; RCW 82.12.02565: RETAIL SALES TAX AND USE TAX – MACHINERY AND EQUIPMENT (“M&E”) TAX EXEMPTION. RCW 82.08.02565(2)(c), which requires qualifying machinery and equipment be “used directly” does not impose any time limitation on the beginning use of the machinery and equipment.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Lewis, T.R.O. – Taxpayer, a bottler of soft drinks, appeals the disallowance of the Manufacturing and Equipment (“M&E”) retail sales and use tax exemption for equipment and labor spent on a bottling line located within Washington. The Department denied the exemption because of the delay in putting the line into full production. We grant Taxpayer’s petition finding the M&E exemption does not contain a time requirement in using the equipment at full capacity.<sup>1</sup>

ISSUE:

Under the provisions of RCW 82.08.02565 (retail sales tax) and RCW 82.12.02565 (use tax) does Taxpayer’s purchase of equipment used to construct a soft-drink bottling line qualify for the M&E exemption?

FINDINGS OF FACT:

Taxpayer is headquartered in . . . . Taxpayer’s business activities in Washington during the audit period included: manufacturing; wholesale sales of soft drink concentrates, syrups, and non-carbonated beverage products; wholesale and retail sales of parts and repairs; and, the lease of fountain service equipment.

The Department’s Audit Division audited Taxpayer’s business records for the period January 1, 2007, through December 31, 2011. The audit examination disclosed that Taxpayer had installed a

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

hot-fill bottling line at a bottling plant located in Washington. Taxpayer installed a hot-fill production line at the . . . facility to produce and bottle sports drinks such as . . . and . . . .

Taxpayer originally contemplated that the production line would be placed into service and production would begin around . . . 2009 or . . . 2010. Due to the complexities associated with the design, purchase, installation, and testing of the production line planning began during 2007 and work began during 2008. The following is a timeline of events associated with the primary construction phase of the production line:

- Between . . . 2008 and . . . 2008 certain existing equipment at the . . . production facility was relocated to create space for a new line.
- During . . . 2008, the existing building was expanded to allow additional room for blending, CIP, and raw material storage.
- During . . . 2008, new water treatment equipment was installed.
- During . . . 2009, new electrical service was installed.
- During . . . 2009, delivery of component parts of the production line equipment began.
- During . . . 2009, primary installation of the production line equipment was accomplished. Test production runs were completed on the production line at this time.

Taxpayer's forecasting of demand for the beverage products produced by the production line proved to be overly optimistic. Between . . . 2008 and . . . 2009, while consumer demand grew, it did not grow as quickly as originally forecast. As a result, full startup of the production line was delayed. Taxpayer explained that running the production line at the lower actual volumes present in . . . 2009 would not have been financially optimal, as certain production volumes are required to obtain economies of scale. Throughout the delay, Taxpayer always intended that the production line would be placed into service. The only question was when.

During . . . 2010, Taxpayer determined that consumer demand for . . . and . . . had grown sufficiently to financially justify full production on the production line.

Work to prepare the production line for final startup began during . . . 2011. During . . . 2011, the production line equipment was started and tested. Hiring the operator positions began during . . . 2011 and training was conducted. During . . . 2011, final product validation was completed and sellable product was produced. During . . . 2011, the production line was completed and began producing sellable product at volume. Thus, there was an approximately 20 month delay between the time the primary construction phase was completed and the first runs were made (. . . 2009) and the time when the production line was fully operational and placed into service (. . . 2011).

On January 8, 2018, the Department issued a \$ . . . assessment against Taxpayer.<sup>2</sup> The tax arose because Audit did not allow the M&E exemption on purchases of machinery and equipment made prior to 2010. Audit stated that the basis for denying for M&E exemption for purchases made prior to 2010 was that the requirements of the M&E exemption did not allow for an overly-long delay in using the equipment purchased.

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<sup>2</sup> The \$ . . . assessment consisted of \$ . . . in use tax and/or deferred sales tax and \$ . . . in interest.

Taxpayer disagreed with the assessment. On March 9, 2018, Taxpayer filed a petition requesting correction of the assessment. Taxpayer's primary argument for correction of the assessment was that the M&E exemption did not contain a requirement dictating that the purchased equipment must be used within a certain time of the purchase. Taxpayer also explained that while the collection and assembly of the custom-made equipment required months, the equipment was "used" timely once it was completed, albeit to test that the production line was operational and that vendors could be paid.

Audit's response to Taxpayer's petition explained:

The assessment proposes to assess use tax on the Production Line equipment installed at the . . . , Washington production facility. [Taxpayer] originally claimed the manufacturing exemption for the equipment, which the auditor partially disallowed. The auditor acknowledged that the production line qualified for the manufacturing exemption once installed in . . . 2011, and thus allowed the exemption for the small portion of purchases that occurred after January 1, 2011. However, the auditor disallowed the exemption for all purchases related to the production line occurring prior to January 1, 2011. The auditor's theory was that [Taxpayer] took too long to begin full production on the production line. The auditor's explanation for the disallowance was as follows:

Upon review of the invoices, the auditor observed that purchases of manufacturing M&E started as far back as 2007 when production did not actually begin until May 2011. Your company contends that start-up of a production line can take many years and that this was a usual practice. Whereas, one would contend that machinery & equipment of this magnitude would become useless and possibly obsolete from non-use. While, it is recognized that the start-up of a production line may take many months the department has not allowed M&E exemption on purchases of manufacturing machinery and equipment prior to 2010.

#### ANALYSIS:

In general, sales in the state of Washington of tangible personal property to consumers are subject to retail sales tax unless the sales are otherwise exempt from taxation. RCW 82.08.020; RCW 82.04.050. Use tax complements the retail sales tax by imposing a tax of like amount upon the privilege of using within this state as a consumer any article of tangible personal property acquired without payment of retail sales tax. See RCW 82.12.020(1), (2).

RCW 82.08.02565 (retail sales tax) and RCW 82.12.02565 (use tax) provide exemptions that are referred to collectively as "the M&E exemption." Specifically, the statutes provide that the retail sales tax and use tax do not apply to sales to, or use by, "a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation . . . ." RCW 82.08.02565(1)(a); RCW 82.12.02565(1)(a). Thus, 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 be "machinery and equipment;"

- 3) The item must be “used directly;”
- 4) In a “manufacturing operation.”

*Id.* The M&E exemption’s first requirement requires that the purchaser/user must be a “manufacturer” or “processor for hire.” RCW 82.04.110 defines “manufacturer” as:

[E]very person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances, or commodities.

The M&E exemption’s second requirement is that the items purchased must be “machinery and equipment.” RCW 82.08.02565(2)(a) defines “machinery and equipment” as:

"Machinery and equipment" means industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts. "Machinery and equipment" includes pollution control equipment installed and used in a manufacturing operation, testing operation, or research and development operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation, testing operation, or research and development operation. "Machinery and equipment" also includes digital goods.

The M&E exemption’s third requirement is that the items purchased must be “machinery and equipment” used directly in the manufacturing process. RCW 82.08.02565(2)(c) explains that “machinery and equipment” is “used directly” in a manufacturing operation, testing operation, or research and development operation if the “machinery and equipment:”

- (i) Acts upon or interacts with an item of tangible personal property;
- (ii) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;
- (iii) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
- (iv) Provides physical support for or access to tangible personal property;
- (v) Produces power for, or lubricates machinery and equipment;
- (vi) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
- (vii) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
- (viii) Is integral to research and development as defined in RCW 82.63.010.

The M&E exemption’s fourth requirement is that the items purchased must be used in a manufacturing operation. RCW 82.08.02565(2)(f) defines “manufacturing operation” as:

[T]he 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. . . .

The purchases at issue are used to mix and bottle the beverages. Audit has not questioned or challenged that Taxpayer is a manufacturer (requirement one), that the items are qualified machinery and equipment (requirement two), or the machinery and equipment were purchased for use in a manufacturing operation (requirement four). Rather, Audit disallowed the M&E exemption for items purchased prior to 2010 because of what it believed to be an overly-long lag between the time the machinery and equipment was purchased and the time that the bottling line was being used. Because of this time lag, Audit concluded the machinery and equipment acquired prior to 2010 were not “used directly” in a manufacturing operation (requirement three).

Audit’s response to Taxpayer’s petition explained:

The department can understand [Taxpayer]’s reason and decision to delay the start of production, however that decision directly affects whether the equipment would still qualify for the M&E exemption since it is not being used directly in the manufacturing process, but rather sitting idle until your company decides to move forward with production for financial reasons.

RCW 82.08.0565 provides a sales tax exemption for sales of M&E “used directly” in a manufacturing operation. It seems the legislative intent of the statute (*sic*) is for M&E purchases to be “used directly” in the manufacturing process within a timely fashion rather than many years later which defies a common sense approach to application of the exemption. Furthermore, purchases of any and all M&E would have been recorded in your company books and records at time of purchase and depreciated accordingly.

While, M&E was purchased for direct use in the manufacturing process, it sat uselessly by for years while not being used for the intended purposes, it seems as though your company has lost the window of opportunity for proper application of this exemption since it is **NOT** being used in the manufacturing process until many years later.

(Emphasis in original.)

In disallowing the M&E exemption for purchases made prior to 2010, Audit has added another requirement to the tax exemption enacted by the Legislature – the equipment and machinery must be used within a certain time of the purchase. Audit cites to the Legislative intent of the M&E exemption for this position. Audit does not cite to a specific piece of legislative history or other evidence to show that the legislative intent of the “used directly” requirement is that items must be used within a certain time of the purchase.

We find Audit’s application of the law is incorrect. It is well-established rule that exemptions to the tax laws are to be construed narrowly. “Taxation is the rule and exemption is the exception.” *O’Leary v. Dep’t of Revenue*, 105 Wn.2d 679, 682, 717 P.2d 273 (1986); *Budget Rent-A-Car of Washington-Oregon, Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972). It is equally well-established that if the statute’s meaning is plain on its face, the plain meaning must be given effect as an expression of legislative intent. *State v. J.M.*, 144 Wn.2d 472, 480, 28 P.3d

720 (2001). “The legislative intent should be derived primarily from the statutory language.” *Duke v. Boyd*, 133 Wn.2d 80, 87, 942 P.2d 351 (1997).

As explained above, the dispute centers on whether the equipment is used directly in the manufacturing process. RCW 82.08.02565(2)(c) explains that “machinery and equipment” is “used directly” in a manufacturing operation, testing operation, or research and development operation if the “machinery and equipment:”

- (i) Acts upon or interacts with an item of tangible personal property;
- (ii) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;
- (iii) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
- (iv) Provides physical support for or access to tangible personal property;
- (v) Produces power for, or lubricates machinery and equipment;
- (vi) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
- (vii) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
- (viii) Is integral to research and development as defined in RCW 82.63.010.

RCW 82.08.02565(2) (c) does not impose any time limitations on the beginning use of the equipment and machinery. The statute is clear and unambiguous. Accordingly, the equipment and machinery to qualify as being “used directly” only need meet the requirements enumerated by the statute, which the machinery eventually did.

#### DECISION AND DISPOSITION:

Taxpayer’s petition is granted.

Dated this 20th day of February 2019.