Cite as Det. No. 21-0152, 43 WTD 25 (2024)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 21-0152
…	)	Registration No. …

WAC 458-20-13601; RCW 82.08.02565; 82.12.02565: RETAIL SALES TAX -- MANUFACTURING EQUIPMENT AND MACHINERY (M&E) EXEMPTION -- QUALIFYING FACILITY -- MANUFACTURING OPERATION. The scope of a manufacturing operation is site-specific[,] and the activities and qualifying use of the equipment must occur at a site that qualifies as a manufacturing operation. To be eligible for exemption the taxpayer must establish that the activities at a specific location constituted a qualifying manufacturing operation. Packaging activities at a separate facility were not substantiated as constituting a qualifying manufacturing operation and so were not eligible for exemption.

Kreger, T.R.O. – A manufacturer of consumer goods protests the conclusion that activities at a Washington facility were not part of a qualified "manufacturing operation" under WAC 458-20-13601(2)(i)(ii), and the equipment used at the facility was therefore ineligible for exemption from retail sales and use tax for qualifying machinery and equipment (M&E) provided in RCW 82.08.02565 and 82.12.02565.[1]

ISSUE

Has the Taxpayer established that the machinery and equipment at issue was used directly in a qualifying "manufacturing operation" to be eligible for the M&E exemption provided by RCW 82.08.02565?

FINDINGS OF FACT

. . . (Taxpayer), is a . . . corporation, headquartered in . . . . The Taxpayer is a domestic manufacturer of name-brand consumer products[,] and its business activities in Washington State during the audit period included the manufacture and sale of consumer-packaged goods. The Taxpayer has a manufacturing facility in . . . . . . [(Manufacturing Facility)], that manufactures . . . vitamins. These products are subsequently delivered to a separate warehouse in . . . [(Warehouse)] that packs and distributes the . . . vitamins it receives from the . . . [Manufacturing Facility], as well as from other . . . [out-of-state] manufacturing facilities.

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

The Department of Revenue's (Department) Audit Division conducted an audit of the Taxpayer's Washington state business activities for the period of January 1, 2014, through December 31, 2017. At the conclusion of the audit the Department issued an assessment, Letter ID: . . . in the amount of $. . . .[2] The Taxpayer timely filed a petition for review disputing the assessment. The Taxpayer protests the conclusion that its activities at the . . . [Warehouse] are not part of a qualified manufacturing operation.

The Audit Division's auditors who conducted the audit made a site visit to both the Taxpayer's . . . [Manufacturing Facility] and the . . . [Warehouse]. Based on this site visit and the information from the Taxpayer about the scope of activities occurring at each facility, the Audit Division concluded that no manufacturing activity was conducted at the . . . [Warehouse]. It was determined that the activities occurring at the . . . [Warehouse] facility were packaging, packing and distribution, and therefore the activities at the . . . [Warehouse] were not part of a qualified "manufacturing operation" under WAC 458-20-13601(2)(i)(ii). [T]he equipment used at the facility was therefore ineligible for exemption from retail sales and use tax for qualifying machinery and equipment (M&E) provided in RCW 82.08.02565 and 82.12.02565, and the exemptions claimed by the Taxpayer under those provisions were disallowed. The review of the Taxpayer's records also resulted in the disallowance of wholesale deductions claimed by the Taxpayer during the audit period, which are not protested on review. The Taxpayer asserts that the quality control and testing activities occurring at the . . . [Warehouse] facility support classifying the activities at that location as part of a qualifying manufacturing operation and correspondingly support the eligibility for M&E exemptions taken on the equipment at issue.

Prior to 2010, the Taxpayer conducted both manufacturing and packaging and distribution at its . . . [Manufacturing Facility]. However, with a demand for an increase in production capacity the Taxpayer invested in additional space and equipment and opened the . . . [Warehouse]. The Taxpayer also stores some raw materials at the . . . [Warehouse]. The Taxpayer manufactures . . . vitamins at other locations, which are packaged into 25-pound transport bags and sent to the . . . [Warehouse] to be packaged and prepared for sale. The 25-pound bags of vitamins are identified by a bar code and are not suitable for retail sale.

After arrival at the [Warehouse], the vitamins are removed from the transport bags, visually inspected, and then fed into equipment that de-clumps and separates the vitamins. The vitamins are reviewed for size; items that do not meet specific size parameters or that are noticeably deformed so as to not meet the desired product appearance are removed. The vitamins then move on to the bottling and labeling equipment. The product labels indicate volume by piece, but the bottles are filled by weight, so prior to proceeding to bottling there is a check that the designated weight selected will yield a piece count that corresponds to the labels. The Taxpayer also stated that random sample bottles are removed throughout the filling and packaging process to check for weight and piece count. The bottles are then vacuum-sealed and FDA compliant lids are attached. Immediately prior to the bottles being sealed they move through a metal detector to confirm that no metal contaminants have entered the bottles. All of the sorting and filling activities occur in a clean room portion of the facility to minimize the risk of product contamination. The Taxpayer

[2] The assessment consisted of a tax adjustment of $. . . , and interest of $. . . . No penalties were included in the assessment.

also stated that on occasion some small orders may be filled by hand rather than going through the sorting and filling equipment.

After being sealed, the bottles leave the clean room portion of the facility and move on to be labeled, and have an expiration date and batch information printed on the individual bottles before moving to packaging for distribution. The information printed on the bottles is used to identify a particular manufacturing batch in the event of problems with the product or any future product recalls. After labeling is complete, the bottles are shrink wrapped, boxed by batch, and loaded onto pallets. At the end of the labeling process, random bottles are checked to ensure that the label matches the product and that the correct dietary information labels were attached to the product. Finally, some samples are pulled from the production for each batch and retained by the Taxpayer for subsequent testing and verification.

The Taxpayer emphasizes that the product enters the . . . [Warehouse] in bulk packaging not suitable for retail sale and exits the facility packaged as a retail saleable product. The Taxpayer also notes that as the product moves throughout this facility, there are a number of quality control steps taken to verify that the product conforms to the label and meets purity standards.

ANALYSIS

All sales of tangible personal property to consumers in Washington are subject to retail sales tax, unless there is a specific exclusion or exemption. RCW 82.08.020(1)(a); RCW 82.04.050(1). In general, the use tax applies upon the first use within Washington of any tangible personal property the sale or acquisition of which has not been subjected to the Washington retail sales tax. RCW 82.12.020(1)(a); WAC 458-20-178(1). The use tax complements the retail sales tax by imposing a tax of like amount. WAC 458-20-178(2).

In this case, there is no dispute that the acquisition of the machinery and equipment at issue was the purchase of tangible personal property that is, absent an exemption, subject to either retail sales tax, or, alternatively, use tax.

RCW 82.08.02565 provides a retail sales tax exemption for certain machinery and equipment sold to a manufacturer or processor for hire and "used directly in a manufacturing operation."[3] RCW 82.12.02565 provides a corresponding use tax exemption. We refer to these collectively as the "M&E exemption." The M&E exemption also covers the repair of qualifying equipment.

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[3] RCW 82.08.02565 provides:

> (1)(a) The tax levied by RCW 82.08.020 does 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 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)(a).

The M&E exemption has three specific 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 purchased/used item must be "used directly in a manufacturing operation or research and development operation."

In addition, WAC 458-20-13601 (Rule 13601) explains that machinery and equipment used both directly in a qualifying operation and also in a nonqualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. Rule 13601(9)(a).

In determining eligibility for this exemption, we must follow several long-accepted general rules of statutory construction. Taxation is the rule; exemption is the exception. *Spokane County v. City of Spokane*, 169 Wash. 355, 13 P.2d 1084 (1932). Exemptions from a taxing statute are to be narrowly construed. *Evergreen-Washelli Mem. Park Co.* v. *Dep't of Revenue*, 89 Wn.2d 660, 574 P.2d 735 (1978); *Budget Rent-A-Car, Inc. v. Dep't of Revenue,* 81 Wn.2d 171, 500 P.2d 764 (1972). The burden is squarely upon the taxpayer to show that the exemption applies, and any ambiguity is "construed strictly, though fairly and in keeping with the ordinary meaning of . . . [the statutory] language, against the taxpayer." Det. No. 04-0147, 23 WTD 369, 375 (2004) (quoting *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 150, 3 P.3d 741 (2000)). Exemptions are not to be extended by judicial construction. *Pacific Northwest Conference of the Free Methodist Church v. Barlow*, 77 Wn.2d 487, 463 P.2d 626 (1969).

At issue here is the third M&E exemption requirement, whether the activities at the . . . [Warehouse] qualify as a manufacturing operation under the statute and applicable rule. The Audit Division found that activities at this location were focused on packaging, packing, and distribution and so did not qualify. The Taxpayer does not dispute that these activities occur at this location, but asserts that the quality control and testing activities that are part of the packaging process are sufficient to characterize the activity as manufacturing.

The scope of the qualifying manufacturing operation and corresponding manufacturing site where those operations occur is guided by the definition of a manufacturing operation. A "manufacturing operation" is defined by statute 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.

RCW 82.08.02565(2)(f).

Rule 13601, the administrative regulation addressing qualifying M&E, provides additional clarification of the term "manufacturing operation" as a process occurring at a specific manufacturing site. Rule 13601(2)(i). Rule 13601 defines a manufacturing site as "the location at which the manufacturing or testing takes place." Rule 13601(2)(o). The term "manufacturing operation" is further explained as:

> **Manufacturing operation.** "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. The operation includes storage of raw materials at the site, the storage of in-process materials at the site, and the storage of the processed material at the site. The manufacturing operation is defined in terms of a process occurring at a location. To be eligible as a qualifying use of M&E, the use must take place within the manufacturing operation, unless specifically exempted by law. **Storage of raw material or other tangible personal property, packaging of tangible personal property, and other activities that potentially qualify under the "used directly" criterion, and that do not constitute manufacturing in and of themselves, are not within the scope of the exemption unless they take place at a manufacturing site**. . . .

Rule 13601(2)(i) (emphasis added).

The scope of a manufacturing operation is site-specific and there is a focus on the activities occurring at that site. This interpretation is supported by the discussion of activities, such as packaging and storage, which do not independently constitute manufacturing because they fall outside the scope of the exemption unless they occur at the manufacturing site. Both the statute and the rule frame qualifying manufacturing operations as beginning with raw materials (here the ingredients for the vitamins) entering the manufacturing site and ending with the processed material (finished . . . vitamins) leaving the site. *See* RCW 82.08.02565(2)(f); Rule 13601(2)(i). The qualifying use must occur "within the manufacturing operation," which is framed as site specific.

In this case the products at issue, . . . vitamins, are manufactured at another location and delivered to the . . .[Warehouse] where they are prepared for sale and packaged and labeled.

The Taxpayer conversely focuses on the more general statutory definition of "to manufacture" which is defined as:

> "To manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use.

RCW 82.04.120(1). The Taxpayer asserts that the transformation of the bulk packaged vitamins to commercially saleable vitamins qualifies as creating a new or different product and should be considered its own manufacturing activity. We disagree. In this case the substance and article being created is the vitamins and the activities do not occur at . . . [the Warehouse]. Rather, the activities at the . . . [Warehouse] take a completed product and prepare and package it for sale. As noted above under Rule 13601(2)(i), these activities do not constitute manufacturing themselves, and in order to qualify for the exemption, the qualifying use must occur at the same site as manufacturing operation.

While the packaging activity at issue here is a multi-step process, which involves placing the product in containers suitable for sale, this does not mean that these steps are creating a new substance. Rather, the Taxpayer is taking the manufactured item, the vitamins, and packaging them for retail sale. Similarly, the quality control steps occurring at the . . . [Warehouse] are verifying the success of the manufacturing activity occurring at other locations and confirming that the packaging process is conforming to label specifications. We find no authority to support the assertion that the complexity of a packaging process is sufficient to characterize these steps as manufacturing and the location where they occur as a separate manufacturing operation.

The Taxpayer asserts that the packaging activity does create a new product, citing the Washington State Supreme Court's test for determining whether a new, different or useful article is produced as articulated in *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962). In concluding that the transformation of whole fish into individual fillets for freezing and then sale constituted manufacturing under RCW 82.04.120, the court developed the following test:

> We think the test that should be applied to determine whether a new, different, and useful article has been produced is whether a significant change has been accomplished when the end product is compared with the article before it was subjected to the process. By the end product we mean the product as it appears at the time it is sold or released by the one performing the process.

Bornstein, 60 Wn.2d at 175**.**

The test articulated in *Bornstein* was relied on in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963), where the court held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The court in *McDonnell* recognized that the *Bornstein* test was "somewhat general in nature and may seem easier as a matter of articulation than as a matter of application." 62 Wn.2d at 556. The court then identified the following factors one should consider in determining if the end product is a new, different, or useful product: "among others, changes in form, quality, properties (such changes may be chemical, physical, and/or functional in nature), enhancement in value, the extent and the kind of processing involved, differences in demand, et cetera, ..." *Id.* at 557.

In this case the packaging activities occurring in the . . . [Warehouse] do not change the form, quality, or properties of the vitamins – they exit the facility with the same properties and characteristics that they enter with, merely in smaller containers. There is an enhancement in value and difference in demand as the vitamins are changed from being held as a bulk product to a product suitable for retail sale. However, the packaging of the vitamins does not further process or change the vitamins. We find that the product at issue, the vitamins, are not a new or different product at the conclusion of the activities undertaken at the . . . [Warehouse].[4]

[[4] The activities in this case to sort by size, inspect, and de-clump bulk-packaged vitamins and transfer them to individual bottles are distinguishable from the processing of recyclable materials in *FPR II v. Dep't of Revenue*, 16 Wn. App. 2d 706, 482 P.3d 320 (2021). In *FPR II*, a contractor provided employees to material recovery facilities to process loose, mixed materials. This required labor and skill to remove non-recyclable materials from the batch of loose materials and sort by type (plastic, cardboard, aluminum), and involved changing the form of recycling materials after compressing them into bales. The court concluded the resulting product was a "fixed, densified form of similar materials" and constituted a significant change in physical form compared to the loose form delivered. *Id.* at 720. In

The Taxpayer characterizes the packaging activities as producing a change in the physical form and function of the vitamins, to place the product into saleable containers. However, we note that what is being changed is the packaging of the vitamins rather than a change to the vitamins themselves. It is the physical form of the bulk packaging that is altered that results in a different function between the 25-pound bags of vitamins that enter the . . . [Warehouse] and the consumer containers that exit that facility. There is no change to the physical nature or elements of the vitamins or to the function of the items that occur at the . . . [Warehouse].

The Taxpayer asserts that the fact that the packaging and labeling requirements are more specific to meet FDA requirements indicates that the activities are more involved than mere packaging. We disagree. We find no support for the assertion that the complexity of a packing process should support characterizing that activity as a manufacturing operation.

The Taxpayer also asserts that its activities are comparable to those in *JJ Dunbar & Co. v. State*, 40 Wn.2d 763,766, 245 P.2d 1164 (1952), where the Washington Supreme Court held that filtering raw whiskey in barrels and packaging the finished product for sale constituted manufacturing. We find that decision distinguishable as the filtration activity constitutes a significant processing step that alters and refines the raw material that entered the site. In this case, there is no comparable process occurring at the . . . [Warehouse]. Here the Taxpayer is not changing or altering the content or form of the vitamins, rather just sorting them into smaller quantities and placing them in containers with the necessary attributes and labels for retail sale.

We find the focus on the manufacturing site in the statute and rule as detailed above to be dispositive here, particularly in light of the requirement to construe exemptions narrowly. Based on the detail and information provided, the Taxpayer has not established that its activities at the . . . [Warehouse] constitute a qualifying manufacturing operation. Accordingly, we sustain the Audit Division's conclusion that the Taxpayer is ineligible for an exemption from retail sales and use tax for qualifying machinery and equipment provided in RCW 82.08.02565 and 82.12.02565 and sustain the assessment as issued.

DECISION AND DISPOSITION

The Taxpayer's petition is denied.

Dated this 15th day of September 2021.

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the present case, the vitamins are already presorted by barcodes[,] and the form of the vitamins does not change—they are not "compressed" or otherwise altered in order to package them in individual bottles. Here, the activities are packaging activities where the process does not significantly change the physical form of the vitamins like the change to the mixed recycling materials in *FPR II*.]