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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. 04-0130
... )	
)	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .
)	Docket No. . . .

RULE 13601; RCW 82.08.02565: SALES AND USE TAX – M&E EXEMPTION – ROCK CRUSHING EQUIPMENT. An earth-moving contractor’s purchase of rock crushing equipment does not qualify for the M&E sales and use tax exemption when the equipment is used to crush rock that is not sold.

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.

STATEMENT OF CASE:

Lewis, A.L.J. -- . . . (“Taxpayer”)<sup>1</sup> appeals the Department of Revenue’s (“Department”) Audit Division’s disallowance of a Machinery and Equipment (“M&E”) retail sales and use tax exemption taken on the purchase and use of a rock crusher. The rock crusher is used the majority of time to crush rock owned by [Taxpayer’s] customers to build logging roads. The Department disallowed the exemption concluding the equipment was not used the majority of the time “in a manufacturing operation.” We affirm the assessment having concluded that the equipment did not qualify for the exemption because the exemption’s definition of use in a “manufacturing operation” requires the sale of the good produced. In this case, the qualifying sale does not occur when Taxpayer crushes rock that already belongs to its customers.<sup>2</sup>

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

<sup>2</sup> Taxpayer does not dispute that the rock crusher was used more than 50% of the time in such nonqualifying use.

## ISSUE:

Whether an earth-moving contractor's purchase of rock-crushing equipment qualifies for the M&E exemption when the equipment's predominant use is to crush its customers' rock for use in building logging roads?

## FINDINGS OF FACT:

Taxpayer constructs logging roads. The Department audited Taxpayer's books and records for the period January 1, 1999 through June 30, 2002. On May 1, 2003 the Department issued two assessments: One, assessment was for \$ . . . ;<sup>3</sup> the other assessment was for \$ . . . . Taxpayer does not protest the first assessment having paid it in full on April 24, 2003.

The second assessment recorded use tax and interest related to the acquisition and repair of rock-crushing equipment. Taxpayer did not pay retail sales or use tax on the purchase and repair of rock-crushing equipment believing the purchases qualified for the M&E sales and use tax exemptions. The Audit Division disallowed the exemptions and assessed the deferred sales tax/use tax concluding that the exemption did not apply because the rock was not sold. The crushed rock was not sold because the equipment crushed rock belonging to [Taxpayer's] customers for use in building logging roads belonging to Taxpayer's customers. According to the audit report:

The equipment is used to crush rock, which is used by the taxpayer to build logging roads for landowners or holders of timber harvest contracts. The rock in question usually belonged to the landowner or holder of the timber harvest contract. After crushing, the rock is then provided to the taxpayer for use in building log roads. The taxpayer does produce some crushed rock for sale. Review of the taxpayer's record show that the rock [sold] is considerably less than 50 percent of the total crushed rock produced. The taxpayer predominantly produces crushed rock for use in the log roads that it contracts to build.

Taxpayer disagreed with the assessment and on May 20, 2003 filed a petition requesting cancellation of the assessment. Taxpayer maintained the Department erred in disallowing the M&E exemption because the rock was sold, albeit "along with other products and services in the construction of logging roads." In the alternative, Taxpayer argued that the rock crushing activity should be considered an integral part of the logging activity. Taxpayer "would essentially be a processor for hire" manufacturing articles integral to the logging operation.

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<sup>3</sup> The assessment recorded retail sales tax on the casual sale of assets and use tax on materials incorporated into logging roads.

## ANALYSIS:

RCW 82.08.02565(1) provides the retail sales tax M&E exemption.

The [retail sales] tax . . . shall not apply to sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation . . . or to sales of or charges made for labor and services rendered in respect to . . . repairing . . . the machinery and equipment . . . .

WAC 458-20-13601 (“Rule 13601”) implements the statute. It describes eligibility for the M&E exemption by stating the requirements as:

Machinery and equipment used directly in a qualifying operation by a qualifying person is eligible for the exemption, subject to overcoming the majority use threshold.

The M&E exemption, like all tax exemptions in Washington, is strictly construed in favor of application of the tax and against the person claiming the exemption. *See, e.g.*, Det. No. 01-007, 20 WTD 214 (2001). The burden of proof is upon the one claiming the exemption. *See, e.g.*, *Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972); *All-State Constr. Co. v. Gordon*, 70 Wn.2d 657, 425 P.2d 16 (1967); *Yakima Fruit Growers Ass’n v. Henneford*, 187 Wash. 252, 258, 60 P.2d 62 (1936).

Thus, for the exemption to apply, Taxpayer must satisfy all its requirements: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation; plus overcome the majority use threshold.

It is unchallenged that Taxpayer satisfied requirements 1, 2, 3, and 4. Requirement 1, **a sale**, was satisfied because Taxpayer purchased the rock crushing equipment. Requirement 2, **to a manufacturer or processor for hire**, was satisfied because crushing rock is a manufacturing activity.<sup>4</sup> Requirement 3, **of machinery and equipment**, was satisfied because rock crushing equipment meets the definition.<sup>5</sup> Requirement 4, **used directly**, was satisfied because the rock crusher “acts upon or interacts with an item of personal property,” the rock.<sup>6</sup>

Thus, whether Taxpayer’s rock crushing equipment qualifies for the M&E exemption turns on requirement 5, whether Taxpayer used the equipment “**in a manufacturing operation**” and satisfied the majority use threshold.

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<sup>4</sup> WAC 458-20-136(2)(a)(iii) specifically states that crushing rock is a manufacturing activity.

<sup>5</sup> Rule 13601(6).

<sup>6</sup> In addition, Rule 13601(9)(a) lists “rock crushers” as equipment that meets the definition of “used directly.”

RCW 82.08.02565(2)(d) defines a “manufacturing operation” as “the manufacturing of articles, substances, or commodities **for sale** as tangible personal property. (Bolding added.)”<sup>7</sup> The statute is clear that to qualify as a “manufacturing operation” the item manufactured must be sold. Even as a processor for hire, it is expected that the goods manufactured will be sold by the owner of the materials. In this case, the crushed rock, which the customers owned, was not sold, but spread on their logging roads.

Rule 13601(5) explains:

A processor for hire who does not sell tangible personal property is eligible for the exemption if the processor for hire manufactures articles, substances, or commodities that will be **sold** by a manufacturer. For example, a person who is a processor for hire but who is manufacturing with regard to tangible personal property **that will be used** by the manufacturer, rather than sold by the manufacturer, is **not** eligible. (Bolding added.)

Taxpayer is not eligible for the exemption when it builds a logging road with rock it has crushed that belongs to the customer because the rock is not sold. Taxpayer’s customer does not sell the rock that Taxpayer crushes. Similarly, Taxpayer does not sell the rock it crushes. Thus, neither party sells the rock. Accordingly, the rock crushing equipment, by definition, is not used in a “manufacturing operation.” In making this conclusion, we reject Taxpayer’s contention that the crushing of a customer’s rock constitutes a sale, based on RCW 82.04.040’s definition of “sale”:

"Sale" means any transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified as a "sale at retail" or "retail sale" under RCW 82.04.050. It includes renting or leasing, conditional sale contracts, leases with option to purchase, and any contract under which possession of the property is given to the purchaser but title is retained by the vendor as security for the payment of the purchase price. It also includes the furnishing of food, drink, or meals for compensation whether consumed upon the premises or not.

Taxpayer argues that because Taxpayer has “possession” of the rock it meets the RCW 82.04.050 definition of sale. We disagree. It is apparent from the plain reading of the statute that the inclusion of “possession of property for a valuable consideration” refers to the “includes renting or leasing, conditional sale contracts, leases with option to purchase, and any contract under which possession of the property is given to the purchaser but title is retained by the

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<sup>7</sup> In addition, Rule 13601(3)(g)(i) explains:

Neither duration or temporary nature of the manufacturing activity nor mobility of the equipment determine whether a manufacturing operation exists. For example, operations using portable saw mills or rock crushing equipment are considered “manufacturing operations” if the activity in which the person is engaged is manufacturing. Rock crushing equipment that deposits material onto a roadway is not used in a manufacturing operation because this is part of a constructing activity, not a manufacturing activity.

Thus, both from the statute and rule rock crushing equipment that deposits material onto a roadway does not qualify for the M&E exemption.

vendor as security for the payment of the purchase price.” The customers do not retain legal title as security for payment under the facts of this case. Here, Taxpayer is not paying for “possession of the property,” rather Taxpayer’s customers are paying Taxpayer to “possess” the property while it crushes the rock. The possession of rock while Taxpayer crushes it is a bailment, not a sale.<sup>8</sup>

The audit report acknowledges that the equipment does have some qualifying use, when it crushes and sells rock [Taxpayer] owns. The audit report states “[t]he taxpayer does produce some crushed rock for sale.” However, “[t]he taxpayer predominantly produces crushed rock for use in the log roads that it contracts to build. Review of the taxpayers (sic) show that the rock produced for sale is considerably less than 50 percent of the total crushed rock produced.”

The amount of use is important because machinery and equipment:

. . . used directly in a qualifying manner and used in a nonqualifying manner is eligible for the exemption only if the qualifying use satisfies the **majority use requirement**. . . . **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 retain 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.<sup>9</sup> (Bolding and footnote added.)

<sup>8</sup> WAC 458-20-211(2)(b) defines bailment as:

The term "bailment" refers to the act of granting to another the temporary right of possession to and use of tangible personal property for a stated purpose without consideration to the grantor.

<sup>9</sup> Majority use is measured by looking at the use of an item during a calendar year using any of the following:

(i) Time. Time is measured using hours, days, or other unit of time, with qualifying use of the M&E the numerator, and total time used the denominator. Suitable records for time measurement include employee time sheets or equipment time use logs.

(ii) Value. Value means the value to the person, measured by revenue if the qualifying and nonqualifying uses both produce revenue. Value is measured using gross revenue, with revenue from qualifying use of the M&E the numerator, and total revenue from use of the M&E the denominator. If there is no revenue associated with the use of the M&E, such as in-house accounting use of a computer system, the value basis may not be used. Suitable records for value measurement include taxpayer sales journals, ledgers, account books, invoices, and other summary records.

(iii) Volume. Volume is measured using amount of product, with volume from qualifying use of the M&E the numerator and total volume from use of the M&E the denominator. Suitable records for volume measurement include production numbers, tonnage, and dimensions.

(iv) Other comparable measurement for comparison. The department may agree to allow a taxpayer to use another measure for comparison, provided that the method results in a comparison between qualifying and nonqualifying uses. For example, if work patterns or routines demonstrate typical behavior, the taxpayer can satisfy the majority use test using work site surveys as proof.

(b) Each piece of M&E does not require a separate record if the taxpayer can establish that it is reasonable to bundle M&E into classes. Classes may be created only from similar pieces of machinery and equipment

The rock crushing equipment does not qualify for the M&E exemption because the majority of the equipment's use is nonqualifying.

In concluding the rock crushing equipment does not qualify for the M&E exemption we considered and rejected Taxpayer's logic that the rock crushing equipment qualifies for the M&E exemption because:

- logging is a manufacturing activity;
- the building of logging roads is part of the logging activity;
- thus, rock crushing equipment used to build logging roads is used in a manufacturing activity;
- rock crushing equipment qualifies for the M&E exemption because it is used in a manufacturing activity.

While Taxpayer's logic may conclude that the rock crushing equipment is used in a manufacturing activity, it does not follow that the equipment automatically qualifies for the M&E exemption. The M&E exemption is not a blanket exemption for any and all equipment used in a manufacturing activity. Rather, the legislature provided that the exemption be allowed only for equipment meeting the qualifications of the exemption. In this case, the rock crushing equipment does not meet the legislative mandated requirements of the M&E exemption.

For a processor for hire to be entitled to the machinery and equipment exemption, the new item of tangible personal property it creates through its use of the equipment must be for sale by its customer. It does not qualify if the property created is for the commercial or industrial use of that customer. Rule 136(3)(a) defines "processor for hire" as "a person that performs labor and mechanical services upon property belonging to others so that as a result a new, different, or useful article of tangible personal property is produced for sale," but also for "commercial or industrial use." While processors for hire, like manufacturers, produce new and different products, only

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and only if the uses of the pieces are the same. For example, forklifts of various sizes and models can be bundled together if the forklifts are doing the same work, as in moving wrapped product from the assembly line to a storage area. An example of when not to bundle classes of M&E for purposes of the majority use threshold is the use of a computer that controls a machine through numerical control versus use of a computer that creates a camera ready page for printing.

(c) Typically, whether the majority use threshold is met is decided on a case-by-case basis, looking at the specific manufacturing operation in which the item is being used. However, for purposes of applying the majority use threshold, the department may develop industry-wide standards. For instance, the aggregate industry uses concrete mixer trucks in a consistent manner across the industry. Based on a comparison of selling prices of the processed product picked up by the customer at the manufacturing site and delivery prices to a customer location, and taking into consideration the qualifying activity (interacting with tangible personal property) of the machinery and equipment compared to the nonqualifying activity (delivering the product) of the machinery and equipment, the department has determined that concrete trucks qualify under the majority use threshold. Only in those limited instances where it is apparent that the use of the concrete truck is atypical for the industry would the taxpayer be required to provide recordkeeping on the use of the truck in order to support the exemption. Rule 13601(10).

the equipment that is used in a “manufacturing operation” qualifies for the M&E exemption. “Manufacturing operation” as defined in RCW 82.08.02565(2)(d) means “the manufacturing of articles, substances, or commodities **for sale** as tangible personal property.” (Bolding added.) Thus, to qualify for the M&E exemption, the equipment must produce goods which are sold. Similarly, the equipment that a processor for hire uses to produce goods for a commercial or industrial use do not qualify if the goods are not sold. Qualification for the exemption requires that each component of the exemption be met. . . .

DECISION AND DISPOSITION:

Taxpayer’s petition is denied.

Dated this 28<sup>th</sup> day of May, 2004.