

Cite as Det. No. 05-0176, 26 WTD 136 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition Appealing a Letter)	<u>D E T E R M I N A T I O N</u>
Ruling of Prior Determination of Tax Liability)	
)	No. 05-0176
)	
...)	
)	Registration No. . . .
)	Docket No. . . .
)	

- [1] RULE 13501, RULE 224; RCW 82.04.280(3) RCW 82.04.220: SERVICE & OTHER BUSINESS ACTIVITIES B&O TAX - PROCESSING FOR HIRE – SCALING OF LOGS – SORTING YARD OPERATIONS – REMOVAL OF BARK. Sorting yard operations including weighing, tagging, banding, appraising and sorting of logs, as well as the scaling of logs and the removal of bark are not manufacturing activities or processing for hire. They are service activities subject to service and other business activities B&O tax.

- [2] RULE 13601; RCW 82.08.02565: RETAIL SALES TAX – M&E EXEMPTION – TESTING OPERATION – SCALING LOGS – DRYING WOOD CHIPS. The scaling of logs is not a testing operation for M&E exemption purposes because it is the mere measuring of board feet that does not determine the properties, qualities, and limitations of the logs. For the same reason, the sampling of moisture content in wood chips is not a testing activity for M&E exemption purposes because it simply assists in determining the quantity of wood chips being bought and sold. Therefore, machinery and equipment used in scaling logs and drying wood chips do not qualify for the M&E exemption.

- [3] RULE 13601; RCW 82.08.02565: RETAIL SALES TAX – M&E EXEMPTION – TESTING OPERATION – CHIP CLASSIFIERS. Wood chip classifiers used in testing operations at testing sites qualify for the M&E exemption because they help determine the properties, qualities, and limitations of the wood chips that are eventually bought and 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.

De Luca, A.L.J. – A corporation headquartered in Washington appeals a letter ruling that denied it the retail sales tax and use tax exemptions intended for the purchase of machinery and equipment (M&E) used in either processing for hire or testing for a manufacturer. We conclude the taxpayer is not entitled to the M&E tax exemptions except for chip classifiers that it purchases.¹

ISSUES

1. Is the taxpayer a processor for hire because it scales logs at its log yard, which requires some cutting and measuring of the logs?
2. Does the use of machinery and equipment for log stacking, log loading, log debarking, and scaling in a log yard qualify as “testing” for the retail sales and use tax exemptions provided in RCW 82.08.02565, RCW 82.12.02565, and WAC 458-20-13601(3)(o) (Rule 13601)?
3. Does the use of certain machinery and equipment in the taxpayer’s wood chip reload operation qualify as “testing” for the retail sales tax and use tax exemptions provided in RCW 82.08.02565, RCW 82.12.02565, and Rule 13601(3)(o)?
4. Is the taxpayer’s scaling of logs and drying and classifying of wood chips in ovens at its log yard “testing” that is used directly in a “testing operation”?

FINDINGS OF FACT

The taxpayer is in the business of commercial marine towing, which includes towing rafts of logs and barges containing wood chips. In connection with its marine towing business, the taxpayer operates log yards and wood chip reloading facilities where it provides services for shippers that own the logs and wood chips and who are manufacturers. Such services include log scaling and wood chip grading. The Taxpayer Information and Education (TI&E) Section of the Department of Revenue (DOR) in a letter dated August 29, 2003, that was in reply to the taxpayer’s request, ruled that log scaling and chip grading do not constitute “testing” as that term is used in the M&E exemption statutes. TI&E found that the measuring of logs and grading of wood chips did not meet the statutory definition of testing, which means performing activities to establish or determine the properties, qualities, and limitations of tangible personal property. Instead, TI&E found the measuring and grading activities were typically part of a sorting and handling process of logs and wood chips in a log yard. The taxpayer appealed the letter ruling to DOR’s Appeals Division.

When logs are delivered by third party motor carriers to the taxpayer’s log yard, the logs are tagged, identified, scaled, sorted, and weighed. The logs are owned by manufacturers/shippers.

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

Briefly, log scaling is the measuring of a log to determine the board foot volume of wood in it, using a maximum scaling length of forty feet. Measurements are made pursuant to the Scribner Log Rule System that measures both gross length and diameter and then reduces the gross measurements to net measurements for any defect losses. *See, e.g.*, WAC 458-40-640. Scaling is done by either the taxpayer or a third party at the taxpayer's log yard. As part of the scaling, the taxpayer cuts logs and measures them. The taxpayer also debarks the logs at its log yard. The taxpayer's employees do the subsequent grading and sorting. The taxpayer provides the scaling information to the manufacturer who, in turn, uses the information to determine the value and eventual use of the log. For example, the manufacturer may decide to make dimensional lumber for building, or it may sell the log overseas for further processing, or make it into paper or other products.

In addition to a log debarking machine, the taxpayer has equipment to transport and sort the logs within its yard. That equipment includes log stackers used for unloading logs from trucks and rolling them out to prepare for scaling. Log stackers also move logs to weight scales and dump logs into water for subsequent transport. Log loaders are used to sort logs by scale, grading standards, and appearance. They also move logs from the debarking machine and prepare bundles of debarked logs for shipping. There are wheel loaders to move bark to a place for the manufacture of "hog fuel" (ground up wood used for fuel.) After the logs have been debarked, scaled, graded, sorted, etc. and placed in rafts in water, the taxpayer will tow them to destinations selected by the shippers/manufacturers, where the manufacturers begin their manufacturing operations.

The taxpayer receives wood chips from local sawmills by truck at its facilities in Washington. The wood chips are owned by manufacturers/shippers. The trucks are weighed on the taxpayer's truck scales. The chips are then unloaded and sorted into piles according to specie. All loads are sampled for moisture content. Samples are weighed wet, then dried in the taxpayer's chip oven for a certain number of hours at a set temperature and then weighed again. The taxpayer will determine the percentage of moisture in the dried chip samples and then apply those percentages to each load to determine the BDU (Bone Dry units) per load. Briefly, BDU means 2400 pounds of chips dried to a constant weight at 220 degrees Fahrenheit. This step is necessary because chips are bought and sold on dry fiber weight. Additionally, at least for one shipper, every eighth load of wood chips from each mill is sampled for quality using a chip classifier. The chips are weighed and measured according to certain quality standards with the results sent to the chip owner and the originating mill. Based on inventory needs or at the shipper's request, the taxpayer tows empty barges to its chip reload facility where the chips are loaded onto the barges using an overhead conveyor system. The taxpayer then tows the chips to the manufacturers' plants, which can be up to a hundred miles or more, where the manufacturers begin their manufacturing operations.

In handling the wood chips, the taxpayer purchases chip ovens to determine the moisture content. It also purchases chip classifiers to determine the grade of chips by size. Additionally, it purchases chip dozers and wheel loaders to move the chips within the yard and at the chip reload facility.

ANALYSIS

[1] The M&E exemption in RCW 82.08.02565 provides:

(1) 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 for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation

WAC 458-20-13601 (Rule 13601) is DOR's administrative rule that explains the M&E exemptions. The taxpayer first contends that it is entitled to the M&E exemptions because it conducts manufacturing as a processor for hire. Rule 13601(5). The taxpayer argues it is a processor for hire because while scaling the logs it cuts and measures them to determine the amount of board feet in them. Accordingly, RCW 82.04.120 defines "manufacturing" to include "cutting, delimiting, and measuring of felled, cut or taken trees."

The term "processing for hire" is not defined by statute; however, DOR's administrative rule, WAC 458-20-136(3)(a) (Rule 136) provides the following definition:

The term "processor for hire" means a person who 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 or commercial or industrial use. Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon his or her own materials.

WAC 458-20-13501 (Rule 13501) explains the application of the tax laws to persons performing activities associated with timber harvest operations. It provides in part:

(4) **Processors for hire.** Persons performing labor or mechanical services for timber harvesters during the manufacturing portion of a timber harvest operation are subject to the processing for hire B&O tax. RCW 82.04.280(3). (See also WAC 458-20-136 for more information regarding processors for hire.)

For example, a person delimiting and bucking severed trees at the harvest site is a processor for hire if another person owns the severed trees. . . .

DOR has addressed this issue of what activities related to timber harvesting constitute processing for hire previously, when it stated:

Cutting, delimiting, and measuring of felled, cut, or taken trees typically occurs at the harvest site in order to enable their transportation elsewhere for further processing. Because cutting, delimiting, and measuring is the predominant activity occurring at the

harvest site once the trees have been felled, cut, or taken, a person performing these activities at the harvest site upon trees owned by another is a processor for hire.

However, we do not believe that cutting, delimiting, and measuring of felled, cut, or taken trees is the predominant activity at either the Sawmill Site or the Log Yard. By the time the logs have been transported to the Sawmill Site or the Log Yard, they have already been cut, delimited, or measured to some degree. Though the Taxpayer may perform some additional processing of the logs, the predominant activities at the Sawmill Site and Log yard consist of storage and handling activities, which do not constitute processing for hire.

Det. No. 04-0097, 24 WTD 92 (2005). Similarly, in the present case the taxpayer admits it does not delimit the logs or fell the trees at the harvest sites. Rather, its work is done in its log yard. Indeed, under Rule 13501(9)(b) scaling services are subject to service B&O tax and are not considered processing for hire. Likewise, sorting yard operations that include services such as weighing, tagging, banding, appraising, and sorting of logs are also subject to service B&O tax, not processing for hire B&O tax. Rule 13501(9)(g); Det. No. 04-0097. Furthermore, the mere removal of bark from logs is not a manufacturing activity. Rule 13501(2)(c)(iii). In sum, the taxpayer is not a processor for hire. Therefore, the taxpayer is not entitled to the M&E exemption on that basis.

[2] Alternatively, the taxpayer asserts that the scaling and grading of the logs is a testing operation as defined in Rule 13601(3)(o) because the taxpayer determines the number of board feet and quality of the logs. That information helps the owner/manufacture determine the logs' value and use before the manufacturer begins its manufacturing operation. Thus, the taxpayer contends the scaling/testing is an essential part of the manufacturing process. Consequently, the taxpayer argues the log stackers, log loaders, wheel loaders, log debarkers, etc. are equipment used to transport and sort the logs within the yard and are necessary to perform the scaling/testing and are subject to the M&E exemption. Thus, according to the taxpayer, all of the above-mentioned equipment is tax exempt because it is primarily used for scaling/testing. RCW 82.08.02565(2)(c)(ii), (iii).

Similarly, the taxpayer argues the chip ovens, chip classifier, and the chip dozers used at its chip reload facilities are tax exempt because that is where the taxpayer measures the moisture content under industry-standard conditions and grades the chips. As noted, the taxpayer then informs the manufacturers of this information prior to towing the wood chips to the manufacturers' manufacturing sites where they begin their manufacturing operations. The manufacturers use this information to determine what products to manufacture.

"Testing" means "activities performed to establish or determine the properties, qualities, and limitations of tangible personal property." RCW 82.08.02565(2)(g); Rule 13601(3)(o). And "Testing operation" means:

[T]he testing of tangible personal property for a manufacturer or processor for hire. A testing operation begins at the point where the tangible personal property enters the testing site and ends at the point where the tangible personal property leaves the testing site.

RCW 82.08.02565(2)(h); Rule 13601(3)(p).

We conclude that the taxpayer's scaling activities do not meet the statute's definition of "testing." Scaling, as discussed above, is the measuring of board feet in a log. Mere measuring of board feet does not come within this definition because it does not determine the properties, qualities, and limitations of the logs. Instead, the taxpayer is measuring the logs to inform the manufacturer of how many board feet the manufacturer bought from third parties. Thus, the machinery and equipment used in scaling, including the loaders, stackers, debarkers, etc., do not qualify for the M&E exemptions.

Likewise, we conclude that the sampling of moisture content in each load of wood chips also is not a testing activity. The taxpayer weighs the samples wet before they are put into the oven. After drying, the taxpayer weighs the samples again to determine how much moisture was in the samples and thereby in the respective loads of woodchips. The taxpayer measures the moisture content so that the buyer of the wood chips knows how much of a load that it is buying actually consists of wood and how much of it is water. That information allows the buyer to determine the load's value, because wood chips are bought and sold on dry fiber weight. Thus, drying the wood chips is measuring the water content by weighing them before and after the drying. It is not testing as defined in RCW 82.08.02565(2)(g) because [the taxpayer] is not determining the properties, qualities, and limitations of the chips, but [only] the quantity being purchased. Consequently, the wood chip ovens and chip dozer do not qualify for the M&E exemptions.

[3] But we conclude that the chip classifiers qualify for the M&E exemptions. Our review of various chip classifiers shows that they are table-sized machines that contain trays or screens with a graduated series of holes in them. The trays or screens are stacked with the largest holes on top and trays or screens with smaller holes beneath the larger ones in descending order. The chip samples are placed on the top tray or screen. A motor in the chip classifier is turned on to shake the chip samples through the holes. The results of the test show the sizes and dimensions of the chips and how they are to be classified according to industry standards. Testing for the size and dimensions of the chips helps determine their quality and the results are important for both the producer and the buyer of the wood chips by informing them that the wood chip loads either meet those standards or not. Unlike scaling of logs and drying wood chips, wood chip classifying is not for the purposes of informing the manufacturers how much raw material they purchased, but to inform them of the properties, qualities, and limitations of the wood chips they purchased. RCW 82.08.02565(2)(g); Rule 13601(3)(o). As long as this testing begins at the point where the wood chips enter the testing site and ends at the point where the wood chips leave the testing site, then the chip classifiers qualify for the M&E exemption used in a testing operation. RCW 82.08.02565(2)(h); Rule 13601(3)(p).

DECISION AND DISPOSITION

The taxpayer's petition is denied in part and granted in part.

Dated this 18th day of August, 2005.