

Cite as Det. No. 00-070, 20 WTD 247 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Approval of)	<u>D E T E R M I N A T I O N</u>
High Technology Application for Sales Tax)	
Deferral)	
)	No. 00-070
)	
...)	Registration No. . . .

RCW 82.63.010(7): SALES TAX -- USE TAX -- HIGH TECH BUSINESS TAX DEFERRALS -- REPLACEMENT MACHINERY, EQUIPMENT, PARTS AND REPAIRS. Replacement machinery, equipment, and replacement and repair parts and labor and services rendered in respect to installing, repairing, cleaning, altering or improving such machinery, equipment, and parts do not qualify as eligible investment projects under chapter 82.63 RCW (Tax Deferrals for High Technology Businesses).

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.

NATURE OF ACTION:

A corporation appeals a decision to deny its application for a high technology sales tax and use tax deferral/exemption.¹

FACTS:

De Luca, A.L.J. -- The taxpayer is a corporation with its headquarters located in the state of Washington. The taxpayer develops and sells computer software. Pursuant to RCW 82.63.020, the taxpayer applied to the Department of Revenue (the Department) for a deferral of retail sales tax and use tax for the taxpayer's "VFD Project." "VFD" is short for Variable Frequency Drives. When certain buildings were constructed on its campus, the taxpayer had contractors install VFDs in the buildings to ensure there would be no critical failures associated with their heating, ventilation, and air conditioning (HVAC) systems. VFDs work with an HVAC system's motors to deliver proper heating, cooling, and ventilation. The taxpayer's computing equipment

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

needs to be kept sufficiently cool to operate properly. The taxpayer explains such HVAC failures could jeopardize the operation of its computer laboratories and office space. The taxpayer installed new VFDs because the original VFDs were undersized and improperly designed to service the computer laboratories and office space and were the source of numerous HVAC failures in the . . . buildings.

The Department's Special Programs Division in a letter denied the taxpayer's application for the tax deferral because the application was for replacement of equipment, rather than for expansion or renovation of an existing facility.

TAXPAYER'S EXCEPTION:

The taxpayer contends it is qualified for the tax deferral because installing the new VFDs will enable the HVAC system to provide the necessary cooling required for existing and future upgrades of computing equipment, thereby diversifying the taxpayer's research and development capabilities in conformance with RCW 82.63.010(7). *Infra*.

ISSUE:

Does the replacement of original HVAC-related equipment (the VFDs) with similar upgraded equipment qualify for the sales tax/use tax deferral/exemption allowed high technology businesses under chapter 82.63 RCW if the original equipment qualified for the tax deferral/exemption?

DISCUSSION:

The Legislature enacted chapter 82.63 RCW, effective January 1, 1995, to allow qualified high technology taxpayers to defer payment of sales tax or use tax on eligible buildings, equipment, and machinery, including labor and services rendered in the planning, installation, and construction or improvement of an investment project. RCW 82.63.010(9).²

The Legislature expressed its purpose for enacting the law in RCW 82.63.005. The statute clearly demonstrates the Legislature's main concern in authorizing the tax deferral program. That is, many high-technology businesses incur significant costs associated with research and development and pilot scale manufacturing many years before they can produce a marketable product. At the same time, state policy discouraged the growth of these companies by taxing them long before they became profitable. Thus, the high technology deferral program is

² While this law allows the deferral of sales tax and use tax payments, chapter 82.63 RCW essentially provides an exemption from the taxes. RCW 82.63.045 provides that the taxes need not be repaid as long as the investment project is used for qualified purposes and/or the purchases would be exempt under the manufacturing machinery and equipment (M&E) tax exemption found in RCW 82.08.02565 and RCW 82.12.02565. We note an HVAC system is not eligible for the M&E tax exemption. See RCW 82.08.02565(2)(b)(iv). Thus, the taxpayer is limited to seeking the tax deferral/exemption pursuant to chapter 82.63 RCW.

designed to alleviate the front-end tax burden of businesses that commit resources on the speculation that those expended resources will eventually result in a marketable product.

However, this statute reveals the Legislature intended the tax deferrals for high technology businesses be limited in scope with strict accountability standards. As noted, the Legislature in RCW 82.63.045 removed the requirement for qualified taxpayers to repay the deferred tax. Thus, there is no distinguishable difference between this deferral program and a tax exemption. Consequently, we must construe the tax deferral program narrowly, like all other exemptions. *See Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 500 P.2d 764 (1974).

The taxpayer contends it qualifies for the tax deferral/exemption program pursuant to RCW 82.63.010(7) because the new VFDs will allow it to diversify its research and development capabilities. That statutory section provides:

(7) "Eligible investment project" means an investment project which either initiates a new operation, or expands or diversifies a current operation by expanding, renovating, or equipping an existing facility. The lessor or owner of the qualified building is not eligible for a deferral unless the underlying ownership of the buildings, machinery, and equipment vests exclusively in the same person, or unless the lessor by written contract agrees to pass the economic benefit of the deferral to the lessee in the form of reduced rent payments.

Thus, it is possible to qualify for the tax deferral/exemption as an "eligible investment project" if a taxpayer expands or diversifies a current operation by expanding, renovating, or equipping an existing facility. The question is whether the taxpayer is diversifying its current operation by replacing the original VFDs in its buildings with better ones to improve its HVAC systems in those buildings, thereby allowing its computer laboratories and computing equipment to work as originally intended.

"Diversify" is commonly defined as...

to make different...1. To make diverse; give variety to; vary...3. To expand (a business, line of products, etc.) by increasing the variety of things produced or of operations undertaken....

Webster's New World Dictionary 411 (2nd College ed. 1974). We recognize the importance of the taxpayer's need to have an HVAC system that functions properly to keep its computing equipment and office space operating without critical failures. With the VFD upgrade, the taxpayer should be able to operate its computer laboratories as it originally intended and, hopefully, the VFD upgrade can accommodate future upgrades of computing equipment. However, we find replacing VFDs to improve the HVAC system is not diversifying a current operation because the taxpayer is not "expanding, renovating, or equipping an existing facility", as required by statute, but merely replacing the original VFDs with better ones. The connection between replacing the VFDs and diversifying the taxpayer's current operation is too tenuous to qualify as an eligible investment project.

Again, tax exemptions are narrowly construed. *Budget Rent-A-Car, supra*. We do not find the language in RCW 82.63.010(7) supports the tax deferral/exemption for merely replacing existing parts or equipment to improve an HVAC system. Unlike RCW 82.08.02565(2)(a) (the M&E exemption statute), there is no express language in RCW 82.63.010(7) exempting repair parts or replacement parts from tax.

Our decision that such replacement equipment or parts do not qualify as an eligible investment project is supported by legislative activity during the 1997 regular session. Specifically, House Bill 1445 and an identical Substitute House Bill 1445 were introduced and referred to the Committee on Trade & Economic Development. The committee passed the substitute bill after receiving testimony in its favor from affected associations, taxpayers, and the then-director of the Department of Revenue. However, the bills did not pass the Legislature and did not become law.

The bills would have allowed replacement equipment to qualify as eligible investment projects by amending RCW 82.63.010(7) with the following bracketed and italicized language:

"Eligible investment project" means an investment project which either initiates a new operation, or expands or diversifies a current operation by expanding, renovating, or equipping an existing facility. *{The term includes the acquisition of qualified machinery and equipment that is a direct replacement for qualified machinery and equipment acquired as part of the initial investment project.}* The lessor or owner of the qualified building is not eligible for a deferral unless the underlying ownership of the buildings, machinery, and equipment vests exclusively in the same person, or unless the lessor by written contract agrees to pass the economic benefit of the deferral to the lessee in the form of reduced rent payments.

These bills were introduced because their sponsors in the legislature, as well as the Department, certain taxpayers, and associations were concerned that the existing chapter 82.63.RCW did not provide tax deferrals/exemptions for replacement equipment, machinery, and parts. The committee members apparently agreed with that concern by passing the substitute bill in light of the House Bill Report for HB 1445. That report noted the Legislature in 1994 created the tax deferral program for high technology businesses (chapter 82.63 RCW). The report also noted the Legislature in 1995 enacted the M&E sales tax and use tax exemption for machinery and equipment used directly in a manufacturing operation or research and development operation by a manufacturer or processor for hire (RCW 82.08.02565 and RCW 82.12.02565). The report then adds:

In 1996, the statewide sales and use tax [M&E] exemption was expanded to include installing, repairing, cleaning, altering, or improving the machinery and equipment. It was later found that research and development firms that do not manufacture a product or license a product to be manufactured by others were not eligible for the tax exemption on machinery and equipment and replacement parts.

Summary of Substitute Bill: The high technology statewide sales and use tax deferral/exemption on machinery and equipment is expanded. The tax exemption applies to: (1) labor and services in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment and (2) replacement parts for the machinery and equipment that has a useful life of one year or more.

The fact that the bills did not pass the Legislature and become law is not decisive in reaching our decision, but it does support our decision that chapter 82.63 RCW currently does not provide the deferral/exemption the taxpayer seeks for the VFDs. We agree with the House Bill Report for HB 1445 and the letter ruling by the Department's Special Programs Division. Replacement machinery, equipment, and parts and repairs do not qualify as eligible investment projects under RCW 82.63.010(7).

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 21st day of April, 2000.