

Cite as Det. No. 99-256, 20 WTD 494 (2001)

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>
Interpretation of	)	
	)	No. 99-256
	)	
...	)	Registration No. . . .
	)	Interpretation
	)	
	)	

- [1] RCW 82.08.02565: SALES TAX – M&E EXEMPTION. An [engine] remanufacturer, which produces [engines] for sale, has a manufacturing operation with respect to the manufacturing machinery and equipment exemption.
- [2] RCW 82.08.02565: SALES TAX – M&E EXEMPTION. In order for an item of machinery and equipment to qualify for the machinery and equipment exemption, the majority of use of the item must be in a manufacturing operation.
- [3] RCW 82.08.02565: SALES TAX – M&E EXEMPTION. Buildings do not qualify for the machinery and equipment exemption. However some components of buildings are potentially eligible as fixtures or support facilities.

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:

An [engine] remanufacturing company appeals a ruling that its purchases of manufacturing equipment are subject to retail sales tax.<sup>1</sup>

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

### FACTS:

M. Pree, A.L.J. – . . . (taxpayer) remanufactures engines. The taxpayer plans to construct a metal building with an overhead crane to be used in its remanufacturing activity. It requested that the Department of Revenue (Department) provide a ruling that the cost of a metal building and other equipment purchased for the manufacturing activity be exempt from retail sales tax.

The Department's Taxpayer Education and Information Section (TI&E) considered the taxpayer's request and issued a letter stating that the taxpayer's purchases would not be exempt. The letter stated the taxpayer was not engaged in a manufacturing operation as required by the exemption statute (RCW 82.08.02565 and 82.12.02565). To qualify as a manufacturing operation, the [engines] would have to be produced for sale. Because the [customers] that owned the [engines] used them, the [engines] were not produced for sale. The TI&E letter did not address other issues.

While most of the taxpayer's customers [used the engines in their businesses] leasing companies owned some of the [engines]. The leasing companies rented the [engines] to the [customers]. Occasionally, the taxpayer took title to an [engine] and resold it.

The taxpayer plans to build a metal frame building to accommodate an overhead crane used on the [engines]. The taxpayer will install the crane on the ceiling of the building. . . . The taxpayer will also purchase other fixtures and equipment.

The taxpayer states that the purpose of the 23,000 square foot building is to support the crane. The building will be enclosed and heated. . . . A portion of the building will contain an office and area for inventory storage. The taxpayer attributes a value of 10% of the building cost to functions not related to the crane contending that the building was designed around the crane.

### ISSUES:

1. Does remanufacturing [engines] constitute a manufacturing operation for purposes of a sales/use tax exemption?
2. Is the purchase of machinery and equipment used both for qualifying and nonqualifying purposes eligible for the machinery and equipment exemption?
3. Does the cost of buildings qualify for the machinery and equipment exemption?

### DISCUSSION:

Processors for hire produce new, useful, or different articles of tangible personal property from materials owned by others. See WAC 458-20-136 (Rule 136). It is undisputed that the taxpayer produced a different article of tangible personal property, substantially altering each engine's properties (i.e. the remanufactured engine often had greater horsepower than when it was new).

[1] Under RCW 82.08.02565, sales of machinery and equipment used in manufacturing operations are exempt from retail sales tax. Subsection (2)(d) of that section defines manufacturing operation:

(d) "Manufacturing operation" means the manufacturing of articles, substances, or commodities for sale as tangible personal property. The manufacturing operation begins at the point where the raw materials enter the manufacturing site and ends at the point where the finished product leaves the manufacturing site . . .

Because the [customers] did not sell the [engines], but used them, TI&E did not consider the [engines] to be manufactured "for sale", and therefore, the machinery and equipment that the taxpayer seeks to exempt was not used in a manufacturing operation. In the case of the [engines] owned by the [customers], this analysis is correct.

However, regarding [engines] owned by leasing companies, the [engines] were produced for sale. The definition of sale includes renting or leasing. RCW 82.04.040. Likewise, the taxpayer's remanufacture of [engines] it owned and sold qualify it as a manufacturing operation. As long as the taxpayer manufactures tangible personal property for sale, its activity constitutes a manufacturing operation.

[2] However, RCW 82.08.02565 requires the taxpayer to use the machinery and equipment directly in a manufacturing operation. Machinery and equipment used to remanufacture [customers'] [engines] is not used directly in a manufacturing operation because the [engines] are not produced for sale. However, the taxpayer uses the same equipment to remanufacture its own [engines] or [engines] owned by leasing companies. The taxpayer uses the same machinery and equipment in its manufacturing operation as it uses it for the processing for hire done for the [customer].

The taxpayer's machinery and equipment qualifies for the exemption if the use of the item in the manufacturing operation is greater than the use in other activities. To make that determination, the nonqualifying use, which in this instance is use for retail activities, is compared to the use in the manufacturing operation. The majority use requirement was considered in the recent legislative enactment of the machinery and equipment exemption. In its 1999 revision of RCW 82.08.02565, the Legislature, as well as the Governor, considered whether a "majority use" test must be met for machinery and equipment to qualify for the exemption. After the legislation was introduced as House Bill 1887, the Department advised the House of Representatives Finance Committee it applied a majority use test to determine whether dual use machinery and equipment qualified for the exemption.<sup>2</sup> One example given the committee involved comparing revenue from sales of manufactured product with revenue generated from repair work.<sup>3</sup> Repaired items

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<sup>2</sup> Audit Practice Document submitted as part of Director Fred Kiga's testimony before the Finance Committee on March 4, 1999.

<sup>3</sup> *Id.*

would be returned to original owners to use as consumers. Aware the Department applied a majority use test, under the existing language in RCW 82.08.02565, the House of Representatives did not alter the relevant language. Following passage by the House of Representatives, the sponsors in the Senate discussed the majority use test.<sup>4</sup> One Senator inquired regarding the absence in the bill of the dual use standard regarding qualifying and nonqualifying use. Another Senator explained:

It is not necessary. The current administrative practice of DOR is "majority use," which means over 50 percent based on time, value, volume, or other measurement for comparison, is reasonable. It is within the administrative authority of the department to use this standard, both for the past and in the future. It is therefore appropriate for the department to put this standard in rule.

Again, the bill passed without changes to the applicable language. Finally, the Governor expressed his understanding in his veto message:

ESHB 1887 clarifies the scope of a tax exemption and is very important. Taxpayers who are eligible for the exemption, as well as our state and local governments, need the certainty that this bill will provide. I have assumed, as did the legislature (as indicated by our respective balance sheets), that there is no fiscal impact associated with sections 1 through 4 of the bill. That is based on the continuing application of the "majority use" standard for machinery and equipment that has both qualifying and nonqualifying uses. The majority use standard affords meaningful use of the exemption to taxpayers, is fair, and is a reasonable way to administer the exemption consistent with the law, legislative intent, and promotion of economic development in our state. I strongly support the Department of Revenue's continued use of this standard.

Clearly, a majority of the use of machinery and equipment must be in a qualified manufacturing operation for the exemption to apply. The percentage of revenue generated from [engines] produced for sale versus [engines] provided to and used by consumers will indicate whether the machinery and equipment qualifies. Additionally, we will also compare time, value, or other measurement factors to determine qualified use.

We have not given the taxpayer an opportunity to check with its customers. The remanufacture of the [engines] for sale is a qualifying operation. The taxpayer would be eligible for the exemption on that machinery and equipment used more in the manufacturing operation than in other activities. Therefore, because that could be the case, we will address the issues of whether the crane facility . . . qualif[ies] as machinery and equipment used directly in the manufacturing operation.

[3] RCW 82.08.2565(2)(a) provided:<sup>5</sup>

<sup>4</sup> Floor colloquy between the bill's prime sponsor, Senator Snyder, and a co sponsor, Senator Loveland ESHB 1887. Read at 3:01 PM April 16, 1999.

<sup>5</sup> Revised June 6, 1996.

"Machinery and equipment" means industrial fixtures, devices, and support facilities. "Machinery and equipment" includes pollution control equipment installed and used in a manufacturing operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation.

Industrial fixtures and support facilities are specifically included in the definition of machinery and equipment. Subsection (2)(b) provides "Machinery and equipment" does not include:

(v) Building fixtures that are not integral to the manufacturing operation that are permanently affixed to and become a physical part of a building, such as utility systems for heating, ventilation, air conditioning, communications, plumbing, or electrical.

While the crane did become a physical part of the building, its use was integral to the manufacturing operation. The charge for the crane, including any qualifying support facilities for the crane, would be exempt provided a majority of the use of the crane was in the manufacturing operation.

The entire building does not qualify for the exemption. Rule 13601, which was filed and immediately effective on May 28, 1999, provides that the building itself is not eligible for the exemption but the industrial fixtures and support facilities that become affixed to or part of the building might be eligible. The subsequent real property status of industrial fixtures does not affect eligibility for the exemption. The rule defines the word "building" in terms of function and states that "Buildings provide work space for people or shelter machinery and equipment." The components of the building that meet the definition of industrial fixture or support facility are potentially eligible for the exemption. Rule 13601 provides the following definition of "support facility":

"Support facility" means a part of a building or a structure or improvement, used to contain or steady an industrial fixture or device. A support facility must be specially designed and necessary for the proper functioning of the industrial fixture or device and must perform a function beyond being a building or a structure or an improvement. It must have a function relative to an industrial fixture or a device. To determine if some portion of a building is a support facility the parts of the building are examined. For example, a highly specialized structure, like a vibration reduction slab under a microchip clean room, is a support facility. Without the slab, the delicate instruments in the clean room would not function properly. The ceiling and walls of the clean room are not support facilities if they only serve to define the space and do not have a function relative to an industrial fixture or a device.

Pursuant to Rule 13601, the building containing the crane should be examined to determine what portion of the building is specially designed and necessary for the proper functioning of the crane.

. . .

DECISION AND DISPOSITION:

Unless the taxpayer can establish that the machinery and equipment in question satisfies the majority use test, the taxpayer is not eligible for the M&E exemption. In addition, to establish eligibility for the building or its components as a support facility, the taxpayer should examine the components of the building to determine what part, if any, of the building is specially designed and necessary for the proper functioning of the crane. The TI&E ruling is revised accordingly.

Dated this 18<sup>th</sup> day of August 1999.