

Cite as Det. No. 00-103, 20 WTD 67 (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>
Assessment)	
)	No. 00-103
)	
...)	Registration No. . . .
)	FY. . . /Audit No. . . .

RULE 13601; RCW 82.08.02565; RCW 82.12.02565: MANUFACTURING MACHINERY AND EQUIPMENT (“M&E”) EXEMPTION – USE DIRECTLY IN A MANUFACTURING OPERATION – LAPTOP COMPUTERS. To qualify for the M&E exemptions:, laptop computers must 1) direct or control machinery or equipment that acts upon or interacts with tangible personal property; or, 2) act upon or interact with an item of tangible personal property. Use of laptop computers that are essential to test the functioning of the machinery being manufactured qualify for the exemption. The verification of proper connections and internal communication, calibration, and testing of the assembled unit performed by the computers is an action that is part of the final stages of the manufacturing operation. This collection of information and verification process is accomplished through the interaction of the laptop computers with the cutting machine’s internal computer programs. As such, the laptop computers are “used directly” in a manufacturing operation as they interact with an item of tangible personal property.

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:

The Taxpayer, a manufacturer, protests the disallowance of the manufacturing and equipment (M&E) exemption from retail sales tax for computers it contends are used in the manufacturing process.¹

FACTS:

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

Kreger, A.L.J. – At the time of the audit at issue, . . . (the taxpayer) was engaged in business in Washington as a sole proprietor and was conducting business under the name In December of 1997, the Audit Division of the Department of Revenue (Department) conducted an examination of the taxpayer's business activities between January 1, 1993 and September 30, 1996 (the audit period). During that period, the taxpayer's business activities included the manufacturing of ultra high-powered water jet cutting systems and the manufacturing of custom parts for repairs to the cutting systems. Based on the information provided, the Audit Division determined that the taxpayer incorrectly reported some of the gross income of the business, and a tax assessment, Document No. FY. . . , was issued on December 31, 1996, for \$. . . . The assessment consisted of \$. . . in use tax, a credit for \$. . . of manufacturing other business and occupation (B&O) tax paid in error, and audit interest of \$. . . .

On January 7, 1997, the taxpayer filed an appeal challenging the Audit Division's conclusion that the computer equipment it purchased and used was not eligible for the M&E exemption from retail sales tax. Because the taxpayer did not pay retail sales tax when it purchased the computer equipment, specifically three laptops, the Audit Division assessed the use tax referenced above. The Department's Appeals Division refrained from issuing a decision on the taxpayer's appeal in anticipation of clarifying legislation of the statute that authorized M&E exemptions for manufacturers.

The taxpayer contends that the laptop computers at issue are integral to the manufacturing process and are used to control, guide and measure the equipment produced and are essential to the final steps of the manufacturing operation. The Audit Division denied the taxpayer's claim of entitlement to the M&E exemption from retail sales tax on the purchase of these computers based on the conclusion that the computers were not used directly in the manufacturing operation. The Audit Division considered the laptop computers merely tools the taxpayer used to convey software to the equipment. The taxpayer contends that the computers are used directly in the manufacturing process and specifically that they are essential to the testing, regulating, and aligning of the component pieces of the items manufactured.

During the audit period, the taxpayer manufactured ultra high-powered water jet cutting systems. The systems were manufactured in component parts, and the system consisted of numerous components. Once the manufacturing was completed, the taxpayer transported the components to the customer's location, assembled the parts, and installed them. Before installing the system at the customer's site, the taxpayer first assembled and tested the machinery at its manufacturing facility to ensure that the completed system was performing to the customer's specifications. The taxpayer characterized this assembly and testing process as the final stage of the manufacturing operation.

The taxpayer explained that the highly complex nature of the systems, and the need for precise assemblage and connection of the component parts to meet the customer's specifications, required diagnostic testing at its manufacturing plant and at the customer's site. In order to conduct the necessary testing to verify calibration and performance of the assembled system, the

taxpayer used specialized testing software. This software was installed on all three laptop computers and was, at all times, the proprietary property of the taxpayer. The testing software is not permanently installed on the completed machinery and is neither transferred to the purchasers nor licensed to them for their use.

Distinct and different operations software was also installed on the laptop computers. The operations software is necessary to run the assembled machines and it is actually installed on the assembled machines. The operations software is transferred and licensed to the purchasers. The taxpayer estimates that 80% of the laptops' use was for the diagnostic testing and for verifying the calibration, connection, and operation of the system. The taxpayer estimates that 20% of the taxpayer's use of the computers related to the installation and transfer of the operating software. The operating software was "encased" until delivery and then copied onto the machinery at the customer's place of business. The operations software was installed on the machinery and licensed to the purchaser for use.

The taxpayer explained each laptop was used for a specific aspect of the operation. The first computer was assigned specifically to a company installer who used the computer exclusively for testing and installing the machinery (system) both at the taxpayer's manufacturing site and at the purchaser's business. This computer ran the software necessary for the testing and transferring the operations software, and was not used for other purposes.

The second laptop was assigned to the operations manager of the company who acted as a backup installer. The operations manager, in addition to working on installations of the equipment, also engaged in some sales activities. In addition to testing and operations software installation, this computer also carried accounting, sales and word processing software to enable the operations manager to complete the necessary sales and expense reports when away from the office. The taxpayer estimated that the operations manager spent approximately 50% of his time fulfilling duties associated with his position as a backup installer and that he used the laptop computer when he was working as a backup installer. The taxpayer stated that use of the laptop computer for sales and expense reports was incidental. The taxpayer stated that the primary use of the second laptop computer was running the testing and operations software. While the taxpayer could not provide an exact breakdown, the taxpayer estimated that at least 60% of the total usage of the second laptop computer was related to the testing functions.

The third computer was assigned to a sales representative and was primarily used for demonstrations for potential customers and instruction clinics for existing customers. The taxpayer acknowledged this computer was rarely used for testing and installing.

The taxpayer stated that the laptops were categorized as capital assets for both federal tax purposes and internal accounting. The cost of the laptop computers was depreciated over a five-year useful life for federal tax purposes. The laptops each carried a manufacturer's warranty of at least one year. At the time the laptops were acquired, their use was intended to exceed one year. The taxpayer asserts that computers were in fact used for more than one year.

The ultra high-powered water jet cutting systems the taxpayer manufactured were designed and built to provide precise and detailed cutting of a number of materials. In order to be able to perform this function it is essential that the individual component pieces of the equipment be properly connected and aligned and that the completed unit operate within specific parameters. The testing software served to verify this. The testing program run on the computer performs diagnostic functions and verifies that the equipment is performing within the necessary tolerances. Absent this testing and verification process, the equipment is not suitable for use. The taxpayer explained that there can be no sale of the manufactured item until these processes are completed to the satisfaction of the customer.

ISSUES:

Whether three laptop computers qualified as exempt machinery and equipment directly used in a manufacturing operation?

DISCUSSION:

General Law:

RCW 82.08.02565 exempts from retail sales tax "sales to a manufacturer . . . of machinery and equipment **used directly** in a manufacturing operation" (Emphasis added). *See also*, RCW 82.12.02565 (use tax exemption); WAC 458-20-13601² (Emergency Rule 13601). The retail sales tax exemption provisions apply to the use tax exemption in RCW 82.12.02565. RCW 82.08.02565; Emergency Rule 13601(1).

RCW 82.08.02565(2)(c) currently provides:

Machinery and equipment is "used directly" in a manufacturing operation or research and development operation if the machinery and equipment:

- (i) Acts upon or interacts with an item of tangible personal property;
- (ii) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site;
- (iii) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property;
- (iv) Provides physical support for or access to tangible personal property;
- (v) Produces power for, or lubricates machinery and equipment;
- (vi) Produces another item of tangible personal property for use in the manufacturing operation or research and development operation;
- (vii) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
- (viii) Is integral to research and development as defined in RCW 82.63.010.

² WAC 458-20-13601 was adopted by the Department as an emergency rule on May 28, 1999. The purpose of the emergency rule is to explain the sales and use tax exemption provided by RCW 82.08.02565 and 82.12.02565.

Emergency Rule 13601(9) provides more detailed discussion of when machinery and equipment is "used directly" in a manufacturing operation and explains:

(9) **The "used directly" criteria.** Items that are not used directly in a qualifying operation are not eligible for the exemption. The statute provides eight descriptions of the phrase "used directly." **The manner in which a person uses an item of machinery and equipment must match one or more of these descriptions.** If M&E is not "used directly" it is not eligible for the exemption. Examples of items that are not used directly in a qualifying operation are cafeteria furniture, safety equipment not a part or component of an eligible item of machinery and equipment, packaging materials, shipping materials, or administrative equipment. Machinery and equipment is "used directly" in a manufacturing operation, testing operation, or research and development operation, if the machinery and equipment meets any one of the following criteria:

(a) Acts upon or interacts with an item of tangible personal property. Examples of this are drill presses, cement mixers (agitators), ready-mix concrete trucks, hot steel rolling machines, rock crushers, and band saws. Also included is machinery and equipment used to repair, maintain, or install tangible personal property. **Computers qualify under this criteria if: (i) they direct or control machinery or equipment that acts upon or interacts with tangible personal property or (ii) if they act upon or interact with an item of tangible personal property.**

(b) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or the testing site. . . .

(c) **Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site.** Examples of "away from the site" are road testing of trucks, air testing of planes, or water testing of boats, with the machinery and equipment used off site in the testing eligible under this criteria. Machinery and equipment used to take readings or measurements, such as devices that take readings or probe with sensors, is eligible under this criteria.

(d) Provides physical support for or access to tangible personal property. . . .

(e) Produces power for, or lubricates machinery and equipment. . . .

(f) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation. Machinery and equipment that makes dies, jigs, or molds, and printers that produce camera ready images are examples of this.

(g) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or

(h) Is integral to research and development as defined in RCW 82.63.010. There is no requirement that the research and development operation produce tangible personal property for sale.

(Emphasis added.)

In the case where machinery and equipment may have a dual use, the Department has adopted a majority use test to determine if the property qualifies for the M&E exemption. Both the legislature and the executive branch have sanctioned this approach. RCW 82.08.02565, H.B.

1887, 56th Leg., 1st Sess., 1999 Washington Laws 211.³ Thus, if the machinery and equipment is used directly in a manufacturing operation it is exempt from retail sales tax and/or use tax, providing it meets the majority use and the useful life criteria. RCW 82.08.02565; RCW 82.12.02565; Emergency Rule 13601.

Were the computers (laptops) used directly in the manufacturing process and so eligible for the M&E exemption?

The taxpayer contends that the computer equipment is used directly in the manufacturing process and specifically that the equipment qualifies under example (9)(c) of Emergency Rule 13601 as the use of the computers is essential to control, guide, measure, align, regulate and test the functioning of the machinery being manufactured. The Audit Division in contrast contends that the computers are merely a tool used to convey information and are not used directly in the manufacturing process.

It is not disputed that the taxpayer is a manufacturer or that the manufacture of the cutting machines is a qualifying manufacturing operation. Also, the record does not show any dispute regarding the taxpayer's assertion that two of the laptops were used primarily for running the testing software and that this activity constituted majority use. Nor, is there any indication in the record that the computers had a useful life of less than one year. The inquiry that remains, therefore, is whether the laptop computers are used directly in the manufacturing operation?

At the outset we note the taxpayer conceded that the majority use of the third laptop computer was use for sales and not for the testing required in the final stages of the manufacturing operation. Therefore, this third computer is not eligible for the M&E exemption and we sustain the assessment of use tax measured by the purchase price.

With respect to the first laptop computer, the taxpayer testified that it is used exclusively for testing and diagnostic functions. The second laptop is primarily used for these functions. The Audit Division has not provided any evidence to the contrary, and we find the taxpayer's characterization of the final assembly and concurrent testing of the assembled machine as the final stage of the manufacturing process credible. Until the components are assembled and properly connected the equipment cannot function. Essentially, the cutting machine the purchaser is acquiring does not come into existence until all the individual parts are connected, tested, and verified as performing the functions desired by the purchaser.

In this instance the complexity of the machinery being manufactured requires complex testing that may only be accomplished through the use of specially created software that was created for, and is the property of, the taxpayer. The taxpayer contends the Audit Division failed to

³ After the bill passed the House, the bill's sponsors in the Senate discussed the majority use test. One senator questioned the absence in the bill of the dual use standard regarding qualifying and nonqualifying use. Another senator explained that such language was not necessary because the Department's administrative practice was to apply a "majority use" test. The senator concluded, "It is within the administrative authority of the department to use this standard, both for the past and in the future."

appreciate the distinction between the testing software--which, they contend, is integral to the manufacturing process and remains the sole property of the taxpayer--and the operations software that is licensed to the purchaser and which is actually installed on the machines. The testing software performs diagnostic and verification functions and assures that the individual components of the machinery are communicating properly with other components of the machine. Until this verification, calibration and internal communication is tested, the machine is not complete.

We note that the examples set forth in (9) of Emergency Rule 13601 all convey an element of actual activity and motion, a direct and active involvement in the manufacturing process. We find that the verification of proper connections and internal communication, calibration, and testing of the assembled unit performed by the computers is an action that is part of the final stages of the manufacturing operation. This collection of information and verification process is accomplished through the interaction of the laptop computers with the cutting machine's internal computer programs.

As such, we find that two of the laptops are "used directly" in a manufacturing operation as they interact with an item of tangible personal property as specified under (9)(a) of Emergency Rule 13601; and, additionally, that the specific function the testing program performs is consistent with the control, guidance, measurement, verification, alignment, regulation, and testing activities articulated in (9)(c) of Emergency Rule 13601. Furthermore, we find that the subsequent repetition of the testing process at the purchaser's site when the machinery is reassembled to be consistent with the permissible "away from site" testing examples set forth in (9)(c) of Emergency Rule 13601. Thus, we find that the two laptop computers, whose majority use was the application of the testing and calibration operations, were directly used in a manufacturing operation and so qualify for the exemption and grant the taxpayer's petition for adjustment as to these two items.

DECISION AND DISPOSITION:

The taxpayers petition is granted in part and denied in part. Two of the laptop computers were directly used in a manufacturing operation and so were eligible for the M&E exemption and we remand for adjustment to the assessment consistent with that finding. However, the third laptop computer's majority use was not in the manufacturing operation and this computer is ineligible for the exemption and the tax assessed on it is affirmed. Remand to Audit for adjustment consistent with this determination.

Dated this 12th day of June, 2000.