

Cite as Det. No. 00-104, 20 WTD 75 (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. 00-104
)	
... )	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 – COMPUTER OR DIGITAL EQUIPMENT. To qualify for the M&E exemptions:, computer and digital equipment 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. The purpose of the AutoCAD and digital equipment at issue was to produce the necessary specifications and schematics to enable the shop machinery to be programmed to make the necessary cuts and alterations to the raw materials to produce the finished cabinets and to generate schematics. Such equipment does not directly control equipment, or interact with an item of tangible personal property which is part of the manufacturing process and does not qualify as directly controlling machinery being used in the manufacturing process.

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.<sup>1</sup>

FACTS:

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

Kreger, A.L.J. – . . . (the taxpayer) is a Washington Corporation . . . . In October of 1998 the Audit Division of the Department of Revenue (Department) conducted an examination of the taxpayer's business activities between January 1, 1994 and December 31, 1997. During that period of time the taxpayer's business activities included the manufacture, sale and installation of cabinets for hospitals, school districts and various business customers. Based on the information provided, the Audit Division determined that the taxpayer had not been reporting all items of income properly and therefore issued an assessment, Document No. F. . . , on September 23, 1998. The assessment was for a total tax liability of \$. . . comprised of \$. . . in use tax; a credit for \$. . . in wholesaling business and occupation (B&O) tax reported in error and \$. . . in interest.

On January 13, 1997, the taxpayer timely filed a petition contesting \$. . . of the use tax assessed. That portion of the assessment arose due to the Audit Division's determination that computer equipment purchased by the taxpayer was not eligible for the M&E exemption from retail sales tax. The petition was subsequently placed on hold, pending legislative action clarifying the M&E exemption.

The taxpayer contends that the computers at issue are integral to the manufacturing process and control the manufacturing activities the taxpayer engages in. At issue is a Computer Design System (AutoCAD) and Digital Computer Equipment used to generate shop drawings. 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 "at no time do the computers and/or autocad system directly control the manufacturing process."<sup>2</sup> The auditor analogized the use of the taxpayer's computer system to the generation of plans by an architect or engineer. The auditor emphasized that the information and specific settings produced by the systems at issue was then entered by hand into plant machinery.

The term "CAD" is an acronym for "computer-aided design" and is a *system* comprised of a combination of computer hardware and software that enables a person to design everything from furniture to airplanes.

In its petition the taxpayer provides the following assertions in support of its claim that the computer systems are directly used in the manufacturing operation: the equipment guides and regulates the parts that are cut by saws; the equipment produces shop drawing that are used in the manufacturing operation; and these shop drawings guide and regulate work performed by workers. The taxpayer disputes the Audit Division's characterization of the use of the computer equipment as similar to producing architectural or engineering plans. Rather the taxpayer states the equipment is necessary to transform the design and architectural drawings that the taxpayer received from its customers into data and information that is necessary to control and direct the creation of the individual component parts of the cabinetry that the taxpayer manufactures. At issue are two systems. The first is the AutoCAD system. This system is used to translate the design specifications into data and instructions, which is then transferred to the saws and other

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<sup>2</sup> Auditors Detail of Differences and Instruction to Taxpayer (Audit Report) dated September 23, 1998.

mechanical systems in the shop. The AutoCAD system translates the dimensions and schematics of a particular cabinet order into specifications for the individual component pieces. These specifications in turn govern how the cuts are made on the individual component pieces so that when completed and assembled the cabinet will match the design submitted to the taxpayer. Due to currently incompatible software platforms the AutoCAD data and information can only be directly conveyed to the router machinery in the shop. The taxpayer stated that the router use constitutes approximately 10% of the manufacturing process. The data the AutoCAD system generates must be manually transferred to all the other cutting and manufacturing equipment in the shop.

The taxpayer stated that conversations with the auditor and his Field Audit Manager, disclosed that if the AutoCAD system were integrated with, and directly connected to, the saws allowing for the direct transfer of data (similar to the integration that is currently possible with the router equipment) that the system would be considered “directly used” in the manufacturing operation and so eligible for the exemption. The taxpayer contends that the fact the information must be reentered rather than being directly conveyed should not disqualify the system from eligibility and that the data produced by the AutoCAD system is still the information that controls the cuts made by the machinery. The taxpayer asserts the fact that the method of conveying the information generated by the AutoCAD system to the machinery is not electronic should not preclude the system from being eligible for the M&E exemption.

The taxpayer states that the AutoCAD system is also used to print out paper copies of the specifications, which are sent to the customers for verification, but that this is only a minimal function of the system. The taxpayer estimates that 98% of the use of the AutoCAD system is the generation of the specifications that guide and control the machinery and only 2% is the production of the copy of the specifications that is provided to the customers. The taxpayer stated that the sole purpose of the system was to generate design and cut specifications for the manufacturing process.

The other equipment at issue is digital equipment that prints out drawings used in the shop. This equipment takes the information generated by the AutoCAD system and generates drawings that are then used by the taxpayer’s employees during the manufacturing process. The taxpayer stated that these drawings guide the employees’ manual activity.

#### ISSUES:

Whether computer systems acquired by the taxpayer are used directly in a manufacturing operation making them eligible for the M&E exemption from retail sales tax?

#### DISCUSSION:

##### General Law:

Prior to addressing the particular requirements of the exemption at issue we first note that this specific exemption must be construed in light of the following well established principles of law that specifically address the interpretation of tax exemptions. It is a general rule that tax exemption statutes must be strictly construed in favor of the application of the tax. *Yakima Fruit Growers Association v. Henneford*, 187 Wn. 252, 60 P. (2d) 62 (1936); *Boeing Aircraft Company v. Reconstruction Finance Corporation*, 25 Wn.2d 652, 171 P. (2d) 838 (1946). Furthermore, no person should be declared exempt unless it clearly appears that such exemption is required by law. *North Pacific Coast Freight Bureau v. State*, 12 Wn.2d 563, 122 P. (2d) 467 (1942). The assertion of any claim of exemption is to be studied with care before depriving the state of revenue. *Alaska Steamship Company v. State*, 31 Wn.2d 328, 196 P. (2d) 1001 (1948).

Laws of 1995, 1st Sp. Sess., ch. 3, effective July 1, 1995, codified as RCW 82.08.02565 (sales tax) and RCW 82.12.02565 (use tax), provides an exemption from sales and use taxes for sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation. RCW 82.08.02565 has been amended several times since 1995.

In relevant part, RCW 82.08.02565(1) provides 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." The terms "machinery or equipment," "directly used," and "manufacturing operation" are defined in subsection (2) of RCW 82.08.02565.

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 458-20-13601<sup>3</sup> (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;

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<sup>3</sup> 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.

- (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.

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.)

Where equipment has multiple or dual uses, the Department has adopted a majority use test to determine if the property qualifies for the exemption. Where direct use in a manufacturing is at least 50% of its use, then ancillary, indirect use will not preclude entitlement to the 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.<sup>4</sup> Thus, if the machinery and equipment is used directly in a manufacturing process 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 used directly in the manufacturing process making them eligible for the M&E exemption?

In this case it is not disputed that the taxpayer is a manufacturer or that the manufacture of the cabinetry is a qualifying manufacturing operation. Rather the inquiry is whether the computer systems at issue are “used directly” in that operation. Additionally, there is no information available that disputes or challenges the taxpayer’s assertion that the majority use of these computer systems is in conjunction with manufacturing and that the computer systems have a useful life of more than one year.

The taxpayer contends that the computer equipment is used directly in the manufacturing process because the computer systems control and guide the functioning of the machinery being manufactured.

The Audit Division, in contrast, contends that the computers are merely tools that are not used directly, as they are not directly connected to manufacturing equipment and neither directly control machinery nor act directly upon the item being manufactured, as required by the rule.

As the two systems at issue involve slightly different functions and purposes we shall address them individually.

The AutoCAD system:

The taxpayer contends that a requirement of a direct linkage between the computers and the shop machinery is unnecessarily narrow construction of the exemption. The taxpayer contends the method of transmitting the information between systems should not be determinative, but rather the eligibility for the exemption should be determined in light of the function of the information. In considering the taxpayer’s argument, we reiterate that exemptions are to be narrowly construed. *Yakima Fruit et al. supra*. Thus, contrary to the taxpayer’s contention it is vital that

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<sup>4</sup> 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."

an activity fit precisely within the definition at issue in order to qualify for the exemption. In this case there is a specific definition of “directly used” in addition to a number of detailed illustrative examples that establish the parameters of exempt equipment. Emergency Rule 13601.

There are two possible means for computers to qualify for the M&E exemptions: 1) to direct or control machinery or equipment that acts upon or interacts with tangible personal property; or, 2) if they act upon or interact with an item of tangible personal property. Emergency Rule 13601(9)(a). Thus, if the computers direct or control machinery that is transforming the materials being used in manufacturing process or if the computer itself interacts with the materials used in the manufacturing process it will qualify.

In this case the AutoCAD system does not directly control equipment other than the routers, and the taxpayer testified that the linkage to the routers was only 10% of its functions. Therefore, the system does not qualify as directly controlling machinery being used in the manufacturing process.

The essential and predominant purpose of the AutoCAD system is to produce the necessary specifications and schematics to enable the shop machinery to be programmed to make the necessary cuts and alterations to the raw materials to produce the finished cabinets. We note that the transmission of information generated by the AutoCAD system is predominately manually reentered into the actual cutting machinery. The taxpayer asserts there is no real distinction between direct conveyance of the AutoCAD specifications through an electronic or digital connection and reentry of that data. We disagree. The severance of the two systems precludes integration of the design function with the actual cutting and manufacturing function and so prevents characterizing the design component as controlling the manufacturing. The AutoCAD system produces information that then can be used in the manufacturing process but the system itself does not directly control manufacturing equipment, other than the 10% use with the router equipment that is integrated.

The second possible means for computer equipment to qualify for the exemption is if it “acts upon or interacts with an item of tangible personal property.” Here the AutoCAD system does interact with tangible personal property, namely the paper upon which the shop drawing are printed. However, the tangible personal property the AutoCAD system interacts with and produces is not part of the manufacturing process. Since the specific examples of qualified computer use are descriptive of when equipment is “used directly” those examples must be read in conjunction with, and as illustrative of, the other provisions and descriptions regarding direct use.

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. The interaction with tangible personal property must be in the course of that tangible personal property being directly used in the manufacturing process. Furthermore, we note that the phrase tangible personal property is also used in the rule to describe the raw materials that are being

used in the manufacturing process to produce the saleable commodity that is the end product of the process. The first definition offered by the rule is that of manufacturing itself, where the rule states that manufacturing: “embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use . . .” Emergency Rule 13601 (2). Thus, to be eligible for the exemption the interaction with the tangible personal property must occur as part of the active manufacturing process.

We concur with the Audit Division’s analogy of the information and drawing generated by the AutoCAD system as being analogous to architectural or engineering plans. The AutoCAD system produces data that provides the directions for operating and programming the machinery that manufactures the cabinets. The necessary element that is lacking in this instance is integration with and control of the actual manufacturing process. The need to manually convey the data generated by the AutoCAD system to machinery actually fabricating the cabinetry severs it from being directly used in the manufacturing process and so renders it ineligible for the M&E exemption.

In light of the mandate that exemptions be strictly construed, we find that the lack of integration and control between the AutoCAD system and the machinery actually manufacturing the cabinetry renders the computer ineligible for the M&E exemption.

#### Digital Equipment to Generate Shop Drawings:

The taxpayer also contends that the computer equipment which generates the shop drawings provided to the craftsmen who operate machinery, should also qualify for the M&E exemption as these drawings “control” the operation of the machinery. The taxpayer asserts that these drawings are another item of tangible personal property used in the manufacturing operation and so would qualify under example (9)(f) of Emergency Rule 13601.

We again note the active use of the tangible personal property listed in example (9)(f) of Emergency Rule 13601, which identifies “machinery and equipment that makes dies, jigs, or molds, and printers that produce camera ready images” as examples of eligible equipment. These examples are all of items that interact directly with machinery. Here, the shop drawings do not interact or come into contact directly with any machinery, but rather provide information that is used by craftsmen who operate that machinery.

As discussed above, the absence of a direct connection with the actual manufacturing equipment precludes classifying this equipment as being “used directly” and so renders it ineligible for the M&E exemption. While the digital system is producing information or data that is then utilized by craftsmen who are engaging in manufacturing, the computer system itself is not directly linked or connected to that process. Therefore, we find that the digital equipment that generates the shop drawings is not “used directly” in a manufacturing operation and so does not qualify for exemption from retail sales tax.



**DECISION AND DISPOSITION:**

The taxpayers petition is denied and the assessment issued by the Audit Division is affirmed.

Dated this 12th day of June, 2000.