

Cite as Det. No. 99-306, 19 WTD 502 (2000)

BEFORE THE APPEALS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	<u>D E T E R M I N A T I O N</u>
	)	
	)	No. 99-306
	)	
...	)	Registration No. . . .
	)	FY. . . /Audit No. . . .
	)	

- [1] RULE 13601; RCW 82.08.02565: SALES TAX -- MANUFACTURING MACHINERY AND EQUIPMENT EXEMPTION -- PRINTING PLATES -- OCCASIONAL USE -- USEFUL LIFE. Eligibility for the manufacturing machinery and equipment (M&E) exemption from the retail sales tax is not limited to machinery and equipment that is purchased for use on a regular and recurring basis. Nor is eligibility limited to machinery and equipment that would last a year or more if used on a regular and recurring basis. Machinery and equipment that is purchased for occasional use with the reasonable expectation that it will still be useful for the purpose purchased a year or more after purchase, may qualify for the exemption.

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:

Taxpayer appeals denial of a request for refund of retail sales tax paid on printing plates used in manufacturing for a period of more than one year, but only used intermittently, and stored between uses. The taxpayer contends the purchases are exempt from tax under the exemption for sales of manufacturing machinery and equipment, RCW 82.08.02565 ("M&E exemption").<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.

Prusia, A.L.J. -- The taxpayer is a Washington manufacturer of plastic bags and print shop operator.<sup>2</sup> It fills specific customer orders for bags, and prints customer data and logos on the bags.

The Audit Division of the Department of Revenue examined the taxpayer's records for the period January 1, 1994 through September 30, 1996. The examination revealed the taxpayer owed additional taxes and interest. During the audit investigation, the taxpayer requested a refund of retail sales tax it had paid on rubber printing plates it purchased for use in manufacturing bags for specific customers. It requested the refund under the exemption for sales of manufacturing machinery and equipment, RCW 82.08.02565 ("M&E exemption"). The request indicated that 82% of the plates were kept in inventory for a period of over one year.

The Audit Division denied the refund request, and consequently did not make an adjustment (credit) in the audit for the tax paid on the printing plates. The stated basis for the denial was that the exemption statute excludes property with a useful life of less than one year, and the plates would have a useful life of less than one year if used on a regular and recurring basis. The Audit Division took notice of the fact that most printing plates have a very limited physical life if used continuously. It interpreted the useful life requirement as excluding property that is used only intermittently, and advised the taxpayer it would have to prove the plates have been used on a regular and recurring basis for more than a year in order to qualify for the exemption.

On December 2, 1998, on the basis of the investigation, the Audit Division issued an assessment, Document No. FY. . . , assessing additional taxes and interest, with no credit for retail sales tax paid on the printing plates. The taxpayer paid the assessment. The taxpayer appealed the Audit Division's denial of its request for a refund of the retail sales tax.

The taxpayer sets out the facts as follows in its petition:

[Taxpayer] purchases materials which are used by [Taxpayer] or their suppliers to make printing plates for use in the production of bags for their customers. These plates are, in general, customer specific.<sup>3</sup> Each plate contains some data or logos that limit the printing plate use to a unique customer. [Taxpayer] does retain control and ownership of these plates.

The fact that some of these plates may be consumed in one or two large production runs is not disputed. The fact that, since a plate may be used only upon a specific customer order, there is intermittent use is not disputed. Our data indicates that 18% of the plates are consumed within one calendar year, therefore are non-exempt and taxable.

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<sup>2</sup> It prints advertising materials and brochures.

<sup>3</sup> The taxpayer explained in the teleconference that it purchases the rubber plates, and either the taxpayer or an outside firm does the artwork, depending upon the complexity of the artwork.

The remaining 82% of the plates are not consumed within one calendar year. These plates are inventoried and warehoused until needed to fulfill a customer order, much as tooling is in the aircraft industry. While it is expensive to store the plates, the cost is less than that of replacement. Further, retaining the plates allows [Taxpayer] to respond more quickly to a customer order. These are valid business reasons for retaining the plates for more than one year.

The taxpayer provided the following additional facts. The taxpayer does not capitalize the printing plates on its books for federal tax purposes. The plates cost about \$300 each, which is below the dollar threshold the taxpayer uses for capitalizing assets. The manufacturer of the plates does not warrant that they will last for any particular period. The amount of time they will last depends upon how heavily they are used. The taxpayer's experience has been that approximately 75% of the plates that are held for re-use actually are reused.

#### ISSUES:

1. Is eligibility for the M&E exemption limited to property that is purchased for use on a regular and recurring basis, i.e., is property that is purchased only for occasional use ineligible for the M&E exemption?
2. Is property that is purchased only for occasional use, and would have a useful life of less than one year if used on a regular and recurring basis, ineligible for the M&E exemption?
3. If the answers to issues 1 and 2 do not eliminate the taxpayer's printing plates from qualifying as "machinery and equipment" for purposes of the M&E exemption, are the taxpayer's purchases of printing plates exempt from the retail sales tax under the M&E exemption?

#### DISCUSSION:

The exemption at issue, RCW 82.08.02565, became effective July 1, 1995. In May 1999, the 56<sup>th</sup> Legislature passed and the governor signed Engrossed Substitute House Bill 1887. The act revised the M&E exemption by more precisely describing terminology and eligibility.<sup>4</sup> On May 28, 1999, the Department filed three emergency rules to implement the legislative changes.<sup>5</sup> All three rules assist in clarifying what activities qualify for the exemption.<sup>6</sup> Other than new sections concerning sales to persons engaged in testing, the 1999 legislation and rules adopted pursuant to it are a clarification of the existing law, and can be applied retroactively to answer the taxpayer's appeal.

RCW 82.08.02565 states, in part:

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<sup>4</sup> The legislation amended RCW 82.04.120, 82.08.02565, and 82.12.02565.

<sup>5</sup> The rules became effective immediately on filing. The Department's Legislation and Policy Division has started the rulemaking process to allow for permanent adoption of all three rules.

<sup>6</sup> The emergency rules are WAC 458-20-135 (revised); WAC 458-20-136 (revised); and, WAC 458-20-13601(new).

(1) The . . . [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 . . . or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment . . .

For purposes of the exemption, “machinery and equipment” means “industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof.” For purposes of the exemption, the term “machinery and equipment” does not include “[p]roperty with a useful life of less than one year.” RCW 82.08.02565(2)(b)(ii).

The M&E exemption, like all tax exemptions in Washington, is strictly construed in favor of application of the tax and against the person claiming the exemption. Yakima Fruit Growers Ass’n v. Henneford, 187 Wash. 252, 258, 60 P.2d 62 (1936); All-State Constr. Co. v. Gordon, 70 Wn.2d 657, 425 P.2d 16 (1967). However, the policy of strict construction of exemption provisions does not mean they will be read so narrowly that the legislative purpose and intent in enacting the provisions are undermined. Cherry v. Metro Seattle, 116 Wn.2d 794, 808 P.2d 746 (1991).

In this case, there is no dispute that the taxpayer is a manufacturer, and the printing plates are used directly in a manufacturing operation. The Department has decided to treat printing plates as potentially eligible for the M&E exemption, as “devices.”<sup>7</sup> What is unresolved is whether the plates have a “useful life” of less than a year, and thus are not “machinery and equipment” for purposes of the exemption.

The 1999 legislation did not revise the provision excluding property with a useful life of less than one year. However, emergency Rule 13601 does address the “useful life” threshold, as follows:

(8) **The "useful life" threshold.** The following steps should be used in making a determination whether an item meets the "useful life" threshold. The series of questions progress from simple documentation to complex documentation. In order to substantiate qualification under any step, a taxpayer must maintain adequate records. Tangible personal property that is acquired for a one-time use does not qualify for the M&E exemption, e.g. a mold or form that is discarded upon use. Catastrophic loss, damage, or destruction of an item does not affect eligibility of machinery and equipment that otherwise qualifies. Assuming the machinery and equipment meets all of the other M&E requirements, the useful life criteria can be determined by answering the following questions for each individual piece of machinery and equipment:

<sup>7</sup> In this regard, printing plates are to be distinguished from negatives that printers use to produce the printing plates. The negative does not become an integral part of the printing machinery. It merely conveys an image. The negative itself does not become attached to printing equipment. Therefore, the film does not meet the statutory requirement of being “machinery and equipment” for purposes of RCW 82.08.02565. Conversely, the printing plate is attached to the press. It applies the ink on to the paper as the paper is fed through the press. Therefore, the blank plates potentially are “machinery and equipment” for purposes of RCW 82.08.02565.

- (a) Is the machinery and equipment eligible to be and actually capitalized for either federal tax purposes or accounting purposes?
  - If the answer is "yes," it qualifies for the exemption.
  - If the answer is "no,"
- (b) Is the machinery and equipment warranted by the manufacturer to last at least one year?
  - If the answer is "yes," it qualifies for the exemption.
  - If the answer is "no,"
- (c) Is the machinery and equipment normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)
  - If the answer is "yes," it qualifies for the exemption.
  - If the answer is "no,"
- (d) Is the machinery and equipment expected at the time of purchase to last at least one year, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)
  - If the answer is yes," it qualifies for the exemption.
  - If the answer is "no," it does not qualify for the exemption.

The taxpayer contends that the printing plates meet the M&E exemption statute's one-year threshold. It argues that the statute contains no frequency requirement. It requires only that the property have a useful life of a year or more. The common dictionary meaning of "useful" is able to be used, or serviceable. Every machine or part has a finite life. If a particular item's life is not expended within one calendar year, it is not excluded from the exemption. The taxpayer also argues that under Emergency Rule 13601(8)(c), the printing plates qualify for the exemption. It argues:

It is the business practice of [Taxpayer] to maintain printing plates in storage at the plant site for immediate availability should the customer submit an order for more product. There is no no-manufacturing use of the plates. (dual purpose) As indicated in my original letter of [date], approximately 82% of the plates are available for a period of time that exceeds one year.

If these plates are available for immediate use does it not follow that they still have some useful life until they are finally consumed?

We agree with the taxpayer that the statute does not have a regular and recurring use requirement. Nor does it have a durability requirement. The Department's official interpretation of the useful life requirement, in Emergency Rule 13601, finds no such conditions in the statute. We conclude that the taxpayer's printing plates are not necessarily ineligible for the M&E exemption merely because they are purchased for occasional use only, or because they are insufficiently durable to last for a year if used on a regular basis.

We can appreciate the Audit Division's concern that not reading a frequency of use intent into the statute would allow a manufacturer to game the system to qualify property that the manufacturer normally would exhaust within a short period. However, we believe that concern can be addressed through application of the third and fourth questions set out in Emergency Rule 13601. As we understand the third question, the machinery or equipment qualifies if the normal replacement interval for such items, given the nature of the taxpayer's business, is a year or more. Thus, an item would not qualify if the taxpayer created an artificial replacement interval by withholding the item from its normal use solely for the purpose of meeting the one-year requirement. As we understand the fourth question, the machinery or equipment must be an item the taxpayer would expect, at the time of purchase, to last at least one year in normal use in its manufacturing operation. This requirement also would exclude items that are withheld from normal use solely for the purpose of meeting the one-year requirement.

How, then, is the useful life of the taxpayer's printing plates to be determined? The emergency rule does not specifically address the situation of equipment that is acquired for occasional use, is serviceable only for occasional use, and is held in inventory for possible occasional use for a year or more.

Emergency Rule 13601 does provide some guidance. Plates the taxpayer purchases for a one-time use do not qualify for the M&E exemption. The determination of useful lives commonly will be based upon the actual experience of the person claiming the exemption. Beyond those principles, common sense suggests some additional guidelines that will assist in determining the extent to which printing plates can be reasonably expected, at the time of purchase, to last at least one year. Plates containing only non-time-sensitive information, such as a company's name, address, and logo, ordinarily can reasonably be expected to have a useful life of at least a year. Certainly there would be exceptions, such as a large order that is likely to exhaust the plate in preparing that order, or a customer who clearly indicates it will place no further orders for which the plate can be used. A plate containing time-sensitive information tied to a date (such as a sale date or a specific event) within a year of the purchase date, ordinarily would not be expected to have a useful life of a year or more. If actual experience shows a certain percentage of plates will be consumed in the manufacturing process during the first year after purchase, the taxpayer cannot reasonably expect that a percentage higher than that will have a useful life of a year or more.

A reasonable approach in the taxpayer's case would be to begin with the 82% of the plates that were still in inventory a year after purchase, and examine them to determine what percentage were still usable, a year after purchase, for the purpose for which they were purchased. Examination of a sample of the plates the taxpayer purchased would be one method of producing a percentage of plates the taxpayer could have reasonably expected to still be usable, for the purpose for which they were purchased, a year or more after the purchase date. We do not preclude use of some other method for determining that percentage.

We will remand the file to the Audit Division to reconsider the taxpayer's refund request, consistent with this determination.

DECISION AND DISPOSITION:

The taxpayer's file is remanded to the Audit Division for reconsideration, consistent with this determination, of the taxpayer's refund request, and possible refund of a portion of the sales tax the taxpayer paid on printing plates it purchased for use in manufacturing bags during the audit period.

Dated this 23<sup>rd</sup> day of November, 1999.