

Cite as Det. No. 00-026, 19 WTD 941 (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. 00-026
)	
...)	Registration No. . . .
)	FY. . . /Audit No. . . .

- [1] RULE 13601; RCW 82.08.02565; RCW 82.12.02565 – SALES TAX – USE TAX – MANUFACTURING MACHINERY AND EQUIPMENT ("M&E") EXEMPTION – MAJORITY USE – BAKERY. To qualify for the M&E exemption, the majority use of equipment must be in the manufacturing operation. Use of equipment outside the manufacturing site to deliver products does not qualify as use in the manufacturing operation.
- [2] RULE 13601; RCW 82.08.02565; RCW 82.12.02565 – SALES TAX – USE TAX – MANUFACTURING MACHINERY AND EQUIPMENT ("M&E") EXEMPTION – FIRST USE – BAKERY. Under the majority use test, provided the taxpayer initially uses equipment in an activity where the majority of its use is an exempt use, the equipment qualifies for the M&E exemption. The fact that an item may have first been used in a minority, nonexempt use that is related to the manufacturing process does not disqualify that item from 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:

Bakery protests assessment of use tax with respect to equipment it claims qualifies for the manufacturing machinery and equipment ("M&E") exemption.¹

FACTS:

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

C. Pree, A.L.J. -- The taxpayer manufactures and sells baked goods. It sells its goods in Washington from depots and thrift stores and through salespersons who have routes in Washington.

The Audit Division of the Department of Revenue audited the taxpayer's records for the period of January 1, 1993, through March 31, 1997. The audit resulted in the assessment of retail sales tax of \$. . ., retailing B&O tax of \$. . ., litter tax of \$. . ., use tax of \$. . ., and interest of \$. . . . The assessment totaled \$. . . . The only item at issue is the assessment of use tax in Schedule 8, which totaled \$. . . . The Audit Division assessed this amount with respect to the taxpayer's purchase and use of items, which the taxpayer claims, is exempt under RCW 82.08.02565.²

The taxpayer purchased the items at issue in its 1997 purchase of the assets of various baking operations in Washington. Racks, pans, trays, hand trucks, and carts were included in this asset purchase. The taxpayer protests the assessment of use tax on these items, which were referenced in the audit as "racks and trucks." The racks and trucks are used in the baking process and are used to move finished goods inventory within the baking operations. In most circumstances, the racks and trucks are also used to distribute bakery items outside of the baking operations.³

The taxpayer reasons that the racks and trucks are exempt because the taxpayer first used these items in baking operations. However, in assessing the tax, the Audit Division reasoned that the racks and trucks did not qualify for exemption "because they are used outside the manufacturing operations (i.e., in delivery trucks and/or at depots.)" Further, in response to the taxpayer's petition, the Audit Division argues that the taxpayer's statement that all of the items were first used by the taxpayer in its manufacturing operations is incorrect. The Audit Division explained:

When [the taxpayer] purchased the assets of [the Washington bakeries], the operations did not shut down. At the time of purchase, some of the racks and trucks were being used in the manufacturing operations and some were being used in the distribution operations.

ISSUES:

Where equipment is sold to or used by a manufacturer, must such equipment be exclusively used directly in a manufacturing operation to qualify for the M&E exemption?

² RCW 82.12.02565 provides an equivalent use tax exemption.

³The taxpayer explains that although all items are used in the baking operations, some of the items "may not necessarily" be used in the distribution of baked goods. The taxpayer notes that although it uses some of the items exclusively in the baking operations, neither it nor the Audit Division has segregated these items. The Audit Division notes that the taxpayer declined to provide the information necessary to determine which items were exclusively used in the baking operations.

Where an item is used both in manufacturing and delivery operations, whether the first use of the item must be in the manufacturing operation to qualify for the M&E exemption.

DISCUSSION:

[1] RCW 82.08.02565 and 82.12.02565 respectively provide retail sales and use tax exemptions for equipment sold to or used by a manufacturer where such equipment is “used directly in a manufacturing operation.”⁴ RCW 82.08.02565 defines a manufacturing operation as beginning “at the point where the raw materials enter the manufacturing site” and ending “at the point where the finished product leaves the manufacturing site.”

The taxpayer argues:

[N]o requirement exists that equipment must be purchased exclusively for use in manufacturing to qualify for the manufacturing sales tax exemption. There is simply no language within RCW 82.08.02565 that in any way states, suggests, or implies that a quantitative level of use in manufacturing must be met to qualify for exemption.

. . .

Clearly, the portion of the statute granting the exemption does not contain any language conditioning the eligibility for the exemption on exclusive or any other special level of “direct use.” Simple direct use of the equipment is all that is required. Further, the definition of “used directly” also contains no mention of any requisite level of use. The clear language of the statute leaves no doubt that the machinery and equipment purchased must merely be “used directly in a manufacturing operation” to qualify for the manufacturing exemption. It is also important to note that the “direct use” in manufacturing of the racks and trucks was not a minor and inconsequential amount of use, but was instead a substantial and continuing use in manufacturing operations.

We agree with the taxpayer that the equipment need not be used exclusively in manufacturing to qualify for exemption. However, we disagree with the taxpayer’s position that no “special level” of direct use is required. Specifically, the Department considers potentially eligible machinery and equipment to qualify for the exemption only if the majority of the use (as measured by the percentage of time, revenue, or volume of products derived, or other reasonable measure) is in the manufacturing operation. The Department’s position is supported by the legislative history of the M&E exemption, which is summarized below.

⁴Although the M&E exemption contains numerous requirements, the issues in this appeal focus only on the extent and timing of use required in the manufacturing operations. As such, other requirements for exemption will not be addressed.

In 1999, the legislature passed and the governor signed Engrossed Substitute House Bill 1887. With exceptions not relevant here, the 1999 legislation clarified the existing law and can be applied retroactively. See WAC 458-20-13601 (Emergency Rule 13601).⁵

In the 1999 revision of RCW 82.08.02565, the legislature and 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 Finance Committee that the Department applies a majority use test to determine whether dual use machinery and equipment qualifies for exemption.⁶ Thus, the House was aware that the Department applied a majority use test under the existing language in RCW 82.08.02565 when the House retained the relevant statutory language.

After the bill passed the House, the bill’s sponsors in the Senate discussed the majority use test.⁷ 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.”

The bill passed the Senate without changes to the applicable language. Finally, the Governor expressed his understanding of the bill 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.

Thus, if the majority use of the racks and trucks was in the baking operations, the racks and trucks qualify for exemption. For purposes of the majority use test, we note that use of the racks and trucks in delivery operations outside the manufacturing site does not constitute use in the

⁵ On May 28, 1999 the Department filed three emergency rules to implement the legislative changes, which became effective immediately on filing. WAC 458-20-135 (revised); WAC 458-20-136 (revised); WAC 458-20-13601 (new).

⁶ See Audit Practice Document submitted as part of Director Fred Kiga’s testimony before the House Finance Committee on March 4, 1999.

⁷ See Floor Colloquy between Senators Loveland and Snyder, ESHB 1887, read at 3:01 PM April 16, 1999.

manufacturing operations.⁸ We remand the taxpayer's petition to the Audit Division to determine whether the majority use of the taxpayer's racks and trucks was in its baking operations. The taxpayer bears the burden to prove its entitlement to the exemption. In re All-State Construction Co., Inc., 70 Wn.2d 657, 665, 425 P.2d 16 (1967).

[2] If the taxpayer proves that the majority use of the racks and trucks was in the baking operations, the next issue is whether the M&E exemption should be denied where the taxpayer's first use of the racks and trucks was in distributing the baked goods outside the manufacturing site.⁹ We note that there is a factual dispute between the taxpayer and the Audit Division regarding this issue. The taxpayer asserts that its first use of all of the racks and trucks was in the baking operations. The Audit Division, on the other hand, asserts that the baking and distribution operations were ongoing at the time the taxpayer purchased the assets of the bakeries (including the racks and trucks). As such, the Audit Division argues, it is reasonable to assume that some of the racks and trucks were first used by the taxpayer in distributing the goods (a taxable use), rather than in the baking operations (an exempt use). We need not resolve this factual dispute, as its outcome is irrelevant to our disposition of this case.

Under the majority use test, provided the taxpayer initially uses the items (racks and trucks) in an activity where the majority of their use is an exempt use (baking operations), the items qualify for exemption. We need not consider whether each individual item was first used in a minority, nonexempt use (distributing goods outside the baking site). To hold otherwise would create an unreasonable administrative burden and would run contrary to the intent of the statute to provide a meaningful and fair exemption to promote economic development. See Governor's veto message of ESHB 1887, set forth above.

In summary, provided the initial use of the racks and trucks was in the baking/distributing operations and the majority use of the racks and trucks was in the baking operations (rather than the off-site delivery operations), the items qualify for exemption.

DECISION AND DISPOSITION:

⁸ See Governor's explanation of the partial veto of HB 2337 (Chapter 290, Laws of 1996), March 30, 1996. In his partial veto, the Governor explained:

Section 6 of House Bill No. 2337 changes the definition of "manufacturing operation" so as to extend the manufacturer's sales and use tax exemption to purchases of vehicles used in timber impact areas to deliver trusses to a construction site. This legislation would establish a disturbing precedent. For purposes of a tax exemption, it would extend the concept of a manufacturing facility beyond the physical plant at which machinery and equipment are used to make a product to include the equipment used to deliver the product to the customer. This is contrary to the aim of the exemption enacted in the 1995 session.

The Governor's partial veto is part of the legislative process and must be considered when determining legislative intent. Shelton Hotel Co. v. Bates, 4 Wn.2d 498, 506, 104 P.2d 478 (1940); State v. Brasel, 28 Wn. App. 303, 309, 623 P.2d 696 (1981). Further, the statute must be interpreted as if the vetoed portion never existed. Id.

⁹ RCW 82.12.010(2) defines "use" as "the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (as a consumer)."

The taxpayer's petition is granted in part. The taxpayer's petition is remanded to the Audit Division for adjustment consistent with this decision.

Dated this 29th day of February, 2000.