

Cite as Det. No. 99-337, 19 WTD 876 (2000)

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 and Refund of )	
)	No. 99-337
... )	Registration No. . . .
)	FY . . . /Audit No. . . .

- [1] EMERGENCY RULE 13601; RCW 82.08.02565, 82.12.02565: MACHINERY AND EQUIPMENT (M & E) EXEMPTION – COMMUNICATIONS EQUIPMENT. The exemption from the retail sales and use taxes for machinery and equipment used by manufacturers is not available if the sole use of the equipment is to communicate with employees.
- [2] EMERGENCY RULE 13601; RCW 82.08.02565, 82.12.02565: MACHINERY AND EQUIPMENT (M & E) EXEMPTION – DUAL USE. When a taxpayer purchases machinery or equipment that is used in both a qualifying and non-qualifying use, then the Department will use a majority use test to determine if the equipment qualifies for the machinery and equipment exemption from the retail sales or use tax.
- [3] EMERGENCY RULE 13601; RCW 82.08.02565, 82.12.02565: MACHINERY AND EQUIPMENT (M & E) EXEMPTION – TANGIBLE PERSONAL PROPERTY. Machinery and equipment must be used to manufacture tangible personal property to qualify for the machinery and equipment exemption. If a taxpayer purchases machinery or equipment that is used to produce items that will be affixed to the real property where it is produced, then the taxpayer is not manufacturing tangible personal property. Therefore, the machinery and equipment exemption does not apply to that equipment.

NATURE OF ACTION:

A cement manufacturer requests correction of an assessment of deferred retail sales tax on its purchase of mobile terminals installed in its concrete mixer trucks; and the purchase of computer hardware and software used in its dispatching, batching, and accounting functions. The taxpayer claims the mobile terminals and computer equipment qualify for the manufacturing machinery

and equipment (M&E) exemption per RCW 82.08.02565. Additionally, the taxpayer requests a ruling that specialized cement delivery trucks also qualify for the M&E exemption.<sup>1</sup>

#### BACKGROUND:

Coffman, A.L.J. -- The taxpayer is a corporation, which sells mixed cement in Washington. When the taxpayer delivers large quantities of its product to the customer, it uses “transit cement mixing trucks”.<sup>2</sup> The taxpayer loads the mixer on the transit cement mixing trucks with sand, cement, gravel, and water. The loading of the mixer occurs at the taxpayer’s place of business and mixing occurs there. The mixer rotates producing cement, commonly referred to as “mud”. The mixer continues to rotate while the transit cement mixing trucks are driven to the customer’s location, where the cement is poured into forms. When the mud dries concrete is formed.

When the taxpayer delivers small quantities of product to the customer, it uses the “Readymixer”, rather than transit cement mixing trucks. The taxpayer loads the sand, cement, and gravel into separate compartments on the vehicle. The “Readymixer” is driven to the customer’s site where water is added and the mud is produced at the customer’s location in the quantity needed.

#### Tax Assessment.

The Audit Division, for the period January 1, 1992 through December 31, 1995, reviewed the taxpayer’s books and records. As a result of this review, the Audit Division issued tax assessment number FY. . . . The tax assessment included use tax on two purchases of tangible personal property made by the taxpayer. In late 1995, the taxpayer purchased . . . Mobile terminals, which were used in the transit cement mixing trucks. Additionally, the taxpayer purchased computer hardware and software. The taxpayer did not provide the sellers with exemption certificates because the sellers were located outside of Washington. However, the taxpayer claimed the M&E exemption on its annual report filed with the Department in January 1996.

There does not appear to be any factual dispute<sup>3</sup> concerning the use of the mobile terminals and the computer hardware and software. The dispute is whether the purchases qualify for the M&E exemption. The Audit Division<sup>4</sup> describes the mobile terminals purchased as follows:

The . . . MOBILE TERMINALS FROM \_\_\_\_\_ consist of mobile radio tracking and transmitting units installed in the company’s trucks, the taxpayer contends that these units are used in the manufacturing process and that ready mix trucks are mobile manufacturing units, as the ready mix is manufactured as the truck is driving down the road and the product is being mixed. Because the system is used for operations that DOR

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

<sup>2</sup> This is a term used by the taxpayer. These vehicles are commonly known as ready mix concrete trucks.

<sup>3</sup> However, the extent of use of the various equipment has yet to be determined.

<sup>4</sup> Auditor’s Detail of Differences and Instructions to Taxpayers. Page 2.

does not recognize as the manufacturing process, the auditor has disallowed the Manufacturing machinery and equipment exemption established by HB 5201.

The mobile terminals were used to communicate with the drivers of the concrete mixing trucks and to dispatch them to various jobs.

The Audit Division<sup>5</sup> describes the computer equipment as follows:

The COMPUTER HARD AND SOFTWARE FROM \_\_\_\_\_ consist of the following: a computer, peripheral equipment, application software, system installation, hardware service and priority software support services (the last two items are billed on a monthly basis). . . . In a nutshell, the software consists of Dispatching, Batching and Accounting applications. The dispatching system encompasses the entire dispatching process from quoting and entering orders, to trucks and plant scheduling. The batching system encompasses the concrete production from the monitoring scales, moisture compensation, falling material and target weight, to control total mix to water. The accounting application incorporates concrete invoicing, profit and sales reporting, and account receivable.

#### Ruling Request.

The taxpayer requested a ruling from the Department's Taxpayer Information and Education Section (TI&E) that the "Readymixer" qualifies for the M&E exemption. TI&E denied the taxpayer's request because the mixing activity does not occur during a "manufacturing operation" as that term is defined in RCW 82.08.02565.

The taxpayer filed timely appeals of both the tax assessment and the TI&E ruling.

#### ISSUES:

1. Do mobile terminals installed on transit cement mixing trucks qualify for the M&E exemption from the retail sales tax?
2. Does the purchase of a computer and software used to dispatch vehicles, control the production of product, and perform accounting functions qualify for the M&E exemption?
3. Does a mobile unit that produces products at the customer's site qualify for the M&E exemption?

#### DISCUSSION:

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<sup>5</sup> Auditor's Detail of Differences and Instructions to Taxpayers. Page 2-3.

The requirements for the M&E exemption are found in RCW 82.08.02565, which exempts certain purchases of machinery and equipment from the retail sales tax. RCW 82.12.02565 provides a parallel exemption from the use tax.

1. Mobile terminals.

[1] The mobile terminals were used to communicate with the drivers of the transit concrete mixing trucks<sup>6</sup> and to dispatch them to various jobs. The Department does not dispute that the concrete mixing trucks can be machinery or equipment used to manufacture concrete. WAC 458-20-13601 (Emergency Rule 13601). However, we are not addressing the transit concrete mixing trucks<sup>7</sup>, we are addressing the communication system between the transit concrete mixing trucks and the taxpayer's offices. To qualify for the M&E exemption, the mobile terminals must be "used directly in a manufacturing operation". RCW 82.08.02565(1).

Emergency Rule 13601(9) states:

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. Examples of this are wheelbarrows, handcarts, storage racks, forklifts, tanks, vats, robotic arms, piping, and concrete storage pads. Floor space in buildings does not qualify under this criteria. Not eligible under this criteria are items that are used to ship the product or in which the product is packaged, as well as materials used to brace or support an item during transport.

<sup>6</sup> We assume the taxpayer uses a similar method to communicate with the drivers of the "Readymixers". However, the taxpayer did not state it was using the "Readymixers" during the audit period. To the extent that the taxpayer uses the terminals in the same manner in the "Readymixers", the same analysis would apply.

<sup>7</sup> We would have to address the issue of whether the trucks were used in a manufacturing operation to determine whether they qualify for the M&E exemption. However, the issue of their taxability is not before us.

- (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. Examples of this are catwalks adjacent to production equipment, scaffolding around tanks, braces under vats, and ladders near controls. Machinery and equipment used for access to the building or to provide a work space for people or a space for tangible personal property or machinery and equipment, such as stairways, is not eligible under this criteria.
- (e) Produces power for, or lubricates machinery and equipment. A generator providing power to a sander is an example of machinery and equipment that produces power for machinery and equipment. An electrical generating plant that provides power for a building is not eligible under this criteria. Lubricating devices such as hoses, oil guns, pumps, and meters, whether or not attached to machinery and equipment, are eligible under this criteria.
- (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.)

[1] The mobile terminals are essentially communication equipment. As such, the mobile terminals (communication) equipment used by the taxpayer does not qualify under any of the eight listed criteria as being "directly used" in the "manufacturing operation". Rather, the mobile terminals (communication) equipment is used for administrative, not manufacturing, purposes. Therefore, the mobile terminals (communication) equipment is not exempt under RCW 82.08.02565.

## 2. Computer hardware and software.

Emergency Rule 13601(9)(a) states, in part: "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." The batching system appears to qualify as being "directly used" in the "manufacturing operation". The computer system is, also, used for dispatching and accounting functions. Thus, the computer system has dual use.

[2] In the case of a dual use, the Department has adopted a majority use test to determine if the property qualifies for the exemption. Both the legislature and the executive branch have sanctioned this approach.<sup>8</sup> The Audit Division did not apply the majority use test. Because factual inquiry is necessary to the majority use test, we are remanding this matter to the Audit Division to determine whether the computer hardware and software qualify for the M&E exemption. If the taxpayer demonstrates majority use of the computers is for batching, then the exemption shall be granted.

### 3. “Readymixers”

The “Readymixer” is different from the transit cement mixing trucks discussed above because it has “separate compartments in the truck’s hopper storage. When the truck arrives at the [customer’s] site, the concrete is [produced] to the customer specifications.”<sup>9</sup>

RCW 82.04.120 defines the term “to manufacture” as:

...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, and shall include: (1) The production or fabrication of special made or custom made articles; (2) the production or fabrication of dental appliances, devices, restorations, substitutes, or other dental laboratory products by a dental laboratory or dental technician; (3) cutting, delimbing, and measuring of felled, cut, or taken trees; and (4) crushing and/or blending of rock, sand, stone, gravel, or ore.

(Emphasis added.)

[3] Thus, if the item produced is not tangible personal property [for sale], then there is no manufacturing activity.<sup>10</sup> When the taxpayer produces concrete at the customer’s site to the

<sup>8</sup> The Governor's partial veto is part of the legislative process and must be considered when determining legislative intent. Shelton Hotel Company, Inc. v. Jack E. Bates, 4 Wn.2d 498, 506, 104 P.2d 478 (1940); State v. Brasel, 28 Wn.App. 303, 309, 623 P.2d 696 (1981). The Governor said:

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.

Governor’s explanation of the partial veto of ESHB No. 1887, May 7, 1999. ESHB No. 1887 amended RCW 82.08.02565 and 82.1202565.

<sup>9</sup> Taxpayer’s letter dated June 29, 1998. The taxpayer used the terms “manufacturing site” and “manufactured”, however because these terms are directly related to the issue, we changed the quote to a neutral “customer’s site” and “produced”.

customer's specifications, it is not producing tangible personal property. Rather, it is producing items that will become affixed to or installed on the real estate.

In Morrison-Knudson v. State of Washington, 64 Wn.2d 90, 390 P.2d 712 (1964), the court was concerned about the construction of pontoons and anchor shells for the Hood Canal floating bridge. Morrison-Knudson built the pontoons and anchor shells in Seattle and transported them to Port Gamble where they were subjected to further modification and stored pending installation to create the bridge. The Department assessed manufacturing B&O tax on the activity of building the pontoons and anchor shells. The court said:

[Morrison-Knudson] argue that these items were "constructed" rather than "manufactured," and that the term "to manufacture" implies the making of a product salable in ordinary commerce. The statutory definition does not so limit the term. We may concede that there are construction activities which are not "manufacturing." Road building, for example, is not "manufacturing" because it does not result in the production of an "article of tangible personal property," but rather the improvement of real property. But the constructing of new, different, or useful articles of tangible personal property is "manufacturing," as defined by the statute.

(Emphasis added.) Id., at 90-91.

The taxpayer's activity of producing concrete at the customer's site is indistinguishable from the road building activity referred to in Morrison-Knudson. Further, in United Builders of Washington, Inc. v. Department of Rev., BTA Docket No. 193 (1968), the Board of Tax Appeals addressed a speculative builder's claim that the Department could not assess manufacturing B&O tax on activities away from the construction site, while not subjecting the same activities occurring at the construction site to the manufacturing B&O tax. Specifically, United Builders constructed trusses, cabinets, and wall panels that were transported from its shop facilities in Yakima to the construction site. The Department assessed manufacturing B&O tax on these activities, but when the taxpayer built the trusses, cabinets, or wall panels at the construction site, the Department did not assess B&O tax. The BTA explained:

The roof trusses, wall panels, and cabinets are new, different, and useful articles of tangible personal property as they are transported from the Appellant's Yakima headquarters and must be considered to have been manufactured by the Appellant for its use in incorporating them into its speculatively built houses.

Further, this distinction between manufacturing tangible personal property and improving real property is incorporated, in part, in the term "manufacturing operation" for the purposes of the M&E exemption. The M&E exemption only applies to "machinery and equipment used directly in a manufacturing operation or research and development operation, or to sales of or charges made

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<sup>10</sup> Also, there would not be a manufacturing operation for the purposes of the M&E exemption because a "manufacturing operation" is defined as "manufacturing ... tangible personal property". RCW 82.08.02565(2)(d).

for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment”. RCW 82.08.02565(1). The term manufacturing operation is defined in RCW 82.08.02565(2)(d) and states, in part: “The manufacturing operation begins at the point where the raw materials enter the manufacturing site and ends at the point where the processed material leaves the manufacturing site.”

The “Readymixer” produces concrete at the customer’s site. Emergency Rule 13601(9)(a)<sup>11</sup>. The product produced does not leave that site. It becomes attached to the real property. Therefore, the “Readymixer” is used in improving real property and not used in a manufacturing operation.

Further, House Bill 2337 (HB 2337) was approved by the legislature during the 1996 session. HB 2337 included a change to the definition of “manufacturing operation” by adding the following:

In the case of the manufacturing of building trusses in eligible areas, as defined in RCW 82.60.020(3)(e), the manufacturing operation ends at the point where the finished product is delivered to the building site.

The Governor vetoed this attempt to expand the definition of a manufacturing operation. The Governor explained his partial veto of HB 2337 by stating:

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

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<sup>11</sup> Emergency Rule 13601(9)(a) states, in part:

...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. ...

(Emphasis added.)

This rule states that ready-mix concrete trucks, what this taxpayer calls “transit cement mixing trucks,” are the type of machinery used directly in a manufacturing operation. It does not say that such trucks are automatically eligible for the M&E exemption. That would depend upon where the operation takes place and whether the majority of their use was in a manufacturing operation. Readymixers, as that term describes the trucks at issue, are different from the ready mix trucks that are addressed directly in the rule. The specific function of readymixers is to produce cement at a construction site.

Further, the “ready-mix concrete trucks” referred to in the Emergency Rule are used directly in manufacturing concrete. The “ready-mix concrete trucks” are used to manufacture large amounts of concrete, while the “Readymixer” is used to produce relatively small amounts. After manufacturing large volumes of concrete at a manufacturing site, the “ready-mix concrete trucks” transport that concrete to another location where the concrete becomes part of the improvement to real property. The normal use of the “ready-mix concrete trucks” is therefore similar to the manufacturing of pontoons in Morrison-Knudson or the trusses, etc. in United Builders. By contrast, the Readymixer trucks, create the concrete at the construction site.



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.

(Emphasis added.) Governor's explanation of the partial veto of HB 2337 (Chapter 290, Laws of 1996), March 30, 1996. This veto message clarifies that machinery and equipment must be at manufacturing plant to qualify for the M&E exemption.

We find the use of machinery and equipment must be at the physical manufacturing plant to qualify for the M&E exemption. However, because we are remanding the appeals to the Audit Division, the taxpayer shall have the opportunity to demonstrate that the "Readymixer" is directly used at the physical site of the taxpayer's manufacturing operation, not the "customer" site. If the taxpayer demonstrates majority use at the site of taxpayer's manufacturing operation, then the exemption shall be granted.

#### DECISION AND DISPOSITION:

The taxpayer's petition is denied as to the mobile terminals used for communications with the transit cement mixing trucks. The taxpayer's petition is remanded to the Audit Division for the purpose of applying the majority use test to computer hardware and software and to the "Readymixers."

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