Cite as Det No. 07-0342, 27 WTD 169 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Letter Ruling to . . .	)	D E T E R M I N A T I O N
	)	No. 07-0342
	)	Registration No. . . .
	)	Appeal of Letter Ruling

[1] RULE 13601; RCW 82.08.02565: EXEMPTIONS SALES OF MACHINERY AND EQUIPMENT FOR MANUFACTURING, RESEARCH AND DEVELOPMENT LABOR AND SERVICES FOR INSTALLATION WATER TREATMENT & DISTRIBUTION. A water distribution business is not a "manufacturer," and treatment of raw water by the water distribution business is not a "manufacturing operation" for purposes of the M&E exemption provided for in RCW 82.08.02565(1).

[2] RULE 13601; RCW 82.08.02565: SALES TAX -- MANUFACTURING MACHINERY AND EQUIPMENT (M&E) EXEMPTION -- SEWAGE SLUDGE -- COMPOST --MANUFACTURING OPERATION. Manufacturing activities commence when the waste products are processed separately and treated as a raw ingredient in producing a new commodity for sale. That separate processing cannot begin until the treatment process is complete. The production of Class B biosolids is part of the treatment process, and those items are a by-product or waste product of sewerage treatment rather than a new manufactured product. However, where the Production of Class A biosolids, involves additional steps and processing after the conclusion of the treatment process to create a new product for sale, then those activities would be qualify as a manufacturing operation. Accord, Det. No. 99-310, 19 WTD 377 (2000).

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.

Kreger, A.L.J. – A Taxpayer building a wastewater treatment plant that will produce water for distribution and compost for sale contests a letter ruling holding that equipment used for these activities is not eligible for the manufacturing machinery and equipment (M&E) exemption set

out in RCW 82.08.02565. With regard to the water treatment and distribution activities, we conclude that the majority use of the water treatment equipment is not in a qualifying manufacturing operation, and, therefore this equipment is not eligible for the M&E exemption. Under the evidence presented, we also affirm TI&E's conclusion that the production of Class B biosolids is part of the treatment process, and those items are a by-product or waste product of sewerage treatment, rather an article produced for sale in a manufacturing operation. Accordingly, we affirm the letter ruling and deny the Taxpayer's petition.[1]

ISSUES

1. Does a Taxpayer building and eventually operating a waste water treatment facility that will produce and distribute water qualify as a "manufacturer" engaged in a "manufacturing operation" for purposes of the manufacturing machinery and equipment exemption set out in RCW 82.08.02565?

2. Does the production of compost for sale from waste produced by a wastewater treatment facility qualify as "manufacturing operation" for purposes of the manufacturing machinery and equipment exemption set out in RCW 82.08.02565?

FINDINGS OF FACT

[Taxpayer] is a subdivision of a municipality engaged in the business of providing transit and water treatment services in . . ., Washington. This regional wastewater treatment utility is a "metropolitan municipal corporation."[2] In . . . 2005, the Taxpayer submitted a request to the Department of Revenue's Taxpayer Information and Education Division section (TI&E) for a ruling that equipment it would purchase and install for [a] wastewater treatment plant would be eligible for the sales and use tax exemption for manufacturing machinery and equipment (M&E) exemptions set out in RCW 82.08.02565 and RCW 82.12.02565.

… TI&E provided an initial ruling that wastewater treatment and distribution equipment was ineligible for the M&E exemption, because the Taxpayer was not engaged in the business of manufacturing. As to the biosolid treatment and production components of the treatment facility, TI&E requested additional information to determine whether these activities constituted manufacturing. Following additional interaction and provision of further information . . ., TI&E issued a second ruling affirming the conclusion that water purification and distribution was not a manufacturing activity and equipment used in that activity was not eligible for the M&E exemption. With regard to the biosolid treatment and production component of the facility, TI&E ruled that the Taxpayer would qualify for the exemption only to the extent that exceptional

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

[2] Metropolitan municipal corporations were created to "provide for the people of the populous metropolitan areas in the state the means of obtaining essential services not adequately provided by existing agencies of local government . . . [and] to enable cities and counties to act jointly to meet these common problems in order that the proper growth and development of the metropolitan areas of the state may be assured and the health and welfare of the people residing therein may be secured." RCW 82.58.010. Included within the functions authorized by RCW 82.58.050 are (1) Metropolitan water pollution abatement and (2) Metropolitan water supply.

quality biosolids were produced by the process. The Taxpayer timely appealed this ruling asserting that it is a manufacturer and entitled to the M&E exemption for items whose majority use is in producing water for distribution and compost products for sale.

The . . . treatment facility includes a wastewater treatment facility, a reclaimed water production facility, a biosolids production facility, and a conveyance system. The treatment plant will produce commercial quantities of reclaimed water for industrial, agricultural, and commercial use, as well as producing biosolids for agriculture and silviculture. The Taxpayer asserts that producing reclaimed water requires more filtration and treatment than necessary for standard wastewater treatment. Thus, the Taxpayer has incorporated additional steps and processes into its treatment process. The additional treatment steps and processes would not be necessary if the wastewater were only being treated to the level required for discharge.

The wastewater treatment is a four-stage process. First the liquid waster water enters the facility and undergoes initial screening to remove trash and large elements from the wastewater, which are sent to a landfill. The second stage is primary treatment, which begins in a sedimentation tank. From there the wastewater is pumped through a finer screening process. Primary treatment removes most of the suspended solids from the wastewater. These solids then enter a separate biosolids production process, which is detailed below. The third stage is the membrane bioreactor treatment phase where soluble and fine suspended dissolved materials are removed from the wastewater through bacteria reactions and a fine filtration process. The bioreactor process requires a higher concentration of bacteria necessitating equipment that is approximately four times larger than conventional processing facilities. From the bioreactor tanks the wastewater moves through membrane tanks that filter very fine solids and bacteria from the wastewater. After passing through the membrane tanks the water will be seven to ten times cleaner than water emerging from conventional wastewater treatment processes. Additional solids collected in the bioreactor phase are also sent to the biosolids production process. The final step of the treatment process is disinfection and conveyance, which occurs by treating the water with chlorine. The . . . plant will use a chlorine contact channel in the water pipeline. The conveyance facilities and pipeline that the reclaimed water goes through will be equipped to measure the chlorine levels in the water and these measurements will influence the quantity of chlorine added as well as the rate at which the water passes through the system to control the rate at which the chlorine dissipates.[3]

Biosolid production takes the solid waste products generated by the water treatment and processes them into commercially marketable soil amendments. Thus while part of the same facility, biosolid production uses different equipment. The Taxpayer currently produces

[3]The Taxpayer notes that the inception and design of the facility incorporated more extensive treatment processes to produce reclaimed water for distribution. The additional steps include modification to the treatment process from that used in conventional activated sludge technology (conventional treatment) that is currently used for most wastewater treatment. Examples of the changes and additional steps required include: use of finer filtration screens and larger channels during preliminary and primary processing; use of additional additives to facilitate settling of solids during primary treatment; use of larger tanks, aeration blowers, and pipes in the membrane bio-reactor treatment process than would be necessary for conventional treatment; and additional disinfection of the water in a chlorine contact channel.

commercially marketable soil amendments at its existing . . . water treatment plants and expects to sell all of the biosolid soil amendments produced at the . . . facility under these existing sales contracts.

Biosolid production is a three-step process. The solids separated during water treatment are transferred by pipeline from the primary treatment facility to be processed. The first stage is thickening where chemical polymers and gravity belt thickeners initially process the raw solids. The thickened solids are then pumped into anaerobic digesters for stabilization, where bacteria break down the organic solids reducing both the volume and pathogens in the sludge. The last step is dewatering through the use of centrifuges to meet market demand for a semi-solid product that can be applied using basic farm and forestry equipment. After de-watering the biosolid, soil amendments will be sorted in storage hoppers.

The Taxpayer does not assert that all of the construction and equipment expenditures for facility fit within the definition of qualifying M&E, but rather is seeking the M&E exemption for the portion it characterizes as used directly in the production of reclaimed water and biosolids and the cost of installing that equipment. Specifically the Taxpayer asserts that 8.9% of the preliminary treatment stage costs, 15% of the primary treatment costs, 63% of the membrane bi-reactor treatment process costs, 64% of the disinfection, chlorine contact channel costs, and 42% of the conveyance system costs are eligible for the M&E exemption. For the biosolids production portion of the facility, the Taxpayer asserts that 57% of the costs are eligible for the M&E exemption.

ANALYSIS

A. Introduction:

[1] RCW 82.08.02565 provides a retail sales tax exemption for certain machinery and equipment sold to a manufacturer and "used directly in a manufacturing operation." A similar exemption is found in the Washington use tax statutes. RCW 82.12.02565. Collectively, these analogous exemptions are commonly referred to as "the M&E exemption."

The M&E exemption has three specific requirements:

1. The purchaser/user must be a "manufacturer or processor for hire;"
2. The purchased/used item must meet the definition of "machinery and equipment;" and
3. The majority use of the purchased/used item must be "directly in a manufacturing operation or research and development operation."

See Det. No. 04-0097, 24 WTD 92, 95 (2005). Thus, the exemption is available only for a qualified person (manufacturer or processor for hire) who purchases qualified property (machinery and equipment) for a qualified use (where the majority use is directly in a manufacturing operation or research and development operation). If any of these elements is missing, the exemption is not available.

The Taxpayer has the burden to show that it is entitled to the exemption. "When we interpret exemption provisions, the burden is upon the taxpayer to show the exemption applies and any ambiguity is 'construed strictly, though fairly and in keeping with the ordinary meaning of their language, against the taxpayer.'" Det No. 04-0147, 23 WTD 369, 375 (2004) (*quoting Simpson Inv. Co. v. Department of Rev.*, 141 Wn.2d 139, 150, 3 P.3d 741 (2000)).

Taxpayer is a division of a metropolitan municipal corporation engaging in water treatment and distribution. Water distribution is a public utility activity subject to public utility tax (PUT). RCW 82.16.010.[4] Income from Taxpayer's water distribution business is specifically exempt from Washington's Business and Occupation (B&O) tax. *See* RCW 82.04.310(1) (the provisions of the B&O tax "shall not apply to any person in respect to a business activity . . . to which tax liability is specifically imposed under the provisions of" the PUT). The Taxpayer's wastewater treatment activities are subject to Washington B&O tax under the service and other activities classification. *See* WAC 458-20-251(4).

B. Taxpayer is not a "Manufacturer" of Reclaimed Water Engaged in a "Manufacturing Operation" and, Therefore, Does Not Qualify for the M&E Exemption for its Water Treatment and Distribution Services.

Water distribution is a public utility activity, which is not subject to the same market competition as other commercial or industrial ventures. Public utilities are regulated monopolies rather than private commercial ventures.[5] The difference between regulated public utility activities and manufacturing activities is significant because the M&E exemption was specifically enacted to increase employment in this state's "manufacturing industries" and to enhance the state's "competitive position" vis-à-vis other states for manufacturing jobs. *See, e.g.,* Laws of 1996, ch. 173 and notes following RCW 82.08.02565. A statement of intent can be crucial aid to the interpretation of a statute. *See, e.g., Roy v. Everett*, 118 Wn.2d 352, 356, 823 P.2d 1084 (1992). Yet, water treatment and distribution are not subject to the same market competition as other commodities. The Taxpayer's treatment plant will entail a significant investment and employ a significant staff. However, this does not make the treatment plant the type of investment that is the target of the M&E exemption.

Water treatment and distribution are local infrastructure services located in the communities they serve. Water treatment and distribution are not subject to the same commercial or geographic competition as manufacturing businesses. The stated intent of the M&E exemption is to increase

[4] RCW 82.16.010(4) defines a "Water distribution business" as: "the business of operating a plant or system for the distribution of water for hire or sale." RCW 82.16.020 levies a public utility tax upon persons engaging in the business of sewerage collection.

[5] "The public utilities industry is one where the legislature has decided that the public interest is best served by direct and uniform regulation of almost every phase of industry activity." *Tanner Elec. Co-op. v. Puget Sound Power & Light Co.*, 128 Wn.2d 656, 681, 911 P.2d 1301 (1996); *see also* Charles F. Phillips, Jr., *The Regulation of Public Utilities* 5 (1984) "[I]f economic power is not to be controlled by the market, it must be controlled by public authority, for a firm's contribution to the general welfare, rather than being the result of voluntary choice, must be compelled." Sewage treatment, including the interception, transfer, storage, treatment, and/or disposal of sewage is taxable as a service activity. WAC 458-20-251(4).

manufacturing jobs in Washington, not to increase public utility services or service activities. The intent to foster investment and employment is focused on a particular type of business. This is consistent with encouraging manufacturers to locate in Washington rather than other jurisdictions. The objective is not just fostering investment or creating jobs, but fostering a particular type of investment and class of jobs – manufacturing. The sale and distribution of reclaimed water is a PUT taxable activity not manufacturing. This conclusion is also consistent with Department precedent in this area. *See* Det. No. 99-310, 19 WTD 377 (2000) (limiting M&E exemption to non-public utility activities).

The legislature's treatment of utilities as separate and apart from this state's manufacturing industries for taxation purposes is long-standing. The B&O tax was first enacted as part of the Revenue Act of 1935. *See* Laws of 1935, ch. 180, Title II. The PUT was created in that same Act. *See Id.* at Title V. Then, as now, the term "manufacturer" was defined within the B&O tax provisions, and the term "water distribution business" was defined within the public utility tax provisions. *See Id.* at Title II, § 5(j); Title V, § 37(d). Furthermore, the Act specifically provided that the B&O tax did not apply to business activity subject to the PUT. *Id.* at Title II, § 11(b) ("The provisions of this title shall not apply to . . . (b) Any person in respect to a business activity with respect to which tax liability is specifically imposed under the provisions of title V of this act.").[6] Thus, it is clear that from the inception of both the public utility tax and the B&O tax the Washington Legislature understood that a "manufacturer" and a "water distribution business" were distinct types of businesses. Manufacturers were (and are) subject to the B&O tax on their gross income from manufacturing operations, while water distribution businesses were (and are) subject to the PUT on income from water distribution operations.[7]

In determining the meaning and intent of the M&E statute, we do not read the terms "manufacturer" engaged in a "manufacturing operation" in isolation. Rather, the terms must be viewed in context. "The construction of two statutes shall be made with the assumption that the Legislature does not intend to create an inconsistency. Statutes are to be read together, whenever possible, to achieve a harmonious total statutory scheme . . . which maintains the integrity of the respective statutes." *Peninsula Neighborhood Ass'n v. Department of Transportation*, 142 Wn.2d 328, 342, 12 P.3d 134, 142 (2000) (citations and internal quotations omitted). The Legislature clearly intended to distinguish between a "manufacturer" and a "public service or water distribution business" when it enacted the B&O tax and the public utility tax. We presume that the Legislature was cognizant of this distinction when it enacted the M&E exemption and that it did not intend to ascribe a different or inconsistent meaning. Taxpayer's suggestion that it

[6] This provision, which is codified at RCW 82.04.310(1), has been amended over the years and currently provides as follows:

> This chapter [chapter 82.04 RCW] shall not apply to any person in respect to a business activity with respect to which tax liability is specifically imposed under the provisions of chapter 82.16 RCW [the public utility tax] including amounts derived from activities for which a deduction is allowed under RCW 82.16.050.

[7] RCW 82.16.060 provides that a PUT business may be taxed under other chapters of Title 82 "with respect to activities other than those specifically within the provisions of this chapter." The Taxpayer's water distribution business is specifically taxable under RCW Ch. 82.16 and it is not taxable as a manufacturer under RCW Ch. 82.04.

qualifies as a "manufacturer" engaged in a "manufacturing operation" for purposes of the sales and use tax M&E exemptions, but not for purposes of the B&O tax and public utility tax, is contrary to the rules of construction set out above.

Taxpayer asserts that the Legislature did not intend to limit the M&E exemption to just those businesses that qualify as a manufacturer for purposes of the B&O tax. Rather, Taxpayer maintains that the exemption also applies to a public service business subject to the PUT so long as that public service business applies labor or skill "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." The Taxpayer is arguing that it can be a "manufacturer" engaged in a "manufacturing operation" for purposes of the sales and use tax M&E exemptions, but not for purposes of the B&O tax and public utility tax. We reach the opposite conclusion. Reading the M&E exemption statute as a whole and in harmony with Washington's other excise tax provisions, we conclude that the Legislature intended to limit the M&E exemption to just those taxpayers that engage in business as a manufacturer under the B&O tax. In other words, the same set of businesses that qualify as a manufacturer for purposes of the B&O tax qualify as a manufacturer for purposes of the M&E exemption; and businesses that do not qualify as a manufacturer under the B&O tax do not qualify as a manufacturer for purposes of the M&E exemption. Because Taxpayer is not a manufacturer for purposes of the B&O tax, it does not qualify for the M&E exemption.

The Taxpayer also notes that Kansas and Missouri have classified water treatment as manufacturing. *Jackson Excavating Co. v. Administrative Hearing Commission*, 646 S.W.2d 48 (Mo. 1983) (Transformation of raw water into potable water constitutes a "manufacturing" process.); *City of Parsons Kansas Letter Ruling* No. P-2003-024 dated April 24, 2003 (2003 WL 2008161(Kan.Dept.Rev.)) (Lease of equipment for filtration and production of water sold to city water utility customers, exempt under the Kansas manufacturing machinery and equipment sales tax exemption.)[8]

However, other jurisdictions have conversely concluded that water treatment is not manufacturing. *The Connecticut Water Co. v. Barbato*, 206 Conn. 337, 537 A.2d 490 (Conn. 1988) (Transformation of raw water into potable water was not "manufacturing."); *White River Environmental Partnership v. Indiana Dept. of Rev.*, No. 49T10-9605-TA-00048 (Ind. Tax Ct., May 15, 1988) (Chemicals and materials consumed in its wastewater treatment process produced a substantially changes the wastewater, but were not eligible for exemption because exemption required creation of a marketable good.)

Thus, there is a split of authority in other jurisdictions as to whether water treatment activities are manufacturing. However, we note that there is a significant structural distinction between the Washington M&E exemption and the exemptions noted above. None of these jurisdictions have a gross receipts tax comparable to our B&O tax, rather these states have corporate income taxes.

[8] However, we note that the applicable Kansas statute also expressly excludes from the definition of a qualifying manufacturing plant or facility "any facility primarily operated for the purpose of conveying or assisting in the conveyance of natural gas, electricity, oil or water." Kan. Stat. Ann. Section 79-3606(kk)(1)(C).

However, as discussed above, both our definition of a manufacturer and manufacturing activities, are found under the B&O tax statute. In this case, wastewater treatment is subject to service & other activities B&O tax, and the subsequent distribution and sale of reclaimed water is subject to PUT. Thus, neither water treatment nor sale of reclaimed water fit under the manufacturing B&O tax classification. There is no Washington authority that supports classifying water treatment as manufacturing.

C. Legislative History Supports Limiting M&E Exemption to Businesses who are Manufactures under the B&O Tax.

Even if we were to find that the term "manufacturer" as used in the M&E exemption was ambiguous and could reasonably be interpreted to include a water distribution or public service company subject to the PUT, we conclude that the legislative history supports restricting the M&E exemption to businesses remitting manufacturing B&O tax.[9]

The M&E exemption was enacted into law in 1995. *See* Laws of 1995, 1st Spec. Sess., ch. 3. The legislation (1995 Substitute Senate Bill 5201) was sponsored by a group of Senators that included Senator Albert Bauer and Senator Emilio Cantu. Prior to sponsoring the M&E exemption legislation, Senators Bauer and Cantu had been part of the Advisory Committee appointed to assist the Department of Revenue in crafting the "Manufacturing Tax Study" that was drafted under the authority of 1994 Senate Bill 6573. *See* Laws of 1994, ch. 94. The Manufacturing Tax Study was finalized and issued in December 1994 and recommended several amendments to the Washington sales and use taxes, including a proposal to "exempt from retail sales/use tax purchases of machinery and equipment by manufacturing firms in all areas of the state." Study, p. 8-2. The recommended sales/use tax exemption for machinery and equipment was incorporated into 1995 Substitute Senate Bill 5201.

During the floor debate on Substitute Senate Bill 5201, Senator Bauer was asked to clarify the scope of the proposed exemption.

> Senator Cantu: "Senator Bauer, I had the honor of serving with you as a member of the Manufacturing Tax Study Committee last summer that resulted in the recommendation of this legislation. In determining the fiscal impact of the proposal, several assumptions were made regarding the scope of the manufacturing and processing included in the recommendations. The scope of manufacturing and processing was described to include all business activities identified in two-digit Standard Industrial Codes 20 through 39 and those businesses' activities identified in the three digit Standard Industrial Code 737.

[9] A statute is ambiguous if it is susceptible to more than one reasonable interpretation. *Wingert v. Yellow Freight Sys., Inc.*, 146 Wn.2d 841, 852, 50 P.3d 256, 262 (2002). "If the statute is ambiguous, the courts must construe the statute so as to effectuate the legislative intent." *Id*. (*quoting Whatcom County v. City of Bellingham*, 128 Wn.2d 537, 546, 909 P.2d 1303 (1996)). In doing so, "it is appropriate to resort to aids to construction, including legislative history." *Department of Ecology v. Campbell & Gwinn L.L.C.*, 146 Wn.2d 1, 12, 43 P.3d 4, 10 (2002).

> "Is it intended that Substitute Senate Bill No. 5201 apply to all business activities identified in two-digit Standard Industrial Codes 20 through 39 and those businesses' activities identified in the three digit Standard Industrial Code 737?"
>
> Senator Bauer: "Yes, Substitute Senate Bill No. 5201 is intended to apply to all business activities identified in two-digit Standard Industrial Codes 20 through 39 and those businesses' activities identified in the three digit Standard Industrial Code 737,"

1995 Senate Journal, Vol. 1, p. 626. A similar Point of Inquiry was held between Representatives Foreman and Van Luven during floor debate in the House. *See* 1995 House Journal, Vol. III, p. 3974.

Senators Cantu and Bauer clarified that the proposed M&E legislation was intended to apply to all business activities that fall within certain Standard Industrial Classifications. The Standard Industrial Classification (SIC) was developed by the federal Office of Management and Budget as a means of analyzing economic data within and between various industries. The SIC is divided into various "Divisions," "Major Groups," "Industry Groups," and finally specific industry classifications. For example, a water supply business falls within Division E (Transportation, Communications, Electric, Gas, and Sanitary Services), Major Group 49 (Electric, Gas, and Sanitary Services), Industry Group 494 (Water Supply), and industry classification 4941 (Water Supply). *See* http://www.osha.gov/pls/imis/sic_manual.html (accessed 7/18/07).

Manufacturing is set out in Division D of the SIC. Within Division D are Major Groups 20 through 39, which constitute the manufacturing industries referred to by Senators Bauer and Cantu during the floor debate of Substitute Senate Bill 5201. Thus, the legislative intent was to create a sales tax exemption that specifically benefited those businesses that operate within Division D (Manufacturing) of the SIC.

In light of this legislative history, it is evident that the terms "manufacturer" and "manufacturing operation" as used within the M&E exemption are intended to encompass business operations that would qualify as Manufacturing under the SIC. We do not mean to infer that only businesses whose **primary** SIC falls within Division D can claim the exemption. *See* Manufacturing Tax Study, p. 4-3 and Table 4-4.[10] *See also* RCW 82.16.060; Det. No. 92-183ER, 13 WTD 096, 101 (1993) ("Generally, if a taxpayer engages in activities which are within the purview of two or more tax classifications, it will be taxable under each applicable

[10] One drawback of the SIC is that the assignment of an industry code to a particular business only reflects the principal activity of that business. Many taxpayers may engage in more than one business activity, but are instructed to report under the SIC that most closely corresponds to their overall business. Recognizing this drawback, the Department did not rely exclusively on the SIC in determining which businesses qualified as a "manufacturing" business. Rather, in compiling data for the Study, the Department used a database of 14,375 businesses that reported at least 10% of their gross income under the manufacturing B&O tax classification during 1992. Only 10,825 of those businesses reported as primarily falling under an industry code set out in Division D of the SIC.

classification."); *City of Kennewick v. State*, 67 Wn.2d 589, 594, 409 P.2d 138, 140-41 (1965) (A public utility is subject to B&O tax on gross receipts generated from activity not covered under the public utility tax.). However, it is clear that the intent of the Legislature was to limit the exemption to machinery and equipment purchased for use in a business operation that fits within the manufacturing activities defined under either Division D or Industry Group 737 of the SIC. If a taxpayer is engaged in two or more business operations, one of which constitutes manufacturing under Division D of the SIC, the machinery and equipment purchased for use within that business operation may qualify for the M&E exemption.

This legislative history supports that the M&E exemption targets particular categories of businesses, all of which fit into the manufacturing B&O tax classification.

The Taxpayer emphasizes that the construction and operation of the . . . facility will involve significant investment, creates family-wage jobs, and asserts that the legislative history of the exemption supports a broad interpretation of the M&E exemption.[11] However, the Taxpayer's advocacy of a broad interpretation of the legislative history is at odds with the rule of construction that exemption statutes are to be narrowly construed. *See Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 174, 500 P.2d 764, 767 (1972). With regard to the production and distribution of reclaimed water, we conclude that since the Taxpayer is not a engaging in business as a manufacturer under the B&O tax it is not eligible for the M&E exemption M&E used in its PUT and Service B&O taxable activities.

D. Discrete Business Activity of Manufacturing of Biosolids is Eligible for the M&E Exemption.

[2] The Taxpayer's biosolid production presents a related but different business activity. Unlike the wastewater treatment or distribution of reclaimed water, production and sale of biosolids will be a separate activity, using different equipment. In Det. No. 99-310, 19 WTD 377 (2000) we considered a similar situation in which a wastewater treatment plant altered its wastewater activities to produce marketable commercial biosolids out of its sewage sludge. We held that a municipality producing biosolids, for sale, from sewage sludge at its wastewater treatment plant, was eligible for the M&E exemption, where a separate manufacturing operation was involved.

Det. No. 99-310 recognized that the municipality was an eligible "manufacturer" for purposes of the M&E exemption notwithstanding that it was principally engaged in the business of wastewater treatment. However, the Determination did not hold that an entire wastewater treatment plant could qualify for the M&E exemption merely because it produces a commercially viable byproduct. To the contrary, the Determination held that the manufacturing operation began at the point where the sludge was processed separately and handled as a raw

[11] The Taxpayer also argues that the M&E exemption is not restricted to private sector businesses. We agree that the M&E exemption is not limited to private sector businesses, as noted in the following section where we affirm the conclusion that a portion of the Taxpayer's manufacture of saleable biosolids meets the definition of a manufacturing activity.

material, which occurred at its digesters. Machinery and equipment used in prior stages was disallowed because it was used primarily for wastewater treatment purposes.

In this case, the TI&E letter ruling restricted the M&E exemption to equipment used in producing exceptional grade (EQ or Class A) biosolids, which under WAC 173-308-250 may be applied to a lawn or home gardens. The Taxpayer objects to this restriction, asserting that producing both Class A and Class B biosolids for commercial sale fit within the definition of manufacturing. Properly managed municipal sewage sludge is defined by statute as a commodity.[12] RCW 70.95J.005. WAC 173-308-005 (1)(b) defines "biosolids" as: "sewage sludge or septage that has been or is being treated to meet standards so that it can be applied to the land." In contrast WAC 173-308-060(3) provides that "[s]ewage sludge or septage that fails to meet standards for classification as biosolids is a solid waste, and may not be applied to the land." Class B biosolids may not be applied to lawns or home gardens, but can be applied to agricultural land, forest land, a public contact site, or a land reclamation site. WAC 173-308-210. On appeal, the Taxpayer emphasizes that all of the biosolids produced at the facility will be sold for application as soil enhancements.

Producing a commodity for sale or commercial or industrial use is an essential element in qualifying as a manufacturer.[13] In this case it is not disputed that all of the biosolids, both Class

[12]RCW 70.95J.005 provides:

> 1) The legislature finds that:
> (a) Municipal sewage sludge is an unavoidable byproduct of the wastewater treatment process;
> (b) Population increases and technological improvements in wastewater treatment processes will double the amount of sludge generated within the next ten years;
> (c) Sludge management is often a financial burden to municipalities and to ratepayers;
> (d) Properly managed municipal sewage sludge is a valuable commodity and can be beneficially used in agriculture, silviculture, and in landscapes as a soil conditioner; and
> (e) Municipal sewage sludge can contain metals and microorganisms that, under certain circumstances, may pose a risk to public health.
> (2) The legislature declares that a program shall be established to manage municipal sewage sludge and that the program shall, to the maximum extent possible, ensure that municipal sewage sludge is reused as a beneficial commodity and is managed in a manner that minimizes risk to public health and the environment.
>
> Federal requirements are set out in the Clean Water Act, as amended, 33 U.S.C. 1345, and 40 CFR §503. Washington Department of Ecology requirements are set out in chapters 173-221 and 173-208 WAC.
>
> The Department of Ecology defines "sewage sludge" as follows, at WAC 173-308-080: "'Sewage sludge' is solid, semisolid, or liquid residue generated during the treatment of domestic sewage in a treatment works. Sewage sludge includes, but is not limited to, domestic septage; scum or solids removed in primary, secondary, or advanced wastewater treatment processes; and a material derived from sewage sludge."
>
> The Department of Ecology uses the term "biosolids" to refer to (and distinguish) municipal sewage sludge that has been treated to meet standards so that it is suitable for application to land. Federal rules do not use the term "biosolids," and rely instead on the term "sewage sludge."

[13]RCW 82.04.120 defines the term "to manufacture" as:

B and the Class A, will be sold by the Taxpayer. The point of dispute is at what point the Taxpayer ends its wastewater treatment activities and commences a separate manufacturing operation.

Subsection (2)(d) of RCW 82.08.02565 defines "manufacturing operation, " for purposes of the exemption, as follows:

> "Manufacturing operation" means the manufacturing of articles, substances, or commodities for sale as tangible personal property. A 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 TI&E letter ruling emphasized that the Taxpayer's facility was "first and foremost a sewage treatment plant" was restricted the manufacturing activity to the production of Class A biosolids. Limiting the manufacturing operation to activities that exceed "mere sewage treatment and disposal." The TI&E ruling considered the production of a Class B biosolid the last step of the sewage treatment process rather than as a product produced by a separate manufacturing process. So as to the Class B biosolids, the Taxpayer was selling a by-product of its treatment process rather than using that by-product as a raw ingredient in a separate manufacturing operation.

The Taxpayer has not established that the production of a Class B biosolid is the result of manufacturing activities occurring after its treatment activities are complete. So, while the Class B biosolids produced by the facility will be sold, the taxpayer will be selling a by-product of its sewerage treatment process rather than a new product that is the result of a separate manufacturing activity.

Under Det. No. 99-310, manufacturing activities commence when the waste products are processed separately and treated as a raw ingredient in producing a new commodity for sale. That separate processing cannot begin until the treatment process is complete. In this instance, the evidence does not show that treatment is completed until after the biosolids have been processed to the Class B, stage.

> 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,. . . .

The statute excludes certain activities, not pertinent here, from the definition of "to manufacture." Any taxpayer whose activities come within the scope of this definition is engaged in manufacturing.
RCW 82.04.110 defines a "manufacturer" as:

> every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his own materials or ingredients any articles, substances or commodities. . ..

Accordingly, under the evidence presented, we affirm TI&E's conclusion that the production of Class B biosolids is part of the treatment process, and those items are a by-product or waste product of sewerage treatment, rather an article produced for sale in a manufacturing operation.

In contrast, if the production of Class A biosolids, involves additional steps and processing after the conclusion of the treatment process to create a new product for sale, then those activities would be qualify as a manufacturing operation, as provided in Det. No. 99-310.

The Department considers potentially eligible machinery and equipment to qualify for the exemption only if the majority of the use, as measured by percentage of time, percentage of revenue, volume or products derived, or other reasonable measure, is in the manufacturing operation. RCW 82.08.02565(2)(d); WAC 458-20-13601(10).

The Taxpayer's petition is denied on this issue.

DECISION AND DISPOSITION

The Taxpayer's petition is denied.

Dated this 7th day of December, 2006