

The taxpayer indicated that it primarily services . . . an auto-recycler and used car parts yard, in addition to providing mobile crushing services to other customers. For services provided to [the auto-recycling yard], the taxpayer provided the following overview of the auto recycling process:

- The auto-recycling yard . . .
 - accepts for purchase inoperable automobiles from private parties;
 - requires that the sellers remove all hazardous materials from the automobiles; and
 - sells the parts from inoperable automobiles at its used parts yard.
- After the automobile is stripped of all saleable parts, the taxpayer moves the resultant hulk . . . to a staging area where the hulk is crushed with the taxpayer's mobile crusher.
- The taxpayer then moves the crushed hulk onto a flatbed trailer for transport to a shredding facility.

In providing crushing services to other customers, the taxpayer transports its mobile crusher to the customer's site and performs the crushing on site. The taxpayer then loads the hulk onto a flatbed trailer for transport to a shredding facility.

The taxpayer indicated that some automobile shredding facilities may have crushing capability but that the facilities prefer that the automobile hulks are crushed prior to delivery. The taxpayer provided a letter from a business which performs automobile shredding and is also a leading scrap metal recycler and steel manufacturer. The letter indicates that, "the value of crushed vehicles is greater than uncrushed vehicles . . . while the actual value of vehicles varies with the market, there is always an increased value for crushed vehicles versus uncrushed vehicles." This particular scrap metal recycler performs automobile hulk crushing also.

The taxpayer asserts in its appeal petition:

Prior to crushing, the hulk is a collection of individual component parts offered for sale. When the demand for individual parts has sufficiently diminished, then the value and demand of a crushed hulk exceeds the value of whatever parts remain. . . .

A crushed hulk is considerably changed from its previous state. It becomes a commodity rather than components for possible automotive related sales. Per the Department's reference to 16 WTD 43, compacting sheet metal into cubes is manufacturing because of the change in density which prevented loss when melted by the purchaser. A crushed hulk is more valuable to our purchaser because it has a higher efficiency rating as well; more steel can be fed through the shredder at a faster rate.

The taxpayer paid manufacturing business and occupation (B&O) tax on its crushing activities and took an exemption from retail sales tax under RCW 82.08.02565 for machinery and equipment that it uses in the crushing process. The Department of Revenue's (Department's) Audit Division (Audit) audited the taxpayer's records for the period of January 1, 2006, through June 30, 2009. Audit concluded that the taxpayer's crushing activities do not constitute manufacturing and issued an assessment of \$. . . . This assessment included \$. . . in use

tax/deferred sales tax, and \$. . . in interest. No adjustment was necessary for reclassifying the taxpayer's sales under the wholesaling B&O classification because the manufacturing B&O tax rate is the same. The taxpayer appeals this assessment arguing that its crushing activities constitute manufacturing within the meaning of RCW 82.08.02565.

ANALYSIS

Washington imposes a retail sales tax on "each retail sale in this state." RCW 82.08.020. Washington also imposes a corresponding use tax on the use of tangible personal property in this state pursuant to RCW 82.12.020. "Deferred sales tax" simply refers to Washington's retail sales tax, the payment of which has been deferred at the taxpayer's election. Det. No. 01-145R, 24 WTD 11 (2005). In this case, Audit assessed use tax/deferred sales tax on the taxpayer's purchases of machinery and equipment . . . used for its crushing activities. The taxpayer argues that its purchases of the items are exempt from retail sales tax under RCW 82.08.02565, and that its use of these items is exempt under the equivalent use tax exemption in RCW 82.12.02565. We collectively refer to these exemptions as "the M&E exemption." See Det. No. 07-0324E, 27 WTD 119 (2007).

As explained in prior determinations by the Department, "the M&E exemption . . . is strictly construed in favor of application of the tax and against claiming the exemption," and the burden of proving entitlement to the exemption is on the taxpayer. Det. No. 05-0193, 25 WTD 143 (2006); Det. No. 01-007, 20 WTD 214 (2001); see also: *Budget Rent-A-Car, Inc. Dep't of Revenue*, 81 Wn.2d 171, 174-5, 500 P.2d 764 (1972); *All-State Constr. Co. v. Gordon*, 70 Wn.2d 657, 425 P.2d 16 (1967); *Yakima Fruit Growers Ass'n v. Henneford*, 187 Wn. 252, 258, 60 P.2d 62 (1936).

The M&E exemption is for sales of machinery and equipment sold to a manufacturer, and "used directly in a manufacturing operation." RCW 82.08.02565. In this case, Audit disallowed the M&E exemption for machinery and equipment used for crushing activities based on its conclusion that the taxpayer's business of purchasing and crushing of automobile hulks for sale to metal recyclers does not constitute a manufacturing operation.

RCW 82.08.02565(2)(d) defines "manufacturing operation" for the M&E exemption as "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." This statute does not define the term "manufacture."² That definition is found in RCW 82.04.120,³ which provides in pertinent part:

² [Section 2 of Chapter 23, Laws of 2011 (enacted after this determination was issued to the taxpayer) amended RCW 82.08.02565 to add definitions of "manufacturer" and "manufacturing":

(d) "Manufacturer" means a person that qualifies as a manufacturer under RCW [82.04.110](#). "Manufacturer" also includes a person that prints newspapers or other materials.

(e) "Manufacturing" means only those activities that come within the definition of "to manufacture" in

“To manufacture” embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use, 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.

The dispute in this case centers on whether the taxpayer’s automobile crushing activities creates “a new, different or useful substance or article of tangible personal property.” In issuing the above assessment, Audit concluded that the taxpayer’s crushing of automobile hulks did not create a new, different, or useful product. This is not the first case in which the Department or Washington courts have considered this requirement of the term “to manufacture.”

The Washington State Supreme Court articulated a test for determining whether a new, different or useful article is produced in *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962). In concluding that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120, the court developed the following test:

We think the test that should be applied to determine whether a new, different, and useful article has been produced is whether a significant change has been accomplished when the end product is compared with the article before it was subjected to the process. By the end product we mean the product as it appears at the time it is sold or released by the one performing the process.

Id. at 175.

RCW [82.04.120](#) and are taxed as manufacturing or processing for hire under chapter [82.04](#) RCW, or would be taxed as such if such activity were conducted in this state or if not for an exemption or deduction. “Manufacturing” also includes printing newspapers or other materials. An activity is not taxed as manufacturing or processing for hire under chapter [82.04](#) RCW if the activity is within the purview of chapter [82.16](#) RCW.

RCW 82.08.02565(2).]

³ We note that even though this definition is found among the statutes applicable to Washington’s B&O tax, it also applies for purposes of the M&E exemption. As explained in Det. No. 07-0342, 27 WTD 169 (2008), “[i]n 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.” This conclusion is based on the Washington State Supreme Court’s holding in *Peninsula Neighborhood Ass’n v. Dep’t of Transportation*, 142 Wn.2d 328, 342, 12 P.3d 134, 142 (2000) (“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.”).

A year later the court relied upon this test in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963) and held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The court in *McDonnell* recognized that the above *Bornstein* test was “somewhat general in nature and may seem easier as a matter of articulation than as a matter of application.” 62 Wn.2d at 556. The court then identified the following factors one should consider in determining if the end product is a new, different, or useful product: “. . . among others, changes in form, quality, properties (such changes may be chemical, physical, and/or functional in nature), enhancement in value, the extent and the kind of processing involved, differences in demand, et cetera, . . .” *Id.* at 557.

We have applied these factors in various Department determinations. In Det. No. 94-255, 14 WTD 092 (1994), we concluded that compressing hay for shipping purposes is not manufacturing because the compressed hay was not significantly more useful than uncompressed hay. In that case, the taxpayer compressed hay for shipping purposes and its compressing processes did not change the underlying properties of the hay. *Id.* Similarly, in Det. No. 07-0082, 26 WTD 231 (2007), we held that a taxpayer that melted coal tar pitch did not engage in manufacturing because the pitch did not change chemically or functionally and did not change the value of the material.

We have also applied these factors in concluding that a taxpayer engaged in manufacturing. For example, in Det. No. 95-170, 16 WTD 43 (1995), we concluded that sorting and compacting loose sheet metal into cubes used by others is a manufacturing activity. In applying the *McDonnell* factors, we concluded that this activity created a new, different, or useful product because the process created metal cubes that took a different form, had different properties, and had a greatly enhanced value compared to the unsorted metal scrap sheets, which were difficult to handle, store, and transport. *Id.* The determination noted that the physical properties of the metal had changed in the process and many large impurities had been removed from the metal scraps. *Id.*

In this case, the taxpayer relies on Det. No. 95-170 and *McDonnell* to argue that its process of crushing automobile hulks creates a new, different, or useful product. The taxpayer indicates that the form and function of the automobile hulk is changed in the crush process by virtue of changing a hulk stripped of saleable parts into a crushed hulk which has increased marketability with the steel shredding facilities. The taxpayer also asserts that the crushed hulk is considerably changed from its uncrushed state in that the size and density of the crushed hulk creates a higher efficiency rating with the steel shredders who are able to feed the crushed hulk through the shredder at a faster rate. The taxpayer distinguishes the crushed hulk from the compressed hay product dealt with in Det. No. 94-255, because the purpose of the hay – which was to feed livestock – remained the same when compressed, as opposed to the crushed hulk whose purpose changes once the crushing occurs.

Audit asserts that, while the taxpayer contends that a crushed hulk is more valuable than an uncrushed hulk, that fact alone is not indicative of a manufacturing activity. Audit indicates that automobile hulk crushing may reduce the height of the hulk but does not make a significant change to the properties of the metal, and that the taxpayer is merely providing a recycling

activity and has not created a “new, different, or useful substance”. Audit relies on the language from the *Bornstein* test that requires a “significant change” to the product at issue. 60 Wn.2d at 175.

We conclude that the taxpayer’s automobile crushing activities do not create a new, different, or useful product. The prominent factor in this case is that the taxpayer’s activities create a product that is more marketable with the steel shredding facilities. However, while change in value is a factor in determining whether a new, different, or useful product is created, it is not the only factor. *McDonnell*, 62 Wn.2d at 556; *see also* Det. No. 94-255. Aside from reducing the height of the automobile hulk, the taxpayer’s crushing activity does not significantly change the physical form of the steel product, and does not change the underlying properties of the steel. Though there is an increase in the marketability of the hulks after they are crushed, the form of the steel product does not significantly change. In addition, the extent of the crushing processing involved is relatively simple.

This change in form is a key factor in the cases that have considered whether the end product was a new, different, or useful product. In *J&J Dunbar & Co. v. State*, 40 Wn.2d 763, 245 P.2d 1164 (1952), the taxpayer took raw whiskey and changed the nature and properties of the product into whiskey suitable for consumption. In *Bornstein*, the taxpayer took whole bottom fish and converted them into salable fish fillets. 60 Wn.2d 169. In *McDonnell*, the taxpayer took whole dried peas and converted them to split peas with a different value and form. 62 Wn.2d 553. In all of these cases, the taxpayers’ activities significantly changed the form, quality, and nature of the underlying property.

Finally, in Det. No. 95-170, the taxpayer took unsorted metal scraps, sorted them, and condensed them into useable 2x2x3 foot cubes. We found that there was a substantial change in form from the large pile of unsorted scrap sheet metal to the 2x2x3 foot compacted metal cubes. Unlike the current case, the metal cubes were composed of a different metal quality and had “a significant change in the physical properties of the metal.” 16 WTD at 46. Though the activities of both the taxpayer and the taxpayer in Det. No. 95-170 resulted in more marketable products, the taxpayer’s activities do not actually change the underlying properties of the steel product or form them to the extent that the taxpayer did in that case. We conclude that the taxpayer’s automobile crushing activities do not create a new, different, or useful product and, therefore, do not constitute a manufacturing operation eligible for the M&E exemption under RCW 82.08.02565.

DECISION AND DISPOSITION

The taxpayer’s petition is denied.

Dated this 15th day of February, 2011.