

Cite as Det. No. 17-0190, 38 WTD 023 (2019)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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 of )	
) )	No. 17-0190
) )	
. . . )	Registration No. . . .
) )	

[1] RCW 82.08.02565 – RETAIL/USE TAX EXEMPTION FOR MANUFACTURING MACHINERY AND EQUIPMENT. Taxpayer’s use of grinding machines to sharpen its own existing tools does not qualify for the M&E exemption.

[2] RCW 82.08.02565; WAC 458-20-13601 – RETAIL/USE TAX EXEMPTION FOR MANUFACTURING MACHINERY AND EQUIPMENT – MAJORITY USE THRESHOLD – The Department properly denied the M&E exemption claimed by the taxpayer for grinding machines that it used both to sharpen its own blades and to produce items of tangible personal property for sale where the taxpayer failed to supply documentation showing its majority use was for producing items of tangible personal property for sale.

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.

Stojak, T.R.O. – A manufacturer of precision hard metal and titanium parts petitions for a correction of use tax assessed on grinding machines it purchased that it uses to sharpen tools for customers, to sharpen its own tools, and to manufacture new tools. It asserts that the purchased machinery qualifies for the machinery and equipment (“M&E”) exemption. We deny the petition.<sup>1</sup>

### ISSUES

1. Whether, under RCW 82.08.02565, machinery used to recondition tools is “used directly” in a “manufacturing operation” and therefore eligible for the M&E tax exemption.
2. Under RCW 82.08.02565(2) and WAC 458-20-13601 (“Rule 13601”), does the documentation provided by Taxpayer establish that it used the machines at issue the majority of the time directly in a manufacturing operation?

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

## FINDINGS OF FACT

... (“Taxpayer”) manufactures and wholesales “precision hard metal and Titanium parts” for the aerospace, marine, medical, electronic, defense, and energy industries.<sup>2</sup> It also sharpens tools for outside customers for a fee. On April 23, 2015, Taxpayer purchased a tool and cutter grinding business. The purchase included all of the business’ assets. Specifically, the assets included in the purchase consisted of “all grinding machines, all grinding machine attachments, all grinding supplies, all tooling specific for said grinding machines, [and] a dust collection system.”<sup>3</sup> Taxpayer reported the equipment purchased as capital assets on its 2015 federal corporate income tax return (Form 1120S). Taxpayer did not ... pay retail sales tax or use tax to Washington State on the assets purchased.

In November of 2016, the Department of Revenue Audit Division (“Audit”) commenced a review of Taxpayer’s records for the period of January 1, 2013, through December 31, 2015. During the course of the review, Taxpayer stated that it uses the grinding machines it purchased eighty percent of the time for sharpening tools for outside customers, and twenty percent of the time for sharpening its own tools or manufacturing new tools.<sup>4</sup> Pursuant to the review, Audit ultimately determined that Taxpayer owed use tax and/or deferred sales tax on the assets acquired pursuant to its purchase of the tool and cutter grinding business. Audit also determined that Taxpayer owed retail sales tax and retailing business and occupation (“B&O”) tax on income it received from sharpening tools for outside customers.<sup>5</sup>

... [O]n February 6, 2017, Audit issued an assessment against Taxpayer for \$ . . . . This total included retail sales tax of \$ . . . , retailing B&O tax of \$ . . . , wholesaling B&O tax of \$ . . . , use tax and/or deferred sales tax of \$ . . . , interest of \$ . . . , and a five percent assessment penalty of \$ . . . .

Taxpayer petitioned for review of the assessment on March 8, 2017. Taxpayer’s petition protests the assessment of use tax on the grinding and cutting tools it purchased. Taxpayer’s petition asserts that “after further review” it concludes that it uses the grinding machines at issue over fifty percent of the time for “in house grinding and manufacturing of tooling.” Therefore, it contends that the purchased machines are “not subject to use tax . . .” Subsequent to filing the petition, Taxpayer provided a copy of weekly timecards for one of its employees. A written explanation did not accompany the timecards. Most, but not all, of the timecards submitted reflect a month and day for the pay period. However, a few of the timecards submitted reflect a year. The total hours worked for the employee are handwritten at the bottom of each timecard. The top of each timecard reflects a number of hours handwritten next to Taxpayer’s name. For most of the timecards submitted, the total number of hours noted next to Taxpayer’s name exceeds fifty percent of the

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<sup>2</sup> See . . .

<sup>3</sup> Schedule A to “Agreement to Sell Business” between . . . and . . . , April 23, 2015.

<sup>4</sup> Email from . . . to . . . , December 20, 2016.

<sup>5</sup> Taxpayer does not dispute the tax assessed on this income. [Although Audit described the assessed tax (at issue) as ‘use tax and/or deferred sales tax on the assets acquired’ by the Taxpayer, we conclude that use tax (not deferred sales tax) applies here.]

total hours worked for the week. However, the timecards provided do not document the activity engaged in by the employee.<sup>6</sup>

A telephonic hearing was held on this matter on Wednesday, July 12, 2017. During the hearing, Taxpayer voiced a strong opposition to Audit's determination that the machines it purchased do not qualify for the M&E tax [exemption]. Taxpayer stated that it uses the machines at issue directly to manufacture and recondition carbide tools.

Following the hearing, Taxpayer provided a description of the equipment purchased at issue. The description provided is as follows:

- Top Work (MCT 500) CNC grinder-grinds tools automatically using numeric controls
- KO LEE (BA96) universal grinder-used for parting off, grinding flutes, adds radius
- Cincinnati (Monoset) universal grinder-grinds flutes, adds radius
- HAAS universal grinder-grinds flutes, adds radius

Taxpayer noted that this equipment "is used also to grind pins [and] bushings for our aerospace customers."

### ANALYSIS

All sales of tangible personal property to consumers in the state of Washington, including successive retail sales of the same property, are subject to retail sales tax, unless there is a specific exemption. RCW 82.08.020; 82.04.050. In general, the use tax applies upon the use within Washington of any tangible personal property where the sale or acquisition of which has not been subjected to the Washington retail sales tax. It complements the retail sales tax by imposing a tax of like amount. Rule 178; RCW 82.12.020 . . . .

RCW 82.08.02565(1)(a) provides a retail sales tax exemption for sales "to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation . . . ." RCW 82.12.02565 provides a corresponding use tax exemption. These two complementary statutory exemptions are often referred to in the singular as "the M&E exemption." Det. No. 07-0324E, 27 WTD 119, 122 (2008); Det. No. 01-007, 20 WTD 214, 216 (2001). The M&E exemption, like all tax exemptions in Washington, 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. See *Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972); Det. No. 01-007, 20 WTD 214, 231 (2001).

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<sup>6</sup> We presume the hours handwritten next to Taxpayer's name represent the hours spent on in-house sharpening activities.

The M&E retail sales tax exemption in RCW 82.08.02565<sup>7</sup> reads as follows:

- (1) (a) The tax levied by RCW 82.08.020 does not apply to sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation, to sales to a person engaged in testing for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation, or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment.

RCW 82.08.02565(2) additionally provides, in parts pertinent to this discussion:

- (2) For purposes of this section and RCW 82.12.02565<sup>8</sup>:

- (a) “Machinery and equipment” means industrial fixtures, devices . . . and tangible personal property that becomes an ingredient or component thereof . . .
- (b) “Machinery and equipment” does not include:
  - . . . .
  - (ii) Property with a useful life of less than one year;
- (c) Machinery and equipment is “used directly” in a manufacturing operation, testing operation, or research and development operation if the machinery and equipment:
  - . . . .
  - (i) Acts upon or interacts with an item of tangible personal property
  - . . . [or]
  - (vi) Produces another item of tangible personal property for use in the manufacturing operation . . . .
- (d) “Manufacturer” means a person that qualifies as a manufacturer under RCW 82.04.110 . . . .
- (e) “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 . . . .

<sup>7</sup> RCW 82.12.02565 provides a corresponding use tax exemption. [Additionally, RCW 82.12.02565(2) provides that the definitions and requirements in RCW 82.08.02565 apply to the use tax M&E exemption. Consequently, we refer to the definitions and conditions set out in RCW 82.08.02565 in addressing whether use tax is owed on the equipment at issue.]

<sup>8</sup> RCW 82.12.02565 provides the use tax exemption that corresponds to the sales tax exemption in RCW 82.08.02565.

RCW 82.08.02565(2). Therefore, the M&E exemption has four distinct 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 item must be “used directly” . . .
4. in a “manufacturing operation.”

Det. No. 04-0097, 24 WTD 92 (2005).

In 2000, the Department adopted Rule 13601, in part to address how to determine whether equipment that is used both in a qualifying and non-qualifying manner is eligible for the M&E tax exemption. Pursuant to this rule, the Department adopts the “majority use threshold” requirement. Rule 13601(9). Rule 13601(9)(a) states:

Machinery and equipment both used directly in a qualifying operation and used in a nonqualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. Examples of situations in which an item of machinery and equipment is used for qualifying and nonqualifying purposes include: The use of machinery and equipment in manufacturing and repair activities . . . Majority use can be expressed as a percentage, with the minimum required amount of qualifying use being greater than fifty percent compared to overall use. To determine whether the majority use requirement has been satisfied, the person claiming the exemption must maintain records documenting the measurement used to substantiate a claim for exemption or, if time, value, or volume is not the basis for measurement, be able to establish by demonstrating through practice or routine that the requirement is satisfied . . .

. . . In this case, Taxpayer [concedes] that using the machines it purchased to sharpen tools for outside customers is a non-qualifying use.<sup>9</sup> . . . [Nor is there any question that using] the machines to manufacture new parts for its customers [is a qualifying use because they interact with an item of tangible personal property which is being manufactured for sale, and are therefore “used directly” in a “manufacturing operation.” RCW 82.04.02565(2)(c)(i) and RCW 82.04.02565(2)(f).] . . . Accordingly, before addressing majority use, we address whether . . . the machines [are “used directly”] in a manufacturing operation when [Taxpayer] uses them to sharpen its own existing tools.<sup>10</sup>

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<sup>9</sup> Taxpayer’s reliance in its petition on its amended breakdown of the proportion of time it uses the machines to grind tools for outside customers, versus the amount of time it uses the machines for in-house uses, suggests Taxpayer concedes this point.

<sup>10</sup> Taxpayer offered few details regarding its in-house use of the machines at issue. Audit based its determination, in part, on the conclusion that Taxpayer uses the machines “to sharpen in-house tooling.” We interpret this to mean Taxpayer uses the grinding machines to recondition already existing tools to ensure they are in optimal working order. Taxpayer does not provide any fact or detail that would contradict this conclusion.

Like Audit, we find the holding in Det. No. 13-0034, 32 WTD 220 (2013) analogous.<sup>11</sup> In that case, the Department determined that using sharpening and grinding equipment to fabricate new blades qualified for the M&E tax exemption, whereas using the same equipment to sharpen old blades did not. The Department reasoned that when the taxpayer uses the machines to fabricate new blades, it produces “another item of tangible personal property for use in the manufacturing operation” . . . . [RCW 82.08.02565(2)(c)(vi).<sup>12</sup>] To the contrary, when the taxpayer uses the same machines to sharpen old blades, it does not “produce another item of tangible personal property,” rather, it “restores old saw blades to proper working order.” *Id.* at 224.

[Here, when Taxpayer uses the grinding machines at issue to sharpen its own existing tools, it does not “produce another item of tangible personal property for use in a manufacturing operation,” as required by RCW 82.08.02565(2)(c)(vi). Accordingly, we find that the M&E tax exemption does not apply to Taxpayer’s use of the machines to sharpen its own tools.]

Having determined that Taxpayer’s use of the machines to sharpen [its] own tools does not meet the requirement that they be used directly in a “manufacturing operation,” we turn to whether Taxpayer’s use of the machines satisfies the majority use threshold requirement in Rule 13601(9)(a). Rule 13601(9)(a) requires taxpayers to “maintain records documenting the measurement used to substantiate a claim for exemption[.]” Here, Taxpayer relies on time as the unit of measurement to satisfy the majority use threshold. It states that it uses the machines over fifty percent “of the time” for in-house uses. However, the only documentation provided by Taxpayer to support its claim for exemption consists of timecards for one of its employees showing the total number of hours worked next to Taxpayer’s name and the total overall number of hours worked. The timecards do not document the amount of time the employee spent sharpening tools for outside customers, sharpening Taxpayer’s own tools, or manufacturing tools for sale.<sup>13</sup> Without such a breakdown we are unable to conclude that Taxpayer’s use of the machines satisfies the majority use threshold requirement. As such, Taxpayer fails to meet its burden to establish that the machines at issue qualify for the M&E tax exemption.

## DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 26th day of July 2017.

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<sup>11</sup> We understand that Taxpayer does not use the relevant machines to sharpen saw blades. Nonetheless, we find the decision in this determination applicable and precedential. The nature of the items sharpened was not dispositive to the determination. Instead, the fact that using the machines to sharpen old blades does not produce “another item of tangible personal property” dictated the resulting conclusion that such sharpening is not a qualifying use for purposes of the M&E tax exemption.

<sup>12</sup> [Subsection (2)(c)(vi) is the only definition of “used directly” that could apply in this instance. The other definitions of “used directly” apply only to machinery and equipment that does something to the item (or ingredients or components thereof) being manufactured for sale, i.e., is used in a “manufacturing operation” as defined in Subsection (2)(f). In contrast, Subsection (2)(c)(vi) applies to machinery and equipment that produces other tangible personal property, which in turn is used in a “manufacturing operation.”]

<sup>13</sup> We also find the fact that Taxpayer amended the proportion of time it uses the machines to perform in-house functions from twenty percent to over fifty percent problematic. Taxpayer provided the twenty percent estimate at the Supervisor’s conference as well as in writing pursuant to an email. Taxpayer fails to explain why its original estimate differed so substantially from the amended amount provided with its petition.