

Cite as Det. No. 03-0321, 24 WTD 176 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of) | <u>D E T E R M I N A T I O N</u> |
| Instructions for) | |
|) | No. 03-0321 |
|) | |
| ...) | Registration No. . . . |
|) | Appeal of TI&E Ruling |
|) | Docket No. . . . |
|) | |

RULE 13601; RCW 82.08.02565; ETA 2012-3S.08.12.13601; ETA 2012-7S.08.12.13601: RETAIL SALES TAX -- M&E EXEMPTION -- WATER SYSTEM -- A water system used throughout a food manufacturing process qualifies for the M&E exemption to the extent the water is used in the process (as opposed to the volume used to clean the building, equipment, or for other nonmanufacturing purposes).

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.

M. Pree, A.L.J. – A manufacturer of frozen french fries, which uses water throughout the manufacturing process, protests a ruling that its purchase of a well and associated fixtures was subject to retail sales tax and not exempt from the tax as manufacturing machinery and equipment (M&E).¹

ISSUE

Does the purchase of a water system, including the well, piping, and controls, qualify for the M&E exemption from retail sales tax when water is an integral part of the manufacturing operation?

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

FINDINGS OF FACT

. . . (taxpayer) manufactures frozen french fries in Washington. Whole potatoes enter its manufacturing facility, where the taxpayer uses water to wash, convey, peel, and blanch the potatoes. The potatoes absorb some of the water. The taxpayer then slices, fries, dries, and freezes the potatoes. The taxpayer also uses water to clean its equipment.

Because the taxpayer's facility uses a large quantity of water in this process, it planned to add a second well with the associated equipment. The taxpayer wrote the Department of Revenue's (DOR) Taxpayer Information and Education section (TI&E) inquiring whether its purchases for the second well would be exempt from retail sales tax as manufacturing machinery and equipment (M&E). TI&E advised the taxpayer these purchases would be subject to retail sales tax. The taxpayer appealed.

The taxpayer stores truckloads of raw, dirty potatoes in a building adjacent to its processing plant. When the taxpayer is ready to process potatoes, a six inch stream of water from pipes along the walls erodes piles of potatoes down into a center trough running through the building. The water flows with the potatoes through a flume into the nearby processing building where screens separate the potatoes, water, rocks, dirt and other debris. The water is recycled and used up to a dozen times for this purpose.² The taxpayer estimates it needs 400,000-500,000 gallons of water a day to convey and wash the potatoes in this manner.

The taxpayer uses steam to peel the potatoes. The steam peeler consumes about 50 gallons of water per minute. The potatoes next enter a pre-heated 13,000-14,000 gallon tank of water preheated to 140°-150°F, which softens the potatoes before they are pumped in the warm water to the taxpayer's cutting system. After they are sliced, they are de-watered using screens. They are graded with smaller pieces being removed for other purposes.³ The sliced potatoes then enter one of two 30,000 gallon tanks holding 30,000 gallons of 180°F water. Each tank consumes 400 – 500 gallons of water a minute. The taxpayer next places the product on a fifty-foot dryer belt, after which it is fried. A small amount of water is sprayed over the fries to separate the oil, prior to freezing the french fries.

The taxpayer also estimates that it uses 400 to 500 gallons of water a minute for cleaning the building and equipment to meet the various sanitary standards for food processors. All of the taxpayer's water is disposed of in accordance with a Department of Ecology waste discharge permit as food process water. The taxpayer holds a water right certificate for 2,500 gallons per minute, 2,960 acre-feet per year, to be used for irrigation and manufacturing. The taxpayer states it only uses the water (2,500,000 gallons per day) for manufacturing.

To meet these water needs, the taxpayer budgeted \$. . . to upgrade its water supply system as follows:

² Muddy and contaminated water is removed and discharged.

³ To make hash-browns, patties, etc.

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| 1. New well, well house, and piping to water storage tank | \$. . . |
| 2. Storage tank with yard piping | \$. . . |
| 3. Booster station retrofit | \$. . . |
| 4. Monitoring and control system | \$. . . |
| 5. Exiting well retrofit | \$. . . |
| 6. Miscellaneous Clean-up | \$. . . |
| 7. Engineering | \$. . . |
| 8. <u>Contingency</u> | <u>\$. . .</u> |
| Project Total | \$. . . |

According to the contract specifications the well was located on the plant property. The taxpayer does not believe sale tax is due on any of these transactions.

ANALYSIS

The M&E retail sales tax exemption is authorized under RCW 82.08.02565, which provides in part:

- (1) The tax levied by RCW 82.08.020 shall not apply to sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation

There are several required elements for the M&E exemption: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation or research and development operation. However, RCW 82.08.02565(2)(b)(iv) excludes building fixtures that are not integral to the manufacturing operation.

The first and second elements do not appear to be in dispute. The taxpayer's inquiry concerns a purchase (a sale). RCW 82.08.02565 does not define "manufacturing." However, RCW 82.04.120 does define manufacturing to embrace, "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" We conclude that the taxpayer engages in manufacturing by transforming raw potatoes into frozen french fries.

The third element is whether the well, piping, and controls are machinery and equipment. For purposes of the M&E exemption, "Machinery and Equipment" means "industrial fixtures, devices, and support facilities" WAC 458-20-13601(3)(d) (Rule 13601). An industrial fixture is an item attached to a building or to land. Rule 13601(3)(c). Attachment alone is determinative as to whether an item is an "industrial fixture." The statutory reference to "buildings" requires a determination as to whether the "items attached" are fixtures attached to the building, or simply part of the building. Building fixtures that are not integral to the manufacturing operation are not eligible for the exemption under RCW 82.08.02565(2)(b)(iv). We must distinguish between the water system's use as an industrial fixture integral to the

manufacturing operation, and the building's general water utility system. The Department's ETA 2012-3S.08.12.13601 recognizes building systems may have qualifying and non qualifying purposes:

Conversely, building fixtures are eligible if they are integral to the manufacturing operation, testing operation, or research and development operation, and meet the other requirements of the exemption, such as the "used directly" test. Thus, while the M&E exemption contemplates that these utility systems are to be separately considered as potentially eligible industrial fixtures and not a part of a "building" for purposes of exemption, not all such systems are eligible for the exemption.

Utility systems that serve a building purpose, as opposed to a manufacturing purpose, do not qualify. For example, a utility system used to perform a general building purpose, such as a HVAC system controlling the air temperature or air quality in general, is not eligible for the M&E exemption.

If a utility system is used for both qualifying and nonqualifying purposes, the system should be allocated so that only the qualifying portion of the system receives the exemption, and the building portion does not receive an exemption.

The Department's Excise Tax Advisory (ETA) 2012-7S.08.12.13601 recognizes that the word "fixture" is a term of art in that it has particular meaning in the context of tax:

The word "fixture" denotes a type of property that can be distinguished from a "building" per se. A fixture does not lose its identity when installed. Examples of fixtures are air conditioning units, furnaces, boilers, and heating units, plumbing fixtures, conveyors, electric generators, transformers, elevators, and cranes. In addition, the M&E exemption recognizes "utility systems" as fixtures. Property outside of buildings also qualifies as "industrial fixtures." Examples are tanks, pipes, pads, and lined ponds.

The new water system is attached to the building and the adjacent property outside of the building.⁴ To the extent the water system is integral to the manufacturing operation, it is an industrial fixture. Thus, being an industrial fixture, the water system meets the definition of "Machinery and Equipment." We conclude that to the extent the water is used for qualifying manufacturing purposes, the taxpayer's water system meets the third element to qualify as machinery and equipment.

However, we note, the taxpayer's water permit allows for the use of the water for other purposes, such as normal building operations and agricultural irrigation. The taxpayer will need to account for its water use because use integral to the operation is qualifying use, while other use does not qualify. Water used to clean, move, steam peel, and soften the potatoes qualifies as integral to

⁴ We understand the entire system is on the taxpayer's property (i.e., the pipes from the well do not cross another property).

the operation as well as water used to clean equipment to meet sanitary standards. Water used for general building purposes (rest rooms, building cleaning, etc.) and irrigation is not integral to the manufacturing operation. If a utility system is used both for qualifying and non-qualifying purposes, the system should be allocated so that only the qualifying portion of the system receives the exemption, and the building portion does not receive an exemption. ETA 2012-3S. One way of allocating a utility system is by applying the ratio of qualified use made by the system to the total use of the system. *Id.* It appears the taxpayer's engineers are able to track the volume of water used for each purpose by the taxpayer. In the taxpayer's operation, an appropriate allocation method would be volume measured by the gallons of water used, with volume from qualifying use of the water in the numerator and total volume from use of the water the denominator. To verify the percentage of exemption for its water system, the taxpayer must maintain sufficient records of the volume water consumed for qualifying purposes and the total volume of water used by the taxpayer.

The fourth and fifth elements required for the exemption are met. The taxpayer's water system meets the "used directly" element. The taxpayer's water system causes the water to directly and actively interact with the raw potatoes as they become french fries in a manner sufficient to meet the various sanitary standards. Through direct contact water moves, cleans, peels, heats, blanches, and is absorbed into the taxpayer's product. The water system is located at the taxpayer's facility and we conclude that it is directly used in the taxpayer's manufacturing operation.

DECISION AND DISPOSITION

We grant the taxpayer's petition in part, and deny the petition in part. To the extent the water system is used for qualifying purchases, the taxpayer may credit the applicable percentage from its retail sales tax or use tax obligation. Retail sales tax or use tax is due on the balance.

Dated this 21st day of November, 2003.