

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

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund and)		<u>D E T E R M I N A T I O N</u>
Correction of Assessment of)		
))		No. 04-0097
))		
))		Registration No. . . .
))		Document No. . . .
))		Audit No. . . .
))		Docket No. . . .

[1] RULE 13601; RCW 82.08.02565: MANUFACTURING MACHINERY AND EQUIPMENT (M&E) EXEMPTION – LOGGING OPERATIONS. Taxpayer that handled logs at a sawmill operated by a third-party manufacturer was subject to Service B&O tax, not Processing for Hire, and therefore not entitled to the M&E exemption. Taxpayer did some minimal processing of logs, but the predominant activities consisted of storing and handling.

[2] RULE 13601; RCW 82.08.02565: MANUFACTURING MACHINERY AND EQUIPMENT (M&E) EXEMPTION – LOGGING OPERATIONS. Taxpayer that handled logs belonging to others at Taxpayer’s log-sorting yard was subject to Service B&O tax, not Processing for Hire, and therefore not entitled to the M&E exemption. Taxpayer did some minimal processing of logs, but the predominant activities consisted of unloading logs, sorting them by species and length, and sending them to destinations selected by the log owner.

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.

Rosenbloom, A.L.J. – . . . (Taxpayer) petitions for a refund of retail sales tax and for correction of an assessment of retail sales/use tax on machinery and equipment used to handle logs at a sawmill operated by a third-party manufacturer and on machinery and equipment used to handle customers’ logs at Taxpayer’s log-sorting yard. Taxpayer argues it is a processor for hire and therefore eligible for the manufacturing machinery and equipment (M&E) exemption. Taxpayer’s petition is denied.¹

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

ISSUES

1. Is Taxpayer a processor for hire and therefore eligible for the machinery and equipment (M&E) exemption with respect to machinery and equipment used by Taxpayer to handle logs at a sawmill operated by a third party manufacturer?
2. Is Taxpayer a processor for hire and therefore eligible for the machinery and equipment (M&E) exemption with respect to machinery and equipment used to handle customers' logs at Taxpayer's log-sorting yard?

FINDINGS OF FACT

Taxpayer conducts business activities at two physical locations:

1. . . . **(Sawmill Site).** This is a lumber manufacturing site owned and operated by . . . (Lumber Company), a third-party manufacturer. Taxpayer performs various log-handling activities at this site under contract with Lumber Company.
2. . . . **(Log Yard).** This is a log-sorting yard owned by Taxpayer where it performs various log handling activities under contract for two major timber companies (Timber Companies).

The machinery and equipment at the Sawmill Site includes two loaders initially purchased by Lumber Company for its own use in performing various log handling activities at its manufacturing site. Lumber Company later decided not to use its own employees to handle logs, so it contracted the work out to Taxpayer and sold the two loaders to Taxpayer. Taxpayer subsequently purchased additional machinery and equipment specifically for the performance of its contract with Lumber Company. The machinery and equipment used at Sawmill Site is dedicated to the Sawmill Site and does not leave the Sawmill Site. (Log Yard machinery and equipment may on occasion be used at the Sawmill Site, but the reverse is never the case.)

The contract with the Lumber Company describes the nature of the work as follows:

Log storage and handling service at [the Sawmill Site], including the following:

- A. Basic Services: Unload trucks, deck loads by sort, rollout sample scale loads, and feed logs into the sawmill, all as specified by designated [Lumber Company] representative.
- B. It is anticipated that the sawmill will utilize 30 to 70 loads of logs per day dependent upon the number of shifts the mill is operated. Log deliveries could be 0 to 90 loads per day.
- C. Contractor will provide a minimum of one fully maintained and operated machine capable of unloading full loads. A backup machine shall be available within 30 minutes of a breakdown of the above-mentioned machine. A second fully maintained and operated machine will be provided for feeding the mill with long

- and short logs. In addition, a 980 Cat loader will be on site for backup. A Scat track will be on site at all times as well for cleanup and other duties.
- D. Feeding the mill is the top priority function – all effort necessary shall be made to avoid running the mill out of logs.
 - E. Deck and reintroduce barked blocks:
 - 1. Blocks containing metal.
 - 2. Blocks stockpiled for use in the event of barker breakdown or maintenance.
 - 3. Blocks sorted for batch runs.
 - F. Reman oversize butts.
 - G. Cleanup and hog fuel movement as required.

The contract with the Lumber Company provides for compensation and payment as follows:

As full compensation for the work to be performed hereunder in accordance with the terms and conditions of this Contract, [Lumber Company] will pay the Contractor the following:

\$. . . /hour	Small stacker and operator – 980 or equivalent.
\$. . . /hour	Large stacker and operator – Wagner, 988B.
\$. . . /hour	Loader – a third log handling machine as required
\$. . . /hour	Scat track
\$. . . /hour	Bucking
\$. . . /hour	Dump truck (yard debris if required).
\$. . . /hour	End Dump 20 cubic yards (yard debris if required).
\$. . . /hour	Water truck (dust control if required).
\$. . . /hour	Miscellaneous inventory work. Pulling tags, closing decks, log accountability work. Cut metal out of debarked blocks upon request.

Taxpayer has contracts with two major Timber Companies to handle logs at Taxpayer's Log Yard. The Timber Companies purchase logs from third parties. The logs arrive on trucks, mixed by species, size, and quality (camp run). Taxpayer unloads the trucks, rolls out logs onto skids, trims (limbs), bucks (shorten, e.g. rot), marks, measures, and sorts the logs by length and species. The logs are scaled by a third party to determine the quality, species, and volume (measured in board feet). Taxpayer is compensated based on volume (board feet) handled. The Timber Company tells Taxpayer where to send the logs. Most logs are sent to a sawmill, some to a pulp mill, and very few to export.

The Department's Audit Division (Audit) examined Taxpayer's books and records for the period January 1, 1998 through December 31, 2001, and issued an assessment for additional taxes and interest. The assessment included use tax and/or deferred sales tax on machinery and equipment and on charges for machinery and equipment repairs and maintenance. Audit determined that Taxpayer was not a processor for hire and therefore not entitled to the M&E exemption.

Taxpayer filed a timely petition for correction of the assessment. During the audit period, Taxpayer reported income received from log handling under the Service & Other Activities business and occupation (B&O) tax classification; however, Taxpayer argues on appeal that it is properly taxable under the Processing for Hire classification and therefore entitled to the M&E exemption and the lower Processing for Hire B&O tax rate. Taxpayer also petitions for a refund of retail sales tax paid during the audit period on machinery and equipment repairs and maintenance.

ANALYSIS

RCW 82.08.02565 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. RCW 82.12.02565 provides the corresponding use tax exemption. (Both exemptions are referred to collectively herein as “the M&E exemption.”)

The M&E exemption therefore 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.”

RCW 82.04.110 defines manufacturer as follows:

“Manufacturer” means 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 or her own materials or ingredients any articles, substances or commodities.

RCW 82.04.120 defines “to manufacture” as follows:

“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: . . . (3) cutting, delimbing, and measuring of felled, cut, or taken trees; . . .

The term “processing for hire” is not defined by statute; however, the Department’s administrative rule, WAC 458-20-136(3)(a) (Rule 136(3)(a)), provides the following definition:

The term “processor for hire” means a person who performs labor and mechanical services upon property belonging to others so that as a result a new, different, or useful article of tangible personal property is produced for sale or commercial or industrial use. Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon his or her own materials.

WAC 458-20-13501 (Rule 13501) provides in part:

(4) **Processors for hire.** Persons performing labor or mechanical services for timber harvesters during the manufacturing portion of a timber harvest operation are subject to the processing for hire B&O tax. RCW 82.04.280(3). (See also WAC 458-20-136 for more information regarding processors for hire.)

For example, a person delimbing and bucking severed trees at the harvest site is a processor for hire if another person owns the severed trees. . . .

[1] Cutting, delimbing, and measuring of felled, cut, or taken trees typically occurs at the harvest site in order to enable their transportation elsewhere for further processing. Because cutting, delimbing, and measuring is the predominant activity occurring at the harvest site once the trees have been felled, cut, or taken, a person performing these activities at the harvest site upon trees owned by another is a processor for hire.

However, we do not believe that cutting, delimbing, and measuring of felled, cut, or taken trees is the predominant activity at either the Sawmill Site or the Log Yard. By the time the logs have been transported to the Sawmill Site or the Log Yard, they have already been cut, delimbed, or measured to some degree. Though the Taxpayer may perform some additional processing of the logs, the predominant activities at the Sawmill Site and Log yard consist of storage and handling activities, which do not constitute processing for hire.

Lumber Company would qualify for the M&E exemption with respect to the machinery and equipment at issue if it were performing the same activities with its own employees rather than contracting the work out to Taxpayer. However, for a person performing services for a manufacturer to get the M&E exemption, the activity it is performing for the manufacturer must itself be a processing for hire activity independent of the manufacturer's other activities.

The "basic services" identified in the Lumber Company contract are to unload trucks, deck loads by sort, rollout sample scale loads, and feed logs into the sawmill, none of which standing alone constitutes manufacturing or processing for hire. We also note that these activities are the most highly compensated under the terms of the contract, whereas "bucking" (cutting the logs to length) is compensated at the lowest rate.

We find that the main purpose of the Lumber Company contract is to provide for the storage and handling of logs, which is a service activity. Other activities performed under the contract, such as yard maintenance, dust control, and minimal amounts of log processing, were incidental to the contract's main purpose. The Lumber Company contract is properly taxable under the Service & Other Activities B&O tax classification, not the Processing for Hire classification. We conclude that Taxpayer is not eligible for the M&E exemption with respect to machinery and equipment used at the Sawmill Site.

Audit asserts that Taxpayer's activities at the Log Yard constituted "export sorting yard operations" as described in Rule 13501(9)(g), and were therefore taxable under the Service & Other Activities B&O tax classification. Taxpayer states that Log Yard was an export sorting yard operations until the 1980s when logging restrictions imposed because of concerns over spotted owl habitat substantially reduced log exports. However, during the audit period the

majority of the logs handled at the Log Yard were sent to sawmills, some to a pulp mills, and very few to export.

Though the Log Yard is no longer operated as an export sorting yard, the processing activities at the Log Yard are no more extensive than the incidental processing activities that might occur in export sorting yard operations. Rule 13501(9)(g) provides:

Export sorting yard operations. Export sorting yard operations generally consist of multiple activities. These activities can include, but are not necessarily limited to, services such as weighing, tagging, banding, appraising, and sorting of logs. Other incidental activities, such as the debarking, removal of imperfections such as crooks, knots, splits, and seams, and trimming of log ends to remove defects, are also performed as needed. Income received by persons performing the export sorting yard activities as identified in this subsection is subject to the service and other activities B&O tax.

[2] At the Log Yard, Taxpayer unloads the logs from trucks, sorts them by length and species, and sends them along to destinations selected by the owner. Taxpayer also trims, bucks and measures logs as needed, but that is not the predominant activity. The only apparent distinction between the Log Yard and an export sorting yard operation described in Rule 13501(9)(g) is the ultimate destination of the logs. Thus, the activities conducted at the Log Yard are subject to the Service & Other Business Activities B&O tax classification, rather than the Processing for Hire classification, for the same reason that similar activities at an export sorting yard are so taxed. We conclude that Taxpayer is not eligible for the M&E exemption with respect to machinery and equipment used at the Log Yard.

DECISION AND DISPOSITION

Taxpayer's petition for refund and correction of assessment is denied.

Dated this 29th day of April 2004.