

Cite as Det. No. 14-0402, 36 WTD 021 (2017)

BEFORE THE APPEALS 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. 14-0402
)	
...)	Registration No. . . .
)	

RCW 82.12.02565; Rule 13601: USE TAX – M&E EXEMPTION – QUALIFYING USE. Reels used to store and ship cable to not have the requisite use to qualify for the M&E tax exemption.

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.

Lewis, A.L.J. – [Taxpayer], a manufacturer of wire and cable products, protests the Department of Revenue’s (“Department”) Audit Division’s (“Audit”) disallowance of the manufacturing and equipment (“M&E”) use tax exemption it took on reels it used to store and ship cable. We sustain the tax assessed concluding the reels are not part of the manufacturing process and do not qualify for the M&E use tax exemption.¹

ISSUE:

Under the requirements of RCW 82.12.02565 and WAC 458-20-13601 (“Rule 13601”), do the wire reels, which Taxpayer purchased without paying retail sales tax, qualify for the M&E use tax exemption?

FINDINGS OF FACT:

Taxpayer is a [out-of-state] Corporation that operates a wire and cable manufacturing plant in Washington. One of the products Taxpayer manufactures in Washington is ACSR (Aluminum-conductor steel reinforced) wire.² As part of the manufacturing process, each wire is given a “cast” (diameter of one loop of wire) and a “helix” (the height and angle of the end of the wire measured from the floor to its tip) during the winding process. The cast and helix are determined by the customer and varies from customer to customer. To maintain this cast and helix a reel must be used. Other methods will not maintain the cast and helix due to the “memory loss” the

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

² ACSR cable is a high capacity, high strength stranded cable typically used in overhead power lines. The outer strands are aluminum, chosen for excellent conductivity, low weight and low cost. The center strand is of steel for the strength required to support the weight without stretching the aluminum.

wire will incur over time (the loss of its shape over time due to physical elements such as gravity). Thus, the reels are used not only to transport the wire, but also to maintain the cast and helix of the wire.

To maintain the cast and helix, the wire must stay on the reels until it is used by the customer. Generally, after a customer places an order, the wire is manufactured and wound onto a reel. Then a third-party common carrier picks the wire up at Taxpayer's plant and transports it to the customer. The shipping terms are FOB so that the title to and liability for the wire transfers to the customer at Taxpayer's manufacturing facility.

The reels, however, are transferred to the customer under a bailment arrangement. Under the bailment arrangement, ownership of the reels remains with Taxpayer, but possession and use of the reels is transferred to the customer during the time the reels are used to transport and store the wire for the customer. The reels are returned by the customer to the Taxpayer after the customer is done using the reels. The reels are then reused. There is no contract requiring return of the reels. Each reel is stamped with Taxpayer's logo and Taxpayer can track the reels to and from its customers. Taxpayer does not collect a deposit from its customers.

Taxpayer paid neither retail sales tax nor use tax on the reels reasoning that the reels qualified for the M&E sales and use tax exemptions. Taxpayer Account Administration Division ("TAA") determined that, while the reel had qualifying use in the manufacturing process at Taxpayer's manufacturing plant, once the reel left the plant its use no longer qualified. Thus, the reel had qualifying and non-qualifying use. The reels did not qualify for the M&E exemption because M&E exemption is only available when qualifying use exceeds 50% of the use.

During 2012, the Department's TAA examined Taxpayer's tax returns for the period January 1, 2008, through March 31, 2012. On December 24, 2012, the Department issued two assessments: a \$. . . assessment for the period January 1, 2008, through March 31, 2008 (Invoice No. . . .) and a \$. . . assessment for the period April 1, 2008, through December 31, 2008 (Invoice No. . . .).³ The tax deficiency arose from the assessment of use tax on the reels

Taxpayer disagreed with the assessments. On January 22, 2013, Taxpayer filed an appeal requesting correction of the assessments. Taxpayer's petition maintained the wire reels had over 50% qualifying use and that TAA erred in disallowing the M&E exemption taken on the reels.

On December 4, 2013, the Department issued Det. No. 13-0376 that sustained the assessments. Even though Taxpayer disagreed with the assessments, on December 26, 2013, Taxpayer paid both assessments.

On December 13, 2013, following the Department's issuance of Det. No. 13-0376, the Department issued a \$. . . assessment covering the period January 1, 2009, through June 30, 2012.⁴ The assessment was based on the same issue; use tax on the value of wire reels used

³ Taxpayer paid both balance due notices on December 26, 2013, following issuance of Det. No. 13-0376 on December 4, 2013.

⁴ On December 24, 2012, the Department issued the \$. . . assessment, which consisted of \$. . . tax and \$. . . interest.

directly in Taxpayer's manufacturing operation. On January 10, 2014, Taxpayer filed an appeal requesting correction of unpaid assessment . . . / Audit No. . . .). On December 26, 2013, Taxpayer paid the two assessments that had been the subject of Det. No. 13-0376. On January 22, 2013, Taxpayer filed a petition requesting refund of the tax it had paid on December 26, 2013.⁵

Taxpayer's Appeal petitions were very similar and stated that "[a] 'Detailed Brief of Issues Under Appeal' that discusses the facts and legal arguments in detail will be submitted at a later date." On March 25, 2014, Taxpayer provided the Appeals Division a supplemental brief, which restated the original arguments addressed in Det. No. 13-0376

ANALYSIS:

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 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. RCW 82.12.020; RCW 82.12.0252; WAC 458-20-178 ("Rule 178").

To qualify for the M&E exemption, a purchaser must establish: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation. Det. No. 03-0325, 24 WTD 351 (2005).

A similar exemption is found in the use tax statutes. RCW 82.12.02565. We collectively refer to these exemptions as "the M&E exemption." Det. No. 07-0324E, 27 WTD 119 (2008).

All requirements must be met for the M&E exemption to apply. Here the concern centers on the whether the reels had sufficient qualifying use in the manufacturing operation. Rule 13601(1)(g) defines "manufacturing operation" as:

"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 operation includes storage of raw materials at the site, the storage of in-process materials at the site, and the storage of the processed material at the site. The manufacturing operation is defined in terms of a process occurring at a location. To be eligible as a qualifying use of M&E, the use must take place within the manufacturing operation, unless specifically exempted by law. Storage of raw material or other tangible personal property, packaging of tangible personal property, and other activities that potentially qualify under the "used directly" criteria, and that do not constitute manufacturing in and of themselves, are not within the scope of the exemption unless they take place at a manufacturing site.

⁵ Taxpayer requested the refund of tax paid on Invoice Nos. . . .

Machinery and equipment used in a manufacturing operation may have qualifying and non-qualifying use. The requirements of the M&E exemption is only satisfied if the qualifying use satisfies the majority use requirement. Rule 13601(9) discusses the majority use requirement:

- (a) Machinery and equipment both used directly in a qualifying operation and used in a non-qualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. ... 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 retain 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. Majority use is measured by looking at the use of an item during a calendar year using any of the following:

Rule 13601(9) explains that use may be measured by time, value, volume, or another comparable measure.

Taxpayer maintains that time is the appropriate way to measure use of the reels. Taxpayer's March 25, 2014, supplemental briefing material acknowledged that:

[T]he only open issue with respect to [Taxpayer's] qualification for the M&E use tax exemption is whether the wire reels are in fact used by [Taxpayer] in a non-qualifying manner, and if so, whether the qualifying use by [Taxpayer] exceeds fifty percent of the total use of the reels by them.

Taxpayer maintained that the reels met the majority use threshold using the time measurement. Taxpayer explains its use of the reels occurs at two locations: 1) inside the manufacturing plant and 2) on the loading dock after the reels have been loaded with cable and are awaiting shipment. Taxpayer further explained that from the time that a carrier picks up the reels for delivery to the customer until the time that the reels are returned to Taxpayer, the use of the reels is by the customer as a bailment and should be excluded from the calculation.

Taxpayer's petition argues that the use of the reels by Taxpayer's customers does not affect the majority use calculation. Specifically, Taxpayer maintains that the only relevant factor is use of the machinery or equipment by the manufacturer. Use of the machinery or equipment by the manufacturer's customers or third parties is not relevant to the determination. Taxpayer's position is based on Rule 13601(1), which states:

This section explains the retail sales and use tax exemption provided by RCW 82.08.02565 and 82.12.02565 for sales to or use by manufacturers or processors for hire of machinery and equipment (M&E) used directly in a manufacturing operation or research and development operation.

According to Taxpayer, it no longer uses the reels once a customer takes possession of them under a bailment arrangement. Therefore, Taxpayer satisfies the majority use threshold because there is no non-qualifying use by Taxpayer after the customer's common carrier takes possession of the reels under a bailment arrangement on behalf of the customer at the manufacturing facility loading dock under the F.O.B. . . . , Washington shipping terms.

We disagree with Taxpayer's analysis. Rule 13601(5) explains: who and what is eligible for the M&E exemption:

Machinery and equipment used directly in a qualifying operation by a qualifying person is eligible for the exemption, subject to overcoming the majority use threshold.

Rule 13601(9)(a) explained the majority use threshold:

Machinery and equipment both used directly in a qualifying operation and used in a non-qualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement.

First, the M&E exemption applies to machinery and equipment used in a manufacturing operation. Qualifying use must take place within the manufacturing operation. In regards to the use of the reels for transportation and storage, Rule 13601(2)(g) states:

The manufacturing operation is defined in terms of a process occurring at a location. To be eligible as a qualifying use of M&E, the use must take place within the manufacturing operation, unless specifically exempted by law. Storage of raw material or other tangible personal property, packaging of tangible personal property, and other activities that potentially qualify under the "used directly" criteria, and that do not constitute manufacturing in and of themselves, are not within the scope of the exemption unless they take place at a manufacturing site.

Even if we accept Taxpayer's assertion that the reels are used to maintain the cast and helix of the cable, under the provisions of Rule 13601 such use would only be qualifying during storage of the cable at the manufacturing site.⁶

Secondly, we are not convinced, as Taxpayer argues, that the use of the reels for transportation and storage should be excluded from the calculation of qualifying and non-qualifying use because the customer "used the reels" and not Taxpayer.

⁶ In regards to the "used directly" requirement, Rule 13601(8) explains:

The "used directly" criteria. Items that are not used directly in a qualifying operation are not eligible for the exemption. The statute provides eight descriptions of the phrase "used directly." The manner in which a person uses an item of machinery and equipment must match one of these descriptions. If M&E is not "used directly" it is not eligible for the exemption. Examples of items that are not used directly in a qualifying operation are cafeteria furniture, safety equipment not part of qualifying M&E, packaging materials, shipping materials, or administrative equipment. Machinery and equipment is "used directly" in a manufacturing operation, testing operation, or research and development operation, if the machinery and equipment meets any one of the following criteria: . . .

(Emphasis added.)

The term “using” is broadly defined in RCW 82.12.010(6) to include both its ordinary meaning as a special statutory meaning, as follows:

Use,” “used,” “using,” or “put to use” shall have their ordinary meaning, and shall mean:

(a) With respect to tangible personal property, the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (as a consumer), and include installation, storage, withdrawal from storage, distribution, or any other act preparatory to subsequent actual use or consumption within this state

Under this statutory framework, the issue is whether Taxpayer gave up dominion or control over the reels. Dominion and control is broadly defined to include "storage, withdrawal from storage preparatory to subsequent actual use or any other act preparatory to subsequent actual use or consumption within this state" The reels were used to contain the cable for transportation and maintain the cast and helix. Subsequently, the reels were returned to Taxpayer. At all times Taxpayer owned the reels, the reels were marked with Taxpayer’s name, and there was the expectation the reels would be returned to Taxpayer. As owner of the reels, Taxpayer could have instructed the customer regarding disposition of the reels. Accordingly, . . . Taxpayer [only] granted temporary use of the reels to its customers

Rule 13601(8) explains that “[i]tems that are not used directly in a qualifying operation are not eligible for the exemption.” Rule 13601(8) further explains that: “[e]xamples of items that are not used directly in a qualifying operation are . . . packaging materials, shipping materials...”

The use of the reels for shipping and packing is a non-qualifying use. While the reels may serve an important purpose in helping to retain the cast and helix of the cable, the reels, which Taxpayer owns, are used by Taxpayer as a packaging material to ship the cable to the customer. We are not convinced, as TAA was not, that the use of the reels for shipping should be excluded from the calculation of qualifying and non-qualifying use because of a bailment of the reels to the customer.

Tax exemption statutes must be strictly construed in favor of the application of the tax. *Yakima Fruit Growers Association v. Henneford*, 187 Wn. 252, 60 P. (2d) 62 (1936) “[T]he burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer.” *Group Health Co-op. v. Tax Comm’n*, 72 Wn.2d 422, 429, 433 P.2d201 (1967). Consistent with that basic principle, Rule 13601 requires that when there is qualifying and non-qualifying use of equipment that qualification for the exemption must be documented. Thus, to the degree Taxpayer can document that the majority of use of the reels was within the manufacturing operation, the M&E exemption will be allowed. Should Taxpayer assemble documents to support qualifying use of the reels, a refund request may be made according to the provisions contained in WAC 458-20-229.

Finally, WAC 458-20-115 (“Rule 115”) provides that packing material are considered part of the sale of the goods purchased, and as a purchase for resale packing materials, are not subject to either retail sales or use tax. However, Rule 115(3)(b) provides:

Sales of containers to persons who sell tangible personal property contained within the containers, but who retain title to such containers which are to be returned, are sales for consumption and subject to tax under the retailing classification. This class includes wooden or metal bottle cases, barrels, gas tanks, carboys, drums, bags and other items, when title to the container remains with the seller of the tangible personal property contained within the container, and even though a deposit is not made for the containers, and when such articles are customarily returned to the seller.

Rule 115(4) provides that sales taxable under the retailing classification are also subject to retail sales tax. Rule 115(5)(a) provides that the use tax applies to “uses of packing materials and containers to which retail sales tax would apply but, for any reason, was not paid at the time such materials and containers were acquired.” Thus, the reels are not exempt from retail sales or use tax as packing materials.

DECISION AND DISPOSITION:

Taxpayer’s petition is denied.

Dated this 19th day of December, 2014.