

Cite as Det. No. 14-0283, 36 WTD 509 (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. 14-0283
)	
...)	Registration No. . . .
)	

[1] RCW 82.08.02565; RCW 82.12.02565; WAC 458-20-13601: MANUFACTURING MACHINERY AND EQUIPMENT EXEMPTION. Machinery and equipment never used does not qualify for a machinery and equipment exemption from tax because it is not “used directly” in a manufacturing operation.

[2] RCW 82.32A.020: TAXPAYER RIGHTS. Taxpayer did not show that it received specific, official written advice or reporting instructions that relieved purchases from tax where the Department stated that if a Rural County Deferral was disallowed, those purchases qualifying for a Machinery and Equipment Exemption would not have to repay tax due.

[3] RCW 82.60.060; WAC 458-20-24001A: WAIVER OF INTEREST ON DISALLOWED TAX DEFERRAL FOR INVESTMENT PROJECTS IN RURAL COUNTIES. Interest on disallowed Rural County Deferral Program purchases begins accruing 30 days following the date of ineligibility for the deferral.

[4] RCW 82.60.060; WAC 458-20-24001A: WAIVER OF PENALTIES ON DISALLOWED TAX DEFERRAL FOR INVESTMENT PROJECTS IN RURAL COUNTIES. Once purchases are disallowed under the Rural County Deferral Program, the Department may assess all penalties applicable to excise tax assessments; this includes the substantial underpayment penalty. We sustain the assessment of the substantial underpayment penalty because the criteria for assessing the substantial underpayment penalty was met.

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.

Anderson, A.L.J. – A business that made purchases under the Rural County Investment Project Tax Deferral under RCW 82.60.070, but never finished the investment project, appeals assessments of use tax/deferred retail sales tax, interest, and penalties. The business asserts the . . . purchases of machinery and equipment [that initially] qualified for the Manufacturing Machinery

and Equipment Exemption (“M&E exemption”) in RCW 82.08.02565 and 82.12.02565, are subject to use tax measured by the items’ values once such items failed to qualify for the exemption. If liable for deferred retail sales tax, Taxpayer argues that WAC 458-20-24001A(108)(b)(i) requires a waiver of interest and penalties. Petition denied in part and granted in part.¹

ISSUES

1. Did purchases of machinery and equipment qualify for the M&E Exemption in RCW 82.08.02565 and RCW 82.12.02565? If so, is the proper measure of tax the purchase price or the value of such machinery and equipment at the time such items failed to qualify for the M&E exemption pursuant to WAC 458-20-13604(3)?
2. Does RCW 82.32A.020(2) . . . prohibit an assessment of use tax/deferred retail sales tax on machinery and equipment no longer eligible for the Rural County Investment Project Tax Deferral?
- . . .
3. Does RCW 82.60.060 and WAC 458-20-24001A(108)(b)(i) require the waiver of penalties and interest on deferred taxes due once the construction of the manufacturing facility was terminated?

FINDINGS OF FACT

. . . (“Taxpayer”) is a . . . manufacturer. In 2005, Taxpayer operated a small . . . manufacturing facility in . . . Washington, and planned to build another . . . manufacturing facility in . . . Washington.

On August 29, 2005, Taxpayer applied for a “Rural County Sales and Use Tax Deferral” for \$. . . in purchases of machinery and equipment and construction to be used in the planned . . . manufacturing facility.² Taxpayer represented that the manufacturing facility would be built by October 1, 2006, and 100% of the structure and machinery and equipment would be eligible for the deferral.

On September 12, 2005, the Washington State Department of Revenue’s (the “Department’s”) Special Programs Division (“Special Programs”) found that Taxpayer’s proposed . . . manufacturing facility met the statutory criteria to be an “eligible investment project” under the Rural County Sales and Use Tax Deferral Program (the “Rural County Deferral Program”) and granted Taxpayer’s application. Special Programs sent Taxpayer a Rural County Sales and Use Tax Deferral Certificate, valid from August 29, 2005 - October 1, 2006, for \$. . . in purchases of qualifying machinery and equipment and construction, along with a letter explaining the Rural County Deferral Program. As relevant here, the letter contained the following statements:

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

² At the time Taxpayer applied, the Rural County Sales and Use Tax Deferral was known as the “Distressed Area Sales and Use Tax Deferral.”

...

Under the Rural County Deferral program, the Department of Revenue issued a deferral certificate “on each eligible investment project” which allows the recipient to defer sales and use tax otherwise due. RCW 82.60.040.

...

Project Complete

...

Please notify me when the investment project is operationally complete. The Department of Revenue will then schedule an audit with you. It is routine procedure for the Department to perform an audit of the investment project to verify that purchases made with the certificate qualify for the deferral.

...

A copy of the enclosed Sales and Use Tax Deferral Certificate must be presented to vendors and contractors for their files. This certificate allows the vendors and contractors to sell to the approved business without charging retail sales tax.

...

Reporting Requirements

...

If, on the basis of a report or other information, the department finds that an investment project is not eligible for tax deferral, the amount of deferred taxes outstanding for the project shall be immediately due.

Even if the deferral is disallowed because program requirements are not met, the taxes do not need to be repaid on machinery and equipment purchased after July 1, 1995, pursuant to the sales and use tax exemption for machinery and equipment.

...

... Taxpayer terminated the construction of the ... manufacturing facility due to lack of financing. Machinery and equipment purchased for the ... manufacturing facility was never used and remains stored in crates, as no operations ever took place at the partially constructed facility.

The Department’s Audit Division (“Audit”) reviewed Taxpayer’s books and records from August 29, 2005, through June 30, 2012 (the “Deferral Period”). Audit determined that in the course of trying to construct the ... manufacturing facility, Taxpayer made purchases of \$... in machinery, equipment, and qualified construction costs, and Taxpayer did not pay retail sales tax on other purchases totaling \$... during the Deferral Period. On June 27, 2013, Audit issued two assessments against Taxpayer. ... Taxpayer appeals the assessments on several bases.

ANALYSIS

The Rural County Deferral Program is provided under RCW 82.60 *et seq.* This deferral is available to certain businesses engaged in manufacturing, research and development, or computer-related activities in eligible areas of Washington. Under this deferral, taxpayers may defer paying retail sales and use taxes otherwise due on investments in qualified buildings, and machinery and equipment to be used therein, as an integral and necessary part of the manufacturing, research and

development, or computer operations of an eligible investment project. *See generally* RCW 82.60.020.

Generally, repayment of deferred taxes is not required; however, where repayment is required, the recipient must begin paying the deferred taxes on December 31 of the third calendar year following the date on which the Department certifies the investment project as operationally complete and has five years to repay the deferred taxes.³ RCW 82.60.063; 82.60.060(1); WAC 458-20-24001A(108). If the Department finds that an investment project is not eligible for tax deferral under RCW 82.60, the amount of deferred taxes outstanding for the project is immediately due. RCW 82.60.070(2); WAC 458-20-24001A(108)(b)(i).

The M&E Exemption provides a retail sales tax or use tax exemption for sales to a manufacturer or processor for hire, of machinery and equipment, used directly in a manufacturing operation. RCW 82.08.02565; RCW 82.12.02565. Under this exemption, purchases and use of machinery and equipment meeting a specific set of criteria, are exempt from retail sales and use tax. It is possible that items of machinery and equipment may qualify for both the Rural County Deferral Program and M&E Exemption. If that is the case, “Repayment of tax deferred under chapter 82.60 RCW is not required, and interest and penalties under RCW 82.60.070 will not be imposed, on machinery and equipment that qualifies for exemption under RCW 82.08.02565 or 82.12.02565.” WAC 458-20-24001A(108). Here, Taxpayer asserts that the purchases at issue qualified for the M&E Exemption on the bases that purchases met the criteria of RCW 82.08.02565 at the time of purchase and the Department stated so in writing.

1. Manufacturing Machinery & Equipment Exemption

RCW 82.08.02565 and RCW 82.12.02565 provide that the retail sales tax and use tax do not apply to “sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation” RCW 82.08.02565(1)(a); RCW 82.12.02565(1)(a). Thus, the M&E exemption has four distinct requirements:

- The purchaser/user must be a “manufacturer” or “processor for hire;”
- The purchased/used item must be “machinery and equipment;”
- The item must be “used directly;” and
- In a “manufacturing operation.”

See Det. 03-0325, 24 WTD 351 (2005). If any of these elements is missing, the exemption is not available. *See also* WAC 458-20-13601. At issue here is whether the machinery and equipment were “used directly” in a manufacturing operation. “Used directly” is statutorily defined as follows:

- (i) Acts upon or interacts with an item of tangible person property;
- (ii) Conveys, transports, handles, or temporarily stores an item of tangible person property at the manufacturing site or testing site;

³ RCW 82.60.060(1) provides recipients shall repay 10% of the deferred tax in year 1, 15% in year 2, 20% in year 3, 25% in year 4, and 30% in year 5.

- (iii) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
- (iv) Provides physical support for or access to tangible personal property;
- (v) Produces power for, or lubricates machinery and equipment;
- (vi) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
- (vii) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
- (viii) Is integral to research and development as defined in RCW 82.63.010.

RCW 82.08.02565(2)(c). “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.” WAC 458-20-13601(8). By Taxpayer’s own admission, the machinery and equipment was never used – it remained unused in the packaging in which it arrived and Taxpayer did not manufacture anything. RCW 82.08.02565 specifically requires items to be “used directly” in a manufacturing operation; therefore, in the absence of any activity – more so, any activity meeting the statutory definition of “used directly” – we cannot conclude that Taxpayer “used directly” the machinery and equipment in a manufacturing operation. Accordingly, we find that Taxpayer’s purchases of such machinery and equipment were not exempt from tax pursuant to the M&E exemption.

Taxpayer also asserts that WAC 458-20-13601(3)(b) [controls the measure of tax on such machinery and equipment. WAC 458-20-13601(3)(b)] details the application of the use tax on machinery and equipment that was eligible but became ineligible for the M&E Exemption – It provides as follows:

If an item of machinery and equipment that was eligible for the use tax or sales tax exemption fails to overcome the majority use threshold or is totally put to use in a nonqualifying manner, use tax is due on the fair market value at the time the item was put to nonqualifying use.

WAC 458-20-13601(3)(b). However, we found that Taxpayer’s purchases were not eligible for the M&E Exemption because they were never used directly in a manufacturing operation. Being that the items were never eligible for the M&E Exemption, WAC 458-20-13601(3)(b) does not apply.

2. RCW 82.32A.020(2) . . .

Taxpayer asserts that such purchases of machinery and equipment qualify for the M&E Exemption pursuant to written correspondence sent to the Taxpayer, and Taxpayer is entitled to a waiver of taxes on such items. Under RCW 82.32A.020(2), a taxpayer has a right to waiver of tax where it relied to its detriment on specific, official written advice or tax reporting instructions [to that taxpayer].

. . .

Taxpayer asserts that the Department is prohibited from assessing tax on purchases of machinery and equipment because the Department allegedly stated, in writing, that even if such purchases did not qualify for the Rural County Deferral Program, Taxpayer would not owe tax upon its purchases of machinery and equipment occurring after July 1, 1995, because such purchases would qualify for the M&E Exemption. In support, Taxpayer cites the following sentence from the letter it received from the Department, explaining the Rural County Deferral Program:

Even if the deferral is disallowed because program requirements are not met, the taxes do not need to be repaid on machinery and equipment purchased after July 1, 1995, pursuant to the sales and use tax exemption for machinery and equipment.

Taxpayer's reading creates a nonrestrictive phrase between the two commas; however, the comma following "1995" does not create a nonrestrictive phrase, it follows the Chicago Manual of Style's recommendation for stating month-day-year style of dates. The Chicago Manual of Style, 15th Ed., "6.31 Restrictive and nonrestrictive phrases."; "6.46 Commas needed or omitted." Thus, the sentence is properly read as stating that taxes would not be due for machinery and equipment purchased pursuant to the sales and use tax exemption for machinery and equipment. This means that if the Rural County Deferral is disallowed, purchases qualifying for the M&E Exemption do not have to be repaid. We do not read this statement as a ruling that purchases will qualify for the M&E Exemption.

Accordingly, we conclude that Taxpayer has failed to show that it received specific, official written advice or tax reporting instructions, stating that purchases of machinery and equipment would be exempt from taxation if they failed to qualify for the Rural County Deferral. RCW 82.32A.020(2). Similarly, we conclude that Taxpayer has failed to show that the Department made an admission, statement, or act, inconsistent with taxing its purchases of machinery and equipment We conclude . . . RCW 82.32A.020(2) . . . [does not] prohibit the Department from assessing tax on such purchases of machinery and equipment.

...

3. Interest & Penalties Waiver

RCW 82.60.060 addresses the assessment of interest and penalties where a taxpayer has qualified for the Rural County Deferral Program. It provides as follows:

(3) Interest may not be charged on any taxes deferred under this chapter for the period of deferral, although all other penalties and interest applicable to delinquent excise taxes may be assessed and imposed for delinquent payments under this chapter. . . .

Taxpayer asserts that WAC 458-20-24001A(108)(b)(i) prohibits the assessment of interest and substantial underpayment penalties on deferred tax amounts.

Audit agrees in part and concedes that pursuant to RCW 82.60.060, interest on the deferred tax amounts should not start accruing until 30 days following ineligibility for the tax deferral – July

30, 2012.⁴ Therefore, to the extent the assessments include interest pre-dating July 30, 2012, we grant Taxpayer's petition and order Audit to adjust the assessments accordingly.

As to Taxpayer's assertion regarding the substantial underpayment penalties, consistent with RCW 82.32.060, WAC 458-20-24001A(108)(b) provides in pertinent part:

(i) **Failure of investment project to satisfy general conditions.** . . . No penalties or interest will be assessed on the deferred sales/use tax; however, all other penalties and interest applicable to excise tax assessments may be assessed and imposed.

Both RCW 82.60.060 and WAC 458-20-24001A(108)(b)(i) permit the Department to assess and impose penalties applicable to excise tax assessments once taxes are no longer deferred. As discussed above, such taxes lost their deferred status and became due on June 30, 2012. The Department was permitted to assess penalties applicable to excise tax assessments after that date and did so in issuing Taxpayer the tax assessments on June 27, 2013. Because the Department's assessment of the substantial underpayment penalty does not conflict with RCW 82.32.060, we look to see if the substantial underpayment penalty was assessed in accordance with the statute authorizing the assessment of such penalties on excise tax assessments.

RCW 82.32.090(2) requires the Department to assess a 5% penalty where it determines that any tax due has been substantially underpaid. A tax is substantially underpaid where a taxpayer has paid less than 80% of the amount of tax determined by the Department to be due and the amount of the underpayment is at least \$1,000. *Id.* Thus, the substantial underpayment penalty is a penalty applicable only to taxes that have become due and are not timely paid.

Here, the payment of retail sales tax/use tax was not due while the deferral certificate was in valid use because the tax was deferred. Use tax/deferred sales tax became due when Taxpayer was ineligible for deferral under the Rural County Deferral Program. At the time Audit issued the assessments, the use tax/deferred retail sales tax was past due and Taxpayer had substantially underpaid the amounts of tax past due; thus, the statutory criteria for assessing the substantial underpayment penalty was met. RCW 82.32.090(2). Accordingly, we sustain Audit's assessment of the substantial underpayment penalty.⁵

DECISION AND DISPOSITION

Taxpayer's petition is granted in part and denied.

Dated this 4th day of September 2014.

⁴ As stated above, Taxpayer's Rural County Tax Deferral Program Certificate expired on June 30, 2012. Thirty days following ineligibility is July 30, 2012. . . .

⁵ We note that the substantial underpayment penalty may be waived or cancelled pursuant to RCW 82.32.105(1), if a taxpayer can show that its failure to timely pay tax by the due date was the result of circumstances beyond its control. Taxpayer did not make such an argument regarding the substantial underpayment penalty.