

Cite as Det. No. 19-0185R, 40 WTD 231 (2021)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition for Reconsideration	)	<u>D E T E R M I N A T I O N</u>
of Correction of Assessment of	)	
	)	No. 19-0185R
	)	
...	)	Registration No. ...
	)	

WAC 458-20-13601; RCW 82.04.110: RETAIL SALES AND USE TAX – MACHINERY AND EQUIPMENT EXEMPTION. The M&E exemption is only available to the entity that produces the new item from its own materials or ingredients.

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, T.R.O. – Taxpayer seeks reconsideration of Determination No. 19-0185, which affirmed the disallowance of the Machinery and Equipment (“M&E”) exemption from retail sales tax and use tax on plastic injection molds it purchased and provided to a vendor that used the molds to create plastic housing units for Taxpayer’s “[Hardware System]” device. We find, on reconsideration, that Taxpayer is not a “manufacturer” of the plastic housing, because Taxpayer does not produce the plastic housing from its own materials or ingredients. . . . Taxpayer provided plastic injection molds to a vendor, so that the vendor could produce plastic housing units for Taxpayer. Taxpayer has provided no proof that it provided any material to the vendor other than the plastic injection molds. On these facts, Taxpayer was not the manufacturer of the plastic housing units. Stated differently, on these facts, the only entity who could be considered the manufacturer of the plastic housing units is the vendor. We sustain the holding in Det. No. 19-0185. Taxpayer’s petition is denied.<sup>1</sup>

ISSUE:

Under RCW 82.04.110 and WAC 458-20-136, is Taxpayer a “manufacturer” of plastic housing when it provided its vendor with injection molds that the vendor used to create the plastic housing?

FINDINGS OF FACT

Taxpayer develops and sells a [Hardware System]. The System consists of a smartphone application (“App”) and a Hub. By means of the App, the owner is able to connect to the Hub,

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

which has the capability of controlling basic utilities and security measures connected to the home.  
...

Taxpayer's business is located within Washington. From its Washington location, Taxpayer performs marketing, sales, and administrative functions. The System is produced in Washington at Taxpayer's Washington business location, and Taxpayer's employees write and code firmware that is embedded in the Hub and sensor units. Taxpayer contracts with two outside companies to provide parts, assembly, packing, and shipping of the Hub.

The Hub is composed of three components: 1) firmware (software),<sup>[2]</sup> 2) a circuit board and sensors, and 3) a plastic container to hold the circuit board and sensors, the "plastic Hub housing."

Taxpayer purchases the plastic Hub housing from [Vendor]. [Vendor] agreed to produce the plastic Hub housing for Taxpayer, but required Taxpayer to provide [Vendor] with the injection molds that [Vendor] used to produce the plastic Hub housing units. [Vendor] charges Taxpayer approximately \$ . . . per plastic Hub housing unit produced. In sum, Taxpayer provides injection molds to [Vendor]; [Vendor] uses the injection molds to create the plastic Hub housing units; and [Vendor] then sells the plastic Hub housing units to Taxpayer.

The Department's Audit Division ("Audit") examined Taxpayer's business records for the period May 1, 2015, through December 31, 2017. On December 19, 2018, the Department issued a \$ . . . assessment. The tax deficiency arose from the assessment of use tax/deferred retail sales tax on the purchase of the injection molds that Taxpayer provides to [Vendor] to produce the plastic Hub. Taxpayer did not pay use tax/deferred retail sales tax on the injection molds believing that they qualified for the Machinery and Equipment sales ("M&E") and use tax exemption. Audit assessed the tax after concluding that Taxpayer did not qualify for the tax exemption because it did not qualify as either a manufacturer or processor for hire [of the plastic Hub housing]. Before Audit concluded that Taxpayer did not qualify as a manufacturer for purposes of the M&E tax exemption, Audit attempted to look at the various cost components that comprised the Hub. Taxpayer did not maintain records that enabled Audit to determine the relative value incorporated into the completed Hub.

Audit determined that Taxpayer provided the injection molds to [Vendor] so that [Vendor] could produce the plastic Hub housing units for Taxpayer. [Vendor] then sold the plastic Hub housing units to Taxpayer. Taxpayer directed [Vendor] to deliver the Hub housing units to another company, [Assembler]. Taxpayer paid [Assembler] to incorporate the firmware that Taxpayer developed onto circuit boards that [Assembler] then placed inside the Hub housing units. Taxpayer then sold the product that [Assembler] assembled as its [Hardware System] Hub. . . .

Taxpayer disagreed with the assessment. On February 6, 2019, Taxpayer filed a petition for correction of the assessment. Taxpayer maintained that Taxpayer qualified as a manufacturer and its purchase of injection molds qualified for the M&E tax exemption.

---

<sup>[2]</sup> "Firmware" is a software program or set of instructions programmed on a hardware device that provides the necessary instructions for how the device communicates with the other computer hardware. <https://techterms.com/definition/firmware> (last accessed August 27, 2020).]

On June 20, 2019, the Department issued Determination No. 19-0185, which sustained the assessment. Taxpayer disagreed with the determination. On September 25, 2019, Taxpayer filed a petition for reconsideration. Taxpayer maintained that the determination erred in concluding that Taxpayer was not a manufacturer because it had not contributed 80% or more of the materials and ingredients incorporated into the product.

The Department scheduled an in-person reconsideration hearing for December 10, 2019. The December 10, 2019 in-person hearing did not take place, however, a teleconference took place with Taxpayer's representative. Subsequently, on February 11, 2020, Taxpayer provided additional written briefing material. Once again, Taxpayer asserted that it is a manufacturer because: 1) it develops prewritten computer software that is not transferred to purchasers by means of tangible media; and 2) it furnished more than eighty percent of the value of all materials and ingredients in the "[Hardware System]" device.

In addition, Taxpayer's submission addressed whether the molds must be used by Taxpayer in its manufacturing operation to qualify for the M&E exemption. Taxpayer explained:

Under Washington tax law, the sales tax does not apply to a manufacturer of machinery and equipment used directly in a manufacturing operation.<sup>3</sup> Thus, in order for a sale to be exempt four requirements must be met: the sale must be to 1) a manufacturer 2) of machinery and equipment 3) used directly 4) in a manufacturing operation.

. . . , Taxpayer is a manufacturer because it develops prewritten computer software that is transferred by means other than tangible storage media and/or because it furnishes more than 80% of the material and ingredients of the manufactured product. There does not appear to be any question about whether the molds are machinery and equipment, or that they are used directly in a manufacturing operation. In our prior conversations you raised a question about whether the molds must be used in the Taxpayer's manufacturing operation. A straight-forward reading of the statute, however, does not suggest this requirement; only that the machinery and equipment be used in a manufacturing operation. It is certainly consistent with the policies of the M&E exemption that machinery and equipment purchased by a manufacturer would qualify if used directly in a manufacturing operation that produces a component of the manufacturer's product. A review of the rule and other Department published guidance does not reveal an interpretation that the manufacturing operation must be that of the taxpayer to qualify.

Audit responded to Taxpayer's arguments by stating its continued belief that Taxpayer is not a manufacturer. Audit contends that other than the software/firmware, the materials used to create the "[Hardware System]" device were furnished by [Vendor] (the plastic portion/body of the unit) and [Assembler] (the circuit boards and packaging). Audit acknowledged the difficulty in valuing the software/firmware because it was created before production of the devices and would need to be spread out over all the future devices, which was difficult to do based on the records available. Additionally, based on an earlier conversation with Taxpayer, Audit alleges that Taxpayer indicated that the unit prices for the plastic parts provided by [Vendor] were around \$ . . . or less

---

<sup>3</sup> RCW 82.08.02565(1)(a).

and [Assembler]'s unit prices were around \$ . . . -\$ . . . . Taxpayer's sales of the devices to distributors during the audit period were between \$ . . . -\$ . . . per unit.<sup>4</sup>

#### ANALYSIS:

In general, sales in the state of Washington of tangible personal property to consumers are subject to retail sales tax unless the sales are otherwise exempt from taxation. RCW 82.08.020; RCW 82.04.050. Use tax complements the retail sales tax by imposing a tax of like amount upon the privilege of using within this state as a consumer any article of tangible personal property acquired without payment of retail sales tax. *See* RCW 82.12.020(1), (2).

RCW 82.08.02565 (retail sales tax) and RCW 82.12.02565 (use tax) provide exemptions that are referred to collectively as “the M&E exemption.” The statutes provide that the retail sales tax and use tax do not apply to sales to, or use by, “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).

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). For the M&E exemption to apply, there must be a sale to, or use by (1) a manufacturer or processor for hire, (2) of “machinery and equipment,” (3) “used directly” in a (4) “manufacturing operation or research and development operation . . . .” RCW 82.08.02565(1)(a). A taxpayer must also show that the machinery and equipment meets the “majority use” threshold, i.e., more than fifty percent of the use of the machinery and equipment occurs directly in a “manufacturing operation.” RCW 82.04.02565; WAC 458-20-13601(9) (Rule 13601(9)); Det. No. 05-0151, 25 WTD 127, 131 (2006). If any of these requirements are not met, the M&E exemption is not available.

The . . . question is whether Taxpayer meets the definition of manufacturer. RCW 82.04.110 defines “manufacturer” as:

[E]very 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 82.04.110(1) (emphasis added). Thus, to meet the definition of manufacturer one must either directly manufacture an item for sale or contract with others to manufacture an item for sale “from his or her own materials.” *Id.* Here, Taxpayer contracts with [Vendor] to produce an “article” or “commodity” for Taxpayer, namely, the plastic Hub housing units. *Id.* Taxpayer provides [Vendor]

---

<sup>4</sup> On reconsideration, Taxpayer provided information using its equity and debt investments to show its direct labor costs for the firmware and software. This calculation included labor costs, such as engineering, and would result in a per unit cost of \$ . . . . As explained in the analysis, we need not consider the firmware and software provided to [Assembler]. This is because only the molds used by [Vendor] to create the plastic shell of the “[Hardware System]” device are at issue. We need not consider whether [Assembler] is the manufacturer or processor for hire of the “[Hardware System]” device as that issue is not before us.

with plastic injection molds; [Vendor] provides the remaining materials, labor, and mechanical services used to produce the plastic Hub housing units.

. . . With respect to the plastic Hub housing,<sup>5</sup> . . . Taxpayer is not a “manufacturer” because it was the “customer” purchasing the plastic Hub housing from [Vendor]. Taxpayer is not the “person furnishing the labor and mechanical services” that produced the plastic Hub housing. *See* RCW 82.04.110; Rule 136(3)(d).

For this reason, we sustain the holding in Det. No. 19-0185.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 3rd day of March 2020.

---

<sup>5</sup> Taxpayer’s arguments are predicated on the assumption that the manufactured product at issue in this case is the “[Hardware System]” assembled by [Assembler], rather than the plastic Hub housing produced by [Vendor]. We find that assumption false. The equipment for which Taxpayer is seeking the M&E exemption is the plastic injection molds that it provides to [Vendor]. Taxpayer provides the plastic injection molds to [Vendor] so that [Vendor] can produce and sell the plastic Hub housings to Taxpayer. As discussed above, that makes Taxpayer the “customer” of the plastic Hub housings, not the “manufacturer.” Whether Taxpayer may or may not qualify as a manufacturer of the [Hardware System] Hub assembled by [Assembler] is irrelevant to the inquiry in this case. With respect to the “article” or “commodity” at issue in this appeal – the plastic Hub housing - Taxpayer is not a “manufacturer” of that article or commodity, it is the customer purchasing that article or commodity. *See* RCW 82.04.110; Rule 136(3)(d).