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Revenue Report

MANUFACTURER'S MACHINERY & EQUIPMENT EXEMPTION



June 2002



State of Washington

Department of Revenue
William N. Rice, Acting Director

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May 31, 2002

TO: Gary Locke, Governor

FROM: William N. Rice, Acting Director

SUBJECT: Review of the Machinery and Equipment (M&E) Exemption

I am pleased to present to you the Department's report on the manufacturer's machinery and equipment (M&E) sales tax exemption. As you requested, the report focuses on the administrative issues surrounding the M&E exemption. You said the goal should be "to make its use as simple as possible" and asked that the Department detail any areas of controversy regarding interpretation of the M&E.

The M&E exemption has been used extensively by manufacturers. Approximately \$140 million of M&E exemption is taken each year. However, there are a number of areas in which the Department and manufacturers disagree on the interpretation of the law.

In preparation for this report, the Department canvassed business stakeholders and Department employees regarding any issues or questions that need to be addressed to remove ambiguity or to clear up disputes. Appendix B of the report is a complete list of the inventory. The main body of the attached report describes the major issues on which taxpayers and the Department differ.

It is the Department's recommendation that an extended and detailed process be put in place to receive additional business input and to develop a fuller understanding of businesses' viewpoints on the controversial, interpretive issues. The report contains a plan and timeline for gathering this input, with a first meeting to begin discussions scheduled for July 10. Business stakeholders agree with and helped design this process. The Department will use this extended stakeholder process to take a second look at its positions.

We agree with business stakeholders that the proposed process outlined in this report offers the best opportunity for achieving the aims of your request.

Attachment

Retail Sales/Use Tax Exemption for Manufacturing Machinery and Equipment

Report by Department of Revenue on the Administration of the Exemption

May 31, 2002

Introduction

The Governor established the Competitiveness Council in August 2001 to examine Washington's ability to compete in a global economy. The Competitiveness Council was set up as a short-term group that would hold a limited number of meetings to develop recommendations for action. The Competitiveness Council looked at five areas that are linked to a state's prosperity, one of which was "Taxes and Fees."

The Council's final report, released in December 2001, contained recommendations in regard to issues that were longer-term in resolution and issues for which progress and accomplishments could be made immediately. The Council stated that "Washington's tax law contains a number of provisions that must be clarified and simplified so that business is able to easily understand any requirements." The Council found that the sales and use tax exemption for manufacturing machinery and equipment (the M&E exemption) has been "a positive factor in the retention and expansion of manufacturing firms in the state of Washington." The Council recommended in its final report that the "Department of Revenue, working with stakeholders, including both industry and local government, shall review its practices with respect to administration of the M&E." Stating that the M&E exemption was "an important factor in keeping our state competitive," the Governor directed the Department of Revenue (the Department) to report on its administrative experience with the M&E by June 1, 2002.

The M&E exemption was enacted in 1995. The intent statement in the legislation acknowledged that the application of the sales/use tax to machinery, equipment, and installation labor used in manufacturing, research and development, and other activities placed Washington at a competitive disadvantage with other states and served as a significant disincentive to a continued development of economic opportunity. The purpose of the exemption was to encourage the state's private sector to commit to continuous improvement of process, products, and services and to deliver high quality, high value products through technological innovations. The objective was to support and attract a diverse, stable, and competitive economic base of private sector employees through the development of new businesses and the retention, expansion, or modernization of existing businesses.

While manufacturers have made extensive use of the M&E exemption, the Department and manufacturers disagree on the interpretation of the law in a number of instances.

This report responds to the Governor's request for a review of the M&E exemption. It sets out the history of the M&E exemption, describes the issues on which taxpayers and the Department differ, briefly describes the Department's current views on the application of the M&E exemption, and sets out a plan for extensive stakeholder input on issues.

Working on this report provided the Department the opportunity to fully articulate its current view on statutory interpretation. We presented our views, and the rationale for those views, as thoroughly and completely as we could to facilitate an understanding of them and to invite stakeholders to respond. There simply has not been adequate time for stakeholders to prepare and articulate alternate positions. To not allow that time would shortchange the stakeholders and deprive the Department of the opportunity to hear alternative views. The recommended, extended stakeholder process (described below) will provide that opportunity, allow a full exploration of these issues, and promote a continuing dialogue.

The Governor's directive stated that "our goal should be to make its use as simple as possible." The overall framework for eventual resolution of the controversial issues includes solutions as simple as providing targeted taxpayer outreach and education and increasing the frequency and quality of training for Department personnel, and solutions that are more substantive that may involve changes in current Departmental interpretations, revisions to the rule, or revisions to the statute.

The Governor's Directive to the Department of Revenue

The Governor asked that the Department to conduct a review of the M&E exemption and, in doing so, to apply the general principles set forth by the Competitiveness Council in their final report. Principles found throughout the final Competitiveness Council's report to the Governor include accountability, responsiveness, customer service, and simplification.

In addition, the Governor identified five areas to address in specific detail. These are:

1. Areas of controversy regarding interpretation of the M&E exemption;
2. Areas where either the statute or rule need clarification;
3. Areas where the administration of the M&E exemption could be made more simple, more understandable, and less burdensome on the taxpayer;
4. Areas where there are federal standards that are duplicative or overlapping; and
5. Whether the M&E exemption statutory scheme is still a good fit to the day-to-day operations of this state's manufacturing firms, or has modernization made some of the exemption language problematic.

The full text of the Governor's directive to the Department is reproduced in Appendix A.

In the process of getting preliminary stakeholder input on Department views it became apparent that substantive input was needed from business stakeholders and that this process would require significant dedication of time. Therefore, it is the Department's recommendation that a detailed process be put in place to receive input on and to develop an understanding of the business viewpoint of the controversial interpretive issues. Because of this, a decision at this time on whether the statute or rule needs clarification is premature. This report contains a plan and timeline for gathering such input, but does not include recommendations to resolve areas of controversy at this time, pending further dialogue between the Department and stakeholders.

Tax Administration in the Context of the M&E Exemption

There are a number of points of customer contact between the Department of Revenue and taxpayers in the administration of the M&E exemption. Manufacturers can write or call the Taxpayer Services Division and ask a question about how the M&E exemption works in general or how it applies to a given fact pattern. The Department's written responses, known as letter rulings, are binding on both the taxpayer and the Department if the taxpayer's identity is disclosed to the Department. In addition, manufacturers who believe they are entitled to the exemption and have overpaid taxes on the purchases can send a refund request to the Department's Taxpayer Account Administration Division. The Department's Audit Division audits on a routine basis, and in this setting Department employees issue credits and assessments, and educate taxpayers, by providing reporting instructions on the M&E exemption. The Appeals Division provides hearings to taxpayers who are adversely affected by actions taken by the Department in the assessment or collection of taxes. A final written determination upholding, modifying, or reversing the Department's actions is issued to the taxpayer. The Legislation and Policy Division works on legislation and rules, and provides assistance on a variety of issues.

The various responsibilities of the divisions necessitate a great deal of coordination and a concerted effort to maintain consistency in the application of tax laws. In areas where controversies exist, such as the M&E exemption, this need is heightened.

Department Review of Issues – Consultation with Stakeholders

The first step the Department took in its review of the M&E exemption was to conduct an internal inventory of issues. All of the affected divisions were canvassed and asked to bring forward any issues that appeared to be controversial, unresolved, or for which additional guidance seemed to be needed. The result of that inventory is a list of issues arranged around the areas identified in the Governor's directive. They are summarized in Appendix B. This inventory was augmented by contacts with business stakeholders on the Tax and Fee Subcommittee of the Competitiveness Council. The second step was to sit down with stakeholders and discuss the identified issues, gather input on additional areas of interest, and lay out the review process.

On February 20, 2002, a meeting was held for local government representatives. A follow-up meeting was held on May 22 with representatives of cities and counties to receive any further input and to share information on the extended stakeholder process that is recommended with the business community. The message from local governments to the Department was that they did not support expansion of the exemption. This position is related to the fiscal situation facing local governments in the state of Washington. Eligible machinery and equipment is exempt from retail sales and use taxes, which are a major source of revenue for local governments. An expansion of the exemption is a significant concern to local governments since it would potentially exacerbate their revenue situation.

It is important to note that some cities are very supportive of the M&E exemption and believe it has been a plus for economic development in their communities. Local governments are, however, wary of the in-depth review and analysis that will be undertaken by the business

stakeholders and the Department, believing that interpretive changes typically only go one way, that is, in the favor of the taxpayer. One suggestion from county representatives is that the statute be simplified by expanding it in some areas and contracting it in other areas, with the objective being to make it easier to use, but the end result being revenue neutral. It was also suggested that simplification of this exemption makes sense and, in any event, will be required as part of the ongoing efforts by states to streamline the sales tax, and that any changes should take into account the direction of those efforts.

On February 27, 2002, the Department met with representatives of the business community. A second meeting for business stakeholders was held on April 11, 2002, to get input from an expanded group of participants, and a third meeting was held on May 15, 2002, to discuss Department views and possible recommendations to the Governor.

At that meeting business stakeholders stated that they disagreed with many, if not all, of the Department's interpretations of the statute. In addition, the stakeholders questioned the timing of and the necessity for any legislative recommendations. They expressly felt that it had not been adequately tested yet whether some of these issues could be resolved administratively. The Department and business stakeholders agreed to the merits of the process to receive detailed input and analysis on the issues of controversy. The process promises no particular outcome or resolution, but the mutual commitment is to an open process approached with open minds, with opportunity for meaningful interaction and communication.

Timeline for Extended Review

The Department and business stakeholders agreed that it was imperative to set up a timeline to keep the participants on track and moving through the issues. A six-month time frame was established, with July 10 identified for the first meeting, and two meetings scheduled each month until December 11. Prior to the July meeting, the business stakeholders have agreed to meet internally to scope and prioritize the issues, and to then meet with the Department to establish the order for discussion of issues. The July 10 meeting will be a question and answer session by the Department and an overview of all of the issues. The subsequent meetings will be structured to have (1) the Department preview an issue to be discussed at a future meeting and (2) the business people present their analysis of a previously previewed issue. Dates for issue discussions will be scheduled in advance so that participants have adequate time for research and analysis.

During this process the Department will brief the local governments on the status of the review and will provide timely notice of any proposed changes in interpretation or recommendations for legislation.

The Machinery and Equipment Exemption Law

RCW 82.08.02565 and 82.12.02565 provide an exemption from state and local sales and use taxes to manufacturers or processors for hire for purchases of certain property used directly in manufacturing operations, testing operations, or research and development operations. In addition to purchases or uses of property, the exemption extends to certain types of retail

services, such as cleaning machinery and equipment. The full text of the exemption is set out in Appendix C.

Rule 13601 is the administrative rule adopted by the Department in 2000 to implement the M&E exemption. It is reproduced in Appendix D.

Most of the issues involving the M&E exemption relate to manufacturing operations, as opposed to research and development (R&D) operations and testing operations. The test for eligibility of a piece of machinery and equipment does not hinge on whether the property is essential or integral to a manufacturer's operation. Instead, the statute looks at how property is used in a manufacturing operation, and allows the exemption only for machinery and equipment "used directly" in the operation. In other words, the eligibility of a particular item of machinery and equipment does not depend upon its importance or contribution to the manufacturing process. A piece of machinery or equipment may be essential or integral to a manufacturing operation but, unless it is "used directly" in that operation, it will not qualify for the exemption.

The statute contains a series of qualifiers that must all be met in order for the exemption to apply to a particular transaction or acquisition.

First, the purchase or use must be by a manufacturer or processor for hire or person engaged in testing for a manufacturer or processor for hire.

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 or research and development operation, to sales to a person engaged in testing for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation...

Second, the property must be "used directly in a manufacturing operation, testing operation, or research and development operation." The phrase "used directly" is defined in the statute by eight descriptive activities, any of which will qualify the property under this criterion.

1. Acts upon or interacts with an item of tangible personal property;
2. Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;
3. Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
4. Provides physical support for or access to tangible personal property;
5. Produces power for, or lubricates machinery and equipment;
6. Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
7. Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
8. Is integral to research and development as defined in RCW 82.63.010 (the sales/use tax deferral/exemption program for high technology businesses.)

In addition, the statute includes definitions for the three types of qualifying operations:

“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 term also includes that portion of a cogeneration project that is used to generate power for consumption within the manufacturing site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 [public utility tax] or the preparation of food products on the premises of a person selling food products at retail.

“Research and development operation” means engaging in research and development as defined in RCW 82.63.010 [high technology program] by a manufacturer or processor for hire.

“Testing operation” means the testing of tangible personal property for a manufacturer or processor for hire. A testing operation begins at the point where the tangible personal property enters the testing site and ends at the point where the tangible personal property leaves the testing site. The term also includes that portion of a cogeneration project that is used to generate power for consumption within the site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 [public utility tax] or the preparation of food products on the premises of a person selling food products at retail.

Third, in order to qualify as a manufacturing operation the product being manufactured must be for sale and must be tangible personal property.

“Manufacturing operation” means the manufacturing of articles, substances, or commodities for sale as tangible personal property.

Fourth, the statute defines “machinery and equipment.”

“Machinery and equipment” means industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts. “Machinery and equipment” includes pollution control equipment installed and used in a manufacturing operation, testing operation, or research and development operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation, testing operation, or research and development operation.

The terms “industrial fixtures,” “devices,” and “support facilities” are not defined in law.

Lastly, the statute altogether excludes four classes of property from the definition of “machinery and equipment,” even if the property is used directly in a manufacturing operation.

“Machinery and equipment” does not include:

- a. Hand-powered tools;
- b. Property with a useful life of less than one year;
- c. Buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building; and
- d. Building fixtures that are not integral to the manufacturing operation, testing operation, or research and development operation that are permanently affixed to and become a physical part of a building, such as utility systems for heating, ventilation, air conditioning, communications, plumbing, or electrical.

The term “building fixture” is not defined in law, nor are the terms “building” or “utility systems.”

History of the M&E Exemption

1994 Study

In 1994, the Legislature asked the Department to study the impact of Washington’s tax system on the manufacturing industry. Essentially what the study found was that Washington was at a disadvantage when measured against its field of competitors. The Department, with the assistance of an advisory group that included industry representatives and legislators, concluded that tax policy was the one variable among a number of factors affecting location decisions that could be addressed in the short term to help keep the state competitive. Two other major areas, transportation and work force, were identified as factors that the state could influence over the long run. The recommendation of the Department was to focus on capital investment, and target sales tax as offering the best return on investment, as well as being an area where Washington’s tax treatment was out of line with most other states.

Legislation and Rule-Making History

1995

In 1995, the Legislature enacted machinery and equipment legislation introduced at the request of Governor Lowry. This legislation provided a sales and use tax exemption for machinery and equipment used in manufacturing operations. It also covered installation charges for qualifying machinery and equipment as well as replacement parts that increased the productivity, improved efficiency, or extended the useful life of the machinery and equipment. See Chapter 3, Sp. S., Laws of 1995.

1996

In 1996, the exemption was revised to include additional services beyond installing. These were repairing, cleaning, altering, or improving the machinery and equipment. The definition of “machinery and equipment” was revised to include tangible personal property that becomes an ingredient or component of the machinery and equipment, including repair and replacement

parts. See Chapter 173, Laws of 1996. In the same session a second act extended the exemption to research and development engaged in by manufacturers or processors for hire and provided a sales and use tax exemption for materials used by small businesses engaged in aircraft design and development. Both acts took effect June 6, 1996. See Chapter 247, Laws of 1996.

By the end of 1996, the Department became aware of differences of opinion regarding the interpretation of some parts of the statute. Examples of these differing views included whether certain activities were manufacturing and the meaning of the word “site” in the context of “manufacturing operation”. Development of a draft rule was halted when it became apparent that the differences in position were substantial and involved a number of taxpayers and a variety of issues.

1997

In 1997 the legislature clarified the small business aircraft design and development target exemption by using specific language regarding “prototypes.” See chapter 302, Laws of 1997.

In September 1997, with the encouragement of Senator Pat Hale, the Department began a lengthy stakeholder process with business and local government representatives. In the first five months the Department held eleven meetings with this group of stakeholders and held other meetings with subgroups on a number of issues.

1998

As a result of this review work, the Department requested legislation to reduce the record-keeping burden on taxpayers imposed by the exemption. The 1995 legislation had included an annual reporting requirement that required sending purchasing detail to the Department. The 1998 bill grew out of the stakeholder process and represented a good faith effort on the part of the working group as a whole. The legislation eliminated the duplicate certificate and annual reporting requirements. After the 1998 Session, the Department and stakeholders continued to work toward reaching agreement on how the M&E exemption worked and what precisely it exempted.

1999/2000

In 1999, legislation was introduced to clarify additional issues. Part of the legislation was retroactive and addressed the issues of logging and mining activities (there had been controversy over whether these activities or any part of these activities were manufacturing,) segmented manufacturing (there was a vagueness in the statute regarding manufacturing occurring at more than one site,) off-site testing by manufacturers (the site requirement had not taken into account the requirement to test some products in the water or air or on the road,) and hand-powered tools (the original statute merely said hand tools, which some people interpreted as hand-held-tools, some of which are sophisticated and expensive.) The exemption was extended on a prospective basis to persons who perform third party testing for manufacturers or processors for hire (which change made the state-wide M&E exemption comparable to the distressed area program as far as eligibility.)

In May 1999, an emergency rule was adopted and a permanent rule adopted in June 2000. The emergency rule reflected those issues for which agreement had been reached during the stakeholder process. However, there were a few issues for which no agreement could be reached and on which the Department eventually adopted positions in the permanent rule. They are:

Converted Use: If a manufacturer takes a piece of equipment out of the manufacturing operation and uses it exclusively for another purpose tax is due on the depreciated value of the property.

Majority Use: A manufacturer who uses an item of machinery and equipment in non-qualifying and qualifying applications is eligible for the exemption if the qualifying use is more than half of the over all use.

Site/Manufacturing: The qualifying use of the equipment must take place at the manufacturing site.

Support Facilities: The statute did not include a definition of support facility, however a definition of support facility was included in Rule 13601.

Buildings: The M&E exemption statute includes two specific exclusions relating to buildings. The exclusions have been problematic. The first is that buildings are not covered by the exemption, however support facilities, which can be parts of buildings, are covered. In addition, building fixtures are only eligible if they are integral to the manufacturing operation.

Current Issues - Department of Revenue Current Views

The issues brought forward by stakeholders and the issues identified by Department staff are virtually identical. Taxpayers want clarification on issues so that they can claim eligible machinery and equipment simply and without risk. As the tax administrator the Department wants taxpayers to have a clear understanding of the law. This will minimize disagreements and promote voluntary compliance. The Department's objective and stakeholder objectives are complementary.

While the 1998 and 1999 legislation and the adoption of the rule provided clarity on some fundamental issues, there is still a significant amount of confusion surrounding the exemption as well as considerable disagreement over interpretation of the law.

The following discussion summarizes the issues of controversy as well as the Department's views. As previously noted, any alternative views will be ascertained and articulated through the extended stakeholder process the Department is recommending. The Department believes articulating its views thoroughly and completely is an important prerequisite to meaningful dialog with stakeholders on the issues of controversy.

Please note that two of the five issues identified above as "issues for which no agreement could be reached" during the rule adoption process are not part of the following issues discussion but will be discussed with business stakeholders during the extended review process.

Building/Support Facility

Relevant Parts of the Statute:

- Definition of machinery and equipment: See RCW 82.08.02565(2)(a), Appendix C.
- Exclusions from definition of machinery and equipment: See RCW 82.08.02565(2)(b)(iii), Appendix C.

Issues: This issue has two parts.

- Are buildings ever eligible?
- Are parts of buildings eligible?

Department View:

- The statewide M&E exemption is different than the more expansive distressed area program (which covers buildings.)
- A building as a whole can never be eligible.
- Support facilities, which by definition in the Rule are component parts of buildings or an improvement, are eligible if they are “used directly” in a manufacturing operation.
- The meaning of the phrase “support facility” is construed so as not to conflict with the legislature’s specific statement that buildings do not qualify. An entire building is not the same as a support facility.
- Special construction standards necessary for the unique manufacturing requirements of its business do not render an entire building a “support facility”.
- Industrial fixtures that are permanently affixed to or become a physical part of a building are eligible if “used directly” in a manufacturing operation.
- Fixtures located outside of a building are not “buildings” or parts of buildings. If they are used directly in the manufacturing operation they are eligible.

Utility Systems and Other Building Fixtures

Relevant Parts of the Statute:

- Definition of machinery and equipment: See RCW 82.08.02565(2)(a), Appendix C.
- Exclusions from definition of machinery and equipment: See RCW 82.08.02565(2)(b)(iv), Appendix C.

Issues:

- Under what circumstances are building fixtures eligible for the exemption?

Department View:

- Building fixtures that only serve a general building function are not eligible.

- Building fixtures, including systems, that are integral to the manufacturing operation are eligible if they are used directly in the manufacturing operation.
- Building fixtures that are used for both qualifying and non-qualifying purposes will be apportioned. Generally this applies to utility systems.

Electrical Machinery and Equipment

Relevant Part of the Statute:

- Definition of manufacturing operation: See RCW 82.08.02565(2)(d), Appendix C.
- Definition of used directly: See RCW 82.08.02565(2)(c), Appendix C.

Issues:

- Does the M&E exemption cover machinery and equipment whose function is to handle or distribute, but not produce, electricity?
- Is electricity tangible personal property under our tax laws, and is this status relevant to the M&E exemption?

Department View:

- Electricity is not tangible personal property for tax purposes. This status applies to the entire tax code.
- Six of the eight “used directly” test refer to “tangible personal property.” Transformers, panels, conduit, and other electrical apparatus and electrical distribution equipment are not “used directly” in a manufacturing operation because electricity is not tangible personal property for tax purposes in Washington.
- Of the eight “used directly” tests one applies specifically to electrical production. Under that test, electrical apparatus that produces power for qualifying machinery and equipment qualifies for the exemption. However, most electrical equipment does not produce power, it handles it.
- Other electrical apparatus and electrical distribution equipment used in a manufacturing operation or testing operation is not eligible because it does not satisfy the “used directly” tests.
- One of the eight “used directly” tests applies specifically to R&D operations. Under that test, electrical apparatus and electrical distribution equipment used in a research and development operation are eligible because they are integral to the R&D operation.
- Electrical equipment that becomes an ingredient or component of qualifying machinery and equipment or that is a repair or replacement part qualifies for the exemption.

Site

Relevant Parts of the Statute:

- Definition of manufacturing operation: See RCW 82.08.02565(2)(d), Appendix C.
- Definition of used directly: See RCW 82.08.02565(2)(c), Appendix C.

Issues:

- Does the M&E exemption require that the use of equipment take place where the qualifying activity occurs or can the use take place anywhere?

Department View:

- There is a site requirement for manufacturing and testing operations. The statute includes the term “site” and the definition of “manufacturing operation” describes a process taking place at a location
- There is no site requirement for research and development operations.
- For a manufacturing operation the site does not have to be a location dedicated solely to manufacturing. Retail, wholesale, or other activities can occur at the same location.
- Manufacturing does not have to begin and finish at the same site, but manufacturing must occur at a manufacturing site for the location to come within the statute.

Computers and Computer Systems

Relevant Part of the Statute:

- Definition of machinery and equipment: See RCW 82.08.02565(2)(a)
- Definition of used directly: See RCW 82.08.02565(2)(c), appendix C.

Issues:

- What type of computer use qualifies?
- How does the definition of “manufacturing operation” impact computer eligibility?

Department View:

- A computer used in a manufacturing operation has to be located at the manufacturing site to qualify.
- Computers are eligible machinery and equipment as long as they satisfy the “used directly” test.
- For example, a computer that *directs or controls* qualifying machinery and equipment is eligible for the exemption. A computer that directs or controls machinery and equipment does so through the transmission of data. The data exchange is in the form of instructions that cause an action or interaction to occur.
- Electrical wiring, fiber optic cable and copper cable systems for computers and computer systems are not eligible because they do not interact or act upon tangible personal property.

- An assemblage of computers into an integrated system should not be viewed as one machine.
- A computer used exclusively for design purposes is not eligible because design is not part of a manufacturing operation as defined by statute.

Design

Relevant Parts of the Statute:

- Exemption from tax: See RCW 82.08.02565(1), Appendix C.
- Definition of manufacturing operation: See RCW 82.08.02565(d), Appendix C.

Issue:

- Are design activities part of the manufacturing operation?

Department View:

- The exemption is limited to activities that take place at the manufacturing site (other than testing or R&D) and during the manufacturing operation.
- The design phase either precedes the manufacturing phase or, if interjected into the process, is distinct from the activity of manufacturing and, therefore, does not qualify.
- “Just-in-time manufacturing” or other approaches in which design may occur simultaneously with manufacturing, do not change the nature of the design work and are not qualified.

Pollution Control Equipment

Relevant Portion of the Statute:

- Definition of “machinery and equipment: See RCW 82.08.02565(2)(a), Appendix C.

Issues:

- Does pollution control equipment automatically qualify without regard to any statutory requirements?
- Does pollution control equipment automatically qualify if it is required by law or regulation?
- Does the exemption cover equipment to control pollutants coming into the manufacturing operation from external sources?

Department View:

- Pollution control equipment required under a permit or regulation or other legal requirements is not automatically eligible for the exemption.
- The pollution control equipment must be used at the site by the manufacturer to be eligible.

- The exemption is limited to machinery and equipment used to prevent pollution or contamination of the natural environment that is a byproduct of the manufacturing operation.
- The exemption for pollution control equipment does not extend to property used in the manufacturing operation to maintain the quality of raw materials or to maintain the quality of the manufacturing environment.

Prototypes

Relevant Portion of the Statute:

- Definition of “machinery and equipment: See RCW 82.08.02565(2)(a), Appendix C.

Issues:

- Does a prototype qualify as machinery and equipment eligible for the exemption?

Department View:

- Eligibility for the exemption is determined on the basis of how property is used, not what property is called.
- In almost all instances a prototype is not used to make, build, or test products, they are the products themselves. In such instances, prototypes do not qualify.
- In an R&D operation, where a prototype is not used to perform R&D but is the object of the R&D, the prototype is not eligible for the exemption.
- “Prototypes” used as tools in a qualifying operation, such as a manufacturing mockup used to calibrate tools or a prototype created and used in R&D as a testing device would qualify, if created for this purpose.

Cogeneration

Relevant Parts of the Statute:

- Definition of manufacturing operation: See RCW 82.08.02565(2)(d), Appendix C.
- Definition of cogeneration: See RCW 82.08.02565(2)(e), Appendix C.

Issues:

- Does the ownership of the cogeneration project affect eligibility for the M&E exemption?
- Does the “project” itself qualify or just the machinery and equipment used directly in the project?
- How is the apportionment of the eligible equipment made between electricity used at the site and electricity used elsewhere?
- Can a stand-alone power plant qualify if it is outside of the manufacturing operation?

Department View:

- The M&E exemption is limited to persons who manufacture. If the cogeneration project is owned in whole or in part by persons other than the manufacturer, the project does not qualify.
- The cogeneration project as a whole is not eligible. The exemption is limited to the industrial fixtures, devices, and support facilities that are used directly in the cogeneration project.
- The M&E exemption applicable to the cogeneration project is apportioned based on power from the project consumed at the manufacturing site compared to total power from the project.

Device

Relevant Parts of the Statute:

- Exemption from tax: RCW 8208.02565(1), See Appendix C.
- Definition of machinery and equipment: RCW 82.08.02565(2)(a), See Appendix C.
- Definition of used directly, RCW 82.08.02565(c), see Appendix C.

Issues:

- Does furniture qualify as a device?
- Do libraries, books, and periodicals qualify?

Department View:

- Furniture can qualify as a device if it is used directly in a research and development operation.
- Libraries, books, and periodicals are representations of content (information and data) and do not meet the definition of device and therefore do not qualify for the exemption.

Rental of Equipment with an Operator

Relevant Part of the Statute:

- Exemption from tax: RCW 82.08.02565(1), see Appendix C.

Issues:

- Is rental of equipment with an operator a rental of tangible personal property?
- If rental of equipment with an operator is not rental of tangible personal property, does it fall under the activity of “service in respect to...?”

Department View:

- The M&E exemption covers rentals and leases of tangible personal property as well as sales of tangible personal property. In addition, the exemption may be taken for

- charges for “services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment.”
- “Rental of equipment with an operator” is a statutory term and is a retail service. It is distinct from and is not a rental of tangible personal property, and does not qualify for the M&E exemption.
 - “Rental of equipment with an operator” is also a separate retail activity from the retail sale of “labor and services rendered in respect to ...the installing, repairing, cleaning, altering ... or improving of tangible personal property “.
 - “Rental of equipment with an operator” does not fall under the activity of “service in respect to...” and does not qualify for the M&E exemption.

Miscellaneous

1. Inventory control systems – do they qualify as machinery and equipment? An inventory control system is a system for measuring and tracking the quantity, identity, location, or value of inventory.
 - Department view – They do not meet any of the “used directly” tests and, therefore, do not qualify. One used directly test does use the word “measure” but the Department has interpreted that to mean more than tracking or counting.
2. Transportation equipment – does its off-site use qualify for the M&E exemption?
 - Department view – No, the statute has a site requirement. In 1999 the Legislature clarified that the site requirement did not apply to activities such as testing. No other aspect of the site requirement was revised at that time.
3. Electrical apparatus that is part of machinery and equipment – why is this eligible when separate switches and transformers are not?
 - Department view – It is eligible because it is a component part of eligible machinery and equipment.
4. Installation of machinery and equipment that involves electrical hookup work – Is this eligible under “services rendered in respect to installing?
 - Department view – If a charge is made for electrical hookup as part of making the machinery and equipment operable it is eligible.
5. Harvesting – does the use of equipment that does some activities in the field that were previously done at a manufacturing plant amount to “manufacturing?”
 - Department view – Generally, no. First, the fact that an activity occurred in the manufacturing plant did not and does not automatically make the activity a manufacturing activity. Raw materials undergo a variety of sorting and processing that in and of itself is not manufacturing. Manufacturing requires that the raw material undergo a process that results in a new, different, or useful product. Second, harvesting is an activity distinct from manufacturing. Many harvesting and processing activities related to agricultural products create a product that is valuable and useful. However, the standard for manufacturing is “new, different, and useful.” Trimming tops off carrots, stemming cherries, and separating chaff from grain, are

examples of activities that significantly improve the marketability of a product, but don't significantly change a product. One is still left with a carrot, a cherry, and grain. An interesting example is a machine that removes the vines from cucumbers by cutting the vine. If this same activity were done by hand, it would clearly be farming. The use of a machine to achieve the same result is not manufacturing. However, if the machine is located in a manufacturing site (in the field or elsewhere) and is "used directly" in a process that ends with a manufactured cucumber product, it would qualify.

Is the M&E Exemption a Good Fit for Today's Manufacturing Firm?

Globalization and global competition, coupled with rapid advances in technology, are changing manufacturing processes and operations at an increasingly rapid rate. Some of the changes in industrial practices are incremental, some are dramatic, but the end result is that the modern manufacturing has made and will continue to make a departure from the traditional industrial model of manufacturing. While traditional vertically integrated manufacturers still exist, there are an increasing number that are integrators and/or assemblers of parts made in other locations. At the same time, just-in-time manufacturing processes have made real time information critical to the manufacturing operation and design-build concepts have blurred the lines between manufacturing and engineering. Computers have become an essential part of, not only, manufacturing equipment but also manufacturing systems.

The current M&E exemption is focused on tangible personal property; that is, either the products being manufactured or the thing doing the manufacturing. This structure may not provide the flexibility necessary to administer the statute in a rapidly changing manufacturing and business environment. The Department has not had the opportunity to thoroughly discuss the issue of whether the M&E exemption is flexible enough to keep pace with the changing face of manufacturing. The process set forth earlier in this report will include a dialogue with the stakeholders on possible options, if necessary, to maximize the adaptability of the M&E exemption.

Appendix A
Governor's Directive

January 22, 2002

TO: William N. Rice, Acting Director
Department of Revenue

FROM: Gary Locke, Governor

SUBJECT: Competitiveness Council Report - Review of the Machinery and Equipment (M&E) Exemption

As you are aware, in August 2001, I convened the Washington Competitiveness Council and charged it with the task of developing ideas to make Washington a better place to do business. In December, the Council presented me with a final report. The report includes a range of recommendations and covers five main areas; taxes and fees; regulations and permitting; infrastructure; human capital and innovation, and benchmarking. Some of the Council recommendations are long term in nature, and some can be tackled immediately.

In the area of taxes and fees, the Council identified its top priorities. In the big picture, the overall concern was the fiscal crisis and the stability of the tax system. The Council also made very specific recommendations. Two of these recommendations, municipal tax fairness and investment income, are the subject of legislation I am introducing this legislative session.

A third high priority issue of the Competitiveness Council involves the manufacturers' machinery and equipment exemption (M&E). The Council recommended that, "The Department of Revenue, working with stakeholders, including both industry and local government, shall review its practices with respect to administration of the M&E." I have made a commitment to the Council to address this issue. I am asking you to do such a review and, in so doing, apply the general principles that were brought forth by the Council in its report.

Specifically, please report to me by June 1, 2002, on the Department's administrative experience with the M&E. The report should detail any areas of controversy regarding interpretation of the M&E and areas where either the statute or rule needs clarification. In addition, I would like you to consider and identify those areas where the administration of the M&E could be made less complex, more understandable, and less burdensome on the taxpayer. If there are areas where there are federal standards that are duplicative or overlapping, please identify those in your report. And lastly, please give consideration to whether the M&E statutory scheme is still a good fit to the day-to-day operations of this state's manufacturing firms and whether modernization made some of the exemption language problematic.

The M&E exemption is an important factor in keeping our state competitive. Our goal should be to make its use as simple as possible. I look forward to receiving your report.

Appendix B List of Issues

Record keeping issues

- Majority use
 - In general the documentation of qualifying versus non-qualifying use is a burden for taxpayers and Department of Revenue auditors.
 - It is difficult for taxpayers to keep records on equipment used for both manufacturing and repair.
 - The use of computer systems, particularly integrated systems, pose allocation problems for taxpayers and auditors.
- Useful life
 - In general the useful life threshold poses record keeping and proof issues for taxpayers.
 - Proof for repair and replacement parts is difficult.
- Taxable events - Parts of buildings are not associated with identifiable “taxable events” and this makes it difficult to determine what, if anything, is eligible.

Areas where similarities between federal and state standards could have some impact on business

- The “useful life” threshold has a distinct meaning for federal income tax reporting.
- Parts of the R&D definitions are similar to some federal standards.
- Under some federal tax credit programs some building components are considered equipment.

Areas of disagreement regarding interpretation

- Support facilities - the phrase is not defined anywhere in statute. A definition was adopted in the rule, but a disagreement continues about what is and isn’t included.
 - What test is used to determine if a part of a building has a function relative to qualifying equipment?
 - What is a vibration reduction slab compared to a building foundation or a floor?
- Transportation equipment
 - Does transportation between a taxpayer’s sites qualify?
 - Does transportation to a customer qualify?
- Buildings
 - Could an entire building qualify?
 - Can parts of a building qualify?
 - Does “excess capacity” “ or “overbuild” qualify – e.g. thicker floors, thicker walls, extra power, and so on.
 - Do utility systems qualify?
 - Specialized walls and ceilings – could they qualify?
- Prototypes - are prototypes eligible devices?
 - Are prototypes used directly in the manufacturing operation?
 - Are prototypes equipment that is integral to research and development?

- The state of the law in Washington State is that electricity is not tangible personal property. This impacts the eligibility of a variety of property.
- Apparatus that converts, transforms, or otherwise handles electricity – does this qualify?
 - Electrical systems that are separate from building – do they qualify?
 - Electrical systems that are “overbuilt” for the building – do they qualify?
- Where does the manufacturing operation begin?
 - Why is the design phase excluded from the manufacturing operation?

Areas that need policy clarification

- Installing eligible equipment
 - Electrical wiring from machine to the wall - is the installing charge eligible?
 - Renovation of building so that machines fit – are the construction services eligible?
- How is a determination made regarding “useful life” of individual parts used in installing, repairing, cleaning, altering, or improving services?
- Rental of equipment with an operator – does this qualify?
- Cogeneration projects
 - What is eligible and how is the eligible equipment apportioned?
- Corporate reorganization might involve bulk acquisition of assets. Does each asset need to be identified as eligible or ineligible?
- Pollution control equipment – what does it include?
- Computer systems and equipment – what qualifies?
- What sorts of structures away from the building qualify?
 - Do settling ponds qualify?
 - Do concrete pads and paved storage areas qualify?
- R&D
 - What is an R&D operation?
 - Do books and other research materials qualify as equipment?
- Manufacturing
 - What is manufacturing versus packing?
 - What is manufacturing versus repair?
 - Where does the manufacturing operation begin?
 - Is data used to create a finished product a “raw material?”

Appendix C
The Manufacturing Machinery and Equipment Statute

RCW 82.08.02565 Exemptions -- Sales of machinery and equipment for manufacturing, research and development, or a testing operation -- Labor and services for installation -- Exemption certificate -- Rules.

(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 or research and development operation, to sales to a person engaged in testing for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation, or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment, but only when the purchaser provides the seller with an exemption certificate in a form and manner prescribed by the department by rule. The seller shall retain a copy of the certificate for the seller's files.

(2) For purposes of this section and RCW 82.12.02565:

(a) "Machinery and equipment" means industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts. "Machinery and equipment" includes pollution control equipment installed and used in a manufacturing operation, testing operation, or research and development operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation, testing operation, or research and development operation.

(b) "Machinery and equipment" does not include:

(i) Hand-powered tools;

(ii) Property with a useful life of less than one year;

(iii) Buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building; and

(iv) Building fixtures that are not integral to the manufacturing operation, testing operation, or research and development operation that are permanently affixed to and become a physical part of a building, such as utility systems for heating, ventilation, air conditioning, communications, plumbing, or electrical.

(c) Machinery and equipment is "used directly" in a manufacturing operation, testing operation, or research and development operation if the machinery and equipment:

(i) Acts upon or interacts with an item of tangible personal property;

(ii) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;

(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.

(d) "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 term also includes that portion of a cogeneration project that is used to generate power for consumption within the manufacturing site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 or the preparation of food products on the premises of a person selling food products at retail.

(e) “Cogeneration” means the simultaneous generation of electrical energy and low-grade heat from the same fuel.

(f) “Research and development operation” means engaging in research and development as defined in RCW 82.63.010 by a manufacturer or processor for hire.

(g) “Testing” means activities performed to establish or determine the properties, qualities, and limitations of tangible personal property.

(h) “Testing operation” means the testing of tangible personal property for a manufacturer or processor for hire. A testing operation begins at the point where the tangible personal property enters the testing site and ends at the point where the tangible personal property leaves the testing site. The term also includes that portion of a cogeneration project that is used to generate power for consumption within the site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 or the preparation of food products on the premises of a person selling food products at retail.

Appendix D The M&E Administrative Rule

WAC 458-20-13601 Manufacturers and processors for hire--Sales and use tax exemption for machinery and equipment. (1) **Introduction.** This rule 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. This rule explains the requirements that must be met to substantiate a claim of exemption. For information regarding the distressed area sales and use tax deferral refer to WAC 458-20-24001 and chapter 82.60 RCW. For the high technology business sales and use tax deferral refer to chapter 82.63 RCW.

On and after July 25, 1999, a person engaged in testing for manufacturers or processors for hire is eligible to take the exemption, subject to the requirements explained below.

(2) **Legislative history.** The manufacturing machinery and equipment exemption, codified as RCW 82.08.02565 and 82.12.02565, became effective July 1, 1995. The exemption has since been the subject of a number of changes. c 3, 1996 c 173, 1996 c 247, 1998 c 330, and 1999 c 211. The 1995 legislation covered installation charges for qualifying machinery and equipment as well as replacement parts that increased the productivity, improved efficiency, or extended the useful life of the machinery and equipment.

(a) In 1996, the exemption was extended to include charges for repairing, cleaning, altering, or improving the machinery and equipment. The same act also revised the definition of “machinery and equipment” to include tangible personal property that becomes an ingredient or component of the machinery and equipment, including repair and replacement parts. A second act extended the exemption to research and development engaged in by manufacturers or processors for hire. Both acts took effect June 6, 1996.

(b) In 1998, the duplicate certificate and annual reporting requirements were eliminated, effective June 11, 1998.

(c) In 1999, the 1995 legislation was clarified retroactively by ESHB 1887, chapter 211, Laws of 1999, to include certain logging and mining activities, segmented manufacturing, and off-site testing by manufacturers, and to explain that hand-powered tools were excluded. On July 25, 1999, the exemption was extended on a prospective basis to persons who perform third party testing for manufacturers or processors for hire.

(3) **Definitions.** For purposes of the manufacturing machinery and equipment tax exemption the following definitions will apply.

(a) “Cogeneration” means the simultaneous generation of electrical energy and low-grade heat from the same fuel. See RCW 82.08.02565.

(b) “Device” means an item that is not attached to the building or site. Examples of devices are: Forklifts, chainsaws, air compressors, clamps, free standing shelving, software, ladders, wheelbarrows, and pulleys.

(c) “Industrial fixture” means an item attached to a building or to land. Fixtures become part of the real estate to which they are attached and upon attachment are classified as real property, not personal property. Examples of “industrial fixtures” are fuel oil lines, boilers, craneways, and certain concrete slabs.

(d) “Machinery and equipment” means industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair

parts and replacement parts. “Machinery and equipment” includes pollution control equipment installed and used in a qualifying operation to prevent air pollution, water pollution, or contamination that might otherwise result from the operation. “M&E” means “machinery and equipment.”

(e) “Manufacturer” has the same meaning as provided in chapter 82.04 RCW.

(f) “Manufacturing” has the same meaning as “to manufacture” in chapter 82.04 RCW.

(g) “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 excepted 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. The statute specifically allows testing to occur away from the site.

The term “manufacturing operation” also includes that portion of a cogeneration project that is used to generate power for consumption within the manufacturing site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 or the preparation of food products on the premises of a person selling food products at retail.

(i) Neither duration or temporary nature of the manufacturing activity nor mobility of the equipment determine whether a manufacturing operation exists. For example, operations using portable saw mills or rock crushing equipment are considered “manufacturing operations” if the activity in which the person is engaged is manufacturing. Rock crushing equipment that deposits material onto a roadway is not used in a manufacturing operation because this is a part of the constructing activity, not a manufacturing activity. Likewise, a concrete mixer used at a construction site is not used in a manufacturing operation because the activity is constructing, not manufacturing. Other portable equipment used in non-manufacturing activities, such as continuous gutter trucks or trucks designed to deliver and combine aggregate, or specialized carpentry tools, do not qualify for the same reasons.

(ii) Manufacturing tangible personal property for sale can occur in stages, taking place at more than one manufacturing site. For example, if a taxpayer processes pulp from wood at one site, and transfers the resulting pulp to another site that further manufactures the product into paper, two separate manufacturing operations exist. The end product of the manufacturing activity must result in an article, substance, or commodity for sale.

(h) “Processor for hire” has the same meaning as used in chapter 82.04 RCW and as explained in WAC 458-20-136.

(i) “Qualifying operation” means a manufacturing operation, a research and development operation, or, as of July 25, 1999, a testing operation.

(j) “Research and development operation” means engaging in research and development as defined in RCW 82.63.010 by a manufacturer or processor for hire. RCW 82.63.010 defines “research and development” to mean: Activities performed to discover technological information, and technical and non-routine activities concerned with translating technological

information into new or improved products, processes, techniques, formulas, inventions, or software. The term includes exploration of a new use for an existing drug, device, or biological product if the new use requires separate licensing by the Federal Food and Drug Administration under chapter 21, C.F.R., as amended. The term does not include adaptation or duplication of existing products where the products are not substantially improved by application of the technology, nor does the term include surveys and studies, social science and humanities research, market research or testing, quality control, sale promotion and service, computer software developed for internal use, and research in areas such as improved style, taste, and seasonal design.

(k) “Sale” has the same meaning as “sale” in chapter 82.08 RCW, which includes by reference RCW 82.04.040. RCW 82.04.040 includes by reference the definition of “retail sale” in RCW 82.04.050. “Sale” includes renting or leasing, conditional sale contracts, leases with option to purchase, and any contract under which possession of the property is given to the purchaser but title is retained by the vendor as security for the payment of the purchase price.

(l) “Site” means the location at which the manufacturing or testing takes place.

(m) “Support facility” means a part of a building, or a structure or improvement, used to contain or steady an industrial fixture or device. A support facility must be specially designed and necessary for the proper functioning of the industrial fixture or device and must perform a function beyond being a building or a structure or an improvement. It must have a function relative to an industrial fixture or a device. To determine if some portion of a building is a support facility, the parts of the building are examined. For example, a highly specialized structure, like a vibration reduction slab under a microchip clean room, is a support facility. Without the slab, the delicate instruments in the clean room would not function properly. The ceiling and walls of the clean room are not support facilities if they only serve to define the space and do not have a function relative to an industrial fixture or a device.

(n) “Tangible personal property” has its ordinary meaning.

(o) “Testing” means activities performed to establish or determine the properties, qualities, and limitations of tangible personal property.

(p) “Testing operation” means the testing of tangible personal property for a manufacturer or processor for hire. A testing operation begins at the point where the tangible personal property enters the testing site and ends at the point where the tangible personal property leaves the testing site. The term also includes that portion of a cogeneration project that is used to generate power for consumption within the site of which the cogeneration project is an integral part. The term does not include the production of electricity by a light and power business as defined in RCW 82.16.010 or the preparation of food products on the premises of a person selling food products at retail. The testing 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 testing operation, unless specifically excepted by law.

(4) **Sales and use tax exemption.** The M&E exemption provides a retail sales and use tax exemption for machinery and equipment used directly in a manufacturing operation or research and development operation. Sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving qualifying machinery and equipment are also exempt from sales tax. However, because the exemption is limited to items with a useful life of one year or more, some charges for repair, labor, services, and replacement parts may not be eligible for the exemption. In the case of labor and service charges that cover both qualifying and non-qualifying repair and replacement parts, the labor and services charges

are presumed to be exempt. If all of the parts are non-qualifying, the labor and service charge is not exempt, unless the parts are incidental to the service being performed, such as cleaning, calibrating, and adjusting qualifying machinery and equipment.

On and after July 25, 1999, the exemption may be taken for qualifying machinery and equipment used directly in a testing operation by a person engaged in testing for a manufacturer or processor for hire.

Sellers remain subject to the retailing B&O tax on all sales of machinery and equipment to consumers if delivery is made within the state of Washington, notwithstanding that the sale may qualify for an exemption from the retail sales tax.

(a) Sales tax. The purchaser must provide the seller with an exemption certificate. The exemption certificate must be completed in its entirety. The seller must retain a copy of the certificate as a part of its records. This certificate may be issued for each purchase or in blanket form certifying all future purchases as being exempt from sales tax. Blanket forms must be renewed every four years.

The form must contain the following information:

- (i) Name, address, and registration number of the buyer;
- (ii) Name of the seller;
- (iii) Name and title of the authorized agent of the buyer/user;
- (iv) Authorized signature;
- (v) Date; and
- (vi) Whether the form is a single use or blanket-use form.

A copy of a M&E certificate form may be obtained from the department of revenue on the Internet at <http://www.dor.wa.gov/>, under “Other forms and schedules” or by contacting the department’s taxpayer services division at:

Department of Revenue
Taxpayer Services
P.O. Box 47478
Olympia, WA 98504-7478

(b) Use tax. The use tax complements the retail sales tax by imposing a tax of like amount upon the use within this state as a consumer of any tangible personal property purchased at retail, where the user has not paid retail sales tax with respect to the purchase of the property used. (See also chapter 82.12 RCW and WAC 458-20-178.) If the seller fails to collect the appropriate retail sales tax, the purchaser is required to pay the retail sales tax (commonly referred to as “deferred sales tax”) or the use tax directly to the department unless the purchase and/or use is exempt from the retail sales and/or use tax. A qualifying person using eligible machinery and equipment in Washington in a qualifying manner is exempt from the use tax. If an item of machinery and equipment that was eligible for use tax or sales tax exemption fails to overcome the majority use threshold or is totally put to use in a non-qualifying manner, use tax is due on the fair market value at the time the item was put to non-qualifying use. See subsection (10) of this rule for an explanation of the majority use threshold.

(5) **Who may take the exemption?** The exemption may be taken by a manufacturer or processor for hire who manufactures articles, substances, or commodities for sale as tangible personal property, and who, for the item in question, meets the used directly test and overcomes the majority use threshold. (See subsection (9) of this rule for a discussion of the “used directly” criteria and see subsection (10) of this rule for an explanation of the majority use threshold.) However, for research and development operations, there is no requirement that the operation

produce tangible personal property for sale. A processor for hire who does not sell tangible personal property is eligible for the exemption if the processor for hire manufactures articles, substances, or commodities that will be sold by the manufacturer. For example, a person who is a processor for hire but who is manufacturing with regard to tangible personal property that will be used by the manufacturer, rather than sold by the manufacturer, is not eligible. See WAC 458-20-136 and RCW 82.04.110 for more information. On and after July 25, 1999, persons who engage in testing for manufacturers or processors for hire are eligible for the exemption. To be eligible for the exemption, the taxpayer need not be a manufacturer or processor for hire in the state of Washington, but must meet the Washington definition of manufacturer.

(6) What is eligible for the 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.

There are three classes of eligible machinery and equipment: Industrial fixtures, devices, and support facilities. Also eligible is tangible personal property that becomes an ingredient or component of the machinery and equipment, including repair parts and replacement parts. "Machinery and equipment" also includes pollution control equipment installed and used in a qualifying operation to prevent air pollution, water pollution, or contamination that might otherwise result from the operation.

(7) What is not eligible for the exemption? In addition to items that are not eligible because they do not meet the used directly test or fail to overcome the majority use threshold, there are four categories of items that are statutorily excluded from eligibility. The following property is not eligible for the M&E exemption:

(a) Hand-powered tools. Screw drivers, hammers, clamps, tape measures, and wrenches are examples of hand-powered tools. Electric powered, including cordless tools, are not hand-powered tools, nor are calipers, plugs used in measuring, or calculators.

(b) Property with a useful life of less than one year. All eligible machinery and equipment must satisfy the useful life criteria, including repair parts and replacement parts. For example, items such as blades and bits are generally not eligible for the exemption because, while they may become component parts of eligible machinery and equipment, they generally have a useful life of less than one year. Blades generally having a useful life of one year or more, such as certain sawmill blades, are eligible. See subsection (8) of this rule for thresholds to determine useful life.

(c) Buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building. Buildings provide workspace for people or shelter machinery and equipment or tangible personal property. The building itself is not eligible, however some of its components might be eligible for the exemption. The industrial fixtures and support facilities that become affixed to or part of the building might be eligible. The subsequent real property status of industrial fixtures and support facilities does not affect eligibility for the exemption.

(d) Building fixtures that are not integral to the manufacturing operation, testing operation, or research and development operation that are permanently affixed to and become a physical part of a building, such as utility systems for heating, ventilation, air conditioning, communications, plumbing, or electrical. Examples of non-qualifying fixtures are: fire sprinklers, building electrical systems, or washroom fixtures. Fixtures that are integral to the manufacturing operation might be eligible, depending on whether the item meets the other requirements for eligibility, such as the used directly test.

(8) **The “useful life” threshold.** RCW 82.08.02565 has a per se exception for “property with a useful life of less than one year.” Property that meets this description is not eligible for the M&E exemption. The useful life threshold identifies items that do not qualify for the exemption, such as supplies, consumables, and other classes of items that are not expected or intended to last a year or more. For example, tangible personal property that is acquired for a one-time use and is discarded upon use, such as a mold or a form, has a useful life of less than one year and is not eligible. If it is clear from taxpayer records or practice that an item is used for at least one year, the item is eligible, regardless of the answers to the four threshold questions. A taxpayer may work directly with the department to establish recordkeeping methods that are tailored to the specific circumstances of the taxpayer. The following steps should be used in making a determination whether an item meets the “useful life” threshold. The series of questions progress from simple documentation to complex documentation. In order to substantiate qualification under any step, a taxpayer must maintain adequate records or be able to establish by demonstrating through practice or routine that the threshold is overcome. Catastrophic loss, damage, or destruction of an item does not affect eligibility of machinery and equipment that otherwise qualifies. Assuming the machinery and equipment meets all of the other M&E requirements and does not have a single one-time use or is not discarded during the first year, useful life can be determined by answering the following questions for an individual piece of machinery and equipment:

(a) Is the machinery and equipment capitalized for either federal tax purposes or accounting purposes?

- If the answer is “yes,” it qualifies for the exemption.
- If the answer is “no,”

(b) Is the machinery and equipment warranted by the manufacturer to last at least one year?

- If the answer is “yes,” it qualifies for the exemption.
- If the answer is “no,”

(c) Is the machinery and equipment normally replaced at intervals of one year or more, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it qualifies for the exemption.
- If the answer is “no,”

(d) Is the machinery and equipment expected at the time of purchase to last at least one year, as established by industry or business practice? (This is commonly based on the actual experience of the person claiming the exemption.)

- If the answer is “yes,” it qualifies for the exemption.
- If the answer is “no,” it does not qualify for the exemption.

(9) **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:

(a) Acts upon or interacts with an item of tangible personal property. Examples of this are drill presses, concrete mixers (agitators), ready-mix concrete trucks, hot steel rolling machines, rock crushers, and band saws. Also included is machinery and equipment used to repair, maintain, or install tangible personal property. Computers qualify under this criteria if:

(i) They direct or control machinery or equipment that acts upon or interacts with tangible personal property; or

(ii) If they act upon or interact with an item of tangible personal property.

(b) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or the testing site. Examples of this are wheelbarrows, handcarts, storage racks, forklifts, tanks, vats, robotic arms, piping, and concrete storage pads. Floor space in buildings does not qualify under this criteria. Not eligible under these criteria are items that are used to ship the product or in which the product is packaged, as well as materials used to brace or support an item during transport.

(c) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site. Examples of “away from the site” are road testing of trucks, air testing of planes, or water testing of boats, with the machinery and equipment used off site in the testing eligible under this criteria. Machinery and equipment used to take readings or measurements are eligible under this criterion.

(d) Provides physical support for or access to tangible personal property. Examples of this are catwalks adjacent to production equipment, scaffolding around tanks, braces under vats, and ladders near controls. Machinery and equipment used for access to the building or to provide a work space for people or a space for tangible personal property or machinery and equipment, such as stairways or doors, is not eligible under this criteria.

(e) Produces power for or lubricates machinery and equipment. A generator providing power to a sander is an example of machinery and equipment that produces power for machinery and equipment. An electrical generating plant that provides power for a building is not eligible under this criteria. Lubricating devices, such as hoses, oil guns, pumps, and meters, whether or not attached to machinery and equipment, are eligible under this criteria.

(f) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation. Machinery and equipment that makes dies, jigs, or molds, and printers that produce camera-ready images are examples of this.

(g) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported.

(h) Is integral to research and development as defined in RCW 82.63.010?

(10) The majority use threshold.

(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. Examples of situations in which an item of machinery and equipment is used for qualifying and non-qualifying purposes include: the use of machinery and equipment in manufacturing and repair activities, such as using a power saw to make cabinets in a shop versus using it to make cabinets at a customer location; the use of machinery and equipment in manufacturing and constructing activities, such as using a forklift to move finished sheet rock at the manufacturing site versus using it to unload sheet rock at a customer location; and the use of machinery and equipment in manufacturing and transportation activities, such as using a mixer truck to make concrete at a manufacturing site versus using it to deliver concrete to a customer.

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:

(i) Time. Time is measured using hours, days, or other unit of time, with qualifying use of the M&E the numerator, and total time used the denominator. Suitable records for time measurement include employee time sheets or equipment time use logs.

(ii) Value. Value means the value to the person, measured by revenue if the qualifying and non-qualifying uses both produce revenue. Value is measured using gross revenue, with revenue from qualifying use of the M&E the numerator, and total revenue from use of the M&E the denominator. If there is no revenue associated with the use of the M&E, such as in-house accounting use of a computer system, the value basis may not be used. Suitable records for value measurement include taxpayer sales journals, ledgers, account books, invoices, and other summary records.

(iii) Volume. Volume is measured using amount of product, with volume from qualifying use of the M&E the numerator and total volume from use of the M&E the denominator. Suitable records for volume measurement include production numbers, tonnage, and dimensions.

(iv) Other comparable measurement for comparison. The department may agree to allow a taxpayer to use another measure for comparison, provided that the method results in a comparison between qualifying and non-qualifying uses. For example, if work patterns or routines demonstrate typical behavior, the taxpayer can satisfy the majority use test using work site surveys as proof.

(b) Each piece of M&E does not require a separate record if the taxpayer can establish that it is reasonable to bundle M&E into classes. Classes may be created only from similar pieces of machinery and equipment and only if the uses of the pieces are the same. For example, forklifts of various sizes and models can be bundled together if the forklifts are doing the same work, as in moving wrapped product from the assembly line to a storage area. An example of when not to bundle classes of M&E for purposes of the majority use threshold is the use of a computer that controls a machine through numerical control versus use of a computer that creates a camera ready page for printing.

(c) Typically, whether the majority use threshold is met is decided on a case-by-case basis, looking at the specific manufacturing operation in which the item is being used. However, for purposes of applying the majority use threshold, the department may develop industry-wide standards. For instance, the aggregate industry uses concrete mixer trucks in a consistent manner across the industry. Based on a comparison of selling prices of the processed product picked up by the customer at the manufacturing site and delivery prices to a customer location, and taking into consideration the qualifying activity (interacting with tangible personal property) of the machinery and equipment compared to the non-qualifying activity (delivering the product) of the machinery and equipment, the department has determined that concrete trucks qualify under the majority use threshold. Only in those limited instances where it is apparent that the use of the concrete truck is atypical for the industry would the taxpayer be required to provide recordkeeping on the use of the truck in order to support the exemption.