Cite as Det. No. 13-0317, 36 WTD 010 (2017)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 13-0317
. . .	)	Registration No. . . .

[1] RCW 82.08.02565: RCW 82.04.110(1); RCW 82.04.120; WAC 458-20-135: RETAIL SALES TAX – MANUFACTURING AND EQUIPMENT EXEMPTION – WHEN AN EXTRACTOR IS ALSO A MANUFACTURER. An exactor cannot claim the Manufacturing and Equipment exemption from retail sales tax on purchases of equipment that screen, sort, and wash extracted materials that are not crushed or blended. WAC 458-20-135(2)(b)(i)(B) limits the exemption to screening and washing activities that are performed in conjunction with blending or crushing activities.

[2] RCW 82.08.02565; WAC 458-20-13601: RETAIL SALES TAX – MANUFACTURING AND EQUIPMENT EXEMPTION – THE MAJORITY USE THRESHOLD. Taxpayer does not meet the majority use threshold for a screener used to screen two-to-six inch cobbles that are later crushed or blended under the value test set forth in WAC 458-20-13601(9)(a)(ii) when the revenue from the sales from the crushed or blended rock constituted only 14% of the revenue earned from all sales of rock and gravel products. There was no evidence that the taxpayer met either the time or volume test of the majority use threshold in WAC 458-20-13601(9).

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.

Sohng, A.L.J. – Quarry operator protests use tax/deferred sales tax [assessed] on [the value of] machinery and equipment [(M&E)] on the grounds that (i) its screening and washing activities take place in conjunction with crushing and blending; (ii) it satisfies the majority use test; . . . . The petition is denied . . . .[1]

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

ISSUES

1. Does screening and washing extracted rock materials that are not crushed or blended take place "in conjunction with crushing or blending" under WAC 458-20-135(2)(b)(i)(B), which would qualify the equipment for the [M&E] exemption under RCW 82.08.02565?

2. Does screening equipment satisfy the majority use threshold set forth in WAC 458-20-13601(9)(a) when crushed or blended rock materials constitute only 14% of the revenue generated by the equipment?

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FINDINGS OF FACT

[Taxpayer] owns and operates a sand and gravel quarry in . . . , Washington. Taxpayer's operations include extracting sand and gravel from the quarry. The extracted product is called "pit run gravel" or "pit run." The pit run is then processed as follows:

1. [Hopper]. The pit run is fed into a 20 Cubic Yard . . . . Hopper . . . , which performs the first screening of the extracted material. The [Hopper] screens out rocks that are six inches or larger, which are set aside for future sale or crushed to make various gravel products. The remaining pit run is placed on a conveyer belt for additional processing.

2. Three-Deck Screener. The remaining pit run is then fed into a . . . Three-Deck Screener (the "Screener"), which separates the material into three products:
   (a) Cobbles between two to six inches, which are set aside for future sale or crushed to make gravel products;
   (b) Sand 1/8 of an inch or smaller, which is set aside for future sale; and
   (c) Sand and gravel between 1/8 to 1½ inches.

3. Wash Plant. The sand and gravel from (c), above, are transferred to a . . .Wash Plant (the "Wash Plant"), which washes and separates them further into the following:
   (a) Washed pea gravel (1/8 to 3/4 inches), which is set aside for future sale;
   (b) Washed No. 5 rock (3/4 to 1 inches), which is set aside for future sale;
   (c) Washed drain rock (1 – 1½ inches), which is set aside for future sale; and
   (d) Washed sand (1/8 inch or less).

4. Sand Screw. The washed sand from (d), above, is transferred to a sand screw for further washing, after which it is set aside for future sale.

The Department of Revenue's ("Department's") Audit Division examined Taxpayer's books and records for the period January 1, 2008, through December 31, 2011 (the "Audit Period"). On September 27, 2012, the Audit Division issued Assessment No. . . . in the amount of $ . . . ,

including $ . . . in taxes, $ . . . in interest, and $ . . . in penalties.[2] Taxpayer claimed the [M&E] exemption for the Screener, the Wash Plant, and the Sand Screw. The Audit Division disallowed the exemption on the grounds that Taxpayer's sales of crushed or blended rock were only 14% of its total sales of rock and gravel products, which does not meet the majority use threshold needed to qualify for the exemption. The Audit Division included only crushed or blended products in the 14% figure and excluded products that were only screened, washed, and/or stockpiled for sale.

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ANALYSIS

1. Machinery & Equipment Exemption

RCW 82.08.02565 provides a retail sales tax exemption for sales to a manufacturer or processor for hire of [M&E] used directly in a manufacturing operation. RCW 82.12.02565 provides the corresponding use tax exemption. (Both exemptions are referred to collectively as "the M&E exemption.") Specifically, the statutes provide that the retail sales tax and use tax do not apply to "sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation . . . ." RCW 82.08.02565(1)(a); RCW 82.12.02565(1)(a). The M&E exemption has four distinct requirements:

1. The purchaser/user must be a "manufacturer" or "processor for hire;"
2. The purchased/used item must be "machinery and equipment;"
3. The item must be "used directly;"
4. In a "manufacturing operation."

See Det. No. 03-0325, 24 WTD 351 (2005).[3] If any of these elements is missing, the exemption is not available. [One] issue here is whether Taxpayer is a "manufacturer."[4] RCW 82.04.110(1) defines a "manufacturer" as "every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances or commodities." RCW 82.04.120 defines "to manufacture" as follows:

> (1) "To manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof

[2] The Audit Division also reclassified a number of wholesale sales to retail sales. However, the Audit Division has agreed to allow wholesale treatment for sales made to . . . (UBI . . .) and will to make a corresponding adjustment to the assessment after the issuance of this determination.

[3] [The M&E statute also requires the purchaser of the equipment to provide the seller with an exemption certificate. RCW 82.08.02565(1)(b); Det. No. 07-0324E, 27 WTD 119, 122 (2008) (listing the requirements of the M&E exemption, including that "[t]he purchaser must provide the seller with an exemption certificate.").]

[4] Taxpayer does not claim to be a "processor for hire." A "processor for hire" is a "person who performs labor and mechanical services upon property belonging to others so that as a result a new, different, or useful article of tangible personal property is produced for sale or commercial or industrial use." WAC 458-20-136(3)(a). Taxpayer is not a processor for hire because it owns the quarry from which it extracts rock and gravel material.

> a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use, and shall include:
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> . . .
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> (d) crushing and/or blending of rock, sand, stone, gravel, or ore.

Thus, the definition of "to manufacture" expressly includes the crushing and/or blending of rock, sand, stone, gravel, or ore. Because Taxpayer engages in manufacturing when it crushes or blends the extracted materials from the quarry, it is a "manufacturer" under RCW 82.04.110.

RCW 82.04.100 defines "extractor" as:

> [E]very person who from the person's own land or from the land of another under a right or license granted by lease or contract, either directly or by contracting with others for the necessary labor or mechanical services, for sale or for commercial or industrial use mines, quarries, takes or produces coal, oil, natural gas, ore, stone, sand, gravel, clay, mineral or other natural resource product. . . .

Under this definition, Taxpayer is also an extractor. WAC 458-20-135 ("Rule 135") is the Department's rule that applies when a taxpayer is both an extractor and a manufacturer.

> (b) **When an extractor is also a manufacturer**. An extractor may subsequently take an extracted product and use it as a raw material in a manufacturing process. The following examples explain when an extracting process ends and a manufacturing process begins for various situations. These examples should be used only as a general guide. A determination of when extracting ends and manufacturing begins for other situations can be made only after a review of all of the facts and circumstances.
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> (i) **Mining and quarrying**. Mining and quarrying operations are extracting activities, and generally include the screening, sorting, and piling of rock, sand, stone, gravel, or ore. For example, an operation that extracts rock, then screens, sorts, and with no further processing places the rock into piles for sale, is an extracting operation.
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> (A) The crushing and/or blending of rock, sand, stone, gravel, or ore are manufacturing activities. These are manufacturing activities whether or not the materials were previously screened or sorted.
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> (B) Screening, sorting, piling, or washing of the material, when the activity takes place in conjunction with crushing or blending at the site where the materials are taken or produced, is considered a part of the manufacturing operation if it takes place after the first screen. . . .

Rule 135(2) (emphasis added.)

Tax exemptions are construed strictly, though fairly, in favor of application of the tax. *See, e.g., Budget Rent-a-Car, Inc. v. Dep't of Revenue*., 81 Wn.2d 171, 500 P.2d 764 (1972); *Group Heath Coop. v. Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967); Det. No. 04-0102, 23 WTD

340 (2004); Det. No. 03-0079, 23 WTD 83 (2004). "Taxation is the rule and exemption is the exception." *O'Leary v. Dep't of Revenue*, 105 Wn.2d 679, 717 P.2d 273 (1986). Thus, "the burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer." *Group Health*, 72 Wn.2d at 429. The rules of statutory construction apply to agency rules and regulations, as well as statutes. *Multicare Medical Center v. DSHS*, 114 Wn.2d 272, 591, 790 P.2d 124 (1990); *Tesoro Refining and Marketing Co. v. Dep't of Revenue*, 164 Wn.2d 310, 190 P.3d 28 (2008); *Madre v. Health Care Auth.*, 149 Wn.2d 458, 472, 70 P.3d 931 (2003); *Port of Seattle v. Dep't of Revenue*, 101 Wn. App. 106, 1 P.3d 607 (2000).

Rule 135 recognizes that while extractors can also be manufacturers, the M&E exemption applies only to manufacturing, not extracting. Rule 135(2)(b)(i)(B) does not provide a blanket exemption for all screening, sorting, or washing activities that occur after the first screen, as Taxpayer claims. Rather, the rule limits the exemption to screening and washing activities that are performed *in conjunction with* blending or crushing activities. Applying the language of Rule 135(2)(b)(i)(B) and the rules of statutory construction, we conclude that only the screening, sorting, and washing of materials that are crushed or blended take place "in conjunction with crushing or blending," and therefore, are part of the manufacturing operation. The mere screening, sorting, and washing of extracted materials that are not crushed or blended do not take place "in conjunction with crushing or blending." These activities are not part of the manufacturing operation, even though they take place after the first screen. The Wash Plant and the Sand Screw only wash and screen extracted material that is not crushed or blended. Thus, the Wash Plant and Sand Screw are not part of the manufacturing operation and Taxpayer cannot claim the M&E exemption with respect to these items. The Screener, however, sorts extracted material that *is* crushed. Thus, the Screener is part of the manufacturing operation, subject to the majority use threshold, described below.

2. Majority Use Threshold

WAC 458-20-13601 ("Rule 13601") provides that [M&E] used for both a qualifying and nonqualifying use is eligible for the M&E exemption only if the qualifying use is greater than 50% of its overall use:

> Machinery and equipment both used directly in a qualifying operation and used in a nonqualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. Majority use can be expressed as a percentage, with the minimum required amount of qualifying use being greater than fifty percent compared to overall use. To determine whether the majority use requirement has been satisfied, the person claiming the exemption must retain records documenting the measurement used to substantiate a claim for exemption or, if time, value, or volume is not the basis for measurement, be able to establish by demonstrating through practice or routine that the requirement is satisfied. Majority use is measured by looking at the use of an item during a calendar year using any of the following:
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> * * *
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> (ii) Value. Value means the value to the person, measured by revenue if the qualifying and nonqualifying 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.

Rule 13601(9)(a) (emphasis added). To be eligible as a qualifying use of [M&E], the use must take place within the manufacturing operation. Rule 13601(2)(g). Here, the qualifying use of the Screener is the sorting and screening of the two-to-six inch Cobbles that are later crushed or blended. During the Audit Period, revenue earned from sales of crushed or blended rock constituted only 14% of the revenue earned from sales of all rock and gravel products.[5] Thus, Taxpayer does not satisfy the majority use threshold based on value set forth in Rule 13601(9)(a)(ii). Taxpayer does not claim that it alternatively meets this requirement by a time or volume test[6] Taxpayer cannot take the M&E exemption with respect to the Screener. We conclude Taxpayer is not entitled to the M&E exemption on equipment it uses to wash and screen material after the first screen . . . . We deny the petition with respect to this issue.

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DECISION AND DISPOSITION

Taxpayer's petition is denied . . . .

Dated this 24th day of October, 2013.

[5] [This 14% figure is specific to Taxpayer's use of the Screener.]

[6] [During the audit, Taxpayer was provided the opportunity to submit evidence that it met one of these alternative methods for the majority use threshold. There is no evidence that Taxpayer meets either the time or volume test of the majority use threshold in Rule 13601(9).]