

Cite as Det. No. 21-0094E, 41 WTD 412 (2022)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
 DEPARTMENT OF REVENUE
 STATE OF WASHINGTON¹

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| In the Matter of the Petition for Correction of) | <u>FINAL EXECUTIVE</u> |
| Assessment of) | <u>LEVEL DETERMINATION</u> |
|) | |
|) | No. 21-0094E |
|) | |
| ...) | Registration No. . . . |
|) | |

[1] RCW 82.04.040: DEFINITION OF “SALE.” When a replacement component is incorporated in a customer’s equipment when providing a retail repair of the equipment, and the repaired equipment with the replacement component is delivered to the customer in exchange for payment, there is a “sale” of the component as defined in RCW 82.04.040.

[2] RCW 82.08.02565; RCW 82.12.02565; RCW 82.04.120: RETAIL SALES TAX – USE TAX – DEFINITION OF “TO MANUFACTURE” FOR M&E EXEMPTION. Using one’s own materials to fabricate equipment replacement components to be incorporated in a customer’s equipment when repairing the equipment in exchange for payment constitutes manufacturing of the components under RCW 82.04.120.

[3] RCW 82.08.02565; RCW 82.12.02565: RETAIL SALES TAX – USE TAX – DEFINITION OF “MANUFACTURING OPERATION” FOR M&E EXEMPTION. Machinery and equipment are used in a manufacturing operation when used to manufacture replacement components to be incorporated in a customer’s equipment during repair of the equipment where the components are delivered within the repaired equipment in exchange for payment. The sale of the replacement components incorporated in the repaired equipment is the sale of tangible personal property.

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.

Eckholm, T.R.O. – A manufacturer of replacement components for industrial equipment, which also incorporates replacement components in repairs of industrial equipment, seeks review of the Department’s disallowance of the manufacturing machinery and equipment sales and use tax exemption. The taxpayer asserts that the Department incorrectly concluded that only fabricating

¹ This unpublished Determination applies only to the taxpayer named herein and may not be relied on by any other taxpayer. This is the decision of the Department of Revenue pursuant to WAC 458-20-100.

components for sale independent of repair constitutes manufacturing and qualifies for the exemption. The Department concludes that the taxpayer's fabrication of components for both purposes—to incorporate during repair and for sale independent of repair—is manufacturing in a manufacturing operation, qualifying for the machinery and equipment sales and use tax exemption. The Department grants the petition.²

ISSUES

1. Does fabricating replacement components to be incorporated in a customer's equipment when providing a retail repair service constitute manufacturing of the components under RCW 82.04.120?
2. If so, does the machinery and equipment used to manufacture the replacement components, qualify for the retail sales tax and use tax exemptions under RCW 82.08.02565 and RCW 82.12.02565?

FINDINGS OF FACT

. . . (Taxpayer) manufactures custom component parts for industrial equipment and provides equipment repair and refurbishing services at its shop location. A significant portion of Taxpayer's repair revenue is from repair of hydraulic equipment and cylinders. Repairs may require replacement components, such as tubes, glands, heads, pistons, piston rods, couplers, and pins. Depending on the component needed, Taxpayer may fabricate the component from various forms of raw material at its shop and then incorporate the component in the customer's equipment. After Taxpayer completes the repair of a customer's equipment, Taxpayer delivers the repaired equipment with the incorporated replacement component to the customer in exchange for payment. Taxpayer also fabricates components for sale independent of repair services, usually based on samples or specifications provided by Taxpayer's customers. Taxpayer's manufacturing equipment includes metal lathes, milling machines, drill presses, welding machines and tables.³

The Department of Revenue Audit Division audited Taxpayer's records for excise tax purposes for the periods January 1, 2013, through December 31, 2013, and January 1, 2014, through December 31, 2016 (Audit Period). The auditor noted that Taxpayer invoiced its customers a non-itemized price for its repair services and did not separately charge for replacement components. The auditor also noted that Taxpayer reported its income under the retailing and wholesaling business and occupation (B&O) tax classifications and had not reported any income under the manufacturing B&O tax classification. Taxpayer used an "M&E Exemption Certificate" to make sales tax-exempt purchases of machinery and equipment during the Audit Period. From review of Taxpayer's records, the Audit Division determined that Taxpayer used its equipment to manufacture components associated with repair services 69 percent of the time, and independent of repair, 31 percent of the time.⁴

² Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

³ Review Petition, attachment, at 6-7.

⁴ Auditor's Detail of Differences and Instructions to Taxpayer

The Audit Division concluded that Taxpayer was not engaged in manufacturing when it fabricated replacement components for installation as part of its repair services. Because Taxpayer did not use its equipment for fabricating components independent of repair the majority of the time, the Audit Division disallowed the machinery and equipment sales and use tax exemption. The Audit Division also assessed manufacturing B&O tax on Taxpayer's income from manufacture of components independent of repair and applied the multiple activities tax credit against the retailing or wholesaling B&O tax paid on sales of those components.⁵ As a result, the Department issued assessments against Taxpayer in the total amount of \$⁶

Taxpayer sought administrative review of the assessments. Taxpayer asserts that its fabrication of replacement components associated with repair services constitutes "manufacturing" (as defined in RCW 82.04.120, RCW 82.08.0565(2)(e) and WAC 458-20-136) in a "manufacturing operation" (as defined in RCW 82.08.02565(2)(f)), qualifying its purchases for the machinery and equipment sales and use tax exemption.⁷ Taxpayer does not dispute the assessment of manufacturing B&O tax on the value of fabricated components sold independent of repair, subject to the multiple activities tax credit for wholesaling or retailing B&O tax Taxpayer reported on those component sales.

The Audit Division responds that Taxpayer provides a repair service classified as a retail sale under RCW 82.04.050(2)(a), and charges one sales price for the repair, including the incorporated replacement components. Therefore, the Audit Division explains, Taxpayer is not selling the incorporated component as tangible personal property, as required to qualify for the machinery and equipment sales and use tax exemption. In addition, the Audit Division notes that Taxpayer appears to recognize that the primary nature or true object of its activities is repair services because it did not report any of its activities under the manufacturing B&O tax classification.⁸

On June 3, 2021, we issued Proposed Executive Level Determination No. 21-0094E in which we granted Taxpayer's petition and remanded to the Audit Division for possible adjustment to the assessments consistent with the determination, considering any additional records provided by Taxpayer. Taxpayer did not file objections to the Proposed Executive Level Determination or provide additional records to the Audit Division. This Final Executive Level Determination is the Department's final decision.

⁵ *Id.*

⁶ For the period January 1, 2013, through December 31, 2013, following two post assessment adjustments, the Department issued Document No. . . . on February 8, 2018, that included assessment of retail sales tax of \$. . . , retailing B&O tax of \$. . . , wholesaling B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , manufacturing B&O tax of \$. . . , interest of \$. . . , assessment penalty of \$. . . and additional post assessment interest of \$. . . , and applied a MATC credit of \$. . . , for a total amount of \$ For the period January 1, 2014, through December 31, 2016, the Department issued Document No. . . . on May 1, 2018, that included assessment of retail sales tax of \$. . . , retailing B&O tax of \$. . . , wholesaling B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , manufacturing B&O tax of \$. . . , reseller permit misuse penalty of \$. . . , and interest of \$. . . , and applied a MATC credit of \$. . . , for a total amount of \$

⁷ Review Petition, attachment, at 8-9.

⁸ Audit Response at 6-7.

ANALYSIS

In Washington, all sales of tangible personal property to consumers are subject to retail sales tax unless the sales are otherwise exempt from tax. RCW 82.04.050; RCW 82.08.020. Retail sales include the sale of “tangible personal property consumed and/or for labor and services rendered in respect to . . . installing, repairing, cleaning, altering, imprinting, or improving of tangible personal property of or for consumers.” RCW 82.04.050(2)(a). Use tax complements retail sales tax by imposing a tax of like amount upon the privilege of using within this state as a consumer any article of tangible personal property acquired without payment of retail sales tax. *See* RCW 82.12.020(1); WAC 458-20-178.

Washington imposes a B&O tax “for the act or privilege of engaging in business” in this state. RCW 82.04.220(1). The tax is measured by applying particular rates against the value of products, gross proceeds of sale or gross income of the business, depending on the business activity. *Id.* Manufacturers are subject to manufacturing B&O tax on the value of products produced in this state, and retailers and wholesalers are subject to retailing and wholesaling B&O tax, respectively, on gross proceeds of sales in this state. RCW 82.04.240; RCW 82.04.250; RCW 82.04.270.

Manufacturers who sell their manufactured products at retail or wholesale may also be subject to either the retailing or wholesaling B&O tax; however, the manufacturer is allowed a multiple activities tax credit against those taxes for any manufacturing B&O taxes paid. RCW 82.04.440(2); WAC 458-20-136(4)(a); WAC 458-20-19301. If the taxpayer manufactures a product in Washington and the sale of the product is sourced outside of Washington under RCW 82.32.730, it is subject to manufacturing B&O tax on the value of the product, but it would not owe retailing or wholesaling B&O tax on the sale. RCW 82.04.240; RCW 82.04.440.

M&E exemption from retail sales tax and use tax.

Here, Taxpayer’s purchases of machinery and equipment to fabricate equipment components are subject to retail sales tax unless the purchases are exempt from tax. RCW 82.04.050(1); RCW 82.08.020(1)(a). RCW 82.08.02565 provides a retail sales tax exemption for sales to a manufacturer of machinery and equipment used directly in a manufacturing operation (M&E exemption).⁹

To qualify for the M&E exemption, a purchaser must establish: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation. Det. No. 07-0324E, 27 WTD 119 (2008); Det. No. 03-0325, 24 WTD 351 (2005). A taxpayer must also show that the machinery and equipment meets the “majority use” threshold, where more than 50 percent of the use of the machinery and equipment occurs directly in a manufacturing operation. WAC 458-20-13601(9).

Here, there is no dispute that Taxpayer’s purchases of qualifying machinery and equipment would meet the requirements for the M&E exemption when fabricating components for sale independent of repair if it satisfied the majority use threshold under WAC 458-20-13601(9). However, the

⁹ RCW 82.12.02565 provides the corresponding use tax exemption. Both exemptions are commonly referred to collectively as the “M&E exemption.” Det. No. 13-0034, 32 WTD 220 (2013).

Audit Division disputes that Taxpayer meets M&E exemption requirements (2), (4) and (5) when Taxpayer fabricates replacement components to be installed during repair, asserting that Taxpayer does not manufacture replacement components in a manufacturing operation.

Manufacture of replacement components to be incorporated during repair services.

The M&E exemption uses the definition of “manufacturer” under RCW 82.04.110. RCW 82.08.02565(2)(d). “Manufacturer” means “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 82.04.110(1) (emphasis added). “To manufacture” is defined in RCW 82.04.120 as “to embrace 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 a new, different or useful substance or *article of tangible personal property is produced for sale or commercial or industrial use . . .*”¹⁰ (Emphasis added.) “Manufacturing” means “only those activities that come within the definition of ‘to manufacture’ in RCW 82.04.120 and are taxed as manufacturing or processing for hire under chapter 82.04 RCW . . .” RCW 82.08.02565(2)(e).

There is no dispute that Taxpayer uses its own materials to produce replacement components that are “new, different or useful” tangible personal property. To determine whether Taxpayer is engaged in manufacturing, the inquiry is whether Taxpayer produces the replacement components for sale or commercial or industrial use.

“Commercial or industrial use” is defined in RCW 82.04.130 as an extractor or manufacturer’s use of a product “as a consumer” and “manufacturing of articles, substances or commodities.” The definition of “consumer” in RCW 82.04.190 includes “any person who purchases, acquires, owns, holds, or uses any article of tangible personal property . . .” The definition of “consumer” excludes the use of tangible personal property for the purpose of “[i]ncorporating such property as an ingredient or component of . . . personal property when installing, repairing, cleaning, altering, imprinting, improving, constructing, or decorating such . . . personal property of or for consumers.” RCW 82.04.190(1)(b); *see* WAC 458-20-173. Taxpayer does not produce the replacement components for commercial or industrial use because it does not consume the components when installing the components in its customer’s equipment or use the components to manufacture other items.

Since Taxpayer does not produce the replacement components for commercial or industrial use, to be a “manufacturer,” under RCW 82.04.120, it must show that it fabricates articles of tangible personal property “for sale.” RCW 82.04.040 defines “sale” as “any transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified

¹⁰ The term “to manufacture” does not include “repairing and reconditioning of tangible personal property for others.” WAC 458-20-136(2)(b)(vi). “To be considered ‘manufacturing,’ the application of labor or skill to materials must result in a ‘new, different, or useful article.’” WAC 458-20-136(6); *see* RCW 82.04.120; RCW 82.08.02565(2)(e). “If the activity merely restores an existing article of tangible personal property to its original utility, the activity is considered a repair or refurbishing of that property.” WAC 458-20-136(6). Taxpayer is not asserting that its repair or refurbishing of industrial equipment constitutes manufacturing.

as a ‘sale at retail’ or ‘retail sale’ under RCW 82.04.050.” See RCW 82.08.010(6) (the meaning of “sale” in chapter 82.04 RCW applies equally to the provisions of chapter 82.08 RCW).

In performing repair services, Taxpayer frequently replaces equipment components. Depending on the component needed, Taxpayer may fabricate the component at its shop from its own materials and then incorporate the component in the customer’s equipment. As noted above, Taxpayer does not consume the replacement component when incorporating it in the customer’s equipment. See RCW 82.04.190(1)(b). After Taxpayer completes the repair, Taxpayer delivers the repaired equipment with the incorporated replacement component to the customer in exchange for payment. At that point Taxpayer transfers ownership of, title to, and possession of the replacement component to its customer for valuable consideration. Therefore, Taxpayer fabricates the replacement components for “sale,” as defined in RCW 82.04.040. The fact that Taxpayer does not itemize the charge for the replacement component separate from the repair service charge, does not change the fact that Taxpayer’s customer pays a valuable consideration for transfer of title, ownership and possession of the component incorporated in the customer’s repaired equipment.

When Taxpayer fabricates components for sale from its own materials or ingredients, whether for purposes of incorporating the replacement component in repairing equipment or for sale independent of repair services, Taxpayer is a manufacturer.

Manufacturing replacement components in a manufacturing operation.

The remaining inquiry is whether Taxpayer manufactures the replacement components in a manufacturing operation. A “manufacturing operation” is “the manufacturing of articles, substances, or commodities for sale as tangible personal property. . . .” RCW 82.08.02565(2)(f). To qualify for the M&E exemption, not only must the replacement components be manufactured for sale but manufactured for sale “as tangible personal property.” *Id.* “Tangible personal property” is defined in RCW 82.08.010(7) as “personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses.” There is no question that the replacement components are tangible personal property that Taxpayer manufactured from its own materials and ingredients. When performing repair services, Taxpayer incorporates one item of tangible personal property that it manufactured, the replacement component, into another item of tangible personal property, the customer’s equipment. The replacement component does not change form and Taxpayer does not consume it when incorporating the component. The replacement component manufactured by Taxpayer does not lose its tangible personal property characteristic when Taxpayer incorporates it as a component of the repaired equipment. Therefore, Taxpayer manufactures replacement components for sale as tangible personal property when incorporating the manufactured components in a customer’s equipment and transferring ownership of the components to the customer in performing repair services.

Taxpayer uses its machinery and equipment directly in a manufacturing operation when it manufactures from its own materials replacement components to be incorporated into a customer’s equipment in repairing the equipment, and in manufacturing components for sale independent of repair. The majority use threshold under WAC 458-20-13601 is not at issue because there is no

evidence Taxpayer uses its machinery and equipment for any other purpose.¹¹ Taxpayer is eligible for the M&E exemption on qualifying purchases. RCW 82.08.02565.

We remand this matter to the Audit Division for adjustment to the assessments consistent with this determination.¹²

DECISION AND DISPOSITION

We grant Taxpayer's petition and remand to the Audit Division for adjustment to the assessments consistent with this determination.

Dated this 21st day of July 2021.

¹¹ If Taxpayer were to use the machinery and equipment to refurbish its customer's components or to fabricate items from materials provided by its customer, or from materials Taxpayer otherwise does not own, that would not be qualifying use and Taxpayer would need to establish it meets the majority use threshold under WAC 458-20-13601 to qualify for the M&E exemption.

¹² Taxpayer does not dispute that it is subject to manufacturing B&O tax on the value of products manufactured in this state, including manufacture of products in this state that it sells outside Washington. *See* RCW 82.04.240; RCW 82.04.440. Based on our determination that Taxpayer manufactures products to be incorporated in repairing equipment, adjustments to the assessments may include manufacturing B&O tax on manufacture of products in association with repair that Taxpayer sells for use outside this state.