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BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of) D E T E R M I N A T I O N
Assessments of)
) No. 11-0052
)
....) Registration No.
)
) Document No. / Audit No.
)
) (May 1, 2001 through December 31, 2002)
) Document No. / Audit No.
)
) (January 1, 2003 through June 30, 2007)
)
) Docket No.

- [1] RULE 24003(4)(g)(i); RCW 82.63.010(13): RETAIL SALES AND USE TAX – HIGH TECHNOLOGY DEFERRAL —PROTOTYPES. Ingredients and components of prototypes are not “qualified machinery and equipment” for purposes of the High Technology Tax Deferral, even though the prototypes may be reasonable and necessary in the development of a qualifying product.
- [2] RCW 82.08.02565(2)(c)(viii); ETA 3126.2009: RETAIL SALES AND USE TAX -- M&E EXEMPTION – PROTOTYPES. Ingredients and components of prototypes do not qualify as exempt M&E, even though the prototypes may be “integral” in the development of a new product.

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.

Bauer, A.L.J. – A Washington company developing a complex medical device protests the Department’s disallowance of the chapter 82.63 RCW High Technology Tax Deferral and the RCW 82.08.02565 machinery and equipment (M&E) exemption for the materials it used to build the prototypes it used for product development. We uphold the assessment.¹

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

ISSUES

1. Did the ingredients and components that Taxpayer used in the prototypes it built in the course of the development of its medical equipment qualify for the High Technology Tax Deferral under chapter 82.63 RCW?
2. Did the ingredients and components that Taxpayer used in the prototypes it built in the course of the development of its medical equipment qualify for the Machinery and Equipment exemption under RCW 82.08.02565?

FINDINGS OF FACT

In 2001, the Department of Revenue (Department) approved the application of [Taxpayer] under the chapter 82.63 RCW High Technology Sales and Use Tax Deferral Program (Deferral Program) and issued Certificate No. . . . for engaging in qualifying research and development (R&D) or pilot scale manufacturing activities in the field of electronic device manufacturing. The Certificate was valid for qualifying purchases made during the audit periods.

The Department's Audit Division (Audit) audited Taxpayer's books and records for the period January 1, 2001 through December 31, 2002, and from January 1, 2003 through June 30, 2007 (collectively, audit periods). In the course of its review, Audit determined that materials Taxpayer used to build its prototypes did not qualify for the M&E exemption. . . . Taxpayer timely appealed. It has not paid these assessments.

During the audit periods Taxpayer, located in the State of Washington, was engaged in the development of a . . . system intended to provide guidance to [a] clinician . . . during . . . radiation therapy. . . . In the course of its development activities, Taxpayer built . . . prototypes, which Taxpayer now refers to as "tools." These "tools" were carried on Taxpayer's books and records as "protos" or "prototypes." . . .

In addition, Taxpayer developed software for use in the system. According to Taxpayer, this software is being continually improved . . . and may be purchased separately and uploaded onto existing systems. The software will be offered as a separate product for separate purchase by customers. . . .

[The] US Food and Drug Administration (FDA) approved the system for use in . . . cancer treatment. Taxpayer began selling the system commercially [the following year].

The FDA, through its strict federal guidelines and regulations, closely governed Taxpayer's development of the system. The FDA revised the Good Manufacturing Practice (GMP) requirements for the design of medical devices in 1996 ensuring that its quality assurance

practices were consistent with quality system requirements worldwide. These changes were incorporated into the FDA's Quality System Regulation (QSR).² An important component was the addition of design controls that were based upon quality assurance and engineering principles. These design controls established a framework that manufacturers were required to use when developing and implementing design controls unique to their own devices, and also served as a system of checks and balances to increase the likelihood that the design transferred into production would translate into a device appropriate for its intended use.

Taxpayer explains that FDA design control begins with the development and approval of design inputs, and included the design of the system and its associated manufacturing processes. Design controls did not end with the transfer of a design to production, but applied to all changes in the manufacturing process, including changes occurring long after a device has been introduced to the market. According to Taxpayer, such changes could be evolutionary (i.e., performance enhancements) or revolutionary (i.e., corrective actions resulting from the analysis of failed product and new product development). Taxpayer asserts that changes are a part of a continuous, ongoing effort to design and develop a device that meets the needs of the user and/or patient, and the design control process is thus revisited throughout the life of a product.

Design reviews were conducted at strategic points in the system's design process to assure that the design input requirements³ were adequate before they were converted into the design specifications. Design input requirements were part of the overall design review process and required both quantitative and qualitative methods of testing.

The Audit Report listed the consumable items it subjected to tax, all of which were used and included in the prototypes here at issue. . . .

Taxpayer asserts that the Department has interpreted, in the context of the M&E exemption statutes, that M&E also includes those parts that constitute the M&E. Therefore, Taxpayer argues that all items Audit taxed as "consumables should be rightfully exempt."

Taxpayer asserts that when it designed the system, its engineers conducted "engineering" confidence testing to ensure that they were confident about the initial design itself. Taxpayer states the "tools" [(prototypes)] were crucial to this phase of confidence testing. Taxpayer then manufactured engineering samples containing the same materials that were used on the actual system that eventually went to market.

Taxpayer's Quality and Engineering departments are separate. The sustainment engineers support manufacturing, and the R&D quality engineers support the . . . system's design and

² U.S. Food and Drug Administration, Design Control Guidance for Medical Device Manufacturers, FDA 21 CFR 820.30 and Sub-clause 4.4 of ISO 9001 (March 11, 1997).

³ Design input requirements fall into three general categories: (1) the functional requirement, which specifies what the device does; (2) the performance requirement, which specifies how much or how well the device must perform, and (3) the interface requirement, which specifies the characteristics and compatibility of the device with external systems and user/patient interface. Thus, each of these FDA input requirements demands continuous analysis, inspection, and testing and development at all stages of the R&D and manufacturing process.

development. Each of the . . . tools built were used differently at different times, depending on which department was using the particular tool

Taxpayer's software group developed [multiple] versions or variants of the system software prior to release into the market. These tools were the only platforms by which the software could be tested and verified under the FDA's QSR requirements. According to Taxpayer, without direct interaction and communication with the software, the software team would not have been able to produce the [multiple] versions of the software.

Additionally, the tools were used to develop other components of the system.

Taxpayer explains that, although it referred to the . . . items at issue in its own books and records as "prototypes," their use is predominantly that of "R&D tools," or "machinery and equipment (M&E)." Taxpayer concedes that some of the . . . testing tools resemble in physical form and actual function, at times, the final product. Taxpayer, however, opines that this is the unique nature of the biomedical industry in general, and [is unique] to Taxpayer in particular. According to Taxpayer, unlike a conventional research or testing environment, Taxpayer's "tools" had to communicate amongst each other as well as maintain communication with the thing that was being developed. Taxpayer asserts that these "tools" made, built, or tested different products, and those different products were the final market devices, the system software, and, on occasion, variants of the final product that could be referred to as prototypes. According to Taxpayer, besides communicating within Taxpayer's own product group, these tools also aided in conducting compatibility assessments with customers and with other medical device manufacturers. Taxpayer states that cancer treatment R&D or device manufacturing does not occur in clear segregated steps using a simple belt or pulley or other piece of qualified M&E noted in Washington's Revenue Act. Taxpayer claims that, in accordance with RCW 82.08.02565(2)(a), its process involves a myriad of existing and unconventional technology, tools, and methods to deliver a solution.

Taxpayer further asserts that FDA guidelines required it to develop and build . . . R&D "testing tools" (i.e., prototypes) because there were no conventional design control testing tools or devices readily available on the market. This is because they were the only viable means of testing and further developing Taxpayer's core R&D inputs and processes, Taxpayer claims it developed these "tools" to substantially function as laboratory R&D machinery and equipment, and that without these "tools," it could not have accomplished either its R&D or manufacturing operations.

To build these "tools," Taxpayer purchased "consumable" items The majority of these items were at one time or another incorporated into the . . . R&D design control testing tools. Each testing tool that these purchased items went into has its own design history file. Taxpayer's files and subfiles contain all items that were incorporated into each testing tool and also contain records of every use of that particular tool. Thus, all of the prototypes were developed out of necessity and for the purpose of testing software, testing new . . . designs, testing or calibrating other tools, making and building other tools, or in a direct supportive capacity in the various

stages of the manufacturing operation. Taxpayer claims this entire process was for the purpose of complying with the FDA's testing guidelines.

According to Taxpayer, various elements of the system – such as the software -- were improved and tested using one or more of the remaining elements of the system, and this sort of testing and improvement was required and intended by the FDA. Thus, Taxpayer argues that the prototypes themselves were manufactured with the intent that they in turn become machinery and equipment “used to produce another item of tangible personal property” – because they became the “test bed” for later versions of the system. . . .

Audit disqualified Taxpayer from both the High Technology Deferral and the M&E exemption on the materials it used to build its prototypes based on the analysis in Excise Tax Advisory Number 3126.2009 (ETA 3126), concluding that Taxpayer’s system was the very object of its research and development as opposed to a tool or equipment

ANALYSIS

Retail sales or use tax is generally due when tangible personal property is purchased (RCW 82.08.020) or used (RCW 82.12.020) in Washington. Two exceptions to this rule are purchases or uses that qualify under (1) the High Technology Tax Deferral, or (2) the Machinery and Equipment (M&E) exemption.

Issue #1: High Technology Tax Deferral.

[1] RCW 82.63.010(14) provides:

"Qualified research and development" means research and development performed within this state in the fields of advanced computing, advanced materials, biotechnology, electronic device technology, and environmental technology.

RCW 82.63.005 provides a description of the legislature’s intention in enacting this tax benefit:

Findings -Intent to create a contract. (Effective January 1, 1995.) The legislature finds that high-wage, high-skilled jobs are vital to the economic health of the state's citizens, and that targeted tax incentives will encourage the formation of high-wage, high-skilled jobs. The legislature also finds that tax incentives should be subject to the same rigorous requirements for efficiency and accountability as are other expenditure programs, and that tax incentives should therefore be focused to provide the greatest possible return on the state's investment.

The legislature also finds that high-technology businesses are a vital and growing source of high-wage, high-skilled jobs in this state, and that the high-technology sector is a key component of the state's effort to encourage economic diversification. However, the legislature finds that many high-technology businesses incur significant costs associated with research and development and pilot scale manufacturing many years before a

marketable product can be produced, and that current state tax policy discourages the growth of these companies by taxing them long before they become profitable.

The legislature further finds that stimulating growth of high-technology businesses early in their development cycle, when they are turning ideas into marketable products, will build upon the state's established high-technology base, creating additional research and development jobs and subsequent manufacturing facilities.

For these reasons, the legislature hereby establishes a program of business and occupation tax credits for qualified research and development expenditures. The legislature also hereby establishes a tax deferral program for high-technology research and development and pilot scale manufacturing facilities. The legislature declares that these limited programs serve the vital public purpose of creating employment opportunities in this state. The legislature further declares its intent to create a contract within the meaning of Article I, section 23 of the state Constitution as to those businesses that make capital investments in consideration of the tax deferral program established in this chapter.

RCW 82.63.005 demonstrates that the Legislature's main concern in authorizing the tax deferral program was that high-technology businesses incur significant costs associated with research and development and pilot scale manufacturing many years before they can produce a marketable product. Existing taxes discouraged the growth of these companies by taxing them long before they became profitable.

Under RCW 82.63.045, deferred amounts of retail sales tax do not need to be repaid unless the items on which tax is deferred are used for purposes other than qualified research and development or pilot scale manufacturing during their year of purchase and seven years thereafter. . . . we must construe the tax deferral program narrowly, like all other exemptions. *See Budget Rent-A-Car, Inc. v. Dep't of Revenue.* 81 Wn.2d 171, 500 P.2d 764 (1974).

Taxpayer argues that the ingredients and components it used in the prototypes it built in the course of the development of its medical equipment qualified for the High Technology Tax Deferral under chapter 82.63 RCW because they were "qualified machinery and equipment" that were an "integral and necessary" part of pilot scale manufacturing or qualified research and development operation." Thus, reasons, Taxpayer, the prototypes it built -- and therefore the purchase of their ingredients and components -- were "tools" that constituted "qualified machinery and equipment" under the High Technology Tax Deferral because they were "integral and necessary" to Taxpayer's development of its "new and improved pilot model[s]" because its research and development could not be accomplished without them. Taxpayer particularly cites to the Department's explanation of "integral" and "necessary" in WAC 458-20-24003(4)(g)(i) – which concerns tax incentives for high technology businesses.

Under RCW 82.63.010(13), "qualified machinery and equipment" is defined as follows:

"Qualified machinery and equipment" means fixtures, equipment, and support facilities that are an integral and necessary part of a pilot scale manufacturing⁴ or qualified research and development operation. "Qualified machinery and equipment" includes: Computers; software; data processing equipment; laboratory equipment, instrumentation, and other devices used in a process of experimentation to develop a new or improved pilot model, plant process, product, formula, invention, or similar property; manufacturing components such as belts, pulleys, shafts, and moving parts; molds, tools, and dies; vats, tanks, and fermenters; operating structures; and all other equipment used to control, monitor, or operate the machinery. . . . (Emphasis added.)

WAC 458-20-24003(4)(g)(i) also provides an illustrative list of examples of "machinery and equipment:" –

. . . laboratory tables, telephones, computer hardware (e.g., cables, scanners, printers, etc.) and software (e.g., Word, Excel, Windows, Adobe, etc.) used in typical workstations.

The list includes only items that would be used in creating a product, and not the product itself, its prototype, or the ingredients or components thereof.

Taxpayer contends it is entitled to the sales and use tax deferral because it is a pilot scale manufacturer whose activities meet the definition of "qualified research and development" under chapter 82.63 RCW, and that Chapter 82.63.RCW established a retail sales and use tax deferral program to promote high technology research and development and pilot scale manufacturing activities in Washington. Therefore, argues Taxpayer, the building of its prototypes is both "integral" and "necessary" in the development of its qualifying product.

Although the building of prototypes may be "integral" and "necessary" in the development of a new product, neither RCW 82.63.010(13) nor WAC 458-20-24003(4)(g)(i) specifically or impliedly include prototypes in their enumeration of what is to be considered qualifying "machinery and equipment." In fact, RCW 82.63.010(13) refers to "other devices used . . . to develop a new or improved pilot model" or "invention" (emphasis ours). Although the Legislature addressed devices used to develop "pilot models" (or prototypes), it did not include pilot models themselves as necessary "machinery and equipment."

Because there is nothing in either the statute or the rule to indicate that prototypes, or their ingredients and components, were ever contemplated by the legislature to be included as

⁴ "Pilot scale manufacturing" means design, construction, and testing of preproduction prototypes and models in the fields of biotechnology, advanced computing, electronic device technology, advanced materials, and environmental technology other than for commercial sale. "Commercial sale" excludes sales of prototypes or sales for market testing if the total gross receipts from such sales of the product, service, or process do not exceed one million dollars. WAC 458-20-24003(3)(d)

The rules of statutory construction apply to agency regulations as well as statutes. *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); *Multicare Medical Center v. DSHS*, 114 Wn.2d 572, 591, 790 P.2d 124 (1990).

“integral and necessary” “tools” that qualify as machinery or equipment under the chapter 82.63 RCW high technology tax deferral, we must deny Taxpayer’s arguments as to this issue.

Issue #2: M&E Exemption.

[2] RCW 82.08.02565(1)⁵ provides:

Neither the retail sales tax nor the use tax shall apply to sales to a manufacturer . . . of machinery and equipment used directly in a manufacturing operation or research and development operation, . . . (Emphasis added.)

RCW 82.08.02565(2)(c)(viii), in turn, provides:

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

. . . (c) Machinery and equipment is "used directly" in a manufacturing operation, testing operation, or research and development operation if the machinery and equipment:
. . . (viii) Is integral to research and development as defined in RCW 82.63.010.
(Emphasis added.)

ETA 3126, relied upon by Audit, states that the M&E exemption is not available for the product that is being manufactured, and that when a prototype is the object (product) of manufacturing or research and development, it does not qualify under the “used directly” test. In other words, the thing being made is the object of the activity and as such is not “machinery and equipment” as that phrase is used in the M&E exemption unless it is used to make, build, or test a different product, or used in some supportive capacity in stages of the manufacturing operation. A prototype used as a test bed will qualify only if it can be shown that the information gained from the test will be used for a different product or process, and will not be used to refine or change the product itself. (Emphasis added.) The prototype must thus be used to test other property (each item of property including all of its components), and not simply later versions of the prototype or the object that will be manufactured.

Taxpayer argues that the ingredients and components of its prototypes qualified for the M&E exemption under RCW 82.08.02565 because the prototypes were, in accordance with RCW 82.08.02565(2)(c)(viii), “integral to research and development as defined in RCW 82.63.010.” Taxpayer argues that the research and development it conducted was in accordance with RCW 82.63.010 (High Technology), and that its prototypes were “integral” to those activities. Taxpayer specifically contends that ETA 3126, which is the Department’s explanation of how the M&E exemption applies to prototypes, is not in accordance with the law that establishes the M&E [exemption], and that the ingredients and components of its prototypes should be allowed the [exemption].

The goal of statutory interpretation is to give effect to the intent of the legislature in enacting the statute. Legislative intent is determined primarily from the language of the statute itself. As

⁵ For ease of discussion, and because RCW 82.12.02565 (which concerns the use tax) refers only to the provisions of RCW 82.08.02565 (which concerns the retail sales tax), we will refer only to RCW 82.08.0265.

summarized in *Tesoro Refining and Marketing Co. v. Dep't of Revenue*, 164 Wn.2d 310, 317, 190 P.3d 28 (2008):

The goal of statutory interpretation is to carry out the legislature's intent. *Burns*, 161 Wash.2d at 140, 164 P.3d 475. If the meaning of the statute is plain, the court discerns legislative intent from the ordinary meaning of the words. Id. Susceptibility to more than one reasonable interpretation renders the statute ambiguous and allows the court to employ tools of statutory construction such as legislative history to interpret the statute. *Dep't of Ecology v. Campbell & Gwinn, LLC*, 146 Wash.2d 1, 12, 43 P.3d 4 (2002). The mere fact that two interpretations are conceivable does not make a statute ambiguous. *Agrilink [Foods, Inc. v. Dep't of Revenue*, 153 Wn.2d 392, 396, 103 P.3d 1226 (2005] (Footnote omitted.)

To ascertain legislative intent, Washington courts employ a "plain meaning" approach to interpreting statutes, absent ambiguity. Traditionally the plain meaning analysis of a statute relied on certain intrinsic aids, such as the use of dictionaries and certain textual aids. Recently, the courts in Washington clarified that the plain meaning rule used in Washington also encompasses related statutes:

Additionally, while traditional plain language analysis of statutes focused exclusively on the language of the statute, this court recently has also recognized that "all that the Legislature has said in the statute and related statutes" should be part of plain language analysis. *Dep't of Ecology v. Campbell & Gwinn, L.L.C.* 146 Wn. 2d 1, 11, 43 P.3d 4 (2002).

(*Cerrillo v. Esparza*, 158 Wn. 2d 194, 142 P.3d 155, 159 (2006)).

Under this approach, the plain meaning is derived both from what the Legislature has said in its enactments and from all that the Legislature has said in the statute and related statutes that disclose legislative intent about the provision in question. If, after this inquiry, the statute remains susceptible to more than one reasonable meaning, the statute is ambiguous and it is appropriate to resort to extra-textual or extrinsic aids, discussed infra. Extra-textual materials include legislative history and rules of construction. See, e.g., *Cockle v. Dep't of Labor & Indus.*, 142 Wn.2d 801, 808, 16 P.3d 583 (2001); *Timberline Air Serv., Inc. v. Bell Helicopter-Textron, Inc.*, 125 Wn.2d 305, 312, 884 P.2d 920 (1994). . . .

Taxpayer relies on the "integral to" language of RCW 82.08.02565(2)(c)(viii). The legislature added the "integral to" criteria to the RCW 82.08.02565(2)(c) "used directly" test in HB 2484 during its 1996 session. Chapter 247 of HB 2484 consisted of six sections. Sections 2 and 3, respectively, added the language that extended the exemption to M&E used in "research and development operations," and added the "integral to research and development" criterion to the "used directly" test. Sections 4 and 5, on the other hand, added new sections to chapter 82.08 RCW and 82.12 RCW that exempted:

The sales [or use] of materials used in designing and developing aircraft parts, auxiliary equipment, and aircraft modification whether from enterprise funds or on a contract or fee

basis for a taxpayer with gross sales of less than twenty million dollars per year. This exemption may not exceed one hundred thousand dollars for a taxpayer in a year.

It was almost immediately necessary to further clarify the exemption granted by Sections 4 and 5.⁶ Therefore, Chapter 302 of SSB 5359 (codified as RCW 82.08.02566) clarified the description of the exemption in the 1996 act with the following:

The tax levied by RCW 82.08.020 shall not apply to sale of tangible personal property incorporated into a prototype for aircraft parts, auxiliary equipment, or modifications; or to sales of tangible personal property that at one time is incorporated into the prototype but is later destroyed in the testing or development of the prototype.

Therefore, the enactment of RCW 82.08.02566 was necessary in order to exempt ingredients and components that go into prototypes for airplane parts, etc. This exemption first appeared -- albeit first worded as "materials used in designing and developing aircraft parts. . ." -- in 1996 in the same bill that also introduced the "integral to research and development" criteria into the "used directly" test. If the "integral to research and development" criteria in Sections 2 and 3 had been meant to cover the manufacture of prototypes, then the legislature's exemption of aircraft prototypes in Sections 3 and 4 would have been unnecessary.

Harmonizing these provisions together, we must conclude that Sections 2 and 3 of HB 2484 were never intended to exempt, as M&E, the ingredients and components of prototypes. Had the legislature intended Sections 2 and 3 to exempt prototypes because they are "integral to research and development," then the enactment of Sections 3 and 4, which exempted aircraft prototypes, would have been completely unnecessary. The legislature does not engage in unnecessary or meaningless acts. *John H. Sellen Construction Co. v. Department of Rev.*, 87 Wn.2d 878, 883, 558 Wn.2d 1342 (1976).

We conclude that the ingredients and components of Taxpayer's prototypes did not qualify for the M&E exemption and Taxpayer's use of the . . . system did not qualify as a tool that "produc[ed] another item of tangible property." When Taxpayer used various elements of the . . . system to test new versions of components of the same system, Taxpayer was not testing another item of tangible personal property. The system, as a whole, included the five hardware items plus the software. Merely testing and improving one or more of the components using the rest of the system did not qualify as testing another item of tangible personal property.

⁶ Sections 4 and 5 of HB 2484 intended to give manufacturers of aircraft parts a \$100,000 exemption in tax – not to exempt the tax on \$100,000 of parts, which is what the enacted bill did. It was therefore necessary for the legislature to clarify these sections in SSB 5359 during its 1997 session. OFM Form FN (10/95) explained:

During the 1996 legislative session HB 2484 was passed and within that bill was a provision to exempt from sales or use taxation materials used in the development of aircraft prototypes by firms with less than \$20 million of annual sales. That bill used language with provided a deduction rather than a tax exemption. This bill clarifies the intent of the original proposal.

We hold that the prototypes that Taxpayer developed and used for testing did not qualify for the M&E exemption.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 15th day of February 2011.