

Cite as Det. No. 13-0171R, 34 WTD 138 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for a Refund) D E T E R M I N A T I O N
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 No. 13-0171R
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 Registration No. . . .
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[1] RULE 13601; RCW 82.12.02565: EXEMPTIONS – MACHINERY AND EQUIPMENT (M&E) USED FOR MANUFACTURING, RESEARCH AND DEVELOPMENT. When a taxpayer removes materials from anaerobic lagoons with the purpose of restoring the materials to their previous condition, this constitutes cleaning or altering of qualifying pollution control equipment. The M&E use tax exemption applies when a taxpayer uses pollution control equipment directly for its manufacturing operation for purposes of RCW 82.12.02565.

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.

Callahan, A.L.J. – A corporation (“Taxpayer”) [petitions for reconsideration of a determination sustaining the assessment of use tax and/or deferred sales tax on] dredging services it purchased for its anaerobic lagoons, because the services are not exempt from [retail sales tax under RCW 82.08.02565] and WAC 458-20-13601 (Rule 13601). . . . [We grant the petition in part.]¹

ISSUES

1. Under RCW 82.12.02565 and Rule 13601, do the anaerobic lagoons qualify as pollution control equipment, and if so, are the labor charges for removal of materials from the [lagoons] tax exempt?
2. . . .
3. . . .

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

FINDINGS OF FACT

Taxpayer petitions for reconsideration of Det. No. 13-0171. The facts contained in Det. No. 13-0171 are, for the most part, restated here.

Taxpayer is a subsidiary of [a holding company]. Its business activities in Washington include operating a [meat] processing plant.² The Department's Audit Division examined Taxpayer's books and records for the period of January 1, 2007, through December 31, 2010 (the "audit period"). On May 23, 2012, Audit issued an assessment (document number . . .) in the amount of \$. . ., which consisted of use tax/deferred sales tax of \$. . .,³ and interest of \$. . .⁴ Audit issued another assessment on July 25, 2012 (document number . . .) in the amount of \$. . ., which consisted of use tax/deferred sales tax of \$. . . on consumable supply purchases, and interest of \$. . . Taxpayer paid both assessments in full and timely petitioned the Department's Appeals Division for a refund.

Taxpayer slaughters [livestock] and processes [meat]. Taxpayer maintains several anaerobic lagoons to contain the [livestock's] solid waste. During the audit period, Taxpayer hired a vendor to dredge and remove the solid waste in two of its anaerobic lagoons. The vendor did not charge Taxpayer retail sales tax on the dredging service it provided. The vendor sold the removed solid waste to a third party. Taxpayer treated the dredging service as a capital project (Capital Project Number . . .) and capitalized the expenses in its books. Audit however determined that the dredging service Taxpayer purchased was not exempt from retail sales tax, disallowed the M&E exemption from retail sales tax taxpayer claimed on these purchases and assessed use tax on the service (document number . . .).

On reconsideration, Taxpayer provided a copy of the Capital Investment Project # . . ., [stating in relevant part:]

Scope of Costs:

Project ID . . .: [Taxpayer's] anaerobic lagoons have filled with solids over the years and have a grease cap that ranges from one to four feet. Solids have carried over into the third pond and have displaced approximately three quarters of the lagoon's treatment capacity. To dredge lagoons #1 and #2 the grease cap will need to be removed with an excavator, and land filled. [Taxpayer] ground will not be available. Approximately 25 million gallons of solids will need to be dredged, trucked off site, and land applied, by an outside contractor.

² Taxpayer reported its gross income under the slaughtering, breaking and processing perishable meat business and occupation (B&O) tax classification. See RCW 82.04.260(4).

³ Taxpayer only disputes the dredging service it purchased from a vendor for its "Capital Investment Project Number . . ." during the audit period.

⁴ During the audit, Audit determined that some of Taxpayer's equipment and labor purchases, including its [livestock] machine yield grading system and fleshing chain repair service, was used for its [livestock] manufacturing operations during the audit period and qualified for the M&E exemption. Audit provided a credit (schedule 2B in the assessment) against the use tax assessment on the dredging service in the amount of \$. . ., which reduced the assessed amount from \$. . . to \$. . .

Project Justification:

The grease cap and solids in the lagoons displace working volume and the required detention time to achieve complete anaerobic treatment. Solids have been carrying over into pond #3, creating anaerobic conditions. Pond 3 empties into the irrigation lagoon and will eventually make the wastewater unfit for irrigation purposes and greater expenses will be incurred if this pond begins to fill up.

Taxpayer argued on reconsideration that it keeps its [livestock] in pens for a short period until it sends them to its adjacent slaughtering facility. The wastewater contains the [livestock] manure and dirt washed from the [livestock] pens and the slaughtering process. The wastewater goes to the anaerobic lagoons through pipes. The wastewater is stored for a few years. (see Capital Project Number . . .). Once in the lagoon, the manure settles into two layers: [the] solid, or sludge, layer and the liquid layer. The manure then undergoes the process of anaerobic respiration, whereby the volatile organic compounds are converted into carbon dioxide and methane.⁵ The anaerobic lagoons are regulated by the Washington Department of Ecology (“DOE”), which issued a Wastewater Discharge Permit to Taxpayer to maintain the lagoons. Taxpayer argues that:

The [livestock] pens are used to contain Taxpayer’s raw materials ([livestock]) prior to processing, the [livestock] pens must be considered part of the manufacturing operation....Waste water generated from the manufacturing operation must be properly disposed of. The water used for cleaning the [livestock] pens is pumped into the anaerobic lagoons for settling and disposal, and thus the anaerobic lagoons are machinery and equipment because they are used as either industrial fixtures and/or pollution control equipment.

In support of its argument, Taxpayer provided a copy of State Wastewater Discharge Permit Number ST-5335 issued by the Washington DOE, which provided that Taxpayer must monitor the influent to the anaerobic treatment lagoons in accordance to the scheduled prescribed by the DOE. Taxpayer relied on Excise Tax Advisory (ETA) 3124.2009 and argues that the anaerobic lagoons are industrial fixtures because the anaerobic lagoons are lined. Taxpayer also relied on Det. No. 03-0325, 24 WTD 351 (2005) and argues that the anaerobic lagoons are similar to the waste water treatment tanks in 24 WTD 351 that are used for pollution control proposes.

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ANALYSIS

RCW 82.08.02565 provides a retail sales tax exemption for certain machinery and equipment and services related thereto when sold to a manufacturer and “used directly in a manufacturing operation.” A similar exemption is found in the Washington use tax statutes. RCW 82.12.02565. Collectively, these analogous exemptions are commonly referred to as “the M&E exemption.”

⁵ Anerobic lagoon, *Wikipedia, The Free Wikipedia*, http://en.wikipedia.org/wiki/Anaerobic_lagoon (last visited December 30, 2013).

As explained in prior determinations by the Department, “the M&E exemption . . . is strictly construed in favor of application of the tax and against claiming the exemption,” and the burden of proving entitlement to the exemption is on the taxpayer. Det. No. 05-0193, 25 WTD 143 (2006); Det. No. 01-007, 20 WTD 214 (2001); *see also Budget Rent-A-Car, Inc. Dep’t of Revenue*, 81 Wn.2d 171, 174-5, 500 P.2d 764 (1972); *All-State Constr. Co. v. Gordon*, 70 Wn.2d 657, 425 P.2d 16 (1967); *Yakima Fruit Growers Ass’n v. Henneford*, 187 Wash. 252, 258, 60 P.2d 62 (1936).

RCW 82.12.02565 provides an M&E exemption from use tax, as follows:

The provisions of this chapter shall not apply in respect to the use by a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation, to the use by a person engaged in testing for a manufacturer or processor for hire of machinery and equipment used directly in a testing operation, or to the use of labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment.

RCW 82.12.02565 (emphasis added). [The M&E exemption from use tax incorporates by reference the definitions and conditions in the corresponding sales tax exemption. RCW 82.12.02565(2); *see also* RCW 82.04.110(1) (defining “manufacturer”)].

RCW 82.08.02565 defines the term “machinery and equipment” as:

[I]ndustrial 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.

RCW 82.08.02565(2)(a) (emphasis added).

However, the term “machinery and equipment” does not include:

...

. . . (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.

RCW 82.08.02565(2)(b).

RCW 82.08.02565(2)(f) defines the term “manufacturing operation” as “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. . . .⁶

The Department implemented WAC 458-20-13601 (Rule 13601) to administer RCW 82.12.02565, which explains that the manufacturing operation includes:

[S]torage 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 exempted 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. . . .

Rule 13601 (emphasis added).

ETA 3124.2009 provides guidance on the term “fixture” for M&E exemption purposes:

Fixtures

The word “fixture” is a term of art in that it has particular meaning in the context of tax. For purposes of the M&E exemption, the Department uses the common law definition of “fixture” as it is commonly understood in Washington State. A fixture is an item of personal property that has been converted to real property by being permanently affixed to the realty. . . . Examples of fixtures are air conditioning units, furnaces, boilers, and heating units, plumbing fixtures, conveyors, electric generators, transformers, elevators, and cranes. In addition, the M&E exemption recognizes “utility systems” as fixtures. Property outside of buildings also qualifies as “industrial fixtures.” Examples are tanks, pipes, pads, and lined ponds.

(Emphasis added).

At issue is whether the anaerobic lagoons constitute qualifying pollution control equipment *and* are used directly for Taxpayer’s manufacturing operation for purposes of RCW 82.12.02565 Rule 13601. We agree with Taxpayer that an anaerobic lagoon is a fixture because it is [lined

⁶ This statute does not define the term “manufacture.” That definition is found in RCW 82.04.120(1), which provides in pertinent part:

“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 a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use, . . .

[The Department recognizes that taxpayers who slaughter animals in order to sell perishable meat products are engaging in a form of manufacturing. *See* ETA 3112.2011. Such persons who sell the perishable meat products at wholesale are subject to B&O tax under the slaughtering, breaking, and processing perishable meat classification in RCW 82.04.260(4), rather than the manufacturing classification in RCW 82.04.240.]

pond], “an item of personal property, that has been converted to real property by being permanently affixed to the realty.” ETA 3124.2009. We also agree with Taxpayer that an anaerobic lagoon is pollution control equipment because an anaerobic lagoon is used to manage and treat refuse from the slaughtering process to prevent water pollution and RCW 82.08.02565(2)(b) does not exclude a man-made lagoon from the definition of machinery and equipment.⁷ See also ETA 3119.2009 (the Department provides that “[t]he pollution control equipment must be used to capture wastes and contain or prevent releases resulting from processes of the operation.”) The statute and the rule provide that the M&E exemption is applicable to the “installing, repairing, cleaning, altering, or improving” of qualify M&E equipment. RCW 82.12.02565. Here, when Taxpayer removed the materials from the lagoons with the purpose of putting them in the conditions they were before, this constitutes cleaning or altering of the qualifying pollution control equipment. Accordingly, the dredging service qualifies for the M&E use tax exemption under RCW 82.12.02565.

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DECISION AND DISPOSITION

Taxpayer's petition is . . . granted in part. We remand the case to Audit to adjust the assessment in accordance with this decision.

Dated this 25th day of August 2014.

⁷ Anerobic lagoon, *Wikipedia, The Free Wikipedia*, http://en.wikipedia.org/wiki/Anaerobic_lagoon (last visited December 30, 2013).