

Cite as Det No. 10-0108, 31 WTD 1 (2012)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 10-0108
...)	
)	Registration No. . . .
)	Document No. . . . /Audit No. . . .
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)	Docket No. . . .
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RCW 82.08.02565; RCW 82.12.02565; RCW 82.04.120: RETAIL SALES TAX – DEFINITION OF “TO MANUFACTURE” FOR M&E EXEMPTION. The sorting and bundling of recyclable materials is not manufacturing under RCW 82.04.120 because the process does not create a new, different, or useful substance. While the process changes the value of the materials, it does not change their form or properties or meet the other factors of manufacturing.

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.

Jensen, A.L.J. – A recycling facility operator in Washington appeals use tax assessed on machinery and equipment purchased for use in the taxpayer’s facility. The taxpayer argues that the sorting and bundling of recyclable materials constitutes a manufacturing operation under RCW 82.08.02565 and any machinery and equipment used in this operation is exempt from retail sales tax and use tax. We uphold the assessment.¹

ISSUE

Whether machinery and equipment purchased for use in sorting and bundling recyclable materials at the taxpayer’s recycling facility is exempt from retail sales tax and use tax under RCW 82.08.02565 and RCW 82.12.02565.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

FINDINGS OF FACT

[Taxpayer] operates a single stream Material Recovery Facility (MRF) located in Washington. The MRF is a large, industrial structure where Taxpayer takes recyclable materials and sorts them into bundles, which it then sells to third parties. The MRF includes various items of machinery and equipment, including cat walks, stairs, conveyer belts, and various sorting machines.

At the MRF, Taxpayer accepts single stream recyclable materials brought to the facilities either by Taxpayer or by third parties. "Single stream" refers to recyclable materials that are received in a commingled or mixed state. The stream mostly consists of newspaper, mixed paper, cardboard, glass, plastic, tin cans, aluminum cans, and contaminants. The stream mostly comes from Taxpayer customers' recycling bins picked up by Taxpayer or brought to the MRF by its customers. In either situation, Taxpayer's customers pay Taxpayer to take the single stream materials.

Taxpayer claims that the commingled single stream materials it receives have a negative value because Taxpayer's customers pay Taxpayer to take them and the materials must be sorted with like materials for the products to be recycled. The product coming into the MRF cannot be sold to third parties because it is not sorted and contains contaminants. Taxpayer claims that roughly five percent of the single stream product includes contaminants, which are non-recyclable waste product such as food and unrecyclable plastics. After removing as many contaminants as possible from the product Taxpayer disposes of the contaminants at its landfill.

Taxpayer puts the single stream through various processes that sort and separate the materials into discrete bundles and removes contaminants. Taxpayer claims that it sells these bundles based upon market conditions and adopted industry specifications for the material, which include allowable levels of contaminants, moisture content, and packing configuration. The price that Taxpayer's customers pay for its bundles depends upon the above mentioned variables that impact the overall quality of the bundles. Taxpayer claims that its customers regularly test product to determine its quality and suitability.

. . . Taxpayer describes the process of sorting and bundling the materials as follows:

- Taxpayer accepts materials at the MRF.
- Taxpayer uses a drum metering feeder device that loads the materials onto a screen line to ensure an even flow of materials through the process.
- The sorting process starts with an automatic disc-screening system that sorts the paper and cardboard off of the sort line.
- Taxpayer processes the materials through a variety of discs, screens, conveyor belts, magnets, sensors, air compressors, and other machinery and equipment to separate the materials into separate streams where further separation occurs. Product is separated using a variety of methods including gravity, magnets, sensors, and controlled air bursts.

- Taxpayer uses individually manned quality control stations throughout the process to remove contaminants and ensure that the materials are further separated where the machinery and equipment fall short. These individuals are usually placed at locations after a piece of screening equipment. The individuals have the ability to stop or slow down the equipment.
- Taxpayer uses an electronic control system to monitor and control the aspects of the MRF and its equipment. The electronic control system is manned by a plant manager who can control such things as ascent angles and the material flow speeds throughout the MRF. Taxpayer explains that the proper flow of materials and configuration of the equipment is important to successful operation of the MRF.
- At the end of the process, the successfully separated items are condensed and baled according to industry standard and specifications. These bales are sold to Taxpayer's customers.

Taxpayer paid manufacturing B&O tax on its activities at the MRF and took an exemption from retail sales tax under RCW 82.08.02565 for machinery and equipment that it uses at the MRF. The Department of Revenue's (Department's) Audit Division (Audit) audited Taxpayer's records for the period of January 1, 2004, through December 31, 2007. Audit concluded that Taxpayer's activities at the MRF do not constitute manufacturing and issued an assessment This assessment included a credit of \$. . . in wholesaling B&O tax, a credit of \$. . . in manufacturing B&O tax, \$. . . in use tax and/or deferred sales tax, and \$. . . in interest. Taxpayer appeals this assessment arguing that its activities at the MRF constitute manufacturing within the meaning of RCW 82.08.02565.

ANALYSIS

Washington imposes a retail sales tax on "each retail sale in this state." RCW 82.08.020. Washington also imposes a corresponding use tax on the use of tangible personal property in this state pursuant to RCW 82.12.020. "Deferred sales tax" simply refers to Washington's retail sales tax, the payment of which has been deferred at the taxpayer's election. Det. No. 01-145R, 24 WTD 11 (2005). In this case, Audit assessed deferred sales tax and/or use tax on Taxpayer's purchases of machinery and equipment used at its MRF. Taxpayer argues that its purchases of the items are exempt from retail sales tax under RCW 82.08.02565, and that its use of these items is exempt under the equivalent use tax exemption in RCW 82.12.02565. We collectively refer to these exemptions as "the M&E exemption." See Det. No. 07-0324E, 27 WTD 119 (2007).

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 Wn. 252, 258, 60 P.2d 62 (1936).

The M&E exemption is for sales of machinery and equipment sold to a manufacturer, and “used directly in a manufacturing operation.” RCW 82.08.02565. In this case, Audit disallowed the M&E exemption for equipment used at the MRF because it argues that the activities at the MRF do not constitute a manufacturing operation.

RCW 82.08.02565(2)(d) defines “manufacturing operation” for the M&E exemption 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.” This statute does not define the term “manufacture.” That definition is found in RCW 82.04.120,² 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, and shall include: (1) The production or fabrication of special made or custom made articles; (2) the production or fabrication of dental appliances, devices, restorations, substitutes, or other dental laboratory products by a dental laboratory or dental technician; (3) cutting, delimiting, and measuring of felled, cut, or taken trees; and (4) crushing and/or blending of rock, sand, stone, gravel, or ore.

The dispute in this case centers on whether Taxpayer’s activities at the MRF creates “a new, different or useful substance or article of tangible personal property.” In issuing the above assessment, Audit concluded that Taxpayer’s sorting and bundling activities at the MRF did not create a new, different, or useful product. This is not the first case in which the Department or Washington courts have considered this requirement of the term “to manufacture.”

The Washington State Supreme Court articulated a test for determining whether a new, different or useful article is produced in *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962). In concluding that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120, the court developed the following test:

We think the test that should be applied to determine whether a new, different, and useful article has been produced is whether a significant change has been accomplished when the end product is compared with the article before it was subjected to the process. By the end product we mean the product as it appears at the time it is sold or released by the one performing the process.

Id. at 175.

² [WAC 458-20-13601].

A year later the court relied upon this test in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963) and held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The court in *McDonnell* recognized that the above *Bornstein* test was “somewhat general in nature and may seem easier as a matter of articulation than as a matter of application.” 62 Wn.2d at 556. The court then identified the following factors one should consider in determining if the end product is a new, different, or useful product: “. . . among others, changes in form, quality, properties (such changes may be chemical, physical, and/or functional in nature), enhancement in value, the extent and the kind of processing involved, differences in demand, et cetera,” *Id.* at 557.

We have applied these factors in various Department determinations. In Det. No. 94-255, 14 WTD 092 (1994), we concluded that compressing hay for shipping purposes is not manufacturing because the compressed hay was not significantly more useful than uncompressed hay. In that case, the taxpayer compressed hay for shipping purposes and its compressing processes did not change the underlying properties of the hay. *Id.* Similarly, in Det. No. 07-0082, 26 WTD 231 (2007), we held that a taxpayer that melted coal tar pitch did not engage in manufacturing because the pitch did not change chemically or functionally and did not change the value of the material.

We have also applied these factors in concluding that a taxpayer engaged in manufacturing. For example, in Det. No. 95-170, 16 WTD 43 (1995), we concluded that sorting and compacting loose sheet metal into cubes used by others is a manufacturing activity. In applying the *McDonnell* factors, we concluded that this activity created a new, different, or useful product because the process created metal cubes that took a different form, had different properties, and had a greatly enhanced value compared to the unsorted metal scrap sheets, which were difficult to handle, store, and transport. *Id.* The determination noted that the physical properties of the metal had changed in the process and many large impurities had been removed from the metal scraps. *Id.*

In this case, Taxpayer relies on Det. No. 95-170 and *McDonnell* to argue that its process of converting single stream materials at the MRF into condensed recyclable material bales creates a new, different, or useful product. Specifically, Taxpayer argues that the following factors demonstrate that a new, different, or useful product is created at the MRF: (1) the bundled recyclable materials are sold to third parties and have significantly more value than the single stream product coming into the facility that cannot be sold in this condition because it does not meet industry specifications; (2) a visual comparison of the two products shows that the products go from being in a commingled state with contaminants to a condensed bundle of like materials; (3) the single stream material is unusable in this condition, compared to bundles of specific recyclable materials that is put to use by Taxpayer’s purchasers; and (4) the single stream consists of mixed recyclable materials and contaminants, whereas the final product is more specific and condensed and contains very few contaminants.

Audit argues that, while the end product has more value than the single stream materials that Taxpayer starts with, the activities at the MRF do not create a new, different, or useful product. Audit relies on the language from the *Bornstein* test that requires a “significant change” to the

product at issue. 60 Wn.2d at 175. Audit's primary argument is that Taxpayer's activities essentially amount to sorting and bundling recyclable materials for shipment. Audit does not see where the activities result in the product changing form or quality and argues that manufacturing activities are more substantive than the processing that occurs at the MRF.

We conclude that Taxpayer's activities at the MRF do not create a new, different, or useful product. The difficulty in this case is that Taxpayer's activities certainly create a product that has more value than the single stream materials that it starts with. Taxpayer's customers pay Taxpayer to take this product. The single stream materials cannot be sold in this condition and if not used by Taxpayer, would have to be disposed by Taxpayer in a landfill. Taxpayer's process of sorting the materials into like recyclable groups and removing contaminants certainly creates a product that has value and can be used by third parties.

However, while change in value is a factor in determining whether a new, different, or useful product is created, it is not the only factor. *McDonnell*, 62 Wn.2d at 556; *see also* Det. No. 94-255. Taxpayer's sorting activities do not physically change the form or character of the underlying property at issue. Though the value of the products increases as Taxpayer sorts them with like materials, the form of those materials does not become something other than recyclable materials.

This change in form factor is a key factor in the cases that have considered whether the end product was a new, different, or useful product. In *J&J Dunbar & Co. v. State*, 40 Wn.2d 763, 245 P.2d 1164 (1952), the taxpayer took raw whiskey and changed the nature and properties of the product into whiskey suitable for consumption. In *Bornstein*, the taxpayer took whole bottom fish and converted them into salable fish fillets. 60 Wn.2d 169. In *McDonnell*, the taxpayer took whole dried peas and converted them to split peas with a different value and form. 62 Wn.2d 553. In all of these cases, the taxpayers' activities actually changed the form, quality, and nature of the underlying property. Taxpayer's bundles consist of the same underlying items that make up the single stream material, minus the contaminants. Taxpayer essentially sorts the materials without changing the underlying character of those materials.

Finally, in Det. No. 95-170, the taxpayer took unsorted metal scraps, sorted them, and condensed them into useable cubes. Unlike the current case, the metal cubes were composed of a different metal quality and had "a significant change in the physical properties of the metal." 16 WTD at 46. Though both Taxpayer and the taxpayer Det. No. 95-170 sort unusable materials into more usable and marketable bundles, Taxpayer's activities do not actually change the underlying properties of the recyclable materials or form them in the manner that the taxpayer did in that case.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 5th day of April 2010.