

Cite as Det. No. 14-0236, 34 WTD 042 (2015)

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  
Assessment of ) No. 14-0236  
                  ) Registration No. . . .  
      . . . )

[1] RULE 13601; RCW 82.08.02565: SALES AND USE TAX – M&E EXEMPTION – EQUIPMENT FOR PRODUCING SEASONAL HOLIDAY ITEMS. A seller of greenery and seasonal holiday wreaths and garland does not qualify for the M&E sales and use tax exemption because the seasonal production of such items fails to meet the majority use test. Specifically, the proposed methods do not result in a comparison between qualifying and nonqualifying uses, as required under Rule 13601(9)(a)(iv).

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.

Yonker, A.L.J. – A seller of floral greenery and seasonal wreaths and garland (Taxpayer) requests a correction of use tax and/or deferred sales tax assessed on various purchases of machinery and equipment, and on payments for repairs on certain machinery and equipment. Taxpayer claims that the purchases at issue qualify for the machinery and equipment (M&E) exemption from retail sales tax and use tax. We deny Taxpayer’s petition.

## ISSUE

Under RCW 82.08.02565, does certain machinery and equipment satisfy the “majority use” test such that purchases of and payment for repairs of such machinery and equipment qualify for the M&E exemption from retail sales tax and use tax?

## FINDINGS OF FACT

[Taxpayer] purchases and sells at wholesale floral greenery to customers both inside and outside of Washington year round. In addition, Taxpayer manufactures holiday wreaths and garlands at wholesale and retail during the Christmas holiday season between October and December each year.

In 2013, the Department's Audit Division conducted a review of Taxpayer's books and records for the period of January 1, 2009, through December 31, 2012 (audit period). During that review, the Audit Division found that Taxpayer should have paid retail sales tax on certain repairs it made to certain machinery and equipment during the audit period. The machinery and equipment at issue consisted of a cooler, a pallet jack, a forklift, and a truck. The repairs consisted of a replacement fan for the cooler, other repairs to the cooler, repairs to pallet jacks, repairs to a forklift, and repairs to a truck. Taxpayer claimed that the machinery and equipment at issue all qualified for the M&E tax exemption, and, therefore, the repairs for such equipment also qualified for the M&E exemption. The Audit Division found that the machinery and equipment at issue did not qualify because it was not used the majority of the time for a qualifying manufacturing operation.

Based on a number of methods, the Audit Division found that the machinery and equipment at issue did not qualify for the M&E exemption because it was not used the majority of the time for a qualifying manufacturing operation. Specifically, the Audit Division found that the machinery and equipment at issue were only used for the qualifying wreath and garland manufacturing operation for approximately three months out of the year, or 25 percent of the time during the audit period. Second, the Audit Division found that the value of the sales of products from the qualifying manufacturing operation only accounted for no more than 16 percent of the value of all Taxpayer's annual sales during the audit period. Finally, the Audit division found that the volume of products produced from the qualifying manufacturing operation accounted for no more than 34 percent of the total volume of products sold annually during the audit period.<sup>1</sup>

On October 10, 2013, based on the Audit Division's findings, the Department issued a tax assessment for \$. . . , which included \$. . . in use tax and/or deferred sales tax, and \$. . . in interest. Taxpayer timely appealed the full amount of the tax assessment. On appeal, Taxpayer conceded that the machinery and equipment did not satisfy the majority use test under any of the methods employed by the Audit Division, but argued that the Audit Division should have used either profitability or wages as measures to determine the majority use of the machinery and equipment.<sup>2</sup>

## ANALYSIS

RCW 82.08.02565 provides a retail sales tax exemption for sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation. RCW 82.12.02565 provides the corresponding use tax exemption. Both exemptions are referred to collectively herein as the "M&E exemption." The M&E exemption has five elements that must be satisfied in order for a taxpayer to qualify:

1. There must be a sale;

<sup>1</sup> Originally, the Audit Division found that the volume of products from the qualifying manufacturing operation accounted for no more than 21 percent, but Taxpayer later provided evidence that some of the products it sold consisted of multiple manufactured products. Based on that additional evidence, the Audit Division recalculated the volume percentage at no more than 34 percent.

<sup>2</sup> In its petition, Taxpayer also disputed the Audit Division's finding regarding the "volume" method, however, in subsequent communications, Taxpayer limited its argument only the "profitability" and "wages" measures; we limit our determination accordingly.

2. The purchaser must be a “manufacturer”<sup>3</sup> or “processor for hire”;
3. The item purchased must be either “machinery” or “equipment”<sup>4</sup>, or repair services for such machinery and equipment;
4. That machinery or equipment must be “used directly”
5. In a “manufacturing operation.”

RCW 82.08.02565(1)(a); Det. No. 03-0325, 24 WTD 351 (2005). Here, the fifth element – whether the machinery and equipment at issue was used directly in a “manufacturing operation” – is the only element at issue. The Audit Division found, and Taxpayer concedes, that only a portion of Taxpayer’s use of the machinery and equipment was directly in a manufacturing operation. Specifically, Taxpayer does not maintain a “manufacturing operation” throughout the year. Instead, Taxpayer is only engaged in the qualifying wreath and garland manufacturing operation between October and December each year. For the remainder of each calendar year, Taxpayer is engaged in selling floral greenery, and Taxpayer concedes that the use of the machinery and equipment at issue for making such floral greenery sales is not a qualifying use in a “manufacturing operation,” and, therefore, not a qualifying use for the M&E exemption.

However, WAC 458-20-13601 (Rule 13601) provides the following for situations in which machinery and equipment is partially used for some nonqualifying 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. . . . 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 or 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 . . . .

Rule 13601(9)(a). Thus, even though a portion of Taxpayer’s use does not qualify, it may still nevertheless qualify for the M&E exemption if at least the majority – or [greater than] fifty percent – of Taxpayer’s use of the machinery and equipment at issue is . . . in a qualifying manufacturing operation. *[Id.]* Taxpayer argues that its use of such machinery and equipment for its production of wreaths and garlands during the Christmas holiday season is a qualifying use, and satisfies the majority use requirement.

Rule 13601(9)(a) provides the following methods for determining the majority use of a particular item of machinery and equipment:

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<sup>3</sup> RCW 82.08.02565(2)(d) states that a manufacturer “means a person that qualifies as a manufacturer under RCW 82.04.110.” RCW 82.04.110, in turn, states that a manufacturer “means every person who . . . manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances, or commodities.” On appeal, Taxpayer made statements suggesting that the Audit Division found that Taxpayer did not qualify as a “manufacturer.” However, the Audit Division’s response makes clear that it agrees that Taxpayer falls under the definition of a “manufacturer,” and we agree.

<sup>4</sup> RCW 82.08.02565(2)(a) states that machinery and equipment “means industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts.”

- (i) Time. Time is measured using hours, days, or other unit of time, with qualifying use of the M&E the numerator, and total time used the denominator. Suitable records for time measurement include employee time sheets or equipment time use logs.
- (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.
- (iii) Volume. Volume is measured using amount of product, with volume from qualifying use of the M&E the numerator and total volume from use of the M&E the denominator. Suitable records for volume measurement include production numbers, tonnage, and dimensions.
- (iv) Other comparable measurement for comparison. The department may agree to allow a taxpayer to use another measure for comparison, provided that the method results in a comparison between qualifying and nonqualifying uses. For example, if work patterns or routines demonstrate typical behavior, the taxpayer can satisfy the majority use test using work site surveys as proof.

The Audit Division concluded, and Taxpayer concedes on appeal, that Taxpayer does not satisfy the majority use test under any of first three methods. Instead, Taxpayer argues on appeal that it satisfies the majority use requirement under the fourth method, “Other comparable measurement for comparison.”

Preliminarily, we note that this fourth method under Rule 13601(9)(a)(iv) is discretionary because of its use of the verb “may” as opposed to “shall” or “will.” *See State v. Little*, 116 Wn.App. 346, 349-50, 66 P.3d 1099 (2003). As such, we conclude that the Department is not required to agree to allow an alternative method of determining majority use. Instead, Rule 13601(9)(a)(iv) provides for a mechanism through which the Department may form a different method particular to a taxpayer’s circumstances, but only so long “that the method results in a comparison between qualifying and nonqualifying uses.” Taxpayer proposed two alternative methods for comparison by the Audit Division. First, Taxpayer argued that profitability during different seasons of the year could also be used as a method. Second, Taxpayer argued that wages paid to its employees could be used as a method. The Audit Division declined to allow either of these methods. Taxpayer maintains on appeal that either of these methods satisfies the majority use requirement of Rule 13601(9)(a).

#### A. Seasonal Profitability Comparison

Taxpayer argued on appeal that the Audit Division should compare Taxpayer’s profitability between January and September of each calendar year with Taxpayer’s profitability between

October and December, and that such a comparison satisfies the majority use test.<sup>5</sup> In essence, Taxpayer's argument is that the profitability of the seasonal wreath and garland production compared with the less profitable floral greenery sales activity the remainder of the year proves that the machinery and equipment at issue was used more in the qualifying wreath and garland manufacturing operation. We disagree that such a comparison satisfies the majority use test.

Rule 13601 states that the Department may agree to allow for a different method for determining majority use "provided that the method results in a **comparison between qualifying and nonqualifying uses.**" Rule 13601(9)(a)(iv) (emphasis added). We conclude that a comparison of the profitability of the seasonal operation and the regular operation does not satisfy the requirements of Rule 13601(9)(a)(iv). A comparison of profitability is not instructive on whether the majority of the "use" of the machinery and equipment was in the qualifying wreath and garland manufacturing operation as opposed to the nonqualifying floral greenery selling operation. In other words, even if the floral greenery operation is not profitable, Taxpayer still may have "used" the machinery and equipment more for that operation over the course of a calendar year than for the wreath and garland manufacturing operation. Thus, we conclude that profitability simply has no relation to quantifying the actual "use" of the machinery and equipment.<sup>6</sup>

#### B. Wages Paid to Employees Comparison

Taxpayer also argued on appeal that the Audit Division should compare the wages paid to its production employees between October and December each year with total annual wages paid to its production employees, and that such a comparison satisfies the majority use test.<sup>7</sup> Apparently, Taxpayer's argument is that because it paid more than half of its total yearly production staff wages between October and December of each calendar year, the majority of the use of the machinery and equipment in question occurred in the qualifying wreath and garland manufacturing operation. We conclude, however, that Taxpayer has failed to prove that such a comparison satisfies Rule 13601(9)(a)(iv).

As previously discussed, under Rule 13601(9)(a)(iv), requires as a threshold matter, that any other method allowed by the Department must "result in a comparison between qualifying and nonqualifying uses" of the machinery and equipment at issue. Taxpayer did not present objective evidence of how wages it paid were linked to the use of the machinery and equipment. We conclude that, based on the record before us, Taxpayer's proposed method of using wages does not result in a meaningful comparison of qualifying and nonqualifying use of the machinery

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<sup>5</sup> Taxpayer stated on appeal that, for 2011, it incurred a loss of \$... from January to September, and then a gain of \$... from October to December. Similarly, for 2012, Taxpayer incurred a loss of \$... from January to September, and then a gain of \$... from October to December.

<sup>6</sup> We also note that the value method specifically states that "gross income" is the measure to be used for that method. This implies that profitability is not an appropriate measure to consider.

<sup>7</sup> Taxpayer provided a summary of its wages paid during the audit period. The summary indicated the following: for 2009, Taxpayer paid 50.51 % of its total yearly production staff wages between October and December; for 2010, Taxpayer paid 57.9 % of its total yearly production staff wages between October and December; for 2011, Taxpayer paid 59.02% of its total yearly production staff wages between October and December; and for 2012, Taxpayer paid 64.68% of its total yearly production staff wages between October and December.

and equipment.<sup>8</sup> Thus, we conclude that Taxpayer has failed to prove that an examination of its wages satisfies the requirements of Rule 13601(9)(a)(iv).

. . . As such, we affirm the Audit Division's assessment as issued.

#### DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 24th day of July 2014.

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<sup>8</sup> In contrast, we note that the time method, described earlier, specifically allows as evidence under that method "employee time sheets or equipment time use logs." Rule 13601(9)(a)(i). Such objective evidence, we conclude, provides the required comparison of uses that is missing in Taxpayer's proposed wages method. However, we presume that such evidence in Taxpayer's case did not satisfy the majority use test, otherwise the Audit Division would have found the test satisfied under the time method.