

Cite as Det. No. 15-0089, 35 WTD 62 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Appeal of Tax Ruling of) D E T E R M I N A T I O N
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 No. 15-0089
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 Registration No. . .
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RULE 113; RCW 82.04.050: RETAIL SALES TAX – RETAIL SALE EXCLUSION – INGREDIENTS AND COMPONENTS. The purchase of liquid oxygen for introduction and use in the production of a mulch-like biosolids product is excluded from the definition of “retail sale” and exempt from retail sales tax, pursuant to RCW 82.04.050(1)(a)(iii) and WAC 458-20-113(2), because the liquid oxygen is used in producing a new product for sale and becomes an ingredient or component of the 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.

Eckholm, A.L.J. – A [taxpayer] appeals a tax ruling that its purchase of liquid oxygen (LOX) for use in its wastewater treatment process is subject to retail sales tax. The [taxpayer] appealed the ruling, asserting that its ruling request did not contain sufficient facts regarding its use of LOX in the manufacture of a mulch-like biosolids product, and that its purchase of LOX for this purpose is exempt from retail sales tax, pursuant RCW 82.04.050(1)(a)(iii) and WAC 458-20-113 (Rule 113) because it is used in manufacturing a new product for sale and becomes an ingredient or component of the product. The taxpayer’s petition is granted.¹

ISSUE

Whether the taxpayer’s purchase of LOX is exempt from retail sales tax, pursuant to RCW 82.04.050(1)(a)(iii) and Rule 113, because it is used in manufacturing a new product for sale and becomes an ingredient or component of the product.

FINDINGS OF FACT

The [taxpayer] submitted a tax ruling request to the Department of Revenue (Department) Taxpayer Information and Education Division (TI&E) with a general inquiry as to whether its purchase of [(LOX)] for use in its wastewater treatment process is subject to retail sales tax. TI&E’s response was, as follows:

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

Yes, [the taxpayer] must pay sales tax on purchases of LOX used in wastewater treatment. In general, there is no sales tax exemption available when purchasing chemicals for this purpose (wastewater treatment).

Chemicals for treating drinking water that end up in the water distributed to the customers are not subject to sales tax or use tax.

This ruling is binding. If you disagree with this ruling, you have appeal rights as described in WAC 458-20-100.

...

Electronic message from TI&E to the taxpayer, dated March 10, 2014.

The taxpayer appealed the ruling, asserting that its ruling request did not contain sufficient facts regarding its use of LOX in the manufacture of a mulch-like biosolids product, . . . , a byproduct of the wastewater treatment process. The taxpayer argues that its purchase of LOX for this purpose is exempt from retail sales tax, pursuant to RCW 82.04.050(1)(a)(iii) and Rule 113, because it is used in manufacturing a new product for sale and becomes an ingredient or component of the product.²

On appeal, the taxpayer specifically described the steps involved in manufacturing [the mulch-like biosolids product]:

There are generally three steps in the production of [the mulch-like biosolids product]. The first step is a physical process in which solids sink and are separated from the liquid. This is called “primary treatment.” Liquid oxygen (LOX) is used in the second step in which dissolved nutrients are removed from liquids. This second step is the “secondary treatment” and is essentially another way to separate liquids and solids. The third and generally final step is the digestion step. This is where the [taxpayer] introduces more LOX so that the micro-organisms eat the LOX. This is the aerobic part of the process. Then, the microbes are placed in an oxygen deprived environment in which the micro-organisms commence to eat each other. The resultant mass of micro-organisms is the commercially saleable product called The [taxpayer] purchases about 50,000 gallons of LOX per year. LOX costs \$0.4004/CCF gallon. Approximately 40% of all LOX purchased in the production of [the mulch-like biosolids product] is used at the third, digestion step. The process of manufacturing [the mulch-like biosolids product] requires the use of LOX. In other words, LOX is essential to making [the mulch-like biosolids product]. LOX can be traced in the final . . . product in the following way: [the

² The taxpayer also asserted its purchase of LOX is exempt from retail sales tax, pursuant RCW 82.04.050(1)(a)(iii) and Rule 113, because it is a qualified chemical used in processing. Because the Department concludes that the taxpayer’s purchase of LOX is exempt from retail sales tax as an ingredient or component, which is a broader exemption than the chemical processing exemption, it is not necessary for the Department to address the exemption related to chemical processing. See *V.R. Van Dyk v. Dep’t of Revenue*, 41 Wn. App. 71, 76, 702 P.2d 472 (1985) (the ingredients exemption is broader than the chemical used in processing exemption, [requiring only that the ingredient inhere in the final product; whereas, the chemicals used in processing exemption is subject to a “primary purpose” test]).

mulch-like biosolids product] contains oxygen atoms that are bonded to organic molecules that make up the biosolids. Those oxygen atoms can be traced from the LOX introduced at the digesters.

Declaration (Supplemental) of [the taxpayer's manager], dated March 24, 2015 (emphasis added).³

Based on these facts, the taxpayer asserts that it is the LOX purchased for introduction at the third stage in the production of [the mulch-like biosolids product] that meets the exclusion as an ingredient or component. The taxpayer concedes that its purchase of LOX for use in the first two stages would not qualify for the exclusion because the taxpayer is not engaging in manufacturing a new article for sale until the third, digestion stage.⁴

ANALYSIS

Retail sales tax is imposed on each retail sale of tangible personal property in this state. RCW 82.08.020(1). The definition of "retail sale" in RCW 82.04.050 contains specific exclusions, including the following exclusion at issue in this appeal:

Purchases for the purpose of consuming the property purchased in producing for sale as a new article of tangible personal property or substance, of which such property becomes an ingredient or component

RCW 82.04.050(1)(a)(iii).

Rule 113 is the Department's rule that implements the above exclusion, and provides:

(2) Ingredients or components. The sale of articles of tangible personal property which physically enter into and form a part of a new article or substance produced for sale does not constitute a retail sale. This does not exempt from the retail sales tax the sale of articles consumed in a manufacturing process which do not enter into and become a physical part of the new article produced for sale, such as fuel used for heating purposes, oil for machinery, sandpaper, etc.

(3) Also, the definition of retail sale does not exclude consumables purchased for use in manufacturing, refining, or processing new articles for sale merely because some constituents of the consumables may also be traceable in the finished product, which are impurities or undesirable or unnecessary constituents of the finished product.

(4) For articles to qualify for sales and use tax exemption as ingredients or components of products produced for sale, such articles or their constituents must be traceable in the

³ [The taxpayer's manager] is the Division Manager of the Business Operations Division within the taxpayer's Environmental Services Division and has been in the business of the sales and manufacturing of biosolids products for 26 years. Declaration of [the taxpayer's manager], dated February 5, 2015.

⁴ The taxpayer's Supplemental Hearing Brief at page 2, footnote 1 ("In Determination No. 99-310, 19 WTD 377 (2000), the Department of Revenue held that in the process of turning sewage sludge into a commercial compost, like TAGRO here, the manufacturing process starts at the 'digesters.' *Id.* at 382. The [taxpayer] does not challenge that position here.")

finished product and identifiable as having been directly provided by the article claimed for exemption.

...

Rule 113 provides that to meet the ingredient or component exclusion, the article purchased must become a physical part of the new article produced for sale, must not simply be an impurity or undesirable or unnecessary constituent of the product, and must be traceable in the finished product. Rule 113(2)-(4); *see* Det. No. 92-161, 13 WTD 75, 85 (1993) (where oxygen was consumed in the production of a new product, of which it became a necessary ingredient and traceable in the new product, the taxpayer's purchase of the oxygen was properly exempt from retail sales or use tax). Here, the taxpayer has met the requirements for the exclusion.

The Department has previously instructed the taxpayer that the taxpayer engages in manufacturing a new article produced for sale when it engages in the production of [the mulch-like biosolids product].⁵ This is consistent with prior Department determinations that producing a compost product for sale as a separate activity from general wastewater treatment constitutes manufacturing. *See* Det. No. 99-310, 19 WTD 377, 381 (2000) (a municipality's turning sewage sludge into commercial compost is manufacturing); Det. No. 07-0342, 27 WTD 169, 180 (2008) (a municipality's manufacturing activity begins when waste products are processed separately and treated as a raw ingredient in producing a new biosolid product for sale).

In producing its new article for sale, [the mulch-like biosolids product], the taxpayer introduces LOX at the third stage of the production process and the LOX becomes a physical part of the [mulch-like biosolids product].⁶ The introduction of LOX at this stage is necessary to feed the micro-organisms that eat raw sewage and it is these micro-organisms that ultimately become the biosolids that make up [the mulch-like biosolids product].⁷ The LOX is traceable in the finished . . . product, and it is not an impurity or undesirable or unnecessary constituent of the product;⁸ it is a necessary ingredient in producing the [mulch-like biosolids product].⁹

The taxpayer's purchase of LOX for introduction and use at the third stage of the [mulch-like biosolids product] production process is exempt from retail sales tax, pursuant to RCW 82.04.050(1)(a)(iii) and Rule 113, because it is used in manufacturing a new product for sale and becomes an ingredient or component of the product. The taxpayer's petition is granted and TI&E's tax ruling is overruled consistent with this determination.

DECISION AND DISPOSITION

The taxpayers' petition is granted and TI&E's tax ruling is overruled consistent with this determination.

Dated this 6th day of April, 2015.

⁵ Auditor's Detail of Differences and Instructions to Taxpayer, Audit No. . . . , issued May 2, 2014, at page 3.

⁶ Declaration (Supplemental) of [the taxpayer's manager], dated March 24, 2015.

⁷ *Id.*; Declaration of [the taxpayer's manager], Dated February 5, 2015.

⁸ [Because the LOX is intentionally added to feed the micro-organisms that eat raw sewage, it is not an impurity, but is a necessary constituent of the mulch-like biosolids product.]

⁹ *Id.*