

## Washington's Taxation of Manufacturing — Part 3: Special Issues Relating to the Manufacturing Machinery and Equipment Exemption

10/14/09

In the second part of this series, we provided an overview of the sales and use tax exemptions for manufacturing machinery and equipment used directly in a manufacturing or research and development operation under RCW 82.08.02565 and 82.12.02565 (the "M&E" exemption). See [Washington's Taxation of Manufacturing — Part 2: The Sales and Use Tax Exemption for Manufacturing Machinery and Equipment](#). In general, the M&E exemption applies the purchase and use by a manufacturer or processor for hire of machinery and equipment that is "used directly" in a qualifying "manufacturing operation" or "research and development operation," as well as machinery and equipment used in "testing" for a manufacturer or processor for hire.

Since the enactment of the exemption in 1995, the statutory provisions for the exemption have undergone several amendments, and various controversies have arisen in the interpretation of the M&E exemption in particular contexts, resulting in the Department of Revenue's issuance of a number of administrative determinations and excise tax advisories relating to the exemption. Summarized below are a number of the issues and problems that frequently arise in the application of the M&E exemption.

### Scope of the "Manufacturing Site"

The nature and extent of the "manufacturing site" and whether a particular piece of machinery and equipment falls within the scope of a manufacturing operation has been a source of continuing controversy. In order for machinery and equipment to be eligible for the exemption, it must generally be used within the "manufacturing operation." Under the statute, 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. The term "manufacturing site" is not defined by the statute. However, the Department has interpreted the term "site" as "the location where the manufacturing or testing takes place," which consists of one or more immediately adjacent parcels of real property (including adjacent parcels separated by a public road). The ownership status of the property is not relevant — the parcel or parcels can be owned, rented or leased by the manufacturer. Furthermore, a manufacturing operation may occur in stages and take place at more than one site, and an eligible manufacturing operation may also be performed in whole or in part at a temporary site, using portable equipment.

The scope of the manufacturing site can be a critical factor in determining eligibility of machinery and equipment that is used for an activity that qualifies under one of the "used directly" criteria but does not otherwise constitute manufacturing, such as racks and bins used to store raw materials, forklifts and conveyor belts used to move materials through stages in the manufacturing process, and equipment used to package finished goods prior to shipment.

Machinery and equipment used to engage in these sorts of activities may fall within the scope of the exemption, but only if the activities take place at a manufacturing site. For example, a refrigeration system used to store finished products at the manufacturing site would generally be eligible for the exemption, whereas the same refrigeration system would be ineligible if it was installed in a storage facility located away from the manufacturing site.

## **Buildings, Fixtures and Support Facilities**

Buildings are expressly excluded from the statutory definition of machinery and equipment, except for “machinery and equipment that is permanently affixed to or becomes a physical part of a building.” Likewise, building fixtures that are not integral to the manufacturing operation, such as utility systems for heating, ventilation, air conditioning, communications, plumbing or electrical power, are similarly excluded. However, fixtures and building components may be eligible for the exemption if they qualify as either “industrial fixtures” or “support facilities.” This distinction is largely a function of whether the fixture or building component in question is integral to the manufacturing process as opposed to merely performing an ordinary building function.

An “industrial fixture” is an article of tangible personal property that has been permanently affixed to land, buildings, or other improvements to such an extent that the article is considered part of the real estate. Examples of eligible industrial fixtures include fuel lines, boilers, cranes, conveyor belts and large machines that are permanently attached to real estate. A “support facility” is a component of a building, structure, or improvement that is used to contain or steady an industrial fixture or device and is specially designed and necessary for the proper functioning of the fixture or device. An example of an eligible support facility is a vibration reduction slab installed under a microchip clean room that is specially designed to ensure the proper functioning of equipment used within the room.

## **Research and Development Operations**

For purposes of the M&E exemption, a “research and development operation” involves activities of a manufacturer performed for the discovery of “technological information, and technical and non-routine activities concerned with translating technological information into new or improved products, processes, techniques, formulas, inventions or software.” Research and development does not include adapting or duplicating existing products that are not substantially improved by application of the technology, or activities such as market research, quality control, computer software developed for internal use or research regarding customer preferences. Machinery and equipment is considered “integral” to a research and development operation if the activity cannot be accomplished without it. As such, the scope of the exemption for machinery and equipment used for research and development is broader than M&E used for general manufacturing purposes because it encompasses items that would not otherwise satisfy any of the criteria under the “used directly” requirement. For example, tables, chairs, telecommunications equipment, and computer hardware and software used by personnel engaged in research and development would be eligible for the exemption, even though such items may not otherwise satisfy any of the “used directly” criteria.

## **Computers, Networks and Software**

Computers qualify for the M&E exemption if they are used directly in a qualifying manufacturing or research and development operation. Likewise, a computer system and its various components, including computer software, may qualify for the M&E exemption if the computer system functions as an integrated unit (*i.e.*, the components of the system are linked through a series of steps and processes) and all of the components are integral and used directly in the manufacturing operation. With respect to computer software, the determinative issue is whether the software performs a task or series of tasks in relation to the manufacturing or research and development process, such as controlling, regulating, monitoring or otherwise interacting with machinery and equipment.

For example, computer software that is used to control the operation of machinery and equipment used to manufacture cabinets would be eligible for the M&E exemption, whereas computers and AutoCAD software used to generate drawings and specifications for the same operation would be ineligible. Likewise, computer software applications used to perform tasks that support the overall operation but are not directly related to the manufacturing or research and development process — such as accounting or inventory control software — are not eligible for the exemption. To the extent that computer systems are used for both qualifying and non-qualifying purposes, eligibility depends on whether the qualifying use satisfies the Department’s majority use text, which permits the exemption if the qualifying use is greater than 50 percent.

## **Rental of Equipment with Operator**

Since the lease or rental of tangible personal property is included within the statutory definition of a “sale,” the M&E exemption applies to charges for the lease or rental of machinery and equipment that would otherwise qualify for the exemption if it were purchased outright by a manufacturer. However, it is important to distinguish between a bare rental or “true lease” of machinery and equipment and the provision of machinery or equipment along with an operator. For sales and use tax purposes, the rental of equipment with an operator is deemed to be the sale of a service rather than a sale of tangible personal property. As such, charges for the rental of equipment with an operator are generally ineligible for the M&E exemption.

## **Electrical Apparatus and Utility Systems**

The electrical apparatus and utility systems of a manufacturing facility are generally not eligible for the exemption if they serve an ordinary building purpose and do not satisfy one of the statutory criteria for the “used directly” requirement. For example, a power substation used to distribute electrical power used throughout an entire manufacturing site (*i.e.*, administrative offices and parking lots, etc.), would not be eligible for the M&E exemption. However, electrical apparatus such as motor control centers, starters, switches, circuit breakers and regulators used to provide power to regulate or control other eligible machinery and equipment may qualify for the exemption in their own right. For example, converters, transformers and other on-site equipment that alter the characteristics of the electricity used by qualifying machinery and equipment will typically satisfy the “used directly” requirement by “producing power” for machinery and equipment.

## **Equipment Used for Product Design and Development**

Computers and other equipment used for product design and development purposes are generally ineligible for the M&E exemption. Product design and development involves activities such as drafting, engineering, and other analytical and creative tasks that either precede or are separate from the manufacturing operation itself, and as such, fail to meet any of the criteria for the “used directly” requirement. Furthermore, the Department has taken the view that product design and development activities do not generally constitute research and development.

## **Pollution Control Equipment**

The M&E exemption extends to pollution control equipment that is installed and used in a qualifying manufacturing operation to “prevent air pollution, water pollution, or contamination that might otherwise result” from the operation. For purposes of the exemption, the Department has interpreted the term “contamination” as any degraded liquid, gaseous or solid substance. As a result, while equipment used to prevent thermal pollution caused by the release of water used in the manufacturing operation would qualify, noise control or abatement equipment is ineligible for the exemption. Furthermore, the Department has interpreted the statutory phrase “that might otherwise result” as embracing pollution control equipment necessary to protect the public interest by reducing environmental hazards. As such, if pollution control equipment is required by law or as a condition of a permit, the Department will assume that equipment is eligible provided that all the other conditions for exemption are met. In this regard, the exemption is not limited to pollution control that is required to prevent pollution or contamination of the external environment, but also includes equipment used to prevent or control the release of contaminants within the workplace.

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