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Washington's Taxation of Manufacturing — Part 2: The Sales and Use Tax Exemption for Manufacturing Machinery and Equipment

In the first part of this series, we provided an overview of the Washington state tax consequences of engaging in manufacturing activities in Washington: *see* [Washington's Taxation of Manufacturing — Part 1](#). Businesses engaged in manufacturing typically make significant capital investments in machinery and equipment. Fortunately, Washington law provides manufacturers with a broad exemption from sales and use taxes for machinery and equipment used directly in a manufacturing operation (“M&E exemption”). The M&E exemption applies to the purchase and use by a manufacturer or processors for hire of machinery and equipment that is used directly in an eligible manufacturing operation. The exemption also applies to machinery and equipment used directly in testing a manufacturer's or processor for hire's tangible personal property, as well as machinery and equipment that is integral to a research and development operation. This article provides an overview of the requirements for qualifying for the M&E exemption, which can significantly reduce the state tax costs of manufacturing.

Basic Requirements of the M&E Exemption

The M&E exemption applies to the purchase and use of: (1) **“machinery and equipment,”** (2) that is **“used directly,”** (3) in an eligible **“manufacturing operation,” “testing operation,” or “research and development operation.”** Each of these requirements is discussed in turn below.

Definition of Machinery and Equipment

The M&E exemption applies to the purchase and use of “machinery and equipment,” which is limited to items that fall within one of the following statutorily defined categories:

- *Devices:* A “device” is defined as tangible personal property that is not attached to a building or underlying land, including items such as forklifts, saws, drills, lathes, air compressors, clamps, shelving, certain types of software, ladders, wheelbarrows and pulleys.
- *Industrial Fixtures:* An “industrial fixture” means tangible personal property that is affixed to a building or land to such a degree that it is considered part of the real estate, such as conveyor belts, cranes, presses, scaffolding, fuel lines, blast furnaces, boilers, and other heavy machinery and equipment.
- *Support Facilities:* A “support facility” refers to a part of a building or other structure or improvement to real property that is used to contain or steady an industrial fixture or

device, such as a concrete slab upon which an industrial fixture is affixed or a vibration reduction slab in a microchip assembly operation. For a structure or improvement to qualify as a support facility, it must be specially designed and necessary for the proper functioning of an industrial fixture or device.

Expressly Excluded Items

The following items are expressly excluded from eligibility for the exemption:

- *Property with a useful life of less than one year:* The exemption does not apply to tangible personal property with a useful life of less than one year, including repair parts and replacement parts. As such, saw blades, drill bits, filters, and similar items that are consumed or replaced more frequently than once a year are generally ineligible for the exemption, even if they become component parts of machinery and equipment.
- *Hand-powered tools:* Screwdrivers, hammers, shovels, brooms, clamps, wrenches and other hand-powered tools are ineligible for the exemption. (Note, however, that electrically powered tools, such as cordless drills, are not considered hand-powered tools, nor are calipers or other measuring devices.)
- *Buildings and building fixtures:* The components of buildings used to house a manufacturing operation (*e.g.*, the ceiling, floor and walls of a manufacturing facility) and ordinary building fixtures (*e.g.*, utility fixtures that provide light, heat, ventilation, air conditioning, telecommunications, water, plumbing or electricity) are ineligible for the exemption if they only serve ordinary building purposes, are not integral to a manufacturing, testing, or research and development operation, and do constitute industrial fixtures or support facilities (discussed above).

The “Used Directly” Requirement

Eligibility for the M&E exemption is limited to machinery and equipment that is “used directly” in a manufacturing, testing, or research and development (“R&D”) operation. In order to meet the used directly requirement, the use of the machinery and equipment must satisfy at least one of the following eight statutory tests:

1. *Acts upon or interacts with an item of tangible personal property:* Examples include drills, saws, lathes, presses, steel rolling machines, cement mixers, rock crushing equipment, and other items used to fabricate or alter tangible personal property. Computers and/or software used to direct or control machinery or equipment that acts upon or interacts with tangible personal property may qualify under this criterion as well.
2. *Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or the testing site:* Examples include conveyor belts, forklifts, pallet jacks, tanks, vats, robotic arms, piping and concrete storage pads. 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, but do not constitute manufacturing in and of themselves, are not within the scope of the exemption unless they take place at a manufacturing site.

3. *Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at or away from the site:* Machinery and equipment used to take readings or measurements is eligible under this test. Additionally, machinery and equipment used for testing purposes qualifies even if it is used “away from the site” (e.g., field testing of prototypes).
4. *Provides physical support for, or access to, tangible personal property:* Examples of eligible items include stairs, platforms, ladders, and catwalks adjacent to and necessary for accessing machinery and equipment, as well as items such as scaffolding surrounding tanks, braces used to support vats, and brackets for affixing machinery and equipment.
5. *Produces power for or lubricates machinery and equipment:* Examples include devices or industrial fixtures used to provide electricity, fuel, lubrication, coolant, etc., to one or more specific pieces of machinery and equipment (e.g., power cables, fuel lines, pumps, hoses, oil guns and meters). Thus, while a generator used to provide power to a specific piece of equipment might qualify for the exemption, a power plant that provides electricity to an entire manufacturing facility would generally be ineligible.
6. *Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation:* Items falling within this criterion include machinery and equipment used to fabricate dies, jigs, castings and molds for subsequent use in a manufacturing operation.
7. *Places tangible personal property in the container, package or wrapping in which the tangible personal property is normally sold or transported:* This criterion covers machinery and equipment used for packaging tangible personal property prior to shipment from the manufacturing operation. Note that the activity of packaging does not constitute manufacturing in and of itself; thus, the packaging operation must be integral to a manufacturing operation in order to be eligible for the exemption.
8. *Is integral to research and development as defined in RCW 82.63.010:* For purposes of a research and development operation, machinery and equipment will be deemed to be used directly so long as it is “integral” to the R&D operation, meaning that it is necessary for some aspect of the R&D operation to occur.

The “Majority Use” Threshold

Although the statute does not expressly address the treatment of machinery and equipment used both for qualifying and non-qualifying purposes, the Department of Revenue’s Rule 13601 provides that dual-use machinery and equipment is eligible for the exemption only if the majority of its use is for a qualifying purpose. For example, ready-mix concrete trucks have been held to satisfy the majority use requirement provided that the majority of their use was to mix cement and aggregate at the plant, rather than to transport and deliver concrete to the customer. Majority use can be measured based on the following ratios: the time that the machinery and equipment is used for qualifying and non-qualifying purposes, the amount of value produced by qualifying and non-qualifying uses, and the volume of output produced by qualifying and non-qualifying uses.

Eligible Manufacturing, Testing, or R&D Operations

The exemption is further limited to machinery and equipment that is purchased for and used directly in an eligible “manufacturing operation,” “testing operation,” or “research and development operation,” as those terms are defined under the statute and rule.

“Manufacturing operation”

Defined as the manufacturing of articles, substances or commodities for sale as tangible personal property. A manufacturing operation begins when raw materials enter the manufacturing site and ends when the processed material leaves the manufacturing site, and includes the storage of raw materials, work-in-progress materials and finished materials at the manufacturing site. Activities that may satisfy one or more of the criterion for the "used directly" requirement but do not constitute manufacturing in and of themselves (*e.g.*, storing raw materials, work-in-progress and finished goods; sorting, packaging and preparing finished goods for transportation) are eligible for the exemption only if the activities take place at the manufacturing site.

“Testing operation”

Refers to testing tangible personal property for a manufacturer or processor for hire and consists of activities performed to establish or determine the properties, qualities and limitations of tangible personal property. A testing operation begins at the point where the tangible personal property enters the testing site and ends at the point where the tangible personal property leaves the testing site. The statute expressly allows testing that occurs away from the manufacturing site (*e.g.*, performing field tests of a vehicles, vessels or aircraft produced by a manufacturer).

“Research and development operation”

Includes activities by a manufacturer or processor for hire that fall within the definition of "research and development" under RCW 82.63.010. Generally, R&D is limited to performing non-routine technical activities for the discovery of technological information, or to translate technological information into new or improved products, processes or techniques. R&D does not include activities to adapt or duplicate existing products that do not involve substantial improvements through the application of technology, nor does it include surveys and studies, social science and humanities research, market research or testing, quality control, sales promotion and service, the development of computer software for internal use, or research regarding the style, taste and seasonal preferences of consumers.

Process for Qualifying for the Exemption

In contrast to most other Washington tax incentives, no application or prior approval from the Department of Revenue is required to claim the M&E exemption. Instead, the manufacturer is required to provide the vendor of the machinery and equipment with a completed Manufacturers’ Sales and Use Tax Exemption Certificate, which the vendor must maintain in order to substantiate that the transaction was exempt from sales tax. The manufacturer may also be required to substantiate its eligibility for the exemption in the event of an audit and can be liable for deferred sales tax, interest and penalties if the exemption is disallowed. As such, a

manufacturer should consider requesting a letter ruling from the Department of Revenue in advance of purchasing machinery and equipment, especially if eligibility for the exemption is uncertain and the potential tax exposure is significant.

Conclusion

With proper planning, the M&E exemption can significantly reduce the state tax costs of establishing and maintaining a manufacturing operation in Washington. However, qualification for the exemption requires careful adherence to the conditions for eligibility imposed by the statute and rule.

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