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Court of Appeals
Division II
State of Washington

No. 501031-II

IN THE COURT OF APPEALS, DIVISION II,
OF THE STATE OF WASHINGTON

SOLVAY CHEMICALS, INC.,
Plaintiff/Appellant,

v.

STATE OF WASHINGTON,
DEPARTMENT OF REVENUE,

Defendant/Respondent.

APPELLANT'S REPLY BRIEF

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I. INTRODUCTION

The statutory language, the Department of Revenue's rule, and its excise tax advisory ("ETA") all support Solvay's position that the machinery and equipment ("M&E") exemption applies to all items that perform a task in a manufacturing operation, unless expressly excluded. It is undisputed that the working solution and its chemical components perform a number of tasks in Solvay's manufacture of hydrogen peroxide and are not expressly excluded. Therefore, they fall squarely within the scope of the exemption.

In its brief, the Department of Revenue provides no clear or consistent explanation of the scope of the exemption and why the working solution does not fall within that scope. Rather the Department urges the Court to ignore the statutory definition of "machinery and equipment," and limit the scope of the exemption to an ill-defined "common understanding" of the terms "machinery" and "equipment."[1]

Even under the Department's "common understanding" interpretation, there is no meaningful analysis of why the working solution and its chemical components do not fall within the scope of the Department's reading of the statute. Indeed, decisions from other states that perform a meaningful analysis of the terms "machinery" and "equipment"

[1] Corrected Brief of Respondent ("Resp. Br.") at 27.

show that long-lasting chemicals used in a manufacturing process fall squarely within the scope of these terms, even in the tax exemption context.

The Department's brief also fails to address the unambiguous statements in its ETA that the test of whether items fall within the scope of "machinery and equipment" in an industrial setting is whether or not they "do work and have an applied function." ETA 3121, CP 203-04. In describing the scope of the term "device," which is expressly included in the exemption, the Department stated:

> In order to be eligible as a device the property has to perform a task and do work. …
>
> *Computer software satisfies Rule 13601's definition of device because it is [sic] performs a task* and is also not attached to a building or site. Consequently, computer software can qualify for the M&E exemption if it meets a used directly test. *The issue is whether the computer software performs a task in relation to the qualifying operation.*

ETA 3121, CP 204 (emphasis added).

This interpretation of "the phrase 'machinery and equipment' … within the context of an industrial setting" is consistent with the rule and the statutory language. *Id.* Yet, the Department makes no attempt to reconcile its own interpretation of the statute, as set forth in the ETA, with its bald assertion in its Response Brief that the chemicals at issue "do not fit with any ordinary understanding of the terms 'machinery and equipment,' 'fixture,' or 'device.'" Resp. Br. at 19. Because the chemicals at issue

perform a task in the manufacturing process, they fall squarely within the scope of the terms "machinery and equipment" and "device" under even the Department's own subjective view. As such, the chemicals at issue qualify for the M&E exemption.

II. ARGUMENT

A. The Court Should Interpret The Statute In A Manner That Is Consistent With The Legislative Intent, Not In The Narrowest Possible Manner.

While the Department makes a number of assertions that Solvay broadly interprets the statute, it does not show how this interpretation is unreasonable or conflicts with the express statement of legislative intent adopted as part of the statute. The primary objective of statutory construction is "'to ascertain and carry out the intent of the Legislature.'" *HomeStreet, Inc. v. Dep't of Revenue*, 166 Wn.2d 444, 451, 210 P.3d 297 (2009) (citation omitted). The Department acknowledges this concept, but fails to apply it in this case. *See* Resp. Br. at 14. Rather, the Department picks and chooses the narrowest possible readings of the narrowest definitions, without regard to the larger context. For example, the Department acknowledges that the term "equipment" has a wide range of definitions, but does not discuss how its narrow reading of its cited definition better aligns with the express statement of legislative intent and statutory context than the definition of "equipment" cited by Solvay. *Id.* at 17.

1. The Department's ignores the common and ordinary meaning of "equipment" that is consistent with the statutory context.

As explained in Solvay's opening brief, when the M&E exemption was passed, the common and ordinary meaning of "equipment" included "all the fixed assets other than land and buildings of a business enterprise." Brief of Appellant ("App. Br.") at 12. This definition aligns almost perfectly with the statutory definition of "machinery and equipment," which includes industrial fixtures, devices, support facilities, and digital goods, but excludes buildings and property with a useful life of less than a year. *See* RCW 82.08.02565(2)(a)-(b).

Courts in other states, analyzing the scope of their states' M&E exemptions, have also noted that this is the most relevant definition of "equipment" in a business setting. *See Walsworth Publ'g Co. v. Dir. of Revenue*, 935 S.W.2d 39, 40 (Mo. 1996) ("In a business setting, one dictionary definition of 'equipment' clearly applies: 'all the fixed assets other than land and buildings of a business enterprise.'" (citation omitted)); *State ex rel. Ariz. Dep't of Revenue v. Capitol Castings, Inc.*, 193 Ariz. 89, 94, 970 P.2d 443 (Ct. App. 1998) (portion of "equipment" definition "that is most relevant in a business setting—the 'fixed assets' of a business enterprise other than land and buildings").

On the other hand, the Department's assertion that the term "machinery and equipment" is limited to "machinery or tools" conflicts with

the statutory definition. *See* Resp. Br. at 17. "Industrial fixtures" are listed as part of the statutory definition, but items such as fuel oil lines and concrete slabs are not "machinery or tools." They do not change, transmit, or direct applied forces to accomplish an objective, nor do they fall within the Department's view of what constitutes a tool.[2] Likewise "support facilities" and "digital goods" are also part of the statutory definition, but do not fall within the narrow view of "machinery or tools" urged by the Department. "Support facilities" do not "change, transmit, or direct applied forces," and "digital goods" are not a "system of rigid bodies." Thus, the Legislature could not have intended the term "machinery and equipment" to be limited to the Department's crabbed reading of those terms.

Further, the Department's circular method of interpretation essentially reads the statutory definition out of the statute and limits the exemption to a narrow reading of the terms "machinery" and "equipment." This reading should be rejected, as it is completely contrary to the holding in *Amalgamated Transit Union Local 587 v. State*.[3] In *Amalgamated Transit*, the court held that "an enactment's definition of a term prevails over a dictionary definition or common understanding of a term." 142 Wn.2d at

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[2] To the extent the Department does assert that these items fall within the definition of "machinery or tools" because they serve a function or accomplish an objective, such a definition would encompass the working solution as well.

[3] 142 Wn.2d 183, 11 P.3d 762 (2000), *as amended* (Nov. 27, 2000), *opinion corrected*, 27 P.3d 608 (2001).

220. The court reasoned, "[i]t would be unnecessary to define the term if it had its common meaning, and, if the term has its common meaning, the definition is superfluous." *Id.* As such, it is inappropriate to determine the scope of the exemption based on narrow and isolated readings of the terms "machinery" and "equipment."

The Department argues that Solvay's interpretation of the exemption reads the term "machinery and equipment" out of the statute. Resp. Br. at 25. This argument is illogical, as Solvay's reading of the statute expressly incorporates the dictionary definition of "equipment," which includes "all the fixed assets other than land and buildings of a business enterprise." App. Br. at 18; *Webster's Third New International Dictionary* 768 (1993). Under this definition, and the express language of the statute, items with a useful life of less than a year, along with the land and buildings are excluded from the definition of "machinery and equipment." RCW 82.08.02565(2)(b). Therefore, the term "machinery and equipment" has a significant role in determining the scope of the exemption under Solvay's reading of the statute and is not rendered superfluous.

Moreover, Solvay's reading of the statute is consistent with the Legislature's express inclusion of "digital goods" in 2009. Solvay admits that the term "device" is limited to items that perform a task. App. Br. at 13. Because "digital goods" are merely pieces of digital information that do not

perform a task,[4] they did not fall within the definition of "device" or any of the other listed terms and had to be added. *See* ETA 3121 at 2, CP 204(stating that CD-ROM of a repair manual does not qualify for M&E exemption because it does not perform a task).

2. The holding in *Bowie* supports Solvay's position when the appropriate "common and ordinary" meaning of "equipment" is used.

Despite the Department's arguments regarding *Bowie* v. *Dep't of Revenue,*[5] the holding in that case actually supports Solvay's reading of the statute, not the Department's. In *Bowie*, the court was reading the term "publication" in light of the language of the statute and its understanding of the legislative intent. 171 Wn. 2d at 12-13. The court concluded that the term "publication" in the context of the statute did not include all printed material because it was used in reference to the term "periodical" and the Val-Pak envelopes could not fit in any common understanding of that term. *Bowie*, 171 Wn. 2d at12.

Here, the common understanding of "equipment" includes "all the fixed assets other than land and buildings of a business enterprise." *Webster's Third New International Dictionary* at 768. This definition aligns

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[4] *See* RCW 82.04.192(6) (defining digital good as "sounds, images, data, facts, or information," but excluding "computer software," which is defined as a set of coded instructions that cause a computer to perform a task).

[5] 171 Wn.2d 1, 248 P.3d 504 (2011).

almost perfectly with the statutory definition, encompassing all of the specifically included asset categories and excluding almost all of the specifically excluded asset categories and is consistent with the express statement of legislative intent to encourage investment by Washington manufacturers. *See* App. Br. at 11. To adopt a reading of the term "equipment" that would exclude a majority of the specifically listed items in the statutory definition and frustrate the express statement of legislative intent, fails to read that term in the context of the statute. Moreover, the Department cannot pick and choose which items listed in the statutory definition must be read in a light that limits them to a narrow definition of "equipment" and which items are not.

The Department's rule implementing the exemption, WAC 458-20-13601 ("Rule 13601"), also shows it understood that the Legislature intended the term "equipment" to include "all the fixed assets other than land and buildings of a business enterprise." *Webster's Third New International Dictionary* at 768. This is the only way to explain why the Department defined "device" and "industrial fixture" to include all "items" between the two of them. Rule 13601(2)(c)-(d).

The Department argues that the examples in the rule show a more limited interpretation of the statute, but this is flatly contradicted by the plain language of Rule 13601 and the Department's own ETA interpreting the scope of the term "device." If the term "device" were limited to items

that are "systems of rigid bodies" as the Department asserts,[6] then it would be inappropriate to list "software" as an example, as it is clearly not a system of rigid bodies. Moreover, as the Department notes in its own ETA, the common thread in all of the examples of "device" in Rule 13601 is that they "do work and have an applied function." CP 204. This is consistent with the general definition of "device" as "a contrivance or invention serving a particular purpose"[7] and does not evidence an intent to draw a more limited interpretation of the term "device." For these reasons, the Department's reading of the statute in this case is unreasonable and should be rejected.

3. The "chemicals used in processing" exemption is not relevant to the scope of the M&E exemption.

The Department argues that the M&E exemption should be read to exclude all chemicals because there is a different exemption for chemicals used in processing. Resp. Br. at 29. While there is a "chemicals used in processing" exemption, there is nothing in the statutory language or Washington law that prevents an item from falling within two separate exemptions. In fact, "digital goods" are expressly exempt under the M&E exemption, but they are also exempt under RCW 82.08.02087 if they are purchased for a "business purpose." *See* RCW 82.08.02565(2)(a); RCW

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[6] Resp. Br. at 17.

[7] *See* CP 204 (citing *American Heritage Dictionary of the English Language* (4th ed. 2000)).

82.08.02087. "Business purpose" is defined as "any purpose relevant to the business needs of the taxpayer claiming an exemption under this section." RCW 82.08.02087(3)(a). Under this definition, it is hard to see how a digital good would qualify for the M&E exemption, but not the "business purpose" exemption. Therefore, it is apparent that the Legislature was not concerned with tying the M&E exemption to other exemptions. Additionally, the Department has not pointed to any evidence that the Legislature intended to take the scope of other exemptions into account when it passed the M&E exemption.

Moreover, the "chemicals used in processing" exemption has a very different scope than the M&E exemption. The M&E exemption only applies where the asset has a useful life of more than a year, while there is no similar restriction for the "chemicals used in processing" exemption. *Compare* RCW 82.08.02565(2)(b)(ii) *with* RCW 82.04.050(1)(a)(iii). Therefore, there are many chemicals that would qualify for the "chemicals used in processing" exemption, but not the M&E exemption, because the chemicals are consumed in the manufacturing process and do not have a useful life of more than a year. As such, Solvay's reading of the M&E exemption does not render the "chemicals used in processing" exemption meaningless.

4. The rule of statutory construction that exemption statutes are construed strictly against the taxpayer does not apply because the statute is not ambiguous.

While it is true that exemptions are construed strictly against the taxpayer, this rule of statutory construction only applies "if there is ambiguity in a provision providing an exemption or deduction." *Avnet, Inc. v. Dep't of Revenue*, 187 Wn.2d 44, 50, 384 P.3d 571 (2016) (citing *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 3 P.3d 741 (2000)). Here, the Department has not shown how the statute is ambiguous. *See HomeStreet*, 166 Wn.2d at 452 ("A statute is ambiguous if 'susceptible to two or more *reasonable* interpretations,' but 'a statute is not ambiguous merely because different interpretations are conceivable.'" (emphasis added; citation omitted)).

The dictionary definitions of "device" and "fixture" cited in Solvay's opening brief are consistent with, and in many cases parrot, the definitions cited by the Department in Rule 13601 and ETA 3121. These definitions focus on whether an item performs a task or has an applied function. This focus is consistent with the legislative intent to decrease the sales taxes paid by manufacturers and incentivize them to invest in modernizing their manufacturing operations in Washington. Laws of 1995, 1st Spec. Sess., ch. 3, § 1. These definitions are also consistent with the only common understanding of the term "equipment" that makes sense in the context of the statute.

In fact, the Department does not appear to dispute Solvay's reading of the terms "fixture" or "device." *Compare* App. Br. at 17-18 *with* Resp. Br. at 15. The definitions cited in both briefs are the same, and the Department acknowledges that the ordinary meaning of both terms is "a mechanism designed to serve a special purpose." Resp. Br. at 15. Therefore, there is no ambiguity in the scope of the statute that must be strictly construed against the taxpayer.

B. The Working Solution Falls Within The Definition Of "Machinery And Equipment" Even Under The Department's Unreasonable Reading Of The Statute.

Despite a number of bald assertions that the working solution and its chemical components do not fall within the common understanding of the terms "fixture," "device," "machinery," or "equipment," the Department fails to provide a cogent analysis supporting this position.[8] Resp. Br. at 18.

1. The working solution falls within the definitions of "fixture" and "device."

As noted above, the Department admits that the ordinary meaning of the terms "fixture" and "device" is "a mechanism designed to serve a special

[8] The Department seems to imply that the functions of the ASG and DC should be analyzed on their own as it is only the purchases of these chemicals at issue. Resp. Br. at 4. Because the Department has already allowed a sales tax exemption for the palladium and the AQ as chemicals used in processing, there is no need to challenge the taxation of these purchases. However, this does not matter as the ASG and DC are indisputably an "ingredient or component" of the working solution. CP 206. Therefore, the working solution is the appropriate item to analyze, as the chemical components of the working solution are exempt if the working solution falls within the definition of "machinery and equipment." *See* RCW 82.08.02565(2)(a) (defining "machinery and equipment" to include items that become an ingredient or component of other qualifying items).

purpose." Resp. Br. at 15. However, the Department provides no analysis of why the working solution does not meet this definition. Remarkably, the Department even admits that "the ASG and DC chemicals serve a purpose in Solvay's manufacturing process." Resp. Br. at 20. Here, the working solution is a mechanism that serves a special purpose in the manufacturing process. CP 206-208. Therefore, it falls within the ordinary meaning of "fixture" and "device."

The Department attempts to avoid this obvious result by arguing that the Court should not stop at the ordinary meaning of "device" or "fixture," but must read these terms in light of the term "machinery and equipment." Resp. Br. at 15. Through this analysis, the Department reads the terms "device" and "fixture" out of the statute, asserting that the working solution must meet its chosen definition of "machinery" and "equipment." *See* Resp. Br. at 17. As shown above, this is an unreasonable reading of the statute. However, even if this were a correct reading of the statute, the Department fails to provide a persuasive analysis of why the working solution does not fall within these definitions.

2. The working solution falls within the definitions of "machinery" and "equipment."

The sole reason given by the Department for why the working solution and its chemical components do not fall within the scope of "machinery" and "equipment" is that they are not a "system of rigid bodies."

Resp. Br. at 17. However, a fair reading of the "machinery" and "equipment" definitions does not limit either of these terms to a "system of rigid bodies." Moreover, the Department's argument in this case directly conflicts with its interpretation that software qualifies for the exemption.

The definition of "machinery" cited by the Department states that it is "a system, usu. of rigid bodies, constructed and connected to change, transmit, and direct applied forces in a predetermined way to accomplish a particular object, as performance of useful work." Resp. Br. at 17. The definition itself expressly acknowledges that there are instances where the system will be composed of non-rigid bodies. The fact that machinery can include non-rigid bodies, such as fluids, is apparent from the other definition of "machinery." "Machinery" is also defined as "machines functioning as a unit." The term "machine" is in turn defined as "an assemblage of parts that are usu. solid bodies but *include in some cases fluid bodies* ... that transmit forces, motion, and energy one to another in some predetermined manner and to some desired end." *Webster's Third New International Dictionary* at 1353 (emphasis added). The definitions of both "machine" and "machinery" turn on whether the system or collection of parts is performing useful work, not the form that system takes. This is supported by the Department's own ETA, which focuses on whether the item is performing a task, and says nothing about the form or physical attributes of the item.

The Department attempts to remedy its inconsistent positions by asserting that "software" only qualifies when it is a mechanism to control other qualified machinery. Resp. Br. at 19. This is completely false, as ETA 3121 specifically states that software qualifies when it "performs a task." CP 204.[9] While controlling other machinery is listed as an example, this does not mean it is the only circumstance in which software will qualify. In fact in a separate ETA adopted the same day, the Department notes that using a computer system to lay out a newspaper qualifies for the M&E exemption. ETA 3125, Appendix A. As such, the software that is used to perform the layout would be exempt even though it is not directly controlling another piece of machinery.

Here, the working solution and its components are a system constructed to change, transmit, and direct chemical and physical forces in a predetermined way to manufacture hydrogen peroxide as well as convey the raw materials and finished product through the manufacturing process. CP 206-208.

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[9] Even if the Department were correct, the working solution would still qualify as it controls the operation of the reactor units. The working solution governs how the chemical reactions occur and how the hydrogen peroxide is extracted. CP 206. Additionally, a reactor unit is not a "reactor" until it is filled with working solution. CP 207. The working solution operates in conjunction with the reactor vessel to create the reactor unit. *Id.* This is no different than loading software onto a milling machine to make it function. Both the software and the physical drill bits work together to form an operational unit that performs the work.

Decisions in other states further support this result. In *Arizona Dep't of Revenue v. Cyprus Sierrita Corp.*, the court acknowledged that certain chemicals fell within the definition of "machine," and were exempt from tax as "machinery and equipment," because "they are an integral part of a complicated process, acting in predetermined manners to obtain a specific desired result." 177 Ariz. 301, 303, 867 P.2d 871 (Tax Ct. 1994). This holding was reaffirmed by the Arizona Supreme Court in *Arizona Dep't of Revenue v. Capitol Castings, Inc.*, in which the court noted that "whether an item qualifies as 'machinery and equipment' must be considered in light of the second element of the exemption, that it be 'used directly' in a manufacturing… process." 207 Ariz. 445, 450, 88 P.3d 159 (2004). The court went on to note that "it does not seem logical that two items performing the same function, but composed of different materials, should be treated differently for purposes of the exemption." *Id.* at 451 n.4.

Here, the working solution and its chemical components are the key items that are used to manufacture hydrogen peroxide to move the raw materials through the working solution loop. Accordingly, they are integral to obtaining the desired result and perform functions just like any other machinery and equipment.

In *Weiss v. Chem-Fab Corp.*, the Arkansas Supreme Court held that milling chemicals used to shape aircraft parts fell within the definition of "equipment" because they were "implements." 336 Ark. 21, 26, 984 S.W.2d

395 (1999). The court noted that the chemicals "serve as instruments or tools to soften metal or to mill away excess metal." *Id.* Like the milling chemicals in *Chem-Fab*, the working solution at issue is an instrument or tool to create hydrogen peroxide and convey the raw materials through working solution loop. CP 65 (working solution conveys hydrogen from hydrogen reactor to next step); CP 207-208 (working solution performs the chemical reactions to form hydrogen peroxide).

For these reasons, the working solution and the chemical components qualify for the exemption even under the Department's definitions of "machinery" and "equipment."

C. The Department's Reading Of The Term "Ingredient Or Component" Is Strained And Creates Absurd Results.

The Department asserts that fluid bodies contained in a piece of machinery or equipment are not components or a part of the machinery or equipment. The Department goes so far as to say that refrigerants in an air conditioner and mercury in a thermometer are not part of that equipment. Resp. Br. at 23. This is a strained reading of the statute that leads to absurd results and, therefore, should be rejected.

The Department asserts that the term "ingredient and component" is something that enters into and becomes part of an "industrial fixture" or "device." Resp. Br. at 20. While a slightly different wording than the dictionary definition of "component," which is defined as "a constituent

part," this is not an unreasonable interpretation. *See* App. Br. at 19. However, the Department's application of that definition is completely unreasonable. Rather than looking at the equipment as a whole, the Department divides up the equipment into individual components and asks if the fluid is part of that constituent part. *See* Resp. Br. at 22 ("Mercury does not become part of the glass bulb, and refrigerants do not enter into and become part of the pipes valves, or compressor in an air conditioner.").

Applying the Department's logic to other contexts demonstrates the absurdity of its position. Under the Department's reading, down would not be part of a pillow because it is not part of the pillowcase, acid would not be part of a battery because it is not part of the plastic shell, and liquid crystals would not be part of an LCD TV or monitor as they are not part of the glass or plastic sheets that encase them. These are clearly absurd results that the Legislature did not intend.

The proper analysis is whether the fluids enter into and form a functional piece of the assemblage of parts making up the machinery. The fact that fluids can be a part of machinery and equipment is clearly demonstrated by the common meaning of "machine." A "machine" is "an assemblage of parts that are usu. solid bodies but *include in some cases fluid bodies* … that transmit forces, motion, and energy one to another in some predetermined manner and to some desired end." *Webster's Third New*

International Dictionary at 1353 (emphasis added). Thus, fluid bodies can clearly be a part of a machine.

This plain reading of the term "component" and "part" is supported by decisions in other states and the Department's prior guidance to manufacturers. In *Chevron U.S.A. Inc. v. Arizona Dept. of Revenue*, the Arizona Department of Revenue agreed that hydraulic oils and transmission fluids were part of the mining equipment. 238 Ariz. 519, 520, 363 P.3d 136 (Ct. App. 2015). The court went on to conclude that the greases and lubricants were also exempt as part of the machinery and equipment.

This is consistent with the historic guidance the Department provided to manufacturers that lubricants lasting more than a year are considered tangible personal property that becomes an ingredient or component of the equipment or industrial fixtures.[10] This language had been in the Department's Manufacturing Industry Guide since 2013, but in response to Solvay's January 2017 motion for summary judgment in this case, the Department removed the term lubricants from the list of components. CP 247 (showing Jan. 9, 2017 download date); CP 318. The Department provided no explanation for the change other than the bald assertion that "lubricants are not devices and do not become ingredients or

[10] *See* CP 247 (M&E exemption applies to "[t]angible personal property that becomes an ingredient or component of [industrial fixtures, devices, or support facilities], including repair and replacement parts, *lubricants*, etc., with a useful life of one year or more." (emphasis added)).

components of machinery and equipment." CP 318, 342. There was no analysis showing why lubricants are not ingredients or components.

Given the fact that this had been the Department's position for almost four years, and that it only changed that position in response to Solvay's motion for summary judgment, there is little reason to believe that the Department's current position is consistent with the plain language of the statute or the intent of the Legislature.

The working solution is a functional part of the reactor units and the working solution loop. By arguing that the working solution is not part of reactors, pumps, and pipes, the Department ignores the fact that the working solution loop operates as a single unit like an air conditioner or a thermometer. Thus, the working solution is more than just a part of Solvay's manufacturing process, it is a functional and integral part of a single machine (the working solution loop) that processes hydrogen and oxygen to create hydrogen peroxide. Therefore, the working solution is a component of the working solution loop and exempt as a component of an industrial fixture.

D. The Statute Does Not Require Solvay To Prove That It Provided Sellers With An Exemption Certificate To Qualify For The M&E Exemption.

The Department also asserts that Solvay does not qualify for the exemption if it does not demonstrate that it provided sellers with an exemption certificate. Resp. Br. at 30. However, nothing in the statute

prohibits buyers, such as Solvay in this case, from receiving the exemption if they did not provide sellers with an exemption certificate. The statute clearly states that "sellers making tax-exempt sales under this section must obtain … an exemption certificate …. The seller must retain a copy of the certificate for the seller's files." RCW 82.08.02565(1)(b). Nothing in this subsection requires the buyer to do anything. It makes no sense to require only the seller to maintain a copy of the certificate in its files, if the buyer is also required to produce a copy of the certificate it provided to the seller to qualify for the exemption.

Moreover, the statute clearly states that sales tax does not apply to sales of "machinery and equipment used directly in a manufacturing operation." RCW 82.08.02565(1)(a). Therefore, all that the buyer needs to do to qualify for the exemption is show that it purchased "machinery and equipment used directly in a manufacturing operation." *Id.*

When read in context, the seller is required to obtain and keep the exemption certificate to prove the sale was tax-exempt, but the buyer is not. This makes sense, as the seller would not necessarily have the information regarding how the property is used to prove that the item was used directly in a manufacturing operation. Without the exemption certificate, it would be very difficult and time-consuming to track down the relevant information from numerous buyers in an audit of the seller. The same is not true for the buyer. The buyer has the information regarding how the item was used and

can demonstrate that it was used as part of the manufacturing operation, as Solvay has done in this case.

Additionally, producing an exemption certificate completely eliminates a seller's liability, whereas the buyer could still be assessed for deferred sales tax or use tax if the items did not qualify for the exemption. RCW 82.08.050(7); Rule 13601(6)(b).

To avoid this logical reading of the statute, the Department makes the strained argument that buyers are not required to retain the exemption certificate, but must "present some evidence that [they] provided sellers with an exemption certificate." Resp. Br. at 33. This argument makes no sense. How would the buyer be able to prove that it provided "an exemption certificate in a form and manner prescribed by the department by rule," unless it produced the actual certificates?

The language of the use tax provision in RCW 82.12.02565 also supports this interpretation. The Department admits that the use tax statute does not contain a requirement to provide an exemption certificate to the seller. Resp. Br. at 34. Because use tax is assessed when sales tax has not been paid on the purchase, it makes no sense to say that the buyer would qualify for the use tax exemption, but not the sales tax exemption, based solely on whether the buyer provided an exemption certificate to the seller. This would give the Department the discretion to assess tax depending on whether it assessed sales or use tax.

The Department's own rule supports this reading. In cases where the Department determines taxpayers did not pay tax on a purchase, they are assessed use tax or deferred sales tax. Rule 13601(3)(b). Under Rule 13601(3)(b), a "qualifying person using eligible machinery and equipment in Washington in a qualifying manner is exempt from the use tax." Unlike the discussion of sales tax, the rule's discussion of use tax or deferred sales tax does not even mention exemption certificates. *Compare* Rule 13601(3)(a) *with* Rule 13601(3)(b). If the Department really believed that both buyers and the sellers had to produce exemption certificates to qualify, then it would have stated so in its discussion of the use tax in the rule.

The legislative history also shows that during the time period at issue, buyers did not have to provide an exemption certificate to qualify for the M&E exemption. While the statute used to state that the exemption applied "only when the purchaser provides the seller with an exemption certificate," this provision was amended in 2011 and the change was expressly retroactive to all open periods. Laws of 2011, ch. 23, §§ 2, 9. By removing the statement that the exemption only applied when an exemption certificate was provided and making it retroactive, the Legislature aligned the sales tax provision with the use tax provision with respect to buyers for all open tax periods.

In this case the Department's determination states that it assessed "use tax and/or deferred sales tax" on Solvay's purchases of the ASG and

DBC CP 11. As the Department notes in Rule 13601(3)(b), use tax is owed "where the user has not paid retail sales tax with respect to the purchase of the property used." It is not owed solely when the seller is not required to be registered. The Department's constant reference to use tax and/or deferred sales tax in the determination and Rule 13601(3)(b) shows that the Department does not see a material difference between the two. To the extent the Department is correct and there is a material difference between the assessment of sales tax versus use tax, there is a genuine issue of material fact as to which tax was assessed. Because facts are construed in the light most favorable to the non-moving party, and there is no clear showing that the Department assessed sales tax and not use tax, it would not be appropriate to grant summary judgment to the Department on this basis.[11]

As such, the trial court's summary judgment order cannot be affirmed even under the Department's reading of the statute. The matter must be remanded to determine which tax was assessed.

E. Solvay Provided The Exemption Certificates Within 120 Days Of The Department's Request For Substantiation.

Finally, even if Solvay was assessed sales tax and was required to provide an exemption certificate to the sellers, it did so. CP 377-384. Nothing in the statute requires the buyer to provide the seller with the

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[11] *See Samis Land Co. v. City of Soap Lake*, 143 Wn.2d 798, 803, 23 P.3d 477 (2001) (in summary judgment, facts and reasonable inferences viewed in a light most favorable to the nonmoving party).

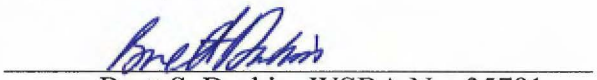
exemption certificate at the time of sale. In fact, RCW 82.08.050(7)(b) states that where a seller has not obtained an exemption certificate, the seller may obtain a completed exemption certificate within 120 days after a request for substantiation by the Department.[12]

Here, the Department first requested that Solvay produce exemption certificates on December 9, 2016, shortly before the Department filed its motion for summary judgment. CP 23. Solvay obtained and provided the exemption certificates 62 days later on February 9, 2017. CP 373-86. Therefore, Solvay met all of the requirements of the statute, even under the Department's strained reading of the statute.

III. CONCLUSION

For the foregoing reasons, the trial court's order granting summary judgment to the Department should be reversed and the matter should be remanded with instructions to enter summary judgment for Solvay.

Respectfully submitted October 30, 2017.



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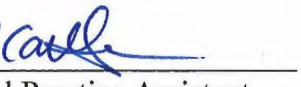
[12] In a determination, the Department even states that a seller who did not collect M&E exemption certificates at the time of sale, could obtain them and claim the exemption even after the Department's assessment of sales tax and the Department issued a determination regarding the assessment. Det. No. 98-098, 17 WTD 424, 427 (1998), Appendix B.

I certify under penalty of perjury under the laws of the state of Washington that, on October 30, 2017, I caused **Appellant's Reply Brief** to be filed with the Court of Appeals, Division II, and caused a true and correct copy of same to be served upon the following parties as indicated below:

Office of Clerk Court of Appeals – Division II 950 Broadway, Suite 300 Tacoma, WA 98402 coa2filings@courts.wa.gov	☐ hand delivery ☐ overnight mail ☐ U.S. Mail ☒ E-filing via Court's Portal
Kelly Owings Assistant Attorney General Chuck Zalesky Assistant Attorney General Attorney General of Washington Revenue Division 7141 Cleanwater Lane SW PO Box 40123 Olympia, WA 98504-0123 Email: KellyO2@atg.wa.gov; chuckz@atg.wa.gov; Susanb5@atg.wa.gov; and, REVOlyEF@atg.wa.gov Attorneys for Defendant	☐ hand delivery ☐ overnight mail ☐ U.S. Mail ☒ e-mail

DATED: October 30, 2017, at Seattle, Washington.

STOEL RIVES LLP



Eileen McCarty, Legal Practice Assistant

APPENDICES

Appendix A - Excise Tax Advisory 3125 (2009)

Appendix B - Det. No. 98-098, 17 WTD 424 (1998)

APPENDIX A

Department of Revenue Washington State

Excise Tax Advisory

Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

ETA 3125.2009 Issue Date: February 2, 2009

Manufacturers' Machinery and Equipment Exemption — Computers

The Department has issued a series of excise tax advisories (ETAs) to address questions regarding the retail sales and use tax exemption provided by RCW 82.08.02565 and 82.12.02565, commonly referred to as the manufacturers' machinery and equipment exemption (M&E exemption). This ETA is issued to address the application of the M&E exemption to computers. Please refer to ETA 3117.2009 for a current list of the issues covered by this series.

In addition to the issues discussed in this ETA series, machinery and equipment must also meet the other requirements of the statutes to be eligible for the exemption. For example, some of the requirements include:

- Purchaser/User must be a manufacturer, processor for hire, or a tester for a manufacturer or processor for hire,
- Must purchase machinery or equipment (devices, industrial fixtures, support facilities, pollution control equipment),
- The machinery or equipment must be used directly in a manufacturing, research and development, or testing operation,
- The machinery or equipment must have a useful life of one year or more, and
- The machinery or equipment must be used more than 50% of the time on an eligible activity.

Therefore, readers are advised that RCW 82.08.02565, RCW 82.12.02565, and WAC 458-20-13601 should also be referenced when making determinations about taxability.

The Department has been asked to provide guidance on the eligibility of computer systems, and hardware and peripherals.

Computer hardware and peripherals qualify for the M&E exemption if used directly in a qualifying operation. Peripherals include keyboards, monitors, mouse devices, and other accessories that operate outside of the computer.

Rule 13601 provides that computers qualify if they "direct or control machinery or equipment that acts upon or interacts with tangible personal property" or "if they act upon or interact with an item of tangible personal property." Computers also qualify if they meet any of the other "used directly" tests. These additional tests are:

- Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;
- Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
- Provides physical support for or access to tangible personal property;
- Produces power for, or lubricates machinery and equipment;
- Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
- Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
- Is integral to research and development as defined in RCW 82.63.010.

Computer systems and networks

"Computer systems" is not a term that has any special meaning in the M&E statute. However, if it can be shown that an assemblage of computers acts as an integrated unit, with the various components acting upon each other and interacting together, the system itself qualifies as machinery and equipment if used directly in a qualifying operation. System components include fiber optic or copper cables and wires that distribute data throughout a system. To be viewed as an integrated unit it must be shown that the components are linked through steps and processes and that all of the components contribute to the overall process and are used in the manufacturing operation. An integrated computer system functions as a whole, and requires the various components to complete its work.

A network should be examined separately from an integrated computer system. A network is not necessarily an "integrated system. Generally a computer network is considered to be a combination of computers connected electronically. The term "network" is used to denote communication capabilities. Parts of a network might use the integrated system, but are not needed to make the integrated system operate. Workstations are examples of this. Each workstation must be individually examined to determine whether it is "used directly" in a qualifying operation.

Manufacturing operation issues

Some computer equipment and systems are used for both qualifying and nonqualifying purposes. For example, writing a story for a book or a newspaper is an activity that takes place outside of the manufacturing operation – it is product development. Product development is not a qualifying activity under the M&E exemption because it is not part of the manufacturing operation. The M&E statute provides that ""[m]anufacturing operation" means 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…." The bright line is that manufacturing does not begin until the product itself is developed and production can begin.

Taking the completed manuscript or the finished story and preparing it for printing is an activity that falls within the manufacturing operation. For example, using a computer system to take a manuscript and prepare it for printing or using a computer system to layout a newspaper is part of the manufacturing operation, provided the final product is tangible personal property. The essential questions are whether the final product, e.g., a book or a printed newspaper, is a manufactured product, and whether the use of the computer equipment or system meets a used directly test. See ETA 3122.2009 for more information on design and a discussion of activities considered part of the manufacturing operation.

While machinery and equipment primarily used in design and product development does not qualify for the M&E exemption, a sales and use tax exemption is available for computer equipment used by a printer or publisher primarily in the printing or publishing of any printed material. This exemption is effective June 10, 2004, and it also includes repair parts and replacement parts for such equipment, as well as sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving such equipment. Refer to RCW 82.08.806 and 82.12.806 for additional information about this exemption.

Also, refer to RCW 82.08.975 and 82.12.975 for additional information about the commercial aerospace manufacturing industry computer equipment exemption on development, design, and engineering activities.

Majority use

Qualifying and nonqualifying uses of computers will be weighed against the majority use test. Computer equipment and computer systems that are used in a manner that satisfies the majority use test qualify for the exemption, provided they meet the other requirements of the exemption.

*****

APPENDIX B

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition Refund of:	)	DETERMINATION
	)	
	)	No. 98-098
	)	
. . .	)	Registration No. . . .
	)	Petition for Refund
	)	

RULE 235; RCW 82.08.02565: MACHINERY AND EQUIPMENT – EXEMPTION – SALES CONTRACTS – SALES PRIOR TO EFFECTIVE DATE OF EXEMPTION. A taxpayer need not collect and remit retail sales tax to the Department of Revenue, on amounts received for sales of machinery or equipment that otherwise qualify as exempt under RCW 82.08.02565, when the unconditional sales contract was entered into prior to the effective date of that statute and the amounts were received prior to the effective date of that statute, if the machinery or equipment was delivered after the effective date of RCW 82.08.02565.

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.

NATURE OF ACTION:

An out-of-state corporation seeks a refund of sales tax paid to it by its customer, claiming that certain machinery sold to its customer qualified for the exemption in RCW 82.08.02565.[1]

FACTS:

Gray, A.L.J. -- The taxpayer is a corporation whose principal place of business is outside of Washington state. In 1994, it procured orders for "traveling water screens" that would be used by its customer at the customer's Washington paper mill.

The taxpayer produced copies of purchase orders from its customer, invoices to the customer from the taxpayer, copies of the bills of lading under which the goods were shipped, and hard copies of computer records from the customer's receiving department. The documents can be

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

matched by the requisition number, the code number used by the customer to identify the taxpayer, and the purchase order number. The taxpayer's invoices (three in number) show that the taxpayer billed its customer on November 18, 1994, January 27, 1995, and May 2, 1995, for 5%, 10%, and 20%, respectively, of the sale price, pursuant to the agreement between the taxpayer and its customer. The taxpayer's bill of lading and the customer's receiving department documents show that none of the machinery was shipped or received until after July 1 1995, the effective date of RCW 82.08.02565 and 82.12.02565, the exemptions from sales and use tax, respectively, for certain types of machinery and equipment.

Except for the timing of these three payments, it appears that the taxpayer qualifies for the exemption, subject to proof that its customer executed a Manufacturer's Sales and Use Tax Exemption Certificate (a copy of the form is attached). See, infra.

The taxpayer argues that it is entitled to a refund of retail sales tax because the machinery was not delivered until after July 1, 1995, and cites WAC 458-20-197(1) ("Rule 197") to support its argument. The customer paid sales tax to the taxpayer when it paid the installments of 5%, 10% and 20% prior to July 1, 1995. However, when the customer later protested payment of the sales tax to the taxpayer, the taxpayer credited the customer with the amount of the tax and became subrogated to the customer's claim for a sales tax refund.

ISSUES:

Is the taxpayer entitled to a refund of sales tax on the sale of equipment that qualifies under RCW 82.08.02565, where the taxpayer uses the accrual system of accounting and was entitled to receive portions of the sale price prior to the effective date of the RCW 82.08.02565?

DISCUSSION:

RCW 82.08.02565 provides for an exemption from sales tax for sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation and to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment. The traveling water screens certainly qualify as "equipment" within the scope of the exemption in RCW 82.08.02565. That statute took effect on July 1, 1995. The question is whether the taxpayer is entitled to a refund of sales tax remitted on amounts received by the taxpayer from its customer prior to July 1, 1995.[2]

Rule 197(1) states, in part:

> For the purpose of determining tax liability of persons making sales of tangible personal property, a sale takes place when the goods sold are delivered to the buyer in this state.

[2] Sales tax is paid by the consumer. RCW 82.08.050. Here, however, the named taxpayer is subrogated to the actual consumer's claim for a sales tax refund because it credited the consumer with the amount of the sales tax previously paid. This fact will allow a refund, subject to audit verification of the crediting of its customer's sales tax. See, WAC 458-20-229(3)(b)(ii).

It is undisputed that delivery of the goods to the taxpayer's customer did not begin until after July 1, 1995. However, Rule 197(2) discusses the tax liability of taxpayers that use the accrual method of accounting:

> (a) When returns are made upon the accrual basis, value accrues to a taxpayer at the time:
>
> (i) The taxpayer becomes legally entitled to receive the consideration, or,
>
> (ii) In accord with the system of accounting regularly employed, enters as a charge against the purchaser, customer, or client the amount of the consideration agreed upon, whether payable immediately or at a definitely determined future time.
>
> (b) Amounts actually received do not constitute value accruing to the taxpayer in the period in which received if the value accrues to the taxpayer during another period. It is immaterial if the act or service for which the consideration accrues is performed or rendered, in whole or in part, during a period other than the one for which return is made. The controlling factor is the time when the taxpayer is entitled to receive, or takes credit for, the consideration.

Though not directly resolving the issue, Rule 197(2) makes clear that the taxpayer was entitled to receive payment on portions of the sale price <u>before</u> the exemption took effect. The remaining question is how to treat those three payments: are they subject to sales tax because the exemption was not yet in effect, or are they exempt from sales tax because delivery of the equipment ultimately was made after the exemption took effect?

WAC 458-20-235 ("Rule 235") is the Department's administrative rule regarding the effects of rate changes on prior contracts and sales agreements. Rule 235 provides, in part:

> When an unconditional contract to sell tangible personal property is entered into prior to the effective date of a rate change, and the goods are delivered after that date, the new rates will be applicable to the transaction. When an unconditional contract to sell tangible property is entered into prior to the effective date, and the goods are delivered prior to that date, the tax rates in effect for the prior period will be applicable.

Although Rule 235 pertains to rate changes, its logic reasonably applies to the question whether sales tax applies to pre-exemption installment payments. Its provisions relate to the statutory requirements for the exempt purchase requirements of RCW 82.08.02565.

To the extent that the contract might have included charges for installation of the traveling water screens, Rule 235 states:

> Persons installing, repairing, cleaning, altering, imprinting or improving tangible personal property for others, or constructing, repairing, decorating or improving buildings or other structures upon the real property of others will collect retail sales tax and pay the business and occupation tax at the new rates with respect to all such services performed and billed on and after the effective date of a rate change. With respect to

> contracts requiring the above services or construction which were executed prior to the effective date of a change in rates, the new rates will be applicable to the full contract price unless the contract work is completed and accepted prior to the effective date.

Here it is clear that labor charges would also be taxed at the "new" rate, so that by analogy, the taxpayer's labor charges would similarly not be subject to sales tax.

We conclude that the taxpayer is entitled to a refund of sales tax on the value of the three installment payments made prior to the effective date of RCW 82.08.02565.

DECISION AND DISPOSITION:

The petition is granted, subject to verification by the Audit Division that the taxpayer actually credited its customer with the amount of sales tax charged on the three installment payments made prior to July 1, 1995, and subject to verification by the Audit Division that the taxpayer's customer has supplied it with a Manufacturer's Sales and Use Tax Exemption Certificate. If the customer did not previously execute such a certificate, it may do so now.

Dated this 29th day of May 1998.

STOEL RIVES LLP

October 30, 2017 - 4:18 PM

Transmittal Information

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Appellate Court Case Number:	50103-1
Appellate Court Case Title:	Solvay Chemicals, Inc., Appellant v State of WA Dept. of Revenue, Respondent
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