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No. 51468-1-II

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

ADVANCED H2O & TYSON FRESH MEATS, INC.,

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

APPELLANTS' RESPONSE BRIEF

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I. INTRODUCTION

The Court faces a straightforward application of the law in this case. Under the applicable statute, a “lease” is defined as the “transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration.” RCW 82.04.040(3)(a). If that “lease” is made “for the purpose of sublease,” it is exempt from retail sales tax. RCW 82.04.050(4)(b). Appellants Advanced H2O, LLC (“Advanced H2O”) and Tyson Fresh Meats, Inc. (“Tyson”) (collectively, “Appellants”) leased pallets from CHEP, USA (“CHEP”). Appellants leased the pallets for the sole purpose of placing their products onto the pallets and transferring possession of those product-loaded pallets via shipment to their customers. Appellants factored the consideration for this exchange into the price of their products. On these facts, Appellants’ pallet rentals from CHEP are exempt from retail sales tax as “leases-for-sublease.”

The alternate issue before the Court also presents a straightforward application of the law. Retail sales tax does not apply to a “sale for resale” of “tangible personal property in the regular course of business without intervening use.” RCW 82.04.050(1)(a)(i). The Department of Revenue’s (“DOR”) own rule states that a sale of “packaging materials to persons who sell tangible personal property contained in or protected by packing materials” is a type of sale-for-resale exempt from retail sales tax. WAC

458-20-115(3)(a). Appellants leased the CHEP pallets for the sole purpose of placing their products onto the pallets and shipping those nonreturnable product-loaded pallets to their customers. On these facts, Appellants' pallet rentals from CHEP are sales-for-resale of packaging materials exempt from retail sales tax.

The Board of Tax Appeals ("BTA"), the state agency tasked with providing fair and efficient resolution of tax appeals, issued orders in Appellants' favor based upon this straightforward application of the law. These orders are comprehensive, well-reasoned, and entitled to deference by this Court. DOR asks this Court to affirm the Superior Court's improper reversal of the BTA's orders on grounds that find no support in the language of the statutes, regulations, or relevant case law. For these reasons, the Court should affirm the BTA's orders granting summary judgment in favor of Appellants.

II. REASSIGNMENTS OF ERROR

1. The Superior Court erred when it reversed the BTA's ruling that Appellants' payments to CHEP were exempt from retail sales tax under RCW 82.04.050(4)(b), where Appellants transferred possession of the pallets to their customers in exchange for consideration.

2. The Superior Court erred when it reversed the BTA's ruling that Appellants' payments to CHEP were exempt from retail sales

tax under WAC 458-20-115, where Appellants transferred the pallets to customers as nonreturnable packing materials as part of the sale of their products.

III. RESTATEMENT OF THE ISSUES

1. Does substantial evidence support the BTA's ruling that Appellants transferred possession of the pallets to their customers in exchange for consideration, and were therefore exempt from retail sales tax under RCW 82.04.050(4)(b)?
2. Does substantial evidence support the BTA's ruling that Appellants acquired the pallets to send to their as nonreturnable packing materials as part of the sale of their products, and were therefore exempt from retail sales tax under WAC 458-20-115?

IV. RESTATEMENT OF THE CASE

A. Background on Appellants' Relationship with CHEP

Advanced H2O manufactures and sells bottled water and other beverages in Washington. AR-H2O 91 ¶ 4.¹ Tyson processes and sells meat products in Washington. AR-Tyson 88 ¶ 3. When Advanced H2O and Tyson sell their products to customers, they place the products onto

¹ This brief refers to the respective administrative records of Appellants as "AR-H2O" and "AR-Tyson."

pallets and deliver both the pallets and the products to the customers. AR-H2O 91 ¶ 6; AR-Tyson 88 ¶ 4.

Appellants acquire the pallets by signing “Hire Agreements” with CHEP. AR-H2O 91 ¶ 7; AR-Tyson 88 ¶ 5. CHEP charges Appellants a flat “Issue Fee” for each pallet based on the anticipated amount of time that Appellants will have possession of the pallet. AR-H2O 122, 123 ¶ 3; AR-Tyson 102, 115.² In exchange for the flat Issue Fee, Appellants have the right to possess the pallet indefinitely; the Hire Agreement is an ongoing agreement with no fixed term. *See* AR-H2O 113, 118 ¶ 12(b) (CHEP can only require the return of pallets from Appellants upon termination of the Hire Agreement).

Appellants also receive pallets from other CHEP participants. If the pallets from other participants are empty, CHEP assesses an “Inbound Movement Fee” in lieu of the Issue Fee. *See* AR-H2O 123 ¶ 4, 138-39 (separating CHEP-issued pallets and empty pallets Advanced H2O received from other CHEP participants). If Appellants receive the pallets as part of a shipment of goods from another CHEP participant, CHEP assesses no fee. AR-H2O 122-23; AR-Tyson 104 ¶ 5. Nothing in the Hire

² While the 2003 Hire Agreement had a provision for daily rental fees if the cycle time rose above a certain point, there is no evidence that daily rental fees were ever imposed. AR-Tyson 102; AR-Tyson 126-37. The contract in effect after May 8, 2008, charged a fixed fee per pallet and there were no provisions for a daily rental fee. AR-Tyson 115.

Agreement prohibits CHEP participants from charging each other when transferring possession of pallets. AR-H2O 113–25; AR-Tyson 111–14. Appellants factor the Issue Fee/Inbound Movement Fee into the amounts they charge their customers for their products. AR-H2O 91 ¶ 8; AR-Tyson 88 ¶ 6.

B. Procedural History

1. Advanced H2O, LLC

Advanced H2O filed a refund request with DOR for the sales taxes it paid on the CHEP rental fees for the January 1, 2008 to December 31, 2011 tax periods. AR-H2O 91 ¶ 3. DOR denied the refund request and Advanced H2O appealed the denial to DOR’s Appeals Division. AR-H2O 92. The Appeals Division affirmed the denial and Advanced H2O timely appealed to the BTA on July 14, 2014. *Id.* The BTA issued a final decision granting summary judgment to Advanced H2O on January 13, 2017. AR-H2O 31. The BTA held that Advanced H2O’s lease of pallets from CHEP was exempt from sales tax because (1) Advanced H2O transferred possession of the pallets to its customers in satisfaction of the definition of “lease” in RCW 82.04.040(3)(a) and the lease-for-sublease exemption under RCW 82.04.050(4)(b); and (2) Advanced H2O leased pallets from CHEP as leases of “packing materials” for sublease to its customers under WAC 458-20-115(2), (3)(a), and (6)(c). AR-H2O 22–33.

On February 13, 2017, DOR filed a Petition for Judicial Review challenging the BTA's decision. AR-H2O 3-5. On January 19, 2018, the Thurston County Superior Court reversed the BTA.

2. Tyson Fresh Meats, Inc.

DOR audited Tyson for the January 1, 2007 to December 31, 2010 tax periods. AR-Tyson 147. DOR assessed Tyson for unpaid use tax on the payments Tyson made to CHEP for the pallets. Tyson appealed the assessment to DOR's Appeals Division. AR 89 ¶ 9. The Appeals Division affirmed the assessment and Tyson timely appealed to the BTA. *Id.* The BTA issued a final decision granting summary judgment to Tyson on January 13, 2017, holding similarly to the BTA's order in favor of Advanced H2O. AR-Tyson 10-19. On February 13, 2017, DOR filed a Petition for Judicial Review challenging the BTA's order. AR-Tyson 3-7. On January 26, 2018, the Superior Court reversed the BTA's order.

3. Appellate procedural history

Appellants timely filed notices of appeal of the Superior Court's reversals of the BTA's orders. On April 18, 2018, the Commissioner of this Court consolidated the appeals into the instant case.

V. ARGUMENT

The Court should affirm the BTA's orders validly concluding that Appellants' leases of pallets from CHEP were exempt from sales tax

under RCW 82.04.050(4)(b)'s lease-for-sublease exemption and under WAC 458-20-115's "packing materials" exemption.

A. Standard of Review

The Administrative Procedures Act ("APA"), Ch. 34.05 RCW, governs judicial review of BTA decisions. RCW 82.03.180. Under the APA, "[t]he burden of demonstrating the invalidity of agency action is on the party asserting invalidity." RCW 34.05.570(1)(a). Summary judgments entered by agencies are typically reviewed under the "error of law" standard. RCW 34.05.570(3)(d); *Verizon Nw., Inc. v. Emp't Sec. Dep't*, 164 Wn.2d 909, 916, 194 P.3d 255 (2008). However, in this case, DOR's arguments revolve almost entirely around conclusory factual assertions, e.g., whether Appellants received consideration for transferring possession of the pallets to their customers.

Even though the BTA's findings of fact "are buried or hidden within conclusions of law, it is within the prerogative of an appellate court to exercise its own authority in determining what facts have actually been found below." *Sprint Spectrum, LP v. Dep't of Revenue*, 174 Wn. App. 645, 653, 302 P.3d 1280 (2013). Under RCW 34.05.570(3)(e), courts will not overturn an agency's factual findings unless they are clearly erroneous and the court is "definitely and firmly convinced that a mistake has been made." *Id.* Additionally, courts review the evidence in the light most

favorable to the party who prevailed in the highest administrative forum to exercise fact-finding authority. *Id.* at 654.

The issues in this case have little to do with the scope of the taxing statutes themselves. For example, the primary issue in this case deals with whether Appellants received consideration for transferring possession of the pallets to their customers. While the general issue of consideration is a legal concept, the existence of consideration in this case is determined by inferences the BTA drew from the raw facts. The case does not turn on the scope of the term “consideration” in RCW 82.04.040, but on the factual issue of whether Appellants received any.

While a summary judgment typically turns on legal issues, it is still appropriate where there is no “genuine” issue of material fact. A nonmoving party may not rely on speculation, argumentative assertions, or conclusory statements to create a genuine issue of material fact. *Paradiso v. Drake*, 135 Wn. App. 329, 334, 143 P.3d 859 (2006).

DOR’s assertions that its interpretation is entitled to deference are misplaced for two reasons. First, deference is only accorded to an agency on questions of law where the statute is ambiguous. *See Waste Mgmt. of Seattle, Inc. v. Utils. & Transp. Comm’n*, 123 Wn.2d 621, 627–28, 869 P.2d 1034 (1994) (agency’s interpretation not afforded deference absent

an ambiguity in the statute). As shown below, there is no ambiguity in the statutes.

Second, to the extent that DOR's arguments involve questions of law, they are legal issues outside its expertise, e.g., whether Appellants had the right to receive consideration for transferring possession of the pallets to customers under their contracts with CHEP. *See Cascade Court Ltd. P'ship v. Noble*, 105 Wn. App. 563, 567, 20 P.3d 997 (2001) ("An agency's legal interpretation in areas outside of its expertise is entitled to no deference.").

As the agency conducting the adjudication, the BTA's decisions are entitled to deference under the APA as to the inferences drawn from the raw facts. *See William Dickson Co. v. Puget Sound Air Pollution Control Agency*, 81 Wn. App. 403, 411, 914 P.2d 750 (1996) (an appellate court "gives deference to factual decisions; it views the evidence and the reasonable inferences therefrom in the light most favorable to the party who prevailed in the highest forum that exercised fact-finding authority").

B. The BTA Correctly Determined that Appellants' Acquisition of Pallets from CHEP was Exempt as a Lease-for-Sublease.

The language of the applicable statutes and the parties' own Stipulations are all that the Court must examine to conclude that the BTA

properly determined that Appellants' pallet rentals from CHEP were exempt from retail sales tax under RCW 82.04.050(4)(b).

A "sale" is "any transfer of the ownership of, title to, or possession of property for a valuable consideration." RCW 82.04.040(1). A "lease or rental" is a type of "sale," defined as "any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration." RCW 82.04.040(3)(a). "The definition in this subsection (3) *must* be used for sales and use tax purposes regardless if a transaction is characterized as a lease or rental under generally accepted accounting principles, the United States internal revenue code, Washington state's commercial code, or other provisions of federal, state, or local law." *Id.* (emphasis added).³ Even if these arrangements might not be viewed as leases in the "ordinary" sense, the statute here fashioned a very specific definition that excludes all other considerations. When the legislature has defined a term, the statutory definition of the term controls its interpretation. *Solvay Chemicals, Inc. v. Dep't of Revenue*, ___ Wn. App. 2d ___, 424 P.3d 1238, 1241–42 (2018).

Washington imposes a tax on each retail "sale" of tangible personal property unless the sale is specifically excluded. RCW

³ Washington courts define the term "must" as "mandatory." *See, e.g., Kelleher v. Ephrata Sch. Dist. No. 165*, 56 Wn.2d 866, 872-73, 355 P.2d 989 (1960) ("To regard 'must' as permissive . . . is to make the act of the legislature meaningless and absurd.").

82.08.020(1)(a). One specific exclusion is “[p]urchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person.” RCW 82.04.050(1)(a)(i). As the BTA noted, this exclusion—which has been variously called the sale-for-resale exemption, purchase-for-resale exemption, and wholesale-sale exemption—provides, in simplest terms, that “[t]he retail sales tax does not apply if the purchaser will resell the item.” Steven J. Hopp, *Sales Tax, WASHINGTON STATE AND LOCAL TAX DESKBOOK* at 4–12 (C. James Judson, ed., 1996).

In RCW 82.04.050(4)(b), the sale-for-resale exclusion from retail sales tax is expressly extended to the lease-for-sublease transaction: “The term [‘sale at retail’ or ‘retail sale’] does not include the renting or leasing of tangible personal property where the lease or rental is for the purpose of sublease or subrent.”

The lease-for-sublease exception framework can more easily be understood by inserting RCW 82.04.040(3)(a)’s definition of “lease or rental” into RCW 82.04.050(4)(b)’s lease-for-sublease exception:

The term [“sale at retail” or “retail sale”] **does not include the renting or leasing of tangible personal property where the** [transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration] **is for the purpose of sub**[transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration].

RCW 82.04.050(4)(b) (emphasis added).

The Court need look no further than the parties' Stipulations to see that Appellants' rental of pallets from CHEP qualifies for the lease-for-sublease exception. First, CHEP transferred possession of the pallets (i.e., "leased" or "rented" the pallets) to consumers (Appellants) for consideration. AR-H2O 91 (Stipulation 7); AR-Tyson 88 (Stipulation 5). Second, Appellants sub-transferred possession of those pallets to purchasers of their products (i.e., "subleased" or "subrented"). AR-H2O 91 (Stipulations 5 and 6);⁴ AR-Tyson 88 (Stipulation 4).⁵ Third, Appellants subleased the pallets for consideration: the parties stipulated that Appellants' "pallet costs are factored into the amounts [they] charge customers for [their products]." AR-H2O 91 (Stipulation 8); AR-Tyson 88 (Stipulation 6).

DOR attempts to distract the Court by reading non-existent and irrelevant requirements into the statutory language. The statute dictates that the definition of "lease or rental" must apply regardless of how the transaction is booked or treated for purposes of any other law—including Washington common law. RCW 82.04.040(3)(a). DOR cannot avoid the

⁴ Parties stipulated that Advanced H2O "uses pallets to ship its products to customers in the State, most of which are large retailers" and "shrink-wraps [product] to the pallets, which are then delivered to retailers or other customers."

⁵ Parties stipulated that Tyson "sells its beef products and ships them to customers using pallets and other packing materials."

plain language of the statute, which imposes two requirements and no others: (1) the taxpayer leases property for the purpose of transferring possession of the leased property (2) for consideration. *See* RCW 82.04.040(3)(b) (defining “lease”).

1. Appellants leased the pallets from CHEP for the purpose of sublease.

Appellants leased the pallets from CHEP for the purpose of sublease (a) with no intervening use and (b) regardless of CHEP’s agreements with Appellants’ customers.

a. Appellants did not use the pallets other than for the purpose of sublease.

DOR repeatedly asserts that Appellants paid CHEP for the purpose of their own use of the pallets during the “rental period.” *See, e.g.*, DOR Brief 18, 22. DOR already stipulated that this argument is wrong: DOR stipulated that Appellants acquire the pallets for the purpose of shipping product to their customers. AR-H2O- 91 ¶ 5; AR-Tyson 88 ¶ 4. Setting aside the Stipulation for argument’s sake, DOR’s argument is incorrect for several reasons.

DOR’s citations to the Hire Agreement fail to support its argument that Appellants use the pallets for a purpose other than sublease. While it is true that Appellants acquire the pallets on an “as-needed” basis, there is no mention of any specified use. The Hire Agreements clearly state that

Appellants are acquiring possession of the pallets for use in shipments to other CHEP customers. Advanced H2O’s Hire Agreement states:

“Customer will use Equipment *only for shipments to [customers].*” AR-H2O 110 § 1.3 (emphasis added). Tyson’s Hire Agreement states:

“[s]tarting on [date], Customer will begin to use CHEP Equipment *for shipments to its customers[.]*” AR-Tyson 98 § 2.1 (emphasis added).

DOR further asserts that Appellants cannot lease the pallets for sublease because they did not have “title to” or “ownership of” the pallets.

DOR Brief at 17. This argument ignores the very underpinnings of a *sublease itself*, where a lessee—who *by definition* does not have title to or ownership of the leased property—leases the property to another.

Moreover, DOR sidesteps the statute’s language: under the plain language of the statute, a “sale” is “any transfer of the ownership of, title to, *or possession of* property for a valuable consideration.” RCW 82.04.040(1) (emphasis added). A “lease or rental” is a type of “sale,” defined as “any *transfer of possession or control of* tangible personal property for a fixed or indeterminate term for consideration.” RCW 82.04.040(3)(a) (emphasis added). The statute contains no requirement that a consumer have title to tangible property; the statute only requires *possession* of the property.

Appellants paid one-time fees to CHEP to acquire possession of the pallets and the right to transfer the pallets to customers. AR-H2O 122,

123 ¶ 3; AR-Tyson 102.⁶ This is no different from acquiring title to pallets for purposes of shipping them to customers as part of the sale of a company’s products, which DOR undoubtedly would agree is not an intervening use of the pallets and would be exempt as a sale-for-resale under RCW 82.04.050(1)(a). As such, DOR’s argument fails.

DOR also incorrectly asserts that several clauses in the Hire Agreement prohibit Appellants from subleasing the pallets to their customers. The Hire Agreement merely prohibits Appellants from assigning the *contract* to any “subcontractors or to any CHEP affiliate.” See AR-H2O 118 ¶ 14; AR-Tyson 100 § 10.2. It is also irrelevant that the Hire Agreement “prohibits” Appellants from selling CHEP’s pallets, destroying or damaging them, or using them in a manner inconsistent with CHEP’s ownership of them. AR-H2O 118 ¶ 6(b); AR-Tyson 99 ¶ 6. Appellants’ sublease is in no way inconsistent with CHEP’s ownership; the subleases do not involve title, financing, etc.

For this reason, Appellants do not dispute DOR’s lengthy point that CHEP acts to protect its property interest in title to the pallets. See, e.g., DOR Brief at 8–10 (detailing CHEP’s “aggressive” protection of title in the pallets). This is totally irrelevant—Appellants *subleased* the

⁶ As discussed *supra*, while Tyson’s 2003 Hire Agreement had a provision for daily rental fees if the cycle time rose above a certain point, there is no evidence that daily rental fees were ever imposed. AR-Tyson 102; AR-Tyson 126-37 (only listing Issue and Transfer Fees on the invoices from CHEP).

property by transferring possession for consideration. RCW 82.04.040(3)(a) (“lease or rental” means “any transfer of *possession or control* of tangible personal property” (emphasis added)). Each “successive transferee” may have had a relationship with CHEP regarding its possession and use of the pallet, but this is irrelevant to the *transfer* of possession. DOR Brief at 18. DOR again confuses CHEP’s title and ownership of the pallets with Appellants’ sublease of the pallets.

DOR additionally asserts that Appellants could not sublet the pallets to their customers because a lease must be a series of transactions. DOR Brief at 19-20. While a lease very well might be a series of transactions in certain circumstances, it is not required by the statute. The plain language of the statute defines a “lease” as “*any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration.*” RCW 82.04.040(3)(a) (emphasis added). Thus, all that is required to satisfy the statutory definition of a “lease” is to transfer possession of property in exchange for compensation. There is no requirement of any ongoing extraction of consideration for the “continued enjoyment of possession” of the leased property.

DOR’s citation to *Gandy v. State*, 57 Wn.2d 690, 359 P.2d 302 (1961), is inapposite and irrelevant for numerous reasons. As an initial point, the definition of “lease” at issue in this case expressly prohibits

referring to typical or common law notions of what constitutes a lease. RCW 82.04.040(3)(a). For this reason alone, the Court should not look to *Gandy* at all, not even as a persuasive authority. Further, *Gandy* was decided over 40 years before the statutory definition of “lease” and the lease-for-sublease exemption were enacted in 2003. Laws of 2003, ch. 168, §§ 103-104. It was undisputed that the transactions at issue constituted leases under the statute. *Gandy*, 57 Wn.2d at 692-93. Thus, any discussion in the case regarding what constitutes a lease is non-binding dicta.

The facts in *Gandy* are also very different from the present case, and the court’s discussion of the facts supports Appellants’ reading of the statute, not the DOR’s. The lease transaction in *Gandy* involved a series of rental payments associated with specific periods of time and required for the lessee’s continued possession of the property. *Id.* at 694. In responding to the taxpayers’ argument that sales tax was due when the contract was executed, the court stated:

If the act of taking possession fixed the obligation of the lessee to make all of his rental payment, it would be difficult to dispute the appellants’ contention. But this is not the case. The lessee’s [payment] obligation depends upon his continued enjoyment of the right to possession.

Id. at 695 (emphasis added).

In this case, Appellants pay consideration for lease of the pallets from CHEP only once (the Issue Fee or Inbound Movement Fee) and receive the right to possess the pallets for an indefinite period of time. Appellants likewise receive a one-time payment from their customers for transferring possession of the pallets for an indefinite period of time. In both circumstances, “the act of taking possession fixed the obligation of the lessee[s] to make all of [their] rental payment[s].” *Id.* As such, the court’s reading of the statute in *Gandy* contradicts DOR’s arguments.

DOR also relies on WAC 458-20-211 (“Rule 211”) for authority that Appellants did not lease the CHEP pallets for the purpose of sublease. DOR Brief at 21. DOR’s reliance on Rule 211 is misplaced. Rule 211 only addresses the sale-for-resale exemption in RCW 82.04.050(1)(a)(i). *See* Rule 211(6)(a). It does not address the lease-for-sublease exemption in RCW 82.04.050(4)(b). DOR’s intervening-use analysis under Rule 211 is not relevant to the lease-for-sublease analysis.⁷

Even if this Court were to fit Appellants’ lease-for-sublease into the misfitted framework of Rule 211, DOR’s argument still fails. Unlike the lease-for-sublease exemption, the sale-for-resale exemption expressly requires that the property be resold “in the regular course of business

⁷ Regardless, and as discussed *supra*, Appellants leased the pallets solely for the purpose of subleasing them (i.e., transferring possession of the pallets for consideration to their customers).

without intervening use.” RCW 82.04.050(1)(a)(i). Appellants sell tangible personal property (the meat products and water bottles), and under Rule 211, the pallets would be “resold” as tangible personal property in the regular course of business. Therefore, there is no intervening use because Appellants do not meet the definition of “consumer.” *See* RCW 82.04.190 (defining “consumer” to exclude persons who purchase property for “resale as tangible personal property in the regular course of business”).

Moreover, in WAC 458-20-115 (hereafter, “Rule 115”), DOR acknowledges that purchasing pallets for the purpose of selling them to customers along with products does not involve intervening use and qualifies for the sale-for-resale exemption. *See* Rule 115(6)(c). Appellants’ facts are nearly identical: Appellants transfer all rights of possession in the pallets to their customers as part of the sale. The customer is not obligated to return the pallets to Appellants, who did not retain the right to reuse the pallets in the future. They do not make intervening use of the pallets. The fact that the pallets are leased does not affect the analysis. For these reasons, Rule 211 does not support DOR’s arguments.

As a final argument that Appellants “used” the pallets, DOR notes that Appellants had possession of the pallets for an average of 56 and 30

days, respectively. AR-Tyson 116; AR-H2O 113. DOR speculates that during that time, Appellants “w[ere] free to use the pallets to” transport items between facilities, including warehouses and freezers. DOR Brief at 24. DOR has zero evidence to support this speculation. It is also in direct contradiction with the facts in the record, including Appellants’ Hire Agreements with CHEP that state that Appellants will only use the pallets in shipping product to their customers. AR-H2O 110 § 1.3; AR-Tyson 98 § 2.1. Further, DOR already stipulated that Appellants use the pallets to ship their product to customers. AR-H2O 91 (Stipulations 5 and 6); AR-Tyson 88 (Stipulation 4).

Moreover, DOR did not raised this argument before the BTA. On review of an order granting or denying a motion for summary judgment, this Court will consider only evidence and issues called to the attention of the BTA. RCW 34.05.554. Because DOR never made an argument to the BTA based on the speculation that Appellants actually used the pallets in their warehouses during their possession, the Court need not consider this argument on appeal. *Id.*

b. CHEP’s agreements with Appellants and Appellants’ customers are immaterial to the statutory framework.

DOR contends that Appellants cannot lease the pallets for sublease because Appellants’ customers were bound by pre-existing agreements

with CHEP. DOR Brief at 22. DOR asserts that because of the pre-existing agreements that all CHEP participants signed, Appellants' rental periods "ended" when they transferred the pallets to their customers, rendering Appellants unable to sublease the pallets. DOR Brief at 17.

The BTA correctly determined that this argument is a "red herring." *See* AR-H2O 27. This case does not concern transactions between CHEP and Appellants' customers; it concerns the transfer of possession only between Appellants and their own customers. Under the Hire Agreements between CHEP and Appellants, CHEP charges a one-time, per-pallet fee. AR-H2O 122, 123 ¶ 3; AR-Tyson 102. CHEP does not charge a fee if a CHEP participant receives a loaded pallet from another participant. AR-H2O 122-23; AR-Tyson 104 ¶ 5. It is only after Appellants transfer a loaded pallet to their customers that any agreement between that customer and CHEP would be triggered. Because any agreement between CHEP and Appellants' sublessees is contingent upon Appellants' prior transfer of possession of the pallet to the sublessees, such agreement cannot pose a barrier to Appellants' sublease of the pallets. AR-H2O 27.

Nor was each sublease of a pallet in fact a separate retail sale by CHEP to the sublessee. Appellants did not purchase or use the pallets "as a consumer" in their business activities. The Hire Agreements make clear

that Appellants leased the CHEP pallets for shipments to other CHEP customers. AR-H2O 110 § 1.3; AR-Tyson 98 § 2.1. Because Appellants did not use the pallets in their business activities, all of the cases relied upon by DOR are inapposite.⁸

Finally, DOR asserts that under Appellants' interpretation, the CHEP pallets will never be subjected to the sales and use tax at any stage in the chain of distribution. DOR Brief at 26. This is incorrect. The parties stipulated that the pallets' costs are factored into the cost of the products sold to Appellants' customers and, in turn, to their customers. These customers at the grocery store need not leave the store with a CHEP pallet, as DOR incorrectly asserts; it is at that stage that the sales and use tax is assessed on the pallets.

For all of the foregoing reasons, DOR cannot escape the reality that Appellants leased the CHEP pallets for the purpose of subleasing the pallets to their customers. *See* RCW 82.04.050(4)(b).

⁸ *See Riley Pleas, Inc. v. State*, 88 Wn.2d 933, 568 P.2d 780 (1977) (distinguishable because construction contractor owed sales taxes on materials and labor purchased for use in constructing on land it owned); *Lakewood Lanes, Inc. v. State*, 61 Wn.2d 751, 380 P.2d 466 (1963) (distinguishable because bowling alley owner owed sales taxes on rental fees it paid for pin-setting machines installed for its own use within bowling alley); *Activate, Inc. v. Dep't of Revenue*, 150 Wn. App 807, 822, 209 P.3d 524 (2009) (distinguishable because Activate gave the phones away); *Mayflower Park Hotel v. Dep't of Revenue*, 123 Wn. App. 628, 98 P.3d 534 (2004) (distinguishable because the hotel was not reselling the furnishings as tangible personal property, but rather consuming them to provide hotel lodging, which is a service); *Black v. State*, 67 Wn.2d 97, 103, 406 P.2d 761 (1965) (corporation which leased a cruise ship did not resell it by leasing out individual cabins within the ship); *Glen Park Assocs., LLC v. Dep't of Revenue*, 119 Wn. App. 481, 82 P.3d 664(2003) (purchaser of an apartment building did not acquire the appliances included in the rental units for purposes of resale).

2. Appellants received consideration.

DOR states that the “sole factual basis” for the BTA’s conclusion that Appellants received consideration for the sublease of the CHEP pallets was that the costs of the pallet subleases were factored into the price of the products sold. DOR Brief at 28; *see* AR-H2O 27–28. This is incorrect. The BTA also noted that “under a basic principle of contract law ... the consideration paid for the bottled water may also serve as consideration for the receipt and use of the pallets on which the water was shipped.” AR-H2O 28. Additionally, even if DOR were correct, neither the Hire Agreements, statutes, nor case law required anything further.

First, nothing in the Hire Agreements prohibited Appellants from extracting compensation from their customers in exchange for giving up the right to continued possession of the pallets. Absent a contractual prohibition, Appellants are free to demand whatever consideration they desired for giving up the right to continued possession of the pallets.

Second, although DOR asserts that Appellants cannot extract consideration for the customers’ continued right to possess the pallets after they receive them, the controlling statutory language only requires a transfer of possession of property for consideration. RCW 82.04.040(3)(a). There are no other requirements. By asserting that “leases” are limited to those situations where the transferor retains rights

to the property, DOR impermissibly adds language to the statute. *See Dot Foods, Inc. v. Dep't of Revenue*, 166 Wn.2d 912, 920, 215 P.3d 185 (2009) (courts cannot add words or clauses to statutes if the legislature has not chosen to include them). As the BTA correctly noted, there is no statutory requirement that consideration be separately stated. AR-H2O 28.

Third, consideration sufficient to support the sublease is easily met under Washington law. Consideration exists in any bargained-for legal detriment, no matter how seemingly small. *Storti v. Univ. of Wash.*, 181 Wn.2d 28, 37, 330 P.3d 159 (2014). In the present case, the parties have already stipulated that Appellants factored consideration for the pallets into the price of the products sold to their customers. AR-H2O 91 (Stipulation 8); AR-Tyson 88 (Stipulation 6). Possession of a pallet is a valuable right. There is no reason why a CHEP participant (including Appellants) would give up its right to possess the pallet without receiving some form of consideration from the customer for that right. The BTA held that a promise to pay a lump sum can supply consideration for multiple promises. AR-Tyson 15 (citing *McKelvie v. Hackney*, 58 Wn.2d 23, 32, 360 P.2d 746 (1961) (where a “contract did not attempt to itemize the consideration, the court should not do so.”)); *see also* Restatement (Second) of Contracts § 80(1) (1981) (“There is consideration for a set of promises if what is bargained for and given in exchange would have been

consideration for each promise in the set if exchanged for that promise alone.”).

The BTA correctly determined that Appellants received consideration in exchange for the transfer of pallets to their customers, and the Court should give deference to the BTA’s factual determination. DOR contends that more evidence is required: that the rental period must be distinct, that the material terms must be ascertainable on the invoices or contain “some evidence of a bona fide resale transaction.” DOR Brief at 30. But the statute does not require *any* of this, and the Court should ignore this argument. RCW 82.04.040(3)(a) (a “lease or rental” is “any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration”).⁹

Finally, DOR points to dicta in *Brambles*, an out-of-state decision, for support of its argument that Appellants cannot “lease-for-sublease” the CHEP pallets because each CHEP customer has a separate agreement with CHEP. DOR Brief at 33. Such dicta is not binding on the Court.

See Blackburn v. Safeco Ins. Co., 49 Wn. App. 423, 425, 744 P.2d 347 (1987), *aff’d*, 115 Wn.2d 82, 794 P.2d 1259 (1990) (dicta is not binding).

Further, *Brambles* supports Appellants’ position. The *Brambles* court held

⁹ Further, DOR has no legal support for this assertion. “Where no authorities are cited in support of a proposition, the court is not required to search out authorities, but may assume that counsel, after diligent search, has found none.” *DeHeer v. Seattle Post-Intelligencer*, 60 Wn.2d 122, 126, 372 P.2d 193 (1962).

that “just as packaging material is purchased for resale when it is purchased for the purpose of transferring the right to use it in return for consideration, leases of packaging material are excluded from sales tax where the material is leased for the purpose of transferring the right to use the packaging material to a subsequent purchaser for valuable consideration.” *Brambles Indus., Inc. v. Dir. of Revenue*, 981 S.W.2d 568, 570 (Mo. 1998).¹⁰

DOR cannot escape the fact that Appellants meet the statutory requirement of consideration. A “lease or rental” is defined as “any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration.” RCW 82.04.040(3)(a). The statute requires nothing more than what the parties already stipulated to: Appellants’ “pallet costs are factored into the amounts [they] charge customers for [their products].” AR-H2O 91 (Stipulation 8); AR-Tyson 88 (Stipulation 6). For the foregoing reasons, the Superior Court erred when it reversed the BTA’s ruling that Appellants’ payments to CHEP

¹⁰ DOR relies on a string cite of out-of-state cases. DOR Brief at 32. Even setting aside the very broad definition of a “lease” in RCW 82.04.040(3)(a), all of these cases can be distinguished. *See In re Appeal of Imperial Sugar Co. from Decision by the Dep’t of Revenue*, No. 2002-108 (Wyo. Bd. Eq. June 11, 2003) (CHEP charged a daily fee to petitioner instead of a flat Issue Fee, and different definition of “sale” applied); Advisory Opinion No. S08081 IA (N.Y. Dep’t of Taxation & Finance, Oct. 18, 2011) (CHEP charged a daily fee to customer instead of a flat Issue fee, and different definition of “sale” applied); Private Letter Ruling No. 04-015 (Utah Tax Comm’n May 31, 2005) (different definition of “sale”); California Sales Tax Counsel Ruling No. 195.1526 (Jan. 2, 1998; May 14, 1998) (different definition of “sale”). AR-H2O 220-50.

were exempt from retail sales tax under the lease-for-sublease exemption of RCW 82.04.050(4)(b).

C. Appellants' Acquisition of Pallets from CHEP Qualifies as Wholesale Sales of "Packing Materials."

Even if Appellants' transfer of their rights to possess the CHEP pallets to customers for consideration does not constitute a "lease-for-sublease" (which it does), their leases of pallets from CHEP are still exempt from retail sales tax as wholesale sales of "packing materials."

A retail sales tax does not apply to a "sale for resale," defined as "any purchase for resale as tangible personal property in the regular course of business without intervening use." RCW 82.04.050(1)(a)(i). DOR's Rule 115 explains the sale-for-resale exception as applied to persons "who sell packing materials and to those who use packing materials." Rule 115(1). "Sales of packaging materials to persons who sell tangible personal property contained in or protected by packing materials are sales for resale." Rule 115(3)(a).

The definition of "packing materials" does not explicitly include pallets, but it "includes all boxes, crates, bottles, cans, bags, drums, cartons, wrapping papers, cellophane, twines, gummed tapes, wire, bands, excelsior, waste paper, and all other materials in which tangible personal

property may be contained or protected within a container, for transportation or delivery to a purchaser.” Rule 115(2).

DOR contends that Appellants seek to expand Rule 115 to create an *ultra vires* tax exemption broader than what is statutorily allowed. DOR Brief at 36. The cases that DOR relies upon are distinguishable; these cases involved situations in clear contravention of legislative intent. In *Tesoro Refining & Marketing Co.*, the court determined that Tesoro’s “burning off” of excess refinery gas at its refinery failed to meet the applicable WAC’s exemption because Tesoro’s use of the exemption would contravene “the legislature’s intent to tax the first possession of refinery gas.” *Tesoro Ref. & Mktg. Co. v. Dep’t of Revenue*, 164 Wn.2d 310, 314, 321, 190 P.3d 28 (2008). In *Budget Rent-A-Car*, the court rejected Budget’s argument that its sales of rental cars to used car dealerships qualified as sales of “capital assets” under WAC 458-20-106, because “[w]hatever label may be applied to the automobiles,” their sale clearly fell within the taxation provision. *Budget Rent-A-Car of Washington-Oregon, Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 176, 500 P.2d 764 (1972).

In the present case, the language of Rule 115’s illustrative example almost exactly describes Appellants’ situation and therefore is not an *ultra*

vires application in clear contravention of legislative intent. The language of the example is as follows:

(c) XY uses three types of pallets in its manufacturing operation. One type of pallet is used strictly for storing paper which is in the manufacturing process. A second type of pallet is returnable and the customer is charged a deposit which is refunded at the time the pallet is returned. The third type of pallet is nonreturnable and is sold with the product. XY is required to pay retail sales or use tax on the first two types of pallets. *The third type of pallets may be purchased by XY without the payment of retail sales or use tax since these pallets are sold with the paper products.*

Rule 115(6)(c) (emphasis added).

Appellants' sublease of the pallets to their customers falls squarely in the third example: Appellants transfer all of their interest in each pallet, which is nonreturnable to Appellants and "sold" with the product. Likewise, there is no statutory basis for distinguishing between situations where the seller passes complete ownership to the pallets or merely a possessory interest. Both transactions meet the definitions of a "sale." *See* RCW 82.04.040(1) (defining "sale" as transfer of "the ownership of, title to, or possession of property"). Here, the pallets are not returnable to Appellants, and Appellants have sold, via lease, their right to possession of the pallets to their customers as part of the sale of their products. As such, the BTA correctly determined that the circumstances of this case are directly analogous to the purchases of pallets in the Rule 115(6)(c)

example cited above, which are not subject to sales tax. *See* AR-Tyson 28.

DOR asserts that Rule 115 does not apply because the pallet rentals are properly viewed as purchases of “returnable” packing materials. DOR Brief at 37. But as the BTA points out, this provision is clearly limited to situations where “such articles are customarily returned to the seller.” AR-Tyson 30 (citing Rule 115(3)(b)).¹¹ DOR does not argue that the pallets are returnable to Appellants. DOR instead reads something into the WAC that is not there: that a packing material that is returnable *to another party entirely* requires that Appellants be prevented from qualifying for the “packing materials” exemption.¹²

DOR cites *no* Washington authority for the proposition that Rule 115 contemplates anything other than packing material returnable to the seller of the product contained therein or thereon. This is consistent with the relevant out-of-state authorities cited within the A.L.R. relied upon by DOR itself. *See, e.g., Consumers Coop. Ass’n v. State Comm’n of Revenue & Taxation*, 256 P.2d 850 (Kan. 1953) (purchase of returnable oil

¹¹ The BTA explained that “[t]he clear intent of [Rule 115(3)(b)] is to explain that ‘containers,’ such as cases, drums, and bags, are not purchased for resale if the product-seller retains title to the purchased container and if the product-seller’s customer is expected to return the container to the product-seller.” AR-H2O at 30.

¹² As with statutes, courts cannot reading additional requirements into a rule. *See Solvay Chemicals.*, 424 P.3d at 1243 (courts “apply normal rules of statutory construction to administrative rules and regulations”).

drums by an oil refinery was held to be subject to the Kansas use tax, where the containers were returned *to the manufacturer of the tangible personal property contained therein*); *Floyd Charcoal Co. v. Dir. of Revenue*, 599 S.W.2d 173 (Mo. 1980) (sales tax was properly levied on purchases by manufacturer of pallets on which charcoal was shipped to customers, where *pallets were returned to manufacturer*).

Finally, DOR contends that Appellants do not qualify for the Rule 115 exemption because Appellants “used” the pallets for their own purposes. DOR Brief at 43. DOR only points to the length of time that the Issue Fees were based on. *Id.* As discussed *supra*, not only is this argument contradicted by the record, but an argument that was neither pleaded nor argued to the BTA cannot be raised for the first time on appeal. RCW 34.05.554(issues not raised before the agency may not be raised on appeal). Because DOR never made an argument to the BTA based on the unsupported assertion that Appellants made actual use of the pallets during their possession, the Court cannot consider this argument on appeal. *Id.* Even if DOR were able to raise this argument now, DOR does not point to any evidence contradicting the BTA’s finding that Appellants acquired the pallets to transfer them to customers along with their products. AR-H2O at 17.

Moreover, it would be improper for the Court to grant summary judgment for DOR on these grounds, as any use of the pallets in Appellant's manufacturing operation would likely be exempt under the machinery and equipment exemption, RCW 82.08.02595; Determination No. 03-0325, 24 WTD 351, 357 (2005), Appendix A (holding that flats used to transport fruit in manufacturing operation exempt from sales tax under RCW 82.08.02595). Because DOR did not raise this issue below, Appellants have had no opportunity to present argument and evidence as to alternative grounds for exemption. Therefore, even if the Court determines that the BTA erred, then the matter should be remanded for further proceedings on this issue. RCW 34.05.554(2).

For the foregoing reasons, the Superior Court erred when it reversed the BTA's ruling that Appellants' payments to CHEP were exempt from retail sales tax under Rule 115 because Appellants used the pallets as packing materials for their products.

VI. CONCLUSION

The Court should reverse the Superior Court's reversal of the BTA's order granting summary judgment in favor of Appellants.

DATED: November 9, 2018.

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CERTIFICATE OF SERVICE

I, Eileen McCarty, hereby certify that I served a copy of the foregoing document on November 9, 2018, via electronic mail, pursuant to an electronic service agreement entered into by the parties, on the following:

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I certify under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED November 9, 2018, at Seattle, WA.



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APPENDIX A

Cite as Det. No. 03-0325, 24 WTD 351 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 03-0325
)	
...)	Registration No. . . .
)	FY . . . /Audit No. . . .
)	FY . . . /Audit No. . . .
)	Docket No. . . .

- [1] RULE 13601; RCW 82.08.02565, RCW 82.12.02565: RETAIL SALES TAX -- M&E EXEMPTION -- MAJORITY USE -- FRUIT FLATS. Fruit flats used a majority of the time in a manufacturing operation may qualify for the M&E sales tax exemption.
- [2] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-7S: RETAIL SALES TAX -- M&E EXEMPTION -- FLOOR. A mezzanine floor upon which machinery and equipment is placed, does not qualify for the M&E exemption. A structure or improvement that functions as a floor, wall, door, roof, or other building component does not qualify for the exemption.
- [3] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-7S: RETAIL SALES TAX -- M&E EXEMPTION -- BUILDING FIXTURES -- FANS. Fans used directly in the manufacturing operation may qualify for the M&E sales tax exemption.
- [4] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; RETAIL SALES TAX -- M&E EXEMPTION -- PLASTIC BUG STRIP CURTAINS. Plastic bug strip curtains hung from the ceiling at a manufacturing facility do not qualify for the M&E sales tax exemption because they are not used directly in the manufacturing operation.
- [5] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-7S: RETAIL SALES TAX -- M&E EXEMPTION -- LOADING DOCK DOOR SEALS -- ADJUSTABLE RAMPS. Metal adjustable loading ramps, distinct from the factory floor, qualify for the M&E sales tax exemption. Door seals affixed to the

building do not qualify because they are not used directly in the manufacturing operation.

- [6] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-8S: RETAIL SALES TAX -- M&E EXEMPTION -- COMPUTER SOFTWARE: ETA 2012-8S provides the Department's position regarding the applicability of the M&E sales tax exemption to computer software purchases.
- [7] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-2S, ETA 2012-3S: RETAIL SALES TAX -- M&E EXEMPTION -- HOLDING TANKS. Waste water holding tanks may qualify for the M&E sales tax exemption as pollution control equipment. The tanks must be used to capture wastes and contain or prevent releases resulting from processes of the operation. A waste water tank plumbed into the building's general waste water, which serves a building purpose, as opposed to a manufacturing purpose, does not qualify for the M&E exemption. Ammonia tanks, which store or temporarily hold an item of tangible personal property integral to the taxpayer's freezing process, meet the directly used test under RCW 82.08.02565(2)(c)(ii).
- [8] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-3S: RETAIL SALES TAX -- M&E EXEMPTION -- ELECTRICAL SYSTEMS: To the extent building electrical fixtures are integral to the manufacturing process, they qualify for the M&E exemption. However, to the extent they serve a building purpose, as opposed to a manufacturing purpose, electrical fixtures do not qualify.
- [9] RULE 13601; RCW 82.08.02565, RCW 82.12.02565; ETA 2012-7S: RETAIL SALES TAX -- M&E EXEMPTION -- BUILDING CONSTRUCTION -- DOCUMENTATION. An engineering study, design, or plan, confirming that the reinforced portion of the wall or floor was designed and constructed to support the machinery and equipment, and that it did in fact separately and differently support the machinery and equipment, would be documentation for qualification. In determining what qualifies for exemption, the portion of the construction that would be there regardless of the support facility does not qualify. Only the additional construction qualifies for the M&E sales tax exemption.

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.

M. Pree, A.L.J. – A manufacturer, which freezes fruit, protests the assessment of sales/use tax on flats used to collect fruit in the fields and temporarily store the fruit in the plant, construction of mezzanines, computer software, holding tanks, loading dock equipment, plastic bug strips, . . . , fans, holding tanks, electrical systems, and other building fixture costs. We grant in part, deny in part, and remand in part the case for additional investigation, verification, and adjustment consistent with Excise Tax Advisories issued after the assessment and which discuss the manufacturing and equipment (M&E) exemption from sales and use tax. The flats, loading dock

ramps, . . . , fans, and ammonia holding tanks are eligible for the M&E exemption. The mezzanines, loading door seals, and bug strips are subject to tax. Additional information is necessary to determine the taxability of the computer software, waste water holding tanks, electrical systems, and other construction items.¹

ISSUES

1. Whether the flats used to collect raspberries in the field and also used in the manufacturing process are eligible for the M&E exemption based on the majority use test?
2. Whether the mezzanine floor of the taxpayer's building qualified for the M&E exemption as a support facility?
3. Were wall and ceiling fans building fixtures used directly in the taxpayer's manufacturing operation and thereby eligible for the M&E exemption?
4. Were the plastic bug strips used directly in the taxpayer's manufacturing operation and thereby eligible for the M&E exemption?
5. . . .
6. Was the loading dock equipment part of the taxpayer's building, ineligible for the M&E exemption, or was it a support facility eligible for the M&E exemption?
7. What information is necessary to determine whether the computer software was used directly in the manufacturing operation?
8. Were the holding tanks fixtures used directly in the taxpayer's manufacturing operation and thereby eligible for the M&E exemption?
9. To what extent were the taxpayer's electrical systems integral to its manufacturing operation?
10. Did the building contractor provide other building fixtures or support facilities eligible for the M&E exemption? . . .

FINDINGS OF FACT

. . . . (taxpayer) flash freezes raspberries and other fruit at its Washington processing facility, which was built [during the audit period] Some of the berries it freezes are grown on fields it owns.²

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

² A . . . field is adjacent to its processing facility and . . . additional fields . . . are located five minutes away.

The taxpayer packages the raspberries, sometimes mixing in other frozen fruit it purchases. Its customers specify how they want the fruit glazed or otherwise processed.

The Department of Revenue (Department) reviewed the taxpayer's books and records for the period from January 1, 1994 through December 31, 1999. In the two assessments referenced above, the Department's Audit Division assessed deferred retail sales or use tax on the flats, construction of mezzanines, computer software, holding tanks, loading dock equipment, plastic bug strips and . . . , fans, electrical systems, and other building costs because the taxpayer did not pay retail sales tax or use tax on these items. Interest was also assessed.

The taxpayer petitioned for correction of the assessment. The taxpayer contends these items were exempt from sales or use tax as manufacturing machinery and equipment. . . .

After the assessment was issued, the Department issued new Excise Tax Advisories (ETAs), which address some of the issues. The taxpayer has offered to obtain more information based upon the ETAs. Some factual information has been provided. While we lack sufficient information to conclusively determine the taxability of every item in the assessment, we recognize the assessment may need to be revised and believe we can provide additional guidance on the major issues to assist the resolution of the issues. We will present the facts available and discuss the applicable law for each item. The assessment will be remanded to the Audit Division to review additional information and revise the assessment accordingly.

Flats. The taxpayer harvests its raspberries with large machines (harvesters), which slowly go up and down each row shaking the bushes, so the ripe berries drop into the harvesters. In addition to the driver of the harvester, there are other employees on the harvester who pick debris out of the berries. The berries are collected in "flats" on the harvesters. The taxpayer did not pay retail sales tax on . . . flats, which cost about \$4 apiece. The flats are about 2' X 2', five inches high, and hold about 6 pounds of berries. They are stackable and have holes in two opposite sides.

The taxpayer stores the empty flats on paved areas outside the taxpayer's processing facility. When the fruit is ripe, the taxpayer's employees stack flats four to five feet high on a flat-bed truck. They drive the truck to the taxpayer's fields and wait for one of the taxpayer's harvesters to reach the end of a row. They load the full flats from the harvesters directly onto the truck and load the empty flats directly from the truck onto the back of a harvester. The harvester then takes about half an hour to pick two rows, going up one row, then back down the adjacent row. It is important to cool the berries and freeze them as quickly as possible, so a truck meets them when they come back to load any full flats on the truck. The taxpayer insists the flats are not placed or stored on the ground. It is necessary to keep the flats clean to reduce possible contamination of the fruit.

It takes less than ten minutes to drive the trucks to the facility from any of the taxpayer's fields. The loaded flats are placed in a chilling room, where cool air is blown through the flats. The sides of the flats have holes on opposite ends, which allow chilled air to pass over the berries. The berries are chilled for 24 hours to 26° Fahrenheit. When the chilling process is completed, the flats containing the chilled berries are carried to another room where they are dumped out of the flats onto a conveyer for further inspection before the berries enter the freezing tunnel, which chills them to

-10° F. After the berries are dumped out, the flats are immediately washed and either placed in a truck or stored upon the pavement adjacent to the building.

The taxpayer uses the flats in its fields (a non-qualifying manner) for up to two hours. The taxpayer then uses the flats in the building (a qualifying manner) for at least 24 consecutive hours. For the purpose of the majority use threshold, we find the flats were used directly in taxpayer's manufacturing operation a majority of the time.³

Mezzanines. Two mezzanines are located in the same room as the tunnel freezer. They are elevated acid resistant cement slabs 4" thick. They are supported by six I beams bolted to the concrete floor on 24" footings. They differ slightly in size and use. One mezzanine holds machinery used in the taxpayer's mixing and poly-bag process. Frozen fruit is loaded on a conveyor on the ground floor below the mezzanine.⁴ On the mezzanine level, a rider or shaker attempts to remove any remaining extraneous material. The fruit is then fed into the top of a twelve-foot high machine rising up through the mezzanine. The fruit is weighed as it drops, and is bagged in a preprinted freezer poly bag, which is then sealed. The sealed bags are placed into shipping boxes, which have been assembled on the mezzanine level and fed by gravity down to a box station located under the mezzanine next to the machine that bags and seals the fruit. The weighing, bagging, and boxing process is designed to utilize gravity from the twelve-foot descent from the mezzanine level to the floor.

The second mezzanine holds up three liquid storage tanks and related piping and equipment. The tanks are used to mix and then store either sugar and water or corn syrup and water according to the customers' requirements. The syrup then flows to a sprayer on the processing line before the sugar-glazed fruit reaches the flash freezer. By using the height of the mezzanine and the weight of the syrup, gravity feeds the sprayers, and the taxpayer avoids a pumping system for these liquids.

Fans. Fans mounted in the walls of the chilling room blow the chilled (26° F.) air through holes in the sides of the flats from one end of the room to the others. They blow air through the flats to chill the berries to 26°. Other ceiling fans are used to raise the temperature of frozen berries from 5° to 20° so they can be handled for packaging.

Plastic Bug Strips. To reduce contamination of the berries, the taxpayer suspend strips of plastic from the ceiling inside the doors to keep flies out of the processing area. The foot-wide strips overlap to screen off the production area from flying insects. One of the taxpayer's customers requires these strips as well as the American Baking Institute (ABI), which inspects and certifies the taxpayer's production conditions and methods. Other customers require ABI certification.

...

³ Audit suspects some of the empty flats may be left in the fields, which the taxpayer vehemently denies. From the examples of the majority use test in Rule 13601(10), to determine total overall use, we add qualifying and non-qualifying use. For this purpose, storage of the flats, whether in the fields or at the facility, is not relevant.

⁴ Rather than using the conveyor, the taxpayer lifts sweet or sour cherries and pineapple with a forklift to the mezzanine level. They are too sticky for the conveyor.

Loading Dock Equipment. The taxpayer loads refrigerated semi-tractor trailers, which back up to its processing building's loading bays. Attached to the building are loading dock levelers and door seals, which are intended to keep the trailers cool while they are loaded. From the pictures provided by the taxpayer, the seals appear to be soft plastic cushions attached to the wall around the opening. The levelers appear to be metal ramps with one end attached to the concrete floor and the other end inclined, designed to adjust to the height level of the trailer. The levelers would allow forklifts carrying boxes of frozen, packaged products to drive from the floor surface of the manufacturing facility directly into the trailers so they can be loaded quickly.

Computer Software. The taxpayer states it purchased and installed computer software to run computers used to operate production equipment. Invoices to verify and provide more detail have been requested, but not provided.

Holding tanks. Located within a few feet of the outer building wall, three large holding tanks serve different purposes. The first tank holds liquid ammonia used in the flash freezing process. The second tank holds waste water from the facility. The third tank, which is buried in the ground, is full of water used to flush the ammonia lines in an emergency. They are all affixed to the realty.

Electrical. The taxpayer contends that some of the facility's electrical fixtures are integral to its manufacturing operation. Some of the electrical system serves a building purpose. The taxpayer has been unable to provide any breakdown of the costs and installation charges for the various electrical components.⁵ The taxpayer proposes to hire an estimator to price the equipment installed and determine the cost of the items integral to its manufacturing operation.

Other building costs. The taxpayer contends that it incurred substantial costs to build a facility necessary to manufacture its products. The taxpayer offers to hire an estimator to determine the costs directly related to manufacturing. . . .

ANALYSIS

A manufacturer's purchase of certain manufacturing machinery and equipment may be exempt under RCW 82.08.02565, which provides:

- (1) The tax levied by RCW 82.08.020 shall not apply to sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation, or to sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment

⁵ According to the taxpayer, the electrical contractor for the plant's construction, "has been completely uncooperative in providing a breakdown of the costs and installation charges required for the electrical components which were installed at the plant, claim none exists."

In determining what items qualify as exempt machinery and equipment under the law, we must follow several long-accepted general rules of statutory construction. Taxation is the rule; exemption is the exception. *Spokane County v. City of Spokane*, 169 Wash. 355, 13 P.2d 1084 (1932). Exemptions from a taxing statute are to be narrowly construed. *Budget Rent-A-Car, Inc. v. Department of Rev.*, 81 Wn.2d 171, 500 P.2d 764 (1972). Exemptions are not to be extended by judicial construction. *Pacific Northwest Conference of the Free Methodist Church v. Barlow*, 77 Wn.2d 487, 463 P.2d 626 (1969). Courts and administrative bodies will not read into an act provisions they conceive the legislative body has unintentionally omitted. *Department of Labor & Industries v. Cook*, 44 Wn.2d 671, 269 P.2d 962 (1954).

There are several requirements for the M&E exemption: (1) a sale; (2) to a manufacturer or processor for hire; (3) of machinery and equipment; (4) used directly; (5) in a manufacturing operation or research and development operation. RCW 82.08.02565. All of these requirements must be met to qualify for the exemption. There is no dispute the taxpayer meets the first two requirements. The items at issue were purchased, and the taxpayer is a manufacturer or processor for hire because, under RCW 82.04.260(1)(c), freezing fruit is a manufacturing activity. *See also* WAC 458-20-136(5)(a)(iv).

The M&E exemption does not apply to:

- (i) Hand-powered tools;
- (ii) Property with a useful life of less than one year;
- (iii) Buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building; and
- (iv) Building fixtures that are not integral to the manufacturing operation, testing operation, or research and development operation that are permanently affixed to and become a physical part of a building, such as utility systems for heating, ventilation, air conditioning, communications, plumbing, or electrical.

RCW 82.08.02565(2)(b). The Department's Rule 13601 (WAC 458-20-13601) elaborates on the requirements, by adding to the definitions, offering threshold tests, and providing examples. On March 31, 2003, the Department issued nine Excise Tax Advisories (ETAs), which address issues specific to the M&E exemption. To the extent we have the relevant facts, we will apply the five statutory requirements and analyze the various disputed items in the assessment.

1. Were the taxpayer's flats used in the taxpayer's manufacturing operation a majority of the time?

[1] Provided the flats have a useful life of over one year (*see* Rule 13601(8) for the useful life threshold test), they would qualify for the M&E exemption if they are used directly in the taxpayer's manufacturing operation a majority of the time. The flats are used in the manufacturing operation to hold the berries while they are chilled and are used to move the berries within the facility. *See* RCW 82.08.02565(2)(d). The flats meet the "directly used" requirement because they are used to transport, handle, and temporarily store the fruit at the manufacturing site. RCW 82.08.02565(2)(c)(ii). However, the taxpayer's use of the flats in the

fields is not part of the manufacturing operation. Use of the flats in the fields constitutes non-qualifying use.

Machinery and equipment both used directly in a qualifying operation and used in a non-qualifying manner is eligible for the exemption only if the qualifying use satisfies the majority use requirement. Rule 13601(10). Generally, machinery and equipment may qualify for the M&E exemption only if the majority of overall use, as measured by percentage of time, percentage of revenue, volume of products derived, or other reasonable comparison measure, is in a “manufacturing operation.”

In the case of the flats, time appears to offer a practical method of applying the majority use threshold. Time is measured using hours, days, or other unit of time, with qualifying use of the M&E the numerator, and total time used the denominator. Rule 13601(10)(a)(i). The flats hold the berries in the chilling room for about 24 hours and are then used to transport them within the facility. They are used in the fields or to transport the berries on the road away from the manufacturing site for not more than two hours. Because the qualifying time used in the building (at least 24 hours) is over 50% of the total time (26 hours), we conclude the flats meet the majority use threshold.

2. Was the mezzanine floor part of the taxpayer’s building, ineligible for the M&E exemption, or was it a support facility eligible for the M&E exemption?

[2] The term “machinery and equipment” means “industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof” RCW 82.08.02565(2)(a). The M&E exemption does not apply to buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building. RCW 82.08.02565(2)(b)(iii). Worded another way, the only parts of a building that may be eligible for exemption are industrial fixtures or support facilities.

The mezzanines are elevated floors permanently attached to the building that hold equipment. Other than a variance in size, we fail to see how the floors do more than serve a building function.⁶ A structure or improvement that functions as a floor, wall, door, roof, or other building component does not qualify for the exemption. ETA 2012-7S.⁷ Physical parts of buildings that cannot be differentiated and that are not separately identifiable from surrounding construction material do not qualify as a support facility. In order to qualify under the M&E exemption, these must be differentiated and separately identified as machine foundations and must not serve a building function. ETA 2012-7S. Because the mezzanines are floors, which are a physical part of the building, they are ineligible for the M&E exemption.

⁶ An engineering study, design, or plan, confirming that the reinforced portion of the mezzanine floor was designed and constructed to support the machinery and equipment, and that it did in fact separately and differently support the machinery and equipment as a machine foundation, would be documentation for qualification. In determining what qualifies for exemption, the portion of the construction that would be there regardless of the support facility does not qualify. Only the additional construction qualifies. ETA 2012-7S.

⁷ ETA 2012-7S.08.12.13601.

3. Were the wall and ceiling fans fixtures used directly in the taxpayer's manufacturing operation?

[3] While buildings are not eligible for the M&E exemption under RCW 82.08.02565(2)(b)(iii), industrial fixtures that are integral to the manufacturing operation might be eligible, depending on whether the fixture meets the other requirements for eligibility, such as the used directly test. Rule 13601(7)(d). A refrigeration unit that cools air is a fixture or device, and it may qualify for the M&E exemption if it is used directly in the manufacturing operation. ETA 2012-7S.

The fans were tangible personal property, which became fixtures when they were permanently attached to the walls and ceilings. The fact that a fixture might be classified as real property or personal property has no bearing on eligibility for the M&E exemption. The word "fixture" denotes a type of property that can be distinguished from a "building" *per se*. For the purpose of the M&E exemption, a fixture does not lose its identity when installed. ETA 2012-7S.

The fans meet the "used directly" test because they move the air over the fruit, for the purpose of altering the fruit temperature (as opposed to maintaining temperature, a normal building function). In this manner, the fans act upon or interact with an item of tangible personal property, and are thus used directly in the taxpayer's fruit freezing operation under RCW 82.08.02565(c)(i).

4. Were the plastic bug strips used directly in the taxpayer's manufacturing operation?

[4] The plastic bug strips, if they were used directly in the taxpayer's manufacturing operation, would qualify for the exemption. Items that are not used directly in a qualifying operation are not eligible for the exemption. Rule 13601(9). RCW 82.08.02565(2)(c) provides eight descriptions of "used directly":

- (c) Machinery and equipment is "used directly" in a manufacturing operation, testing operation, or research and development operation if the machinery and equipment:
 - (i) Acts upon or interacts with an item of tangible personal property;
 - (ii) Conveys, transports, handles, or temporarily stores an item of tangible personal property at the manufacturing site or testing site;
 - (iii) Controls, guides, measures, verifies, aligns, regulates, or tests tangible personal property at the site or away from the site;
 - (iv) Provides physical support for or access to tangible personal property;
 - (v) Produces power for, or lubricates machinery and equipment;
 - (vi) Produces another item of tangible personal property for use in the manufacturing operation, testing operation, or research and development operation;
 - (vii) Places tangible personal property in the container, package, or wrapping in which the tangible personal property is normally sold or transported; or
 - (viii) Is integral to research and development as defined in RCW 82.63.010.

The manner in which a person uses an item of machinery and equipment must match one of these descriptions. Rule 13601(9). None of the eight descriptions of in RCW 82.08.02565

applies to the taxpayer's use of the plastic strip curtains. They do not act on or with anything. They passively hang in place creating a barrier for flies.

The taxpayer asserts the strip curtains are used directly because "they directly support the sanitary operation of the plant required by the health department to keep operating." They do not provide *physical* support for or access to tangible personal property described in RCW 82.08.02565(2)(c)(iv).⁸ We conclude the taxpayer's purchases of strip curtains do not qualify for the M&E exemption.

...

6. Was the loading dock equipment part of the taxpayer's building, ineligible for the M&E exemption, or was it a support facility?

[5] The loading dock equipment consists of two different fixtures, leveling ramps and door seals. Each must be analyzed. ETA 2012-7S provides:

Because fixtures and support facilities are considered to be a "physical part of a building" it is necessary to distinguish between eligible and ineligible physical parts.

Those parts of buildings that serve a building function do not qualify for the exemption. Walls, roofs, and floors of buildings are designed on a case by case basis to accommodate a particular building use, whether that use is by a manufacturer, retailer, or professional service provider. . . .

Physical parts of buildings that cannot be differentiated and that are not separately identifiable from surrounding construction material do not qualify as a support facility. In order to qualify under the M&E exemption, these differentiated and separately identifiable parts must meet a used directly test and must not serve a building function.

The Department distinguishes buildings from support facilities, based on the notion of "purpose and function." For example, a reinforced wall that is designed to bear the weight of the roof trusses does not qualify as a support facility. Roof trusses are part of the building and as such are not machinery and equipment. A portion of the reinforced wall specifically designed and constructed to provide physical support for a fixture or device as a machine foundation could be a support facility if (1) a taxpayer could show that its design is necessary for the operation of the machinery and equipment, and (2) that the reinforced wall can be shown to be differentiated and identifiable from the building. Floors are subject to the same analysis. In order for a part of a floor to qualify as a

⁸ Examples of this are catwalks adjacent to production equipment, scaffolding around tanks, braces under vats, and ladders near controls. Machinery and equipment used for access to the building or to provide a work space for people or a space for tangible personal property or machinery and equipment, such as stairways or doors, is not eligible under this criteria. Rule 13601(9)d).

support facility it has to be differentiated and separately identified and must be a machine foundation. Floors as such do not qualify for the M&E exemption.

From the pictures we have, the loading dock ramps appear distinguishable from the underlying floor.⁹ If they are metal, with the concrete floor under them, the concrete serves the building's floor function. The ramps are designed to rise above the floor, allowing the forklifts carrying the frozen fruit to drive into the trailers. Therefore, the ramps are necessary for the operation of the forklifts (equipment), and the metal adjustable ramps are separate and different from the concrete building floor. The ramps meet the two ETA 2012-7S support facility requirements.

The ramps are used directly in the manufacturing operation under RCW 82.08.02565(2)(c)(iv). They are designed for the forklifts to drive into trailers. They provide physical support for or access to tangible personal property. Rule 13601(9)(d).

The door seals do not fall under any of the used directly descriptions in RCW 82.08.02565(2)(c). Based upon the information we have, we conclude the leveling equipment (ramps) are eligible for the M&E exemption, but the door seals are not.

We understand the building contractor may have installed the leveling equipment. In determining what qualifies for exemption, the portion of the construction that would be there regardless of the support facility does not qualify. Only the additional construction qualifies. ETA 2012-7S.

7. To what extent was the computer software used to operate production equipment?

[6] At the hearing, we requested that the taxpayer provide the invoice for the computer software in dispute. We have not received the invoice or any description. Taxpayers must make records available to the Department upon request or be barred from further questioning the correctness of the assessment. RCW 82.32.070. We will allow the taxpayer thirty days from the date of this determination to provide a copy of the invoice and description of the software to the Audit Division. ETA 2012-8S provides the Department's position regarding the applicability of the M&E exemption to computer software purchases.

8. Were the holding tanks fixtures used in the taxpayer's manufacturing operation?

[7] The holding tanks located outside of the building at the manufacturing site constitute industrial fixtures because they did not lose their identity when installed and can be distinguished from the building. See ETA 2012-7S, which mentions tanks as an example of fixtures. Building fixtures can qualify for the M&E exemption if integral to the manufacturing process. In order to qualify under the M&E exemption, these different and separately identifiable tanks must meet a used directly test and must not serve a building function. ETA 2012-7S.

⁹ We have not toured the facility. We only have pictures. If the Audit Division inspects the facility and finds our factual understanding from the pictures is incorrect, this analysis and conclusion are not applicable to the loading dock equipment in dispute.

The waste water tank may qualify as pollution control equipment under RCW 82.08.02565(2)(a):

"Machinery and equipment" includes pollution control equipment installed and used in a manufacturing operation, testing operation, or research and development operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation

The pollution control equipment must be used to capture wastes and contain or prevent releases resulting from processes of the operation. ETA 2012-2S.08.12.13601. The waste water tank may be plumbed into the building's general waste water, serving a building function. Utility systems that serve a building purpose, as opposed to a manufacturing purpose, do not qualify for the M&E exemption. ETA 2012-3S. The Audit Division will need to further investigate the function of the waste water tank. A portion of the waste water tank may qualify for the exemption.

Because the two ammonia tanks store or temporarily hold an item of tangible personal property integral to the taxpayer's freezing process, they meet the directly used test under RCW 82.08.02565(2)(c)(ii). These tanks should qualify for the M&E exemption.

9. To what extent were the taxpayer's electrical systems integral to its manufacturing operation?

[8] The taxpayer's manufacturing activity is freezing fruit. This process not only requires special equipment, but also consumes more electrical power than would ordinarily be required of a manufacturing facility. Building fixtures such as electrical utility systems that are not integral to the manufacturing operation, do not qualify for the M&E exemption under RCW 82.08.02565(2)(b)(iv). To the extent the electrical fixtures are integral to this freezing process, they qualify for the M&E exemption. See ETA 2012-3S. However, to the extent they serve a building purpose, as opposed to a manufacturing purpose, the electrical fixtures do not qualify. *Id.*

The taxpayer has been unsuccessful in obtaining a cost breakdown from its electrical contractor for the components of its electrical system. Fortunately ETA 2012-3S anticipates this problem, and offers a solution for the taxpayer's specific industry, manufacturing frozen raspberries:

If a utility system is used for both qualifying and nonqualifying purposes, the system should be allocated so that only the qualifying portion of the system receives the exemption, and the building portion does not receive an exemption.

One way of allocating a utility system is by applying the ratio of the qualifying use made of the system to the total use of the system. This ratio must be established and substantiated by sufficient documentation, such as, but not limited to, engineering analyses and power bills. Thus, if the taxpayer can document that 30 percent of a system is used for the manufacturing activity (e.g., 30 percent of the system is dedicated

to manufacturing frozen raspberries vs. 70 percent dedicated to cold storage) then this 30 percent qualifies for the exemption.

The taxpayer provided a summary showing five payments totaling \$. . . for the electrical systems. The taxpayer has offered to hire an expert to estimate the price the components related to the taxpayer's M&E. ETA 2012-3S applies a ratio to the total. The Audit Division may consider additional documentation including an expert's analysis and power bills.

10. Did the building contractor provide other building fixtures or support facilities eligible for the M&E exemption?

[9] The taxpayer asserts that a substantial portion of its building cost should be exempt as a qualifying M&E expenditure. The taxpayer's building contractor is unable to provide a cost breakdown of the industrial fixtures and support facilities. The taxpayer initially asked that we allow the difference between the cost of its building designed for its manufacturing process and the estimated cost of a general purpose building. However, RCW 82.08.02565(2)(b)(iii) specifically provides that the machinery and equipment definition does not include buildings. Because many factors can be attributed to a buildings cost, other than fixtures and support facilities that may be eligible as M&E, the taxpayer is not entitled to an M&E exemption based upon cost difference of buildings. ETA 2012-7S states:

Those parts of buildings that serve a building function do not qualify for the exemption. Walls, roofs, and floors of buildings are designed on a case by case basis to accommodate a particular building use, whether that use is by a manufacturer, retailer, or professional service provider. Walls, roofs, and floors are also designed differently on the basis of external elements such as stability of the underlying earth, winter and summer temperature, and precipitation levels. Walls, roofs, and floors thus serve a general building function, even if designed and constructed differently.

* * *

The M&E exemption does not extend to buildings and this restriction applies even if the building is specially designed and unique.

In the alternative, the taxpayer offers to hire a cost estimator to analyze the cost to construct those items directly related to the manufacturing process. While helpful and interesting, that information alone does not entitle the taxpayer to the exemption. Again, ETA 2012-7S guides us to determine what may qualify as industrial fixtures and support facilities under RCW 82.08.02565(2)(b) and specifies the documentation necessary:

An engineering study, design, or plan, confirming that the reinforced portion of the wall or floor was designed and constructed to support the machinery and equipment, and that it did in fact separately and differently support the machinery and equipment, would be documentation for qualification. In determining what qualifies for exemption, the portion

of the construction that would be there regardless of the support facility does not qualify. Only the additional construction qualifies.

We will allow the taxpayer sixty days from the date of this determination to make such documentation available to the Audit Division. We strongly suggest the taxpayer and the Audit Division meet prior to having a study, design, or plan produced to identify the specific industrial fixtures and support facilities, which may qualify as M&E. The Audit Division, in its discretion, may extend the due date for providing such information. . . .

DECISION AND DISPOSITION

We grant the taxpayer's petition in part, deny in part, and remand in part. The flats, loading dock ramps, . . . , fans, and ammonia holding tanks are eligible for the M&E exemption. The mezzanines, loading door seals, and bug strips are subject to tax. Additional information is necessary to determine the taxability of the computer software, waste water holding tank, electrical system, and other construction items. This matter is remanded to the Audit Division for adjustment to the assessment based on this decision and for possible additional adjustment based on records the taxpayer must provide within sixty (60)

Dated this 26th day of November, 2003

STOEL RIVES LLP

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