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ETA 3122.2016

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Manufacturers' Machinery and Equipment Exemption – Design and Product Development

Purpose

The Department has issued a series of excise tax advisories (ETAs) to address questions regarding the retail sales and use tax exemptions 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 design and product development. Refer to ETA 3117.2009 for a current list of the issues covered by this series.

Additional M&E Exemption Requirements

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 satisfy the majority use requirement.

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.

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**M&E Used
for Design and
Product
Development**

Questions have been raised regarding whether machinery and equipment used for design and product development purposes are eligible for the M&E exemption. In terms of manufacturers engaging in research and development, this ETA only addresses “design” that is not “research and development” as that term is used in chapter 82.63 RCW.

**Manufacturing
Operation**

The manufacturers’ machinery and equipment exemption is directed toward activity that takes place from the point where raw materials enter the manufacturing site to the point where processed materials leave the manufacturing site. This range of activity is referred to in the M&E statute as the “manufacturing operation.” Design is an activity that precedes or is separate from actual manufacturing and is not part of the “manufacturing operation,” as that phrase is defined in the M&E statute. Design includes engineering, and other analytical and creative work.

The Department makes a distinction between activities that take place within the manufacturing operation and activities that either precede or follow the manufacturing operation. For example, creation and design of information, such as writing text for a newspaper, is an activity that takes place before the manufacturing operation begins. However, the preparation of this information for use in a manufactured product is an activity that generally occurs in the manufacturing operation. Composition of a book or the writing of a newspaper article are activities that are considered product development and outside of the manufacturing operation, and thus are not considered to be within the scope of the M&E exemption. Similarly, design of an automobile or engineering of a piston are considered product development and outside of the manufacturing operation. However, taking a completed manuscript and preparing it for printing could be part of the manufacturing operation, as could be the layout and pagination of a newspaper. Other products that have information content, such as compact discs and music, are subject to the same tax application.

Essentially, the creation of the information is not manufacturing and is not part of the manufacturing operation. Property that is used both in product development and in manufacturing of tangible personal property may be eligible for the M&E exemption, if all other requirements of the exemption are met.

**Exception to
Product
Development
Exclusion
from M&E
Exemption**

Effective August 1, 2015, the M&E statutes (RCW 82.08.02565 and RCW 82.12.02565) provide an exception to the exclusion of machinery and equipment used in product development from the M&E exemption. For purposes of the M&E exemption, “manufacturer” includes persons engaged in the development of prewritten computer software that is not transferred to purchasers by means of tangible storage media. Therefore, a software developer that delivers the final product to their customers electronically (e.g., via digital download or by remote access) is eligible for the M&E exemption provided the additional M&E exemption requirements found in RCW 82.08.02565, RCW 82.12.02565, and WAC 458-20-

13601 are satisfied.

A business defined as an “ineligible person” (per RCW 82.08.02565) may not claim the sales and use tax exemptions.

Ineligible Person

An “ineligible person” means all members of an affiliated group when all the following apply:

1. At least one member of the affiliated group was registered with the Department of Revenue to do business in Washington State on or before July 1, 1981; and
2. As of August 1, 2015, the combined employment in Washington of the affiliated group exceeds forty thousand full-time and part-time employees, based on data reported to the Employment Security Department; and
3. The business activities of the affiliated group primarily include development, sales, and licensing of computer software and services.

An “affiliated group” means a group of two or more entities that are either:

- Affiliated as defined in RCW 82.32.655; or
 - Permitted to file a consolidated return for federal income tax purposes.
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Presumption

The Department will presume that design activity is not part of the manufacturing operation and machinery and equipment used in design is not eligible for the M&E exemption. Equipment used in redesign or refinement of a product after manufacturing has begun is not eligible for the M&E exemption. This presumption can be overcome by showing that the design decisions and the application of labor and skills to the raw materials are the same activity.

Computer Equipment Used by a Printer, Publisher, or the Aerospace Industry

While machinery and equipment primarily used in design and product development generally 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," as defined in RCW 82.08.806, primarily in the printing or publishing of any printed material. This exemption 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.
