Cite as 3 WTD 447 (1987)

BEFORE THE INTERPRETATION AND APPEALS SECTION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of)	D E T E R M I N A T I O N
	No. 86-250
	Registration No. . . .
. . .	

[1] **RULE 228**: INTEREST -- UNCLEAR TAX LIABILITY. The fact that the taxpayer's tax liability was unclear and it could not compute its tax without an interpretive ruling and audit is not identified by Rule 228 as a circumstance under which the Department will cancel interest.

[2] **RULE 178**: USE TAX -- PUT TO USE. Use tax liability arises at the time the property is first put to use in this state. Property is not put to use if invoiced but not received in Washington.

[3] **RULES 155 and 224**: USE TAX -- INTERVENING USE -- CUSTOM SOFTWARE -- INTERACTIVE COMPONENTS -- INTEGRATED SYSTEM OF COMPUTER HARDWARE AND CUSTOM SOFTWARE. Use tax not due on computer systems and similar electronic hardware which is purchased for resale and becomes part of a final manufactured product, even though the items also are used throughout the development process to store data, develop, test and modify the software that is incorporated into the final product.

Situations described in ETB's 79, 106, 240, 391, 442, 475 and 479 in which a taxpayer was subject to use tax liability are distinguishable, as none involved the use of products incorporated into the final product.

These 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.

TAXPAYER REPRESENTED BY: . . .
. . .

DATE OF HEARING: July 24, 1986

NATURE OF ACTION:

Taxpayer petitions for a waiver of interest assessed and a ruling that "interactive components" are purchased for resale and not subject to use tax.

FACTS AND ISSUES:

Anne Frankel, Administrative Law Judge -- The taxpayer registered its business in 1984, describing the principal product or services rendered as "design, develop and support computer graphics software and hardware."

The taxpayer was awarded a subcontract with another corporation . . . which has a contract with the United States [Government] to develop a computer generated [program] . . . .

The completed system consists of three major components: a Data Base Construction System, an Image Generator, and a number of video displays. The taxpayer's subcontract called for it to provide the first two components, referred to as the "Visual System."

On November 5, 1985 the taxpayer wrote the Department requesting an interpretive ruling regarding the proper excise treatment of the subcontract activities. The Department's Taxpayer Information and Education Section responded to the request by letter dated January 14, 1986, summarizing the taxpayer's excise tax liability on the subcontract as follows:

1) Income from manufacturing the [visual] system is subject to wholesaling or manufacturing tax, depending on whether delivered within or outside Washington. The taxable amount is the gross contract price, less the value of the custom produced software involved;

2) Consumable supplies are subject to retail sales or use tax;

3) Inactive and Interactive components are not subject to retail sales or use tax because purchased for resale; and

4) Charges for the development and production of custom programs required for the operation of the manufactured system are subject to the Service and Other Activities B&O tax upon the full value of such programs.

As the taxpayer's subcontract did not segregate the income received for developing the custom programs from that received for manufacturing the system, the taxpayer requested an audit so it could correctly report and pay its excise taxes. The audit was completed February 23, 1986 and covers the period July 1, 1984 through December 31, 1985. The audit resulted in Tax Assessment No. . . . for . . . in taxes and interest. The bulk of the assessment is for use tax.

At the hearing, the taxpayer expressed some disagreement with the assessment of use tax for 1984, contending the tax was assessed on some items which were not used until 1985. Primarily, however, the taxpayer protests the assessment of . . . in interest. The taxpayer believes the interest should be waived for the following reasons:

1) Prior to the audit, the law was unclear as to how various elements of the subcontract should be reported for excise tax purposes.

2) The taxpayer could not compute and pay the correct amount of tax without an interpretive ruling and did all that it could to compute and pay the correct amount of tax in a timely manner.

3) Unlike the excise tax itself, interest and penalties are not reimbursable subcontract costs; thus the taxpayer will suffer an "economic penalty" unrecoverable as part of its costs of doing business.

4) The taxpayer gained no economic advantage from use of the funds to pay the taxes due. The taxpayer is only reimbursed for actual costs incurred. Since the assessment was not received until March of 1986, the taxpayer will not be reimbursed for the assessment until April, 1986.

The auditor's report also contained a note advising the taxpayer that for future reporting periods, interactive components used in producing custom software would be subject to retail sales or use tax. The auditor found the earlier instructions issued by the Department's Taxpayer Information and Education Section incorrect. The taxpayer seeks a ruling upholding the earlier instructions.

DISCUSSION:

[1, 2] RCW 82.32.050 makes mandatory the assessment of interest upon delinquent payment of tax. The only authority to cancel penalties or interest is found in RCW 82.32.105. That statutory provision allows the Department to waive or cancel interest or

penalties, if the failure of a taxpayer to pay any tax on the due date was the result of circumstances beyond the control of the taxpayer. RCW 82.32.105 also requires the Department to prescribe rules for the waiver or cancellation of interest and penalties.

The administrative rule which implements the above law is found in the Washington Administrative Code 458-20-228 (Rule 228). Rule 228 list two situations which will constitute circumstances under which a waiver or cancellation of interest upon assessments pursuant to RCW 82.32.050 will be considered by the department:

> 1. The failure to pay the tax prior to issuance of the assessment was the direct result of written instructions given the taxpayer by the department.
>
> 2. Extension of the due date for payment of an assessment was not at the request of the taxpayer and was for the sole convenience of the department.

Neither of those circumstances apply in this case to provide grounds for the Department to cancel the interest that was assessed.

Instead, the taxpayer presents an equitable argument that its tax liability was unclear and it could not compute its tax without an interpretive ruling and audit. Although we agree that the issue as to whether the taxpayer was providing a service or manufacturing a product was unclear, the bulk of the assessment at issue is for use tax. We do not agree that the issue of use tax liability is unclear.

WAC 458-20-178 (Rule 178) is the administrative rule dealing with the use tax. The rule clearly provides that use tax applies upon the use as a consumer of tangible personal property, the sale or acquisition of which has not been subjected to the Washington retail sales tax. Use tax liability arises at the time the property is first put to use in this state. Rule 178 states that "put to use" includes any act "by which the taxpayer takes or assumes dominion or control over the article and shall include installation, storage, withdrawal from storage, or any other act preparatory to subsequent actual use or consumption within the state."

The auditor relied on vendor invoices in assessing use tax. The 1984 assessment was based on invoices dated for September and December of 1984 for computers, image writers, etc. Use tax clearly arose in 1984 if these items were received by the taxpayer in Washington at that time. Interest is imposed at the rate of nine percent per annum from the last day of the year in

which the deficiency is incurred until the date of payment. RCW 82.32.050.

If any of the items were invoiced but not "put to use" by the taxpayer in 1984, the taxpayer can present such evidence to the auditor and receive a correction of the amount of interest assessed. Such facts would be shipping documents or other evidence showing that the items were not received by the taxpayer in Washington in 1984.

Otherwise, the assessment of interest is sustained. Although the taxpayer has not had the use of these funds and may realize an "economic penalty" because the interest is unrecoverable as part of its contract costs, as an administrative agency we have no discretion to grant relief for that reason.

[3] In its November 5, 1985 letter to the Department, the taxpayer described interactive components as

> (3) Computer systems and similar electronic hardware which become part of the final system, but which also are utilized in the development of the system itself. These items, such as the . . . computers, are used throughout the development process to store data, develop, test and modify software, design circuitry that will be part of the system, etc.

In referring to these items as "interactive components," the taxpayer emphasized that in all cases they are purchased for ultimate delivery to the government as integral parts of the finished Visual System. As noted above, the Department's Taxpayer Information and Education section concluded interactive components are for resale and are not taxable at retail nor subject to use tax, noting resale certificates should be provided.

In revoking these instructions, the auditor noted that the development and production of computer software for a specific user is taxable under the Service and Other Activities classification. See WAC 458-20-155. The auditor relied on WAC 458-20-224 (Rule 224) which states "The Retail Sales Tax applies upon all sales of tangible personal property made to persons for use or consumption in performing a business activity which is taxable under the Service and Other Activities classification of Chapter 82.04 RCW." RCW 82.04.050 provides that a "retail sale" does not include tangible personal property purchased for resale in the regular course of business without intervening use by such person. The auditor did not dispute that the property was purchased for resale in the regular course of business, but contended the taxpayer's use of the computer systems and

electronic hardware in producing the custom software represented "intervening use." The auditor stated the Department would honor the letter ruling with regard to the subcontract at issue, but that tangible personal property used similarly in the future will be subject to Retail Sales Tax or Use Tax.

The system developed by the taxpayer consists of customized hardware and software components which are interdependent. The integrated visual system is produced as a package. We do not believe testing and using the components in the production of the software--which is part of the integrated system--is taxable use. We do not see how a manufacturer could produce a computer-based product without testing and using the total system. We would not agree, for example, that one programming an onboard computer for use in an airplane would be liable for use tax on the airplane, if the two were designed and sold as an integrated system and the airplane was "used" in designing and testing the operational software.

We agree that the use tax or retail sales tax applies to any computer hardware purchased only for use in developing custom software, or to hardware purchased for resale as part of the manufactured integrated system which is also used in testing and developing software other than that integrated into the system.

At the hearing, however, the taxpayer stated it does not use any of the interactive components to produce any custom software other than that produced as a part of the visual system. The components are marked with a coded sticker indicating they are property of the federal government. The taxpayer is prohibited from using the government property for any use other than the project for which it was purchased: in the present case developing the [visual] system.

We find the taxpayer's use of "interactive components" distinguishable from situations in which a manufacturer was subject to use tax liability, as where a manufacturer produces tools to a customer's specifications and then uses these tools to manufacture parts for the customer. Even though the customer is subsequently billed for, and becomes the owner of the tools and the parts, the use tax is due on the value of the tooling. See ETB 479.12.178.136. The auditor relied in part on such decisions in determining use tax is due on the taxpayer's use of interactive components in designing the custom software.

WAC 458-20-134 gives examples of commercial or industrial use:

> 1. The use of lumber by the manufacturer thereof to build a shed for his own use.

> 2. The use of a motor truck by the manufacturer thereof as a service truck for himself.
>
> 3. The use by a boat manufacturer of patterns, jigs and dies which he has manufactured.
>
> 4. The use by a contractor building or improving a publicly owned road of crushed rock or pit run gravel which he has extracted.

None of these are examples of the use of property which is incorporated into the manufactured product.

The taxpayer distinguished other situations in which a manufacturer was subject to use tax liability under WAC 458-20-136 (Rule 136). Rule 136 provides that manufacturers are liable for use tax "upon the use of articles manufactured by them for their own use in this state." The taxpayer noted that those situations typically involve a one-time use of an item which is "consumed" to produce another product, not the process of incorporating the articles into the final product. The taxpayer cited ETB 79.12.178 (use tax imposed on the manufacture of dies; the possession of the dies was held exclusively by the taxpayer and the dies were not part of the product sold to the customers); ETB 240.12.134 (use and manufacturing tax on production of molds used to produce finished product); ETB 442.12.142 (use tax due on film used to produce portraits); and ETB 391.12.144 (printers liable for use tax upon the use of "printing masters" even though they are sold to customers).

As the taxpayer noted, none of the above tax bulletins described situations which involved the use of products incorporated into the final product. The opinion in ETB 442 states that the negatives were not a component or ingredient of the completed portrait. ETB 391 notes the "use" by the printer was a separate and distinct taxable activity from any subsequent sale of the same articles.

In ETB 475.12.178, the question was whether the use of "pins and loads" (powder fasteners used in the construction industry) were subject to the use tax. The bulletin states:

> Since the "pin" portion of a "pin and load" becomes a component part of the finished structure, it is purchased for resale. The "load" portion (powder load) is used in the construction and not resold as a part of the completed structure. Therefore, the Department has held the use or sales tax to be applicable to the use or purchase of powder loads but not to the use or purchase of the pins. Since the pins and loads are

> purchased as units, the tax applies only to that part of the price attributable to the loads.

Similarly, ETB 106.12.178 states the Tax Commission had upheld use tax on paper roll cores used to contain and transport paper manufactured. "The Tax Commission held that the large roll cores did not become components of the articles produced for sale but were merely for the taxpayer's own use."

We conclude that the earlier instructions provided by the Taxpayer Information and Education Section are correct. The retail sales tax or use tax does not apply to the taxpayer's use of the interactive components which become part of the final system, but which also are utilized in the development of the system itself.

DECISION AND DISPOSITION:

1) The taxpayer's petition for correction of Tax Assessment No. . . . is denied. The amount remaining owing of . . . , plus unwaived extension interest of . . . , for a total sum of . . . shall be due by October 2, 1986. Because the delay in issuing this Determination was not the result of any action by the taxpayer, but was for the convenience of the Department, interest on the unpaid balance shall be waived from June 15, 1986 through the new due date.

If the taxpayer believes use tax was improperly assessed for some items in 1984, it may present that evidence to the auditor. The evidence should be presented prior to the new due date if it wishes a correction of the assessment or within the statutory time limit imposed by RCW 82.32.060 (four years) if it wishes to petition for a refund.

2) Interactive Components are for resale and are not taxable at retail nor subject to use tax. Resale certificates should be provided.

DATED this 12th day of September 1986.