Cite as Det. No. 98-110, 18 WTD 26 (1999)

BEFORE THE APPEALS DIVISION
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. 98-110
. . .	)	Registration No. . . .
	)	FY/Audit No. . . .

[1] RULE 136: B&O TAX -- MANUFACTURING - MAJOR COMPONENTS -- MINOR COST OF ASSEMBLY. The physical assembly of a motor and a pump constitute manufacturing because a "new, different and useful" product has been produced, even though the cost in time and money of such assembly is minimal when compared with the cost of its major components.

[2] RULE 136: B&O TAX -- MANUFACTURING -- PHYSICAL ASSEMBLY OF COMPONENTS -- ETB 398 --APPLICABILITY. ETB 398 is applicable when there is the combination and/or packaging of individual components, and not when various components are physically assembled in this state. While the source of components is one factor to be considered under ETB 398 in order to determine whether an activity is manufacturing, the source of components is not a factor when there is actual physical assembly.

[3] RULE 193: B&O TAX - DELIVERY TO BUYER'S OWN IN-STATE FREIGHT FORWARDING OFFICE. For the purposes of Rule 193, when delivery is made to a buyer's Washington office, which office acts as the buyer's own freight forwarder, that office cannot be considered an independent 'freight forwarder" merely because buyer's employees do not inspect the goods received there before forwarding them out-of-state.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

Taxpayer protests the disallowance of the interstate sales deduction for sales to Alaska customers who do their own freight consolidation, and the classification of its activities as manufacturing.[1]

FACTS:

Bauer, A.L.J. -- Taxpayer's books and records were audited by the Department of Revenue (Department) for the period January 1, 1991 through March 31, 1996. As a result of this review, the above-referenced tax assessment has been issued in the final amount of $ . . . , including interest. Taxpayer timely petitioned for correction of assessment.

Taxpayer is a distributor of air compressors, industrial pumps, motors, and various other parts and supplies for this line of equipment. In all cases, equipment sold by Taxpayer is sold under the manufacturer's brand name, and in all cases, warranties are those of the manufacturer only. Taxpayer does not sell pumps, compressors, or assemblies under its own brand name.

Taxpayer sells, as individual items, pumps, compressors, motors, and other parts. It is not unusual for a customer purchasing a pump and motor to request that Taxpayer assemble them before they are shipped. This is a simple procedure which typically involves bolting a motor directly to the pump, or in some cases, bolting the motor to the pump using a coupling. Depending upon the particular customer's needs and the type of pump that is being sold, the pump may also be mounted on a structural base. In most instances, the base unit is purchased from [a third party or the manufacturer of the motor/pumps] but in some cases (e.g., if the pump is a different brand), Taxpayer may simply bolt the pump to a piece of channel steel. Components commonly necessary for completing such assemblies include a motor, pump, a coupling guard, and a base.

According to Taxpayer, the cost of a pump that has been mounted with a motor is the same as it would be if the components were sold separately, except that a labor cost is added for the time spent in the mounting process. Because the mounting process is simple, the labor charge is insignificant when compared to the cost of the unit. For example, in one actual case involved in this audit, the cost of the pump and motor was $48,597 and the labor cost for mounting was $660 (1.3% of the total cost).

Most of Taxpayer's sales do not require any mounting. Of those sales where mounting is requested by the customer, the majority are transactions where all component parts are purchased from a single vendor (individually, not in bulk). A small portion are sales which require purchases from various vendors to meet delivery requirements. Flexibility is crucial to meet customer's requirements, and to stay in business.

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

The Department's Audit Division (Audit) imposed the manufacturing B&O tax on Taxpayer's interstate sales of motors and pumps in those instances in which Taxpayer assembled motors and pumps onto mounting plates for customers.

Taxpayer does a significant amount of business with large fish processing companies located in Alaska. In typical transactions, buyers in Alaska order parts or equipment from Taxpayer for shipment to their Alaskan facilities. Deliveries of these goods, which tend to be large and bulky, are usually made by ship rather than by air. Most of these Alaskan buyers avail themselves of the retail sales tax exemption in RCW 82.08.0269 (sales bound for noncontiguous states), and physically take possession of the goods at their own freight consolidation offices at or near the docks in Seattle, Washington. These facilities, maintained by the Alaskan buyers, are only for freight consolidation. Employees at those sites simply receive the goods, consolidate them with other goods, and place them on board ships bound for Alaska. These employees do not know (other than from shipping documents) what the goods are, and have no authority to accept or reject them. Their sole function is to facilitate the shipment of needed supplies and equipment to their Alaskan facilities. Only when the goods are received in Alaska are they uncrated and examined to determine whether they conform to the contract and are suitable for their intended purposes.

The Department's Audit Division (Audit) disallowed the interstate sales business and occupation (B&O) tax deduction in those instances where the freight was consolidated in the buyers' own consolidation facilities, even though there was no dispute that the goods were bound for Alaska. Audit did allow the retail sales tax exemption under RCW 82.08.0269 in these cases, and also allowed a deduction for sales when goods were delivered to third-party freight consolidators hired by buyers.

TAXPAYER'S EXCEPTIONS:

Schedule II: Manufacturing B&O Tax Due on Assembled Products (Disallowed Interstate Wholesale Sales).

Taxpayer is appealing Audit's decision that it is a manufacturer on practical grounds. Its success has been to simplify and automate functions within the company, and the Department's holding that it is a manufacturer has defied this.

Taxpayer complains that there are no definitive manufacturing guidelines promulgated by the Department. Colloquially, Taxpayer is not a manufacturer. Although Taxpayer knows that the legislature has not used the colloquial definition of "manufacturer," it claims that this doesn't help people who are applying this on a day-to-day basis. Washington Supreme Court guidance has not brought much clarity to the issue. Here, a customer wants a pump, and wants a motor along with the pump.

Taxpayer compares itself to a car dealer who adds options to new cars, but are nevertheless not considered to be manufacturers. Taxpayer also cites Det. No. 92-231, 12 WTD 233 (1993),

which Taxpayer cites for the proposition that the combining of stereo components for sale is not manufacturing. Taxpayer states that, although it has been audited five times, it has never before been deemed a manufacturer

Taxpayer cites Bornstein Sea Foods, Inc. v. State of Washington, 60 Wn.2d 169, 373 P.2d 483 (1962), in which the court ruled that filleting fish constituted "manufacturing" because changing a fish to a fish fillet constituted a "significant change." Taxpayer also cites McDonnell & McDonnell v. State of Washington, 62 Wn.2d 553, 556-57, 383 P.2d 905 (1963) (McDonnell), wherein the court identified factors to be considered in determining whether there was a "significant change":

> We realize that the criterion stressed in Bornstein -- namely, whether there has been a significant change -- is somewhat general in nature and may seem easier as a matter of articulation than as a matter of application. Nevertheless, as we stated in Bornstein, the end product -- that is, the product or substance as it is released or sold by the one performing the process -- must be compared with the substance initially received by that processor. In making this comparison, consideration should be given to the following factors: among others, changes in form, quality, properties (such changes may be chemical, physical, and/or functional in nature), enhancement in value, the extent and the kind of processing involved, differences in demand, et cetera, which may be indicative of the existence of a "new, different, or useful substance."

Taxpayer argues that, in this case, there is no change in form or quality or property of the goods. The motor remains a motor, and the pump remains a pump. The only change is that the two are bolted together. Taxpayer further argues that the enhancement in value is minimal. The labor charge for the mounting is usually less than ten per cent of the total sale.

Taxpayer points out that the "extent and kind of processing involved" depends on the definition of "processing." If one applies the Webster definition -- "to subject to a special method or process" -- Taxpayer doubts there is any "processing" at all.

Taxpayer argues there is little, if any difference, in demand between the pump and motor as separate units versus the pump and motor after mounting. The mounting process is done as an accommodation to the customer. Taxpayer could just as easily sell the pump and motor separately, deliver both to the customer, and assist the customer in bolting them together.

Finally, Taxpayer addresses ETB 398, upon which the auditor relied, objecting that it does not contain the same criteria as the Supreme Court cases referenced below.

Schedule IV: Disallowed interstate sales to Alaska customers who do their own freight consolidation. Taxpayer argues that WAC 458-20-193 (Rule 193) does not require that the freight consolidation be performed by a hired third party freight consolidator, and is not aware of any other direct legal authority on this point. Taxpayer notes that the closest case is Det. No. 92-015, 12 WTD 057 (1992), in which Audit asserted a deficiency for retail sales tax because goods

had been delivered in Washington to a wholly-owned subsidiary of the taxpayer for transportation to the taxpayer in Oregon. The determination held, in remanding the case, that the wholly-owned subsidiary could be considered a for-hire carrier, despite its affiliation to the taxpayer.

In another analogous case, the Washington Supreme Court held that goods had entered the export stream even though they had been delivered by the seller to the buyer's own packing facility within Washington. See Carrington Co. v. Department of Rev., 84 Wn.2d 444, 527 P.2d 74 (1974) (Carrington).

Taxpayer submits that under the plain language of Rule 193, if a buyer operates its own freight consolidation facility, and the person actually consolidating the goods for shipment to Alaska has no authority to accept of reject the goods, the transaction should not be taxable for B&O tax purposes. Taxpayer also points to ETB 561.04.193.

Taxpayer further notes that, for practical reasons, it is important that sales which are exempt from retail sales tax also be exempt from B&O tax. For a small company, treating hundreds of invoices every week differently is administratively and logistically unmanageable.

ISSUES:

1. When Taxpayer, a supplier, sells a pump and a motor to an out-of-state buyer, and at the buyer's request mounts them on a base plate and physically joins them together so that they work mechanically as a unit, does this activity constitute manufacturing even though the labor involved is nominal when compared with the purchase price of the two components, and even though Taxpayer does not additionally provide a name or warranty to the unit?

2. When Taxpayer sells goods to an Alaskan company which takes physical possession of them at its own freight consolidation office at or near the docks in Seattle, Washington, and the buyer's employees there have no authority to accept or reject the goods, but merely consolidate and ship them to the Alaskan facility, is the sale B&O tax exempt under WAC 458-20-193 (Rule 193)?

DISCUSSION:

Manufacturing. RCW 82.04.120 defines the term "to manufacture":

> "To manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use.

Taxpayer is correct in noting that this is not the conventional meaning of "to manufacture," and it does it lend itself to perfect clarity. Taxpayer has strenuously argued that the physical

assembly of motors and pumps is not manufacturing because it do not result in a "new, different, or useful" product under RCW 882.04.120. We disagree.

Taxpayer has articulated in its petition the correct legal standard as to whether manufacturing -- the creation of a "new, different, or useful product" -- has taken place. Taxpayer has cited McDonnell, quoted above, which advised that the product or substance as it is sold must be compared with the substance initially received by the processor.

In this case, Taxpayer receives a separate motor and a pump. The pump is incapable of pumping without a motor. The motor, in and of itself, is incapable of pumping or performing any other useful function. Once physically joined, the pump and motor are capable of performing a pumping function. This is therefore a basic change in both form and function. The fact that buyers request Taxpayer to physically assemble these components before they are shipped indicates that, for at least those buyers, the physically-assembled product is not only different, but more desirable, than the components received separately.

As to Taxpayer's argument that the "extent and kind" of processing involved is minimal and therefore could not constitute "manufacturing," the ultimate test is whether the end product is "new, different, or useful." As demonstrated in Det. No. 88-354, 6 WTD 371 (1988), even the minor addition of silk screening to an already completed shirt has been held to be manufacturing. The shirt -- undeniably wearable as a shirt before and after, and therefore not remarkably different in either function or value -- was a markedly different product after the silk-screening process because it was then fashionably attractive to an entirely different type of buyer.

Taxpayer has compared itself to a car dealer who adds options to new cars. Dealer options are normally minor additions to a vehicle which do not change the basic nature of the vehicle, and are therefore taxable under the retailing classification as alterations or improvements under RCW 82.04.050(1)(b). Taxpayer has also cited Det. No. 92-231, supra, for the proposition that its activity is similar to the combination of stereo components. We would have to note that because the determination concerned the combination of food items in gift basket, the stereo component example was not at issue and is therefore dicta. However, we note that the physical assembly of Taxpayer's motor and pump differ markedly from the stereo component example, in that stereo components are generally intended and designed to be immediately and easily interchangeable with other stereo components, and are only tenuously joined together by removable cables. Further, Det. No. 92-231 pre-dated the issuance of ETB 398, concerning the combination and packaging of individual items into sets or kits, so its rationale may be of limited usefulness.

Taxpayer states that, although it has been audited five times, it has never been determined to be a manufacturer. However, the Department's mere failure to discover a liability in the course of an audit is not binding. The Washington Supreme Court, in addressing a similar situation in Kitsap-Mason Dairymen's Assoc. v. Tax Commission, 77 Wn.2d 812, 818, 467 P.2d 312 (1970), held that the state may not be estopped from collecting taxes rightfully due because of a mistake or oversight by one of its employees:

> This is not a case in which the auditors changed their interpretation of a statute or rule. It is one in which they overlooked through ignorance, neglect or inadvertence Kitsap's error in computing the tax. The fact that the oversight only recently has been discovered does not relieve Kitsap of its liability for the correct tax during the audit period now under consideration. (Emphasis supplied.)

In this case, therefore, Taxpayer is not excused from correct payment of its taxes because the Department, in previous audits, failed to assess manufacturing tax.

[1] For the reasons stated above, we hold that the physical assembly of a motor and a pump constitute manufacturing because a "new, different and useful" product has been produced, even though the cost in time and money of such assembly is minimal when compared with the cost of its components.

It appears from Taxpayer's file that there has been reliance by Audit, followed by Taxpayer, on Excise Tax Bulletin 398.04.136 (First Revision) (ETB 398). Such reliance is misplaced. By its very terms, ETB 398 addresses the combination of individual items, as opposed to their mere "packaging" or "marketing." Such combination and packaging - but not physical assembly - may in some instances create a new and different product subject to the manufacturing tax. ETB 398 states, in part:

> In some cases the "assembly" may consist solely of combining parts from various suppliers to create an entirely different product which is sold as a kit for assembly by the purchaser. In these situations the manufacturing tax will apply even if the person combining the parts does not completely assemble the components, but sells them as a package.

An example given in ETB 398 includes individual items of prepackaged food, each component of which is left in its original packaging under its own label, but, which when combined together in a decorative basket, becomes a gift basket. Items subject to ETB 398 contain components which, although they may be packaged together as a whole, are not otherwise physically joined.

The sentences which precedes the language of ETB 398 quoted above is the language upon which Taxpayer and Audit have apparently relied:

> The Department considers "manufacturing" to include the assembling of products from component parts. The manufacturing tax applies to persons located in Washington who purchase from various suppliers component parts and apply labor to assemble these parts into a new, different, or useful product.

[Emphasis added.] While the manufacturing tax does, in fact, apply to those who purchase and assemble components from different suppliers, the converse is neither implied nor correct: that those who purchase their components from a single supplier are not manufacturers. The above-emphasized sentence from ETB 368 merely illustrates one situation in which manufacturing will apply, in order to serve as a departure into the ETB's discussion about the combination and

packaging of components which are not physically assembled. In some instances, such mere combination will be considered manufacturing, even though there might not be a physical assembly. In making that determination, one circumstance to be considered is whether the components came from one or multiple suppliers. Where there is actual physical assembly of an item, the source of its components is not an issue to be considered.

[2] Therefore, we advise that ETB 398 is applicable when there is an combination and/or packaging of individual components, and not when various components are physically assembled in this state. While the source of components is one factor to be considered under ETB 398 in order to determine whether an activity is manufacturing, the source of components is not a factor when there is actual physical assembly.

The pumps and motors subject to this appeal are physically joined together by Taxpayer in this state, and are not merely combined and packaged together as a set. The reasoning of ETB 398 is therefore not applicable to this case. It appears that motors and pumps acquired from the same source may not have been taxed by Audit. We will not disturb this finding, but merely advise that, from the date of this determination, acquisition of components from the same source will not be grounds for exemption.

Taxpayer's petition as to the manufacturing issue is denied.

Freight Forwarding by Customers. As to Taxpayer's concerns regarding the taxability of sales when products have been delivered to the in-state freight forwarding offices of its Alaskan customers, Rule 193(3)(b) provides:

> (b) Where the seller delivers the goods to the purchaser who receives them at a point outside Washington neither retailing nor wholesaling business tax is applicable. This exemption applies even in cases where the shipment is arranged through a for-hire carrier or freight consolidator or freight forwarder acting on behalf of either the seller or purchaser. It also applies whether the shipment is arranged on a "freight prepaid" or a "freight collect" basis. The shipment may be made by the seller's own transportation equipment or by a carrier for-hire. For purposes of this section, a for-hire carrier's signature does not constitute receipt upon obtaining the goods for shipment unless the carrier is acting as the purchaser's agent and has express written authority from the purchaser to accept or reject the goods with the right of inspection.

(Emphasis added.) The above-emphasized language indicates that, in order for the exemption to apply, the seller must deliver the goods to a third party freight forwarder, and not merely a satellite office of the buyer which engages in freight forwarding activities on its own behalf. This interpretation is necessitated by the emphasized language, which provides that the carrier, freight consolidator, or freight forwarder must "act... on behalf of either the seller or purchaser." Only a third party freight forwarder would need written express authority to "act on behalf of either the seller or the purchaser" -- an office of the buyer itself needs no such express authority, because the buyer cannot be an agent for itself. See also ETB 561.04.193, titled "Receipt of Goods Through an

Agent" (emphasis added) which concerns receipt of inbound goods at an out-of-state location which may be accepted out of state by freight forwarders having "express written authority to accept or reject the goods for the purchaser with the right of inspection."

Although not directly on point, Det. No. 92-015, 12 WTD 057 (1992) concerned the imposition of use tax on an out-of-state corporate customer when its goods were picked up in Washington and transported out of state to the buyer by the buyer's separately-organized corporate affiliate. It was held that a separately-organized corporation could in fact be considered a for-hire carrier notwithstanding a corporate affiliation to the buyer, and the matter was remanded to Audit to determine if there was a delivery bill of lading or other contract of carriage to support an exemption. In this case, however, the satellite offices were not separately-organized affiliates of the buyers.

As to Taxpayer's reliance on Carrington, that case, by its very terms, concerned the US Const. art. 1, § 10 prohibition against the states' levying any impost or duty upon imports of exports The holding in Carrington was that goods had "entered the export stream" with a "certainty of export" even though they had been delivered by the seller to the buyer's own packing facility within Washington. This holding, however, was based on federal case law which provided:

> "[t]o enjoy the constitutional protection as an export, goods must have entered the export stream with certainty of a foreign destination. Neither intent to export nor the ultimate fact of actual exportation alone is sufficient to invoke to immunity.

(Richfield Oil Corp. v. State Bd. of Equalization, 329 US 69 (1946); Empresa Siderurgica, SA v. County of Merced, 337 US 154 (1949).) Exports are thus exempt once they have been delivered "into the export stream with certainty of a foreign destination." While RCW 82.08.0269 provides a somewhat similar retail sales tax exemption to buyers in noncontiguous states, there is no such parallel authority for a B&O interstate tax exemption in either ch. 82.04 RCW or in WAC 458-20-193, the latter of which provides:

> (1) INTRODUCTION. This section explains Washington's B&O tax and retail sales tax applications to interstate sales of tangible personal property. It covers the outbound sales of goods originating in this state to persons outside this state and of inbound sales of goods originating outside this state to persons in this state. This section does not include import and export transactions....
>
> (3) Washington state does not assess its taxes on sales of goods which originate in Washington if receipt of the goods occurs outside Washington.
>
> (a) Where tangible personal property is located in Washington at the time of sale and is received by the purchaser or its agent in this state, or the purchaser or its agent exercises ownership over the goods inconsistent with the seller's continued dominion over the goods, the sale is subject to tax under the retailing or wholesaling classification. The tax applies even though the purchaser or its agent intends to and thereafter does transport or send the property out-of-state for use or resale there, or for use in conducting interstate or foreign

> commerce. It is immaterial that the contract of sale or contract to sell is negotiated and executed outside the state or that the purchaser resides outside the state.

Finally, Taxpayer argues that it is an unfair logistical and administrative burden for it to have to report tax on noncontiguous state sales if they are simultaneously exempt from retail sales tax and taxable under the B&O tax because delivery is made in-state. Taxpayer implies that the Department should declare such sales exempt from the B&O tax also. As an agency, however, the Department has no authority to change the law. Further, we note that there are other instances when the retailing B&O and retail sales taxes do not coincide, such as sales to the federal government. Taxpayer's file indicates that auditor assistance has been offered in order to facilitate such administration, and this offer still stands.

[3] For the purposes of Rule 193, we conclude that when delivery is made to a buyer's Washington office, which office acts as the buyer's own freight forwarder, that office cannot be considered a "freight forwarder" independent of the buyer merely because buyer's employees do not inspect the goods received there before forwarding them out-of-state. Although employees in the buyer's Washington office may not have such inspection authority, the buyer, as an organization, has in fact taken delivery in this state, whether it inspects the goods or not. Only when delivery is made to an independent third party is there an issue to that party's authority to inspect and accept or reject goods, and thereby act on the buyer's behalf

Accordingly, in those instances when Taxpayer delivered its product to buyers' local offices, which offices have acted in a freight-forwarding capacity, we conclude that the interstate sales deduction was properly denied

DECISION AND DISPOSITION:

Taxpayer's petition for correction of assessment is denied.

Dated this 23rd day of June 1998.