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BEFORE THE INTERPRETATION AND 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. 88-303
. . .)	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .

[1] **RULE 136 and RULE 155:** B&O TAX -- MANUFACTURING -- CONTRACTING WITH OTHERS -- SOFTWARE DISKS AND PACKAGING. The duplicating of software disks and their packaging with documentation into a consumer-useful product results in "a new, different or useful ... article of tangible personal property" and is thus manufacturing.

[2] **MISCELLANEOUS AND RULE 136:** ADMINISTRATIVE LAW -- B&O TAX -- MANUFACTURING -- PROCESSING FOR HIRE -- NONRESIDENT. An administrative agency has no authority to determine constitutionality of the law it administers. The Department may therefore not consider whether the provision in RCW 82.04.110 which exempts nonresidents whose materials are processed for hire in this state from the manufacturing tax is unconstitutional.

[3] **RULE 19301:** B&O TAX -- EXEMPTION -- MULTIPLE ACTIVITIES -- INVALIDATION. The RCW 82.04.440 multiple activities exemption was ruled unconstitutional in Tyler Pipe Industries, Inc. v. Washington Department of Revenue, 483 U.S. ____, 97 L.Ed.2d 199, 107 S.Ct. 2810 (1987). The issue of remedy was remanded to the Washington Supreme Court.

[4] **RULE 100, RCW 82.04.4286 AND RCW 82.32.060:** B&0 TAX -- EXEMPTION -- MULTIPLE ACTIVITIES -- REFUNDS -- RETROACTIVITY. The Washington

Supreme Court in National Can Corporation v. Department of Revenue and Tyler Pipe Industries, Inc. v. Department of Revenue, 109 Wn.2d 878, cert. denied, 56 U.S.L.W. 3828 (1988) held that the U.S. Supreme Court decision in Tyler Pipe, which invalidated the multiple activities exemption of the B&O tax, applied prospectively only, and that RCW 82.04.4286 and 82.32.060 did not require the State to refund taxes paid before the filing of a court decision invalidating a tax statute if the decision applies prospectively only.

[5] **RULE 19301:** B&O TAX -- EXEMPTION -- MULTIPLE ACTIVITIES --INVALIDATION -- POST-DECISION ASSESSMENTS. Assessments issued after the U.S. Supreme Court decision in Tyler Pipe on June 23, 1987 for taxes attributable to reporting periods prior to that time, are lawfully collectible by the state. National Can and Ashland cited.

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

Petition concerning an in-state manufacturer's liability for manufacturing taxes.

FACTS:

Burroughs, A.L.J. -- The taxpayer is a Washington corporation which designs/develops/writes/sells computer programs for various business accounting applications.

The taxpayer was audited for the period January 1, 1983 through March 31, 1987, and an assessment for $ . . . was issued on December 8, 1987, which amount included interest. Taxes assessed therein included manufacturing business and occupation tax. An adjusted assessment in the amount of $ . . . was issued on February 2, 1988.

The taxpayer develops computer programs for various business accounting applications. The development process results in a "master copy" program diskette and an instruction manual text.

The taxpayer contracts with another business to duplicate the instruction manual - the "documentation" - which will eventually become part of the finished product sold by the taxpayer.

The taxpayer then provides another business (Company B) with the "master copy" diskette and the completed "documentation" materials. Company B uses the taxpayer's "master copy" diskette to make duplicates of the software program. These duplicates, along with the documentation, are then assembled for sale by the taxpayer. Company B was assessed business and occupation tax as a processor for hire since more than 20% of the materials used in the duplicatingand packaging were supplied by the taxpayer.

The taxpayer sold its product - which consisted of packaged software disks and accompanying documentation - in interstate commerce. The taxpayer was assessed manufacturing tax on the processing performed by Company B.

TAXPAYER'S EXCEPTIONS:

The taxpayer objects to the assessment of the manufacturing tax on three bases:

First, that the activity taxed was in fact merely a packaging activity not taxable under the manufacturing classification. The taxpayer bases its argument on (1) a Departmental letter concerning another taxpayer which basically held that the repackaging of stuffed toys from large bulk containers to individual boxes for retail sale was not manufacturing, and (2) a 1975 Determination which held that a taxpayer which placed kit components in a plastic bag subsequent to a small amount of cutting was not a manufacturer.

Second, that the manufacturing tax as imposed by WAC 458-20-136 (Rule 136) is unconstitutional under the Commerce Clause. Specifically, the taxpayer points to the Rule 136 language which provides:

> (2) The word "manufacturer" means every person who, from the person's own materials or ingredients manufactures for sale, or for commercial or industrial use any articles, substance or commodity either directly, or by contracting with others for the necessary labor or mechanical services.
>
> (3) However, a nonresident of the state of Washington who owns materials process[ed] for hire in this state is not deemed to be a manufacturer because of such processing. . . . (Emphasis added.)

The taxpayer argues that the rule is discriminatory in nature against businesses located in Washington because a nonresident business utilizing the same Washington vendor to perform the same functions as performed for the taxpayer would not be considered a manufacturer solely because of its nonresident status.

Third, that the manufacturing tax imposed is unconstitutional as violative of the commerce clause under the U.S. Supreme Court's holding in Tyler Pipe Industries, Inc. v. Washington Department of Revenue, 483 U.S. ____, 97 L.Ed.2d 199, 107 S.Ct. 2810 (1987) (hereinafter, Tyler Pipe).

ISSUES:

1. Whether the taxpayer's activity was an activity taxable under the manufacturing classification.

2. Whether Rule 136 is discriminatory in nature against businesses located in Washington.

3. Whether the taxpayer is exempt from the manufacturing tax under the holding of Tyler Pipe.

DISCUSSION:

RCW 82.04.120 defines "to manufacture" as follows:

> "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, and shall include the production or fabrication of special made or custom made articles.

RCW 82.04.110 defines "manufacturer:"

> "Manufacturer" means every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his own materials or ingredients any articles, substances or commodities. When the owner of equipment or facilities furnishes, or sells to the customer prior to manufacture, all or a portion of the materials that become a part or whole of the manufactured article, the department shall prescribe equitable rules for determining tax liability: *Provided*, That a nonresident of this state who is the owner of materials processed for it in this state by a processor for hire shall not be deemed to be engaged in business in this state as a manufacturer because of the performance of such processing work for it in this state. . . (Emphasis added.)

Rule 136 further explains these terms and their relationship:

(2) The word "manufacturer" means every person who, from the person's own materials or ingredients manufactures for sale, or for commercial or industrial use any articles, substance or commodity either directly, or by contracting with others for the necessary labor or mechanical services.

(3) However, a nonresident of the state of Washington who owns materials process[ed] for hire in this state is not deemed to be a manufacturer because of such processing.

. . .

(5) The term "processing for hire" means the performance of labor and mechanical services upon materials belonging to others so that as a result a new, different or useful article of tangible personal property is produced for sale or commercial or industrial use. Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon that person's own materials.

. . .

(11) Processing for hire. Persons processing for hire for consumers or for persons other than consumers are taxable under the processing for hire classification upon the total charge made therefor.

(12) Materials furnished in part by customer. In some instances, the persons furnishing the labor and mechanical services undertakes to produce a new article, substance, or commodity from materials or ingredients furnished in part by them and in part by the customer. In such instances, tax liability is as follows:

(a) The persons furnishing the labor and mechanical services will be presumed to be the manufacturer if the value of the materials or ingredients furnished by them is equal to or exceeds 20% of the total value of all materials or ingredients which become a part of the finished product.

(b) If the person furnishing the labor and mechanical services furnishes materials constituting less than 20% of the value of all of the materials which become a part of the finished product, such person will be presumed to be processing for hire. The person for whom the work is performed is the manufacturer in that situation, and will be taxable as such.

> (c) In cases where the person furnishing the labor and mechanical services supplies, sells, or furnishes to the customer, before processing, 20% or more in value of the materials from which the finished product is made, the person furnishing the labor and mechanical services will be deemed to be the owner of the materials and taxable as a manufacturer. (Emphasis added.)

Likewise, WAC 458-20-155 (Rule 155) provides

> Persons who produce . . . prewritten software, and materials in this state and who sell, lease, license, or otherwise transfer such things to buyers outside this state and deliver such things outside this state . . . are subject to the Manufacturing classification of the business and occupation tax. (Emphasis added.)

[1] Under the above statutory and regulatory authority, the duplicating of the software disks was clearly the production for sale of "a new, different or useful . . . article of tangible personal property" and constituted manufacturing. Since the disk(s) without the documentation, and likewise the documentation without the disk(s), were substantially useless to the average consumer, their combination and assembly into a distinct unit for sale likewise has resulted in the production of "a new, different or useful . . . article of tangible personal property." Thus, manufacturing had taken place.

Since the value of the materials supplied by the taxpayer to the vendor was in excess of 20% of the final value of the boxed product, Rule 136(12) required the vendor to be taxed as a processor for hire, and the taxpayer to be taxed as a manufacturer. The audit was correct.

[2] The taxpayer has challenged the constitutionality of Rule 136's provision -- that a nonresident of the state of Washington who owns materials processed for hire in this state is not deemed to be a manufacturer because of such processing--claiming that the provision is discriminatory against in-state firms. That portion of the Rule simply paraphrases the similar provision in RCW 82.04.110. It is a fundamental principle of administrative law and procedure in this state that "(a)n administrative body does not have authority to determine the constitutionality of the law it administers; only the courts have that power." Bare v. Gorton, 84 Wn.2d 380 (1974).

Thus, as an administrative agency, the Department of Revenue does not have the requisite authority to consider or declare RCW 82.04.110 unconstitutional. Accordingly, the taxpayer's petition for correction on the basis that RCW 82.04.110 and its corresponding provision in Rule 136 are unconstitutional must be denied.

[3] The taxpayer has lastly argued that, if it is considered a manufacturer, imposition of the tax is invalid under the holding of Tyler Pipe. In Tyler Pipe, supra., the U. S. Supreme Court invalidated the RCW 82.04.440 multiple activities exemption and remanded the case to the Washington Supreme Court to decide the issue of remedy.

[4] On January 28, 1988, the Washington Supreme Court issued its opinion in National Can Corporation v. Department of Revenue and Tyler Pipe Industries, Inc. v. Department of Revenue, 109 Wn.2d 878, cert. denied, 56 U.S.L.W. 3828 (1988) (hereinafter, National Can). The Court therein ruled that the U. S. Supreme Court's decision in Tyler Pipe should be applied prospectively only from the June 23, 1987 date the opinion was issued. Thus, taxpayers are properly subject to Washington's B&O tax - as calculated with the multiple activities exemption - for periods prior to that date.

Because the assessment at issue pertains to tax reporting periods prior to June 23, 1987 the taxpayer's petition is denied. Under the Washington Supreme Court's January 28, 1988 decisions in National Can the taxpayer is clearly subject to the tax in question prior to that date.

[5] Likewise, there is no authority which requires that relief be granted simply because the assessment was not issued until after the U.S. Supreme Court's ruling on June 23. The Washington Supreme Court in National Can directly addressed the issue of a tax assessed but not paid at the time the tax was declared unconstitutional:

> . . . Whether the taxes had been collected or still remained to be collected is not relevant to the issue of retroactive application. The Ashland[1] court explained that it was irrelevant whether the disputed taxes had been paid or were simply assessed. . . . Both taxes collected and those assessed and unpaid fall within the prospective application of Armco and could be retained or collected by the State. (Emphasis added.)
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> National Can, supra., at 891.

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[1] Ashland Oil, Inc. v. Rose, 350 S.E.2d 531,535 (W.Va. 1986), dealt with the question of whether the ruling in Armco, Inc. V. Hardesty, 467 U.S. 638 (1984), which had similarly declared a portion of the West Virginia gross receipts tax unconstitutional, should be retroactive or prospective.

Thus, the Court adopted the Ashland rationale that it made no difference whether the taxes had been paid or simply assessed, and that assessed taxes could be collected prospectively.

Neither the Ashland court or Tyler Pipe specifically addressed the question of the collectibility of those taxes which had not yet been assessed at the time of the decision, since there could be no parties representing that position. It would clearly be inappropriate, however, to grant tax relief to a taxpayer who has successfully evaded discovery of nonpayment of taxes until after issuance of Tyler Pipe, when those taxpayers who were actually issued tax assessments prior to the issuance of that decision are still held liable for taxes for the same reporting periods. We therefore hold that assessments issued after the U.S. Supreme Court decision in Tyler Pipe on June 23, 1987 for taxes attributable to reporting periods prior to that time, are lawfully collectible by the state.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 28th day of July 1988.