THIS DETERMINATION HAS BEEN WITHDRAWN EFFECTIVE NOVEMBER 17, 2017, AND IS NO LONGER IN EFFECT. SEE ETA 3133.2019.

Cite as 10 WTD 123

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

In the Matter of the Petition For Refund of . . .	D E T E R M I N A T I O N No. 90-342 Registration No. . . . . . ./Audit No. . . .

[1] RULES 136 & 155: B&O TAX -- SOFTWARE -- PROCESSING FOR HIRE -- 20% RULE. A seller of software who hires third parties to copy diskettes and manual will be deemed the party furnishing the original diskettes and manuals notwithstanding the fact that the originals may have been shipped directly to the third parties by the parent company of the seller.

[2] RULES 136 & 155: B&O TAX -- SOFTWARE -- PROCESSING FOR HIRE -- 80% RULE. In determining if one who employs a processor for hire furnishes more than 20% of the value of the materials or ingredients manufactured so as to be subject to Manufacturing B&O tax, intangible contributions such as the intelligence on an original computer diskette are to be taken into account.

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: June 24, 1988

NATURE OF ACTION:

Protest of Manufacturing B&O tax on software sold out-of-state.

FACTS AND ISSUES:

Dressel, A.L.J. -- [Taxpayer] renders data processing services. Its books and records were examined by the Department of Revenue (Department) for the period . . . through . . . . As a result a tax assessment, identified by the above-captioned numbers, was issued for $ . . . . The taxpayer has paid the assessment but, in this action, appeals for a partial refund.

The taxpayer, a subsidiary of . . . , Ltd., of . . ., B.C., has a local facility in . . . , Washington. The taxpayer sells software to schools. It also sells a maintenance service and holds training seminars. Regarding the software, the taxpayer provides an original computer diskette, which holds application software, to a processor who copies the information onto blank diskettes which are provided by the processor. These diskettes are delivered to the taxpayer and then sold as a software package. The processor bills the taxpayer.

The original diskette is obtained by the taxpayer from its parent company (Ltd.) in Canada. Profit is allocated between the parent company and taxpayer at a rate of 45% of sales. The selling price of various software packages sold ranges from $395 to $7500. In effect, says the Department's auditor, this percentage allocation is in payment for the software developed by the parent.

There is another element to the software, instruction manuals. The creation of these follows a course very much analogous to that of the diskettes. The taxpayer hires a Seattle-area printer who mass produces the manuals based on the copying of an original which also comes from Ltd.

The printer and the processor send the manuals and diskettes to the taxpayer's facility in [Washington]. There, the taxpayer assembles the final software package, which, typically, includes an instruction manual in three loose leaf binders and 10 diskettes. In putting the packages together, the taxpayer removes the diskettes from plastic bags, puts them into a personal computer to have the diskettes customized with the customer's name, puts the diskettes into paper sleeves, puts them in a box, and sends them out. Also [in Washington], the taxpayer puts the printed manual pages into the binders and adds tabs to the binders. The completed software packages are then sent from [Washington] to destinations across the United States and Canada.

At issue in this case is the auditor's assessment of Manufacturing B&O tax against the taxpayer on its sales of these software packages to out-of-state buyers. The auditor concluded that the taxpayer is the manufacturer of the software, notwithstanding that the manuals and diskettes are actually made by the printer and the processor, because the taxpayer furnishes more than 20% of the

value of the materials manufactured. See WAC 458-20-136 (Rule 136). The auditor takes this position in spite of the fact that the blank manual pages and blank diskettes are furnished by the printer and processor. She reasons that the intelligence or knowledge from the master copies of the manual and diskette constitute more than 20% of the value of the copied manual and diskette.

The auditor believes that the taxpayer objects to the 20% allocation because the taxpayer believes that the intelligence of the diskette (and manual) is an intangible and, therefore, not properly included in measuring the value of the copied product. In its petition and at the telephone hearing of this matter, however, the taxpayer makes a different argument. It simply stresses that the intelligence from the master copies was contributed, not by it, but by its parent company, Ltd. Because that item came from a different corporation, it was not furnished by the taxpayer who is, therefore, not accountable as a manufacturer or for Manufacturing B&O tax.

Is a seller of software a manufacturer, in terms of the B&O tax, when the components of the software, computer diskettes and an instruction manual, are produced by third parties? That is the issue in this case.

DISCUSSION:

[1] Generally speaking, those who manufacture goods in this state are subject to B&O tax on either the manufacturing activity itself or on the selling activity which follows. See Rule 136, ¶s (6) and (7). Special provisions are made in this administrative rule for those situations in which a party hires somebody else to manufacture something for that party. The person hired is called a "processor for hire". Such person may, however, for purposes of the B&O tax, be considered a manufacturer if she or he furnishes more than 20% of the value of the materials which become part of the finished product. This application of Rule 136 is explained in paragraph 13 which reads as follows:

> (13) 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.
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> (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 ours.

From what we have been told, ¶(c) doesn't apply because whatever the processor or printer sells to the taxpayer is sold after the processor or printer performs its copying (manufacturing) function. We are left with ¶s (a) and (b). In essence, our task is to decide which fits the situation presented by the facts of this case.

First of all, we will deal with the taxpayer's precise argument, viz., it should not be deemed the manufacturer because its parent company furnished the intelligence which goes into the software. While it is true that the Department recognizes the separate existence of related corporations for purposes of applying Washington's excise taxes[1], we do not think a strict distinction between parent and subsidiary is necessary or appropriate in this instance. Rule 136 (13)(a) speaks in terms of who furnishes the materials or ingredients. It doesn't say directly furnishes the ingredients. Thus, in this case, even if the parent company was the direct supplier of the intelligence to the processor and printer, that does not mean that the taxpayer (subsidiary) was not the indirect supplier. In fact, we are going so far as to presume that the taxpayer either requested the parent to send the original diskette and manual to the reproducers or that there was an agreement between parent and subsidiary that the parent would do so. Either way, it occurs to us that the taxpayer had a role, even if indirect, in furnishing the materials to the processor and printer. More is not required, in our judgment.

If we were to subscribe to the taxpayer's argument, one might be able to circumvent the Manufacturing B&O tax by arranging for suppliers of materials to be manufactured to send the materials directly to a processor for hire. Then one could say that the

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[1]See WAC 458-20-203.

suppliers furnished the materials, that he or she did not furnish the materials, and that, therefore, he or she is not taxable as a manufacturer. If everybody similarly situated chose that approach, ¶13 of Rule 136 would become virtually meaningless in that nobody using the medium of a processor for hire would owe Manufacturing B&O tax. In saying this we do not mean to suggest that the taxpayer's argument is anything less than an honest and legitimate reaction to the subject assessment and the administrative rule as written. We are confident, though, that the taxpayer can recognize the effect of the position it is taking if it were carried to extremes. We are equally confident that such effect was not the intent of either the drafters of Rule 136 or the legislature when they enacted the B&O tax[2] or when they authorized the Department in RCW 82.32.300 to promulgate rules to implement the tax. Further, to hold that one must directly furnish materials or ingredients would be to exalt form over substance which the law does not compel us to do in this instance.

[2] Having determined that the taxpayer did furnish materials or ingredients to processors for hire, we next look at the question of whether it furnished more than 80%. The finished product, computer software, consists of a manual with printed instructions in it and diskettes laden with information for the purpose of running a computer program. Before these items were manufactured, the processors for hire[3] had as "raw" materials blank diskettes and blank pages. Although the testimony varies somewhat on this point, the blank diskettes, at this stage, were worth less than $8

apiece.[4] The blank paper used to print the manuals were certainly worth less than that. Yet, as pointed out by the auditor, when the information from the original diskette(s) and manual is copied to the blank materials, the whole package is worth an average of $5,000. Clearly, it is the information on the original diskette and manual that make the final product so valuable. In comparison, the value of the materials furnished by the printer and the processor are worth next to nothing.

Although it is the primary component in terms of value, the intelligence or knowledge of the original diskette and manual is intangible or, at least, partially so in that it is not readily perceivable by one's senses in the case of the diskette and in that its value far exceeds the medium in which it is contained in the

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[2]And, in particular, RCW 82.04.110, wherein the term "manufacturer" is defined.

[3]The processors for hire are the printer of the manuals and the copier of the original diskette.

[4]The taxpayer, in fact, stated that it paid only about $1 per copied diskette.

cases of the diskette and the manual. Rule 136, however, in reciting the "20%" rule for the purpose of determining if one employing a processor for hire is a manufacturer, doesn't specify whether the ingredients contributed have to be tangible or intangible. The rule just says "materials or ingredients". Certainly, the intelligence imparted to the diskette and manual is an ingredient. In fact, it is the significant ingredient in the final product. Without it, the software would be useless. As found earlier, it was contributed or furnished by the taxpayer. Also, as found earlier, its value is greater than 20% of the ingredients combined by the processors for hire. Therefore, per Rule 136, the taxpayer is a manufacturer subject to Manufacturing B&O tax.

DECISION AND DISPOSITION:

The taxpayer's petition for refund is denied.

DATED this the 18th day of September 1990.