Cite as 10 WTD 305 (1990).

BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Ruling of . . .	FINAL DETERMINATION No. 89-486A Registration No. . . .

[1] RULE 136 & 112 -- RCW 82.04.450(2) -- MANUFACTURING B&O TAX -- VALUE OF THE PRODUCT -- GROSS PROCEEDS OF SALE -- RENTALS. Where gross proceeds from rentals are not indicative of the true value of the subject matter of the sale, the gross proceeds are not "comparable sales" for purposes of establishing the value of a product for Manufacturing B&O tax.

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:

The taxpayer appealed to the Director for a reversal of Determination 89-486 with respect to the measure of manufacturing tax.

FACTS:

Roys, Sr. A.L.J. -- The taxpayer manufactures and rents . . . instruments to customers located both within and without the state of Washington. The taxpayer manufactures the instruments in its production facility in Washington. The instruments are then transferred at their manufactured cost to the product pool available to its rental unit division. [Over 90%] of the taxpayer's rental activities take place out of state.

The taxpayer was audited by the Department in 1988. The auditor discovered that in respect to out-of-state rentals,

the taxpayer was reporting manufacturing tax based on the cost of manufacturing the rental instruments and deducting all out-of-state rental proceeds as interstate sales. Although the auditor believed that this reporting procedure was incorrect, the auditor found that the taxpayer was reporting in accordance with the instructions given by the previous Department auditor.

The taxpayer was advised to begin reporting manufacturing B&O tax on the gross proceeds of the rentals of those items which were manufactured in this state. The audit instructions stated that the proper measure of the tax was the gross proceeds derived from the taxpayer's rentals, whether the instruments were rented in this state or outside this state.

The taxpayer disagreed with the future reporting instructions and appealed for a ruling under WAC 458-20-100. The taxpayer stated the [instruments] are small items which tend to go astray easily. Some of the instruments are only rented once before they are lost; others may be returned to be rented several times.

The taxpayer argued that it is illogical to apply two different cumulative valuations for the purposes of computing manufacturing tax on identical instruments solely on the basis of differing rental proceeds. The taxpayer's position was that the previous audit instructions were correct. The previous auditor's (May 1984) instructions stated that "inasmuch as [taxpayer] manufactures a unique product, not sold but instead rented both inter and intra state, cost must be computed to arrive at the manufactured valued."

Determination 89-486 denied the taxpayer's petition. The Determination held that the measure of the tax was determined by RCW 82.04.450(2) and that the taxpayer's rentals in this state were "sales in this state of similar products."

ISSUE:

What is the proper measure of the manufacturing tax to be applied to equipment manufactured in this state for rental outside this state?

DISCUSSION:

[1] RCW 82.04.240 imposes a B&O tax under the Manufacturing tax classification measured by the "value of the product". RCW 82.04.450(1) provides that the "value of the product" is to be determined by the "gross proceeds of sale," except:

> (a) Where such products, including byproducts, are extracted or manufactured for commercial or industrial use;
>
> (b) Where such products, including byproducts, are shipped, transported or transferred out of the state, or to another person, without prior sale or are sold under circumstances such that the gross proceeds from the sale are not indicative of the true value of the subject matter of the sale.
>
> (2) In the above cases the value shall correspond as nearly as possible to the gross proceeds from sales in this state of similar products of like quality and character, and in similar quantities by other taxpayers, plus the amount of subsidies or bonuses ordinarily payable by the purchaser or by any third person with respect to the extraction, manufacture, or sale of such products:....

Determination 89-486 found that in respect to the 96% of the taxpayer's instruments which are manufactured in Washington and thereafter transferred to out-of-state locations for rental, that those instruments fall within the exception provided by RCW 82.04.450 1(b). The Determination found that the exemption applied because the instruments were "transferred out of the state, . . . without prior sale." The Determination did not consider whether the taxpayer's out-of-state rentals were sales which indicated the true value of the instruments.

RCW 82.04.040 defines the term "sale" to include renting or leasing. The Determination applied the guidelines for determining value in subsection (2). That subsection simply refers to gross proceeds from sales in this state of similar products. The Determination concluded that the taxpayer's rentals in this state are "sales in this state of similar products" for purposes of RCW 82.04.450 (2).

In St. Regis Paper Co. v. State, 63 Wn.2d 564 (1964), the Court considered the purpose of the exception in RCW 82.04.450(1) for manufactured products shipped or transported out of the state without prior sale. The Court stated:

> This exception, we think, is designed to cover the many transactions that do not yield readily to classification as a sale of products, such as

> exchanges of products, or shipment of products by a company to its subsidiary out of the state for further manufacture or fabrication, or exchanges of products for services where the value of the products to the manufacturer cannot be readily measured.

In this case, the instruments transferred out of state prior to their rental. If the products were transferred and then sold under circumstances that the gross proceeds from the sale did indicate the true value of the subject matter of the sale, the selling price would be the best indication of "value" of the product for the manufacturing B&O tax.

The taxpayer argued that neither the proceeds from its instate nor its out-of-state rentals indicative of the true value of instruments sold. The taxpayer contends, therefore, that the gross proceeds from its rentals should not be used as the measure of the manufacturing tax.

The gross proceeds of the taxpayer's individual rentals vary because the number of times one instrument may be rented varies. For example, one instrument may have been rented once, generating $23.50 worth of sales, whereas another instrument may have been rented fifty times generating $1,175.00 worth of sales. We agree that in such a case, rental proceeds do not reflect the true value of the instruments.

As neither the taxpayer's instate nor the out-of-state rentals are sales which indicate the true value of the instruments, then the gross proceeds from the rentals should not be used to determine "value" for purposes of measuring the manufacturing B&O tax.

Furthermore, the manufacturing tax is imposed on the act or privilege of engaging in business as a manufacturer, not on the activity of selling. We believe a better result is one which allows the manufacturing tax to be determined and paid shortly after the manufacturing is completed. This can not be done if the tax is measured on unknown future rental payments.

The taxpayer stated that its product is unique, and that sales of similar products of like quality, character, and quantities by other taxpayers are not available. Rule 112 provides:

> In the absence of sales of similar products as a guide to value, such value may be determined upon a cost basis. In such cases, there shall be included every item of cost attributable to the particular

> article or article extracted or manufactured, including direct and indirect overhead costs.

Assuming there are no sales of similar [instruments] to use as a guide to value, the taxpayer should report manufacturing B&O tax on the instruments that are transferred to its rental pool for out of state rental based on their manufactured cost. This "assumption" is subject to audit verification. The measure of the manufacturing tax, therefore, will be the same for all instruments manufactured and rented out of state where the costs for manufacturing the items are the same, regardless of the differences in the rental proceeds for the instruments.

The taxpayer should report retailing B&O and retail sales tax on the proceeds from its rentals of instruments manufactured and rented in this state. The measure of the two B&O taxes may be different for instruments rented instate from those rented outside the state. Because retailing B&O tax is on the activity of selling and manufacturing B&O tax is on the activity of manufacturing, this result is not unreasonable.

DECISION AND DISPOSITION:

The taxpayer's petition is granted.

DATED this 20th day of February 1991.