

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

In the Matter of the Petition	)	<u>D E T E R M I N</u>
	<u>A T I O N</u>	
For Correction of Assessment and	)	
Refund of	)	
	)	No. 88-
339	)	
	)	
No. . . .	)	Registration
	)	
Nos. . . .	)	Tax Assessment
	)	
	)	

- [1] **RULE 136, RULE 193A, RULE 193B, RCW 82.04.440:** B&O TAX -- EXEMPTION MULTIPLE ACTIVITIES -- NATIONAL CAN -- REFUNDS. Refunds of business and occupation tax paid prior to June 23, 1987 will not be granted if the basis for the refund request is Tyler Pipe v. Washington, 483 U.S. \_\_\_, 97 L. Ed 2d 199, 107 S. Ct. 2810 (1987).
- [2] **RULE 113:** RETAIL SALES TAX -- USE TAX -- EXCLUSION -- INGREDIENT OR COMPONENT -- PRIMARY PUPOSE TEST. Copper/aluminum flex and aluminum/steel casing used in the smelting of aluminum are ingredients whose purchase and use is not subject to sales or use tax. Although the primary purpose of these items is not to be ingredients of a finished product they nevertheless are ingredients. The primary purpose test for ingredients was rejected in Lone Star v. Revenue, 97 Wn.2d 630, 647 P.2d 1013 (1982).
- [3] **RULE 113 AND RULE 228:** B&O TAX -- CREDIT -- INVENTORY -- INGREDIENT. If an item is an ingredient for purposes of the sales tax exemption for ingredients then it is also inventory for purposes of the inventory tax credit. F.I.D.
- [4] **RULE 178:** USE TAX -- MEASURE -- VALUE OF THE ARTICLE USED -- NO COMPARABLE RETAIL SELLING PRICE -- VALUE OF

PRODUCTS -- LABOR AND OVERHEAD. Pots used in the aluminum smelting process and manufactured by the user are subject to use tax measured by the cost of materials and the value of labor and overhead utilized in manufacturing the pots. Pots are not available for sale so comparative pricing is impossible. In such cases the Department determines the value of the article used by the same method used to determine the value of products. That method uses all costs of production including labor and overhead. F.I.D.

[5] **RULE 113:** RETAIL SALES TAX -- USE TAX -- EXCLUSION -- PRIMARY PUPOSE TEST -- CHEMICAL USED IN PROCESSING: Liquid caustic soda used to recover cryolite as part of the aluminum smelting process is a chemical used in processing where cryolite is a product for sale. F.I.D.

[6] **RULE 113:** RETAIL SALES TAX -- USE TAX -- EXCLUSION -- INGREDIENT OR COMPONENT -- PRIMARY PUPOSE TEST. Magnesite used in the aluminum smelting process is an ingredient in the final product. F.I.D.

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 16, 1987

NATURE OF ACTION:

The taxpayer petitioned for a correction of assessments issued for the period from January 1, 1981 through June 30, 1985. It also petitioned for a refund of certain taxes it paid during that period.

ISSUES:

Potegal, A.L.J. -- 1. The taxpayer contests portions of each assessment on grounds that Washington's business and occupation tax system impermissibly burdens interstate commerce. At the time the petition was filed this question was pending before the United States Supreme Court in litigation to which the taxpayer was a party.

2. The taxpayer seeks a refund of use tax paid in 1981 and 1982 on copper/aluminum flex and aluminum/steel casing. These materials are used in the aluminum smelting process. A portion of these

materials became an ingredient of the finished product which the taxpayer sells. Under the decision in Lone Star Industries, Inc. v. Department of Revenue, 97 Wn.2d 630, 647 P.2d 1013 (1982) use tax would not be due.

In a related issue the taxpayer contests the disallowance, in Tax Assessment No. . . . , of \$ . . . in inventory tax credit which the taxpayer had claimed for property tax it had paid on similar materials. The auditor disallowed the credit on grounds that these materials are consumable supplies rather than inventory held for resale.

3. The taxpayer requests a refund of use tax paid in 1981 and 1982 on the value of in-house labor and overhead attributable to the production of items which the taxpayer manufactured for its own use. The taxpayer had already paid sales tax or use tax on the materials used to manufacture the items. It believes that no further tax should have been paid on these materials.

The taxpayer also objects to the assessment of use tax in Schedule X of the audit report resulting in Tax Assessment No. . . . . The tax is assessed on in-house labor and overhead attributable to the production of items manufactured for the taxpayer's own use. The same grounds for objection are stated as for the refund request.

4. The taxpayer objects to use tax assessed on printed materials in Schedule X of the audit report resulting in Tax Assessment No. . . . . The taxpayer asserts that it purchased these items in [State X] and paid sales tax to that state.

5. The taxpayer objects to the assessment of use tax in Schedule XII of the audit report resulting in Tax Assessment No. . . . on purchases of liquid caustic soda, magnesite, and cryolite bags. Grounds for this objection are as follows:

a. Liquid caustic soda. The taxpayer asserts that this is a chemical used in processing. As such it would be exempt from use tax under WAC 458-20-113.

b. Magnesite. While magnesite is not a chemical used in processing the taxpayer asserts that it becomes an ingredient of a finished product.

c. Cryolite bags. The taxpayer contends that these are packing materials exempt under WAC 458-20-115.

#### DISCUSSION:

The issues will be discussed in the same order presented in the ISSUES section.

[1] 1. The United States Supreme Court invalidated a portion of Washington's business and occupation tax in Tyler Pipe Industries, Inc. v. Washington Department of Revenue, 483 U.S. \_\_\_, 97 L. Ed 2d 199, 107 S. Ct. 2810 (1987). The case was remanded to the Washington Supreme Court to decide the issue of remedy. The Washington Court, in National Can Corporation, et al. v. Department of Revenue, 109 Wn.2d 878 (1988), ruled that the decision in Tyler Pipe should only apply from June 23, 1987, the date the U.S. Supreme Court's opinion was issued. Because that date occurred after the close of the audit period the taxpayer's petition as to this item will be denied.

2. Copper/aluminum flex and aluminum/steel casing are both part of the carbon anode used to introduce electricity into a bath containing alumina. Electrons passing from a negatively charged cathode to the anode combine with aluminum ions to form elemental aluminum. In the course of the manufacturing operation the casing, containing aluminum, is melted into and mixed with the molten aluminum. Over a period of time the flex loses its ability to conduct electricity efficiently. It is then replaced and is added to the molten metal in controlled amounts to alloy the metal to specifications with respect to the percent of copper desired. Thus, even though the primary purpose for which the taxpayer uses flex and casing is as tools in the manufacturing process, portions of the flex and casing become necessary ingredients of the product being manufactured -- aluminum.

[2] For the reasons expressed in Lone Star and Det. No. 87-74, 2 WTD 379 (1987), . . . , we agree that the taxpayer is entitled to the refund requested.

The definition of inventory, upon which the payment of property tax leads to a business and occupation tax credit, is contained in former RCW 82.04.443. In part, that definition includes:

. . . personal property . . . acquired . . . for the purpose of consuming such property in producing for sale or lease a new article of tangible personal property of which such property becomes an ingredient or component.

[3] This is essentially the same language in RCW 82.04.050 considered by the court in Lone Star. Because both statutes are from the same chapter of the RCW we think they are subject to the same interpretation. Therefore, if something is considered an ingredient for purposes of RCW 82.04.050, it would also be considered an ingredient for purposes of RCW 82.04.443. If something is an ingredient for purposes of RCW 82.04.443, property tax paid upon that item may be credited against the business and occupation tax. Since flex and casing are ingredients for purposes of RCW 82.04.050 they are also ingredients for purposes of RCW 82.04.443. Property tax paid upon those items may be credited

against the business and occupation tax. Tax Assessment No. . . .  
will be adjusted accordingly.

3. RCW 82.12.020 imposes the use tax on the use of:

any article of tangible personal property . . .  
manufactured by the person so using the same. . . .

"To manufacture" is defined by RCW 82.04.120 to include:

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 . . .

The articles in question are pots used in the aluminum smelting process. The pots consist of steel shells which the taxpayer lines with various materials. The taxpayer acknowledges that what it does with the pots is manufacturing within the meaning of RCW 82.04.120. This is because it agrees with the assessment of Manufacturing classification business and occupation tax assessed in connection with this activity.

As set out above, RCW 82.12.020 requires that use tax be applied to the use by the manufacturer of any manufactured article of tangible personal property. Since the taxpayer manufactured the pots and used them it is liable for use tax. Contrary to the taxpayer's assertion, it has not already paid tax on the pots. What it has paid tax on are the materials from which the pots are made. Under Washington's excise tax laws this is not a distinction without a difference. By the very definition of "to manufacture" in RCW 82.04.120 the article manufactured is something different from the materials out of which it is made.

The measure of the use tax is the "value of the article used." RCW 82.12.020. The definition of "value of the article used" is contained in RCW 82.12.010(1) which states in part:

In case the article used is . . . manufactured by the  
person using the same . . . the value of the article used  
shall be determined as nearly as possible according to  
the retail selling price at place of use of similar  
products of like quality and character under such rules  
and regulations as the department of revenue may  
prescribe.

The articles in question here, pots, are not sold at retail so the value can not be determined by direct comparison. The Department has not prescribed a rule for determining the value of a manufactured item where similar items are not sold at retail. However, the Department does have such a rule for "value of

products." "Value of products" is the measure of Manufacturing classification business and occupation tax. RCW 82.04.240. The statutory definition of "value of products" for products manufactured by the user, as in the case of the pots, provides:

. . . 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. . . . The department of revenue shall prescribe uniform and equitable rules for the purpose of ascertaining such values.

RCW 82.04.450.

This definition is practically identical to the definition of "value of the article used." The Department has prescribed a rule for determining the "value of products." This rule covers products, such as the pots in this case, for which there are no retail sales which may be used for comparison. WAC 458-20-112 states in part:

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.

The method described in the rule was precisely what the auditor used to determine the value of the pots both for Manufacturing business and occupation tax purposes, where "value of products" is the measure, and for use tax purposes, where "value of the article used" is the measure. To the cost of materials the auditor added the cost of labor and overhead. When assessing use tax on the pots credit was given for tax already paid on the materials.

[4] In view of the fact that the statutory definitions of "value of the article used" and "value of products" are practically identical it is reasonable for the Department to apply the same value to the pots for purposes of both business and occupation tax (which the taxpayer has not contested) and use tax. The taxpayer's petition will be denied on this item.

4. The taxpayer operates an in-house print shop in [State X] for the production of some forms and other printed material. The items upon which use tax was assessed were shipped from the [State X] shop to Washington. According to the taxpayer sales tax or use tax was paid to [State X] on these materials.

By virtue of RCW 82.12.035 the taxpayer is entitled to a credit against Washington's use tax in the amount of [State X]'s sales or use tax paid on these materials prior to their use in Washington.

The determination of the amount of the credit is strictly a factual matter which will be referred back to the audit staff of the Department for such verification that it reasonably deems necessary. The burden of producing evidence requested by the audit staff is on the taxpayer.

5. a. Liquid caustic soda. RCW 82.04.050 and WAC 458-20-113 in effect provide that the purchase or use of chemicals used in processing is not subject to sales or use tax. A chemical used in processing is one whose primary purpose "is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale." RCW 82.04.050.

The liquid caustic soda (NaOH) reacts with cryolite (Na<sub>3</sub>AlF<sub>6</sub>)

6) to form sodium fluoride (NaF), sodium aluminate (Na<sub>3</sub>AlO<sub>3</sub>), and water (H<sub>2</sub>O).

Flue gas, containing about 10% carbon dioxide (CO<sub>2</sub>), is then bubbled through the sodium fluoride and sodium aluminate causing cryolite to precipitate out. At the start of this process the cryolite is contained in a slurry which also contains carbon. The liquid caustic soda is added in order to extract and separate the cryolite from the slurry. Cryolite is a product sold by the taxpayer to third parties.

[5] The chemical used in processing exemption applies to liquid caustic soda as used in this procedure. It creates a chemical reaction directly with the product being produced for sale--cryolite. Its primary purpose is to create this reaction. Thus, it meets the statutory definition of a chemical used in processing.

The taxpayer's petition will be granted on this item.

[6] b. Magnesite. In a prior Determination issued to this taxpayer, No. . . . , the Department acknowledged that magnesite was an ingredient of the finished product. However the Department denied a sales or use tax exemption because the primary purpose of the magnesite was not to be an ingredient of a finished product. At the time, WAC 458-20-113 applied a primary purpose test for ingredients. Since that time the primary purpose test for ingredients has been overruled. See Lone Star, supra.

The taxpayer's petition will be granted on this item.

c. Cryolite Bags. The taxpayer purchased these bags to hold the cryolite it produces. Some of the cryolite is sold, some is used by the taxpayer.

WAC 458-20-115 provides that sales of bags to persons who then sell property contained in those bags are sales for resale. They are therefore not subject to sales or use tax. Under the rule the

purchase of those bags which the taxpayer fills with cryolite and sells to others is not taxable. However, the purchase and use of those bags which the taxpayer does not sell to others is taxable.

The taxpayer has provided a breakdown of use tax attributable to bags which it consumed and did not sell. The taxpayer's petition on this item will be granted as to cryolite bags purchased and sold to others. The audit staff will verify the taxpayer's figures to the extent deemed reasonably necessary.

DECISION AND DISPOSITION:

1. The taxpayer's petition is denied.
2. The taxpayer's petition is granted. A refund with interest will be issued subject to verification of the taxpayer's figures by the audit staff. Tax Assessment No. . . . will be adjusted and reissued in accordance with the Discussion.
3. The taxpayer's petition is denied.
4. Referred back to the audit staff for verification.
- 5.a. The taxpayer's petition is granted.
- b. The taxpayer's petition is granted.
- c. The taxpayer's petition is granted subject to verification by the audit staff.

DATED this 25th day of August 1988.