

Cite as Det No. 13-0001, 32 WTD 213 (2013)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON¹

In the Matter of the Petition For Correction of) D E T E R M I N A T I O N
Assessment of)
) No. 13-0001
...)
) Registration No.
) Document No.
) Audit No.
) Docket No.
)

- [1] RULE 458-20-136; RCW 82.04.120: MANUFACTURING TAX – DEFINITION OF “TO MANUFACTURE” – CUSTOM BUILDING OF MARINE GENERATORS AND PROPULSION SYSTEMS. The activity of custom building of marine generators and propulsion systems constitutes manufacturing under RCW 82.04.120 and WAC 458-20-136 (Rule 136) because the activity creates a new, different, or useful article of tangible personal property. The gross proceeds from the taxpayer’s sales of the resulting products is subject to the manufacturing business and occupation (B&O) tax.
 - [2] RCW 82.32.070; RCW 82.32.100: RECORDKEEPING – FAILURE TO KEEP RECORDS – ESTIMATE OF TAX LIABILITY. If a taxpayer fails to maintain and provide adequate records to determine the taxpayer’s excise tax liability, the Department is authorized to use the records available to arrive at its best estimate of the taxpayer’s tax liability.
 - [3] ESTOPPEL – PRIOR AUDIT. The Department is not estopped from asserting tax liability based on an auditor’s failure to discover the taxpayer’s incorrect reporting in an earlier audit.

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.

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

Eckholm, A.L.J. – A business that builds, repairs, and sells customized marine engines, generators, and related products, objects to the classification of its activities as manufacturing, as defined in RCW 82.04.120(1), and the assessment of manufacturing business and occupation (B&O) tax on the manufacture of its products. The taxpayer's petition is denied.

ISSUES

1. Whether the customization of marine engines, generators, and related products, constitutes manufacturing as defined in RCW 82.04.120(1).
2. Whether the Department properly estimated the taxpayer's tax liability based on the taxpayer's available records pursuant to RCW 82.32.100(1).
3. Whether the taxpayer is eligible for waiver of taxes, under RCW 82.32A.020(2) or the doctrine of equitable estoppel, based on the Department's failure to notify the taxpayer of its incorrect reporting during prior audits.

FINDINGS OF FACT

[Taxpayer] sells and repairs marine engines, transmissions and generator units, and sells parts for those products. The taxpayer manufacturers some of the parts for these products The taxpayer describes its activities in its Appeal Petition as follows:

We do in fact manufacture some items, These items are made from raw materials that we create new and useful products. We do not manufacture the engines, transmissions, or generators that we assemble. They are manufactured by our vendors, For instance we purchase a [brand name] propulsion engine, we assemble parts from [brand name] and inventory that we sell on a regular basis. The end product is marketed and sold as a [brand name] propulsion engine Much like adding a radio to a new car or exchanging street tires for all weather tires on the car. We do not manufacture the propulsion engine, we enhance it, accessorize it and sell it as the same product with the same purpose as intended by the manufacturer

The taxpayer's Appeal Petition at page 3.

The taxpayer [describes its activities as specializing in the custom building of various brand name marine generators and propulsion systems].

The Department of Revenue (Department) Audit Division reviewed the taxpayer's business records for the period January 1, 2007, through June 30, 2011. The auditor determined that the taxpayer's customization and assembly of engines, generators and related products, constituted manufacturing and assessed the taxpayer manufacturing B&O tax on unreported manufacturing activities. . . .

The taxpayer appealed the assessment asserting that: a large portion of its activities were incorrectly classified as manufacturing, the audit sample period was not representative of its

manufacturing income, and it should not be subject to the manufacturing B&O tax retroactively because in prior audits the Department did not find that the taxpayer was incorrectly reporting its income.

ANALYSIS

[1] Washington imposes the business and occupation (B&O) tax on the privilege of engaging in business in this state. RCW 82.04.220. The measure of the tax, as well as the tax rate, varies depending upon the nature, or classification, of the activity. *Id.* A taxpayer engaged in manufacturing activities is subject to the manufacturing B&O tax rate of .0484 percent, multiplied by the value of the products manufactured. RCW 82.04.240.

RCW 82.04.120(1) defines the term “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 includes: (a) The production or fabrication of special made or custom made articles; (b) The production or fabrication of dental appliances, devices, restorations, substitutes, or other dental laboratory products by a dental laboratory or dental technician; (c) Cutting, delimiting, and measuring of felled, cut, or taken trees; (d) Crushing and/or blending of rock, sand, stone, gravel, or ore.

The primary issue in this appeal is whether the taxpayer’s activities result in creating a “new, different or useful substance or article of tangible personal property,” thereby, constituting manufacturing activities.

The Washington courts have applied the definition of “to manufacture” in RCW 82.04.120(1) in several cases. In *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962), the Washington Supreme Court articulated a test for determining whether a new, different or useful article is produced. In concluding that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120, the court developed the following test:

We think the test that should be applied to determine whether a new, different, and useful article has been produced is whether a significant change has been accomplished when the end product is compared with the article before it was subjected to the process. By the end product we mean the product as it appears at the time it is sold or released by the one performing the process.

60 Wn.2d at 175.

A year later the court relied upon this test in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963), and held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The court in *McDonnell* recognized that the above *Bornstein* test was “somewhat general in nature and may seem easier as a matter of articulation

than as a matter of application.” 62 Wn.2d at 556. The court then identified the following factors one should consider in determining if the end product is a new, different, or useful product: “. . . 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,” *Id.* at 557. In stating these factors, the court emphasized that the definition of the term “manufacturing” in RCW 82.04.120 is broader than the “classical or orthodox definition of manufacturing, which, in common understanding, usually would connote a spinning, knitting, sewing, sawing, synthesizing, assembly or other fabrication process.” *Id.*

The Department has applied the *Bornstein* test and *McDonnell* factors in a number of determinations that addressed the issue of whether a taxpayer’s activities constitute manufacturing. *See* Det. No. 92-034, 12 WTD 77 (1993) (combining component parts in model kits constituted manufacturing because the assembled kit resulted in a significant change from the individual parts and increased market value); Det. No. 91-260, 11 WTD 423 (1992) (combining and attaching parts to machinery in addition to installing the hydraulic and electrical systems constituted manufacturing because the assembling process resulted in a significantly different product); Det. No. 89-406, 8 WTD 157 (1989) (refurbishing used engine cores constituted manufacturing rather than repair of an existing engine because the refurbishing activities resulted in a different, more useful product); Det. No. 88-443 7 WTD 49 (1988) (selecting and placing educational materials into a container for shipment to customers is not a manufacturing activity, but laminating some of the items to enhance durability is manufacturing because it results in a new product with added value); Det. No. 94-255, 14 WTD 092 (1994) (compressing hay for shipping purposes was not manufacturing because the compressed hay was not significantly more useful than uncompressed hay); Det. No. 95-170, 16 WTD 43 (1995) (sorting and compacting loose sheet metal into cubes is manufacturing because the materials took a different form and different properties, and the materials were enhanced in value); Det. No. 10-0108, 31 WTD 1 (2012) (sorting and bundling materials for recycling was not manufacturing because the form and properties of the materials did not change).

The taxpayer’s activities in 12 WTD 77, *supra*, are similar to the activities of the present taxpayer though the taxpayer here engages in significant additional activities, as noted below. In 12 WTD 77, the taxpayer manufactured and distributed parts and equipment for making remote-controlled racing models. The taxpayer manufactured some of the parts but most of the parts and equipment were manufactured by other suppliers. The taxpayer sold the parts and equipment individually and in groups, referred to as “kits,” which contained the materials necessary for assembly of a specific model. 12 WTD at 78. The Department applied the *Bornstein* test and the *McDonnell* factors, and held that the taxpayer engaged in manufacturing because there was a significant change between the unrelated collection of individual parts and the kit assembled by the taxpayer to build the specific model requested by the customer. *Id.* at 81-82. The Department also found that the market demand for the kit was much greater than the demand for the purchase of the individual parts alone. *Id.*

Here, in most instances, the taxpayer does more than select the necessary components to build a customized engine or generator for the customer; it also designs and assembles those

components according to the customer's needs. The taxpayer [asserts] that the engine manufacturers do not build marine engine or generator sets, and that it specializes in the custom building of generator and propulsion systems In addition to custom-built products, the taxpayer also selects and assembles specific parts from its inventory that are marketed and sold as kits, as the taxpayer did in 12 WTD 77. In both situations, the taxpayer creates new, different and more useful products, more marketable than the individual parts. Based on the above authorities, the taxpayer's activities constitute manufacturing as defined in RCW 82.04.120(1).

[This analysis is consistent with] the Department's administrative rule addressing the assembly of component parts, WAC 458-20-136(7) (Rule 136(7)). The rule incorporates the considerations applied by the Department in the determinations involving component parts discussed above, including, whether: the products are purchased from various suppliers; the person combining the products attaches its own label on the resulting product; the products are purchased in bulk and broken down to smaller sizes; the combined product is marketed at a substantially different value from the selling price of the individual components; or the person combining the items does not sell the items except within the package. Rule 136(7)(b). The rule provides that any single factor is not considered conclusive evidence of a manufacturing activity; though the presence of one or more of the factors raises a presumption that the activity is manufacturing. *Id.*

The taxpayer purchases the parts from various suppliers and the combined product is marketed at a substantially different value from that of the sale of the individual components. These activities, in addition to the taxpayer's custom design and building of the products, constitute manufacturing under Rule 136(7)

[2] The taxpayer also asserts in its appeal petition that most of the transactions identified as manufacturing during the sample period are not representative of its average sales of manufactured products. The taxpayer indicates that during the audit it identified invoices that were classified as sales of manufactured products and explained to the auditor how the itemization in the invoice established that the sale was not of a manufactured product. The auditor removed certain sales from the sample period and adjusted the assessment accordingly. The taxpayer also indicated that it was difficult to locate records from prior periods, and difficult to determine from the way it kept its records whether a particular sale represented a taxpayer-manufactured product or whether the sale was for a package containing several items sold individually. The taxpayer asserts that it would have changed the way it itemized within its invoices and the way it organized its records if the Department had notified it of its incorrect reporting.

Taxpayers have a statutory duty to maintain suitable records and allow the Department to examine them. RCW 82.32.070 provides:

Every person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which he may be liable, which records shall include copies of all federal income tax and state tax returns and reports made by him. All his

books, records, and invoices shall be open for examination at any time by the department of revenue. . . .

If a taxpayer fails to maintain and provide adequate records to determine the taxpayer's excise tax liability, the Department is authorized to use the records available to arrive at its best estimate of the taxpayer's tax liability. RCW 82.32.100(1).

Here, the taxpayer agreed to the sample period. The auditor selected invoices from that period for sales of customized engines, generators, and other products with indicia of manufacturing activities, and classified those sales as sales of manufactured products. The auditor used those representative sales during the sample period in estimating the amount of sales of manufactured products during the audit period. In a time-period sample the reasonable assumption is that the activities during the sample period are representative of the actual operations of the business for the entire audit period. *See, e.g.*, Det. No. 99-341, 20 WTD 343 (2001); Det. No. 04-0084, 24 WTD 365 (2005). The auditor used the best records available to estimate the taxpayer's income from manufacturing its products. If the taxpayer's records more accurately described its sales, it is possible that the Audit Division would have arrived at some different conclusions with regard to some of taxpayer's activities. The taxpayer's dominant activity detected by the Audit Division is manufacturing and taxes were correctly imposed based on the records provided.

The taxpayer is incorrect in its assertion that the value of the engine component incorporated in a customized product should not be included in the measure of the B&O tax because it did not manufacture the engine component. The auditor correctly measured the tax due based on the value of the product manufactured; here, the customized engines and other products, without deduction for the value of a component. *See* RCW 82.04.240; 8 WTD at 161 *citing Engine Builders, Inc. v. State of Washington*, 66 Wn.2d 147, 401 P.2d 628, (1965) (manufacturing tax on rebuilt automobile engines is measured by the gross proceeds derived from the sale of the rebuilt engine, without deduction for the value of used engine core component received from the customer).

[3] Finally, the taxpayer asserts that during prior audits by the Department it was not assessed or made aware of the applicability of the manufacturing B&O tax to its activities and that it should not be assessed tax on periods prior to receiving reporting instructions issued in the current audit. Under RCW 82.32A.020(2), a taxpayer has a right to waiver of tax where it relied to its detriment on specific, official *written* advice or tax reporting instructions. The taxpayer has not identified any prior audit reports or written statements by the Department to the taxpayer where the Department instructed the taxpayer on, or even addressed, the applicability of the manufacturing B&O classification to its income; therefore, it is not entitled to waiver of taxes under RCW 82.32A.020(2).

In addition, the taxpayer has not shown that it is eligible for waiver of tax under the doctrine of equitable estoppel, based on a prior statement or act of the Department upon which it relied to its detriment, a showing that is necessary to invoke the doctrine. *Kramarevky v. Dep't of Social & Health Serv.*, 122 Wn.2d 738, 743, 863 P.2d 535 (1993). Where a taxpayer's improper reporting was overlooked, the Department is not barred from asserting a tax liability because an auditor

failed to find an error during an earlier audit. *Dep't of Revenue v. Martin Air Conditioning*, 35 Wn. App. 678, 688, 668 P.2d 1286 (1983); *Kitsap-Mason Dairymen's Assoc. v. Tax Commission*, 77 Wn.2d 812, 818, 467 P.2d 316-317 (1970); Det. No. 93-191, 13 WTD 344 (1994); Det. No. 91-059, 10 WTD 413 (1990). Contrary to the taxpayer's assertion that it was never provided notice that its activities constituted manufacturing, a description of what constitutes a manufacturing activity is set forth in RCW 82.04.120(1) and Rule 136, and in Department determinations relying on those authorities issued as early as 1988. The mere fact that the taxpayer was not assessed manufacturing B&O tax in a prior audit is insufficient evidence of an inconsistent act. 12 WTD at 83.

Based on the foregoing analysis, the Department correctly classified the taxpayer's activities and assessed manufacturing B&O tax on the income from those activities. The taxpayer's petition is denied.

DECISION AND DISPOSITION

The taxpayer's petition is denied

Dated this 3rd day of January 2013.