Cite as Det. No. 91-322, 11 WTD 521 (1992).

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. 91-322
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 224 & RULE 223: SERVICE B&O TAX -- TIME AND MATERIALS CONTRACT -- PRIMARY BUSINESS ACTIVITY -- BASIC ORDERING AGREEMENT. A basic ordering agreement that outlined the general scope and subject matter of the work to be done in addition to listing the standardized terms and conditions of work, but which contemplated that the actual tasks and compensation would be determined at a later time, did not constitute a lump sum contract. Subsequent task orders which identified the actual task to be performed, the compensation to be received, and the time required for completion were subject to taxation based on the primary business activity engaged in while performing those tasks.

[2] RULE 178: USE AND/OR DEFERRED SALES TAX -- BAILED EQUIPMENT -- DOMINION AND CONTROL -- AUTHORIZED USE. A contractor is not subject to use tax as a bailee on government-owned equipment unless it has dominion and control over the equipment and actually subsequently uses that equipment. Where the contractor has specific authorization to use the equipment in its contract, actual subsequent use will be presumed.

[3] RULE 211: USE AND/OR DEFERRED SALES TAX -- USED BAILED EQUIPMENT -- VALUE. Use tax on used bailed equipment is to be computed based on the reasonable rental value of comparable used equipment. In the absence of comparable rentals, the reasonable rental value will be computed by prorating the retail selling price of

similar used equipment over the period of possession by the bailee.

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: October 22, 1991

NATURE OF ACTION:

The taxpayer protests the imposition of additional taxes and interest assessed in an audit report.

FACTS:

Okimoto, A.L.J. -- [The taxpayer] contracts with the various agencies of the United States Government to provide a variety of technical, engineering, and scientific services. Although its headquarters are located in [California], it has engineering offices at . . . and in . . . , Washington. It also has a fabrication facility in . . ., Washington. The taxpayer's books and records were examined by a Department of Revenue (Department) auditor for the period January 1, 1986 through March 31, 1990. An audit report resulted in additional taxes and interest owing in the amount of $ . . . and Doc. No. . . . was issued in that amount [in November 1990]. The taxpayer has protested the assessment and it remains due.

TAXPAYER'S EXCEPTIONS:

Schedule III: Income Reclassification - Service

In this schedule, the auditor reclassified those portions of individual contracts which were reported under the Manufacturing tax classification to the Service and Other Activities tax classification. The auditor did not dispute that the individual tasks for which the taxpayer was billing the federal government involved manufacturing, but concluded that the manufacturing activity was only part of a larger personal services contract. Because the auditor concluded that the "primary activity" of the larger single contract was taxable under the Service and Other Activities Tax classification, then the entire contract was taxable under that tax classification. The auditor specifically did not allow an allocation between the different activities of what he considered a single contract.

At the hearing, the taxpayer described the contract negotiation process as follows:

> 1. The taxpayer and federal government enter into a Basic Ordering Agreement. This agreement sets out the general terms and conditions of the contract but identifies no specific tasks to be performed and sets no dollar amounts (except a general upper limit).
> 2. When the government decides that it needs to have some work done under the contract, it will issue a Task Authorization Memorandum (TAM) to the taxpayer. This TAM references the Basic Ordering Agreement, and identifies the task to be performed.
> 3. The taxpayer evaluates the TAM and then submits a Task Execution Plan (TEP) to the government for approval. In the TEP, the taxpayer explains how it will execute the desired task, the time required, and the cost to the government.
> 4. The government then evaluates the TEP and either approves or rejects the plan.

The taxpayer first disputes the auditor's characterization of the Basic Ordering Agreement as a "single" contract. Although the taxpayer concedes that all task orders are referenced to that Basic Ordering Agreement number, it nevertheless contends that it is not intended to be a final contract. The taxpayer argues that it is more like an open purchase order. The taxpayer explained that the Basic Ordering Agreement is merely a preliminary process whereby the government and the taxpayer agree on the general contractual terms of future negotiated contracts. In this manner, it can avoid the necessity of having to go through the formal contract proceedings every time a task is ordered. The taxpayer argues that a final contract is not entered into until the TEP is submitted by the taxpayer and approved or accepted by the government. The taxpayer states that even with the executed Basic Ordering Agreement, if no tasks are required, and no TAM's issued, then the taxpayer receives no compensation. The taxpayer argues that each TEP should be considered an individual contract and taxed on its respective business activity. The taxpayer does concede, however, all tasks ordered must be within the scope of the Basic Ordering Agreement.

Schedule IV: Use Tax Assessed on "Service" Taxable Contracts

In this schedule the auditor asserted use and/or deferred retail sales tax on all purchases made pursuant to a "service taxable" contract. The auditor made no distinction between taxpayer's material purchases which were incorporated into the manufacturing type tasks of the Basic Ordering Agreement and those material purchases which were consumed during "personal services" type

tasks. The auditor considered all materials purchased for a primarily service taxable Basic Ordering Agreement as being for consumption and subject to retail sales tax.

The taxpayer argued in its petition that "...materials purchased for incorporation into products manufactured for sale to the U.S. government are not subject to Washington use tax" because they are purchased for resale.

Schedule V: Use Tax on Government Furnished Equipment

In this schedule the auditor assessed use tax on U.S. Government-owned equipment stored in a warehouse for which the taxpayer had accounting responsibility. The auditor reasoned that because the taxpayer had dominion and control over the equipment, then the taxpayer was subject to use tax as a bailee. The auditor further assessed the tax on the total value of the equipment stored in the warehouse and only made a downward adjustment for equipment acquired by the taxpayer during the current contract and taxed in a separate schedule.

The taxpayer objects to this use tax assessment for the following reasons. At the hearing, the taxpayer stated that the Government-owned equipment being taxed is stored in a large government-owned warehouse. The taxpayer explained that under the terms of all past contracts and the current contract, title to equipment procured by the contractor for use in performing its services transfers to the federal government at the end of the contract. This equipment is then stored in the government warehouse and made available to subsequent contractors. The age and condition of the equipment varies, and some may have been acquired as much as 40 years ago.
The taxpayer further contends that it never had actual dominion and control over the majority of the equipment stored in the government warehouse. Although the taxpayer concedes that its current contract requires it to maintain an accounting system of all equipment in the warehouse, it states that it must receive special authorization from the government before it can actually utilize any of the previously-acquired equipment. Normally this special authorization is contained as an addendum in each of the task orders.

The taxpayer further explained that the federally owned warehouse is operated by government personnel, who log-out and log-in the individual pieces of equipment. In order for the taxpayer to use this equipment, it must first check it out from the warehouse at which time its authorization is verified. Furthermore, during the audit period in question, the taxpayer did not even perform the actual accounting paperwork of the warehouse equipment. Because of its lack of accounting personnel, the taxpayer chose

to subcontract that portion of its responsibility to the prior contractor. Thus, the taxpayer argues that except for the equipment for which it had received specific authorization, it never even had dominion and control over the government-owned equipment, much less use.

Even assuming that the taxpayer is found to have used the equipment stored in the warehouse, it also protests the auditor's method of computing measure of the tax. It argues in its petition:

> First, no adjustment was made for property which was previously furnished to other U.S. government contractors in Washington. Such other contractors would have paid the use tax to the state or were assessed the tax upon audit by the Department. In any event, the contractors using the property prior to [the taxpayer] have the responsibility for the payment of the tax. Second, no adjustments were made for specific exemptions provided by the code (e.g. property which is entirely consumed during research, development, experimental and testing activities). Third, the auditor incorrectly prorated the retail selling price of the property over the term of [taxpayer]'s contracts without appropriate consideration of rental price as required by the code. (Emphasis theirs)

ISSUES:

1. Does a Basic Ordering Agreement that outlines the general scope and subject matter of the work to be done, in addition to listing the standardized terms and conditions of work, but which contemplates that the actual tasks and compensation be determined at some later date, constitute a lump sum contract taxable under one tax classification based on its primary business activity?
2. Is a contractor subject to use tax as a bailee of government-owned equipment if it is not authorized in its contract to use the equipment during the performance of its contract?

3. How should the use tax on used bailed equipment be computed?

DISCUSSION:

Schedule III: Income Reclassification - Service

[1] RCW 82.04.220 imposes the business and occupation tax (B&O) upon every person "...for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be." RCW 82.04.070 defines "gross proceeds of sales" to mean "...the value

proceeding or accruing from the sale of tangible personal property and/or for services rendered..." RCW 82.04.080 defines "gross income of the business to mean "...the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services..."

Based on the above statutes, we believe that it is fundamental to the B&O taxing system that income be taxed according to the type of business activity being performed[1]. We also believe that a given business may be involved in more than one classification of business activity. In fact, audit assessments of businesses routinely include more than one B&O tax classification. For example, a business might be doing accounting functions for affiliates, making retail sales, printing forms for internal use, etc. and it would be assessed the applicable B&O tax on all of those activities. See, e.g., Group Health Cooperative of Puget Sound v. Department of Rev., 106 Wn.2d 391 (1986)(B&O tax upheld on Group Health's carpentry and print activities). Also, a personal service business would be subject to retailing B&O and retail sales tax on any income received from sales of tangible personal property apart from the rendition of personal services. WAC 458-20-148.

We have examined the Basic Ordering Agreement and find that it is certainly not a "lump sum" contract but rather "an indefinite quantity, Time and Materials type contract[2]." The contractor receives compensation based on the labor and materials required to perform certain tasks. We characterize it more as a general agreement that outlines the general scope and focus of the work to be done in addition to listing the standardized terms and conditions of work while at the same time fully contemplating that the actual tasks and compensation be negotiated at a later date. This is done through the process of TAMs and TEPs. We believe that it is this finally executed TEP, which identifies the task to be performed, the time period required, and the estimated amount of compensation to be actually received that governs the tax classification of the business activity being engaged in and not the Basic Ordering Agreement. Accordingly, the taxpayer's petition is granted on this issue.

Schedule IV: Use Tax Assessed on "Service" Taxable Contracts

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[1]See Fidelity Title Co. v. Department of Rev., 49 Wn.App.662 (1987); ETB 49.04.171; Pan Am World Airways, Inc. v. State, (Thurston Cty. Superior Ct. No. 82-2-00358-9, 1983)

[2]Award/contract . . . .

The taxpayer's petition is granted on this issue. See discussion involving Schedule III above.

Schedule V: Use Tax on Government Furnished Equipment

[2] RCW 82.12.020 states in part:

> There is hereby levied and there shall be collected from every person in this state a tax or excise for the privilege of using within this state as a consumer any article of tangible personal property purchased at retail,... (Emphasis ours)

The definition of "use" in RCW 82.12.010 simply provides that the term has its ordinary meaning and also states that use:

> "... shall mean the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (as a consumer), and include installation, storage, withdrawal from storage, or any other act preparatory to subsequent actual use or consumption within this state." (Emphasis ours)

We interpret the above statutes to mean that the first act of dominion or control over the article of tangible personal property triggers the use tax liability if but only if the taxpayer subsequently actually uses or consumes the article within this state. Dominion or control of an article without the subsequent actual use does not incur liability for use tax. This interpretation is supported by the common and ordinary meaning of "use" which is: "to put or bring into action or service; employ for or apply to a given purpose." Webster's New Universal Unabridged Dictionary, Deluxe Second Edition (1983), p. 2012. This meaning is also embodied in its statutory definition in the phrase, "as a consumer." Consequently, we believe that use is contingent upon finding that the taxpayer has put the article of tangible personal property into service for either its given purpose or some other purpose. Absent this finding, there is no use tax liability.

In the taxpayer's case, not only did the taxpayer testify that it was not authorized to use the vast majority of the equipment stored in the warehouse, but that it also did not have dominion and control over the equipment. Under these circumstances, we agree that the taxpayer is not subject to the use tax. The taxpayer's petition is granted on this issue.

However, as to equipment stored in the warehouse that it was specifically authorized to use pursuant to its Task Execution Plans, we believe that the use tax was properly assessed. Where

the contractor is given specific authorization in the contract to use identified government-owned equipment, the Department will presume that actual use subsequently occurred, unless the taxpayer submits clear evidence contradicting that presumption.

[3] As to the taxpayer's objection to the measure of the tax assessed, we note RCW 82.12.010 states that where:

> the articles used are acquired by bailment, the value of the use of the articles so used shall be in an amount representing a reasonable rental for the use of the articles so bailed, determined as nearly as possible according to the value of such use at the places of use of similar products of like quality and character under such rules and regulations as the department of revenue may prescribe... (Emphasis ours)

WAC 458-20-211 (Rule 211), the Department's duly-promulgated rule implementing this statute, provides that:

> The measure of the use tax for articles acquired by bailment is the reasonable rental for such articles to be determined as nearly as possible according to the rental price at the place of use of similar products of like quality and character. ... No further use tax is due upon property acquired by bailment after tax has been paid by the bailee or any previous bailee upon the full original value of the article. (Emphasis ours)

We agree that if a previous bailee has paid use tax on the full original value of the article used, the taxpayer is not subject to use tax on the taxpayer's subsequent use of the equipment. However, the burden is on the taxpayer to establish that fact and the taxpayer has failed to present any such documentation. Nevertheless, this issue shall be remanded to the audit division for examination of any documentation that the taxpayer can provide which substantiates its contention.

RCW 82.12.0265 exempts from the use tax:

> ... the use by a bailee of any article of tangible personal property which is entirely consumed in the course of research, development, experimental and testing activities conducted by the user, provided the acquisition or use of such articles by the bailor was not subject to the taxes imposed by chapter 82.08 RCW or chapter 82.12 RCW.

We agree that if the taxpayer can document that any of the materials received from the government-owned warehouse consisted

of tangible personal property which was entirely consumed in the course of research, development, experimental and testing activities conducted by the taxpayer, it is exempt from tax. This issue is remanded to the audit division for further examination.

Rule 211 provides that:

> The measure of the use tax for articles acquired by bailment is the reasonable rental for such articles to be determined as nearly as possible according to the rental price at the place of use of similar products of like quality and character. In the absence of rental prices for similar products the reasonable rental may be computed by prorating the retail selling price over the period of possession had by a bailee and payable in monthly installments.

Rule 211 clearly provides that the measure of use tax is to be based on the reasonable rental value of similar products of like quality and character. Accordingly, if the taxpayer can provide information on comparable rentals of similar used equipment, the use tax shall be measured by that value. In the absence of comparable rentals, the reasonable rental value will be computed by prorating the retail selling price of similar used equipment over the period of possession by the bailee. However, in all cases, the burden is on the taxpayer to present the proper documentation. These issues shall also be remanded to the audit division for further examination.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part, and remanded in part. The taxpayer's file shall be remanded to the audit division for the proper adjustments consistent with this determination.

DATED this 27th day of November 1991.