

Cite as Det. No. 91-340, 11 WTD 547 (1992).

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 A T I O N</u>
For Correction of Assessment)	
of)	No. 91-340
)	
. . .)	Registration No. . . .
)	. . ./Audit No. . . .
)	
)	

[1] RULE 136 and RULE 155: B&O TAX -- MANUFACTURING -- CONTRACTING WITH OTHERS -- SOFTWARE DISKS AND PACKAGING. The production of software disks and their packaging results in "a new, different or useful . . . article of tangible personal property" and is thus manufacturing.

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: December 5, 1991

NATURE OF ACTION:

The taxpayer was audited with a total deficiency due and assessed of \$ The taxpayer paid \$. . . and the balance remains contested.

FACTS AND ISSUES:

Free, A.L.J. -- The taxpayer designed and developed a . . . computer software program. It would send the program to a duplicating company that would copy it on diskettes¹ and wrap them. They were returned to the taxpayer who stored them until it sold them. In 1987, the taxpayer prepared an operation

¹ 23 5.25 inch floppy diskettes or 11 3.5 inch diskettes.

manual. It contracted with another company to produce the manuals. Upon receipt of an order, the taxpayer combined the computer diskettes with the manuals for final shipment. The taxpayer conducted all its activities in Washington, but would sell the software to customers both in and out of Washington. The auditor assessed manufacturing business and occupation tax on the out-of-state sales of the software. He found that the diskettes without the documentation were substantially useless to the average consumer. He classified the activity as manufacturing because the combination and assembly into distinct units for sale resulted in new and useful products.

The taxpayer contends that the proper classification was retailing. From 1983 through 1987, the diskettes were sold without manuals. Its customers relied on a one-day training session plus the help screens incorporated in the program. The taxpayer asserts that its customers were sophisticated and able to use the programs without manuals. The taxpayer disputes the auditor's contention that the disks were useless to its consumers.

The taxpayer states that it often did not pay its officers who were responsible for the programs. During those periods, its only costs in producing the programs were the charges from the companies duplicating the disks and providing the manuals. It argues that since it did not provide over 20% of the cost of the final product that it was not a manufacturer under WAC 458-20-136(13)(b).

The issue is whether the taxpayer was a manufacturer or a retailer. If the taxpayer was a manufacturer, it was subject to manufacturing business and occupation tax on those articles produced in Washington. If it was a retailer, the sales occurring outside Washington would be exempt from the retailing business and occupation tax.

DISCUSSION:

RCW 82.04.110 defines "manufacturer" stating in part:

"Manufacturer" means every person who, either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his own materials or ingredients any articles, substances or commodities.
(Emphasis supplied.)

WAC 458-20-136 (Rule 136) defines manufacturer:

(2) The word "manufacturer" means every person who, from the person's own materials or ingredients manufactures for sale, or for commercial or industrial use any articles, substance or commodity either directly, or by contracting with others for the necessary labor or mechanical services. (Emphasis supplied.)

WAC 458-20-155 (Rule 155) provides:

Persons who produce . . . prewritten software, and materials in this state and who sell, lease, license, or otherwise transfer such things to buyers outside this state and deliver such things outside this state . . . are subject to the Manufacturing classification of the business and occupation tax. (Emphasis added.)

We believe that the taxpayer's activity is clearly manufacturing and manufacturing business and occupation tax is due on the sales of the software packages. The taxpayer supplies the principle ingredient, the program. It contracts with others to provide the duplicating and printing services.

The taxpayer² has read Determination No. 88-303, 6 WTD 255 (1988) which contained the following explanation:

Since the value of the materials supplied by the taxpayer to the vendor was in excess of 20% of the final value of the boxed product, Rule 136(12)³ required the vendor to be taxed as a processor for hire, and the taxpayer to be taxed as a manufacturer.

The taxpayer believes that since it did not pay salaries, the costs of the program it provided was less than 20% of the cost of the final product, making it a processor for hire or even a retailer. It likens itself to a department store that combines a shirt and tie in a sale, arguing that the fact it combines these articles, doesn't change it from a retailer to a manufacturer.

The 20-80% test was introduced in Rule 136 to provide a clear guideline between processors for hire and manufacturers. It applies when the customer of the taxpayer furnished such a significant portion of the materials produced, that the taxpayer

² The taxpayer was also furnished a copy of Det. No.86-214, 1 WTD 9 (1986) which made no distinction of the value of materials furnished.

³ The Rule has been amended so the proper reference is now (13).

is merely seen as providing an assembly service for the furnisher of the materials. Under Rule 136 if the value of the materials or ingredients furnished by the taxpayer is equal to or exceeds 20% of the total value of all materials or ingredients which become a part of the finished product, the taxpayer's activity is considered manufacturing.

Rule 136 refers to value, not cost. Intelligence imparted to the diskettes is an ingredient.⁴ The program furnished by the taxpayer is the primary component of the software package in terms of value. The taxpayer's products sold for \$1,600 - \$2,200. The program is clearly worth more than 80% of the value of the finished product. Therefore, under Rule 136 as well as Rule 155, the taxpayer is a manufacturer subject to manufacturing B&O tax.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 27th day of December, 1991.

⁴ Det. No. 90-342, 10 WTD 123 (1990)