Cite as 11 WTD 113 (1991).

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. 91-091
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 114 -- B&O TAXES -- DEDUCTION -- GRANTS -- RESEARCH REPORTS. Where a federal agency awarded a taxpayer a grant for doing research and product development in certain designated areas and also required a written report on the results of that research, the income was subject to service B&O tax.

[2] RULE 241: MANUFACTURING TAX -- USE TAX -- MASTER VIDEOTAPE PRODUCTION -- ORIGINAL. An original one-of-a-kind master videotape purchased from a production company is merely the tangible evidence of an artistic-type service, and is not subject to manufacturing or use taxes. This is true even though some preliminary production steps may have been done by the taxpayer itself, or contracted out directly to other companies.

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: September 14, 1989

NATURE OF ACTION:

A taxpayer protests the imposition of additional taxes assessed in an audit report.

FACTS:

Okimoto, A.L.J. -- . . . (taxpayer) is a producer and seller of [videotapes] located in . . . , Washington. Taxpayer's books and records were examined by a Department of Revenue (Department) auditor for the period January 1, 1985 through September 30, 1988. The audit resulted in additional taxes and interest owing of $ . . . and Docket No. . . . was issued in that amount [in June of 1989]. The taxpayer has appealed the entire assessment, and it remains due.

TAXPAYER'S EXCEPTIONS:

Schedule IV: Tax Due on Grant Revenue:

In this schedule the auditor asserted Service B&O tax on unreported grant money received under the Small Business Innovation Research (SBIR) program sponsored by the federal government. Although each federal agency administers its own SBIR program so that there are some differences between agencies, the essential characteristics are as follows:

Phase I of the government project consists of research and development activities resulting in a report (feasibility study) which is designed to evaluate the scientific technical merit and feasibility of an idea. A Phase I award will normally not exceed $50,000.

Upon completion of Phase I, the government evaluates the results of Phase I and unilaterally determines whether additional funding for Phase II should be awarded. Phase II involves expanding on the results of and further pursuing the development of Phase I. Only the Phase I recipient can be awarded the Phase II award. Phase II awards can be up to $500,000 and normally do not exceed two years.

Phase III is the actual commercialization, production and sale of products which resulted from the research and development in Phases I & II. The recipient is required to obtain non-government funding for this portion of the program. Because the research and development rights belong to the award recipient, it may patent any products developed, provided that the government is granted a non-exclusive license to use the design. However, the government may not release or make public the contents of the awardee's report for a period of two years after the report was filed.

The taxpayer argues that the SBIR awards are donations, or contributions, and therefore deductible from B&O taxes under RCW 82.04.4282 and WAC 458-20-114, (Rule 114). In support of this the taxpayer makes several rather lengthy arguments which we have summarized.

1. Federal agencies are required by law to use procurement contracts -- and forbidden to make grants -- when they want to obtain goods or services, including research services. Because the federal agency involved did not use a procurement contract, then the SBIR award was a grant and not a contract for services.

2. The taxpayer contends that this money was given to the taxpayer with "no strings attached" and should be considered a non-taxable donation. In support of this, the taxpayer cites the following facts. a) The taxpayer initiated the grant by proposing to investigate the subject matter of the grant. b) The taxpayer's report at the completion of the grant was limited to its accountability that it had used its grant money pursuant to its original application. c) The government agency was not given a copy of the [videotapes] that were the objective of the research. d) Taxpayer unilaterally eliminated two of the six [videotape] subjects that it had specified in its grant application without the agencies' permission and without a reduction of the grant.

Schedules II & IV: Master Tapes Subject to Mfg and Use tax:

In this schedule the auditor assessed Manufacturing and Use tax on the value of two master video tapes produced by the taxpayer in conjunction with other local production companies. Because these master tapes are not resold, but copied onto [other tapes] which are sold to the public, the auditor considered them to be mere tools which are used in the production of the eventual [videotape] product. As such, the auditor assessed tax based on the capitalized $50,000 value of the two tapes.

The taxpayer explained at the hearing that one of its Phase I grants was utilized "... in the design, development and production of [a tape] used to prepare patients . . . ." The taxpayer described its activity in its Phase I report to the Public Health Service as follows:

> The first three months of this Phase I grant were occupied with preparation of the content outline and script, selecting the best quality slides from existing slide-tape programs that had been developed

> earlier by the . . . , taking additional slides where needed, filming of . . . segments, audio taping of the narrator, patients, and . . . , and editing in a local TV studio. This master videotape was then sent to [a corporation] in Minnesota for [dubbing onto a tape].

The taxpayer further explained at the hearing, that in addition to using its own personnel, the taxpayer contracted with three major companies to produce the master videotape. One company was used to transfer photographic images to videotape. A second company was used to edit stills, and finally, . . . Productions, . . . was used to shoot all live action scenes and to combine all of the above parts into the final master videotape.

The taxpayer objects to the tax assessments in Schedules II and IV on the following grounds.

First, that the creation of original videotape masters is the result of an artistic-type service and not the manufacturing of tangible personal property. The taxpayer likens it to custom computer software, which the Department has found to be not subject to manufacturing and use tax.

Second, even if the master videotapes are found to be tangible personal property, the taxpayer argues that there was no taxable use of the tapes within the state of Washington. The taxpayer emphasized that although the masters may have been viewed as part of the editing and production process, it was then immediately sent to Minnesota where its use as a master for the production of [videotapes] was actually performed. The taxpayer argues that manufactured articles of tangible personal property are not subject to use tax unless there is a clearly separate and distinct commercial or industrial use within the state after the manufacturing process is complete. The taxpayer contends that this commercial use did not occur in Washington, but in Minnesota. The taxpayer cites Det. No. 87-364, 4 WTD 351, in support of its position.

Third, even assuming that the master videotapes are found to be tangible personal property and that there has been a taxable use in Washington, the taxpayer argues that the masters should be valued as prototypes of a [videotape] that will be offered for sale. Accordingly, under RCW 82.12.010 the "value of the article used" of the masters should be "...(a) The retail selling price of such new or improved

product when first offered for sale;...." The taxpayer testified this value to be $350.

ISSUES:

1. If a federal agency awards a grant to a taxpayer for doing research and product development in certain designated areas and also requires a written report on the results of that research is that income deductible from its gross receipts as a donation?

2. Is manufacturing and use tax due on original one-of-kind master videotapes, where the taxpayer either contracts with other companies directly or performs certain preliminary production steps by itself, but contracts with a production company perform live filming and to combine all of the prior production steps into the master videotape?

DISCUSSION:

Schedule IV: Tax Due on Grant Revenue

[1] RCW 82.04.4282 allows a deduction from gross income those amounts derived from "... (3) contributions, (4) donations... (8) endowment funds. WAC 458-20-114 (Rule 114) is the lawfully promulgated rule implementing the above statute and it has the full force and effect of law until overturned by a court of record not appealed from. RCW 82.32.300. It states in part:

> Only amounts which are received as outright gifts are entitled to deduction. Any amounts, however designated, which are received in return for any goods, services, or business benefits are subject to business and occupation tax under the appropriate classification depending upon the nature of the goods, services, or benefits provided. Thus, for example, so- called "grants" which are received in return for the preparation of studies, white papers, reports, and the like do not constitute deductible contributions, donations, or endowments. (Emphasis ours)

Rule 114 clearly states that "so-called `grants' which are received in return for the preparation of studies, white papers, reports, and the like do not constitute deductible contributions, donations, or endowments." We believe the above underlined sections of the rule to be directly on point. The taxpayer's "so-called grant" is merely compensation

received for its research and development activity regarding its [videotape] project which culminated in a final written report. We must therefore deny the taxpayer's petition on this issue.

Schedules II & IV: Master Tapes Subject to Mfg and Use tax:

WAC 458-20-241 (Rule 241) is the applicable rule for determining the tax classification of master videotapes produced by broadcasters or independent filmmakers. It explains the applicable tax classifications of radio and television broadcasters and states in part:

> SERVICE AND OTHER ACTIVITIES. Taxable on gross income from personal or professional services, including gross income from producing and making custom commercials or special programs, fees for providing writers, directors, artists and technicians, charges for the granting of a license to use facilities ...

Applying the above rule to the taxpayer's facts, we believe that it is clear that the master videotapes which the taxpayer contracted with . . . Productions to produce constituted "custom ...special programs" within the meaning of Rule 241. We note that each master videotape was of "an original, one-of-a-kind nature" made specifically for the taxpayer[1]. Therefore, these tapes constitute only the tangible evidence of an artistic-type service performed by the various production companies and are not subject to either the manufacturing or use taxes. The taxpayer's petition is granted on this issue.

DECISION AND DISPOSITION:

The taxpayer's petition is denied in part and granted in part.

DATED this 9th day of April 1991.

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[1]We do not believe that it is significant that some of the preliminary production steps, such as script writing, editing, still photography, and etc. may have been either contracted out or actually done by the taxpayer, so long as the final finished master videotape is of an original or one-of-a-kind nature.