Cite as Det. No. 92-034, 12 WTD 77 (1993).

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. 92-034
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 136: MANUFACTURING TAX -- DEFINITION -- MODEL BOAT KITS. The activity of combining hundreds of component parts with assembly instructions in order to produce easy-to-assemble model kits is taxable under the manufacturing tax classification on the gross proceeds of sale derived from those kits. Accord: ETB 398; Dist.: Det. No. 88-443, 7 WTD 49 (1988); Det. No. 88-180, 5 WTD 307 (1988).

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.

NATURE OF ACTION:

A taxpayer protests additional manufacturing taxes and interest assessed on sales of model kits.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: . . .

FACTS:

Okimoto, A.L.J. -- . . .(taxpayer) manufactures and distributes parts and equipment for making remote-controlled racing models. The taxpayer's books and records were examined by a Department of Revenue (Department) auditor for the period January 1, 1986 through June 30, 1990 and an assessment was issued.

The taxpayer described its business activities as follows:

> Much of the equipment [taxpayer] sells is manufactured by other suppliers. [Taxpayer] buys it and distributes it at wholesale to hobby shops in several states, including Washington. [Taxpayer] also does a limited amount of manufacturing. It uses its own injection molds to manufacture plastic boat hulls and car bodies, which are among the items available for sale by [taxpayer].
>
> All equipment that [taxpayer] sells is available for separate purchase. Each item of hardware (down to the last set of miniature nuts and bolts) is separately listed in [taxpayer's] supply catalog. It is also common in the industry to combine a group of components into one package (a "kit"). A kit may consist of the components for a particular subassembly, e.g., an electronics kit or a hardware kit, or a kit may include everything needed to assemble a working model. When [taxpayer] sold items together, rather than individually, these packages or "kits" contained a plastic boat hull or car body that [taxpayer] had manufactured, together with the other parts (manufactured by others) that hobbyists would need to assemble a working model.

The taxpayer stated that it does not assemble or manufacture any portion of the parts included in the kits except for the boat hulls and car bodies.

TAXPAYER'S EXCEPTIONS:

Schedule II: Reconciliation of Income by Year

In this schedule, the auditor assessed manufacturing B&O taxes on the gross proceeds of sale from model kits delivered to customers outside the state. The taxpayer protests this adjustment.

Although the taxpayer concedes that it owes manufacturing B&O tax on that portion of the kits attributable to the injection molded boat hulls and car bodies, it believes that it does not owe manufacturing tax on the value of the parts included in the kits that it did not manufacture. The taxpayer contends that it is merely packaging these non-manufactured parts with items that it manufactures. The taxpayer cites Det. No. 88-443, 7 WTD 49 (1988) for support of this position.

Next, the taxpayer states that the prior auditor accepted the taxpayer's method of reporting manufacturing tax on only that portion of the kits attributable to the boat hulls and car bodies

that it manufactured. The taxpayer now argues that the Department should be estopped from changing that position. It states that it relied on those instructions to its detriment since it could have avoided the tax by not packaging manufactured parts with nonmanufactured parts.

Finally, the taxpayer contends that the doctrine of procedural fairness requires the Department to apply any change in position on a prospective basis only. It cites Hansen Baking Company v. Seattle, 48 Wn. 2d. 737 (1956) in support of this position.

ISSUE:

1. Where a taxpayer combines hundreds of component parts with assembly instructions in order to produce an easy-to-assemble model kit, does that activity constitute manufacturing?

DISCUSSION:

[1] RCW 82.04.110 defines "manufacturer" as follows:

> "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....

RCW 82.04.120 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,...

Thus, the question of whether a "manufacturing" activity has occurred depends on whether the taxpayer's application of skill or labor to its own materials results in a "new, different or useful" article. Our Supreme Court has considered the question in a number of cases. In Continental Coffee Company v. State, 62 Wn.2d 829 (1963), the court held that:

> ... the changing of green coffee beans, useful only to coffee processors, to a roasted and blended coffee, and usable item is a change of such significance as to render it manufacturing....

In McDonnell & McDonnell v. State, 62 Wn.2d 553 (1963), the court held that splitting peas was a manufacturing activity. In the

course of rendering that decision, the court noted that a change in value or demand were significant factors in determining whether a new, different or useful substance had resulted. In reaching its conclusion, the court stated:

> There are differences in the demand for the respective products -- whole peas v. split peas -- the demand dependent in part upon the personal preferences of the ultimate consumers. Without such a difference in demand there would be no practical reason to engage in the operation of splitting peas.

Id. at 556.

In Bornstein Seafoods, Inc. v. State, 60 Wn.2d 169 (1962), the process held to be manufacturing was a change from fish to fish fillet. In Stokely-Van Camp v. State, 50 Wn.2d 492 (1957), the court held that freezing fruit and vegetables fell within the statutory definition of manufacturing. In that case, the taxpayer unsuccessfully attempted to distinguish its situation from certain others previously considered by the court:

> ... on the ground that in each of these cited cases the materials used were transformed into a different and useful article of commerce, whereas
>
> > ... the activities of respondent create no usefulness which did not previously exist, but only a preservation of that same degree and form of usefulness through packaging and preservation.
>
> It is argued by respondent that the fruit and vegetables frozen by it are still the same fruit and vegetables they were when they arrived at its plant.

Stokely-Van Camp at 497.

In J&J Dunbar and Company v. State, 40 Wn.2d 763 (1952), the court held that the activity of screening and filtering of raw whiskey constituted manufacturing.

In all of the above cases, the court found that the kinds of activities performed resulted in a significant change which resulted in a "new, different or useful substance or article." This test was first enunciated in Bornstein where the court stated:

> 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.

Bornstein at 175. (Emphasis supplied.)

The court in McDonnell further identified some of the factors to be considered when determining whether a significant change had resulted from a taxpayer's business activity. It stated:

> ...In making this comparison, consideration should be given to the following factors: 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, which may be indicative of the existence of a "new, different, or useful substance."

McDonnell at 557.

The "significant change" test requires that we first examine the article before it was subjected to the process and compare it to the end product sold. Here, the article before consisted of hundreds of individual screws, nuts, bolts, hulls and other parts, each of which could be used to assemble either a model boat or some other item of tangible personal property. The taxpayer's process took these unrelated parts and combined them with assembly instructions in order to produce easy-to-assemble model kits. The kits contain all of the necessary components to build the desired motorized model. Assembly requires no engineering skills and the kits are designed specifically to enable a layperson to assemble and build sophisticated motorized models.

In applying the test, we find that a clear and unmistakable significant change has been accomplished when the end product is compared with the article before it was subjected to the taxpayer's process.

When examining the factors listed in McDonnell, we first note that there has been a definite change in form. What was previously hundreds of loose parts has now become one single package called a model kit. The kit constitutes a saleable consumer product as opposed to a myriad of screws, nuts and other unrelated components. Second, although the value of the components may not have been enhanced (since the sum of the selling prices of all parts included in the kits may exceed the

selling price of the kit) the demand has certainly been greatly increased. Complete model kits are normally much more in demand by consumers than loose parts. In addition, we see as a secondary benefit of producing model kits, as opposed to just selling individual parts, the creation and maintenance of a consumer base for subsequent spare part sales. We believe that if the taxpayer had not sold the original model kits, any market for its spare parts would be nominal.

Next, we consider the taxpayer's reliance on the Department's published Det. No. 88-443, 7 WTD 49 (1988) to be misplaced. That case involved the sale of learning materials such as books, video cassettes, posters, transparencies, games and puppets some of which the taxpayer manufactured and some of which it did not. The Administrative Law Judge (ALJ) found that the manufacturing B&O tax was due only on that portion of the kit or unit which was actually manufactured by the taxpayer and not the entire sales price of the kit. The ALJ relied in part on previously-published Det. No. 88-180, 5 WTD 307 (1988). Key to both of these determinations, however, was the finding by both ALJs that the combining of these finished products into a unit did not, in itself, constitute manufacturing. In both determinations, the individual items being combined were finished consumer products by themselves and could be sold either separately or as part of a unit. The ALJs simply held that the activity of packaging these separate consumer products together and selling them as a unit did not create a new, different, or useful article.

Those cases are significantly different from the taxpayer's situation. In the taxpayer's case it is gathering from an inventory of unrelated parts, items which must first be combined with other components in order to produce a finished consumer product. They are not finished products in themselves. Nor do they have a separate utility until they are combined with these other components. Based on these differences, we find the cited published determinations to be distinguishable.

Next, we will address the taxpayer's estoppel argument. The Washington State Supreme Court stated in Harbor Air v. Board of Tax Appeals, 88 Wn.2d 359 (1977):

> Three elements must be present to create an estoppel: (1) an admission, statement, or act inconsistent with the claim afterwards asserted, (2) action by the other party on the faith of such admission, statement, or act, and (3) injury to such other party resulting from allowing the first party to contradict or repudiate such admission, statement, or act.

Harbor at 366-7.

The taxpayer has neither presented nor specifically identified any admission, statement, or act made by the Department's auditors in the prior audit report which is inconsistent with the current audit assessment. The mere fact that more B&O tax is being assessed in the current audit than the prior audit is insufficient evidence of an inconsistent act. Nor has the taxpayer established the other two elements of estoppel. Accordingly, we must reject the taxpayer's argument. Because we told the taxpayer at the hearing that we would allow the submission of further documentation on this issue in connection with a motion for reconsideration, the taxpayer is instructed to submit such documentation by the new due date.

Finally, we believe Hansen Baking Co. to be equally inapplicable. That case involved the issuance of a letter by the comptroller of the City of Seattle to Hansen Baking Co. regarding the proper measure of the city's manufacturing tax. The letter stated:

> "Referring to conference in the City Comptroller's office with representatives of the baking industry, on September 10, 1943, regarding value of products manufactured in Seattle but shipped out to surrounding cities for sale:
>
> "It will be acceptable to this office to use the same method of arriving at the value of such products as has been set up by the state in arriving at value of products shipped out of the state, which we understand to be either cost, or not less than 70% of the usual selling price."

Hanson at 740.

In finding that the letter constituted an unrescinded ruling by the comptroller that it was acceptable for Hansen Baking Co. to use the cost method of measuring the value of product transported out of the city without prior sale, the court stated:

> It may well be that the city comptroller erred in making the factual determination, or exercised unsound judgment, or abused his discretion in reaching the conclusions represented by the administrative ruling. If so, he is at liberty to alter his findings and conclusions, and promulgate a different rule - but only for future application. An administrative agency may not retroactively impeach its own general rules because of asserted errors of fact, judgment, or discretion on its own part.

Hanson at 743.

We have examined the prior audit report and can find no written instructions or any prior ruling issued by the Department authorizing the taxpayer to not report manufacturing tax on the gross proceeds of manufactured model kits. Nor has the taxpayer identified any such ruling. Accordingly, the taxpayer's petition is denied on this issue.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 20th day of February 1992.