Cite as Det. No. 13 WTD 96 (1993).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Executive Level Reconsideration and Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 92-183ER
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RCW 82.04.290: SERVICE B&O TAX -- CLASSIFICATION OF INCOME -- "BIFURCATION" OR SEGREGATION -- PRIMARY ACTIVITY -- TESTING. Where a taxpayer agrees to perform an activity taxable primarily under a particular classification and only incidentally engages in other activities in furtherance of that activity, the taxpayer will be taxed according to its primary activity. Final Det. No. 89-433A, 11 WTD 313 (1992). Testing, which does not result in a new, different, or useful article of tangible personal property, does not constitute processing for hire. Further, simply testing property that will be used in construction is not sufficient to convert that service to a retail sale.

[2] RCW 82.04.040; RCW 82.08.010; RCW 82.08.020; RCW 82.12.010; RCW 82.12.020; RULE 178: USE TAX -- DEFERRED SALES TAX -- DEFINITION OF "USE" -- DEFINITION OF "SALE" -- DEPOSIT -- PROPERTY NEVER DELIVERED. Where a taxpayer simply pays a deposit for the purchase of tangible personal property and never receives the property, such deposit is not subject to use or deferred sales tax.

[3] RCW 82.32.050; RCW 82.32.080; RULE 228: INTEREST -- PAYMENT OF UNPROTESTED PORTION OF ASSESSMENT -- APPLICATION OF PAYMENT. Where a taxpayer has filed a timely appeal with the Interpretation and Appeals Division and has sent payment designated as payment of the unprotested tax portion of the assessment, that payment will be applied first against interest and

> penalties on the unprotested portion only and then to the unprotested tax.

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 AND PLACE OF HEARING: . . .

NATURE OF ACTION:

Taxpayer in business of "examining different types of metal and metal parts" petitions for executive level reconsideration of Det. No. 92-183, which (1) upheld the Audit Division's reclassification of a portion of taxpayer's income from the retailing and wholesaling B&O tax classifications to the service classification, and (2) did not address the imposition of use or deferred sales tax on a deposit. Taxpayer also protests the application of its payment of the unprotested tax portion of the assessment to interest.

FACTS AND TAXPAYER'S EXCEPTIONS:

Eggen, A.L.J. -- Taxpayer was audited for the period January 1, 1986, through March 31, 1990. That audit resulted in credits of retailing and wholesaling B&O tax and the assessment of service B&O tax, use tax, and interest.[1] . . . .

Taxpayer petitioned for correction of assessment with respect to two issues: the reclassification of its income from retailing and wholesaling to service and the assessment of use tax on a hand tank. Det. No. 92-183 denied taxpayer's petition. Taxpayer now petitions for executive level reconsideration of that determination.

Reclassification of Income from Retailing and Wholesaling to Service. Det. No. 92-183 described taxpayer's business as "examining different types of metal and metal parts." The determination found that taxpayer generally did not repair parts during the audit period. The determination continued:

> Often these parts are incorporated by . . . manufacturers into [machines], but the taxpayer's business is not limited to testing [machine] parts. In

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[1]The Audit Division stated that taxpayer will receive a credit or refund of retail sales tax if it provides evidence that such tax has been refunded to its customers.

order for a part to be used on a [machine], for example, it must be certified that it meets certain standards; otherwise, it cannot be used. Sometimes the manufacturers contract with outside businesses to perform the testing and examination; the taxpayer is such a business.

The tests are highly technical in nature. The taxpayer described them as follows:

1. X-Ray: The taxpayer will x-ray an item at the request of the customer. The taxpayer will look at the x-rays and comment upon what "indications" appear in the x-ray. The taxpayer then transfers the x-ray and its comments to the customer.

2. Magnetic Particle Inspection: The taxpayer uses a machine that employs magnetic properties to locate indications in the metal.

3. Macro Etching: The taxpayer cuts, polishes and etches the metal. The purpose is to examine the grain. The grain is important, because the grain limits particular uses to which the metal might be put.

4. Penetrant Inspection: The taxpayer submerges parts into a dye. The dye finds its way into the flaws. The flaws are then illustrated when the part is placed under a black light and inspected.

5. Chem Line: The taxpayer cleans, etches and deoxidizes the metal. (The [assessment] did not reclassify this process.)

6. Passivate Processing: The taxpayer removes contaminants from the surface of stainless steel. (The [assessment] did not reclassify this process.)

7. Abrasive Cleaning: In connection with the activities described above, cleaning is necessary in order to inspect and repair the metal.

(Footnotes omitted.)[2]

Taxpayer performs two types of work: field work and in-house work. In-house work involves customers bringing metal items to taxpayer "for examination." Taxpayer states that this examination is part of the customers' manufacturing processes. Field work entails taxpayer bringing its equipment and technicians to construction sites to "examine[] tangible personal property or fixtures on real property."

Taxpayer may employ one or more of the activities described above in any in-house or field work job, but taxpayer does not itemize its charges for each activity. Rather, taxpayer bids the job based on the average amount of time it estimates will be necessary to cover the job costs.

Det. No. 92-183 affirmed the assessment, which resulted in taxpayer's chem line and passivate processing activities being classified as processing for hire (but see footnote 2, above) and its remaining activities being classified as service.

In its petition for reconsideration, taxpayer raised three arguments with respect to the reclassification issue:[3] (1)

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[2]Although the Audit Division found the chem line and passivate processing to be processing for hire, it did not reclassify this income "since the tax rates are identical." In its petition for reconsideration, taxpayer states that the Audit Division also classified taxpayer's abrasive cleaning income as processing for hire. However, our review of the audit report indicated that the abrasive cleaning income was reclassified as service.

[3]Taxpayer also notes that, after it filed its appeal, the Interpretation and Appeals Division requested the Audit Division to reexamine taxpayer's accounts. According to taxpayer, the Audit Division orally informed taxpayer that its field work should be classified as retailing. However, taxpayer states that the Audit Division did not confirm this at the time Det. No. 92-183 was drafted. Taxpayer states:

> As the auditor disagrees with [taxpayer's] recollection, [taxpayer] is entitled to know what the auditor found in order to know if, upon executive level reconsideration, a reconsidered decision will be premised upon accurate facts.

This reconsideration is based solely on taxpayer's statements at the reconsideration hearing and statements contained in the

taxpayer's activities must be viewed in their entirety and not "bifurcated"; (2) its activities are properly classified as processing for hire, wholesaling, or retailing; and (3) the service classification is a "catch all" provision of last resort.

Use or Deferred Sales Tax on Hand Tank. Taxpayer states that it simply paid a deposit on a hand tank and that it never actually received the hand tank. In its original petition, taxpayer requested that the use or deferred sales tax assessed on this deposit be removed. Det. No. 92-183 did not address this issue.

Application of Payment of Unprotested Portion of Tax to Interest. After filing its original petition, but prior to the issuance of Det. No. 92-183, taxpayer paid the unprotested tax portion of the assessment. This payment was applied first to interest on the entire assessment and then to the unprotested portion of tax. Taxpayer argues that the Department erred in failing to apply the payment entirely to the unprotested tax portion of the assessment.

ISSUES:[4]

1. Whether Det. No. 92-183 erred in classifying taxpayer's in-house and field work as service.

2. Whether use or deferred sales tax applies to an item of tangible personal property that was never delivered to taxpayer.

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original audit report, Det. No. 92-183, and taxpayer's original petition and petition for reconsideration.

[4]At the reconsideration hearing, taxpayer briefly argued that the Department was estopped from reclassifying its income because taxpayer had been reporting under the retailing or wholesaling classification for fifteen years. If taxpayer previously reported its taxes incorrectly, even if the Audit Division overlooked this error in prior audits, taxpayer is not excused from correctly paying its taxes for the audit period under consideration. See, e.g., Kitsap-Mason Dairymen's Assoc. v. Tax Comm'n, 77 Wn.2d 812 (1970); Det. No. 89-482, 8 WTD 293 (1989); Det. No. 89-452, 8 WTD 209 (1989); Det. No. 87-192, 3 WTD 231 (1987); Det. No. 86-285, 1 WTD 331 (1986). Because this principle is well-established, we will not address this issue further.

3. Whether taxpayer's payment of the unprotested tax portion of the assessment was erroneously applied to interest.

DISCUSSION:

[1] Reclassification of Income from Retailing and Wholesaling to Service.

a. Segregation. Det. No. 92-183 did not specifically address the segregation issue. However, Det. No. 92-183 affirmed the assessment, which resulted in some of taxpayer's activities being classified as processing for hire and others being classified as service.

Taxpayer argues that the implicit requirement in Det. No. 92-183 that taxpayer "bifurcate" its income "departs from long standing department policy, classifying a taxpayer by what it primarily does." Taxpayer continues:

> The policy focuses upon the primary nature of the activities and determines a single classification when a taxpayer engages in multiple activities for which a single charge is made. This is true although such activities, when viewed independently, might be in different B&O classifications.

Taxpayer notes that it is not arguing that making a single charge is the basis for choosing a single classification for multiple activities. Taxpayer continues:

> The correct basis for choosing a single classification is practical tax administration for both taxpayers and auditors. In such situations, the Department must exercise judgement to determine a reasonable classification under the circumstances; the test is a tool that reasonably groups multiple activities into a single taxable activity.

(Emphasis original.)

The B&O tax is imposed for the privilege of engaging in business activities. RCW 82.04.220. The tax rate or rates applicable to a particular taxpayer depends upon the type of activity or activities in which it engages, e.g., manufacturing, wholesaling, or retailing. Generally, if a taxpayer engages in activities which are within the purview of two or more tax classifications, it will be taxable under each applicable classification. See RCW 82.04.440; Group Health Coop. v. Department of Rev., 106 Wn.2d 391 (1986).

However, where a taxpayer agrees to perform an activity taxable primarily under a particular classification and only incidentally engages in other activities in furtherance of that activity, the taxpayer will be taxed according to its primary activity. In Final Det. No. 89-433A, 11 WTD 313 (1992), we stated:

> [B]ifurcation of a contract for taxation will be the unusual case. In most cases income from a performance contract will be taxed according to the primary nature of the activity.

See, e.g., ETB 544.04\08.245; ETB 85.08.107; Det. No. 91-163, 11 WTD 203 (1991).

In short, taxpayer's income from its contracts should be taxed according to the primary nature of the work performed under the contracts.[5]

b. Proper Classification of Income. Taxpayer argues that the primary nature of its in-house work is processing for hire or retailing or wholesaling and the primary nature of its field work is retailing or wholesaling.

1. In-house work. RCW 82.04.280 imposes B&O tax on processing for hire. Processing for hire is defined in WAC 458-20-136 (Rule 136) as follows:

> [T]he performance of labor and mechanical services upon materials belonging to others so that as a result a new, different or useful article of tangible personal property is produced for sale or commercial or industrial use. Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon that person's own materials.

See also RCW 82.04.120.

Det. No. 92-183 summarized taxpayer's argument regarding processing for hire as follows:

> The taxpayer argues that it produces a "useful" product because the metal parts are certifiable as a direct

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[5]Simply separating an activity into component activities and entering into a separate contract for each component activity is insufficient to overcome the requirement that the taxpayer be taxed according to its "primary" activity; there must be substance to the charges for individual activities. See, e.g., ETB 373.08.172\135.

result of the taxpayer's examination; otherwise, the parts could not be used and would be "useless:"

> The taxpayer uses labor and mechanical services to screen and clean the raw metal or parts it processes. As a result of the process, the poor quality raw metal or parts can be eliminated. The process upgrades the remaining raw metal or parts, because such metal and parts are now known to be of a certain quality and it is known whether such metal and parts are certifiable. These are things that a manufacturer does in its manufacturing process.

(Emphasis taxpayer's.) Det. No. 92-183 concluded that taxpayer's activities did not constitute processing for hire:

> The testing techniques used by the taxpayer are apparently sophisticated and complex in terms of the machinery that is used, the level of skill that is involved, and the degree of perfection that is tested, but the activities remain, nonetheless, testing. . . .
>
> Using the factors in McDonnell & McDonnell, we conclude that the taxpayer's tests do not substantially change the form, quality, or properties of the metal parts. To the extent that the tests also "clean" the parts, that is not a substantial change in form, quality or property of the metal, and is only incidental to the testing procedure. The tests in and of themselves do not enhance the value of the metal. The taxpayer does not add to or alter the metal. Consequently, the taxpayer's activities during the audit period cannot be classified as "processing for hire."

In its petition for reconsideration, taxpayer argues that Det. No. 92-183 erred in failing to apply or distinguish Alf Christianson Seed Co. v. Department of Rev., BTA Docket No. 28880 (April 19, 1985). In that case, the BTA held that the taxpayer was properly classified as a "processor for hire" because it produced a "new, different, or useful article" by (1) the separation of contaminating seeds of other crops, weeds, and inert matter, (2) the elimination of poor quality seed, and (3) the upgrading of the remaining good seed. Taxpayer argues that the BTA result is "virtually indistinguishable" from its situation: "[Taxpayer] is no different, it separates good parts from bad parts."

We disagree. First, as will be discussed further below, taxpayer's primary activity is more accurately classified as "testing" rather than simply "separating" good parts from bad. Second, the process in Christianson did not simply entail separating good seed from bad; it also "conditioned" the remaining seed. In contrast, the tests performed by taxpayer resulted in no physical, functional, or chemical change in form, quality, or properties of the parts. In short, after the tests, the parts were precisely the same as they were prior to the tests; the testing simply increased the customers' knowledge of the properties of the parts. See, e.g., McDonnell & McDonnell v. State, 62 Wn.2d 553 (1963). (Although parts may have been cleaned as part of the testing process, Det. No. 92-183 correctly held the cleaning to be incidental to the testing.)

While the definition of manufacturing is quite broad, neither the statutes nor rules include testing within the definition. Further, no cases have extended this term to include a process the primary purpose of which is testing. See, e.g., Continental Coffee Co. v. State, 66 Wn.2d 194 (1965)(changing green coffee beans to a roasted and blended coffee); McDonnell, 62 Wn.2d 553 (splitting peas); Bornstein Sea Foods, Inc. v. State, 60 Wn.2d 169 (1962)(cutting whole fish into fish fillets); Stokely-Van Camp, Inc. v. State, 50 Wn.2d 492 (1957)(freezing food); J & J Dunbar & Co. v. State, 40 Wn.2d 763 (1952)(screening and filtering raw whiskey).

Taxpayer further argues that Det. No. 92-183 erred in failing to recognize that the parts had increased in value as the result of the testing:

> The customers cannot install the [parts] . . . without knowing whether the metal meets the necessary strength specifications. The metal is enhanced in value if the customer knows it can safely use or sell the part or metal for a particular purpose.

Even if we agreed that certification enhances the value of the parts, enhancement in value alone is insufficient to qualify an activity as "manufacturing"; the enhancement in value must be indicative of the existence of a "new, different, or useful substance." E.g., McDonnell, 62 Wn.2d at 557.

Taxpayer also implies that its in-house work should be characterized as processing for hire because the services are part of its customers' manufacturing processes. Taxpayer employs similar reasoning in arguing that its in-house activities constitute retailing or wholesaling. Taxpayer argues that its customers are installing parts, and they will not install the parts unless the parts meet certain quality standards; taxpayer's

testing of those parts is therefore in respect to its customers' installation activities. See RCW 82.04.050(2)(a). However, we must analyze taxpayer's activities and tax them accordingly. The fact that taxpayer's customers may be performing manufacturing or retailing activities does not change the nature of taxpayer's activities.

Det. No. 92-183 properly analyzed taxpayer's activities as primarily involving testing, which is subject to the service classification (RCW 82.04.290). See, e.g., WAC 458-20-172 (Rule 172)(persons who perform "mere core drilling of or testing of soil samples" are subject to service B&O tax); WAC 458-20-224 (Rule 224)(the service classification "includes persons rendering professional or personal services to persons (as distinguished from services rendered to personal property of persons) such as . . . appraisers, . . . laboratory operators . . . .").

Taxpayer raised a specific argument with respect to its x-ray activity, i.e., that its customers are actually purchasing the x-rays; the comments are simply provided as a convenience to the customer. Because we have found that taxpayer is primarily in the business of testing and because taxpayer is required to provide comments with the x-rays, we must conclude that the x-rays are simply the medium on which taxpayer's test results are carried. The primary nature of the contract is taxpayer's provision of information, through tests, to customers about their parts.

In short, taxpayer's in-house work primarily involves testing, which the determination properly classified as service. Thus, taxpayer's income from in-house contracts should generally be reported under the service classification. Det. No. 92-183 is affirmed and taxpayer's petition is denied with respect to this issue. However, after paying the assessment, taxpayer may petition for refund if it is able to document that certain of its contracts involved primarily passivate processing, chem line, or other activities which are properly classified under a different classification, such as retailing, wholesaling, or processing for hire. Taxpayer bears the burden of providing sufficient records to prove that the service classification does not apply to all of its contracts. See RCW 82.32.070.

Given the brief description of taxpayer's chem line and passivate processing income, it is difficult to ascertain whether these processes, like the abrasive cleaning, are simply incidental to the tests performed. However, because the Audit Division classified these activities as processing for hire, Det. No. 92-183 did not disturb this classification, and taxpayer did not argue that these activities should be reclassified to service, we will not now disturb their classification. However, if taxpayer

is audited in the future and it is determined that these activities are merely incidental to its testing activities, these activities may be reclassified. This determination shall not be binding precedent that would prohibit such reclassification.

2. Field work. Taxpayer contends its field work should be classified as wholesaling or retailing. Det. No. 92-183 did not specifically address taxpayer's field work. Instead, the determination held that all but two of taxpayer's activities were "testing" activities subject to tax under the service classification.

Taxpayer argues that its field work was performed "in respect to . . . constructing, repairing, [or] . . . improving of . . . buildings or other structures . . . including the installing or attaching of any article of tangible personal property." RCW 82.04.050(2) classifies these activities as retail sales when performed for consumers, and RCW 82.04.060 classifies them as wholesale sales when not performed for consumers. WAC 458-20-170 (Rule 170) provides:

> The term "constructing, repairing, decorating or improving of new or existing buildings or other structures," in addition to its ordinary meaning, includes: . . . the sale of or charge made for all service activities rendered in respect to such constructing, repairing, etc., regardless of whether or not such services are otherwise defined as "sale" by RCW 82.04.040 or "sales at retail" by RCW 82.04.050. Hence, for example, such service charges as engineering fees, architectural fees or supervisory fees are within the term when the services are included within a contract for the construction of a building or structure. The fact that the charge for such services may be shown separately in bid, contract or specifications does not establish the charge as a separate item in computing tax liability.

Simply performing a service with respect to property that will be used in a construction activity is not sufficient to convert that service to a retail sale. Cf. Chicago Bridge & Iron Co. v Department of Rev., 98 Wn.2d 814 (1983); Det. No. 90-123, 11 WTD 45 (1990); Det. No. 90-366, 10 WTD 149 (1990); Det. No. 88-239, 6 WTD 73 (1988); Det. No. 88-39, 5 WTD 125 (1988).

In short, taxpayer's field work does not constitute a service "in respect to construction." Thus, taxpayer's field work will be taxed according to the same criteria applicable to its in-house work.

c. Service Classification as a Classification of "Last Resort." Taxpayer argues that Det. No. 92-183 failed to address its argument that the service classification "is a 'catch all' provision of last resort that applies only when there is no other classification that can apply."

We will not address this issue in detail because we have found (subject to taxpayer providing documentation to the Audit Division to the contrary) that taxpayer's activities do not fall within any of the enumerated classifications and that taxpayer's activities are analogous to those specifically included in the service classification.

[2] Use or Deferred Sales Tax on Hand Tank. Taxpayer simply paid a deposit on a hand tank, which it never received. Taxpayer argues that without possession, there can be no use, and without use, there can be no use tax.

Use tax is imposed for "the privilege of using within this state as a consumer any article of tangible personal property" acquired by certain means. RCW 82.12.020. RCW 82.12.010 provides that "use" shall have its "ordinary meaning" and 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)." "Use" also includes any "act preparatory to subsequent actual use or consumption within this state." Id.; see also WAC 458-20-178 (Rule 178). Thus, taxpayer is basically correct in stating that because it never possessed the hand tank it is not subject to use tax.

Alternatively, the assessment imposed "deferred sales tax" on the deposit. Generally, there must be transfer of ownership, title or possession to constitute a sale for sales tax purposes. See RCW 82.04.040, 82.08.020. Because there was no transfer of ownership, title, or possession of the hand tank to taxpayer, the deposit is not subject to deferred sales tax.

Taxpayer's petition with respect to this issue is granted. The assessment of use or deferred sales tax on the deposit will be deleted from the assessment.

[3] Application of Payment of Unprotested Portion of Tax to Interest. Finally, taxpayer argues that it paid the unprotested portion of tax, but the entire payment was first applied to interest on the entire assessment and then to the unprotested tax portion.

RCW 82.32.080 and WAC 458-20-228 (Rule 228) provide that payments by taxpayers shall be applied "first against penalties and interest, and then upon the tax, "without regard to any direction

of the taxpayer." However, where a taxpayer has filed a timely appeal with the Interpretation and Appeals Division and has sent a payment designated as payment of the unprotested tax portion of the assessment, that payment will be applied first to penalties and interest on only the unprotested portion and then to the unprotested portion of the tax itself.

Taxpayer's petition with respect to this issue is granted. This issue is remanded to the Audit Division for application of the payment as set forth above.

DECISION AND DISPOSITION:

Taxpayer's petition is remanded to the Audit Division for adjustment consistent with this decision and issuance of an adjusted assessment. A penalty of 10% of the tax due and additional interest will be assessed if payment is not received by the due date of the adjusted assessment.

Except as noted above, this determination constitutes the final action by the Department of Revenue. However, taxpayer may petition for a refund in Thurston County Superior Court in accordance with RCW 82.32.180. The Thurston County Superior Court is the only court in the state that has original jurisdiction to hear excise tax matters and where venue is proper.

In the alternative, appeal may be taken to the Board of Tax Appeals (PO Box 40915, Olympia, WA 98504-0915) pursuant to RCW 82.03.190. The petition must be filed with the Board within thirty days of this denial.

DATED this 31st day of August 1993.