Cite as Det. No. 92-044, 13 WTD 51 (1993)

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

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 92-044[1]
. . .	)	Registration No. . . .
	)	Document No. . . .

[1] RULE 178 - USE TAX - DEMONSTRATORS HELD FOR SALE -SOLD AT DISCOUNT - CARRIED ON BOOKS. Even though demonstrators are eventually sold to customers, they are not exempt of use tax when they are carried on the taxpayer's books of account as "demonstrators" or are discounted as used equipment when sold. Accord: ETB 332.12.178.

[2] RULE 178 - USE TAX - DEMONSTRATORS - OUT-OF-STATE USE. If a demonstrator is not actually used as such in this state, it will not be subject to use tax even though a taxpayer's books of account may identify it as demonstrator.

[3] RULE 19301 - MATC - DEMONSTRATORS - INTERVENING USE BETWEEN MANUFACTURE AND SALE. When a taxpayer manufactures a product for ultimate sale with intervening use as a sales demonstrator, it may avail itself of the RCW 82.04.440 multiple activities tax exemption/credit (as applicable).

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: . . .

NATURE OF ACTION:

Petition concerning use tax and the application of multiple activities exemption/credit on demonstrators.

[1] The reconsideration determination, Det. No. 92-044R, is published at 13 WTD 63 (1993).

FACTS:

Bauer, A.L.J.-- The taxpayer's business records were examined for the period January 1, 1983 through June 30, 1986. The above-referenced assessment was issued . . . [and] included interest. The assessment was paid with the exception of [the] amount the taxpayer has protested.

The taxpayer develops and manufactures electronic equipment in Washington. In marketing its equipment, the taxpayer used worldwide sales offices which were, during the audit period, subsidiaries, in addition to its own marketing people. These separate entities, however, operated functionally like one company. These subsidiaries maintained more than one hundred field representatives. Few of the taxpayer's marketing efforts occurred in Washington, although the company is headquartered here and maintains an inventory of demonstrator equipment here.

The auditor assessed use tax and business and occupation tax under the manufacturing classification in Schedule IV of the assessment on the value of the equipment manufactured by the taxpayer and placed in its demonstrator inventory. The Auditor's Detail of Differences and Instructions to the Taxpayer set forth the following rationale:

> In Schedule IV the manufacturing tax has been assessed on the total value of all products manufactured and used for demonstration purposes. Use tax applies only to those products put to use in Washington. Use tax has been assessed on the value of products entered into your domestic demonstrator inventory. The auditors recognize that the domestic demo inventory may include items not put to use in this state or that some duplication may occur due to transfers. Any adjustment to this assessment will require additional records.

The taxpayer represents that all demos used by its field representatives were eventually sold to third party buyers.

The taxpayer explains that demos were placed into a "demo pool" in the taxpayer's accounting records because it allowed the taxpayer to account for and manage the sales activities better, but that all demos were at all times subject to sale.

The taxpayer published a written policy entitled "Demonstration Inventory Accounting Policy" (S.O.P. 3.7) in August 1986, which provides in pertinent part:

> 3.1 Instruments, options and accessories used by the sales force to demonstrate to the customer how these products work are referred to as demo inventory. Since these items are accounted for as inventory it is important that they be sold before they become more than one year old. It is also important that demo inventory be in like-new condition to make a favorable impression on the customer. By rotating the demo inventory before it gets too old this can be accomplished. Early rotation will also help to minimize refurbishment expenses.

3.2 Management believes a reasonable goal for the selling organization is to sell demo inventory before it becomes more than one year old. Since demo inventory is at times more difficult to sell than new equipment, Management goals and objectives will be spread over two years (See paragraph 7.2).

3.3 Generally, as demos become older they have a higher chance of being obsoleted by a new product, they may not have new modifications and they may have a battered appearance. For these reasons it may be necessary to highly discount demo units. To encourage turnover of demo inventory and achievement of corporate goals, its age will be a factor in the variable compensation matrix of subsidiary / branch / region / group General Manager.

* * *

6.2.1 At the end of each quarter demo inventory which is reported to be more than three years old is to be written off the books.

A second policy entitled "Demonstrator/Used Equipment Discount Policy" ("Policy #1.4" dated [October 1988]) provides in pertinent part:

PURPOSE
To give nationwide visibility to all demonstrator and training equipment inventory which is available for sale, thereby increasing the probability that it will be sold for reasonable prices instead of being written off.

POLICY
All reasonable efforts shall be made to sell demos and training inventory in the field. Unsold equipment is to be returned to the factory pool of used equipment 18 months after the original shipment date. . . . Equipment with no market value shall be scrapped in the field.

Necessary refurbishment of returned equipment will be performed at the factory and the costs will be charged back to the sending organization. If the item isn't sold before it is 36 months old, it is expensed to the sending organization.

The U.S. Sales and Applications department will manage the factory pool of used equipment. All products in the pool will be sold with the standard new equipment warranty.

Sale price for Demos at market value is determined by equipment age, condition and new product delivery. Full price may be appropriate. New demos are never sold at a discount.

After determining that it is necessary to offer a discount in order to sell available equipment, whether in the field or in the pool, the following discounts may be applied without further approvals:

AGE DISCOUNT	
2 - 6 months	7%
6 - 12 months	10%
12 - 18 months	15%
Over 18 months	20%

Sales of used demo equipment at a discount greater than listed above must have prior approval of the Commercial Sales Manager, or Regional General Manager if equipment is in that region's Demo Inventory.

GUIDELINES AND GENERAL INFORMATION

When customers for used products are found, contact the Sales and Application Department to assure availability and arrange for the products to be reserved. A reservation number, to be used when placing the order, will be assigned. . . .

TAXPAYER'S EXCEPTIONS:

Petition #1.

In its first petition, the taxpayer objected to the imposition of $ . . . of use tax on all finished goods debited to the taxpayer's domestic demonstrator ("demo") pool. The taxpayer acknowledged the application of the use tax based upon the value of the products manufactured and used and the manufacturing business and occupation tax. However, it disagreed with the method used to assess these taxes, since each and every debit to the demo pool was assessed tax.

The taxpayer argued that the auditor's procedure resulted in a greatly overstated assessment for the following reasons:

First, the taxpayer argued that not all demos were used within Washington. Some were stored in Washington, but only used at out-of-state locations (trade shows, conventions, etc.).

Second, demos were frequently removed from the pool, refurbished and then moved back into the pool. This, according to the taxpayer, resulted in the same demo being assessed use tax more than once.

Third, demos were sometimes removed from the pool and either expensed or capitalized, with use tax being automatically charged within the taxpayer's accounting system and paid to the State at that time. To tax those demos again through the audit would be double taxation.

Fourth, some demos would be sold to subsidiaries and others might be returned from subsidiaries. Any demo being returned would be taxed twice if it were sold out of the domestic pool.

The taxpayer made two proposals at the time of the audit: (1) that a formula be used for the demo pool (as is done in the auto industry), or (2) the taxpayer pay tax on the net increases in the finished goods demo pool rather than the gross increases. The auditors rejected these proposals, and the resulting assessment ensued.

The taxpayer contended that assessing tax on the net increases would allow tax on a base and then only on future positive additions; all the activity going in and out of the pool would not be assessed as this would result in the same demo being taxed over and over. The auditors declined to adopt either of the taxpayer's proposals.

In its first petition, the taxpayer requested that the Department review the two proposals outlined above, and accordingly grant relief.

Petitions #2 and #3.

After filing the original petition, the taxpayer submitted a second petition requesting (1) refund . . . of use tax and . . . of manufacturing business and occupation tax paid in 1985 on finished goods classified as demonstrators, and (2) total cancellation of the assessment already appealed in its first petition. A third petition was submitted petitioning for [a higher] refund . . . of use tax and . . . manufacturing business and occupation tax paid in 1986 on finished goods classified as demonstrators. The taxpayer subsequently recognized that the third petition was duplicative and otherwise filed by error and requested it be dismissed.

The taxpayer argued that the goods classified as demonstrators were at all times themselves available for sale and, moreover, were in fact sold. Or, in the rare case where one was not sold, it was capitalized or expensed on its accounting records with tax paid at that time. The taxpayer cites WAC 458-20-132, ETB 61.12.178, and ETB 332.12.178, arguing that items displayed which are themselves available for sale are not subject to use tax. Therefore, the taxpayer now contends it is entitled to a full refund of use and manufacturing tax amounts paid on such items as well as the cancellation of the above-referenced assessment.

ISSUES:

1. Is use tax properly due on demonstrators if they were at all times available for sale to customers and were, in fact, actually sold?

2. Is use tax properly due on demonstrators carried on the taxpayer's books of account as "demonstrators" if they are not used in the state of Washington as such.

3. Assuming questions 1 or 2 are answered affirmatively, would either of the following methods proposed by the taxpayer be appropriate in order to preclude duplication of taxes as demos move in and out of the demo pool and are used out-of-state:

(1) a formula for the demo pool similar to that in the auto industry, or

(2) the payment of tax on the net increases in the finished goods demo pool rather than the gross increases (all debits without relief for any credits)?

4. In light of the RCW 82.04.440 exemption and credit, was manufacturing business and occupation tax properly due on demonstrators if they were at all times available for sale to customers and were in fact actually sold?

DISCUSSION:

ETB 61.12.178 (ETB 61) reads:

USE TAX AND GOODS DEMONSTRATED
IN THE PROCESS OF SALE

> Are machines which are a part of the regular stock of goods available for sale, but which are also used for demonstration purposes by company salesmen subject to Use Tax liability?
>
> Taxpayer employed salesmen who were provided with a stock of goods for sale. None of the machines was issued to the salesmen for the particular purpose of serving as demonstration models and all machines were available for sale in the regular course of business. The company policy was to sell the machine displayed and demonstrated.
>
> The taxpayer was using a specific machine for demonstration purposes only in connection with efforts to sell that same machine. As such the Use Tax was not applicable as the demonstration was a part of the retail sale process, and not a separate use of the machine by the taxpayer.

(Emphasis added.)

The taxpayer relies particularly on the language in the last paragraph of this ETB, reasoning that use tax should not apply to its demonstrators at all because they are ultimately sold.

ETB 332.12.178 (ETB 332), however, provides:

USE TAX ON DISPLAY MERCHANDISE

> The Use Tax applies to articles which are substantially used for sales promotion purposes. This includes automobiles, boats or appliances regularly used as demonstrators, display advertising materials, samples or advertising material given away to customers, and samples carried by salesmen.

> The tax is not applicable to the brief and superficial use which occurs when articles held for sale are displayed in single trade shows (boat shows, home shows, auto shows, agricultural fairs, conventions, etc.) for short periods, or are used in floor or window displays, and are thereafter sold as new merchandise.
>
> As a general guide, such articles will be deemed to have been substantially used, and subject to the Use Tax, when carried in the taxpayer's books of account as demonstrator or display merchandise, or when so extensively used for demonstration or display purposes that they can no longer be sold as new merchandise.

(Emphasis added.)

The taxpayer is of the opinion that this latter ETB is less correct than ETB 61. We think, however, that it is directly applicable to the taxpayer's situation. Not only are the taxpayer's demonstrators carried in the taxpayer's books of account as demonstrator merchandise, but, by its own policies, the taxpayer "highly discount[s]" its demonstrators beginning only after two months' use because they can no longer be sold as new merchandise.

[1] Therefore, we hold that, even though demonstrators are eventually sold to customers, they are not exempt of use tax when they are carried on the taxpayer's books of account as "demonstrators" or are discounted as used equipment when sold.

[2] We agree with the taxpayer, however, that, if a demonstrator is not actually used as such in this state, it will not be subject to use tax even though a taxpayer's books of account may identify it as a demonstrator. Thus, items of equipment carried in the taxpayer's books as "demonstrators" which were not actually used as demonstrators in Washington[2] will be exempt of Washington's use tax.

As to the third issue, the taxpayer has requested that a formulary approach be approved by the Department in order to preclude duplication of taxes as demos move in and out of the demo pool and are used out-of-state. The taxpayer has suggested one similar to that used in the auto industry, or the payment of tax on the net increases in the finished goods demo pool rather than the gross increases (all debits without relief for any credits).

WAC 458-20-132 provides the formula for the taxation of automobiles used by dealers for demonstration purposes. This formula is based on the assumption that a dealer could receive the benefit of the retail sales tax "trade in" provision when an automobile is transferred from demonstrator use back to inventory. Automobiles are assumed to be taken out of demonstrator service and placed into sales inventory at the same time as another car is removed from sales inventory and placed in demonstrator use. The rule provides in part:

> The use of demonstrators is subject to the use tax on the basis of one demonstrator for each one hundred new automobiles and pickup trucks, or fractional part of such

[2] Or stored preparatory to use in Washington.

> number, of all makes or models sold at retail including lease transactions during a calendar year.

Because this rule applies specifically to automobile dealers who rotate vehicles used as demonstrators more frequently than the taxpayer, we hold it to be inapplicable in this case.

We likewise hold that any other formulary approach would be inappropriate in light of the fact that a majority of the demonstrators are apparently not used in Washington and are accordingly not use taxable.

The taxpayer has enumerated certain problems of items moving into demonstrator use, moving out to be refurbished, and then returning, resulting in a possible multiple assertion of tax. Similarly, there appears to be a problem with items removed from demonstrator use and expensed or capitalized with use tax again being paid at that latter time. Added to these difficulties will be the tracking of the multiple activities credits.

The taxpayer will need to address and resolve these identification problems through its own records.

The fourth issue is whether manufacturing business and occupation tax was due on demonstrators during the audit period since they were at all times available for sale to customers and were in fact actually sold and wholesaling or retailing B&O tax paid.

The taxpayer takes the position that, because it manufactured a product destined for ultimate sale with intervening use only as a sales demonstrator, it may avail itself of the RCW 82.04.440 multiple activities tax exemption prior to June 23, 1987, or the RCW 82.04.440 multiple activities tax credit thereafter.

Prior to June 23, 1987, RCW 82.04.440 provided a multiple activities tax exemption. This read in part:

> Every person engaged in activities which are within the purview of the provisions of two or more of sections RCW 82.04.230 to 82.04.290, inclusive, shall be taxable under each paragraph applicable to the activities engaged in: Provided, That persons taxable under RCW 82.04.250 [retailing] or 82.04.270 [wholesaling] shall not be taxable under RCW . . . 82.04.240 [manufacturing]. . .[3]

WAC 458-20-136 provided in part as follows:

> (6) BUSINESS AND OCCUPATION TAX. Persons who manufacture products in this state and sell the same at retail in this state are subject to the business and occupation tax under the classification retailing and those who sell such products at wholesale in this state are taxable under the classification wholesaling-all others. Persons taxable under the classification retailing and wholesaling-all others are not

[3] RCW 82.04.240, by reference to RCW 82.04.120, includes those who manufacture for commercial or industrial use.

> taxable under the classification manufacturing with respect to the manufacturing of products so sold within this state.

The Washington Supreme Court in Crown Zellerbach v. State, 45 Wn. 2d 749 (1954), in construing the multiple activities exemption, stated in part:

> Before analyzing and discussing the pros and cons of this appeal any further, we shall make an observation that may seem like oversimplification, and perhaps it is. However, in it lies, we think, the crux of this entire matter. The observation is simply this: The legislative purpose, or tax policy, of the above-quoted statutes [RCW 82.04.230,-240,-270,-440] is to provide for as equitable an imposition of actual tax liability as possible in so far as our state business and occupation tax is concerned. Implicit in this policy is the avoidance of an imposition of double or triple tax liability as to particular products. In other words, the policy is to impose actual liability for payment of tax only once -- on either (a) extracting, or (b) manufacturing, or (c) wholesaling. Thus, actual liability for the payment of the business and occupation tax is the key to the problem. The corollary of this policy is that actual liability for business and occupation tax be imposed on at least one activity.
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> * * *
>
> Indeed, the exemption section, RCW 82.04.440, is phrased in terms of such tax status. The classification, on its face, appears to have the soundest of policy reasons to support it, namely, the avoidance of double taxation.

(Emphasis the court's.)

After the multiple activities exemption was found to be unconstitutional on June 23, 1987, the RCW 82.04.440 exemption became a credit provision:

> (1) Every person engaged in activities which are within the purview of the provisions of two or more of sections RCW 82.04.230 to 82.04.290, inclusive, shall be taxable under each paragraph applicable to the activities engaged in.
>
> (2) Persons taxable under RCW 82.04.250 [retailing] or 82.04.270 [wholesaling] shall be allowed a credit against those taxes for any (a) manufacturing taxes[4] paid with respect to the manufacturing of products so sold in this state, . . . The amount of the credit shall not exceed the tax liability arising under this chapter with respect to the sale of those products. . . .

WAC 458-20-19301, in part, implements the new credit provision as follows:

[4] RCW 82.04.240, by reference to RCW 82.04.120, includes those who manufacture for commercial or industrial use.

> . . . This tax credits system replaces the multiple activities exemption which, formerly, assured that the gross receipts tax would be paid only once by persons engaged in more than one taxable activity in this state in connection with the same end products. . . .
>
> * * *
>
> Internal tax credits arise from multiple business activities performed entirely within this state, all of which are now subject to tax, but with the integrated credits offsetting the liabilities so that tax is only paid once on gross receipts. Under this system Washington . . . manufacturers who sell their products in this state at wholesale and/or retail must report the value of products or gross receipts under each applicable tax classification. Credits may then be taken in the amount of the extracting and/or manufacturing tax paid to offset the selling taxes due. . . .
>
> * * *
>
> (h) Products manufactured in Washington are sold in Washington. Again, the payment of the manufacturing tax reported may be credited against the selling tax (wholesaling and/or retailing business and occupation tax) reported.
>
> * * *
>
> (4) Eligibility for taking credits. Statutory law places the following eligibility requirements and limitations upon the MATC system.
>
> (a) The amount of the credit(s), however derived, may not exceed the Washington tax liability against which the credit(s) may be used. Any excess of credit(s) over liability may not be carried over or used for any purpose.
>
> * * *
>
> (c) The taxes which give rise to the credit(s) must be actually paid before credit may be claimed against any other tax liability. Tax liability merely accrued is not creditable.
>
> (d) The business activity subject to tax, and against which credit(s) is claimed, must involve the same ingredients or product upon which the tax giving rise to the credit(s) was paid. The credits must be product- specific.

[3] We agree that, when a manufacturer has manufactured a product in Washington destined for ultimate sale in Washington with intervening use as a sales demonstrator, it may avail itself of the RCW 82.04.440 multiple activities tax exemption prior to June 23, 1987, or the RCW 82.04.440 multiple activities tax credit thereafter. There is no reason in law or policy to deny this treatment in such an instance when the product is clearly destined for sale.

Audit staff will perform the adjustments necessary to allow for the RCW 82.04.440 multiple activities exemption and credit. The following special reporting instructions will be applicable in calculating the multiple activities tax credit in this situation: Manufacturing tax will be reported and paid on a demonstrator's value at the time it is identified as a demonstrator. At the time that demonstrator is sold, retailing tax will be reportable on its selling price. A credit may then be taken against this selling tax in the amount of the manufacturing tax previously paid on that demonstrator (such credit not to exceed the amount of the selling tax).

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part. Audit will make the necessary adjustments as supported by the taxpayer's own records.

DATED this 28th day of January 1992.