

Cite as Det. No. 94-255, 14 WTD 092 (1994).

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. 94-255
)	
. . .)	Registration No. . . .
)	FY. . ./Audit No. . . .

RULE 136; RCW 82.04.120: MANUFACTURING TAX --
DEFINITION -- COMPRESSING HAY FOR SHIPMENT. The
business activity of purchasing and compressing hay for
shipping purposes is not a manufacturing activity
because it does not result in a new, different or
useful substance.

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:

An agricultural commodities dealer protests the assessment of manufacturing B&O tax on its hay compressing activities.

FACTS:

Okimoto, A.L.J. -- Taxpayer is a broker and seller of baled alfalfa and grass (hay). Taxpayer's books and records were examined by a Department of Revenue (Department) auditor for the period January 1, 1989 through June 30, 1993.¹

Schedule II: Unreported Manufacturing

¹Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

In this schedule, the Audit Division assessed manufacturing B&O tax on Taxpayer's sales of compressed hay bales to foreign customers.

Taxpayer explained that it purchases 140 pound bales of hay from farmers and upon delivery places the bales into a compressor. Taxpayer stresses that no foreign substances or materials are added to the pure hay. Hydraulic presses then compress the bales into approximately one half their original length while maintaining the same approximate girth. These compressed bales are then cut into two 70 pound bales, wrapped in plastic, packed into export containers, and shipped to Taxpayer's overseas customers.

Taxpayer stresses that no physical change involving grinding or cubing occurs. The bale is merely compressed into a more convenient size for shipping. In fact, Taxpayer's customers prefer the natural unground hay, because it is a more efficient source of feed for their milk production business. Furthermore, Taxpayer testified that it makes no difference to its customers whether the hay bales are compressed or not. The customers use both compressed and uncompressed hay in the exact same manner, i.e. as livestock feed.

Taxpayer relies on the following Board of Tax Appeal cases in support of its position; Smith and Ardussi, Inc. v. Washington State Dep't of Rev., BTA Docket No. 42140 (1994); Custom Apple Packers Quincy, Inc. v. Washington State Dep't of Rev., BTA Docket No. 39498, 11 WTD 289 (1991) and W.R. Grace & Company v. Department of Rev., BTA Docket No. 10700 (1976).

Schedules IV: Capital Asset Invoices Not Found

In this schedule, the Audit Division assessed use and/or deferred sales tax on capital asset additions for which Taxpayer could not document as having paid retail sales tax. Since the original audit was submitted, Taxpayer has located additional documentation and submitted it for our review. Because this is primarily a factual issue, we have referred the submitted documentation to the Audit Division for verification and/or adjustment.

ISSUE:

Does compressing and cutting bales of hay into approximately 1/4 of their original size for shipping purposes constitute manufacturing within the meaning of RCW 82.04.120?

DISCUSSION:

Persons who manufacture in this state and sell outside the state are taxable under the manufacturing classification of the B&O tax based upon the value of the articles manufactured. RCW 82.04.240; WAC 458-20-136 (Rule 136). RCW 82.04.120 contains the broad statutory definition of manufacturing:

"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

Rule 136 continues:

[Manufacturing] means the business of producing articles for sale, or for commercial or industrial use from raw materials or prepared materials by giving these matters new forms, qualities, properties, or combinations.

In Bornstein Sea Foods, Inc. v. State, 60 Wn.2d 169, 175, 373 P.2d 483 (1962), the Washington State Supreme Court articulated the test for determining whether a new, different and useful article has been produced:

[W]hether 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.

In McDonnell & McDonnell v. State, 62 Wn.2d 553, 557, 383 P.2d 905 (1963), the court set forth specific elements to be considered in comparing the product before and after a taxpayer completes its activities:

[C]hanges 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."

The issue then becomes whether compressing, halving, and plastic-wrapping hay bales results in a "significant change" when the compressed and plastic-wrapped bales are compared with the uncompressed bales used to form them.

Applying the test in McDonnell, we first note that there is only a minor change in form from the 140 pound uncompressed bales to 70 pound compressed bales. There is also no change in quality. The compressed hay is exactly the same as the uncompressed hay. We further note that the extent of the processing is minimal. Next, we note that there is no change in properties, either of a chemical, physical, or functional nature. Indeed, Taxpayer specifically refrains from such changes in order to preserve the hay in its more natural and digestible state².

Enhancement of value also must be considered. Taxpayer acknowledges that it receives three dollars more per thousand pounds of compressed hay than uncompressed hay. Therefore, there does appear to be some enhancement of value. Finally, although Taxpayer ships and sells much more compressed hay than uncompressed hay, it is unclear whether this increased volume results from an increased demand for compressed hay, or merely from the economics of shipping costs. After balancing all of the above factors, we believe that Taxpayer's activity of compressing hay bales does not result in a new, different, or useful article of tangible personal property within the meaning of RCW 82.04.120.

We find this activity to be clearly distinguishable from the "hay cubing" activity described in ETB 565.04.136/209 (ETB 565) and the Board of Tax Appeals (BTA) case relied upon by the Audit Division³. Hay cubing involves both the addition and/or subtraction of additional moisture, and an extensive amount of processing which results in significant changes in form, demand, and value. Instead, we find Taxpayer's hay compressing activity more similar to the sulfur "prilling" process in the BTA case Smith and Ardussi, Inc. v. Department of Rev., BTA Docket No. 42140 (1994). That taxpayer purchased molten sulfur, reformed it into prills, stored the prills, and subsequently sold and exported the prills overseas. The sulfur prills were formed by a machine which pumped molten sulfur through a "shower-head type nozzle" into a large cooling tub of water. The water solidified the molten sulfur into "small but irregular pebbles of pure elemental sulfur." The sulfur was prilled because of the expense involved in storing and shipping molten sulfur and not to make it

²Taxpayer testified that the prickling action of coarse natural hay fibers within the cows stomach stimulates the production of certain acids, thereby aiding digestion.

³The Audit Division referred to the case of P.J. Taggares, dba Taggares Fertilizer Company vs. Department of Rev., Docket No. 10866, (1975) in its audit report.

more useful to the ultimate consumer. Before using the sulfur, the ultimate consumers returned the sulfur to its molten form. The BTA noted:

As a practical matter, the cooling of sulfur has nothing to do with its usefulness to the buyer. [The taxpayer] cools the sulfur to make handling and transporting the sulfur more convenient for [the taxpayer.]

Similarly, Taxpayer compresses the hay bales solely for its own economics of transportation. The compressed hay is not significantly more useful to Taxpayer's customers since it is used for exactly the same purpose as uncompressed hay. For the above reasons, we find that Taxpayer's activity of compressing hay does not result in a new, different, or useful substance and is not taxable under the manufacturing-other B&O tax classification. Accordingly, Taxpayer's petition is granted on this issue.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part and remanded in part. Taxpayer's file shall be remanded to the Audit Division for the proper adjustments consistent with this determination.

DATED this 29th day of November, 1994.