

Cite as 2 WTD 219 (1986)

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

In the Matter of the Petition )	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u> <u>N</u>
for Correction of Assessment )	
)	No. 87-45
)	
. . . )	Registration No. . . .
)	Tax Assessment No. . . .
)	
)	

[1] **RULE 136, RULE 134 and RCW 82.04.240:** BUSINESS AND OCCUPATION TAX - MANUFACTURING - COMMERCIAL OR INDUSTRIAL USE - SIGNS. A taxpayer primarily engaged in retailing, which internally produces signs and other display materials for use in its stores, is engaged in manufacturing under the business and occupation tax.

[2] **RULE 136, RULE 134 and RCW 82.12.020:** USE TAX - MANUFACTURED PROPERTY - COMMERCIAL OR INDUSTRIAL USE - SIGNS - DISPLAY MATERIALS. A taxpayer which manufactures signs for its own use in its retail stores is liable for use tax on the "value of the articles so used."

[3] **RULE 134 and RULE 112:** BUSINESS AND OCCUPATION TAX - MANUFACTURING - COMMERCIAL OR INDUSTRIAL USE - MEASURE - "VALUE OF PRODUCT" - COSTS. When it is not possible to determine with any reasonable accuracy the "gross proceeds from other sales at comparable locations in this state of similar products of like quality and character," the Department may determine the "value of product" on a cost basis. The fact that salaries and other overhead may be a substantial portion of those costs does not render the tax to be a tax on salaries and other intangibles.

[4] **RULE 134, RULE 178 and RULE 112:** USE TAX - MANUFACTURED PRODUCTS - COMMERCIAL OR INDUSTRIAL USE

- MEASURE - "VALUE OF THE ARTICLES USED" - COSTS. When it is not possible to determine the "retail selling price, at the place of use, of similar products of like quality, quantity and character," under the provisions of Rule 178, the standard of determining value on a cost basis as set forth in Rule 112 may be used. The fact that salaries and other overhead may account for a substantial portion of such costs does not render the tax to be a tax on salaries or other intangibles.

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: November 18, 1985

#### NATURE OF ACTION:

As a result of an audit, the taxpayer was assessed business and occupation and use tax upon internal sign making and the production of other display items.

#### FACTS:

Burroughs, A.L.J.-- The Department of Revenue examined the business records of the taxpayer (. . . ), a retail seller, for the period of July 1, 1980 to June 30, 1984. As a result of this and a supplemental audit, the Department issued a final tax assessment on August 1, 1985 assessing excise tax liability in the amount of \$. . . and interest in the amount of \$. . . , for a total amount due of \$. . . . A check for \$. . . was received by the Department on September 3, 1985 in satisfaction of unprotested amounts due.

The taxpayer is primarily engaged in this state as a retailer.

#### ISSUES:

Four issues are before us for resolution in this appeal: First, whether the Manufacturing classification of the business and occupation tax is applicable to the internal making of signs and other items of display used in its retail stores. Second, whether use tax on those signs and displays

is due. Third and fourth, if such taxes are due, whether the amounts assessed were proper.

TAXPAYER'S EXCEPTIONS:

The taxpayer's petition dated August 29, 1985 reads in pertinent part as follows:

We do not agree with the assessment of tax (both Business & Occupation Tax and Use Tax) upon internal sign making and display activities. Accordingly, we respectfully petition the Department of Revenue for a correction of the amount of the assessment.

Internal sign making and display activities of a retailer are not subject to either Business & Occupation Tax or use Tax. Internal sign making and display activities do not constitute manufacturing or processing as to be subject to the Business & Occupation Tax nor should internal labor and overhead charges constitute an appropriate use taxable measure. Pursuant to RCW 82.12.020 a use Tax can only be applied to any article of tangible personal property produced or manufactured by the person using same. As indicated above, the making of signs for use in [the taxpayer] does not constitute "manufacturing" or "production" within the meaning of those terms. These factors notwithstanding, we also believe that the estimated labor and overhead amounts used to calculate the tax deficiency are overstated.

At the hearing, the taxpayer pointed out that it is a retailer and not a manufacturer. It then argued that RCW 82.12.020 specifically indicates that the use tax is applicable to the "consumption of personal property." The taxpayer argues that in using the cost of intangible labor and overhead in arriving at a dollar figure, the Department is taxing intangibles and not tangible personal property.

It was explained by one of the taxpayer's representatives that, of the more than fifty stores covered by the audit, he operates seventeen stores in the Puget Sound area - some of the largest and smallest stores in the country. That taxpayer's representative testified that he had personally had experience working in all sizes of stores, and knows display activities. Among the variables which determine how many sign

and display people that are needed in a store are the size and square footage of the store, and its sales volume size.

Thus, in the taxpayer's very small stores, there is normally not a display department. In the store at South Center outside of Seattle, one department consists of one supervisor, three presentation specialists (display people), and one person assigned to sign making. A few extra people are added at Christmas. In the Tacoma store, there is essentially the same mix of people. The Northgate mall store has one supervisor, two presentation specialists, and one sign maker. At three other stores, there are one supervisor, one and a half display people, and one sign maker. And so on down to the smaller stores where there may be only one display person.

Every store does not have a sign maker; normally stores doing \$5 million or less in business have no such staff. Such stores order signs from the taxpayer in New York on which use tax is paid. Smaller stores do use mannequins and bust forms.

The taxpayer contends that the auditor's determination that fifty per cent of the salaries of all display department personnel should be determinative in the calculation of the correct measure of the taxpayer's "manufacturing" activities was an inflated "guess." The taxpayer has explained that the supervisor in the larger stores spends almost no time in "manufacturing," and that display people spend most of their time dressing mannequins. Sign makers normally spend only fifty per cent of their time actually making signs or other display items - the other half of their time is spent taking signs to departments and helping with display areas. In those stores which only employ one person, maybe only twenty per cent of that person's time is spent in signmaking, and the rest of his or her time in working with mannequins and other display items.

The taxpayer buys display racks, tables, and other assorted items ready made, so there is little time spent in building or assembling anything of that nature. The taxpayer noted that this is a different situation from that of another major retailer which the Department has audited.

The taxpayer contends that other retail stores were assessed differently. The taxpayer argues that it had originally overestimated for the auditor both the salaries of display personnel and the percentage of time used by these employees on signmaking and other manufacturing activities. The

taxpayer additionally argues that overhead should not be based on 100% of display salaries.

The taxpayer's representative after the audit solicited more detailed information from the individual stores, asking for a total of sales and display salaries for 1983. The information received did not correspond to the estimates originally given the auditor (reflected in column 5 of page 14 of 15, and on page 1 of 15, Schedule III), which totalled \$1,685,661.

The taxpayer's representative proposes that total salaries, as he has now computed them, equal \$643,912 and that this should be multiplied by 10% (instead of 50%), because that is an accurate assessment of how much time is spent by these employees in the manufacturing activity. As to overhead, instead of using a factor of 100% of display salaries, the taxpayer states the percentage applied should be 54% (total operating expenses excluding salaries divided by total salaries), which it claims is more in line with the percentage which was applied to several other comparable Washington retailers named at the hearing.

The taxpayer has proposed ratios to replace page 1 of 15, Schedule III, as follows:

#### RATIOS

Actual advertising and Display salaries	\$	
<u>643,912</u> = 1.2%		
Total Washington salaries		
52,972,000		
Total Operating Expenses	\$	
28,684,000		
Advertising	and	Display
<u>1.2</u>		factor
		\$
344,208		
Salaries	\$	
643,912		
Overhead		
<u>344,208</u>		
		\$
988,120		
Actual		factor
<u>10%</u>		

Basis for tax  
98,812

\$

#### DISCUSSION:

RCW 82.04.240 imposes a tax on manufacturers:

Upon every person . . . engaging within this state in business as a manufacturer; as to such persons the amount of the tax with respect to such business shall be equal to the value of the products, including byproducts, manufactured, multiplied by the rate of forty-four one-hundredths of one percent. (Emphasis added.)

RCW 82.04.110 provides a definition of "manufacturer:"

"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. . . . (Emphasis added.)

RCW 82.04.120 further provides:

"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, and shall include the production or fabrication of special made or custom made articles. . . . (Emphasis added.)

RCW 82.12.020 imposes the use tax:

There is hereby levied and there shall be collected from every person in this state a tax or excise for the privilege of using within this state as a consumer any article of tangible personal property purchased at retail, or acquired by lease, gift, repossession, or bailment, or extracted or produced or manufactured by the person so using the same, . . . (Emphasis added.)

WAC 458-20-136 (Rule 136) and WAC 458-20-134 (Rule 134) in pertinent parts, as they were in effect during the audit period, implement the above-cited statutes and further illustrate the meaning of "manufacturing" and "commercial or industrial use." Rule 136 provides as follows:

...[The term "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. It includes such activities as making, fabricating, processing, refining, mixing, slaughtering, packing, curing, aging, canning, etc. It includes also the preparing, packaging and freezing of fresh fruits, vegetables, fish, meats and other food products, the making of custom made suits, dresses, and coats, and also awnings, blinds, boats, curtains, draperies, rugs, and tanks, and other articles constructed or made to order. It also includes the generation or production of electrical energy for resale or consumption outside the state.

The word "manufacturer" means every person who, from his own materials or ingredients manufactures for sale, or for commercial or industrial use any articles, substance or commodity either:

1. Directly, or
2. By contracting with others for the necessary labor or mechanical services.

. . . .

MANUFACTURING FOR COMMERCIAL USE. Persons who manufacture products in this state for commercial or industrial use are taxable under the classification manufacturing on the value of the products used. (See WAC 458-20-134 for definition of commercial or industrial use.)

Rule 134 provides in pertinent part as follows:

"The term 'commercial or industrial use' means the following uses of products, including by-products, by the extractor or manufacturer thereof: (1) Any use as a consumer; and (2) The manufacturing of

articles, substances or commodities." (RCW 82.04.130).

Following are examples of commercial or industrial use;

1. The use of lumber by the manufacturer thereof to build a shed for his own use.
2. The use of a motor truck by the manufacturer thereof as a service truck for himself.
3. The use by a boat manufacturer of patterns, jigs and dies which he has manufactured.
4. The use by a contractor building or improving a publicly owned road of crushed rock or pit run gravel which he has extracted.

#### BUSINESS AND OCCUPATION TAX

Persons manufacturing or extracting tangible personal property for commercial or industrial use are subject to tax under the classifications manufacturing or extracting, as the case may be. "The tax is measured by the value of the product manufactured or extracted and used. (See WAC 458-20-112 for definition and explanation of value or products.)

#### USE TAX

Persons manufacturing or extracting tangible personal property for commercial or industrial use are subject to use tax on the value of the articles used. (See WAC 458-20-178 for further explanation of the use tax and definition of value of the article used.)

. . .

[1] In this case the taxpayer, through its employees, applied labor and skill to materials in order to internally produce signs, each of which was a "new, different or useful ... article of tangible personal property," for use in its retail



stores. Such activity clearly constitutes "manufacturing" under the business and occupation tax, and is taxable under the manufacturing classification of the business and occupation tax. It needs to be pointed out that, under the law, a taxpayer need not be engaged primarily in manufacturing to be a manufacturer. The business and occupation tax looks to all of a taxpayer's activities, and taxes them accordingly. In this case, the taxpayer, which is primarily a retailer, is also engaged in the activity of manufacturing.

[2] Because the taxpayer has manufactured the signs for its own "commercial or industrial use," it is subject to use tax on the "value of the articles so used." This is in addition to the retail sales and use taxes paid on the materials which went into the manufactured product, because the subsequent use of the manufactured article itself must be distinguished from the use of the material in making the product.

The taxpayer has questioned the calculation of the tax measure - "value of products" - used by the auditor in arriving at the amount of business and occupation tax due. WAC 458-20-112 (Rule 112) describes how "value of products" is to be calculated:

The law provides that where products extracted or manufactured are

(1) For commercial or industrial use (by the extractor or manufacturer - see WAC 458-20-134). . . ; the value shall correspond as nearly as possible to the gross proceeds from other sales at comparable locations in this state of similar products of like quality and character, in similar quantities, under comparable conditions of sale, to comparable purchasers, and shall include subsidies and bonuses.

In the absence of sales of similar products as a guide to value, such value may be determined upon a cost basis. In such cases, there shall be included every item of cost attributable to the particular article or article extracted or manufactured, including direct and indirect overhead costs.

[3] Thus, when it is not possible to determine with any reasonable accuracy the "gross proceeds from other sales at comparable locations in this state of similar products of like quality and character....," the value may be determined upon a cost basis.

It is our understanding that, at the time of the audit, it was not possible to determine with any accuracy the quantity and types of signs and other display items which had been manufactured during the test period, nor the relative value of each. The auditor therefore based his calculations of value on the costs incurred by the taxpayer in manufacturing them. This procedure was correct. The fact that salaries and other overhead were a substantial portion of those costs included in the calculation of the manufacturing measure does not render the tax to be a tax on salaries, and not the manufacturing activity itself.

The taxpayer has specifically questioned those amounts used in arriving at the tax measure, namely: (1) sales and display salaries for test year 1983, (2) that calculation of the percentage of time spent by sales and display employees on the manufacturing activity, (3) the calculation of overhead.

As to the salaries, we have examined those figures presented at the hearing as representing salaries paid to sales and display personnel. Therefore, that factor will be changed from \$1,685,661 to \$643,912.

As to auditor's determination that fifty per cent of salaried time is spent in the manufacturing activity, the taxpayer contends that ten per cent is representative. There is no documentation available to support either position.

Even taking into consideration the taxpayer's testimony and arguments on this point, we find it difficult to accept the assertion that only ten per cent of salaried time was spent carrying out such a primary function of the sales and display department, a function which gives rise to the position name of a majority of such employees, i.e., sign making. In so stating, we are cognizant of the fact that supervisory personnel presumably do not spend a significant amount of their time in the manufacturing activity itself, and that even sign makers themselves have other duties and function.

We will, based on the taxpayer's testimony, direct that the factor be adjusted to twenty-five per cent for this audit period only. For subsequent periods, documentation as to the percentage of time spent in the manufacturing activity will be required.

Pursuant to its objection regarding the auditor's estimate that the overhead factor was 100% of display department salaries, the taxpayer has submitted that this percentage

should be calculated by dividing its total operating expenses (minus salaries) by total salaries. We accept this formula.

The taxpayer, in arriving at its proposed percentage of 54%, determined the numerator of the fraction (total operating expense [minus salaries] / total salaries) to be \$28,684,000. In reviewing the taxpayer's calculations and Operating Statement, the latter of which was supplied at the hearing, we note that the taxpayer's numerator correctly includes payroll taxes, advertising and display, general expense, and interest. The taxpayer did not, however, include rent, plant and equipment, taxes, district and regional services, and corporate services, which are also part of the taxpayer's cost direct and indirect overhead, in that figure. These additional costs total \$31,724,000. The numerator of the fraction resulting in the overhead factor must now be increased by \$31,724,000, for a total of \$60,408,000. The denominator - total salaries - remains \$52,972,000

Thus, the correct overhead factor is not 54% as suggested by the taxpayer, but 114%.

For purposes of determining use tax liability measured by the "value of the article used," WAC 458-20-178 (Rule 178) as it was in effect during the audit period provides in pertinent part as follows:

COMPUTATION OF TAX. The tax is levied and collected on an amount equal to the value of the article used by the taxpayer. ... In case the article used was extracted or produced or manufactured by the person using the same or was acquired by gift or was sold under conditions where the purchase price did not represent the true value thereof, the value of the article used must be determined as nearly as possible according to the retail selling price, at the place of use, of similar products of like quality, quantity and character. ...

For purposes of determining use tax liability, then, one normally looks to the "retail selling price, at the place of use, of similar products of like quality, quantity and character." As is often the case with the determination of manufacturing business and occupation tax, however, it may be impossible to determine with any reasonable accuracy the "retail selling price, at the place of use, of similar products of like quality, quantity and character..." This case is such an instance.

[4] Therefore, the Department's established practice is to utilize Rule 112 and calculate the costs of the property involved in order to further determine the true value of the property being taxed. This practice is acceptable. As was the case here with the determination of the proper measure for the manufacturing business and occupation tax, salaries of personnel and overhead account for a substantial portion of such costs. Such a determination of taxable measure does not render the tax to be one on intangibles, as the taxpayer has suggested. We are constrained to note that included in the cost or value of almost any manufactured product is the proportionate cost, including salaries, of any effort put into manufacturing it.

Therefore, we find that the "true value" of the manufactured property upon which use tax must be assessed will in this case be identical to the "value of the product" as determined for business and occupation tax.

#### DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is denied in part and granted in part. The Audit Section, after making the adjustments indicated by this determination, will issue an amended assessment, payment of which will be due on the date indicated therein.

DATED this 10th day of February 1987.