Cite as Det. No. 14-0057, 33 WTD 429 (2014)

BEFORE THE 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. 14-0057 Registration No. . . .

[1] RULE ; RCW 82.04.260(12) – PREFERENTIAL B&O TAX RATE FOR MANUFACTURING AND SELLING OF TIMBER PRODUCTS – DEFINITION OF "MANUFACTURING": A Taxpayer's activity may constitute "manufacturing" either under the specific definition related to certain timber activities contained in RCW 82.04.120(1)(c), or under the general definition contained in RCW 82.04.120(1) for the purpose of qualifying for the preferential B&O tax rate for manufacturing and selling of timber products.

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.

Yonker, A.L.J. – A corporation (Taxpayer) that purchases raw logs and then further cuts those logs to specific specifications and grade qualities, contends that its gross income from such activity should be taxable under the preferential tax rate for manufacturing and selling of timber products under RCW 82.04.260(12) because its activity qualifies as "manufacturing." We deny the petition in part and grant in part.[1]

ISSUE

Is gross income from Taxpayer's sale of certain logs cut for subsequent veneer manufacturing properly taxable under the preferential tax rate for manufacturing and selling of timber products under RCW 82.04.260(12)?

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

FINDINGS OF FACT

Taxpayer is a Washington corporation that operates a log yard located in . . . Washington. Taxpayer's business operation involves a number of different steps. First, Taxpayer purchases cut ("felled") logs of various types of wood[2] from timber extractors. The logs are typically thirty to forty feet long. Taxpayer then has the purchased logs transported to its log yard. At the log yard, Taxpayer examines the logs to determine the grade and quality of the logs as they typically contain sections of varying degrees of grade and quality.[3] Based on that examination, Taxpayer marks and cuts ("bucks") the logs further so that each log will yield the grades and qualities needed to satisfy various customer orders.

Two distinct categories of shorter log segments result from Taxpayer's bucking activity. First, the primary source of Taxpayer's income is from selling what it calls "veneer blocks" to veneer wood mills, which further process the veneer blocks into thin sheets of wood veneer. Taxpayer cuts the logs in order to maximize the amount of log length that can be used for veneer wood manufacturing. Taxpayer stated one log can yield up to three separate veneer blocks. The veneer blocks are sorted for customers who inspect the logs and select which ones they will purchase. Taxpayer then measures the cut veneer blocks and sorts them by grade for invoicing. Taxpayer sells veneer blocks for approximately sixty percent higher that Taxpayer's cost to purchase the original log.

Second, any remnants of the original logs that are not suitable to become veneer blocks are sold as "saw logs" to other customers. Saw logs are used for various purposes including furniture manufacturing. Taxpayer estimated that between ten percent and fifty percent of an original log may end up being sold as saw logs. Taxpayer sells saw logs at cost or slightly below cost.

For alder and maple logs specifically, Taxpayer performs two additional steps. First, Taxpayer inserts "fletch savers" into the ends of the veneer blocks, which prevents the logs from cracking or splitting. Second, Taxpayer paints the ends of the alder logs with a seal wax to prevent the veneer blocks from staining.

In 2013, the Department's Audit Division conducted an audit of Taxpayer's books and records for January 1, 2009 through June 30, 2012 (audit period). The Audit Division found that while Taxpayer had reported its business activity under the extracting and extracting for hire business and occupation (B&O) tax classification,[4] Taxpayer should have reported this business activity under the wholesaling B&O tax classification. The Audit Division reclassified Taxpayer's business activity during the audit period accordingly. The Audit Division also assessed use tax on certain consumable supplies.

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[2] While Taxpayer purchases mixed loads of logs, which could include Douglas fir, cedar, maple, ash, and oak, Taxpayer reports that it focuses "mostly" on alder.

[3] The grade and quality is based on the presence of knots, and how many sides of the log do not have knots.

[4] Department records indicate that Taxpayer submitted the "Timber Industry Incentives" survey for all years within the audit period.

On June 4, 2013, the Department issued a tax assessment for $. . . in additional tax liability,[5] a $. . . five percent assessment penalty, and $. . . in interest, for a total tax assessment of $. . . . On June 20, 2013, Taxpayer timely appealed the full amount of the tax assessment.[6]

ANALYSIS

Washington imposes a B&O tax "for the act or privilege of engaging in business" in this state. RCW 82.04.220(1). The B&O tax measure is "the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be." *Id.* The rate used is determined by the type of activity in which a taxpayer engages. *See generally* Chapter 82.04 RCW.

Here, the audit division found that Taxpayer's business activity constituted wholesale sales under RCW 82.04.060, and reclassified Taxpayer's business activity accordingly. Taxpayer, however, contends that its business activity during the audit period is taxable under a preferential tax rate for certain timber activities contained in RCW 82.04.260(12). Effective July 1, 2006, the legislature provided for a reduced B&O tax rate on the following activities:

> (a) Until July 1, 2024, upon every person engaging within this state in the business of extracting timber or extracting for hire timber . . . .
> (b) Until July 1, 2024, upon every person engaging within this state in the business of manufacturing or processing for hire: (i) Timber into timber products or wood products; or (ii) timber products into other timber products or wood products . . . .
> (c) Until July 1, 2024, upon every person engaging within this state in the business of selling at wholesale: (i) Timber extracted by that person; (ii) timber products manufactured by that person from timber or other timber products; or (iii) wood products manufactured by that person from timber or timber products . . . .

RCW 82.04.260(12). In addition, a taxpayer claiming these preferential tax rates must submit an annual survey pursuant to RCW 82.32.585. RCW 82.04.260(12)(f). A qualified taxpayer may report its income under this preferential tax rate provided it meets all of the statutory requirements. Det. No. 08-0316, 28 WTD 110 (2008). We note that preferential tax rates such as the one at issue here are considered a "tax preference," along with exemptions, exclusions, and deductions. RCW 43.136.021. As such, like other exemptions and deductions, any ambiguity in a preferential tax rate must be "strictly construed, though fairly, and in keeping with the ordinary meaning of their language, against the taxpayer." *Lacey Nursing v. Dep't of Revenue*, 128 Wn.2d 40, 905 P.2d 338 (1995); *see also Port of Seattle v. State*, 101 Wn.App.

[5] The audit division assessed $. . . in wholesaling B&O tax, $. . . in use tax, and credited Taxpayer for $. . . in extracting timber B&O tax, which Taxpayer originally paid.
[6] On appeal, Taxpayer asserted no argument relating to the $. . . in use tax assessed by the audit division. As such, we consider that issue to be beyond the scope of Taxpayer's appeal, and we do not address that issue in this determination.

106, 1 P.3d 607 (2000) ("exemption statutes are construed strictly against the taxpayer, and the taxpayer has the burden of establishing any exemption").[7]

During the audit period, Taxpayer initially reported its business activity under the preferential tax rate contained in RCW 82.04.260(12)(a) for "extracting timber" or "extracting for hire." On appeal, Taxpayer conceded that its activity is not "extracting timber" or "extracting for hire" under that subsection. However, Taxpayer argued instead that its business activity during the audit period instead was "manufacturing" timber products into other timber products under RCW 82.04.260(12)(b)(ii), and selling at wholesale timber products Taxpayer "manufactured" from other timber products under RCW 82.04.260(12)(c)(ii). Thus, in order to qualify for the preferred tax rate under either RCW 82.04.260(12)(b) or (12)(c), Taxpayer must prove that it meets all of the following statutory requirements:

1. Taxpayer "manufactured"
2. "Timber" or "Timber Products" into
3. Other "timber products" or "wood products" and
4. Submitted the required annual survey[8]

We first address whether Taxpayer's business activity constituted "manufacturing." RCW 82.04.260 does not contain a definition for manufacturing. However, RCW 82.04.120 provides two definitions of manufacturing that are relevant here. First, RCW 82.04.120(1)(c) specifically states that manufacturing includes "**[c]utting, delimbing, and measuring of felled, cut, or taken trees**." (Emphasis added). In addition, RCW 82.04.120(1) provides a general definition, stating that manufacturing "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." (Emphasis added). Taxpayer's business activity must fall under one of these two definitions of "manufacturing" in order to qualify for the preferential tax rate allowed under RCW 82.04.260(12).

1. Manufacturing Definition Under RCW 82.04.120(1)(c)

In 1999, the legislature added the specific language of "[c]utting, delimbing, and measuring of felled, cut, or taken trees" to the definition of manufacturing in RCW 82.04.120. The purpose of this change in the definition was to "make certain logging . . . activity eligible for the manufacturing machinery and equipment sales and use tax exemption." Final House Bill Report, ESHB 1887 (1999).[9]

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[7] Taxpayer argued on appeal that issues of classification "are construed most strongly against the power to tax and in favor of the taxpayer," citing *Group Health Cooperative of Puget Sound, Inc. v. Department of Revenue*, 106 Wn.2d 391, 722 P.2d 787 (1986). While this rule of statutory construction applies to general taxing statutes, it does not apply to exemptions and deductions. *Id.* at 401-02.

[8] Because Department records indicate that Taxpayer submitted all required surveys during the audit period, we conclude that Taxpayer has already met this statutory requirement.

[9] available at http://apps.leg.wa.gov/documents/billdocs/1999-00/Pdf/Bill%20Reports/House/1887-S.FBR.pdf, last visited on October 18, 2013.

WAC 458-20-13501 (Rule 13501), entitled "Timber harvest operations," elaborates on the definition of manufacturing as it relates to timber harvesting activities. Rule 13501(2)(c) states that manufacturing includes "cutting into length (bucking), delimbing, and measuring (for bucking) of felled, cut (severed), or taken trees."

For two reasons, we find that Taxpayer's activity does not qualify as manufacturing under the specific definition under RCW 82.04.120(1)(c). First, under RCW 82.04.120(1)(c), the activity that qualifies as manufacturing is "[c]utting, delimbing, **and** measuring of felled, cut, or taken trees." (Emphasis added). It is clear that the legislature intended this definition to be limited to only those situations in which a taxpayer performs all three activities. This is even more evident given the language of RCW 82.04.120(1)(d), which states "[C]rushing **and/or** blending of rock" is manufacturing. (Emphasis added). This subsection was enacted at the same time as RCW 82.04.120(1)(c), and because (1)(c) uses "and" as opposed to "and/or," the legislature's intent is clearly that a taxpayer must do all three activities to fall within this definition of manufacturing. Here, Taxpayer concedes that it does no delimbing, and therefore, Taxpayer does not do all three required activities.

Second, the Department has generally applied the specific definition of manufacturing under RCW 82.04.120(1)(c) to only those qualifying activities done at the harvest site incidental to the harvesting operation as opposed to subsequent activities that are done later at a log yard or sorting yard. *See* Det. No. 04-0097, 24 WTD 92 (2005) ("Cutting, delimbing, and measuring of felled, cut, or taken trees typically occurs at the harvest site in order to enable their transportation elsewhere for further processing" and these activities were not the "predominant activity" at the taxpayer's log yard); *see also* Det. No. 05-0176, 26 WTD 136 (2007). Taxpayer's activity here does not occur at the harvest site or incidental to any harvest operation. Instead, Taxpayer's activity at its log yard is a subsequent activity separate from any harvesting activity or incidental manufacturing process occurring at the harvest site.[10]

We conclude that because Taxpayer's activities were not "cutting, delimbing, and measuring" of trees as part of the manufacturing portion of a timber harvest operation at the harvest site, Taxpayer's activities at its log yard do not fall under the specific definition of manufacturing contained in RCW 82.04.120(1)(c).

2. Manufacturing Definition Under RCW 82.04.120(1)

Because the definition of manufacturing under RCW 82.04.120(1)(c) discussed above is not applicable to Taxpayer's activities at its log yard, Taxpayer's activities must fall under the general definition of manufacturing in RCW 82.04.120(1) to qualify for the preferential tax rate. Pursuant to that definition, the product of Taxpayer's activity must be "a new, different or useful

[10] Rule 13501(2)(c), pertaining to activities by timber harvesters, distinguishes the "manufacturing" activity that occurs incidental to the harvest operation at the harvest site from "further manufacturing subsequent to manufacturing conducted at the harvest site." We consider Taxpayer's activity at its log yard analogous to timber harvesters who perform "further manufacturing" separate from the "manufacturing" that occurs at the harvest site.

substance or article of tangible personal property." *Id.* In *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 175, 373 P.2d 483 (1962), the Washington State Supreme Court offered the following test for determining what constitutes manufacturing under RCW 82.04.120(1):

> 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.

Id. at 175 (Emphasis added). Applying the test articulated above, the *Bornstein* court concluded that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120. In reaching this conclusion, the *Bornstein* court made the following statement:

> It is true . . . that after the filleting process is accomplished the end product is fish in fillet form. In the *Stokely-Van Camp* case, however, the taxpayer performed a process on peas (and other vegetables and fruits), and, after the process, he still had peas. In *Drury the Tailor v. Jenner* . . . , a tailor transformed a bolt of cloth into a suit; the end product was still cloth, in the form of a suit. In *J. & J. Dunbar & Co. v. State* . . . , the taxpayer removed impurities from whiskey. The end product was whiskey. The crucial point in each of these cases was the fact that the activities of the taxpayer changed a product **to make it more usable**. The process of filleting transforms near valueless whole bottom fish into useful and salable consumer items. This change is significant. The fact that the end product is still fish does not mean that the end product is not new and different after the process of filleting is accomplished.

Bornstein, 60 Wn.2d at 176-77 (Emphasis added). It follows, then, that even though Taxpayer begins with a log and ends with a log, the process here may still constitute manufacturing.

A year after *Bornstein*, the Washington State Supreme Court again relied on this same test in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963), and held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The *McDonnell* court recognized that the above *Bornstein* test was "somewhat general in nature and may seem easier as a matter of articulation than as a matter of application." *McDonnell*, 62 Wn.2d at 556. The court then identified the following factors to "consider" in determining if the end product is a new, different, or useful product: ". . . 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, ..." *Id.* at 557. Thus, when considering *Bornstein* and *McDonnell* together, determining whether there has been a significant change requires comparison of the article before it was subjected to the process and compare it to the end product, as well as the actual scope and nature of the changes undertaken in that process. Further, we note that no one factor in the *McDonnell* test is determinative, but we must "evaluate" and "balance" the named factors. Det. No. 07-0082, 26 WTD 231 (2007).

We have previously applied the *McDonnell* test on multiple occasions. In Determination No. 95-170, 16 WTD 43 (1995), we found that a taxpayer's activity of sorting and compacting loose sheet metal into 2x2x3 foot cubes at wrecking yards and landfills was manufacturing. We applied the *McDonnell* factors in that case as follows:

> There is a substantial change in form from the large pile of unsorted scrap sheet metal to the 2x2x3 foot compacted metal cubes. The quality of the metal also changes, since it has now been sorted and many large impurities have been removed. Furthermore, Taxpayer testified that there has been a significant change in the physical properties of the metal. In its compacted form the metal cubes are much easier to handle, store, and transport than in the loose and unsorted piles. More importantly, however, the metal scraps can now be melted down into molten steel without burning up. The compacting process has significantly changed the combustion point of the product. Indeed, these additional properties not only enhance the value of the scrap sheet metal to the steel recyclers but also greatly increase the products overall market value. Based on the above factors, we believe that the sorting and compacting of loose scrap sheet metal into 2x2x3 foot cubes does constitute a "significant change" resulting in a new, different or useful substance within the meaning of RCW 82.04.120.

Conversely, in Determination No. 10-0108, 31 WTD 1 (2010), we held that a taxpayer's activity of sorting recycled materials into various streams of similar materials did not constitute manufacturing. Applying the *McDonnell* factors in that case, we concluded that while there was a change in value due to the taxpayer's activity, those activities did "not physically change the form or character of the underlying property at issue." *Id.* *See also* Det. No. 94-255, 14 WTD 092 (1994) (holding that compressed hay is not manufacturing because it is not significantly more useful than uncompressed hay).

Here, Taxpayer's activity at its log yard resulted in both a change in form and in quality. Taxpayer begins with a raw log of varying degrees of quality and following Taxpayer's activities, the resulting product is multiple shorter logs of specific grades or quality. The change in dimension – a thirty to forty foot raw log cut into up to three logs of varying lengths – constitutes at least some change in form. In addition, because the logs are cut so as to maximize the grade and quality of each shorter log segment, Taxpayer's customers are able to purchase logs of specific grade quality as opposed to larger logs that contain various inferior grade or quality portions. While the shorter logs all come from the same raw log, because Taxpayer separates out the higher grade quality portions, the overall effect is shorter logs of higher individual grade and quality when compared with the original varied grade and quality of the full raw log.

Further, there is certainly an increase in value due to Taxpayer's activities. Taxpayer stated that he sells the shorter veneer blocks he cuts at approximately sixty percent higher than what he paid for the raw logs. The enhanced value in the shorter logs of higher grade and quality is because Taxpayer's customers are able to purchase veneer blocks from Taxpayer of the needed grade and quality as opposed to having to purchase full raw logs that have to be cut and the lower quality

portions discarded. The mark up in price indicates that the shorter logs of higher grade and quality are significantly more valuable to Taxpayer's customers than full raw logs. Like the fish fillets in *Bornstein* and the split peas in *McDonnell*, the shorter logs of higher grade and quality are significantly more valuable to Taxpayer's customers than a raw log.

We also recognize that Taxpayer attaches fletch savers and wax seals to the ends of some types of logs to prevent splitting and staining. While these actions do not change the actual properties of the log, they preserve the desirable properties of the logs for Taxpayer's customers.[11] These additional actions by Taxpayer ensure that the logs will maintain their higher value as split or stained logs would not be of use to Taxpayer's customers.

On the other hand, we find that some of the stated *McDonnell* factors are not as evident in this case. For instance, we do not find that Taxpayer's activities change the internal properties of the log. Besides the change in length, there is no other change to the makeup of the logs themselves. In addition, we do not find that the extent of Taxpayer's process is particularly complex or extensive. Here, the "manufacturing" activity we are examining consists primarily of cutting the raw logs with a chainsaw. No other machinery, equipment, or process is employed to perform this task.

Based on our evaluation and balancing of the factors named in *McDonnell*, we conclude that a "significant change" has occurred and that Taxpayer's final product is a "new, different, or useful product" when compared to the original raw log.[12] Taxpayer does not merely "buck" logs into convenient lengths; Taxpayer makes new logs of specific lengths, grades, and quality, free of splitting or staining, based on its examination of the raw logs and the specific requests of its customers. As the *Bornstein* and *McDonnell* courts concluded with the fish and peas at issue in those respective cases, the process at issue here transforms a raw log into something more useful for Taxpayer's customers, although the end result of the process may still be called a log. Our conclusion on this point is reinforced by the *McDonnell* Court's reasoning:

> In utilizing the aforementioned factors, it is necessary to bear in mind the admonition in *Bornstein* that 'In short, we have come to the position now where we are classifying as "manufacturing" activities which realistically are not manufacturing in the ordinary sense at all.' That is, the definition in RCW 82.04.120 of the term *manufacture* and its tax scope is subject to legislative determination. This determination is not necessarily confined to a classical or orthodox definition of manufacturing, which, in common

[11] We note that Washington courts have even held that certain preservation measures can constitute manufacturing. *See Valley Fruit v. Dep't of Revenue*, 92 Wn.App. 413, 963 P.2d 886 (1998) (treating apples with fungicide and brushing the apples clean of mineral deposits constituted "manufacturing" because it increased the life of the apples, thereby making the product of that process "a more useful product.").

[12] Our earlier decisions in Determination No. 05-0176, 26 WTD 136 (2007) and Determination No. 04-0097, 24 WTD 92 (2005), both discussed earlier, do not alter our conclusion here because those cases dealt only with the specific definition of manufacturing under RCW 82.04.120(1)(c), and did not address the general definition of manufacturing under RCW 82.04.120(1). Further, in those earlier cases, the taxpayers' predominant activity at the log yards was "storage and handling" services, whereas here, the predominant activity is the cutting of the logs to maximize grades and qualities pursuant to customer requests.

> understanding, usually would connote a spinning, knitting, sewing, sawing, synthesizing, assembly or other fabrication process.

McDonnell, 62, Wn.2d at 557 (Emphasis in original). For all of these reasons, we conclude that Taxpayer's business activity meets the general definition of manufacturing as described in RCW 82.04.120(1).

3. Timber Products Under RCW 82.04.260(12)(e)

Having concluded that Taxpayer's activity constituted "manufacturing," we now turn to the nature of product of that manufacturing process. As discussed earlier, under RCW 82.04.260(12)(b) or (c), Taxpayer must also begin its manufacturing process with either "timber" or "timber products," and that process must result in either "timber products" or "wood products." RCW 82.04.260(12)(e) provides definitions for these terms as follows:

> (iv) "Timber" means forest trees, standing or down, or privately or publicly owned land.
>
> (v) "Timber products" means:
>
> (A) **Logs**, wood chips, sawdust, wood waste, and similar products obtained wholly from the processing of timber . . .
>
> (B) Pulp, including market pulp and pulp derived from recovered paper or paper products; and
>
> (C) Recycled paper, but only when used in the manufacture of biocomposite surface products.
>
> (vi) "Wood products" means paper and paper products; dimensional lumber; engineered wood products such as particleboard, oriented strand board, medium density fiberboard, and plywoods; wood doors; wood windows; and biocomposite surface products.

(Emphasis added). Here, it is undisputed that Taxpayer begins its manufacturing process with a "log," which qualifies as a "timber product" under RCW 82.04.260(12)(e)(v)(A). Following the manufacturing process discussed above, the final products are other shorter logs of higher grades and quality. These final products – logs – also qualify as "timber products." Because Taxpayer begins with a timber product and ends with other timber products, we conclude that Taxpayer has met all of the statutory requirements to claim the preferential tax rates under RCW 82.04.260(12)(b) and (c).

As such, we grant Taxpayer's petition for reclassification of gross income from wholesaling to the preferential tax rate for manufacturing or selling timber products for that portion of Taxpayer's gross income related to the manufacturing activity discussed above. . . . We . . . deny Taxpayer's petition as it relates to the use tax assessed as Taxpayer presented no evidence regarding that issue. We remand this matter for adjustment to the tax assessment consistent with this decision.

DECISION AND DISPOSITION

Taxpayer's petition is denied in part and granted in part.

Dated this 18th day of February 2014.