Cite as 4 WTD 351 (1987)

BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| In the Matter of the Petition For Correction of Assessment of) | F I N A L D E T E R M I N A T I O N |
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| ) | No. 87-364 |
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| . . . ) | Registration No. . . . |
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[1] **RCW 82.04.130 AND RULE 134:** B&O -- MANUFACTURING -- COMMERCIAL OR INDUSTRIAL USE. In order to be taxed as a manufacturer of an article for the manufacturer's own commercial or industrial use, there must be a distinct and separate use of the article after the manufacturing has been completed. The very act of manufacturing an article is not using that article for commercial or industrial purposes.

[2] **RCW 82.04.440 AND RULE 115:** B&O -- CUSTOM OR COMMERCIAL PACKING -- MANUFACTURING ACTIVITY AS PART OF SERVICE RENDERED. Where the rendition of custom packing services also involves some activities which, when isolated, would be considered "manufacturing" activities, there must be a clearly separate and distinct commercial or industrial use of the manufactured article in order for multiple tax liability to arise.

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: . . .

HEARING CONDUCTED BY DIRECTOR'S DESIGNEES:

Matthew J. Coyle, Deputy Director
Gary O'Neil, Assistant Director
Garry G. Fujita, Assistant Director
Edward L. Faker, Sr. Administrative Law Judge

DATE AND PLACE OF HEARING: September 23, 1985; Olympia, Washington

NATURE OF ACTION:

The taxpayer appeals from the assessment of business and occupation tax under the classification, Manufacturing-Other, and interest thereon, and from use tax and interest assessed upon the value of manufactured custom crating. The taxpayer had regularly reported tax under the Service b&o tax classification as a custom packer, and had paid sales tax upon its acquisition of packing materials. The additionally assessed taxes were based upon the Department's conclusion that the taxpayer manufactured custom crating for its own commercial or industrial use in rendering its custom packing services. Thus, tax was due under all three, multiple activity, classifications.

By approval of the Department the taxpayer's appeal was heard at the Director's level, pursuant to WAC 458-20-100(14), as a matter of first impression.

FACTS AND ISSUES:

Faker, Sr. A.L.J. -- The taxpayer's business records were audited for the period from January 1, 1980 through March 31, 1984, revealing a total tax and interest deficiency of $ . . . . Tax Assessment No. . . . was issued in that amount on December 18, 1984. The assessment was timely appealed, but after several conferences and correspondence for initial consideration, the petition and taxpayer's file were mislocated. The assessment remains unpaid.

The taxpayer's business activity is that of custom or commercial packing. Some of this activity entails the construction of customized crating and packaging of a "wraparound" nature, whereby the taxpayer prepares large machinery and equipment for safe and efficient transportation by land and sea. The size and configuration of these goods require that the packaging be constructed around the goods, according to the contour of the goods. Thus, the taxpayer

does not separately construct these containers and then pack them according to customer specifications. Rather, the custom packing service itself entails constructing the boxes or containers in such a manner as to enclose the contents as the construction is performed. The taxpayer submitted numerous photographs of typical examples of this work.

The audit conclusions were that the taxpayer engaged in two distinct and separate functions or business activities, to wit: 1) manufacturing containers and, 2) using the containers for its own commercial or industrial purposes, as a consumer, by custom packing its customers' goods within them. Thus, in addition to the Service business tax which the taxpayer had reported, Manufacturing business tax was assessed upon the value of the containers. Use tax was also assessed upon the full manufactured value of the containers, with credits offset for the amount of sales tax the taxpayer had already paid to its suppliers of the materials from which the containers were constructed.

TAXPAYER'S EXCEPTIONS:

The taxpayer's petition contains the following pertinent statements.

> A glance at the pictures of the packages involved here should suffice to persuade you that the articles which the Audit Division alleges were "manufactured" in the instant case are not severable from the services rendered by the taxpayer. The taxpayer's business is packing for safe and efficient transportation of personal property that comes in all sizes and shapes. Therefore the packages are customized to fit the particular property. As you can see from the pictures, the packages represent a variety of sizes, configurations and materials. One has only to look at the pictures of the packages to appreciate the impossibility of severing the taxpayer's business into two income streams. The Audit Division necessarily envisions both a manufacturing and a service component in the taxpayer's business. The manufacturing component is the building of a package. The service component includes placing the property to be shipped within the package. In practice, of course, the taxpayer simply builds the package around the property to be shipped. Under the Audit Division's position, however, some means

> must be found to determine when manufacturing ends and the service of placing the contents into the package begins. Physically such a division is likely to be impossible even for one package, let alone all of them. The variety in sizes, configurations and materials differs so much that even if a satisfactory division could be made for one package, it would not be applicable to the other packages. The fact is that the packages in question constitute the whole of the taxpayer's service. If one were to try to sever the so-called "manufactured" package from the taxpayer's service, there would be nothing left of the taxpayer's service. The situation here has, in short, been confused with distinguishable cases where the manufacturing can be severed by obtaining the article from a separate supplier.

The taxpayer maintains that in order for the activities to be taxed as separate business activities they must be capable of producing separate and independent income streams to the taxpayer. Thus, because the taxpayer does not manufacture the boxes, crates, or packages in question here in such a manner that they could be sold outright, only a single income flow is possible or taxable, to wit, custom packing. In this precise respect, the taxpayer asserts, its situation is clearly distinguishable from other custom packers who independently manufacture boxes, crates, and packages separate and apart from their subsequent service activity of packing the crates.

The taxpayer stresses that, unlike normal custom packers, it cannot build the containers without the contents to build them around, to exact dimensions. Thus, it is literally impossible to segregate any manufacturing activity from its service activity. It is impossible, by the use of any established accountancy principles to separate any manufacturing function from the overall service provided. Only by the application of a completely arbitrary formula, as allegedly done in the audit, can any functional separation be perceived.

Finally, the taxpayer asserts that the audit position directly conflicts with the provisions of WAC 458-20-115 (Rule 115) governing custom packers. The rule provides that such packers are the consumers of materials they acquire for their own use in rendering packing services and must pay sales tax upon purchases of such lumber, nails, and similar consummables. The audit position is that the taxpayer is not a "consumer" until it manufactures the completed crate or package.

The taxpayer asserts that it's correct and full tax liability is that of Service b&o tax on its gross packing receipts and sales or use tax upon packing materials only, as it consistently reported.

DISCUSSION:

[1] RCW 82.04.120 defines the term, "(t)o manufacture" as embracing,

> . . . 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 supplied.)

RCW 82.04.130 defines the term, "(c)ommercial or industrial use" to mean,

> . . . the following uses of products, including byproducts, by the extractor or manufactured thereof:
>
> (1) Any use as a consumer; and
>
> (2) The manufacturing of articles, substances, or commodities.
> (Emphasis supplied.)

WAC 458-20-134 (Rule 134) repeats the statutory definition of "commercial or industrial use," and then cites examples of the common and ordinary understandings of such uses. In each such example, as well as within the commonly understood meaning, there is a distinct use of a manufactured article after it has been manufactured, separate and apart from the act of manufacturing that article. The conclusion that the very act of manufacturing something is not the same as using that thing for commercial or industrial purposes is so fundamental as to require no support. If, however, there is an isolated and identifiable business use of any manufactured article, subsequent to and separate from the act of manufacturing the article, then the manufacturer has engaged in manufacturing for its own commercial or industrial use and is so taxable. That excise tax liability can be threefold -- (a)

manufacturing business tax on the value of the article manufactured, (b) use tax upon the value of the article manufactured, and (c) service business tax upon gross receipts from rendering any service involving the subsequent use of the manufactured article. The Department has consistently and uniformly administered tax in this manner when these three activities coexist.

Moreover, it is immaterial that each of the activities may be incapable of producing a distinct income flow or, standing alone, may not produce income. The manufacture of specialized, single-use tools by a person who will use such tools in the further production of some product or service is subject to manufacturing business tax (and use tax) even though the tools may have no market value, cannot be purchased or sold, and are capable of only a single commercial use; viz: high tech specialty tooling for rocketry. Even though they are incapable of producing an income stream separate from the sale of the end product upon which they are used, such molds or tools are produced and used for distinct commercial purposes after they are manufactured. For purposes of taxation the distinction lies in the separateness of the commercial purpose, not in the capacity to produce income. We reject the taxpayer's contentions regarding the necessity of some potential for separate income streams before distinct business activities can be separately taxed. There is no support for any such position under the law, nor inherent within the multiple activities tax provisions of RCW 82.04.440.

[2] However, there is a dispositive distinction in cases such as that before us here. Where the claimed manufacturing activity is inseparably bound up within the service being provided and is indistinguishable from that service, then there is no distinct incident of use of the manufactured article for commercial or industrial purposes after the manufacturing activity has ceased. In short, when the manufacturing ends there is no further use. Examples abound. Doctors manufacture casts in providing medical services to patients; dentists manufacture bridgework in patients' mouths; attorneys produce leather bound wills and estate planning portfolios in rendering legal services to clients; architects make drawings and portrait painters produce paintings. Sometimes, too, custom packers must build the customized packaging around the contents such that any activity which might be perceived as manufacturing is inherently part of the professional packing activity. In all cases such as these the service provider is subject to service business tax measured

by gross income, under the provisions of RCW 82.04.290. Also, under the provisions of RCW 82.04.190, such service providers are, themselves, the "consumers" of the tangible personal property they use in providing the service. They are engaged in singular, not multiple business activities.

We agree with the taxpayer that these cases are highly distinguishable, on their own facts, from cases involving other commercial packers who manufacture crates, boxes, wrappings, containers, and packing materials and, after that manufacturing is complete, use such things to custom pack contents for their customers or sell these manufactured materials outright. The distinction derives from the technical workings of the statutory law itself, not from theoretical casting about concerning separate income streams. There cannot be any manufacturing of anything for one's own commercial or industrial use unless there is some proven commercial or industrial use of the thing after it is manufactured.

Because of our conclusion that the taxpayer has not engaged in manufacturing the crating in question for its own commercial use, the use tax may not be measured by the full value of the completed boxes or crates. See RCW 82.12.020 which imposes use tax and RCW 82.12.0252 which grants exemption for property upon which retail sales tax has been paid. Here, the taxpayer did not use any manufactured product, it only used the materials upon which sales tax had already been paid.

DECISION AND DISPOSITION:

The taxpayer's petition is sustained.

DATED this 18th day of December 1987.