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BEFORE THE INTERPRETATION AND 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. 88-167 Registration No. . . .

[1] **RULE 136**: RCW 82.04.120 -- B&O TAX -- MANUFACTURING -- WHAT CONSTITUTES. The taxpayer's activity of buying patches and hats and sewing the patches on the hats and silk screening t-shirts for re-sale found to constitute manufacturing for purposes of the B&O tax.
Manufacturing includes producing articles for sale from prepared materials by giving them new form, qualities or combinations.

[2] **RCW 82.04.440**: MULTIPLE ACTIVITIES TAX CREDIT -- NATIONAL CAN. Effective June 1, 1987, Washington manufacturers selling outside this state may take a credit against their manufacturing B&O tax for "gross receipts taxes" paid to another state on the same products being taxed in Washington.

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: October 6, 1987

NATURE OF ACTION:

The taxpayer protests the assessment of manufacturing tax on grounds its activity does not constitute manufacturing.

FACTS AND ISSUES:

Frankel, A.L.J. -- The taxpayer's records were examined for the period April 1, 1982 through December 31, 1985. The audit disclosed taxes and interest owing in the amount of $ . . . . Assessment No. . . . in that amount was issued on November 25, 1986.

The taxpayer protested the following portions of the assessment:

1) Manufacturing B&O tax on unreported out-of-state sales (Schedule II - $ . . .) and

2) Sales reclassified from Wholesale to Retail ($ . . .).

The taxpayer sells caps, t-shirts, jackets, etc., on which it has placed insignias, patches and/or silk screen imprints. The taxpayer contends its activities do not constitute manufacturing.

In the alternative, the taxpayer protested the manufacturing tax on grounds the tax is unconstitutional.

The auditor reclassified some sales from wholesale to retail by extrapolating the results obtained in four test periods over all sales during the audit period. After further review of its records, the taxpayer concluded the test periods were representative of the amounts that should have been used. The taxpayer agreed to have the auditor review its 1982 sales and expand the 1983 and 1984 test periods to correct the assessment. The review has been completed and an adjustment of the assessment will be made.

DISCUSSION:

Manufacturing tax -- Persons who manufacture products in this state and sell the products out of state are taxable under the Manufacturing classification upon the value of the products sold. WAC 458-20-136 (Rule 136). The rule contains the broad statutory definition of manufacturing:

> The term "to manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand of 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. (RCW 82.04.120.) It 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. . . .

The taxpayer cited four Washington cases which it contends are the only relevant cases interpreting the above definition of manufacturing: Reynolds Metal Co. v. State, 65 Wn.2d 882 (1965); Continental Coffee Co. v. State, 62 Wn.2d 829 (1963); McDonnell & McDonnell v. State, 62 Wn.2d 553 (1963); and Group Health v. Department of Rev., 106 Wn.2d 391 (1986). The taxpayer contends that the court only found a taxpayer's activities constituted manufacturing if the activity produced a "significant" or "substantial" change in a product. In this case, the taxpayer contends the size, shape, texture purpose and function of the hats are the same after the patches are attached; thus the taxpayer argues no requisite significant change takes place.

In McDonnell & McDonnell v. State, supra, the court held splitting peas was manufacturing. In considering whether an activity constitutes manufacturing, the court stated that the product or substance that is sold must be compared with the substance initially received. In making the comparison, two of the factors considered included changes in function, enhancement in value, differences in demand; changes which may indicate the existence of a "new, different, or useful substance." 62 Wn.2d at 557. The court quoted the following from Bornstein Sea Foods, Inc. v. State, 60 Wn.2d 169 (1962): "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." Id.

In this case, the taxpayer's employees use hand and/or machinery to sew a patch or label on a hat which the taxpayer then sells. The taxpayer also silk screens t-shirts for sale. We believe these activities produce "different" products and fall within the definition of manufacture. The taxpayer is not merely reselling component parts. Instead, the taxpayer

gives the component parts it purchases a new combination, and produces an article for sale. The Department has found that the combining of materials for sale, even where all components were purchased from others, manufacturing. See, e.g., ETB 398.04.136 (arranging, assembling, and packaging candies, toys and components into Easter baskets and Christmas gift packages constituted manufacturing). As stated in that bulletin, "the Department is not concerned with mere packaging, but rather with the end result of the taxpayer's efforts." The Department also found that a taxpayer's business activity of affixing hinges, guide wheels, and pivots to louvered door panels which had been purchased from manufacturing firms constituted manufacturing. ETB 25.04.136 (1966).

If all the taxpayer did was to put the patch and hat in a box and market them as components under their original brand names, we would agree that the taxpayer was only packaging the components for resale. The taxpayer, however, combines the components to make a single new product which it sells under its own trade name. Furthermore, the taxpayer does the activity in considerable quantities as a regular business which is another factor courts consider in determining whether an activity is manufacturing. See Schumacher Stone Co. v. Tax Commission of Ohio, 18 N.E.2d 405, 407 (1938). Accordingly, we find the activity does constitute "manufacturing" as the term has been broadly defined by the courts and legislature.

[2] Washington's "multiple activities exemption" provision, RCW 82.04.440, provides that manufacturers who sell their products in Washington pay retailing or wholesaling tax, but are exempt from the manufacturing tax. Only Washington manufacturers selling outside the state, as the taxpayer, pay the manufacturing tax.

In Armco Inc. v. Hardesty, 467 U.S. 638 (1984), the Supreme Court held that West Virginia's similar manufacturing B&O tax was invalid. After Armco was issued, the Washington State legislature enacted a "credit fix" to take effect if Washington's multiple activities exemption was found to discriminate against interstate commerce. In the recent Tyler Pipe-National Can case, 483 U.S. ___ (1987), the Court did find that Washington's multiple activities exemption was unconstitutional. The Court remanded the cases back to the

Washington Supreme Court to address the questions of remedies and refunds.[1]

The ruling in National Can triggers the B&O tax credit enacted in 1985. Washington manufacturers or extractors can now take a credit against their B&O taxes for any gross receipts taxes paid to another state. The credit can be taken for all sales made on and after June 1, 1987. The taxes paid to the other state must be taxes on the same products being taxed in Washington state.
If the taxpayer provides evidence that it has paid gross receipts taxes to any other state, it is entitled to a tax credit for such taxes paid.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 23rd day of March 1988.

[1] On January 28, 1988, the Court issued its opinion, ruling Tyler Pipe should be applied prospectively only from the date the opinion was issued, June 23, 1987. 109 Wn.2d 878.