Cite as Det. No. 99-143, 21 WTD 97 (2002)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 99-143[1] |
| . . . | ) | Registration No. . . . |
| | ) | FY. . ./Audit No. . . . |

[1] RCW 82.04.260: B&O TAX -- SOYBEAN OIL -- MODIFYING. The special tax classifications in subsections (1) and (2) of RCW 82.04.260, relating to trading in soybeans, and the manufacturing of soybeans into soybean oil, do not apply to the activity of modifying bulk soybean oil to make specialty oils.

[2] RULE 136, RCW 82.04.120: B&O TAX -- MANUFACTURING -- NEW, DIFFERENT OR USEFUL -- SOYBEAN OIL. Where the taxpayer buys soybean and canola oil in bulk and modifies it to meet the requirements of various categories of users by adding agents that alter its physical and chemical qualities, and by heat sealing it to increase shelf life, the taxpayer's industrial activity produces a new, different or useful product under the rationale of applicable case law, because a significant change has been accomplished when the end products are compared with the article before it was subjected to the process. The activity is taxable under the manufacturing B&O tax classification.

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:

A company that buys bulk soybean and canola oils and modifies them before packaging and selling them to wholesaler-distributors protests its business and occupation (B&O) tax reclassification from soybean and canola processing to wholesaling. It contends it is properly classified either as a trader in commodities or a manufacturer of soybeans into soybean oil and canola into canola oil.[2]

[1] The reconsideration determination, Det. No. 99-143R, is published at 21 WTD 106 (2002).
[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FACTS:

Prusia, A.L.J. -- The taxpayer is a corporation doing business in . . ., Washington. Its activities include purchasing soybean and canola oil in bulk, modifying the oil to meet the requirements of various categories of users, packaging the oil, and selling the packaged oil to wholesalers and distributors. . . . It makes sales both in Washington and out of state.

The Department of Revenue (Department) audited the taxpayer's books and records for the period January 1, 1994 through September 30, 1997. As a result of the audit, on April 17, 1998, the Department's Audit Division issued a tax assessment, in the total amount of $. . ., including interest of $. . . . The taxpayer has paid $. . . ($. . . applied to interest, and $. . . applied to principal). The balance remains due.

The taxpayer protests Schedules 2, 3, and 4 of the audit report.

Schedules 2 and 3

During the audit period, the taxpayer reported sales of all products under the business and occupation (B&O) tax classification of soybean and canola processing. It deducted interstate sales. Schedule 2 gives the taxpayer a credit for all sales reported under that classification and Schedule 3 assesses tax on those sales under the wholesaling-other B&O classification. Schedule 3 allows a deduction for interstate sales. The audit report stated that the taxpayer's business activities do not fall under the soybean and canola processing classification because they do not involve processing soybeans into soybean oil or canola into canola oil, and sales should have been reported under the wholesaling or retailing classification. . . .

The taxpayer disagrees with the reclassification of sales of oil from the soybean and canola processing B&O classification to the wholesaling-other B&O classification. . . .

The taxpayer described its operations in detail in its petition and at hearing. The taxpayer has a plant in a large warehouse in [Washington] . It purchases soybean and canola oil in bulk. The oil is delivered to the [Washington] plant in railroad cars. The taxpayer does not merely pump the base oil from the tanker cars to containers. The oil that is delivered is a base oil the taxpayer modifies for specific uses. The modification requires the use of specialized equipment. After modifying the base oil, the taxpayer packages it into containers (gallon, 55 gallon, or totes), and sells the packaged oil to wholesalers and distributors. It does not sell directly to retailers.

The taxpayer buys two kinds of base oil -- salad oil and hydro (hydrogenated) oil. Both types of bulk oil must be heated and circulated as they are pumped out of the tanker cars, to separate out sediments. The hydro oil is a soft solid, and must be heated to a temperature of 140 degrees. The heated and circulated oil is pumped into large tanks from which it is later removed for further processing.

Some of the salad oil is directly packaged after the initial heating and separation. Most is modified by the addition of additives for use in baking applications, salad dressing, mayonnaise, and cooking applications. For example, to produce oil for baking, the taxpayer adds TBHQ (an antioxidant to help preserve freshness) and, sometimes, coloring. To produce liquid fry shortening for heavy duty frying, the taxpayer adds TBHQ, Citric Acid, and dimethylpolysiloxane (an anti-foam agent). To produce liquid frying oil, the taxpayer adds TBHQ and dimethylpolysiloxane. To produce pourable pan and grill oil, it mixes soybean and canola oil with lecithin, coloring (carotene), artificial flavor, TBHQ, citric acid, and dimethylpolysiloxane. To produce mayonnaise oil, it adds TPHQ and a cooling agent. The taxpayer adds color and flavoring to some batches of oil to produce specialty oils.

Whenever additives are used, precise measurement is required. A substantial amount of mixing and blending is required to ensure product consistency and integrity. The mixing and blending are done in smaller tanks. The mixing, blending and heating totally change the physical and chemical properties of the oil, including smoke point, viscosity, and the entire fatty acid profile.

The hydro oil the taxpayer purchases is the base oil for making liquid and solid shortenings. After the initial heating and storage in large tanks, the oil is removed and dimethylpolysiloxane is added. The oil then is pumped into a heat exchanger where it undergoes intense agitation and rotation, supported by an ammonia compressor. The oil then is rapidly chilled to 74 degrees. Some of the oil is changed into a solid state. The liquid oil is pumped into a tank, and from there is packaged. The solid oil is packaged into 50-pound boxes. The processing changes the texture and the chemical composition of the oil.

All packaged products are heat-sealed to preserve freshness, prolong shelf life, and prevent tampering. The value of the oil increases by 30-40% as a result of the processing and heat sealing.

The taxpayer is licensed by the Washington Department of Agriculture as a food processor. The canola oil and soybean oil the taxpayer prepares are certified kosher . . . .

In protesting the reclassification, the taxpayer argues as follows. Soybean oil is traded as a basic commodity, and has been traditionally classified in the same category as soybean in the industry. It is traded as a distinct, separate commodity classification in the Commodity Exchange. RCW 82.04.260(1) provides a special classification for the business of buying and selling basic commodities like corn and canola, and taxes the activity at a rate of 0.011 percent. The fact that soybean oil is not explicitly mentioned in RCW 82.04.260(1) is probably an oversight. The manufacture of soybeans into soybean oil is mentioned in subsection (2) of the statute, to which a higher B&O rate applies, but it makes no sense to have that tax category, because no one in the state is engaged in manufacturing soybeans into soybean oil. There is sufficient ambiguity in the classification that the taxpayer should be afforded relief under the Fair Tax Doctrine, and RCW 82.04.220. The taxpayer should be taxed at the rate of 0.011 percent as a trader in the commodity of soybean oil. The taxpayer further argues that it is working with the Washington Port authorities to establish them as through ports for soybean oil, for eventual shipment to

Pacific Rim countries, and an essential element of the effort would require the B&O tax to be minimal or the commodities to be exempt.

In the alternative, the taxpayer argues that it should be classified as a manufacturer of soybean oil and other commodities. It argues that the wholesaling business is traditionally an operation that buys and sells packaged goods without additional processing. In contrast, its business requires more equipment, changes the physical and chemical properties and the state of products, and enhances product values. It contends that its activities meet the definition of "to manufacture" in RCW 82.04.120, both under the literal language of the definition and as the Department as interpreted that definition. It cites the following authority in support of its position: McDonnell & McDonnell v. State, 62 Wn.2d 553, 383 P.2d 905 (1963); Bornstein Sea Foods, Inc. v. State, 60 Wn.2d 169, 373 P.2d 483 (1962); Det. No. 88-167, 5 WTD 241 (1988); and Det. No. 90-246, 10 WTD 37 (1990).

The Audit Division argues that the law is very specific in RCW 82.04.260 that the special tax classification of soybean and canola processing applies only to persons who manufacture "soybeans into soybean oil." The taxpayer never takes possession of the soybeans. It purchases the oil that someone else has manufactured. The Audit Division views the taxpayer's activity as there mere repackaging of a product, and not an activity that rises to the level of manufacturing as that term is used in RCW 82.04.120.

. . .

ISSUES:

1. What is the proper B&O classification of the taxpayer's activity with respect to soybean and canola oils -- trading in commodities, manufacturing of soybeans into soybean oil and canola into canola oil, manufacturing in general, or wholesaling?

2. With respect to the taxpayer's sales to [Trading Co.], is the taxpayer selling its own oil or processing and packaging [Trading Co.]'s oil?

. . .

DISCUSSION:

Business and occupation tax is imposed upon the privilege of engaging in business activities within Washington. The measure of the tax as well as the tax rate vary depending upon the nature (or classification) of the activity. RCW 82.04.220. In this case, we must determine under which classification(s) the taxpayer's oil-processing activities fall.

RCW 82.04.260 specifies the measure of tax and tax rate applicable to buyers, wholesalers, manufacturers, and processors of certain foods and byproducts. The version in effect during the audit period provided, in relevant part:

> (1) Upon every person engaging within this state in the business of buying wheat, oats, dry peas, dry beans, lentils, triticale, canola, corn, rye and barley, but not including any manufactured or processed products thereof, and selling the same at wholesale; the tax imposed shall be equal to the gross proceeds derived from such sales multiplied by the rate of 0.011 percent.
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> (2) Upon every person engaging within this state in the business of manufacturing wheat into flour, barley into pearl barley, soybeans into soybean oil, canola into canola oil, canola meal, or canola byproducts, or sunflower seeds into sunflower oil; as to such persons the amount of tax with respect to such business shall be equal to the value of the flour, pearl barley, oil, canola meal, or canola byproduct manufactured, multiplied by the rate of 0.138 percent.

RCW 82.04.270 specifies the measure of tax and tax rate applicable to most wholesalers. The version in effect during the audit period provided, in pertinent part:

> (1) Upon every person except persons taxable under subsections (1) or (8) of RCW 82.04.260 engaging within this state in the business of making sales at wholesale; as to such persons the amount of tax with respect to such business shall be equal to the gross proceeds of sales of such business multiplied by the rate of 0.484 percent.

RCW 82.04.240 specifies the measure of tax and tax rate applicable to most manufacturers. The version in effect during the audit period provided, in pertinent part:

> Upon every person except persons taxable under RCW 82.04.260(2), (3), (4), (5), (7), (8), or (9) 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 0.484 percent.
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> The measure of the tax is the value of the products, including byproducts, so manufactured regardless of the place of sale or the fact that deliveries may be made to points outside the state.

RCW 82.04.280 specifies the measure of tax and tax rate applicable to processors for hire. WAC 458-20-136 (Rule 136) provides the following definition of the term “processing for hire”:

> The term "processing for hire" means the performance of labor and mechanical services upon materials belonging to others so that as a result a new, different or useful article of tangible personal property is produced. Thus, a processor for hire is any person who would be a manufacturer if he were performing the labor and mechanical services upon his own materials.

A processor for hire, by definition, does not make sales of goods because the goods already belong to the customer. Det. No. 86-295A, 3 WTD 443 (1987).

Any activity that has not been specifically classified or exempted from B&O taxation is subject to B&O tax at the other business or service classification rate. RCW 82.04.290(4).

When a wholesaler delivers goods to a purchaser who receives them at a point outside Washington, wholesaling B&O tax is not applicable to the sale. WAC 458-20-193 (Rule 193).

Persons who both manufacture and sell those products in this state must report their gross receipts under both the manufacturing and retailing or wholesaling classifications. A credit may then be taken against the selling tax in the amount of the manufacturing tax reported. Persons who manufacture products in this state and sell the same in interstate or foreign commerce are taxable under the classification manufacturing upon the value of the products sold, and are not taxable under retailing or wholesaling with respect to such sales. Rule 136.

Schedules 2 and 3

[1] The special tax classifications in RCW 82.04.260 are very specific and narrow classifications. Neither subsection (1) nor subsection (2) applies to the taxpayer. With respect to soybeans and canola, subsection (1) applies only to persons who buy dry beans or canola. It expressly does not apply to one who buys manufactured or processed products of soybeans or canola, such as oil. The taxpayer does not buy dry beans or canola. It only buys the oil manufactured from those sources. Subsection (2) applies only to persons who take the soybeans or canola and manufacture them into oil. The taxpayer does not engage in that activity.

Statutory language is to be construed strictly, though fairly, and in keeping with the ordinary meaning of the language employed. Group Health Coop. of Puget Sound, Inc. v. Wash. State Tax Comm'n, 72 Wn. 2d 422, 433 P.2d 201 (1967). It is to be construed in favor of the public and the right to tax. Thurston County v. Sisters of Charity of House of Providence, 14 Wash. 264, 44 Pac. 252 (1896). As an administrative agency, the Department does not have discretion to change the law. See Det. No. 86-278, 1 WTD 287 (1986), Det. 85-283A, 2 WTD 123 (1986), Det. 87-19, 2 WTD 151 (1986). If the taxpayer believes the failure to mention soybean oil in subsection (1) of RCW 82.04.260 is probably an oversight, its only remedy is to seek a legislative change.[3]

[2] We now consider whether the taxpayer, although not taxable as a manufacturer under RCW 82.04.260, may nonetheless be a "manufacturer" of the products it sells, and thus taxable under RCW 82.04.240. RCW 82.04.120 broadly defines the term "to manufacture":

> "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 statute excludes certain activities, not pertinent here, from the definition of "to manufacture." Any taxpayer whose activities come within the scope of this definition is engaged in manufacturing.

[3] We note that in 1998 the Legislature amended RCW 82.04.260 to eliminate the special classification for buyers and sellers of dry beans and canola. Laws of 1998, ch. 312.

Rule 136 guides taxpayers on the Department's interpretation and administration of RCW 82.04.120. Rule 136(1) repeats the statutory definition of "to manufacture" and then states:

> 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. 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, coats, awnings, blinds, boats, curtains, draperies, rugs, and tanks, and other articles constructed or made to order, and the curing of animal hides and food products.

The question whether the taxpayer engages in a "manufacturing activity" in its handling of the soybean and canola oil depends upon whether the taxpayer's application of skill or labor to the bulk oil that is delivered to it results in a "new, different or useful" article. The Washington Supreme Court has considered the question numerous times, providing some guidance on the scope of the definition. In Bornstein Sea Foods, Inc. v. State, supra, the Court said:

> 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.

Bornstein, 60 Wn.2d at 175.

In McDonnell & McDonnell v. State, supra, the court acknowledged the difficulty of making the comparison test in Bornstein, and identified factors that should be considered when determining whether a significant change has resulted from the taxpayer's business activity:

> In making this comparison, consideration should be given to the following factors: 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, which may be indicative of the existence of a "new, different, or useful substance."
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> 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 understanding, usually would connote a spinning, knitting, sewing, sawing, synthesizing, assembly or other fabrication process. (Emphasis by the Court.)[4]

McDonnell, 62 Wn.2d at 557. Later cases follow the analysis in Bornstein and McDonnell. In Continental Coffee Co. v. State, 62 Wn.2d 829, 832, 384 P.2d 862 (1963), the Court said:

> In the Bornstein case, where we held that the processing of near valueless whole bottom fish into fish fillets, which were useful and salable consumer items constituted manufacturing, we said
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> > " . . . 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 . . . ."
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> Applying this test, we find that the changing of green coffee beans, useful only to coffee processors, to a roasted and blended coffee, a usable consumer item, is a change of such significance as to render it manufacturing under the Bornstein decision.
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> In the Stokely-Van Camp case, we held that the processing and freezing of fresh fruits and vegetables constituted manufacturing, despite the taxpayer's contention that its activities did not create a degree of usefulness which had not previously existed, but merely preserved that same degree. The reasoning under the facts of the Stokely-Van Camp case is applicable to the instant case. Since, in the Stokely-Van Camp case, the process of preserving an already edible food constituted manufacturing, it follows that a process which takes an inedible product and, by blending and roasting, creates an edible product must also be manufacturing.
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> In the J & J Dunbar case, the process of converting raw whiskey, which was not suitable for consumption as a beverage, into one capable of use as such was found to constitute manufacturing. That case involved the screening out of charcoal particles and other foreign matter from non-potable whiskey. With the addition of water, an 85 proof whiskey was produced, which was then bottled and sold. The activities in both the J & J Dunbar case and the instant case have achieved the same result-the conversion of a product not suitable for consumption to one that is. If the mere activity of screening and filtering of raw whiskey constitutes manufacturing, then the blending and roasting of green coffee must also constitute manufacturing.

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[4] In a similar vein, the Court said, in Rusan's, Inc. v. State, 78 Wn.2d 601, 603, 478 P.2d 724 (1970):

> Thus, the power of the legislature in the field of excise taxation is such that taxes may be imposed upon activities which, although not normally considered to be within a given category, are, nevertheless, deemed by the legislature, for tax purposes, to be within such a category. See Bornstein Sea Foods, Inc. v. State, 60 Wn.2d 169, 373 P.2d 483 (1962); Stokely-Van Camp, Inc. v. State, 50 Wn.2d 492, 312 P.2d 816 (1957). Such taxes have frequently raised judicial hackles and doubts; nevertheless, even more frequently they have been held to be within the legislature's power of enactment.

After considering the statute, the rule, and the court cases, we conclude that the taxpayer's activities with respect to soybean oil and canola oil are within the scope of the definition of "manufacturing" as found in RCW 82.04.120. The taxpayer does accomplish a significant change to the soybean and canola oils when the end products are compared to the oil before it is subjected to the taxpayer's processes. Without the initial heating and circulation, not even the bulk salad oil the taxpayer purchases would be commercially usable as salad oil. Most of the oil the taxpayer purchases is further changed chemically and functionally, and some is changed physically from a liquid to a solid state. The modifications require several steps, specialized equipment, and careful control. The taxpayer's processes create end products that have a different demand than exists for the oil it purchases. The taxpayer's customers have no use for the oil in its pre-processed form. They require purer oil. Many require oil that is modified so as to have specific cooking or blending qualities, and/or specific taste or color. The heat sealing results in a product with a significantly longer shelf life than the raw materials. The taxpayer's processing substantially enhances the value of the oil.

We note the reclassification of the taxpayer's oil processing activities will require it to report its gross receipts from in-state sales of oils under both the manufacturing and the wholesaling classifications, as described in Rule 136. It also means that manufacturing B&O tax will be assessed upon oil it manufactures that is delivered to points outside the state. See RCW 82.04.240, Rule 136, Rule 193, and 458-20-19301 (Rule 19301).

. . .

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is granted in part and denied in part. The assessment is remanded to the Audit Division . . . for adjustments in accordance with this determination.

Dated this 24th day of May 1999.