

Cite as Det. No. 16-0230, 37 WTD 001 (2018)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition for Correction of )	<u>D E T E R M I N A T I O N</u>
Assessment and Refund of )	
)	No. 16-0230
)	
... )	Registration No. . . .
)	

[1] RCW 82.04.450; WAC 458-20-112: USE TAX – VALUE OF PRODUCTS – COMPARABLE SALES. Audit correctly valued the taxpayer’s internal transfers of asphalt for use tax purposes by using comparable sales. The sales were comparable because they were to (1) comparable purchasers (2) at comparable locations (3) under comparable conditions of sale and (4) involve similar quality products (5) in similar quantities. Audit correctly valued the taxpayer’s manufactured aggregates for use tax purposes by including loading, ticketing, and dispatch costs in its cost basis calculation, as these costs were incurred at the processing point and not from the processing point to the job site.

[2] RCW 82.08.02565; WAC 458-20-13601: RETAIL SALES TAX – EXEMPTION – M&E – CANVAS CANOPY. The taxpayer’s canvas canopy was used to “shelter” recycled asphalt and not “store” it, making it a building that cannot qualify for M&E exemption.

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.

Sattelberg, T.R.O. – An asphalt and aggregate manufacturer and road paver (“Taxpayer”) protests the Department of Revenue’s (“Department”) assessment of use tax and manufacturing business and occupation (“B&O”) tax arguing the Department incorrectly valued asphalt and aggregate products it manufactured and used in public road construction projects. Taxpayer also disputes the Department’s disallowance of the manufacturers’ machinery and equipment (“M&E”) exemption for a canvas covering it purchased to shelter recycled asphalt. We remand the petition in part and deny it in part.<sup>1</sup>

ISSUES

1. Whether Audit correctly calculated the value of asphalt and aggregates manufactured by Taxpayer and incorporated into public road construction jobs for use tax purposes, under

<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

RCW 82.12.020, 010(7) and WAC 458-20-178 (“Rule 178”), and manufacturing B&O tax, under RCW 82.04.240, 450 and WAC 458-10-112 (“Rule 112”).

2. Whether Audit correctly disallowed the M&E exemption, under RCW 82.08.02565(2)(b)(iii), for a canvas covering Taxpayer purchased to shelter recycled asphalt.
3. Whether Audit correctly applied a 2% “inflation factor” to post-audit periods when calculating the value of asphalt and aggregate for public works contracts purposes, under RCW 82.32.090(5) and RCW 82.32.100(1) & (2).

### FINDINGS OF FACT

Taxpayer is an asphalt and aggregate manufacturer and road paver operating several divisions engaging in various activities. Taxpayer’s Aggregates Division operates a quarry and an aggregate manufacturing facility in . . . , Washington, where it manufactures aggregates from the quarry it leases.<sup>2</sup> Taxpayer’s Asphalt Division manufactures approximately twenty-five different types of asphalt both at its . . . location and also at a second asphalt manufacturing facility in . . . , Washington. Taxpayer manufactures multiple types of asphalt depending on its own or its customers’ needs, using various sizes of aggregates and types of binder oils as needed. Taxpayer purchases some commercial grades of aggregates due to the limitations of the raw materials at its . . . quarry. Taxpayer is its own largest customer of asphalt, and also sells asphalt and aggregates to third party customers at wholesale and at retail. Taxpayer’s Recycle Division accepts recycled asphalt in . . . , where it is reprocessed to be used in manufacturing new asphalt. Taxpayer’s Construction and Pave & Grade Divisions pave roads and other smaller paving projects, and sometimes acts as the general contractor and other times as a subcontractor. Taxpayer also has a Delivery Division that transports Taxpayer’s products, a Sales Division that sells Taxpayer’s products, and a Shop Division that repairs and maintains equipment used in Taxpayer’s other divisions.

In 2013, the Department’s Audit Division (“Audit”) began partially auditing Taxpayer’s records for the time period January 1, 2009, through December 31, 2012. After significant discussions and adjustments for several other issues, Audit issued Taxpayer an assessment of \$ . . . on August 25, 2014.<sup>3</sup> After the assessment was issued from the audit, eight Public Works Contract Reconciliation of Taxes were completed that addressed similar issues raised in the audit, which Taxpayer paid under protest.<sup>4</sup> Taxpayer continued to provide Audit with documents to support adjustments from the original assessment, and Audit issued a post-assessment adjustment lowering the total amount due to \$ . . . on May 22, 2015.<sup>5</sup> On June 19, 2015, Taxpayer paid \$ . . .

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<sup>2</sup> Examples of aggregates include sand and gravel.

<sup>3</sup> The assessment consisted of \$ . . . in use tax/deferred sales tax, \$ . . . in retail sales tax, \$ . . . in retailing B&O tax, \$ . . . in manufacturing B&O tax, \$ . . . in service & other activities B&O tax, a credit of \$ . . . for public road construction B&O tax paid, a credit of \$ . . . for wholesaling B&O tax paid, and \$ . . . in interest.

<sup>4</sup> Public Works Contract Reconciliation of Taxes for . . . were issued on December 11, 2014. . . . was issued on April 8, 2015. . . . was issued on April 15, 2015. . . . was issued on June 12, 2015. A second . . . reconciliation was issued on February 1, 2016. . . . was issued on April 14, 2016. A second . . . reconciliation was issued on May 12, 2016,

<sup>5</sup> The post-assessment adjustment consisted of \$ . . . in use tax/deferred sales tax, \$ . . . in retail sales tax, \$ . . . in retailing B&O tax, \$ . . . in manufacturing B&O tax, \$ . . . in service & other activities B&O tax, a credit of \$ . . . for

toward the assessment, the portion of the post-assessment adjustment it agreed was due, and timely filed an administrative review contesting the remainder.<sup>6</sup> Taxpayer has also sought administrative reviews regarding the eleven Public Works Contract Reconciliation of Taxes, which the Department's Administrative Review and Hearings Division consolidated into this review.<sup>7</sup> The factual findings are grouped by issue.

### 1. Asphalt

When it paves roads, Taxpayer does not sell the asphalt it manufactured in its Asphalt Division to its Construction Division, but transfers it internally. Taxpayer assigned a price to these internal transfers, which it used for use tax reporting purposes.<sup>8</sup> During the audit, Audit looked to determine if it could more accurately value these internal transfers using comparable sales. Audit obtained individual sales data from Taxpayer and separated it into three categories: 1) type of binder oil used . . . , 2) location of sale . . . , and 3) year of sale. Audit found several of Taxpayer's largest customers were governmental entities, just like the governments that hired Taxpayer for their public works projects.<sup>9</sup> Audit found that the location of the sales were comparable as they all occurred in the . . . regions, just like Taxpayer's public works projects. Audit found that two thirds of the asphalt purchased by private customers was to be used in highway, street, and bridge construction, the same purposes for which Taxpayer was internally transferring asphalt. Audit found that the types of asphalt Taxpayer manufactures and consumes are the same types of asphalt that it sells.<sup>10</sup> Audit found that the public works contract that Taxpayer consumed the most asphalt on was the city of . . . , where it consumed 6,358 tons of asphalt.<sup>11</sup> Comparatively, Taxpayer's largest customer, . . . , purchased 9,893 tons of asphalt in September of 2010.<sup>12</sup> Audit also found that customers made other purchases comparable in size to the city of . . . through the audit period.<sup>13</sup> Given all these findings, Audit determined that comparable sales existed.

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public road construction B&O tax paid, a credit of \$ . . . for wholesaling B&O tax paid, \$ . . . in interest, and \$ . . . in extension interest. Taxpayer paid \$ . . . on June 19, 2015.

<sup>6</sup> Taxpayer acknowledges that it did not pay wholesaling B&O tax on certain wholesale sales, it mistakenly claimed the M&E exemption on certain equipment, and it failed to pay retail sales tax on certain construction materials, and that used the wrong value to report and pay taxes on materials it manufactured and consumed.

<sup>7</sup> The Department received Taxpayer's petition regarding the Public Works Contract Reconciliation of Taxes for . . . on February 12, 2015. The Department received its petition regarding . . . on April 20, 2015. [A]nd, the Department received its petition regarding . . . on July 10, 2015. Finally, the Department received its petition regarding the second . . . , and the second . . . reconciliations on June 2, 2016.

<sup>8</sup> At hearing, Taxpayer explained that it set this price to control to the profit margin for both its Asphalt and Construction Divisions.

<sup>9</sup> Taxpayer's ten largest customers included the governmental entities of . . .

<sup>10</sup> Audit notes that asphalt products Taxpayer most commonly consumed, 1283 Superpave ½" PG 64-22, 1284 Superpave ½" PG 64-22 w/rap, 1295 Cmrcl Superpave ½" 64-22 w/rap, 1311 . . . Class B, 1721 Modified Class B, and 1910 Cold Mix MC, are the most commonly consumed by Taxpayer's twenty largest customers.

<sup>11</sup> Of the other five initially petitioned public works projects, 4,657 tons were consumed on the . . . , 2,651 tons on the . . . , 4,395 tons on the . . . , and 4,418 tons on the . . . . Audit's response dated March 2, 2015, Exhibit B, pages 1-5.

<sup>12</sup> Audit's Exhibit E, Quantities of Asphalt for External Customers, to its July 20, 2015 response.

<sup>13</sup> Other purchases over 4,000 tons included:

In determining the comparable sales for sales using 64-22 binder oil, Audit considered the lowest dollar/per ton sale to an external customer per year that was at least 1,000 tons, by location, to be the most comparable sale. Audit used the value of asphalt sold per ton in its comparable sales, by year, to calculate the amount subject to use tax per year.<sup>14</sup> This methodology resulted in the following weighted average price per ton over the audit period for sales using 64-22 binder oil for each location: \$ . . . for . . . and \$ . . . for . . . .<sup>15</sup> Audit used a similar methodology for sales using 70-22 binder oil, except it reduced its minimum comparable sale size to 100 tons as sales of 70-22 asphalt were much smaller, resulting in a weighted average price per ton over the audit period of \$ . . . for . . . and \$ . . . for . . . .<sup>16</sup>

Taxpayer contests the value Audit used for asphalt, arguing that there are no comparable sales because none of the criteria for making a sale comparable have been satisfied.<sup>17</sup> Since Taxpayer argues there were no comparable sales, it instead proposes to use its own cost basis calculations to value internally transferred asphalt.<sup>18</sup> Taxpayer’s calculations result in the following weighted average price per ton over the audit period, as compared to Audit’s comparable sales values:<sup>19</sup>

Location	Binder Oil Type	Taxpayer’s Cost Basis Value	Audit’s Comparable Sales Value
Auburn	64-22	\$ . . .	\$ . . .
Seattle	64-22	\$ . . .	\$ . . .
Auburn	70-22	\$ . . .	\$ . . .
Seattle	70-22	\$ . . .	\$ . . .

Customer	Period	Tons
. . .	August 2009	9,676
. . .	June 2010	5,636
. . .	March 2012	4,358
. . .	November 2011	4,220
. . .	April 2012	4,142

Audit’s Exhibit E, Quantities of Asphalt for External Customers, to its July 20, 2015, response.

<sup>14</sup> Audit took this total amount and divided into fourths and allocated one fourth to . . . .

<sup>15</sup> The weighted average is calculated by taking the sum of tons sold per year that Taxpayer supplied in its Revised ASPHALT Materials Cost Per Ton from May 21, 2015, multiplied by Audit’s value per year in its Value of Materials by Ton from March 2, 2015, divided by the total tons sold during the entire period.

<sup>16</sup> The methodology for the weighted average calculation is similar to the previous calculation.

<sup>17</sup> Taxpayer argues in its petition dated April 20, 2015, that Audit instructed Taxpayer to use a method for determining the value of asphalt in its future reporting instructions that is administratively impossible. Taxpayer claims Audit instructed it to report monthly using a value it could not calculate until the end of the year. Audit responds that its future reporting instructions of August 25, 2014, instructing Taxpayer to calculate the value of asphalt either using sales data from the previous month for its largest customer or use a three to six month moving average.

<sup>18</sup> Taxpayer submitted its cost basis calculation for asphalt in its Revised ASPHALT Materials Cost Per Ton from May 21, 2015.

<sup>19</sup> The methodology for the weighted average calculation is similar to the previous calculations except it uses the Taxpayer’s value per year from its Revised ASPHALT Materials Cost Per Ton from May 21, 2015.

Audit notes Taxpayer's public price listing of its asphalt products as of February 1, 2014, as follows:

Product	Price per ton
HMA (hot mix asphalt) Class ½"	\$ . . .
Class A, B or Modified B	\$ . . .
HMA Class 3/8" of Class G	\$ . . .
HMA Class 1" or Class E	\$ . . .
Asphalt Treated Base	\$ . . .
MC-250 Cold Mix	\$ . . .

## 2. Aggregates

For the aggregates Taxpayer manufactured, Audit discovered that Taxpayer was using a cost basis price for use tax reporting purposes for sales and internal transfers. Audit looked to determine if it could more accurately value these internal transfers using comparable sales, but found that it could not. Audit examined Taxpayer's cost basis calculations and determined Taxpayer had made some errors in its calculations.<sup>20</sup> Audit found the following activities were part of the manufacturing activity, and included the costs related to them as a direct cost to Taxpayer's Aggregate Division:

1. Loading: taking finished manufactured aggregates and loading them on customer or its own trucks
2. Scaling and ticketing: weighing the trucks to determine how much aggregate is being sold or loaded and issuing a ticket that invoices the customer
3. Dispatch: directing truck drivers where to deliver deliveries

Audit found that the employee costs of payroll taxes, retirement contributions, and health insurance for the employees involved in loading, scaling, ticketing, and dispatch should have correspondingly been included in the cost basis calculation as general overhead indirect costs allocated among Taxpayer's operating divisions based on a payroll factor.<sup>21</sup>

Taxpayer contests Audit's inclusion of loading, scaling, ticketing, and dispatch arguing they are part of the selling activity and not part of the manufacturing activity. As such, Taxpayer argues, they are not direct costs associated with the manufacture of aggregates, but should be assigned wholly to the selling activity. Taxpayer also argues that, correspondingly, employee costs associated with loading, scaling, ticketing, and dispatch should not be allocated to the manufacture of aggregates.

<sup>20</sup> Taxpayer originally argued that Audit erroneously included aggregates purchased from third parties and resold without any modification. Audit subsequently agreed, making this no longer an issue on review.

<sup>21</sup> Taxpayer also argues that Audit improperly included a portion of the Shop Division's direct payroll costs in the Aggregate Division's payroll. Audit responds that it included these costs in a preliminary calculation but subsequently removed them. We find that Audit has adequately explained that this has been resolved in its responses dated March 18, 2015, and July 20, 2015.

### 3. Canvas Canopy

In 2012, in order to protect its stockpile of recycled asphalt from frequent rains, Taxpayer purchased a large canvas canopy. Taxpayer placed the canvas on a light metal frame, which it in turn placed on a foundation of ecoblocks.<sup>22</sup> The canvas canopy and ecoblock foundation surrounded the concrete slab upon which Taxpayer had historically placed its recycled asphalt.

During the course of the audit, Audit discovered that Taxpayer had not paid retail sales tax on the canvas canopy. Audit determined the canopy did not qualify for the M&E exemption because it was sheltering tangible personal property, making it a building, and assessed use tax on it.

Taxpayer contests Audit's disqualification of its canvas canopy from the M&E exemption. Taxpayer states its canvas canopy and ecoblock foundation are temporary because they are not annexed to the realty because Taxpayer's lease is set to expire in the near future, and therefore the canvas canopy cannot legally be a building.<sup>23</sup> Taxpayer provided one photograph of the canvas covering in use, and one photograph of the canvas covering having another layer of ecoblocks added to it by several truck cranes.

### 4. Inflation Factor

Taxpayer is regularly performing ongoing public transportation projects in the . . . and . . . region. In order to receive the 5% of the contract price retained for the conclusion of these public transportation projects, the Department must certify that the taxes owed on the projects have been paid.<sup>24</sup> The eleven projects at issue here were completed after Audit had issued its initial assessment, and Taxpayer continues to engage in such projects.<sup>25</sup> In order to account for price inflation to the value Audit determined Taxpayer's asphalt products to be worth in 2012, Audit has added an "inflation factor" of 2% each subsequent year when completing Public Works Contract Reconciliation of Taxes forms. In its Detail of Differences for its original audit, Audit gave Taxpayer several future reporting instructions. Audit instructed Taxpayer to value asphalt based on a moving average sales price to its largest customer that purchases asphalt. Taxpayer has not followed this instruction as it is awaiting the outcome of this review.

Taxpayer protests the 2% inflation factor arguing that the percentage is arbitrary, and argues instead that it should be based on easily obtainable government data. Taxpayer cites to the United States Department of Labor's Producer Price Index for commodities for asphalt as being the appropriate source for this data.

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<sup>22</sup> Ecoblocks are short for ecology blocks, which are made of left-over or unused concrete. The blocks are designed to be easily fitted together with tongue and groove, and easily moveable with a built-in rebar picking eye at the top. Full blocks are 2'x 2'x 6' and weigh 3,850 lbs.; half blocks are 2'x 2'x 3' and weigh 1,900 lbs.

<sup>23</sup> Taxpayer provided an excerpt of its lease stating that structures, foundations, pads, and fixtures and equipment were to be removed from the property within 120 days of the expiration or termination of the lease. Taxpayer states it is nearing the end of extractable amount of natural resources from the property, and will be ending operations there in the near future. No documentation was provided to support this claim.

<sup>24</sup> The authority for the 5% amount retained is found in RCW 60.28.011.

<sup>25</sup> See footnotes 4 and 5 for the timing of the initial assessment and subsequent completion of public works contracts.

Audit counters that it considered the Producer Price Index when determining its inflation factor percentage, except it used the industry value for asphalt paving mixture and not the commodities index for asphalt. Audit notes that the industry index increased .35% from 2013 over 2012 and increased 1.82% from 2014 over 2013. Audit states that these percentages are not significantly different than the 2% it used. We note that the percentage change for 2015 over 2014 was a decrease of 3.3%.<sup>26</sup>

## ANALYSIS

### 1. Valuation

Public road construction is the activity of “building, repairing or improving any street, . . . which is owned by a municipal corporation or political subdivision of the state or by the United States and which is used or to be used primarily for foot or vehicular traffic, either as a prime contractor or as a subcontractor.” RCW 82.04.280(1)(b); WAC 458-20-171 (“Rule 171”). Additionally, construction of roads dedicated to a city or county is also public road construction. Both prime and subcontractors engaging in public road construction are taxable under the public road construction classification of the B&O tax on the total contract price. RCW 82.04.280.

Public road contractors are the consumers of the materials they incorporate as an ingredient or component of a road. RCW 82.04.190(3). Therefore, public road contractors must pay retail sales or use tax on all materials they place in, or on, the road as well as on equipment and supply purchases. Rule 171; WAC 458-20-134 (“Rule 134”). This applies to materials whether they are purchased, provided by others, or manufactured/extracted by the contractor. Det. No. 03-0269, 23 WTD 182 (2004) (holding a public road contractor owes use tax on its use of rock materials taken from a country stockpile for no charge).

The production of asphalt or aggregates at a location away from the construction job site is a manufacturing activity. RCW 82.04.110, 120; ETA 3071.2009. Public road contractors who manufacture asphalt or aggregates for commercial use are subject to manufacturing B&O tax measured by the value of asphalt or aggregates manufactured. RCW 82.04.240; 82.04.450. Use tax is also due on the value of the asphalt or aggregates used. ETA 3071.2009; Rule 134(4); Rule 171.

The measure of taxes for the manufacturing B&O tax and use tax is essentially the same. RCW 82.04.450 defines the “value of products” for purposes of the B&O tax as follows:

(1) The value of products, including by-products, extracted or manufactured shall be determined by the gross proceeds derived from the sale thereof whether such sale is at wholesale or at retail, . . . , except:

(a) Where such products, including by-products, are extracted or manufactured for commercial or industrial use;

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<sup>26</sup> Based on data from the Department of Labor’s Bureau of Labor Statistics for asphalt paving mixture & block manufacturing. <http://data.bls.gov/cgi-bin/dsry> (accessed June 10, 2016).

(b) Where such products, including by-products, are shipped, transported or transferred out of the state, or to another person, without prior sale or are sold under circumstances such that the gross proceeds from the sale are not indicative of the true value of the subject matter of the sale.

(2) In the above cases the value shall correspond as nearly as possible to the gross proceeds from sales in this state of similar products of like quality and character, and in similar quantities by other taxpayers, plus the amount of subsidies or bonuses ordinarily payable by the purchaser or by any third person with respect to the extraction, manufacture, or sale of such products: . . . . The department of revenue shall prescribe uniform and equitable rules for the purpose of ascertaining such values.

#### A. Asphalt: Comparable Sales

Where products are manufactured for commercial or industrial use, “value of products” is further explained in Rule 112:

[T]he 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.

Use tax is imposed on the value of articles used. RCW 82.12.020(4)(a); Rule 134(4). RCW 82.12.010(7)(a) similarly defines the “value of the article used,” in pertinent part:

“Value of the article used” is the purchase price for the article of tangible personal property, the use of which is taxable under this chapter. . . . In case the article used is acquired by lease or by gift or is extracted, produced, or manufactured by the person using the same or is sold under conditions wherein the purchase price does not represent the true value thereof, the value of the article used is determined as nearly as possible according to the retail selling price at place of use of similar products of like quality and character under such rules as the department may prescribe.

Rule 178(13) adds only that the quantity of the articles sold should also be considered in determining value.

To summarize, the “value of products” is determined by the gross proceeds of sales. Where there are no proceeds of sales, the product should be valued by comparable sales. “A comparable sale is one to (1) comparable purchasers (2) at comparable locations (3) under comparable conditions of sale and (4) involve similar quality products (5) in similar quantities. The comparison required need not be exact, but rather ‘as nearly as possible.’” *Texaco Refining and Marketing v. Dep’t of Revenue*, 131 Wn. App. 385, 398-399 (2006) (citations omitted).

We find that Audit correctly concluded that comparable sales existed and should have been used to value Taxpayer’s asphalt manufactured and transferred internally. Comparable purchasers existed, as some of the largest private purchases of Taxpayer’s asphalt were governmental



entities, similar to those for which Taxpayer performed its public works contracts. Sales were made in comparable locations, as sales were made to private parties across the . . . and . . . region, just like the locations of Taxpayer's public works contracts. The conditions were comparable to those where sales were made, as most of Taxpayer's largest customers were paving highways, streets, and bridges, and some of them were governmental entities, like the governmental entities for which Taxpayer performed highway paving. The product qualities were similar, as all of the types of asphalt Taxpayer manufactures and consumes are the same types of asphalt that Taxpayer sells, and which Taxpayer's largest consumers regularly purchased. Finally, the product quantities were similar, as Taxpayer's private customers often purchased in the multiple thousands of tons, just like Taxpayer consumed in its public works projects.

Because Audit produced a valuation based on comparable sales, the burden shifts to Taxpayer to prove Audit's valuation is not correct. *Id.* at 400. Taxpayer argues that none of the comparable criteria are met here. Taxpayer argues there were no comparable purchasers, stating that none of its customers can as accurately predict the amount of asphalt it will need as it can itself, and this therefore saves it from unnecessary waste or additional plant start-up costs. It states even its largest customers insist on contract terms and requirements that are different than how it manufactures asphalt for itself. While the sales of asphalt to the external governmental entities may not have been exactly the same as when it manufactures and transfers asphalt internally, we find that there has been nothing provided that persuades us that they were not comparable under the provisions of Rule 178.

Taxpayer argues that there were no internal transfers under conditions similar to those of its external sales because its Asphalt Division is always "paid" for its internal transfers, and that there is no credit risk associated with internal transfers. This argument, however, leads to the result of never being able to compare sales and internal transfers. Statutes are construed so as to avoid strained or absurd consequences. *Wright v. Engum*, 124 Wn.2d 343, 351-52, 878 P.2d 1198 (1994). The rules of statutory construction apply to agency regulations as well as statutes. *Tesoro Refining and Marketing Co. v. Dep't of Revenue*, 164 Wn.2d 310, 190 P.3d 28 (2008); *Madre v. Health Care Auth.*, 149 Wn.2d 458, 472, 70 P.3d 931 (2003); *Port of Seattle v. Dep't of Revenue*, 101 Wn. App. 106, 1 P.3d 607 (2000); *Multicare Medical Center v. DSHS*, 114 Wn.2d 572, 591, 790 P.2d 124 (1990). If Taxpayer were to prevail on this argument, then it would mean that there could never be comparable sales in cases where there are internal transfers, a result clearly contrary to Rule 112. Because it leads to an absurd result, we must reject Taxpayer's argument on this issue. Additionally, Taxpayer has not provided any supporting authority for this position.

Taxpayer argues that the products at issue are not similar products of a like quality and character because Audit lumped together dozens of different products into one of only two categories based on binder oil type only. Taxpayer argues that by ignoring the aggregate size, the design load, and the aggregate gradation, and focusing solely on the binder oil type, Audit is lumping together sales that are not comparable.<sup>27</sup> We disagree. Taxpayer asks that we scrutinize its asphalt products to a degree not required by law. As RCW 82.04.450(2) states, and as the Court of Appeals echoed in *Texaco*, the comparison required need not be exact, but rather "as nearly as

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<sup>27</sup> Aggregate gradation is the particle size distribution within the asphalt mixture.

possible.” *Id.* at 399. In Det. No. 91-260, 11 WTD 423 (1992), referring to RCW 82.04.450, we stated “that the statute does not contemplate identical sales, but merely requires similar sales upon which to base a reasonable estimate of the value of the products sold.” (Emphasis added.) *See also* Det. No. 90-83, 9 WTD 149 (1990). We concur with Audit that the types of asphalt Taxpayer manufactures and consumes are similar products of a like quality and character to those that it sells for the construction of highways, streets, and bridges.<sup>28</sup>

Taxpayer argues that there were no comparable sales of similar quantities. Taxpayer notes that its five public works projects totaled 22,507 tons of asphalt, an average of 4,501 tons per project. Taxpayer argues that this quantity cannot be compared to a sale of 1,000 tons, which is what was used for sales of 64-22 binder oil. There were several sales to external customers that were in the 4,000 ton range, though, and Taxpayer’s public works contract with the city of . . . was only for 2,651 tons. While we agree that a sale of 4,501 tons cannot be compared to a sale of 1,000 tons in terms of total dollars, they can be compared in terms of price per ton. These sales have the unit measure in common, and as the comparison chart above shows, the price per ton Taxpayer proposes from its cost basis calculation and the price per ton Audit arrived at using comparable sales are generally comparable. Neither value is close to the prices posted on Taxpayer’s website just over a year after the end of the audit period, and we note the prices for the various products listed are all uniformly higher. Since individual sales quantities were comparable, Taxpayer’s argument here fails.

We find that Audit correctly determined the value of asphalt manufactured and internally transferred by using comparable sales from sales data Taxpayer supplied, and accordingly deny Taxpayer’s petition on this issue.

#### B. Aggregates: Cost Basis

The parties agreed with using a cost basis calculation for aggregates, for the audit period, as a comparable sales calculation was not feasible. Where products are manufactured for commercial or industrial use and comparable sales do not exist, “value of products” is further explained in Rule 112:

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.

The Department’s rule regarding use tax, Rule 178, provides the following for articles produced for commercial or industrial use:

- (e) A person who extracts or manufactures products or by-products for commercial or industrial use is subject to use tax and the business and occupation (B&O) tax on the value of products or by-products used.

. . .

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<sup>28</sup> These sales made up two thirds of Taxpayer’s private sales.

- (i) The extractor or manufacturer is responsible for remitting retail sales or use tax on all materials used while developing or producing an article for commercial or industrial use. This includes materials that are not components of the completed article.
- (ii) The value of the extracted or manufactured article is subject to use tax when the article is completed and used.

The Department's ETA 3153.2009 further explains how to compute the measure of value for road construction businesses consuming sand, gravel, and rock they extracted and manufactured:

In the case of extracted materials which have been crushed, washed, screened, mixed with other processed materials or otherwise subjected to any form of manufacturing or processing, the measure of value for computing the use tax is the total cost of extraction and processing, including the cost of transportation to the processing point, but not including labor and transportation from the processing point to the job site.

(Emphasis added.)

Audit first assigned Taxpayer's direct costs for manufacturing aggregate to the Aggregate Division. Audit then allocated fixed overhead costs to the Aggregate Division using a payroll allocation based on Aggregate Division payroll as a percentage of total payroll.<sup>29</sup> Audit finally allocated indirect overhead costs by using a similar Aggregate Division payroll allocation, reducing the payroll expenses by scaling costs. Audit included Taxpayer's loading, ticketing, and dispatch costs as indirect overhead, and also included related employee costs. When Taxpayer's loaders loads either its own or its customer's trucks and tickets them at its . . . plant, they are still at the processing point. The dispatch office is still at the processing point as well. We conclude Audit correctly included loading, ticketing, and dispatch costs and related payroll costs in the measure of value of its cost calculation for Aggregate since these costs were all incurred at the processing point. ETA 3153.2009. The ETA only excludes labor and transportation costs incurred from the processing point to the job site, not costs incurred at the processing point.

Taxpayer argues that ETA 3153.2009 supports its position that these costs should be excluded from the cost calculation. We disagree. As we stated above, the ETA specifically excludes from the measure of value only labor and transportation from the processing point to the job site, and does not exclude any labor and transportation occurring at the processing point.

## 2. Canvas Covering

A manufacturer's purchase of certain manufacturing machinery and equipment may be exempt from retail sales tax. RCW 82.08.02565. RCW 82.08.02565(1) provides:

The provisions of this chapter shall not apply in respect to the use by a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation, to the use by a person engaged in testing for a

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<sup>29</sup> Taxpayer's fixed overhead costs include its general overhead, sales, and administrative costs.

manufacturer or processor for hire of machinery and equipment used directly in a testing operation, or to the use of labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the machinery and equipment.

“Machinery and equipment” is defined as:

[I]ndustrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts. "Machinery and equipment" includes pollution control equipment installed and used in a manufacturing operation, testing operation, or research and development operation to prevent air pollution, water pollution, or contamination that might otherwise result from the manufacturing operation, testing operation, or research and development operation.

RCW 82.08.02565(2)(a). However, “machinery and equipment” does not include:

(iii) Buildings, other than machinery and equipment that is permanently affixed to or becomes a physical part of a building . . .

RCW 82.08.02565(2)(b). The Department’s rule regarding the M&E exemption, WAC 458-20-13601, further discusses what buildings are in the context of what does not qualify for the M&E exemption:

. . . Buildings provide work space for people or shelter machinery and equipment or tangible personal property. The building itself is not eligible . . .

WAC 458-20-13601(6)(c) (emphasis added).<sup>30</sup>

Once an industrial fixture, device, support facility, or tangible personal property has been determined to be machinery and equipment, it must next meet the “used directly” test. RCW 82.08.02565(2)(c). An industrial fixture, device, support facility, or tangible personal property can meet this test if it “temporarily stores an item of tangible personal property at the manufacturing site . . . .” RCW 82.08.02565(2)(c)(ii). Thus, a structure will not qualify for the M&E exemption if it is “shelters” tangible personal property, but could qualify if is an industrial fixture, device, or support facility “storing” tangible personal property.

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<sup>30</sup> The Department issued Excise Tax Advisory 3124.2009 to help identify the physical parts of a building that qualify for the M&E exemption, among other reasons. The ETA states:

Those parts of buildings that serve a building function do not qualify for the exemption. Walls, roofs, and floors of buildings are designed on a case by case basis to accommodate a particular building use, whether that use is by a manufacturer, retailer, or professional service provider. Walls, roofs, and floors are also designed differently on the basis of external elements such as stability of the underlying earth, winter and summer temperature, and precipitation levels. Walls, roofs, and floors thus serve a general building function, even if designed and constructed differently.

In Det. No. 05-0345, 25 WTD 90 (2006), we specifically considered whether a canopy covering a slab used to store tangible personal property in a manufacturing operation was eligible for the M&E exemption. The taxpayer in that case erected a steel canopy over an asphalt pad to keep its finished treated lumber out of the rain. We concluded that the canopy did not qualify for the M&E exemption reasoning that the canopy “sheltered” tangible personal property instead of merely “storing” it, and therefore the canopy was a “building,” meaning it was specifically disqualified from the M&E exemption.

Just like in 25 WTD 90, Taxpayer here uses its canvas canopy to protect its recycled asphalt from frequent rains. Because Taxpayer “shelters” tangible personal property with its canvas canopy, the canopy is a “building” for M&E purposes. Since it is a “building,” it cannot qualify for the M&E exemption.

Taxpayer argues that its canvas canopy cannot legally be a “building,” citing to the three part test in *Chase v. Tacoma Box Co.* 11 Wn. 377, 39 P. 639 (1895) of when a chattel becomes a fixture.<sup>31</sup> As it’s not a “building,” Taxpayer argues, it is an “industrial fixture” subject to the M&E exemption under RCW 82.08.02565(2)(a) as it is “used directly” in its manufacturing operation by storing an item of tangible personal property at the manufacturing site. We disagree. The test for determining whether a covering is a “building” for M&E purposes is not found in *Chase*, but instead is a function test. 25 WTD 90. As we found above, like we found in 25 WTD 90, the canvas canopy here “shelters” the recycled asphalt, not “stores” it. Accordingly, Audit correctly excluded this item as being eligible for the M&E exemption, and we deny Taxpayer’s petition on this issue.

### 3. Inflation factor

Audit initially determined that Taxpayer could and should value its asphalt products using a comparable sales methodology. Taxpayer disagreed, and petitioned for review of Audit’s conclusion. Since filing for review, Taxpayer has completed numerous public works projects and has paid tax under protest, as it disagrees with the comparable sales methodology Audit has used to calculate the value subject to tax in completing these public works contracts. Audit has also added a 2% inflation factor for each year following 2012 to calculate the value of asphalt transferred internally. Taxpayer has disputed this 2% inflation factor. Since we concluded above that comparable sales is the proper valuation methodology, we remand to Audit to allow Taxpayer the opportunity to recalculate the values it has used in these public works contracts using comparable sales for years after 2012.

## DECISION AND DISPOSITION

We remand Taxpayer’s petition in part and deny it in part. We remand to Audit to allow Taxpayer the opportunity to recalculate the values it has used in these public works contracts

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<sup>31</sup> Taxpayer argues it does not meet the first and third elements of the three part test:

1. It is actually annexed to the realty,
2. Its use or purpose is applied to or integrated with the use of the realty it is attached to, and
3. The annexing party intended a permanent addition to the freehold

*Chase*, 11 Wn. at 381.

using comparable sales. Taxpayer has 60 days from the date of this determination to submit these recalculations, along with supporting documentation, or a longer timeframe at Audit's discretion. We deny the remainder of Taxpayer's petition.

Dated this 20th day of July 2016.