

Cite as Det. No. 94-244ER, 16 WTD 18 (1996)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition)	<u>D</u> <u>E</u> <u>T</u> <u>E</u> <u>R</u> <u>M</u> <u>I</u> <u>N</u> <u>A</u> <u>T</u> <u>I</u> <u>O</u> <u>N</u>
For Executive Reconsideration)	
of the Assessment of)	
)	No. 94-244ER
)	
. . .)	Registration No. . . .
)	FY. . . /Audit No. . . .
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RULE 136: MANUFACTURING - PACKAGING - COMBINING ITEMS TO ACHIEVE A SPECIAL PURPOSE - ANALYSIS UNDER ETB 398. Absent new legislation, case law, or regulations, the 1993 revision to ETB 398 will be used exclusively to determine the tax consequences of combining items to achieve a special purpose product; the Department, in revising the ETB, considered and weighed all of the manufacturing/packaging cases that had been previously decided.

1 RULE 136; ETB 389: MANUFACTURING v. PACKAGING - COMBINING ITEMS TO ACHIEVE A SPECIAL PURPOSE. When Taxpayer has components manufactured to its specifications in Germany, including the stamping of its name on each piece, and has these components shipped in bulk to its Washington location where it packages the components in sets of six without modifying them. Taxpayer is engaged in mere packaging, and not manufacturing, for B&O tax purposes.

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:

Petition concerning the applicability of manufacturing business and occupation (B&O) tax to the packaging of components for sale to consumers so that they may assemble a test set.¹

FACTS:

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

Bauer, A.L.J. -- This is an executive-level reconsideration of Determination No. 94-244 issued November 23, 1994. That determination held Taxpayer liable for manufacturing B&O tax on its packaging of six component parts which, when put together by a consumer, constituted an industrial test lead set. Taxpayer disagreed, contending that the Administrative Law Judge erred in finding that its packaging of the six components of a test set in a blister pack resulted in a new and different product.

The facts are as stated in Determination No. 94-244. Summarized, they are as follows:

A German company manufactured components of an industrial test kit to Taxpayer's specifications. Each kit was comprised of two clamps, two needle probes, and two connector cords. The German company impressed Taxpayer's name on each component, wire-tied each connector cord, and shipped them to Taxpayer in bulk, i.e., boxes of cords, boxes of clamps, and boxes of probes.

Taxpayer took the components out of the boxes in which they had been shipped in bulk from Germany and put them into individual cardboard-backed blister packages -- two of each of the three components (for a total of six) to a box. These packages were then shipped to Taxpayer's distributors as test kits.

No assembly, connection, reconfiguration, change, or processing of the components occurred. No changes were made to those components received from the German manufacturer; they were simply taken out of the boxes in which they had been shipped from Germany and packaged.

The individual cardboard-backed blister packages into which the finished products were placed were purchased by Taxpayer from a Michigan supplier. Like the individual components being packaged, the packaging was not further altered or processed by Taxpayer. No instructions on use of the kit were added to the packages, but a description of each of the components was printed on the cardboard portion of the package when fabricated in Michigan.

Once sold by Taxpayer's distributors, ultimate purchasers would use these test kits to test electrical current by using a combination of the connector cords, clamps, and probes. No complicated assembly into a final product was necessary.

The components, when combined into kits, sold for a lower price than if the same number and type of components were purchased separately.

Taxpayer has requested a credit or refund for taxes it paid on its combining and packaging of these test kits.

ISSUES:

1. What is the appropriate standard by which the Department will determine whether the combining and packaging of different parts, sold as a kit for assembly by the consumer, constitutes an entirely new and different product subject to the manufacturing B&O tax?

1. Is a Washington taxpayer liable for manufacturing B&O tax when three different components are manufactured to its specifications in Germany, imprinted with Taxpayer's name, and are shipped in bulk to Taxpayer in Washington for packaging into sets of two of each, without further modification, resulting in test kits to be assembled by consumers?

DISCUSSION:

[1] Excise Tax Bulletin 398.04.136 (ETB 398), last revised March 1, 1993, represents the Department's position on the tax consequences of combining items to achieve a special purpose product. In adopting this revision of the ETB, the Department considered all of the many manufacturing/packaging cases that had previously been decided regarding this state's manufacturing B&O tax, most of which have also been extensively cited and analyzed by both Taxpayer and the Department in the course of this case. The principles of these cases, none of which specifically addressed this fact pattern, were weighed and considered in the Department's 1993 revision of ETB 398. Thus, the ETB already takes into account these cases, and they need not be further analyzed to reach the correct result.

The ETB provides, in part:

. . . The Department considers "manufacturing" to include the assembling of products from component parts. The manufacturing tax applies to persons located in Washington who purchase from various suppliers component parts and apply

labor to assemble these parts into a new, different, or useful product. In some cases the "assembly" may consist solely of combining parts from various suppliers to create an entirely different product which is sold as a kit for assembly by the purchaser. In these situations the manufacturing tax will apply even if the person combining the parts does not completely assemble the components, but sells them as a package. For example, a person who purchases component parts from various suppliers to create a wheelbarrow, which will be sold in a "kit" or "knock-down" condition with some assembly required by purchaser, will be a manufacturer. The purchaser of the wheelbarrow will not be a "manufacturer" even though the purchaser must attach the handles and wheel.

The Department will consider various factors in determining if the person who combines various items into a single package is engaged in manufacturing. These factors include, but are not limited to:

- (1) The ingredients are purchased from various suppliers.
- (2) The person combining the ingredients attaches its own label to the product.
- (3) The ingredients are purchased in bulk and broken down into smaller sizes.
- (4) The combined product is marketed at a substantially different value from the selling price of the individual components.
- (5) The person combining the items does not sell the individual items except within the package.

Any single one of the above factors is not conclusive evidence of a manufacturing activity. However, the presence of one or more of the above factors raises a presumption that a manufacturing activity is being performed. Persons who combine items into special purpose packages should request a ruling from the Department if they are uncertain of their tax liability. . . .

(Emphasis added.)

[2] In applying factors (1) and (2) of the ETB to the facts in this case, it is significant that Taxpayer did not purchase the component parts of its test kit from different suppliers. All components, in fact, were manufactured by a German manufacturer to Taxpayer's own specifications, including the individual imprinting of each piece with Taxpayer's name.

Factor (1), "[t]he ingredients are purchased from various suppliers," clearly may not be answered in the affirmative. All components in fact came from, and were specially manufactured for, Taxpayer by the same German manufacturer.

Factor (2), "[t]he person combining the ingredients attaches its own label to the product," addresses situations in which various components are combined in this state and, as a result of such combination, take on a completely new identity separate and apart from the mere sum of those components of which it is made. In other words, this factor addresses the situation whereby a taxpayer has, in combining a variety of components, so changed their collective character that they are no longer merely a variety of others' products, but a newly-identifiable product in its own right.

In this case, Taxpayer did, technically, package its product in this state with packaging that was imprinted with its name. Taxpayer's "label," however, was already on each and every component before being shipped to Taxpayer in this state, already having been imprinted with Taxpayer's name at the time of its manufacture in Germany. These components, further, were conceived, designed and manufactured by and at Taxpayer's direction to be used with each other. Taxpayer's "attach[ment] of its own label to the product" to the packaging in this state, therefore, did not signify that a new product had been formed from a combination of previously unrelated parts, and the labeling by Taxpayer did not denote that a combination of previously unrelated parts had now assumed a new and different identity. Therefore, factor (2) in this case is not answered in the affirmative.

As to factor (3), the components were indeed purchased in bulk (i.e., large quantities) and broken down into smaller sizes (i.e., smaller quantities). This factor, then, must be answered in the affirmative.

Although the Administrative Law Judge in Det. No. 94-244, supra, at 4-5, found that there had been an "enhancement in value" because of an "increased demand caused by the grouping," we do not agree that factor (4) of the ETB is referring to this sort of enhancement. Factor (4) of the ETB merely attempts to establish whether the combination of various components in a single package has enhanced the sales value. To determine this, the ETB looks to the variance in selling prices of the packaged combination of components versus the total of the individual components sold separately. A substantial increase in value (measured by selling price) of the combination of components over the combined selling prices of the individual components is indicative that a "manufacturing" activity has taken place. An absence of a substantial increase in selling price, however, does not necessarily indicate the opposite - that manufacturing has not taken place. This is because there are many marketplace reasons (such as packaging, inventory control, etc) why the combined selling prices of individual components might still

equal or exceed the price of the combined components.² Therefore, the absence of a substantial increase in value will be considered a neutral factor.

Taxpayer prepared the components for sale both separately and in the combined test kit package. The combined product consisting of six of these components (i.e., the packaged test kit) was sold for \$34, and the individual components, purchased separately, sold for \$42. The selling price of the packaged test kit sold for less than its components purchased separately. Because Taxpayer did in fact market the individual components separately for a higher combined price, neither factor (4) nor (5) can be answered in the affirmative.

In reconsidering Taxpayer's activities and arguments solely in light of ETB 398's criteria, we are persuaded that its Washington activities did not constitute manufacturing in this state. Taking all five of the ETB's factors together, qualitatively as well as quantitatively, we find that Taxpayer was merely combining and packaging its own product in this state, and that the presumption of manufacturing raised by factor (3) has been overcome by the strength of factors (1), (2), and (5). Therefore, we hold that there were no changes in the form, quality, or properties of the components -- either individually or as a group -- which mandated the imposition of the manufacturing tax.

DECISION AND DISPOSITION:

Taxpayer's petition for correction of assessment and refund is granted. This matter is being remanded to the Audit Division for issuance of the appropriate refund amount.

DATED this 29th day of March, 1996.

² For example, the selling price of a manufactured automobile is substantially less than the combined selling prices of all its component parts, even though manufacturing has taken place.