Cite as Det. No. 98-224, 19 WTD 212 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 98-224
. . .	)	Registration No. . .
	)	FY . . ./Audit No. . . .

[1] RULE 159; RCW 82.04.480: B&O TAX -- PROCESSING FOR HIRE OR MANUFACTURING -- AGENCY SOFTWARE -- FULFILLMENT CENTER. Taxpayer's claim of agency on sales of computer software to customers was not recognized where Taxpayer failed to establish all of the requirements of Rule 159.

[2] RULE 103, RULE 230; RCW 82.04.040, RCW 82.32.050: USE TAX -- LIMITATION FOR ASSESSMENTS -- TIME AND PLACE OF SALE -- DELIVERY -- TITLE TRANSFER. Use tax was not due on the plate-making machine originally sold and delivered in 1988 even though title did not actually transfer until 1991.

. . .

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 computer software supplier protests the disallowance of a credit for overpaid business and occupation (B&O) taxes on amounts reported on software sales and other taxes assessed in an audit report. [1]

FACTS:

Okimoto, A.L.J. -- . . . (Taxpayer) is a computer software supplier based in . . ., Washington. Taxpayer's books and records were examined by the Audit Division (Audit) of the Department

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

of Revenue (Department) for the period October 1, 1990 through March 31, 1994. The initial audit resulted in additional taxes and interest owing of $. . ., and Document No. FY . . . was issued in that amount on December 12, 1994. Because of factual errors in the original assessment, Audit sent out a second auditor to correct the original assessment. The amended assessment resulted in additional taxes and interest owing of $ . . ., and Document No. FY . . . was issued in that amount on March 13, 1996. Taxpayer made a partial payment of $ . . . on the unprotested portion of the assessment, and the balance remains due.

Sales of Computer Software to OEMs

In Schedules IV & VII, Audit assessed wholesaling and manufacturing B&O taxes on the gross amounts billed and collected from sales of duplicated software disks and manuals that were sold to original equipment manufacturers (OEMs). Taxpayer described its business activity in its petition as follows:

> [Taxpayer] serves as an order fulfillment center for software development companies (Software Co.) such as . . . . Pursuant to a contractual agreement with Software Co., [Taxpayer] will receive a diskette copy containing software source code, plus instructions for producing the appropriate software packaging, documentation, labels and disk envelopes. [Taxpayer] will then produce CDs containing the software program. [Taxpayer] also produces all the software packaging and manuals, resulting in a completed shrink-wrapped "canned" software program ready for sale.
>
> Software Co. is engaged in creating and selling its software programs and will contract with various purchasers, primarily large distributors, to purchase its software. After Software Co. has entered in a sales relationship with a purchaser, Software Co. or the customer will place purchase orders with [Taxpayer]. [Taxpayer] will then ship shrink-wrapped software packages to the purchaser. [Taxpayer] issues invoices and collects funds in Software Co.'s name. [Taxpayer] also maintains a telephone ordering number and 24-hour fax line in Software Co.'s name for receiving orders from Software Co.'s customers. The purchaser is not necessarily aware that it is dealing with a third party fulfillment center.
>
> [Taxpayer] invoices Software Co.'s customers for a total amount which includes a "Price" and a "Fee". The "Price" is an amount established by Software Co. [Taxpayer] may not charge any more or less than the established price. The "Fee" is an amount negotiated between [Taxpayer] and Software Co. and is [Taxpayer]'s fee for producing and shipping the software packages and serving as Software Co.'s collection agent for the software it ships. [Taxpayer] forwards the "Price " amount to Software Co. and retains the fee. (Bracketed material added.)

Although Taxpayer acknowledged that it had reported 100 percent of gross proceeds collected from the sale of software disks and manuals under the retailing and wholesaling tax classifications during the audit period, it now argues that it incorrectly reported that income. Taxpayer states that it should

have reported only fees retained under the processing for hire tax classification. Taxpayer relies on WAC 458-20-159 (Rule 159) and WAC 458-20-136 (Rule 136) in support of its position.

After the hearing and, again, prior to this determination being drafted, Taxpayer was asked to submit sample copies of its software invoices to OEMs to substantiate its claim that charges for software packages were billed solely in the name of Software Company and not in the name of Taxpayer. So far, no invoices have been submitted.

. . .

Use Tax on Plate-Making Equipment:

In Schedule XI, Audit assessed use tax on plate-making equipment that was purchased at a reduced price from [supplier]. Audit assessed tax based on the equipment's estimated fair market value of $67,000. Taxpayer explained in its petition:

> In October 1988 [Taxpayer] entered into an agreement with . . . [supplier] whereby [Taxpayer] agreed to purchase from [supplier] $230,000 worth of merchandise per year for a period of three years. Pursuant to this agreement, [Taxpayer] purchased equipment from [supplier] for a stated price of $20,000 (Attachment B). The amount paid for this equipment was less than the typical retail price of $67,000. [Taxpayer] received a price discount as a result of its agreement to purchase substantial amounts of supplies from [supplier]. The equipment became the property of [Taxpayer]'s at the termination of the three year agreement. If [Taxpayer] failed to purchase the agreed upon volume of supplies, the equipment would either be purchased by [Taxpayer] at its depreciated value less deposit, or returned to [supplier].

First, Taxpayer relies on RCW 82.32.050 and argues that the statute of limitations for assessments has expired on equipment acquired in 1988. Taxpayer states that the Department is barred from imposing any additional tax on this equipment. In addition, Taxpayer maintains that it has already been assessed and paid use tax on $18,400 attributed to this same equipment during a prior audit. Taxpayer contends that it should only owe tax on the unpaid difference, if at all. Although Taxpayer concedes that $67,000 was the fair market value of the equipment at the time it was first used in 1988, Taxpayer states that it actually paid only $20,000 and that the proper measure of the tax should be the $20,000 selling price.

Consumable Supplies Projection:

In Schedule XIII, Audit tested the sample year 1992 to determine the amount of consumable supplies upon which Taxpayer had failed to pay retail sales or use tax. Based on the results of the test year, Audit projected that error factor into other years to arrive at a projected amount of purchases subject to use tax throughout the audit period.

First, Taxpayer states that the sample year, 1992, was not representative of the entire audit period. Taxpayer explains that in 1993 Taxpayer implemented new procedures for reporting use tax and that it estimates that it now reports 95% of all consumable purchases subject to use tax on its monthly excise tax return. Although Taxpayer acknowledges that 1992 may be representative for years prior to that date, it is not representative for periods after the new procedures were implemented.

Second, Taxpayer objects to the following items included in the test period.

> A purchase from . . . for "FULL SERVICE SOFTWARE SUPPORT ANNUAL" in the amount of $3,600 dated Oct. 1, 1991 and invoice #105205. Taxpayer states that this represents charges for computer software telephone support that is exempt under WAC 458-20-155 (Rule 155). Audit contends that it includes some software maintenance charges.
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> Purchases of fountain solutions from . . . and . . . . Taxpayer states that fountain solutions are exempt as a chemical used in processing under RCW 82.04.050(1).
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> Purchases of paper from . . . Co. for $2,685.14. Taxpayer states that the paper becomes a component part of printed products that are sold to customers and therefore exempt under RCW 82.04.050(1).

Sales Tax on Equipment Sales to out-of-state Purchasers:

In Schedule XVII, Audit assessed uncollected retail sales tax on two sales of fixed assets. In January of 1993 Taxpayer sold bindery equipment to . . ., a company located in . . ., Georgia. In June of 1993, Taxpayer sold a punching tool to Ash Equipment, a company located in . . ., California. In both instances, Taxpayer states that it shipped the equipment to purchasers via a common carrier. Taxpayer denies that the purchasers took delivery in Washington and, therefore, contends it was not obligated to collect retail sales tax. In the alternative, Taxpayer also argues that both purchases were for resale.

ISSUES:

1) Is Taxpayer selling packages of canned computer software solely as an agent of Software Company, or in its own name?

. . .

3) Is use tax due on a plate-making machine originally acquired in 1988 even though title did not actually transfer until 1991?

4) If so, is use and/or deferred retail sales tax due on the $20,000 purchase price or on the $67,000 fair market value of the equipment?

5) Is use and/or deferred retail sales tax due on various purchases of consumable supplies?

DISCUSSION:

Sales of Computer Software to OEMs

Taxpayer and Audit agree that Taxpayer manufactures and sells canned computer software to OEMs. Both also agree that these constitute sales of tangible personal property. The only issue is whether Taxpayer sells these products in its own name and therefore taxable on the gross proceeds of sale, or in the name of and as an agent for, Software Company. Under the latter scenario, Taxpayer contends that Rule 136 taxes only that portion of the sales proceeds retained by Taxpayer under the processing for hire tax classification.

RCW 82.04.480 provides specific statutory guidance for persons selling products in their own name or as agents. It states in pertinent part:

> Every consignee, bailee, factor, or auctioneer having either actual or constructive possession of tangible personal property, or having possession of the documents of title thereto, with power to sell such tangible personal property in his or its own name and actually so selling, shall be deemed the seller of such tangible personal property within the meaning of this chapter; and further, the consignor, bailor, principal, or owner shall be deemed a seller of such property to the consignee, bailee, factor, or auctioneer.
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> The burden shall be upon the taxpayer in every case to establish the fact that he is not engaged in the business of selling tangible personal property but is acting merely as broker or agent in promoting sales for a principal. Such claim will be allowed only when the taxpayer's accounting records are kept in such manner as the department of revenue shall by general regulation provide.

Rule 159 implements RCW 82.04.480 and clarifies:

> Any person who claims to be acting merely as agent or broker in promoting sales for a principal or in making purchases for a buyer, will have such claim recognized only when the contract or agreement between such persons clearly establishes the relationship of principal and agent and when the following conditions are complied with:
>
> (1) The books and records of the broker or agent show the transactions were made in the name and for the account of the principal, and show the name of the actual owner of the property for whom the sale was made, or the actual buyer for whom the purchase was made.
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> (2) The books and records show the amount of gross sales, the amount of commissions and any other incidental income derived by the broker or agent from such sales.

Rule 159 clearly states that in order for Taxpayer's claim of agency to be recognized, it must establish all three factors listed in the rule. The failure of any one factor nullifies the claim of agency. The first factor is that the agreement between Taxpayer and the principal, must clearly establish the principal/agency relationship. We have examined Taxpayer's Manufacturing, Fulfillment and Distribution Agreement dated March 24, 1992 between Taxpayer and Software Company. Nowhere in the agreement do we see a clear statement identifying Taxpayer as an agent for Software Company. Although the agreement does contain some language that allows for a principal/agency relationship, it also contains language allowing for a distributor/seller relationship. Regardless, the contractual language certainly **does not clearly** establish a principal/agency relationship between Taxpayer and Software Company, and we so find. Second, Taxpayer's books and records must "show the transactions were made in the name and for the account of the principal, and show the name of the actual owner of the property for whom the sale was made…" To verify this fact, we requested copies of Taxpayer's billing invoices to OEMs and other customers and related documentation. Subsequent follow-up requests have failed to produce the documentation. Therefore, we must presume that Taxpayer's records do not support its claim of agency. Since Taxpayer could not establish either of the first two factors, we find that Taxpayer's claim of agency shall not be recognized. Accordingly, Taxpayer's gross proceeds from its sales of canned software are properly taxed under the manufacturing and wholesaling tax classifications. Taxpayer's petition is denied on this issue.

Taxpayer also states that it incorrectly reported amounts retained under the service and other activities tax classification, thus resulting in double reporting this income. Since this is primarily a factual issue, we will remand this issue back to Audit for investigation or further factual development.

Use Tax on Plate Making Equipment

The limitation of assessments on which Taxpayer relies is contained in RCW 82.32.050(3). It states in pertinent part:

> No assessment or correction of an assessment for additional taxes, penalties, or interest due may be made by the department more than four years after the close of the tax year, except (a) against a taxpayer who has not registered as required by this chapter, (b) upon a showing of fraud or of misrepresentation of a material fact by the taxpayer, or (c) where a taxpayer has executed a written waiver of such limitation.

Taxpayer contends that the equipment was first used and placed into service on Taxpayer's books in October of 1988 when an initial payment of $20,000 was made. Taxpayer argues that this date marks the point from which the statute of limitations period begins.

RCW 82.04.040 defines "sale" as:

> . . . any transfer of the ownership of, title to, or possession of property for a valuable consideration and includes any activity classified as a "sale at retail" or "retail sale" under

> RCW 82.04.050. It includes renting or leasing, conditional sale contracts, leases with option to purchase, and any contract under which possession of the property is given to the purchaser but title is retained by the vendor as security for the payment of the purchase price.

WAC 458-20-103 (Rule 103) explains the time and place of a sale. It provides:

> For the purpose of determining tax liability of persons selling tangible personal property, a sale takes place in this state when the goods sold are delivered to the buyer in this state, irrespective of whether title to the goods passes to the buyer at a point within or without this state.

Rule 103 clearly states that a sale of tangible personal property takes place in this state when the goods are delivered to the buyer in this state. In Taxpayer's case, the plate machine was delivered to Taxpayer in 1988. Furthermore, RCW 82.04.040 clarifies that even though title to the goods may be retained by the vendor for security purposes, this does not preclude the existence of a sale. Indeed, we find Taxpayer's acquisition of the plate machine to be simply a sale for a cash payment of $20,000, in addition to a promise to purchase a minimum amount of plate supplies. This transaction is analogous to a conditional sales contract, in which case the "…seller reserves title until buyer pays for goods, at which time, the condition having been fulfilled, title passes to buyer." Black's Law Dictionary, at 267 (5th ed. 1979). In Taxpayer's case, the seller reserved title to the plate machine until Taxpayer fulfilled its obligation to purchase a minimum amount of plate supplies over a three year period at which time title passed to Taxpayer.

WAC 458-20-198 (Rule 198) explains how conditional sales are to be reported. It states:

> Persons making conditional sales or other installment sales of tangible personal property must report the total selling price of such sales in the tax period in which the sale is made.
>
> The foregoing is true irrespective of the fact that such sellers arrange to receive payment of tax in installments or that a contract may be discounted or pledged with or sold to a finance company.

Rule 198 states that the total selling price of a conditional sales contract is to be reported in the tax period during which the initial sale was made. This is true even though the purchaser may be required to make future payments or fulfill other contractual obligations. In Taxpayer's case, its "other contractual obligation" was to purchase a minimum amount of plate supplies over a three year period. Even though this contractual obligation was not fulfilled until 1991, Rule 198 dictates that the sale was made in 1988. Since RCW 82.32.050 requires that assessments for additional taxes must be made within four years of the close of the calendar year in which the equipment was sold (in this case December 31, 1992), the assessment period for this equipment has expired. See also, WAC 458-20-230(9)(a)&(f). Accordingly, Taxpayer's petition is granted on this issue.

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Consumable Supplies

Taxpayer's objections in Schedule XIII involve several legal issues, which we will cover separately. Concerning Taxpayer's objection to the test period, we take administrative notice that the use of test periods is a standard audit procedure, which benefits both the Department and the taxpayer by saving substantial amounts of time and effort. Fundamental to the use of test periods, however, is the necessity that both parties be satisfied that the period utilized is a true and accurate representation of the error factor throughout the audit period. In this case, Taxpayer believes that this error factor is not an accurate representation and, therefore, is not satisfied with the test period. Accordingly, we will remand this issue back to Audit for an expansion of the test period.

Next, Taxpayer protests the assessment of use tax on a purchase from . . . for $3,600 dated Oct. 1, 1991, invoice #105205. After the hearing Taxpayer submitted a copy of invoice #105205. It contained the following information.

October 1, 1992	Full service software subscription	$850.00
	Full service software support	$300.00
	Full service AOS/VS subscription and support	$ 43.75
Total		$1,193.75

Taxpayer explained that the auditor in the previous audit period had assessed use tax on only the $893.75 ($850 + $43.75) software portion of the above monthly invoice. Following that auditor's instructions, Taxpayer states that it had been reporting use tax on the software portion of these invoices. Taxpayer speculates that the $3,600 charge is the annualized amount of the $300 monthly support charge. We agree that under Rule 155, telephone computer support is not subject to retail sales tax. Furthermore, since Taxpayer is separately paying for software, it seems unlikely that the above $300 charge would include a charge for software updates. Taxpayer's petition is granted on this issue.

Taxpayer also protests use tax assessed on purchases from . . . in the amount of $24,622.68. Subsequent to the hearing, Taxpayer's research indicated that most of these purchases were consumed in the manufacturing process. Taxpayer now contests only $5,001.42 in purchases for fountain solutions. Taxpayer also protests use tax assessed on purchases of fountain solutions from . . . . Taxpayer contends that fountain solutions are very similar to ink and actually become component parts of the printed products. Taxpayer's Pressroom Manager states:

> Fountain solutions used in offset lithography are comprised of water, wetting agents and a fountain solution concentrate. Fountain solutions are an integral part of the ink to water chemical balance that is required by the offset lithography process. Characteristics such as

> conductivity and pH play critical roles in the success of printability. The fountain solutions become part of the ink that is imprinted on paper materials produced by [Taxpayer].

Taxpayer argues that these purchases are exempt as a chemical used in processing. RCW 82.04.050(1) allows an exemption from retail sales tax for "a chemical used in processing, when the primary purpose of such chemical is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale…" Taxpayer has submitted no evidence explaining the nature of the alleged chemical reaction taking place or that the reaction is the fountain solution's primary purpose. Based on the submitted evidence, we remain unconvinced that the primary purpose of the fountain solutions is to create a chemical reaction directly through contact with an ingredient of a new article being produced for sale. Accordingly, Taxpayer's petition is denied on this issue.

Regarding Taxpayer's ingredient and components argument, we similarly find the proper documentation to be lacking. We note that the fountain solutions are not the same as ink, but only mix with ink that then becomes a component of the printed product. Taxpayer has submitted no evidence on the percentage of fountain solution remaining in the final printed product or even its existence there. Based on the submitted evidence, we remain unconvinced that fountain solutions are entitled to an ingredient and components exemption. We do believe, however, this area needs further factual development and we will remand this issue back to Audit to determine the amount, if any, of fountain solution that becomes part of the final printed product.

Sales Tax on Equipment Sales to out-of-state Purchasers:

In this Schedule XVII, Audit assessed uncollected retail sales tax on two sales of fixed assets. In January of 1993 Taxpayer sold bindery equipment to . . . , a company located in . . . , Georgia. In June of 1993, Taxpayer sold a punching tool to . . , a company located in . . , California. In both instances, Taxpayer states that it shipped the equipment to the purchasers via a common carrier. Taxpayer denies that the purchasers took delivery in Washington and, therefore, Taxpayer contends that it was not obligated to collect retail sales tax. In the alternative, Taxpayer also argues that both purchases were for resale. Subsequent to the hearing, Taxpayer submitted signed resale certificates from both companies. . . . certificate stated it was in the business of servicing and overhauling equipment in Georgia. . . . certificate indicated that it was in business of selling used equipment in California. Based on this documentation, we are satisfied that the equipment was purchased for resale and not subject to retail sales tax. Taxpayer's petition is granted on this issue.

DECISION AND DISPOSITION:

Taxpayer's petition is granted in part, denied in part, and remanded in part.

Dated this 29th day of December 1998.