Cite as 9 WTD 179 (1990)

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

In The Matter of the Petition For Correction of Assessment of . . .	)	D E T E R M I N A T I O N No. 90-93 Registration No. . . . . . ./Audit No. . . .

[1] RULE 211, RULE 178: USE TAX -- TOOLING -- USE AS BAILEE. The use of tooling as a bailee is subject to use tax in situations where the bailor has not paid the use or sales tax on the items. When the items are used by the bailee before the sales tax is billed or paid by the owner, or where the bailor is not subject to such taxes, the use tax is due from the bailee on the reasonable rental value of the tooling.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .

DATE AND PLACE OF CONFERENCE: . . .
. . .

NATURE OF ACTION:

Taxpayer protests the assessment of use tax/deferred sales tax on tooling.

FACTS AND ISSUES:

Hesselholt, A.L.J. (successor to Potegal, A.L.J.) -- Taxpayer is a manufacturer of . . . parts. Its books and

records were audited for the period . . . through . . . . Taxpayer objected to several parts of the assessment.

On Schedule VI of the audit, taxpayer claimed credit on the use tax for deferred sales tax on consumables. Taxpayer requested a credit based on a 60% figure supplied by the "tooling supervisor." In the explanation of the schedule, the auditor stated that adjustments would be made when documentation was provided. At the time the audit was finalized, the taxpayer had agreed to pull the purchase invoices for examination so that the amount could be corrected. Taxpayer apparently determined later not to pull the invoices and requested the 60% credit.

On Schedule VII of the audit, which represented use tax on tooling, the auditor explained the tax as follows:

> As the tooling had not been purchased by the buyers before it was put to use by [Taxpayer], a bailment situation does not arise. [Taxpayer] has manufactured tooling for its own "commercial and industrial use". Manufacturing of tangible personal property for "commercial and industrial use" is subject to BOTH the manufacturing business and occupation tax and the use tax on the RETAIL SELLING PRICE of the articles produced. (Wac 458-20-134 and WAC-20-178) . . .
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> However, for future tax planning, the reverse is true. If the tooling had been purchased by the buyer BEFORE it was put to use by [taxpayer], a bailment situation does arise. "Bailment" being the right of possession to and the use of tangible personal property without consideration (458-20-211). If the bailor/buyer has paid the sales tax, there would be no use tax liability to [taxpayer]. If the bailor buyer has not paid the sales tax, the retail value of the property is subject to use tax.

Taxpayer argued that

> [Taxpayer] is directed to make . . . parts and tooling for various customers. Customer/buyer agrees to pay for tooling after it has successfully completed a test run of parts. Upon completion, customer will pay for the tooling and the usable parts made during the test run. If the test run does not result in a usable part, [taxpayer] must

> continue to develop the tooling until an acceptable test run is obtained. Hence the tool does not exist until it has completed the test run and said test run is accepted by the customer.
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> The materials used to make the tool belong to the customer/buyer from the point of purchase by [taxpayer], as indicated by copy purchase order agreement and trade agreement enclosed for your perusal. Our client has agreed to bill their customer for the materials and labor upon completion of the development of the tool. The Use of Tool for a Test Run Does Not Constitute Use of Tool by [taxpayer].
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> In view of the abovementioned, tools are owned by the customer/buyer first as after the test-run is completed, o.k.[ed] by the customer, manufacturing is complete, title passes on to the buyer automatically. Use by [taxpayer] either during the Test Run or after the Test Run is o.k.[ed], manufacturing completed, title passes to the buyer, is as Bailee only using the same without consideration to the Bailor/Customer. . .
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> Sale of Tooling has taken place Prior to Use by [taxpayer] during Test-Run or After Test-Run O.K.[ed], Manufacturing is Completed, Title Passes to the Buyer/Customer immediately and automatically.

Taxpayer submitted a copy of what it referred to as "Agreement Purchase Order." The document was a list of provisions to which a purchase order was subject. The following sections are relevant:

> 13. INFORMATION: (a) Drawings, data, design, inventions, computer software and other technical information <u>supplied by Buyer</u> shall remain Buyer's property and shall be held in confidency by Seller. Such information shall not be reproduced, used or disclosed to others by Seller without Buyer's prior written consent, and shall be returned to Buyer upon completion by Seller of its obligations under this order or upon demand. (b) Any information which Seller may disclose to Buyer with respect to the design, manufacture, sale or use of the articles

covered by this order shall be deemed to have been disclosed as part of the consideration for this order, and Seller shall not assert any claim against Buyer by reason of Buyer's use thereof.

14. BUYER'S PROPERTY: (a) All property used by Seller in connection with this order which is owned, furnished, charged to or paid by Buyer including, but not limited to, materials, tools, dies, jigs, molds, patterns, fixtures, equipment, drawings and other technical information, specifications, and any replacement thereof, shall be and remain the property of Buyer subject to removal and inspection by Buyer at any time without cost or expense to Buyer and Buyer shall have free access to Seller's premises for the purpose of inspecting or removing such property. All such property shall be identified and marked as Buyer's property, used only for this order and adequately insured by Seller at its expense for Buyer's protection. Seller shall assume all liability for and maintain and repair such property and return the same to Buyer in its original condition, reasonable wear and tear excepted, and when such property is no longer required hereunder, Seller shall furnish Buyer with a list thereof and shall comply with any Buyer disposition instructions applicable thereto. Buyer shall not be obligated to pay any invoices for tooling until the first article produced therefrom shall be received and accepted. Notwithstanding the foregoing, upon written notice to Buyer and to the extent such use will not interfere with Seller's performance of this or other orders from Buyer in effect at the time Seller enters into a direct contract with the U.S. Government, Seller shall have the right to use Buyer's property in the manufacture of end items for direct sale to the U.S. Government to the extent the Government has the right under its prime contracts with Buyer to authorize such use by Seller, provided that, to the extent practicable, Seller prominently identifies each such end item as being manufactured by Seller for direct sale to the U.S. Government. (B) Materials, excluding Government Property, furnished by Buyer on other than a charge basis in connection with this order shall be held by Seller as bailee thereof. Seller agrees to pay Buyer's replacement cost for all such material spoiled or otherwise not satisfactorily

> accounted for over and above 2% thereof allowable for scrap loss.
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> * * *
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> 26. TITLE: Except if title has heretofore passed to Buyer or Buyer's customers under provisions of this order, title to the articles shall pass to Buyer upon delivery of the articles to the F.O.B. point named herein.

(Emphasis ours.)

During the audit, taxpayer's representative sent a letter to the Department of Revenue's Taxpayer Information and Education Division (TI&E) requesting an opinion regarding the taxability of taxpayer's activities. The taxpayer's identity was not disclosed in the letter. Taxpayer has not provided a copy of the initial letter to TI&E, but has enclosed a copy of the first letter it received from TI&E. That letter states, in part:

> You stated that a client of yours is a manufacturer of . . . parts and is a subcontractor to . . . manufacturers. In order to make a specific part for an . . . company, it often has to first manufacture a tool to make the part. In such cases, the tool can only be used to make the one part it was designed for. In addition, under the terms of the contract between the two parties, a copy of which you enclosed, the tool is at all times the property of the customer as bailor. The customer/bailor has unrestricted right of access and removal of the tools from your client/bailee.
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> . . . You would like it confirmed that the fact that your client uses the tool as bailee before it has billed the customer/bailor does not affect the tool's taxability with respect to use tax.
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> . . . based on the facts as you have presented them, your client is not subject to use tax on the value of the tool it manufactures and uses as a bailee. A sale takes place in Washington at the time title

> passes to the buyer. In the instant case, this takes place at the time the manufacturing of the tool is completed. Thus, the sale of the tool has taken place prior to use by your client, the customer is the bailor, and will pay retail sales tax on the tool. The timing of payment of the sales tax by the customer/bailor is immaterial.

On July 13, once TI&E had been notified that the letter had been requested on behalf of someone who was under audit, it sent a letter to taxpayer's representative explaining that the original letter was to be disregarded. Taxpayer claimed, in October, to be relying on the letter.

Taxpayer also submitted several letters from its customers stating that

> . . . tools from day one are our property, title vests with us from the time manufacturing of the tooling is complete after successful test runs at the same as O.K. by us.

Taxpayer also submitted a copy of the clause covering title to tooling on work done for the U.S. government, which states that

> Immediately, upon the date of this contract, title to all parts. . . special tooling. . . ; special test equipment and other special tooling to which the Government is to acquire title . . . theretofore acquired to produced by the Contractor and allocable or properly chargeable to this contract. . . shall forthwith vest in the Government; and title to all like property thereafter acquired or produced by the Contractor and allocable or properly chargeable to this contract as aforesaid shall forthwith vest in the Government upon said acquisition, production or allocation. . . .

Taxpayer submitted a list of purchase orders in which title vested with the Federal Government under the above section, claiming that because the titled vested with the Federal Government, which is a sales tax exempt entity, taxes on such items should be deleted. Taxpayer also argued that the sales were wholesale sales (as taxpayer was a subcontractor for the parts) and that it took resale certificates on the sales in good faith.

DISCUSSION:

The use tax is imposed by RCW 82.12.020. It is imposed on the value of tangible personal property used in this state, unless the use tax or retail sales tax has previously been paid on the property. RCW 82.12.020. RCW 82.12.010 provides, in relevant part:

> . . . In case the articles used are acquired by bailment, the value of the use of the articles so used shall be in an amount representing a reasonable rental for the use of the articles so bailed, determined as nearly as possible according to the value of such use at the places of use of similar products of like quality and character under such rules and regulations as the department of revenue may prescribe. . .
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> In the case of articles manufactured or produced by the user and used in the manufacture or production of products sold or to be sold to the department of defense of the United States, the value of the articles used shall be determined according to the value of the ingredients of such articles.

(Emphasis ours.)

RCW 82.12.0252 provides, in relevant part, that:

> The provisions of this chapter shall not apply in respect to the use of any article of tangible personal property purchased at retail or acquired by lease, gift or bailment if the sale thereof to, or the use thereof by, the present user or his bailor or donor has already been subjected to the tax under chapter 82.08 or 82.12 RCW and such tax has been paid by the present user or by his bailor or donor. . . .

A bailment is defined at WAC 458-20-211 as

> . . . the act of granting to another the temporary right of possession to and use of tangible personal property for a stated purpose without consideration to the grantor. . . .

Taxpayer argues that the situation created between itself and its customers results in a bailment situation once the tooling has been accepted. According to it, its contracts provide that the title to the articles passes when they are accepted. The purchase orders provided show that articles charged to the buyer become its property. It is not clear that the articles are charged to the buyer at the time that they are accepted, although that is a reasonable assumption. It is clear that the taxpayer and its buyers consider that the buyers are the owners of the tooling from the moment it is accepted, and Washington law provides that a buyer and seller can agree to pass title to goods at any time once they have been identified; otherwise, title passes once the seller has completed his performance with respect to those goods.[1] In this case, taxpayer has probably completed its performance with respect to the tooling once it has been accepted, and title passes at that time. In a situation such as this, the buyer does not purchase the goods to take possession of them; instead the buyer bargains for completion of the tool so that it can be used in manufacturing parts. Once title to the goods has passed, the buyer is bailing the tooling to the taxpayer for its use. It is clear that the buyer is not billed for the articles before they are used in the manufacturing process. Sales tax on the articles is therefore not paid before their use in the manufacturing.

It argues that the "use" of the tooling for a test run, to determine if the tooling is functioning correctly, is not a taxable use of the tooling. With this conclusion we agree. The testing required to determine whether or not a tooling functions correctly does not constitute taxable use of the tooling.

However, the Audit Division did not assert tax on the testing of the tooling. The tax was asserted on the use of the tooling to manufacture the actual parts that taxpayer sold to its buyers. The Department has always held that such use of the tooling is taxable use; in fact, the statutes cited above explicitly state that it is taxable use. The statutes provide that the only situations in which the use tax does not apply is when the tooling has already been subjected to sales or use tax and the tax has already been paid by the buyer.

The Audit Division asserted tax, arguing that the taxpayer was using the tooling for its own commercial or industrial use

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[1]RCW 62A.2-401.

because the tooling had not yet been purchased by the buyer. The fact that the purchase may not have been completed does not control here; title passed to the buyer and a bailment was created. The Audit Division correctly stated the tax consequences in a bailment situation.

[1] In this case, the taxpayer has not invoiced the buyer for the tax or received the tax from the buyer at the time it begins manufacturing items with the tooling. In many of the cases, the tooling is to be sold to an out-of-state buyer, or to a buyer who has stated that the item is to be resold to the United States government. The taxpayer has not and will not collect retail sales tax on those sales. The taxpayer is liable for use tax for the tooling used to produce those items. The activity being taxed here is not the sale of the tooling to the buyer, but the taxpayer's use. When the sale of the tooling is to an entity that is not subject to the use or sales tax, such as the U.S. government, then the taxpayer will always be liable for use tax on its use of the tool to manufacture the required parts. The tax is imposed, not on the exempt entity, but on the taxpayer.[2]

When the sale of the tooling is made to an entity subject to the Washington sales or use tax, if the tax is billed and collected before taxpayer uses the tooling to manufacture parts, taxpayer's use of the tooling will not be subject to the use tax. This is the explicit statutory scheme set by the legislature and the Department of Revenue has only the power to enforce those provisions, not to disavow or amend them.

The audit assessed the tax on the retail selling price of the tooling. The actual measure of the tax should have been the "reasonable rental value" of the tooling. RCW 82.12.010 defines the term as follows:

> In case the articles used are acquired by bailment, the value of the use of the articles so used shall be in an amount representing a reasonable rental for

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[2]This taxing arrangement was explicitly approved by the United States Supreme Court in Washington v. U.S., 460 US 536, 1983, which held that so long as the tax imposed on "those who deal with the Federal Government is a integral part of a tax system that applies to the entire state. . . " it was constitutional. The fact that the state could not tax the federal government directly did not rule out taxing it indirectly by imposing the tax on those who deal with the government.

> the use of the articles so bailed, determined as nearly as possible according to the value of such use at the places of use of similar products of like quality and character under such rules and regulations as the department of revenue may prescribe. . . .

Rule 211 provides that the reasonable rental value is to be determined as follows:

> The value of tangible personal property held or used under bailment is subject to tax if the property was purchased or acquired under conditions whereby the retail sales tax was not paid by the bailor. Tax liability is that of the bailor, or of the bailee if the bailor has not paid the tax. The measure of the use tax for articles acquired by bailment is the reasonable rental for such articles to be determined as nearly as possible according to the rental price at the place of use of similar products of like quality and character. In the absence of rental prices for similar products the reasonable rental may be computed by prorating the retail selling price over the period of possession had by a bailee and payable in monthly installments. No further use tax is due upon property acquired by bailment after tax has been paid by the bailee or any previous bailee upon the full original value of the article.

The audit will be remanded to the Audit Division for a recalculation of the amount of use tax due on the tooling. It is not clear from the facts presented whether the tooling can be used again after the parts are manufactured, or if the tooling is only usable for a limited period of time. If the tooling cannot be or is not used again, the retail selling price may be the correct rental value for the use of the tooling.

[2] Taxpayer claims that it has relied on the advice contained in the letter from TI&E dated June 22, 1988. The letter was explicitly rescinded and taxpayer was instructed on July 13, 1988, that it could not rely on it. In addition, the facts recited in the letter are not the true facts that existed. Any reliance by taxpayer on those letters is misplaced: firstly, TI&E was not given all of the relevant facts; secondly, the letter was rescinded; and thirdly, to the extent that the letter implies that any taxpayer could use tooling or dies to manufacture products without having first

both invoiced and collected the applicable sales tax, the letter is an incorrect statement of the law in Washington.

The taxpayer has been assessed tax on its use of bailed tooling in at least two previous audits, in 1975, and again in 1984. It appears that the tax was also assessed in the 1971 and 1979 audits, although it was not broken out into a separate schedule.

With respect to the tax assessed on consumable supplies in Schedule VI, taxpayer has proposed that it be allowed to deduct sixty percent of the items on the schedule. Taxpayer has provided no support for that figure; nor has it provided any documentation to show that the items taxed were not properly subject to tax or that tax had previously been paid on the items. The Audit Division informed taxpayer that it would review any invoices it was able to pull together. Taxpayer has apparently decided not to go through its invoices.

RCW 82.32.070 requires that any person subject to tax under the Revenue Act must keep adequate records so that his tax liability may be established. Failure to keep or provide such records to the Department renders that person unable to question any assessment in any proceeding. Taxpayer has produced no records showing that the assessment of tax in the Audit is incorrect. Once the tax is paid, should taxpayer locate such records within the statutory time limit, it may present them to the Audit Division and request a refund of taxes paid on those items.

DECISION AND DISPOSITION:

Taxpayer's petition is denied. The audit will be referred to the Audit Division for a recalculation of the use tax due on the tooling.

DATED this 26th day of February 1990.