Cite as Det. No. 04-0084, 24 WTD 365 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	DETERMINATION
	)	No. 04-0084
. . .	)	Registration No. . . .
	)	Document No. . . .
	)	Audit No. . . .
	)	Docket No. . . .

[1] RULE 112, RULE 189; RCW 82.12.010(1): USE TAX – PRINTED MATERIALS PRODUCED BY A COUNTY FOR ITS OWN USE -- MEASURE OF VALUE TAXED. The correct measure of tax includes every item of cost attributable to the production of the particular item. Such costs include labor, materials and both direct and indirect overhead.

[2] STATISTICAL SAMPLING – AUDIT DIVISION'S USE. Statistical sampling is a widely used and accepted sampling method. The Department will not overturn the results of such a sample when the use of the statistical sampling method was discussed with the Taxpayer prior to its use, no objection was raised until after the assessment was issued, and no factual error or legal authority was presented to overturn the results.

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.

Lewis, ALJ – Taxpayer appeals the assessment of use tax on the labor and overhead charges associated with the production of the printed materials used internally by the county. Taxpayer also appeals the Department's use of statistical sampling to calculate the amount of deferred retail sales tax/use tax due on the purchase of consumable supplies. We affirm the tax on both issues concluding: 1) the correct measure of value subject to use tax on printing done in-house for the county's own use is the total costs of production including, labor, overhead, and materials; and 2) Taxpayer has not presented any factual or legal argument to challenge the Audit Division's use of commonly accepted statistical sampling techniques to identify the tax

that is due.[1]

ISSUES:

1. Did the Audit Division err in assessing use tax on labor and overhead charges incurred by Taxpayer to produce printed materials for the use of the various county departments?

2. Did the Audit Division's use of statistical sampling to develop the amount of deferred retail sales tax/use tax due on consumable purchases result in flawed results?

FINDING OF FACTS:

. . . ("Taxpayer") is . . . also, the purchasing department of [County]. Taxpayer is separately registered with the Department of Revenue ("Department"). Taxpayer is the county department that reviews and pays all county purchases. As part of its business activity, Taxpayer operates an in-house printing plant, producing printed materials for all the county's departments. It has been Taxpayer's past practice to pay retail sales tax on its purchases of materials used in the printing operation.

The Audit Division of the Department audited Taxpayer's books and records for the period January 1, 1998 through December 31, 2001. On June 17, 2003 the Department issued a $ . . . tax assessment. On July 10, 2003, Taxpayer paid $ . . . , representing the uncontested portion of the assessment. On July 17, 2003, Taxpayer filed a petition requesting cancellation of the use tax arising from two audit adjustments.

The use tax was assessed on labor and overhead costs incurred by the county's in-house print shop on materials printed for and used by the various county departments. Apparently, the county had paid retail sales tax or use tax on the raw materials used, such as the paper and ink, but had failed to pay use tax on the associated labor and overhead costs.

Taxpayer also protested the use tax assessed on consumable supplies used by the county on which no retail sales tax had previously been paid. Taxpayer's protest was based on the use of statistical sampling to develop the amount of tax due. The Audit Division maintains that prior to the beginning of the audit a letter was sent to Taxpayer outlining the proposed sampling procedures that would be used. According to the Audit Division's response to Taxpayer's petition, "[a]t no time during the sample planning, sample review, or at the supervisor meeting did the taxpayer indicate a problem with the projection of errors found. The taxpayer had many opportunities to discuss the sampling procedures used in the audit. It appears the taxpayer's first formal communication of disagreement occurred in an appeal after the audit had been assessed."

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

ANALYSIS:

[1] Taxpayer's first issue of appeal, whether the Department correctly assessed use tax on the labor and overhead costs incurred by Taxpayer when producing printed materials for internal use by the other county departments, is not an issue of first impression. The issue is squarely addressed by both a published determination and administrative rule.

Det. No. 89-546, 8 WTD 445 (1989), addresses the exact same issue that Taxpayer raises. In Det. No. 89-546, the taxpayer was a Washington county. The taxpayer acknowledged that the various county departments used the materials produced. Thus, there was no question that use tax applied; the only question to be answered was the correct measure of tax.

The determination concluded that the production of printed materials for in-house use was manufacturing for commercial and industrial use activity. RCW 82.04.120; RCW 82.04.130. RCW 82.12.010(1) provides that in cases where the article used is:

> 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 shall be determined as nearly as possible according to the retail selling price at place of use of similar products of like quality and character . . . .

(Emphasis added.)

When a comparison may be impossible or impractical because of the unique nature of the materials produced, WAC 458-20-112 (Rule 112) provides:

> 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.

(Emphasis added.)

In applying these provisions, Det. No. 89-546 concluded by stating:

> From this authority we conclude that labor and other overhead costs related to the printing of materials by a county for its own use are to be included in determining the measure of the use tax owed on such materials. Indeed, the "article used," upon which the use tax is supposed to be based, is the finished, printed product as opposed to the principal ingredients of that product, the paper and the ink.

WAC 458-20-189(7)(d) (Rule 189(7)(d)) echoes Det. No.89-546's tax treatment of a county's printing of materials for its own use, stating:

> Persons producing or manufacturing products for commercial or industrial use are required to remit use tax upon the value of those products, unless a specific use tax exemption applies. RCW 82.12.020. This value must correspond as nearly as possible to the gross proceeds from retail sales of similar products. (See WAC 458-20-112 and 458-20-134 on value of products and commercial or industrial use, respectively.)
>
> For example, a municipal corporation operating a print shop and producing forms or other documents for its own use must remit use tax upon the value of those products, even though a B&O tax exemption is provided by RCW 82.04.397

Accordingly, the tax on printing done in-house for the county's own use is measured by the total costs of production including, labor, overhead, and materials.

[2] Taxpayer also challenges the use tax assessed on the purchase of consumable items, based on the fact that the amount of tax was calculated based on the projection of an error rate found in the examination of a sample of paid invoices. Like the first issue, this is not an issue of first impression. In 2003, the Department [published] Det. No. 02-0114, 22 WTD 174 (2003).

Like here, Det. No. 02-0114 addressed a situation where a taxpayer disagreed with the use of statistical sampling to develop the amount of use tax due on previously untaxed consumable purchases. In Det. No. 02-0114, the taxpayer not only disagreed with the results of the sample, but also maintained that it had not agreed to the use of the sample.

Det. No. 02-0114 explained that:

> Statistical sampling requires random selection of the sample and the use of probability theory to evaluate the sample results. Over recent years the use of statistical sampling in sales and use tax audits has increased. Statistical sampling can add greater accuracy and precision to the efficiency that block sampling provides.[2] *See generally*, Faranak

[2] The potential differences in accuracy between block and statistical sampling was discussed in Will Yancey & Roger C. Pfaffenberger, *Use and Abuse of Sampling in Sales and Use Tax Audits*, 97 *COST State Tax Report* , Issue 6, pp. 2-9 (November 1997), reprinted in 13 *State Tax Notes* 1673 (December 29, 1997), as follows:

> The severe limitation of nonstatistical sampling is that it does not allow the auditor to make a quantitative estimate of sampling risk. An example of nonstatistical sampling is block sampling in which the auditors select a few days or weeks from the population which the auditor or taxpayer deems to be representative of the entire population. By not taking sample transactions over the entire audit period, block samples run the risk of producing sample information that is relevant only to the period for which the sample was taken. If the tax deficiency rate in the sample differs significantly from the population, the block sampling method will produce results that are not valid.
>
> *Statistical sampling* methods provide a quantitative estimate of the sampling risk. Statistical sampling requires that the person selecting the sample rely on a random sample selection process rather than his or her judgment about the extent to which the sample represents the population. The statistical sample might

> Naghavi, Jeri Mulrow, & Eric Falk, *Reversals and Use Tax Audits and Statistical Sampling: A Double Benefit*, 11 J. Multistate Tax'n 18 (2002). . . .
>
> The determination of the size of the sample in a sales and use tax audit is an important consideration as the sample size affects the reliability of the results. Sample size determination is inevitably a trade-off between the cost of sampling and precision. Increasing sample size results in both a more costly audit and a more precise estimate.[3]

Det. No. 02-0114 denied Taxpayer's challenge to the assessment based on a claim that the use of statistical sampling methodology was flawed. Consistent with Det. No. 02-0114, we uphold the use tax assessed on consumables purchased based on the use of a statistical sampling methodology.

While concluding that the use of statistical sampling was valid, Det. No. 02-0114, remanded the case to the Audit Division for review of all records based on Taxpayer's claim that it did not consent to the use of a statistical sampling methodology. That is not the case here. The Audit Division's records show that a letter was sent on June 17, 2001 to [County] outlining the proposed sampling procedures to be used in the audit. Verbal discussions about sampling occurred before the sampling procedures were used as part of the audit examination. At no time during the sample planning, sample review, or at the supervisor meeting did Taxpayer indicate a problem with a projection of the errors found.[4] It is only after the assessment was issued that a challenge to the assessment has been made. The challenge does not offer any specific factual error or legal authority to alter the Audit Division's adjustment other than a bald assertion that "[t]he basing of amounts due from a governmental unit which deals with public funds should not be based on such unsubstantiated accounting practices."

Taxpayer has offered neither factual errors nor legal authority to overturn results based on accepted statistical sampling methods. Thus, we uphold the use by the Department of statistical sampling to develop tax adjustments. Accordingly, Taxpayer's petition is denied on this issue

DECISION AND DISPOSITION:

> not be a good representation of the population in some instances, but this sampling risk can be quantified using statistical formulas derived from the theory of probability.

[3] As stated in Herbert Arkin, *Sampling Methods for the Auditor: An Advanced Treatment* 153 (1982) with respect to the use of a lower limit in a tax audit:

> It will be remembered that the lower limit is calculated by subtracting the sampling error of the total from the point estimate of the total. Thus, the smaller the sample, the larger the sampling error and the less collected!
>
> This gives rise to a cost-benefit relationship of considerable importance. The larger the sample, the greater the amount collected, but also the greater the cost of the audit.

[4] The Audit Division also asserts that both the auditor and computer audit specialist followed the procedures outlined in the letter.

Taxpayer's petition is denied.

Dated this 31st day of March 2004.