

Cite as Det. No. 16-0264, 36 WTD 239 (2017)

BEFORE THE APPEALS 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 of)	
)	No. 16-0264
)	
)	Registration No. . . .
)	
)	
)	

[1] ETA 3094; RULE 224; RCW 82.04.050; RCW 82.08.020: RETAIL SALES TAX – PHYSICAL REPRESENTATION OF PERSONAL SERVICES – PROTOTYPES – MATERIALS USED. Where a personal service provider gives its client items, such as plans, models or reports, that represent the services provided, such items are considered the tangible representation of the services. The materials used to create the items are consumed by the service provider in providing their services; therefore, the purchases of the materials are subject to retail sales tax. A prototype produced as part of engineering and product development services is the tangible representation of those services and materials purchased to produce the prototype are subject to retail sales tax.

[2] RULE 136; RULE 13601; RULE 159; RCW 82.04.120; RCW 82.08.02565: RETAIL SALES TAX – M&E EXEMPTION – PROCESSOR FOR HIRE – PROTOTYPES – MATERIALS USED. RCW 82.08.02565(1)(a) provides a retail sales tax exemption for sales to a manufacturer or processor for hire of machinery and equipment (M&E) used directly in a manufacturing operation or research and development operation. A processor for hire is a person who performs manufacturing services upon property belonging to others. Any person who claims to be acting merely as agent in making purchases must evidence such claim with records specified in Rule 159. A taxpayer does not establish it was a processor for hire eligible for the M&E exemption on purchases of prototype materials without presenting evidence that the materials belonged to its manufacturer clients or that it was engaged in manufacturing.

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.

Eckholm, T.R.O. – A mechanical engineering and product development services provider protests the assessment of use tax and/or deferred retail sales tax on the materials it used to produce prototypes as part of its mechanical engineering and product design services, asserting that it is a manufacturer and entitled to purchase the materials at wholesale under RCW 82.04.050(1)(a)(iii). In the alternative, the taxpayer asserts that its purchases of materials used to produce prototypes

are exempt from tax under the [M&E] exemption, RCW 82.08.02565, because it purchased the materials as a processor for hire and agent of its manufacturer clients. The taxpayer's petition is denied.¹

ISSUES

1. Are the taxpayer's purchases of materials used to produce prototypes as part of its mechanical engineering and product design services exempt from tax as wholesale purchases under RCW 82.04.050(1)(a)(iii), because it engaged in manufacturing when it produced the prototypes, or did it consume those materials as part of its engineering and product design services?
2. Are the taxpayer's purchases of materials used to produce prototypes as part of its mechanical engineering and product design services exempt from tax under the [M&E] exemption, RCW 82.08.02565, where the taxpayer asserts that it purchased the materials as a processor for hire and agent of its manufacturer client?

FINDINGS OF FACT

[Taxpayer] provides engineering and product development services. The Department of Revenue (Department) Audit Division conducted a review of the taxpayer's records for the period of January 1, 2009, through June 30, 2012. The taxpayer provided a sample Master Contractor Services Agreement (Agreement) typical of the agreements that governed the services it provided to its clients during the audit period. The Agreement refers to the taxpayer as "Contractor" and provides that the taxpayer, as independent contractor, "will perform professional engineering and product development services for [client] in accordance with the description of services set forth in Exhibit 1 ("Description of Services"), and the terms and conditions herein (the "Services"). . . ." ² The Agreement specifies that the Description of Services outlines the services that the taxpayer will perform and the fees its client will pay in return.³ The Description of Services is brief and does not contain any text under certain headings. The services, and payment for those services, are described as:

1. Labor assigned to this project:

Type (Modality)

Engineering design work

2. Contractor Fee:

\$. . . per hour (blended rate)

. . .

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

² Agreement, paragraph 1.1; paragraphs 5.1 and 17.2 (taxpayer as independent contractor). In quoted excerpts from the Agreement within this determination, the Agreement's reference to the taxpayer as "Contractor" is retained and the client's name is replaced with the bracketed term "client."

³ Agreement, paragraph 1.1.

6. Total Cost:

Material cost is to be determined and will be billed at cost plus 10%.⁴

The Description of Services also provides for client approval of travel expenses.⁵ The Agreement provides that the taxpayer is required to invoice the client bi-monthly with documentation supporting the costs and expenses incurred in performing the services, and maintain records evidencing all costs for labor, materials, equipment, supplies and services, and any other costs and expenses for which reimbursement is claimed.⁶ The Agreement also provides that as part of the services provided, the taxpayer is required to submit draft and final reports to the client, including the description of analytical methods and quality assurance procedures employed.⁷

The Agreement includes a provision entitled, “Acceptance of Deliverables,” though “deliverables” is not defined within the Agreement and the term is not referenced in the Description of Services.⁸ The taxpayer indicated that these deliverables include prototypes that are used by its clients in the manufacture and sale of their products. The “Acceptance of Deliverables” provision states:

[Client] will inform Contractor, in writing, within thirty (30) days of receiving a deliverable, whether it accepts or rejects such deliverable, which acceptance shall not be unreasonably withheld, [client] may reject any deliverable which does not comply with the Description of Services and/or with [client’s] standards based upon mutually agreed acceptance test criteria. If [client] fails to notify Contractor within the above specified time, the deliverable shall be deemed accepted. If [client] rejects such deliverable, [client] shall identify in its written notice of rejection the non-compliance and basis for such determination and shall allow Contractor thirty (30) days from receipt of written notice to revise the deliverable to render it acceptable to [client] at no additional cost to [client]. Acceptance of any deliverable shall render all payments and other amounts due hereunder associated with such deliverable non-refundable.⁹

The auditor noted that the taxpayer itemized charges for labor and materials used in creating prototypes in the invoices to its clients. The taxpayer reported the labor charges for designing the prototypes under the service and other activities business and occupation (B&O) tax classification. The taxpayer reported the charges for the prototype materials under either the retailing B&O and retail sales tax classifications, or the wholesaling B&O tax classification, depending on whether the client had provided a reseller permit or other exemption certificate to the taxpayer. Where the client had not provided a reseller permit or exemption certificate, the taxpayer added a ten percent mark-up for retail sales tax. The taxpayer indicated to the auditor that when it invoiced its clients for the charges related to the prototype materials that it considered the charges to represent sales of the prototypes (or those materials) to its clients. The taxpayer did not pay retail sales tax or use tax on the materials it used in creating the prototypes.

⁴ Agreement, Exhibit 1, Description of Services.

⁵ *Id.*

⁶ Agreement, paragraph 3.2

⁷ Agreement, paragraph 3.1.

⁸ Agreement, paragraph 2.

⁹ *Id.*

The auditor concluded that the taxpayer's charges for both the labor and materials were payment for its engineering and product development services, and that the prototypes were provided as part of its services as the tangible representation of those services and not sold to the clients. As a result, the auditor reclassified the taxpayer's income under the service and other activities B&O tax and assessed use tax and/or deferred retail sales tax on the prototype materials. Following other adjustments not at issue in this review, the Department issued an assessment in the total amount of \$. . . , primarily composed of use tax and/or deferred retail sales tax.¹⁰

The taxpayer filed a petition for review of the portions of the assessment resulting from reclassification of its income and imposition of use tax and/or deferred retail sales tax.¹¹ The taxpayer made a number of assertions that were later updated in its supplemental brief filed in advance of the hearing. The taxpayer's assertions on review boil down to two alternative arguments: the taxpayer was engaged in manufacturing when it produced prototypes as part of its mechanical engineering and product design services, thereby qualifying it for wholesale purchase of the materials under RCW 82.04.050(1)(a)(iii); or, in the alternative, the taxpayer's purchase of materials used to produce prototypes as part of its mechanical engineering and product design services were exempt from tax under the [M&E] exemption, RCW 82.08.02565, because it purchased the materials as a processor for hire and agent of its manufacturer client.

In support of its assertions on review, the taxpayer provided copies of sample client reseller permits not specific to a type of sale or transaction. The taxpayer also provided an email invoice for mechanical engineering and development services, workspace rent, and travel expenses, which was approved by one of its clients and included the client's State of Washington Manufacturer's Sales and Use Tax Exemption Certificate.

ANALYSIS

1. Are the taxpayer's purchases of materials used to produce prototypes as part of its mechanical engineering and product design services exempt from tax as wholesale purchases [under] RCW 82.04.050(1)(a)(iii) because it engaged in manufacturing when it produced the prototypes, or did it consume those materials as part of its engineering and product design services?

All sales of tangible personal property to consumers in Washington are subject to retail sales tax unless a specific exemption applies. RCW 82.08.020; RCW 82.04.050. The retail sales tax applies upon all sales of tangible personal property made to persons for use or consumption in performing a business activity, which is taxable under the service and other business activities classification of chapter 82.04 RCW. [RCW 82.04.050(1)(a)(iii);] WAC 458-20-224(6) (Rule 224(6)). The use tax complements the retail sales tax and is imposed for the privilege of using, within this state as

¹⁰ Document No. . . . , issued on December 4, 2013, includes assessment of retail sales tax of \$. . . , service and other activities B&O tax of \$. . . , a credit of retailing B&O tax of \$. . . , a credit of wholesaling B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$

¹¹ The taxpayer included in its petition for review a request for a ruling as to whether it would qualify for the High Technology Tax Deferral under chapter 82.63 RCW if it applied for the deferral, and that it intended to seek such a ruling from the Department's Tax Information and Education (TI&E) Section. After receiving the review petition, the TRO confirmed in an email to the taxpayer representative that it was appropriate to seek such a ruling from the TI&E Section and that if it received an adverse ruling pending this review, it could petition for review of the ruling and the reviews would be consolidated. No such petition for review has been filed.

a consumer, any article of tangible personal property that was not previously subjected to the retail sales tax. RCW 82.12.020(1)(a); WAC 458-20-178(2).

The retail sales tax does not apply to purchases of tangible personal property for the purpose of consuming the property purchased in producing for sale as a new article of tangible personal property or substance, of which such property becomes an ingredient or component. RCW 82.04.050(1)(a)(iii). Manufacturers are generally eligible for this sales tax exemption for the purchases of ingredients and components incorporated in the products they manufacture because, by definition, manufacturing is where “a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use” RCW 82.04.120 (definition of “to manufacture”).

The auditor determined that the taxpayer provided engineering and product development services to its clients, and that the prototypes were delivered to its clients, along with required reports, as the tangible representations of those services. This conclusion is consistent with the terms of the Agreement provided by the taxpayer. The Agreement states that the deliverables for which the taxpayer is compensated includes its professional mechanical engineering and product development services, reports of those services, and though not specifically referenced in the Agreement, the taxpayer indicated deliverables also include the creation and provision of prototypes that result from its services. The Agreement, in numerous places, describes the taxpayer’s performance under the Agreement as services and specifically describes such services in the “Description of Services” as “engineering design work.”¹² The provision related to deliverables states that the deliverables are to conform to the Description of Services.¹³ Nowhere in the Agreement is the sale of prototypes referenced. Though the taxpayer asserts that the invoices reflecting charges for the prototype materials establish that the prototypes or the materials were sold to the clients, the provision in the Agreement governing fees and costs clearly states that the invoicing should reflect the taxpayer’s costs and expenses incurred in performing the services.¹⁴

Although the Agreement requires the taxpayer to deliver some tangible items encompassed by the deliverables, we conclude that the items represent the tangible evidence of the taxpayer’s engineering and product development services, and delivery of these items pursuant to the Agreement do not constitute sales of these items. The reports and prototypes document the taxpayer’s skilled engineering and product development services, and permit the client to evaluate the feasibility of manufacturing their products. Consequently, the taxpayer’s contracted performance was for mechanical engineering and product development services, and not for the manufacture and sale of prototypes.

Where a personal service provider provides a physical representation of these services as part of its services, such as drawings, plans, or a report, such items are considered the tangible representation of the professional services and the service provider is not considered to have made a sale of tangible personal property to its client. *See* Excise Tax Advisory 3094.2009 – Sales of Drawings and Plans (ETA 3094); Det. No. 08-0067E, 27 WTD 194, 199 (2008) (taxpayer established that employment screening reports were not retail sales of employment screening tools

¹² Agreement, paragraphs 1.1, 1.2, 3.1, 3.2, and Exhibit 1, Description of Services.

¹³ *Id.*, paragraph 2.

¹⁴ *Id.*, paragraph 1.2.

to its clients but were tangible representations of the contracted professional employment screening services).

In regards to drawings and plans provided as part of professional services, ETA 3094 provides:

In the process of performing design services for a customer, the customer will generally receive one or more copies of drawings or plans. These drawings or plans are considered to be the mere representation of the professional services which were provided to the customer. The service provider is not considered to have made the sale of tangible personal property when the drawings or plans are intended to be part of the professional service. The service provider is the consumer and required to pay retail sales or use tax on any materials, such as paper, ink, etc., that went into the drawings or plans. . . .

Similarly, the taxpayer's engineering and product development services are represented by the prototype in conjunction with the required reports of its analyses and methods employed in performing its services. The taxpayer was properly assessed use tax and/or deferred retail sales tax on the materials it used to produce the prototypes as part of its engineering services. RCW 82.04.290(2); WAC 458-20-224(2), (6); WAC 458-20-138.

The taxpayer viewed the reimbursement of the costs of its use of the prototype materials as proceeds from sales of the prototypes to the clients – either wholesale or retail depending on whether it obtained a reseller permit or exemption certificate from the client. The taxpayer asserted that it was a manufacturer of the prototypes and that the materials became ingredients or components of the prototypes that it later sold to its clients; therefore, the purchases of materials were exempt from retail sales tax under RCW 82.04.050(1)(a)(iii).

Manufacturing occurs when “a new, different or useful substance or article of tangible personal property is produced for sale or commercial or industrial use” RCW 82.04.120 (definition of “to manufacture”). The taxpayer has not established that it was engaged in manufacturing by producing the prototypes for sale; therefore, it is not eligible for the sales tax exemption per RCW 82.04.050(1)(iii).

2. Are the taxpayer's purchases of materials used to produce prototypes as part of its mechanical engineering and product design services exempt from tax under the [M&E] exemption, RCW 82.08.02565, where the taxpayer asserts that it purchased the materials as a processor for hire and agent of its manufacturer client?

The taxpayer makes the assertion, in the alternative, that it is a processor for hire for its manufacturer clients when it produces the prototypes as part of its mechanical engineering and product development services. In making this alternative argument, the taxpayer asserts that rather than *selling* the prototypes or materials to its clients and *receiving* reseller permits from its clients for those sales (as asserted above and during the audit), that it purchases the materials *as an agent* of its clients and is authorized to use the client's reseller permit in making the purchases from its suppliers; therefore, its clients own the materials. As a processor for hire, it asserts, it is entitled to the retail sales tax exemption for [M&E] purchased by manufacturers or processors for hire that

are used directly in a manufacturing operation or a research and development operation under RCW 82.08.02565(1)(a).

RCW 82.08.02565(1)(a) provides a retail sales tax exemption for sales “to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation or research and development operation” RCW 82.12.02565 provides a corresponding use tax exemption. These two complementary statutory exemptions are often referred to in the singular as “the M&E exemption.” Det. No. 07-0324E, 27 WTD 119, 122 (2008); Det. No. 01-007, 20 WTD 214, 216 (2001). The M&E exemption, like all tax exemptions in Washington, is strictly construed in favor of application of the tax and against claiming the exemption, and the burden of proving entitlement to the exemption is on the taxpayer. See *Budget Rent-A-Car, Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 174-75, 500 P.2d 764 (1972); Det. No. 01-007, 20 WTD 214, 231 (2001).

For the M&E exemption to apply, there must be a sale to or use by (1) a manufacturer or processor for hire, (2) of “machinery and equipment,” (3) “used directly” in a, (4) “manufacturing operation or research and development operation”¹⁵ RCW 82.04.02565(1)(a). A taxpayer must also show that the [M&E] meets the “majority use” threshold, i.e., more than fifty percent of the use of the [M&E] occurs directly in a “manufacturing operation.” RCW 82.04.02565; WAC 458-20-13601(9) (Rule 13601(9)); Det. No. 05-0151, 25 WTD 127, 131 (2006). If any of these requirements are not met, the M&E exemption is not available.

Department rule defines the term “processor for hire” as:

[A] person who performs labor and mechanical services *upon property belonging to others* so that as a result a new, different, or useful article of tangible personal property is produced for sale or commercial or industrial use. *Thus, a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon his or her own materials.*

WAC 458-20-136(3)(a) (Rule 136(3)(a)) (emphasis added).

The taxpayer cannot qualify as a processor for hire because it has not shown that the materials it used to create the prototypes belonged to its clients. The taxpayer’s books and records evidence that the taxpayer purchased the materials from its suppliers in its own name, and the Agreement provided by the taxpayer specifically provides that the taxpayer is *not* the agent of the client.¹⁶ The existence of a true agency relationship between the client and the taxpayer requires a factual determination that both parties consented to the agency relationship and that the principal exercised control over the agent. See *Washington Imaging Services, LLC v. Dep’t of Revenue*, 171 Wn.2d 548, 562, 252 P.2d 885 (2011); Det. No. 05-0206E, 25 WTD 72 (2006); Restatement (Third) of Agency § 1.01 (2006).

¹⁵ RCW 82.04.02565(1)(a) also provides other bases for exemption, none of which are at issue here, namely sales to a person engaged in testing for a manufacturer or processor for hire of [M&E] used directly in a testing operation, or sales of or charges made for labor and services rendered in respect to installing, repairing, cleaning, altering, or improving the M&E. The taxpayer makes an assertion in its supplemental hearing [brief] that it engages in testing for its manufacturer clients but it has not provided evidence of this activity or that it qualifies for this exemption.

¹⁶ Agreement, paragraph 17.2.

WAC 458-20-159 (Rule 159) is the Department's regulation regarding the manner in which agents should account for their activities on behalf of a principal and proof necessary for establishing an agency relationship. Rule 159 provides:

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.

...

Rule 159(1).

The taxpayer has already indicated that it obtained the reseller permits from its clients in relation to sales *to* its clients, not for use in making purchases on their behalf. This statement was made to the auditor and is consistent with the taxpayer's records and the taxpayer's reporting. We will not assume a fact contradicted by the evidence even in relation to an alternative argument. In any event, the taxpayer's possession of its clients' reseller permits does not establish it was authorized to use them as their agent in making purchases. The taxpayer has provided no evidence that it was an agent of its client in purchasing the materials.

As determined above, the taxpayer is not engaged in manufacturing the prototypes because the prototypes are created as part of its engineering and product development services. Rule 136(3)(a) provides that "a processor for hire is any person who would be a manufacturer if that person were performing the labor and mechanical services upon his or her own materials." *Id.* Manufacturing is where "a new, different or useful substance or article of tangible personal property *is produced for sale or commercial or industrial use . . .*" RCW 82.04.120 (emphasis added). The taxpayer has not established that it manufactures the prototypes for sale to its clients, or that it manufactures the prototypes on behalf of its clients to sell the prototypes or for its own commercial or industrial use.¹⁷ The taxpayer fails to establish that it was either a manufacturer or processor for hire in producing the prototypes and, therefore, it fails to establish the first requirement for eligibility for the M&E exemption and we need not address the other requirements for the exemption.

The taxpayer has not established the assessment was issued in error. The taxpayer's petition is denied.

¹⁷ A processor for hire who does not sell tangible personal property may be eligible for the M&E exemption (if it meets the other criteria) if the processor for hire manufactures articles, substances, or commodities that will be sold by the manufacturer, but a processor for hire who manufactures tangible personal property that will be used by the manufacturer rather than sold by the manufacturer, is not eligible. WAC 458-20-13601(4).

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 25th day of August 2016.