Cite as Det. No. 17-0243, 37 WTD 112 (2018)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 17-0243
. . .	))	Registration No. . . .

[1] BUSINESS AND OCCUPATION TAX – DISSOCIATION. A manufacturer and seller of baby carrots cannot establish that its sales to certain purchasers should be dissociated.

[2] RCW 82.32.730; RCW 82.04.040(1); WAC 458-20-193: BUSINESS AND OCCUPATION TAX – SOURCING OF SALES TO WHERE GOODS ARE RECEIVED. Taxpayer's customers received its products in Washington where the documentation showed the goods were shipped to, regardless of where title to the goods passed.

[3] RCW 82.04.330(1); RCW 82.04.213; RCW 82.04.120: BUSINESS AND OCCUPATION TAX – FARMING EXEMPTION - AGRICULTURAL PRODUCTS OR MANUFACTURED PRODUCTS. A taxpayer that takes whole carrots and makes baby carrots manufactures a product for B&O tax purposes that is ineligible for the farming exemption for agricultural products in RCW 82.04.330(1).

[4] RCW 82.32.105; WAC 458-20-228: PENALTIES AND INTEREST: WAIVER FOR CIRCUMSTANCES BEYOND THE TAXPAYER'S CONTROL. A misunderstanding of the tax liability is not a circumstance beyond the taxpayer's control for waiver of penalties. Furthermore, the Department did not delay issuing the assessment, such that Taxpayer qualifies for waiver of interest.

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.

Yonker, T.R.O. – An out-of-state grower of carrots (Taxpayer) that also makes "baby" carrots from whole carrots, and sells such baby carrots, protests the assessment of business and occupation (B&O) tax on such sales. Taxpayer argues that (1) it is entitled to "dissociate" its sales of baby carrots to customers in Washington, (2) the baby carrots were received by customers outside of

Washington, and (3) Taxpayer's sales of baby carrots are exempt from B&O tax because Taxpayer is a farmer. We deny Taxpayer's petition . . . .[1]

ISSUES

1. [M]ay Taxpayer "dissociate" certain sales of products that were sold to customers located in Washington, where Taxpayer concedes that it had physical nexus with Washington?

2. Under WAC 458-20-193, is Taxpayer subject to B&O tax in Washington on gross proceeds of sales for products sold to customers located in Washington, where third-party for-hire carriers picked up the products from Taxpayer outside of Washington and delivered those products to customers in Washington?

3. May Taxpayer claim the exemption from Washington's B&O tax available for farmers under RCW 82.04.330(1), on wholesale sales of baby carrots to customers located in Washington?

4. Under RCW 82.32.105 and WAC 458-20-228(9), has Taxpayer demonstrated any circumstances beyond its control entitling it to a waiver of penalties?

5. Under RCW 82.32.105 and WAC 458-20-228(10), has Taxpayer demonstrated any circumstance entitling it to a waiver or cancelation of interest?

FINDINGS OF FACT

. . . (Taxpayer) is a grower of fruit and vegetable crops for eventual human consumption, based [out-of-state]. Taxpayer harvests the fruits and vegetables it grows, and either sells them in their original form, or in some derivative form, to retailer customers such as grocery store chains.

Taxpayer's primary crop is carrots. Taxpayer represented that of its revenue from carrot sales, 30 percent is from the sale of "whole carrots," which are essentially carrots harvested from the ground, washed, and packaged as is. Taxpayer represented that its standard wholesale price for whole carrots is $ . . . per pound.

Another 60 percent of carrot revenue is from the sale of "baby whole carrots," or, more simply, "baby carrots." Baby carrots are the small, approximately two-inch carrots with rounded ends that are widely available in grocery stores. Relevant to this case is a brief history of the development of baby carrots. In 1986, a carrot farmer [out-of-state] began cutting baby carrots from misshapen carrots that could not be sold in whole form.[2] The year after the introduction of the baby carrot, carrot consumption jumped nearly thirty percent.[3] Between 1985 and 1997, per capita consumption of carrots more than doubled from 6.5 pounds to 14.1 pounds.[4] According to a 2007

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] "Baby Carrots are not Baby Carrots," by Roberto A. Ferdman, The Washington Post, Jan. 13, 2016, found at www.washingtonpost.com/news/wonk/wp/2016/01/13/no-one-understands-baby-carrots/?utm_term=.4f1ea982fdb3, last visited on September 12, 2017.
[3] *Id.*
[4] *Id.* (citing statistics provided by the USDA).

report by the USDA, "[t]he development and rapid consumer acceptance of packaged fresh-cut carrot products [including baby carrots] during the 1990s has helped the carrot industry evolve from a supplier of low-value bulk products to a marketer of relatively upscale value added products."[5]

Taxpayer represented that the baby carrots that it sold went through the following general process steps at Taxpayer's location [out-of-state]:

- The whole carrots are plucked from the ground.
- The whole carrots are washed with water only.
- The whole carrots are cut into two-to-three inch pieces using an automated cutting mechanism.
- The cut pieces are peeled, smoothed, and polished using a separate automated smoothing mechanism, creating the familiar rounded look of the baby carrots.
- The baby carrots are then packaged in plastic bags.

Taxpayer represented that the baby carrots are not subjected to any other chemical treatments or washes besides the initial water wash given to the whole carrots upon harvesting. Likewise, Taxpayer represented that nothing else is done to the baby carrots to extend their "shelf life" beyond that of the traditional whole carrot. Taxpayer represented that its standard wholesale price for baby carrots is $ . . . pound. The final ten percent of carrot revenue is from other carrot products, such as carrot juice, "snack carrots," and frozen cut carrots.[6]

Taxpayer produced a sample of five bills of lading for sales of products that all indicated the following:

- The "ship to" location was in Washington.
- The products were all "loaded" [out-of-state].
- The "shippers" or "carriers" that transported the products were unrelated, third-party entities hired by the purchasing retailer customers of the products.[7]

Taxpayer represented that title to the products passed at the time the third-party shipper or carrier picked up the products at Taxpayer's [out-of-state] location, and that the sales were all made "FOB [out-of-state]," meaning that Taxpayer no longer had liability for the products. However, the bills of lading only had an "FOB" term, without any other location designation.[8]

---

[5] *Id.* (citing a USDA 2007 study that is no longer available online).

[6] "Snack carrots" are different from baby carrots in that "snack carrots" are cut into the shape of disks with a "ridged" pattern. Further, Taxpayer represented that its standard wholesale price for its snack carrots is $ . . . per pound.

[7] During the review, we initially understood from Taxpayer that some purchasers of products provided their own shipping of the purchased products. However, Taxpayer later clarified that "[i]t is not with trucks the company owns, but with transportation companies that they contract/hire to pick up their goods." Therefore, the record only contains examples of sales in which the "shipper" or "carrier" were third-party entities. There is no evidence in the record that these entities were affiliated with the purchasing retailer customers in any way.

[8] The back of the bill of lading form contains language that says "[i]t is acknowledged and agreed that if the term of sale is 'FOB Shipping Point' . . . ." However, the term of sale on the front of each bill of lading does not state "FOB Shipping Point," but merely, "FOB." Thus, it is unclear the intention of the "FOB" designation.

During the relevant time period, Taxpayer had representatives that came to Washington to promote sales and business relationships with various retailer customers. Included in the record is an annual list created by Taxpayer of different retailer customers with locations in Washington to which Taxpayer sold products during the relevant time period. That list indicated that Taxpayer's representatives made visits to eight retailer customers in Washington in 2009 and 2010, and to seven in Washington in 2011 and 2012. Taxpayer represented that its representatives did not contact the other retailer customers at their Washington locations, but instead, such communications were handled through those retailer customers' out-of-state locations.

In 2013, the Department's Compliance Division commenced an investigation to determine if Taxpayer had taxable business activity in Washington. According to Department records, the following relevant communications between the Compliance Division and Taxpayer occurred during that investigation:

- On March 1, 2013, the Compliance Division sent a business questionnaire to Taxpayer with a deadline of April 1, 2013, to complete and return to the Department.
- On April 9, 2013, after not receiving the completed business questionnaire, the Compliance Division sent a second questionnaire with a new deadline of May 1, 2013, to complete and return to the Department.
- On May 6, 2013, the Compliance Division was notified that Taxpayer had engaged a representative to represent Taxpayer during the investigation.
- On June 24, 2013, the Compliance Division met with Taxpayer's representative to discuss the investigation. Taxpayer's representative represented that she would provide more information from Taxpayer in the near future.
- On July 30, 2013, the Compliance Division emailed Taxpayer's representative instructing her to produce "figures for [Taxpayer's] sales into Washington" by August 29, 2013.
- On November 3, 2015, the Compliance Division contacted Taxpayer's representative to confirm that she was still the representative. The Compliance Division also stated there was still incomplete information regarding Taxpayer's business activity. Taxpayer's representative stated she would need to review her notes and contact Taxpayer.
- On March 15, 2016, Taxpayer's representative emailed additional information to the Compliance Division, and stated "[w]e deeply apologize for how long it has taken us to respond to your data request."
- On April 21, 2016, Taxpayer's representative requested a meeting to discuss the investigation.
- On April 28, 2016, the Compliance Division held a meeting with Taxpayer's representative. At that meeting, the Compliance Division again requested additional information regarding Taxpayer's business activity.
- On November 30, 2016, the Compliance Division received complete information from Taxpayer to finish the investigation regarding taxability of Taxpayer's business activity in Washington between January 1, 2009, and December 31, 2012 (review period).

On December 9, 2016, as a result of the Compliance Division's investigation, the Department issued a tax assessment for $ . . . , which included $ . . . in unreported [wholesaling] B&O tax,[9] $

[9] . . .

. . . in litter tax, a delinquent penalty of $ . . . , a $ . . . five-percent assessment penalty, a $ . . . unregistered business penalty, and $ . . . in interest. Taxpayer subsequently sought review of the full amount of the tax assessment.

ANALYSIS

Washington imposes a B&O tax on "every person that has a substantial nexus" with Washington "for the act or privilege of engaging in business" in this state. RCW 82.04.220(1). "[T]he legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state." *Impecoven v. Dep't of Revenue*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992); *see also Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971). Thus, in general, all business activity is subject to B&O tax unless some specific exemption applies. The applicable B&O tax rate is determined by a taxpayer's specific business activity. *See generally* chapter 82.04 RCW. Here, Taxpayer does not dispute that, to the extent its sales of baby carrots are taxable in Washington, such sales are properly classified under the wholesaling B&O tax classification pursuant to RCW 82.04.270.

WAC 458-20-193 (Rule 193) explains the B&O tax liability associated with interstate sales of tangible personal property received in Washington. Rule 193(1) [describes when the tax applies]: "In general, Washington imposes its B&O and retail sales taxes on the sales of tangible personal property if the seller has nexus in Washington and the sale occurs in Washington." Specific to wholesale sales, Rule 193(103)(b) states that "[a] person that makes wholesale sales of tangible personal property and has nexus with Washington . . . is subject to B&O tax on that person's wholesale sales **sourced** to Washington." (Emphasis added.) Thus, Rule 193 makes clear that for a particular seller of goods to be liable for B&O tax, (1) the seller must have nexus in Washington, and (2) the sale must occur in, or be "sourced" to, Washington. We first address these two requirements for taxation.

1. Substantial Nexus

Taxpayer states on review that it "freely concedes that it has established nexus with the State of Washington through its contacts, however infrequent, with the State." Generally, substantial nexus for one sale is substantial nexus for all sales. Det. No. 15-0151, 35 WTD 182 (2016) (*citing* Det. No. 04-0208, 24 WTD 217 (2004)); Det. No. 94-209, 15 WTD 96 (1994).

However, Taxpayer also states that "it has not established nexus with many of its purchasers located in Washington." In other words, Taxpayer asserts that it is entitled to "dissociate" some of its sales into Washington so that it is not subject to B&O tax on such sales. . . . The burden of proving dissociation essentially requires the "absence of any connection" between the state and the sales the taxpayer seeks to exclude from the state's tax. *Avnet, Inc. v. Dep't of Revenue,* 187 Wn.2d 44, 60, 384 P.3d 571 (2016). [That burden likely cannot be met with respect to a tax imposed on a transaction consummated in the taxing state. *See Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184 (1995) ("It has long been settled that a sale of tangible goods has a sufficient nexus to the State in which the sale is consummated to be treated as a local transaction taxable by the State).]

Here, Taxpayer has offered no specific evidence in support of dissociation. . . . Therefore, we hold that Taxpayer is not entitled to "dissociate" any of its sales into Washington . . . .

2. <u>Sales "Sourced" to Washington</u>

Washington defines "sale" as "any transfer of the ownership of, title to, or **possession of property** for a valuable consideration . . . ." RCW 82.04.040(1) (emphasis added). WAC 458-20-103 (Rule 103) defines the place of sale as follows:

> 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 193(103)(b) further makes clear that a taxpayer with substantial nexus in Washington is subject to B&O tax on wholesale sales "sourced" to Washington. Rule 193(201) provides guidance on how sourcing occurs, stating that "RCW 82.32.730 explains how to determine where a sale of tangible personal property occurs based on 'sourcing rules' established under the streamlined sales and use tax agreement." RCW 82.32.730(1), in turn, provides for two general rules for "sourcing" sales. First, according to RCW 82.32.730(1)(a), when tangible personal property "is **received** by the purchaser at a business location of the seller, the sale is sourced to that business location." (Emphasis added). *See also* Rule 193(203)(a). Second, when tangible personal property "is not **received** by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser . . . occurs." (Emphasis added). *See also* Rule 193(203)(b).

RCW 82.32.730(9)(f) defines "receive" or "receipt" as "taking possession of tangible personal property." Rule 193(202)(a) defines those terms further as meaning "the purchaser first either taking physical possession of, or having dominion and control over, tangible personal property." RCW 82.32.730(9)(f) specifically states that receipt *does not* include "possession by a shipping company on behalf of the purchaser." *See also* Rule 193(202)(b)(i); Det. No. 15-0281, 36 WTD 28 (2017). According to Rule 193(202)(b)(ii), a shipping company is defined as a "separate legal entity that ships, transports, or delivers tangible personal property on behalf of another, such as a common carrier, contract carrier, or private carrier either affiliated or unaffiliated with the seller or purchaser."

Rule 193(203)(a) contains two relevant examples, as follows:

> **Example 3.** An out-of-state purchaser sends its own trucks to Washington to receive goods at a Washington-based seller and to immediately transport the goods to the purchaser's out-of-state location. The sale occurs in Washington because the purchaser receives the goods in Washington. The sale is subject to B&O and retail sales tax.
>
> **Example 4.** The same purchaser in Example 3 uses a wholly owned affiliated shipping company (a legal entity separate from the purchaser) to pick up the goods in Washington to deliver them to the purchaser's out-of-state location. Because "receive" and "receipt"

> do not include possession by the shipping company, the purchaser receives the goods when the goods arrive at the purchaser's out-of-state location and not when the shipping company takes possession of the goods in Washington. The sale is not subject to B&O and retail sales tax.

Here, the bills of lading in the record indicate that the "carrier" or "shipper" in each case was a "separate legal entity that ships, transports, or delivers" products on behalf of a purchaser. Therefore, we conclude that the "carrier" or "shipper" in each bill of lading was a "shipping company," and, as such, they could not have "received" the products at Taxpayer's [out-of-state] location. Instead, the products were received at the purchasers' locations in Washington as indicated by the "ship to" location on the bills of lading. This is consistent with Example 4 in Rule 193(203)(a), in which an affiliated shipping company picked up goods at the seller's location in Washington and delivered them out of state, and instead of "receipt" occurring in Washington where the shipping company picked up the goods, "receipt" occurred out of state, where delivery to the purchaser occurred.

Taxpayer advanced two arguments in support of its argument that receipt of the products occurred outside of Washington; however, both arguments must fail. First, while Taxpayer argues that title passed from Taxpayer to the purchaser at the time the "carrier" or "shipper" picked up the products at Taxpayer's [out-of-state] location, this fact, if true, is irrelevant to where the products are "received" for taxation purposes. *See* Rule 103; Det. No. 14-0383, 34 WTD 265 (2015) ("However, where legal title to goods passes is not determinative of whether delivery has occurred in Washington under Rule 193.")[; *see also* Rule 193(203)(b)(iii) ("Commercial law delivery terms, and the Uniform Commercial Code's provisions defining sale or where risk of loss passes, do not determine where the place of receipt occurs.")].

Similarly, while Taxpayer emphasizes the general terms included in the bills of lading regarding the rights of acceptance that are bestowed upon the "carrier" or "shipper," these terms are irrelevant here since any "right to inspection" that the "carrier" or "shipper" may have had is only a consideration under the former version of Rule 193 . . . . Accordingly, we decline to embark on an analysis of any "right to inspection" that may or may not have been granted through the bills of lading, and conclude that the products at issue, based on the record before us, and consistent with Rule 103 and Rule 193, were received at the "ship to" locations in Washington.

3. <u>Farming Exemption from B&O Tax</u>

Having concluded that Taxpayer has substantial nexus and that the sales at issue occurred in Washington, Taxpayer is generally subject to B&O tax on its gross proceeds of sales, unless some specific exemption applies. Taxpayer argues that some of its business activity is exempt from B&O tax under RCW 82.04.330(1), which states the following:

> [The B&O tax] does not apply to any farmer in respect to the sale of any agricultural product at wholesale or to any farmer who grows, raises, or produces agricultural products owned by others, such as custom feed operations. This exemption does not apply to any person selling such products at retail or to any person selling manufactured substances or articles.

We note that tax exemption statutes must be strictly construed in favor of the application of the tax. *Yakima Fruit Growers Ass'n v. Henneford*, 187 Wn. 252, 60 P.2d 62 (1936). "[T]he burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer." *Group Health Co-op. v. Tax Comm'n,* 72 Wn.2d 422, 429, 433 P.2d 201 (1967). Thus, under the first sentence of RCW 82.04.330(1), Taxpayer has the burden of proving the following elements: (1) that it is a farmer, and (2) that the products at issue were "agricultural products" sold at wholesale or to farmers. Additionally, [under] the second sentence of RCW 82.04.330(1), . . . the exemption [does not] apply [to sales of] "manufactured substances or articles."

Regarding the first element, RCW 82.04.213(2)(a) defines "farmer" as "any person engaged in the business of growing, raising, or producing . . . any agricultural product to be sold." The parties do not dispute that, under this definition, Taxpayer qualifies as a farmer due to its activity of growing whole carrots and selling the same.

Regarding the second element, RCW 82.04.213(1) defines "agricultural product" as follows: "any product of plant cultivation or animal husbandry including, but not limited to: A product of horticulture, grain cultivation, vermiculture, viticulture, or aquaculture . . . or any animal . . . or the substances obtained from such an animal . . . ." The whole carrots that Taxpayer grew and sold clearly qualify as an "agricultural product" because they are products of plant cultivation. However, we conclude the same cannot be said of the derivative baby carrots.

We have previously held that the scope of "agricultural products" is limited to the products that are the naturally resulting product of the various activities listed in RCW 82.04.213(1). In Determination No. 99-198R, 19 WTD 468 (2000), we examined the case of a farmer that cultivated chicken eggs, but removed the eggs from their shells prior to selling the resulting "liquid eggs." In that case we reasoned as follows:

> The agricultural exemption is not available because the product sold by this farmer is no longer an agricultural product. Before its sale, the taxpayer has converted it to something else. It has subjected an agricultural product, whole chicken eggs, to a manufacturing activity to create something which is not, strictly speaking, an agricultural product, namely, *liquid* eggs. . . . By virtue of this process, the eggs are no longer "the substances obtained from such an animal." The substance obtained from the animal is an egg in a shell. The substance at issue and sold by the taxpayer is a *manufactured* egg. It has been subjected to a process which has caused it to lose its identity, for tax purposes, as an agricultural product. Thus, it is ineligible for the B&O exemption found at RCW 82.04.330.

(Emphasis in original). Just as the "substance obtained from the animal" in 19 WTD 468 was the egg in a shell, and not the derivative liquid eggs, we hold that the "product of plant cultivation" at issue here was the whole carrot, and not the derivative baby carrots. It follows that the baby carrots do not qualify as an "agricultural product," because, as we held the liquid eggs to be "manufactured" eggs, the baby carrots here are "manufactured" carrots, and Taxpayer may not claim the B&O tax exemption for its sales of baby carrots.

Moreover, to the extent that a product is "manufactured," it cannot simultaneously be an "agriculture product." This is evident from the second sentence of RCW 82.04.330(1), which expressly states that "[t]his exemption does not apply to any person selling . . . manufactured substances or articles." Indeed, as we made clear in 19 WTD 468, discussed above, the "liquid eggs" there were *manufactured* eggs, and, therefore, not eligible for the exemption. We likewise conclude here that the baby carrots were *manufactured* carrots.

RCW 82.04.120(1) provides the following guidance on what constitutes manufacturing:

> "To manufacture" embraces all activities of a commercial or industrial nature wherein labor or skill is applied, by hand or machinery, to materials so that as a result thereof 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(2) goes on to identify specific activities that are not manufacturing, as follows:

> "To manufacture" does not include:
>
> . . .
>
> (c) The growing, harvesting, or producing of agricultural products;
>
> (d) Packing of agricultural products, including sorting, washing, rinsing, grading, waxing, treating with fungicide, packaging, chilling, or placing in controlled atmospheric storage.

Clearly, the Legislature has expressly declared that certain activities related to agricultural products are not manufacturing. While Taxpayer makes much of the exclusion of "producing of agricultural products" and "packing of agricultural products" from the definition of manufacturing, we disagree that these exclusions apply to the process undertaken by Taxpayer that results in the baby carrots. We conclude, however, that the "producing" and "packing" of agricultural products is still limited to "agricultural products," which we have already concluded the baby carrots are not. While Taxpayer argues that the inclusion of those activities broadens the exclusion from manufacturing to include the process through which a whole carrot becomes a baby carrot, we find no evidence that these terms were meant to automatically capture such a process.

Instead, we conclude that the baby carrots are the result of a manufacturing process, and, in turn, cannot be an agricultural product, based on the specific nature of the process. The Washington Supreme Court has provided guidance on more than one occasion for identifying "manufacturing" activities. In *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 175, 373 P.2d 483 (1962), the Court offered the following test for determining what constitutes manufacturing under RCW 82.04.120(1):

> We think the test that should be applied to determine whether a new, different, and useful article has been produced is whether **a significant change has been accomplished** when the end product is compared with the article before it was subjected to the process. By the end product we mean the product as it appears at the time it is sold or released by the one performing the process.

Id. at 175 (Emphasis added). Applying the test articulated above, the *Bornstein* court concluded that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120. In reaching this conclusion, the *Bornstein* court made the following statement:

> It is true . . . that after the filleting process is accomplished the end product is fish in fillet form. In the *Stokely-Van Camp* case, however, the taxpayer performed a process on peas (and other vegetables and fruits), and, after the process, he still had peas. In *Drury the Tailor v. Jenner* . . . , a tailor transformed a bolt of cloth into a suit; the end product was still cloth, in the form of a suit. In *J. & J. Dunbar & Co. v. State* . . . , the taxpayer removed impurities from whiskey. The end product was whiskey. The crucial point in each of these cases was the fact that the activities of the taxpayer changed a product **to make it more usable**. The process of filleting transforms near valueless whole bottom fish into useful and salable consumer items. This change is significant. The fact that the end product is still fish does not mean that the end product is not new and different after the process of filleting is accomplished.

Bornstein, 60 Wn.2d at 176-77 (Emphasis added).

A year after *Bornstein*, the Court again relied on this same test in *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963), and held that preparing and processing whole peas into split peas was manufacturing under RCW 82.04.120. The *McDonnell* court recognized that the above *Bornstein* test was "somewhat general in nature and may seem easier as a matter of articulation than as a matter of application." *McDonnell*, 62 Wn.2d at 556. The court then identified the following factors to "consider" in determining if the end product is a new, different, or useful product: ". . . among others, changes in form, quality, properties (such changes may be chemical, physical, and/or functional in nature), enhancement in value, the extent and the kind of processing involved, differences in demand, et cetera, ..." *Id.* at 557. Thus, when considering *Bornstein* and *McDonnell* together, determining whether there has been a significant change requires comparison of the article before it was subjected to the process and article after it is subjected to the process, as well as the actual scope and nature of the changes that occur to the article as a result of that process. Further, we note that no one factor in the *McDonnell* test is determinative, but we must "evaluate" and "balance" the named factors. Det. No. 07-0082, 26 WTD 231 (2007).

We have considered what constitutes manufacturing on numerous occasions. In Determination No. 99-198, 19 WTD 463 (2000), we held that the process through which eggs underwent where the shell was removed and the "liquid eggs" were then packaged in large bags or buckets constituted "manufacturing" under RCW 82.04.120.[10] In that case we reasoned as follows:

> Liquid eggs have a new form, certainly, as compared to whole eggs. They are liquid and contained in large bags or buckets, as contrasted to whole eggs in their familiar shells. They have a different utility as well in that they are suitable for large, commercial baking operations. Liquid eggs can be transported in quantity more easily than "conventional" eggs. Bakers can simply [pour] a bucket or bag of liquid eggs into their baking mixture, a

[10] This determination was the original "liquid eggs" determination that was issued prior to the subsequent petition for reconsideration that ultimately resulted in 19 WTD 468, discussed earlier.

> process that is infinitely more convenient than cracking individual eggs and adding them one at a time. Liquid eggs have developed a specialized market. To this market they are "a different or useful substance."

19 WTD 463 (2000). And more recently, in Determination No. 14-0057, 33 WTD 429 (2014), we held that the process through which raw logs were converted to shorter "veneer blocks" and "saw logs" constituted manufacturing. In that case, we relied on the *McDonnell* Court's factors, observing that the process involved in that case that a change in form and quality, and an increase in value, were all evident, but that other *McDonnell* factors were not as evident. *Id.* Thus, an activity need not satisfy every one of the factors articulated in *McDonnell* to be manufacturing.

With all of this in mind, we now turn to the activity at issue here and apply the *McDonnell* factors of (1) form, (2) quality, (3) properties (chemical, physical, and/or functional in nature), (4) enhancement in value, (5) the extent and the kind of processing involved, and (5) differences in demand.

Regarding change in form, there are clearly a number of changes to the form of the baby carrots compared to the original whole carrot. First, baby carrots are much shorter than the original whole carrots. Further, baby carrots do not have the outer skin that covers the original whole carrots. Finally, the ends of the baby carrots are uniformly rounded, whereas the original whole carrots grow in a variety of shapes naturally. We noted in Determination No. 10-0108, 31 WTD 1 (2010), that a "change in form" is "a key factor" in determining that an activity constitutes manufacturing. Based on the clear changes in the "key factor" of form we observe, we conclude that this first factor is indicative of a manufacturing activity.

Next, regarding quality and properties, we observe no specific changes. In 33 WTD 429, we held that when logs were cut into smaller segments for the purpose of selling the higher quality portions of the logs in smaller segments, there was a change in quality. Here, we have no evidence that the cutting of the carrots into "baby" form somehow increases the overall quality of that "baby" portion of the original whole carrot, except that the baby carrots are more convenient and ready to eat than the original whole carrots because they are a smaller size and have been peeled. Likewise, there appears to be no difference in the chemical, physical, or functional properties of the baby carrots compared to the original whole carrot. Therefore, we conclude that these two factors are not indicative of a manufacturing activity.

Regarding the enhancement in value, Taxpayer represented that the price of baby carrots is approximately twenty percent higher than the price of the original whole carrots. We consider this enhancement to be significant, even if the increase in value is not as high as in some of the prior cases we have considered. *See* 33 WTD 429 (holding that a sixty percent increase in value of the final product was "significantly" higher than the original product value); Det. No. 95-170, 16 WTD 43 (1995) (holding that a 470 percent increase in value was a factor that supported a "significant change" in the product at issue in that case). We conclude that the enhancement in value evident here remains indicative of a manufacturing activity.

Regarding the kind of processing involved, there is no dispute that the process involves all of the following activities: washing, cutting, storing, sorting, peeling, polishing, and packaging. There

is also no dispute that this process requires specialized equipment to accomplish. Taxpayer correctly points out that some of these activities are expressly declared to not be manufacturing under RCW 82.04.120(2), at least when done to an "agricultural product." However, cutting, peeling, and polishing are not expressly included in RCW 82.04.120(2). These specific activities are not unlike other activities that we have previously declared to be manufacturing. *See* 33 WTD 429 (holding that cutting logs was a manufacturing activity); 19 WTD 463 (holding that removing eggs from egg shells was a manufacturing activity). *See also McDonnell*, 62 Wn.2d 553 (holding that the splitting of peas constituted a manufacturing activity).
We also note that, as the *McDonnell* Court observed,

> In utilizing the aforementioned factors, it is necessary to bear in mind the admonition in *Bornstein* that "In short, we have come to the position now where we are classifying 'manufacturing' activities which realistically are not manufacturing in the ordinary sense at all." That is, the definition in RCW 82.04.120 of the term *manufacture* and its tax scope is subject to legislative determination. This determination is not necessarily confined to a classical or orthodox definition of manufacturing, which, in common understanding, usually would connote a spinning, knitting, sewing, sawing, synthesizing, assembly or other fabrication process.

McDonnell, 62 Wn.2d at 557 (emphasis in original). Accordingly, we conclude that the cutting, peeling, and polishing evident in the process at issue here is indicative of a manufacturing activity.

Finally, regarding the difference in demand, Taxpayer argues that whole carrots and baby carrots are "equally marketable." We disagree that the marketability of both forms of carrots are "equal." It is clear that baby carrots are in high demand compared to whole carrots. Indeed, the advent of the baby carrot was primarily responsible for the significant increase in carrot consumption that has occurred since the 1980s, when the baby carrot was first marketed. While Taxpayer argues that both whole carrots and baby carrots are "both staples of any produce section in grocery stores," there is clearly a strong and distinct market for baby carrots. This is consistent with Taxpayer's representation that baby carrots account for sixty percent of its sales while whole carrots account for only thirty percent of its sales. We conclude that the significant demand for baby carrots compared to whole carrots is indicative of a manufacturing activity.

Ultimately, on balance, we conclude that, after applying *McDonnell* factors, the process of converting whole carrots to baby carrots is, in totality, a manufacturing activity. We, therefore, conclude that the baby carrots, which are the result of that activity, are "manufactured substances or articles," and not "agricultural products," and, as such, cannot qualify for the exemption from B&O tax under RCW 82.04.330(1). We, therefore, conclude that Taxpayer's sales of baby carrots into Washington remain subject to B&O tax.

. . .

4. Waiver of Penalties

Taxpayer also requests a waiver of the delinquent penalty. RCW 82.32.105, which provides the circumstances under which the Department may generally waive a delinquent penalty, requires waiver when the Department finds that a taxpayer's failure to pay the proper amount or to pay timely was the result of "circumstances beyond the control of the taxpayer." RCW 82.32.105(1).

"Circumstances beyond the control of the taxpayer," in turn, is defined in WAC 458-20-228 (Rule 228), which states the following:

> Circumstances beyond the control of the taxpayer are generally those which are immediate, unexpected, or in the nature of an emergency. Such circumstances result in the taxpayer not having reasonable time or opportunity to obtain an extension of the due date or otherwise timely file and pay.

Rule 228(9)(a)(ii). Additionally, the circumstance "must actually cause the late payment." *Id.*

Taxpayer offers no specific evidence of circumstances which were "immediate, unexpected, or in the nature of an emergency." *Id*. To the extent that Taxpayer has implied that it failed to pay the proper amount of taxes based on a misunderstanding of its tax liability in Washington, such misunderstanding is specifically included as a circumstance that is *not* beyond the control of Taxpayer. Rule 228(9)(a)(iii)(B). *See also* Det. 01-096, 22 WTD 126 (2003) (holding that lack of knowledge of a taxpayer's tax liability "is not a 'circumstance beyond the control of the taxpayer' because the law, regulations, and Department publications explaining all tax laws are publicly available not only to taxpayer's, but to the tax professionals who support them.")

Further, to the extent that Taxpayer has implied that the length of time it took the Compliance Division to complete its review supports a waiver of penalties, we disagree. Rule 228(9)(a)(ii) specifically states that a circumstance beyond the control of Taxpayer must have actually caused the late payment. However, any delay by the Compliance Division could not have "caused" Taxpayer's ongoing failure to know, report, and pay, its tax liability to Washington. Such delay, thus, cannot form the basis of a circumstance beyond the control of Taxpayer through which it would be entitled to a penalty waiver under Rule 228(9). Therefore, we do not have authority to waive the substantial underpayment penalty here.

5. Waiver of Interest

Regarding the interest assessed, the Department may only waive or cancel interest in two limited circumstances: (1) The failure to timely pay the tax was the direct result of written instructions given to the taxpayer by the Department; or (2) the extension of a due date for payment of an assessment of deficiency was not at the request of the taxpayer and was for the sole convenience of the Department. RCW 82.32.105(3); Rule 228(10).

Taxpayer's argument here is that "the exorbitant duration of the Compliance Division's tax investigation was for the sole convenience of the Department." A review of the communication between the Compliance Division and Taxpayer's representative indicates that there was fairly regular contact between those parties between 2013 and 2016, with the exception of one period between July 30, 2013, and November 3, 2015, when there does not appear to have been any communication. Department records indicate that on July 30, 2013, the Compliance Division directed Taxpayer's representative to provide "figures for [Taxpayer's] sales into Washington" by August 29, 2013. There is no record that Taxpayer ever produced that additional information. In fact, the next record of correspondence, November 3, 2015, indicates that there was still information the Compliance Division expected to receive from Taxpayer. While it is unclear why so much time passed between those two communications, Taxpayer did not provide information as directed during that time, and, therefore, any delay cannot qualify as being "for the sole convenience of the Department." Indeed, on April 15, 2016, Taxpayer's representative stated "[w]e deeply apologize for how long it has taken us to respond to your data request." Therefore, the delay in issuing the tax assessment in this case appears to have been at least partially due to Taxpayer's delays in providing adequate information. Accordingly, we affirm the interest as assessed.

DECISION AND DISPOSITION

Taxpayer's petition is denied . . . .

Dated this 5th day of October 2017.