

Cite as Det. No. 18-0191, 42 WTD 005 (2023)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 18-0191
)	
... )	Registration No. . . .
)	

[1] RCW 82.04.120; RCW 82.04.240; WAC 458-20-136: B&O TAX – MANUFACTURING – PERSONALIZED PRODUCTS. A taxpayer changing the physical property of pet collars or tags by physically stamping or embroidering them is creating “new, different, or useful” products, or engaging in manufacturing activities. The fact it is a customization or personalization for a specific customer does not render the activities non-manufacturing.

[2] RCW 82.04.120; RCW 82.04.240; WAC 458-20-136: B&O TAX – MANUFACTURING – NON-PERSONALIZED PRODUCTS. A taxpayer reselling non-personalized pet collars or tags is not engaging in manufacturing activities.

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.

Casselman, T.R.O. – A Washington limited liability company and online seller of personalized pet products, such as tags, collars, and leashes, protests the Department of Revenue’s assessment of manufacturing business and occupation (B&O) tax on its sales of personalized and non-personalized products. We grant Taxpayer’s petition in part and deny it in part.<sup>1</sup>

ISSUES

1. Are sales of personalized products subject to the manufacturing B&O tax, under RCW 82.04.120, RCW 82.04.240, and WAC 458-20-136, where Taxpayer personalizes information on its products as requested by its customer, and includes attachment devices?
2. Are sales of non-personalized products subject to the manufacturing B&O tax, under RCW 82.04.120 and RCW 82.04.240, and WAC 458-20-136, where Taxpayer ships non-personalized products to customers without changing or assembling any of the component parts?

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

## FINDINGS OF FACT

Taxpayer makes online sales of pet products such as tags, collars, leashes, and people products, such as military identification (ID) tags, medical ID tags, and travel tags. Although all of Taxpayer's sales are made online, it has [a] physical location in . . . , Washington, where it houses its . . . stamping, and . . . embroidery machines. The overwhelming number of Taxpayer's sales are to customers located outside of Washington, to individual buyers rather than customers buying in bulk. The typical customer is a pet owner purchasing a personalized collar or tag for their pets. Taxpayer's largest source of revenue is from the sale of pet products, 30 percent of which Taxpayer sells with no personalization. Taxpayer maintains that customers purchase its pet products to ensure a pet is returned to them in the event the pet is lost. In other words, Taxpayer recognizes pet identification as necessary to ensure a pet's safe return.<sup>2</sup> A secondary purpose for purchase is for decorative use or pet jewelry. The pet collars and leashes sold by Taxpayer are available in a variety of colors, with or without reflective properties, and can be personalized. The pet tags sold by Taxpayer are available in a variety of shapes and designs, in either steel or aluminum. Like the collars and leashes, the tags can be personalized. Taxpayer ships all pet products, except leashes, with a ring or rivet for attachment. Taxpayer does not attach the split ring or rivets to any of the products itself; rather, it leaves it to the customer to attach if desired.

The prices of Taxpayer's products do not change based on whether the customer chooses to personalize or not. Taxpayer uses both domestic and foreign suppliers for its split rings, thread, silencers,<sup>3</sup> rivets, tags, and collars. Taxpayer purchases its materials in bulk from various suppliers and repackages the items as necessary to fill individual orders. For example, when Taxpayer receives an order for a personalized metal tag, Taxpayer will "stamp" the tag using its machines located in . . . , Washington. Taxpayer will then package the stamped tag with an attachment device (either the split ring or rivet depending on customer's purchase), and ship to the customer in a shipping envelope with Taxpayer's logo on it. Taxpayer does not identify the supplier of its components and when the customer receives the product, it will appear as if the attachment device and tag all come from the Taxpayer. Taxpayer does not advertise items such as split rings, silencers, and rivets for individual sale on its website.<sup>4</sup>

In 2017, The Department's Audit Division (Audit) reviewed Taxpayer's books and records for the period from January 1, 2014, through June 30, 2017 (audit period). Audit determined that Taxpayer was engaged in manufacturing and reclassified Taxpayer's income from the retailing B&O tax classification to the manufacturing B&O tax classification. Based on its audit findings, on December 11, 2017, the Department assessed Taxpayer for a total of \$ . . .<sup>5</sup> On January 8, 2018, Taxpayer filed a petition protesting the assessment of manufacturing B&O tax and related interest and penalties. Taxpayer maintains that its activities associated with its products are not manufacturing activities and that the assessment of manufacturing B&O tax was in error.

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<sup>2</sup> . . . .

<sup>3</sup> A silencer is a bumper for the tag, which appears to be made of rubber.

<sup>4</sup> . . . (last visited June 21, 2018).

<sup>5</sup> The assessment, Document No. . . . , was comprised of \$ . . . in retailing B&O tax, \$ . . . in wholesaling B&O tax, a multiple activities tax credit (MATC) for \$ . . . , \$ . . . in interest, and a 5% assessment penalty of \$ . . .

## ANALYSIS

RCW 82.04.220 is the general imposition statute for the B&O tax. It provides:

There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

Chapter 82.04 RCW provides the rate and measure of B&O tax, as well as the activity being taxed. There are four main tax classifications and a number of unique classifications or special rates. The four main classifications are extracting, manufacturing, wholesaling, and retailing.

Persons who manufacture in Washington are taxable under the manufacturing classification of the B&O tax based upon the value of the articles manufactured. RCW 82.04.240; WAC 458-20-136. RCW 82.04.120 contains the broad statutory definition of 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 . . . .

The Washington courts have broadly construed the definition of “manufacturing.” Where a taxpayer’s processes have caused a significant change in the product, the courts have found the activity to constitute manufacturing. *See, e.g., Continental Coffee Co. v. State*, 62 Wn.2d 829, 384 P.2d 862 (1963) (roasted, blended coffee from green coffee beans); *McDonnell & McDonnell v. State*, 62 Wn.2d 553, 383 P.2d 905 (1963) (split peas from whole, dried peas); *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962) (fish fillet from whole fish); *J&J Dunbar & Co. v. State*, 40 Wn.2d 763, 245 P.2d 1164 (1952) (whiskey from raw, undrinkable whiskey).

In *Bornstein Sea Foods, Inc. v. State*, 60 Wn.2d 169, 373 P.2d 483 (1962), the Washington State Supreme Court articulated a “significant change” test for determining whether a new, different, or useful article is produced. In concluding that the transformation of whole fish into individual fillets for freezing and sale constituted manufacturing under RCW 82.04.120, the court developed the following test:

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.

A year later the court relied upon this 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 court in *McDonnell* 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.” 62 Wn.2d at 556. The court then identified the following factors one should consider in determining if the end product is a new, different, or useful product: “[A]mong 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.

WAC 458-20-136 (Rule 136) is the Department’s rule that implements RCW 82.04.240 and discusses the taxability of products manufactured in Washington. Rule 136 explains that “[t]he physical assembly of products from various components is manufacturing because it results in a ‘new, different, or useful’ product, even if the cost of the assembly activity is minimal when compared with the cost of the components.” Rule 136(7). Rule 136 also explains that even when the manufactured product is delivered out of state, because the manufacturing activities take place in Washington, the manufacturer is subject to the manufacturing B&O tax upon the value of these manufactured products.<sup>6</sup> *See* Rule 136(4).

1. *Sales of personalized products are subject to the manufacturing B&O tax, where Taxpayer personalizes information on its products as requested by its customer.*

Taxpayer maintains that Taxpayer’s personalization does not change the quality of the items, does not change the chemical, physical or functional properties of the items, and there is no enhancement of value, rather, the marketability of the item is drastically reduced, as it is useful only to the one customer whose information is added to the item. We disagree. Taxpayer is changing the physical property of the tags or collars by physically stamping or embroidering them. The physical changing of the tag and collar in turn changes the functionality of the tags and collars dramatically. The tags and collars transform from merely decorative items into a powerful method of identifying the owner of a lost dog. It creates a way for the owner to reunite with their lost pet, which according to Taxpayer, is the number one reason for purchase of a personalized pet product. For a consumer looking for pet identification products, Taxpayer’s products only have value because they are customizable.

Taxpayer further argues that the colloquial definition<sup>7</sup> of manufacturer does not apply to Taxpayer’s activities but recognizes that the legislature has not used the colloquial definition of “manufacturer.” The court in *McDonnell & McDonnell* addressed this tension between the colloquial definition and the statutory definition of manufacturing:

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 as ‘manufacturing’ activities which realistically are not

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<sup>6</sup> A credit may be available if a gross receipts tax is paid on the selling activity to another state. *See* WAC 458-20-19301 (multiple activities tax credits). Additionally, manufacturers who sell their products at retail or wholesale in Washington are also subject to either the retailing or wholesaling B&O tax, as the case may be. In such cases, the manufacturer must report under both the “production” (manufacturing) and “selling” (wholesaling or retailing) classifications of the B&O tax, and claim a multiple activities tax credit (MATC). *See* Rule 136(4)(a).

<sup>7</sup> In the hearing, Taxpayer referred to “Webster’s Dictionary” definition and argued that Taxpayer did not fall within the dictionary definition of manufacturing.

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 & McDonnell*, 62 Wn.2d at 557 (emphasis in original).

Taxpayer maintains that the process of stamping or embroidering is too “simple” to be considered manufacturing. The Department has addressed facts and arguments similar to the ones Taxpayer makes in this case. In Det. No. 88-354, 6 WTD 371 (1988) a taxpayer argued that the silk screening of T-shirts should not be considered a manufacturing activity. In that case, the taxpayer was engaged in the business of imprinting designs and pictures on various apparel, including shirts. *Id.* The taxpayers purchased finished goods, and using a silkscreen process, imprinted patterns or designs on blank shirts. *Id.* Taxpayers argued that the imprinting of designs on the shirts did not make the shirts more “usable” and that, if anything, the imprinted shirts were less usable because the market for the shirt was dramatically reduced when an imprint was added. *Id.* The Department held that the silk screening of shirts fell within the broad definition of manufacturing because the taxpayer was processing blank shirts and by its labor, skill, and machinery, was producing a new, different, and useful product. *Id.* The taxpayer’s activity increased the salability of the imprinted shirt to those individuals that wanted to wear imprinted shirts. *Id.* Similarly here, the value of the tags as identification increases when it contains the customer’s personalized information. For a pet owner wanting a tag or collar for purposes of identification, the tags are only valuable if they are customizable. Taxpayer is applying labor or skill to change blank tags with limited marketability into customized imprinted tags that pet owners use to identify their pets. The fact that the new tag, once created, is only marketable to the person who has it personalized does not make them less marketable overall. Pet owners want personalized tags and this process, which is the activity subject to tax, is what creates the marketability of the product.

2. *Sales of non-personalized products are not subject to the manufacturing B&O tax, where Taxpayer ships non-personalized products to the customer, without attaching or changing any of the component parts.*

For the small number of non-personalized products, we agree with Taxpayer. Where the Taxpayer ships only a collar, or tag with a split ring in the same envelope, Taxpayer is not physically assembling, connecting, reconfiguring, changing, or processing the component parts. Rule 136(7)(c)(iii)(C). For non-personalized products, Taxpayer is not engaging in any activity that results in a new, different, or useful product. *See generally* RCW 82.04.120. In fact, Taxpayer engages in no activity at all in relation to these tags other than acquiring the products and shipping them to purchasers. . . . [F]or sales of non-personalized products where Taxpayer is not assembling or changing the component parts, we agree with Taxpayer that manufacturing B&O tax does not apply.

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DECISION AND DISPOSITION

Taxpayer's petition is denied in part and granted in part. We deny the petition with respect to personalized products, which we find are subject to manufacturing B&O tax. We grant the petition with respect to non-personalized products, which we find are not subject to manufacturing B&O tax.

Dated this 2nd day of July 2018.