

Cite as Det. No. 14-0098, 35 WTD 267 (2016)

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. 14-0098
)	
... )	Registration No. . . .
)	

[1] RULE 112, RULE 136; RCW 82.04.110, RCW 82.04.120, RCW 82.04.220, RCW 82.04.240: BUSINESS AND OCCUPATION TAX – MANUFACTURING – CONSTRUCTION – SUBCONTRACTORS – DESIGN AND ENGINEERING SERVICES – YACHT. The Department concluded that a yacht builder was liable for Manufacturing B&O tax on payments it received from a client for subcontracted engineering and design services associated with the construction of a custom yacht.

[2] RCW 82.04.050, RCW 82.08.010, RCW 82.08.020: RETAIL SALES TAX – SELLING PRICE – DESIGN AND ENGINEERING COSTS – YACHT. The Department concluded that subcontracted design and engineering costs associated with the construction of a custom yacht were properly included in the selling price of the yacht for retail sales tax purposes.

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.

Valentine, A.L.J. – [Taxpayer] appeals the assessment of manufacturing business and occupation (B&O) tax and retail sales tax on sales of yacht design and engineering services. Taxpayer contends the sales income was properly reported under the service and other activities (service) B&O classification. We conclude that the income at issue is properly included in the gross proceeds of sales and selling price and is subject to manufacturing B&O tax and retail sales tax. Taxpayer’s petition is denied.<sup>1</sup>

ISSUES

1. When a yacht builder pays subcontractors for engineering and design services associated with the construction of a custom yacht, and subsequently bills its client for the services, is the design and engineering income received by the yacht builder subject to manufacturing B&O tax under RCW 82.04.240, WAC 458-20-112, and WAC 458-20-136?

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

2. Are design and engineering costs associated with the construction of a custom yacht properly included in the selling price as defined by RCW 82.08.010 and, therefore, subject to retail sales tax under RCW 82.08.020?

### FINDINGS OF FACT

The audit period at issue is January 1, 2009 through September 30, 2012. The assessment includes \$ . . . for retail sales tax, a \$ . . . credit for B&O tax paid under the service classification, \$ . . . for manufacturing B&O tax, and \$ . . . in interest, for a total assessment of \$ . . . . Taxpayer appeals the entire assessment.

Taxpayer is a second-generation Washington company in the business of building custom luxury yachts. Taxpayer bills customers for time and materials plus an agreed upon profit margin. Taxpayer bills customers monthly as work progresses. The final cost is open-ended because, according to Taxpayer, buyers frequently ask for design changes during luxury yacht construction, particularly to the interiors.<sup>2</sup>

Typically, the building process begins with a potential buyer contacting Taxpayer expressing interest in yacht construction. Prior to the onset of construction, Taxpayer engages the services of a third-party naval architect and a third-party marine designer to design and engineer the yacht to the customer's specifications. Taxpayer's customers often pay the design and engineering costs directly to providers of the services. Sometimes, however, as in the present case, Taxpayer pays the providers for the services and then bills its customer. When Taxpayer pays for these services, it is generally for goodwill or the convenience of the customer. On these occasions, Taxpayer bills its customer for the design, drafting, and engineering costs separately from construction costs. Taxpayer does not add mark-up to the design and engineering costs.

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The income at issue in this case stems from four invoices from Taxpayer to its customer for design, engineering, and drafting services. The invoices are dated July 19, 2011; July 31, 2011; August 31, 2011; and September 30, 2011. The four invoices total \$ . . . . The invoices were all paid in full by October 14, 2011.

The Department of Revenue's (Department) Audit Division (Audit) describes its understanding of the design and construction timeline as follows:<sup>3</sup>

From July to September 2011, taxpayer hired two boat design companies to design a boat for a customer, and then billed the customer for the design fee. After the design was accepted by the customer, taxpayer began the manufacturing process of the boat in January 2012. The boat was finished in September 2012. There was no written contract. Per taxpayer's bookkeeper, it was a handshake deal. Taxpayer reported the design

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<sup>2</sup> At the hearing, Taxpayer clarifies that design changes occurring during yacht construction are reported and taxed the same as the construction activity.

<sup>3</sup> These comments are included in Audit's written response, dated March 25, 2013, to Taxpayer's petition. A copy is contained within the record.

income under Service B&O and the manufacturing part under Retailing and [retail sales tax] classifications.

Audit asserts that the design services were provided contemporaneously to the manufacturing of the yacht, thus making the income for both design and manufacturing taxable under the manufacturing B&O classification, with retail sales tax liability as well. In support of its position, Audit cites Det. No. 90-366, 10 WTD 149 (1990) and Det. No. 88-221, 6 WTD 33 (1998).<sup>4</sup>

Taxpayer reported the \$ . . . as income under the service B&O classification. Audit reclassified the income to manufacturing and also assessed retail sales tax (see assessment details above). Taxpayer contends that its original reporting B&O classification of service was proper, thereby relieving Taxpayer of retail sales tax liability. In support of its position, Taxpayer cites Det. No. 92-050, 12 WTD 101 (1993), Det. No. 98-012, 17 WTD 247 (1998), Det. No. 93-158, 13 WTD 302 (1994), and Det. No. 89-43A, 8 WTD 5 (1989).<sup>5</sup>

### ANALYSIS

1. When a yacht builder pays subcontractors for engineering and design services associated with the construction of a custom yacht, and subsequently bills its client for the services, is the design and engineering income received by the yacht builder subject to manufacturing B&O tax?

RCW 82.04.220 levies the B&O tax for “the act or privilege of engaging in business activities” in Washington. The tax is measured by “the application of rates against *value of products, gross proceeds of sales, or gross income of the business.*” *Id.*

(Emphasis added.)

A person or business entity engaged in providing engineering and design services typically reports gross income under the service B&O classification.<sup>6</sup>

A person or business entity reports gross income under the manufacturing B&O classification if the person or business entity “either directly or by contracting with others for the necessary labor or mechanical services, manufactures for sale or for commercial or industrial use from his or her own materials or ingredients any articles, substances, or commodities.”<sup>7</sup> The phrase “to manufacture” means “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

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<sup>4</sup> 10 WTD 149 deals with architecture and design services associated with a contract for construction of a building on real property. 6 WTD 33 deals with engineering services associated with the repair of tangible personal property.

<sup>5</sup> 17 WTD 247 deals with the development, sale, and installation of software for the seafood processing industry. 12 WTD 101 deals with photo session fees and beauty salon services. 13 WTD 302 deals with use/deferred sales tax on the use of software support services. 8 WTD 5 deals with modifications to software programs.

<sup>6</sup> RCW 82.04.290(2); WAC 458-20-224; WAC 458-20-138.

<sup>7</sup> RCW 82.04.110(1), WAC 458-20-136.

substance or article of tangible personal property is produced for sale or commercial or industrial use, and includes: (a) The production or fabrication of special made or custom made articles.”<sup>8</sup>

Taxpayer constructs custom yachts for sale. Clearly, then, Taxpayer’s yacht building activities are properly classified as manufacturing for B&O tax purposes. There is agreement between Audit and Taxpayer on this issue. The question, however, is whether income received for the naval architecture and marine design services at issue is properly reported under the manufacturing B&O classification as well.

Manufacturers in this state are taxed, for B&O tax purposes, on the “value of the products.”<sup>9</sup> “*The value of products . . . manufactured shall be determined by the gross proceeds derived from the sale thereof* whether such sale is at wholesale or at retail.”<sup>10</sup> “Gross proceeds of sales” means “the value proceeding or accruing from the sale of tangible personal property . . . and/or for other services rendered, *without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount paid, delivery costs, taxes, or any other expense whatsoever paid* or accrued and without any deduction on account of losses.”<sup>11</sup> The measure of B&O tax for manufacturers, such as Taxpayer, who do business on the basis of “cost-plus” or “time and material” contracts “includes the amount of profit or fee above cost received, plus the reimbursements or prepayments received on account of materials and supplies, labor costs, taxes paid, *payments made to subcontractors, and all other costs and expenses incurred by the manufacturer or processor for hire.*”<sup>12</sup>

In the present case, Taxpayer’s customer was not billed directly by the naval architect and marine designer for the engineering and design services. Taxpayer paid the costs directly to the subcontractors and billed its client for these services in addition to billing and receiving payment for the yacht construction itself. Manufacturers pay B&O tax on the “gross proceeds of sales” a term that means the value gained from the sale of tangible personal property, and/or for services rendered, without deductions allowed for labor or any other expense.<sup>13</sup> We conclude, therefore, that Taxpayer’s income derived from its customer’s payments for design and engineering services is properly included in the “gross proceeds of sales,” as related to the manufacturing of the yacht at issue, and, therefore, properly reported under the manufacturing B&O classification. Taxpayer’s petition is denied on this issue.

2. Are design and engineering costs associated with the construction of a custom yacht properly included in the selling price of the yacht and, therefore, subject to retail sales tax?

RCW 82.08.020 imposes retail sales tax “on each retail sale in this state . . . unless the sale is specifically excluded from the RCW 82.04.050 definition of a retail sale.” The “selling price”

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<sup>8</sup> RCW 82.04.120(1)(a). *See also* WAC 458-20-136.

<sup>9</sup> RCW 82.04.240. *See also* WAC 458-20-136.

<sup>10</sup> RCW 82.04.450. *See also* WAC 458-20-112: “The law provides . . . that under the . . . manufacturing [classification] of the business and occupation tax the value of products . . . manufactured shall be determined by the gross proceeds of sales in every instance in which a bona fide sale of such products is made, and whether sold at wholesale or at retail.” (Emphasis added.)

<sup>11</sup> RCW 82.04.070. *See also* WAC 458-20-112. (Emphasis added.)

<sup>12</sup> WAC 458-20-136. (Emphasis added.)

<sup>13</sup> *Id.*

provides the basis for the retail sales tax. *Id.* RCW 82.08.010(1)(a) defines “selling price” or “sales price” as follows:

“Selling price” includes “sales price.” “*Sales price*” means the total amount of consideration . . . for which tangible personal property [is] sold. No deduction from the total amount of consideration is allowed for the following: (i) The seller’s cost of the property sold; (ii) the cost of materials used, *labor or service cost* . . . and any other expense of the seller; (iii) charges by the seller for any services necessary to complete the sale, other than delivery or installation charges.

(Emphasis added.)

RCW 82.04.050 includes in the definition of “sale at retail” and “retail sale” the sale of tangible personal property to consumers. A yacht is tangible personal property and income gained, or total consideration received, from the sale of the yacht is part of the selling price or sales price subject to retail sales tax. No deduction from total consideration received is allowed for labor or service costs, or any charges related to “services necessary to complete the sale.”<sup>14</sup> There would be no yacht sale in this case without the design and engineering services provided by the subcontractors.

We also note that, “in any taxable transaction, as in the case of the ordinary . . . retail sale of personal property, the measure of the tax is to be the cost to the buyer or consumer, and not the cost to the seller.”<sup>15</sup> In the present case, the buyer’s cost included the charges for the design and engineering services that were necessary as part of the yacht construction. Thus, the design and engineering costs are part of the buyer’s costs, which is the measure of the tax.

We determine, therefore, that the costs of the design and engineering services at issue are properly included in the total selling price of the yacht and are subject to retail sales tax.<sup>16</sup>

Taxpayer’s petition is denied on this issue.

#### DECISION AND DISPOSITION

Taxpayer’s petition is denied.

Dated this 17th day of March, 2014.

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<sup>14</sup> RCW 82.08.010(1)(a).

<sup>15</sup> *Thys et al. v. State*, 31 Wash.2d 739, 199 P.2d 68 (1948) citing *Klickitat County v. Jenner*, 15 Wash.2d 373, 130 P.2d 880 (1942). In the *Thys* case, the Court concluded that the cost (labeled royalties) to buyers of patented designs of equipment to be manufactured was properly included in the total sale price for retail sales tax purposes.

<sup>16</sup> Regarding the Department determinations cited by Audit and Taxpayer, our review of these cases shows that none are applicable to the manufacturing B&O classification. Thus, we conclude that the analysis in these cases is not applicable to the present case. Rather, we determine that the statutes and rules expressly related to manufacturing B&O tax and retail sales tax properly determine the outcome of this appeal.