

Cite as Det. No. 18-0276, 39 WTD 179 (2020)

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. 18-0276
)	
...)	Registration No. ...
)	

[1] RCW 82.04.260(11)(a); RCW 82.04.290(4); RCW 82.32.550; ETA 3210.2018: BUSINESS AND OCCUPATION (B&O) TAX – AEROSPACE B&O TAX CLASSIFICATION – MANUFACTURER OR SELLER OF COMMERCIAL AIRPLANES OR COMPONENTS – INSTALLATION – FAA CERTIFICATION DOCUMENTATION – TYPE CERTIFICATE (TC) – PRODUCTION CERTIFICATE (PC) – SUPPLEMENTAL TYPE CERTIFICATE (STC). To qualify for the preferential rate, the manufacturer or seller of components subsequently sold to and used by other manufacturers must show that the components are 1) certified by the Federal Aviation Administration (FAA); and 2) are sold for installation into a commercial airplane. In instances where manufacturers or sellers do not receive a separate FCC certification for the components, they must adequately document their activities to substantiate qualification for the preferential rate. Examples are purchase orders, sales invoices, or other records that identify the TC, PC, or STC issued by the FAA to the commercial airplane manufacturer, under which the materials or components are sold.

[2] RCW 82.04.260(11)(a); RCW 82.04.290(3): B&O TAX – NON-MANUFACTURING AEROSPACE PRODUCT DEVELOPMENT – To qualify for the preferential B&O tax rate in RCW 82.04.290(3), persons must perform aerospace product development for others. Although a taxpayer developed certain kits for someone else to manufacture, the taxpayer was ultimately designing the kits for sale to its own customers, and was not being paid by the third-party manufacturer for these development services. Thus, the taxpayer was not providing development services “for others” as contemplated by the statute.

[3] RCW 82.04.4461(1): B&O TAX CREDIT FOR QUALIFIED AEROSPACE PRODUCT DEVELOPMENT EXPENDITURES – A B&O tax credit is allowed for qualified pre-production aerospace product development expenditures. The term “for all other persons” generally includes persons who perform aerospace product development for their own purposes. Credits must be claimed against taxes due for the same calendar year in which the qualified

aerospace product development expenditures are incurred. Credit earned may not be carried over into other periods. The credit for each calendar year may not exceed the amount of tax otherwise due for the calendar year. Refunds may not be granted in the place of a credit.

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.

LaMarche, T.R.O. – A Washington-based business engaging in aerospace product development argues that it qualifies for certain aerospace incentive business and occupation (B&O) tax rates, and the B&O tax credit for aerospace product development. We grant the petition in part and deny it in part.¹

ISSUES

1. Has Taxpayer shown that its activities qualify for the B&O tax rate in RCW 82.04.260(11)(a) for aerospace manufacturers and processors for hire, or the B&O tax rate in RCW 82.04.290(3) for aerospace product development for others?
2. Has Taxpayer shown that it is entitled to the B&O tax credit in RCW 82.04.4461(1) for qualified aerospace product development expenditures?

FINDINGS OF FACT

. . . (Taxpayer), is a Washington limited liability company that develops and sells aerospace products. Taxpayer does not engage in manufacturing activity.

. . .

[Taxpayer reports] that in a few instances it performs research and development (R&D), design, or engineering services directly to its customers.² However, the majority of Taxpayer's revenue comes from sales of aftermarket kits and [FAA]-approved parts to its customers worldwide.

Taxpayer explains that it engineers, designs, and develops the aftermarket kits and parts and, if applicable, has them [FAA]-certified. Taxpayer then contracts with third-party manufacturers who manufacture the kits and parts to Taxpayer's specifications using their own materials. Taxpayer purchases the completed kits and parts at wholesale from the manufacturers and resells them to its customers at retail.

. . .

The Audit Division (Audit) of the Department of Revenue (Department) conducted an audit of Taxpayer's business activities for the period of January 1, 2012, through December 31, 2015

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

² Taxpayer did not provide R&D, design, or engineering services directly to its customers during the audit period, as we will discuss below.

(Audit Period). Initially, Audit classified certain unreported income under the Service and Other Activities B&O tax classification, and imposed use tax and/or deferred sales tax on certain tooling/setup charges.

The Department issued an assessment on March 28, 2017, Document No. . . . , totaling \$. . . , which consisted of \$. . . in Service and Other Activities B&O tax, \$. . . in use tax and/or deferred sales tax, \$. . . in interest, and a 5% assessment (substantial underpayment) penalty of \$ Taxpayer made a payment of \$. . . on April 27, 2017, leaving a balance of approximately \$. . . , and filed a petition for correction of the assessment and refund on April 27, 2017.

After the petition was filed, Taxpayer and Audit agreed to certain adjustments. . . .

The remaining issues are whether Taxpayer's instate activities qualify for either of two aerospace B&O tax classifications, and whether Taxpayer qualifies for the B&O tax credit for qualified aerospace product development expenditures.

ANALYSIS

1. Aerospace B&O Tax Rates

Washington imposes a B&O tax “for the act or privilege of engaging in business activities” in this state. RCW 82.04.220(1). The measure of the B&O tax is the appropriate tax rate multiplied by the “value of products, gross proceeds of sales, or gross income of the business, as the case may be.” *Id.* The specific tax rate is determined by the nature of the business activity in which a taxpayer is engaged. *See generally* chapter 82.04 RCW.

RCW 82.04.260(11)(a)³ imposes a B&O tax on manufacturing activities in this state of commercial airplanes, components, or aerospace tooling, as follows:

Beginning October 1, 2005, upon every person engaging within this state in the business of manufacturing commercial airplanes, or components of such airplanes, or making sales, at retail or wholesale, of commercial airplanes or components of such airplanes, manufactured by the seller, as to such persons the amount of tax with respect to such business is, in the case of manufacturers, equal to the value of the product manufactured and the gross proceeds of sales of the product manufactured, or in the case of processors for hire, equal to the gross income of the business, multiplied by the rate of:

- (i) 0.4235 percent from October 1, 2005, through June 30, 2007; and
- (ii) 0.2904 percent beginning July 1, 2007.

RCW 82.04.260(11)(a) (emphasis provided).

³ RCW 82.04.260 was amended many times during the Audit Period. However, none of the amendments pertain to the issue here, and the language in RCW 82.04.260(11) remained unchanged during the Audit Period. *Compare* Laws of 2017, ch. 135, § 11, effective July 1, 2018; *and* Laws of 2011, ch. 2, § 203 (Initiative Measure No. 1107, approved November 2, 2010).

[In contrast,] RCW 82.04.290(3)⁴ provides a B&O tax rate of 0.9 percent for non-manufacturing aerospace product development, for “every person engaging within this state in the business of performing aerospace product development for others.” (Emphasis provided.) Although not an issue here, we note that taxpayers reporting under RCW 82.04.290(3) must file a complete annual report with the Department as provided under RCW 82.32.534. RCW 82.04.290(3)(b).

“Aerospace product development” is defined in RCW 82.04.4461(5)(b),⁵ in relevant part, as:

[R]esearch, design, and engineering activities performed in relation to the development of an aerospace product or of a product line, model, or model derivative of an aerospace product, including prototype development, testing, and certification. . . . The term does not include manufacturing activities or other production-oriented activities, however the term does include tool design and engineering design for the manufacturing process. . . .

Here, Taxpayer claims it qualifies for each of the aerospace B&O tax rates under RCW 82.04.260(11)(a) and RCW 82.04.290(3)(b). We disagree.

First, to qualify for the B&O tax rate in RCW 82.04.260(11)(a), Taxpayer must show that Taxpayer itself manufactures components of commercial airplanes. Here, Taxpayer contracts with independent parties who use their own materials to manufacture components it designs, but Taxpayer itself is not a manufacturer. Therefore, its activities do not qualify for the manufacturing B&O tax rate in RCW 82.04.260(11)(a).

Next, the B&O tax rate in RCW 82.04.290(3)(a) is available to “every person engaging within this state in the business of performing aerospace product development for others.” (Emphasis provided.) Although Taxpayer indicates that it provided instate aerospace product development for others in the past, it did not do so during the Audit Period.

Here, when Taxpayer engages in aerospace product development (i.e., research, design, and engineering activities, etc.) during the course of creating the kits and parts it sells, it does not perform such services “for others.” RCW 82.04.290(3)(a). Instead, Taxpayer performs aerospace product development activities for its own purposes during its development of its products. Taxpayer does not receive any income for providing these services.

This is different from directly performing aerospace product development for customers, because the customers want to acquire the product development to, for example, manufacture the product

⁴ RCW 82.04.290 was amended during the Audit Period. The most recent amendment reorganized the section, moving the definition of “aerospace product development” to a new subsection (c), and adding under RCW 82.04.290(3)(b) the requirement that persons reporting under RCW 82.08.290(3) must file a complete annual report with the Department pursuant to RCW 82.32.534. We refer to the most recent version of the statute in our discussion. Laws of 2014, ch. 97, § 404; (Laws of 2014, ch. 97, § 403 expired July 9, 2014). Laws of 2013, 3rd sp. sess., ch. 2, § 8 made minor grammatical changes, and Laws of 2013, ch. 23, § 314 did not affect RCW 82.04.290(3).

⁵ RCW 82.04.4461 was amended once during the Audit Period, but the amendment did not affect RCW 82.04.4461(5)(b). Laws of 2013, 3rd sp. sess., ch. 2, § 9.

themselves.⁶ In this case, the expenses related to Taxpayer's aerospace product development activities are Taxpayer's own costs of doing business, and are a business expense. "Gross proceeds of sales" means, in relevant part, "the value proceeding or accruing from the sale of tangible personal property, . . . without any deduction on account of the cost of property sold, the cost of materials used, labor costs, . . . or any other expense whatsoever paid or accrued." RCW 82.04.070 (emphasis provided).

Thus, in the context of its retail sales of tangible personal property, Taxpayer's aerospace product development expenses are incorporated into its gross proceeds from retail sales. RCW 82.04.070. Gross proceeds from those sales are taxable under RCW 82.04.250(1), which imposes B&O tax on persons engaging in sales at retail (with certain exceptions not relevant here). Because Taxpayer did not receive gross income from aerospace product development for others during the Audit Period, its aerospace product development activities during that period do not qualify under RCW 82.04.290(3).

In conclusion, because Taxpayer has not shown that it qualifies for the aerospace manufacturing B&O tax rate in RCW 82.04.260(11)(a), or the B&O tax rate in RCW 82.04.290(3)(b) for qualified aerospace product development for others, we deny the petition as to those issues.

2. Aerospace Product Development B&O Tax Credit

As we discussed above, Taxpayer does engage in aerospace product development with regard to development of the kits and parts it sells at retail, although it does so during the performance of its own activities, rather than for others.

RCW 82.04.4461⁷ provides a B&O tax credit for qualified preproduction development expenditures for aerospace product development activities, as follows:

- (1)(a)(i) In computing the tax imposed under this chapter, a credit is allowed for each person for qualified aerospace product development. For a person who is a manufacturer or processor for hire of commercial airplanes or components of such airplanes, credit may be earned for expenditures occurring after December 1, 2003. For all other persons, credit may be earned only for expenditures occurring after June 30, 2008. . . .
- (2) The credit is equal to the amount of qualified aerospace product development expenditures of a person, multiplied by the rate of 1.5 percent.
- (3) Except as provided in subsection (1)(b) of this section the credit must be claimed against taxes due for the same calendar year in which the qualified aerospace product development expenditures are incurred. Credit earned . . . may not be carried over. The credit for each

⁶ [Although taxpayer develops the kits for someone else to manufacture, the taxpayer is ultimately designing the kits for sale to its own customers and is not being paid by the third-party manufacturer for these development services. Thus, the taxpayer is not providing development services "for others" as contemplated by the statute.]

⁷ The version of RCW 82.04.4461 in effect during the latter part of the Audit Period expired on December 31, 2017. We refer here to the newest version adopted in Laws of 2017, ch. 135, § 15, effective January 1, 2018, which replaced the term "annual report" in RCW 82.04.4461(6) with the term "annual tax performance report."

calendar year may not exceed the amount of tax otherwise due under this chapter for the calendar year. Refunds may not be granted in the place of a credit. . . .

RCW 82.04.4461(1)-(3) (emphasis provided).

. . .

Here, Taxpayer is not a manufacturer or processor for hire of commercial airplanes or components of such airplanes. However, it does engage in aerospace product development when it performs, for its own purposes, research, design, and engineering activity “in relation to the development of an aerospace product or of a product line, model, or model derivative of an aerospace product, including prototype development, testing, and certification.” RCW 82.04.4461(5)(b). Therefore, with regard to its aerospace product development expenditures, Taxpayer is included under the plain language of the statute, falling within the catch-all term “all other persons” in RCW 82.04.4461(1)(a)(i).

However, Taxpayer has no B&O tax liability for aerospace product development during the Audit Period. Although prior to the Audit Period Taxpayer engaged in taxable aerospace product development activity in this state for which it made expenditures, it did not perform this activity during the Audit Period. Taxpayer may apply the credit towards B&O tax liability only for calendar years in which it incurred such expenses, and cannot carry the credit over to other years. RCW 82.04.4461(3). Nor may Taxpayer get a refund in place of a credit. *Id.* Therefore, the B&O tax credit is not applicable under the facts here, and we deny the petition as to this issue.

DECISION AND DISPOSITION

Taxpayer’s petition is granted in part and denied in part. We deny the petition with regard to whether Taxpayer’s described activities qualify for the B&O tax rate in RCW 82.04.260(11)(a) for aerospace manufacturers and processors for hire, or the B&O tax rate in RCW 82.04.290(3) for aerospace product development for others. We also deny the petition with regard to Taxpayer’s claim to the B&O tax credit for qualified aerospace product development expenditures in RCW 82.04.4461.

However, we grant the petition with regard to the two adjustments agreed upon between the Department and Taxpayer. The first adjustment is a reclassification of certain income from the Service and Other Activities B&O tax classification to the Retailing classification. This adjustment is necessary because the income was derived from Taxpayer’s out-of-state retail sales. Subject to verification, the adjustment will result in a credit of approximately \$ If all of Taxpayer’s retail sales were sourced outside of Washington, the result of the latter adjustment will be to eliminate all retail sales tax and Retailing B&O tax liability in the assessment. The second adjustment, subject to verification, eliminates use tax and/or deferred sales tax for certain tooling items, which will result in an anticipated credit of approximately \$

Dated this 16th day of October 2018.