

Cite as Det. No. 16-0294, 36 WTD 248 (2017)

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. 16-0294
)	
...)	Registration No. . . .
)	

[1] RULE 15503; RCW 82.04.020, RCW 82.08.050: RETAIL SALES TAX – DIGITALLY AUTOMATED SERVICES – SERVICES OFFERED FOR SALE. Digitally Automated Services are subject to retail sales tax when they are offered for sale, as opposed to an internal, noncommercial service.

[2] RULE 228(9); RCW 82.32.105 – PENALTIES – SUBSTANTIAL UNDERPAYMENT PENALTY – CIRCUMSTANCES BEYOND A TAXPAYER’S CONTROL. There is no requirement that a taxpayer must have intended to avoid taxation for such taxpayer to be subject to a substantial underpayment penalty.

[3] RULE 193D; RCW 82.04.260(7) – B&O TAX – STEVEDORING – ASSOCIATED ACTIVITIES. A taxpayer may not report its gross income from activities associated with stevedoring if that taxpayer does not also engage in actual stevedoring services.

[4] RULE 193D; RCW 82.04.260(7) – B&O TAX – STEVEDORING – SERVICES PROVIDED IN A FOREIGN TRADE ZONE. Services provided within a Foreign Trade Zone are not automatically classified as stevedoring and associated activities. The nature of the activities, as opposed to the location of such activities, is controlling for classification 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.

Yonker, T.R.O. – A provider of services associated with “supply chain management” (Taxpayer) protests a tax assessment of use tax and/or deferred sales tax on the purchase of certain consumable supplies on various grounds. Taxpayer further protests future reporting instructions requiring Taxpayer to refrain from reporting any of its gross income under the stevedoring and associated activities business and occupation (B&O) tax classification, and to report its gross income on various other tax classifications instead. Taxpayer argues that it should be entitled to report under

the stevedoring and associated B&O tax classification because Taxpayer's services occur within a foreign trade zone. We deny Taxpayer's petition on all counts.¹

ISSUES

1. Were certain purchases of consumable supplies subject to retail sales tax under RCW 82.08.020 or use tax under RCW 82.12.020?
2. Is Taxpayer entitled to a waiver of penalties under RCW 82.32.105(1) and WAC 458-20-229?
3. Does Taxpayer qualify to report any portion of its gross income under the stevedoring and associated activities B&O tax classification pursuant to RCW 82.04.260(7) or WAC 458-20-193D, because Taxpayer's business activities occur within a foreign trade zone?

FINDINGS OF FACT

[Taxpayer] is a Washington corporation that provides "supply chain management" services primarily to major retailer customers. Taxpayer explains its business activity as follows:

While [Taxpayer] doesn't operate a waterfront terminal, we provide the same services, under the same stringent security expectations. The difference is that we handle the uncleared cargo on a carton and/or unit level, while the waterfront operators handle the goods at the container level.

In essence, when Taxpayer's customers have cargo shipped in containers from abroad, they engage Taxpayer to do custom packaging, repackaging, re-labeling, and warehousing. Taxpayer does not load or unload cargo from ships at the port; nor does Taxpayer itself transport the cargo from the port to Taxpayer's facility in . . . , Washington, where Taxpayer performs all of its services.² While Taxpayer's facility is not located at or near a port, the facility is located in the . . . Foreign Trade Zone (FTZ).³

In 2014, the Department's Audit Division commenced a review of Taxpayer's records for the time period of January 1, 2011, through September 30, 2014 (audit period). As part of its review, the Audit Division reviewed a sample of Taxpayer's records of consumable supply purchases. Within the sample reviewed, there were five purchases from [Vendor A] for [business to business integration services]. The Audit Division found that these purchases were for "digital automated services" subject to retail sales tax or use tax. Based on this finding and other findings not relevant

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

² Although, upon request from its customers, Taxpayer will arrange for the transportation of the cargo from the port to the . . . facility through a third-party transporter.

³ FTZs were created by the Foreign-Trade Zones Act of 1934 for the purpose of "expedited and encouraging foreign commerce." The program was later broadened to permit manufacturing and exhibiting within the FTZ boundaries. FTZs are "secured areas under U.S. Customs supervision that are considered outside the customs territory of the United States. Merchandise may be moved into an FTZ for storage, exhibition, manufacture, or other operations not otherwise prohibited by law. Customs duties on foreign merchandise are not collected until the merchandise is entered into the U.S. Customers territory." See <http://portoftacoma.com/sites/default/files/ZoneSchedule2015.pdf>, last visited on August 10, 2016.

here, the Audit Division calculated an error percentage for the sample that was then applied to the full audit period.

Additionally, as part of its review, the Audit Division reviewed certain consumable supply purchases on an “actual basis.” One such purchase was from [Vendor B] for an “exchange server upgrade.” The Audit Division found that this purchase likewise was subject retail sales tax or use tax.

Finally, the Audit Division reviewed the [B&O] tax classification under which Taxpayer reported its business activity to the Department. Previous to and throughout the audit period, Taxpayer reported the majority of its business activity under the stevedoring and associated activities B&O tax classification. This classification was not previously questioned by the Audit Division during a previous audit period. The Audit Division found that none of Taxpayer’s business activity qualified for the stevedoring and associated activities B&O tax classification.

On October 13, 2015, as a result of the Audit Division’s review, the Department issued a tax assessment against Taxpayer for \$. . . , which includes \$. . . in use tax and/or deferred sales tax, \$. . . in retail sales tax, a \$. . . five-percent assessment penalty, and \$. . . in interest.

The Audit Division also issued the following future reporting instructions as part of its review:

No adjustment is made in the audit because the incorrect reporting was accepted in the prior audits. However in the future, you must report “Handling Income” under the Warehousing tax classification; “Reconfiguration Projects,” “Pallet Charges,” “Overbox Charge,” “Cartage – Warehouse,” and “Brokerage – Ocean Freight” income under the Service and Other Activities tax classification; “Transportation – Brokerage” and “transportation Revenue” income under the Urban and Motor Transportation tax classification.

Taxpayer subsequently sought review of the full amount of the tax assessment, which remains unpaid, and sought review of the future reporting instructions.

ANALYSIS

1. Use Tax and/or Deferred Sales Tax on Consumable Supply Purchases

Washington imposes a retail sales tax on each “retail sale” within this state, unless some specific exemption applies. RCW 82.08.020. To the extent that a sale of an item that qualifies as a “retail sale” is not subjected to retail sales tax, Washington imposes a corresponding use tax on the use of that item. RCW 82.12.020; WAC 458-20-178(2).

The Audit Division found that five payments Taxpayer made to Vendor A for business-to-business integration services were “digital automated services.” The term “retail sale,” as defined under RCW 82.04.050, states the following:

(8)(a) The term [retail sale] also includes the following sales to consumers of digital goods, digital codes, and digital automated services:

- (i) Sales in which the seller has granted the purchaser the right of permanent use;
- (ii) Sales in which the seller has granted the purchaser a right of use that is less than permanent;
- (iii) Sales in which the purchaser is not obligated to make continued payment as a condition of the sale; and
- (iv) Sales in which the purchaser is obligated to make continued payment as a condition of the sale.

RCW 82.04.192, in turn, defines “digital automated services,” or DAS, as “any service transferred electronically that uses one or more software applications.”

Taxpayer argues that the services it purchased from Vendor A constituted exempt “non-commercial” DAS. In support of its argument, Taxpayer relied on a “tax topic” discussion published on the Department’s website entitled “Digital Products including Digital Goods,” which included the following question and answer:

Are there any common digital goods that are exempt from tax?

Yes. Digital goods that are not offered for sale are exempt from tax when they are:

- Noncommercial (such as personal e-mail communications).

...

This guidance, however, merely clarifies that a sent e-mail does not constitute a taxable digital good because it is not “offered for sale.” Here, the services Taxpayer purchased from Vendor A were not in the nature of a “personal e-mail communication,” but were clearly “offered for sale” as Taxpayer paid Vendor A for the services.⁴ Therefore, this guidance is not applicable to the services Taxpayer purchased from Vendor A.

Taxpayer next argues that the services at issue were telecommunications services as opposed to DAS. Yet, Washington includes “telecommunications services” in the definition of retail sale under RCW 82.04.050(5). Thus, even if the services at issue were telecommunication services, the sale of such services would still qualify as a retail sale under RCW 82.04.050(5), and therefore, would still be subject to retail sales tax or [deferred sales tax].⁵ As such, Taxpayer has failed to meet its burden of proving that its purchase of Vendor A’s services was exempt from retail sales tax or [deferred sales tax], and the tax assessment is affirmed as it relates to this issue.⁶

⁴ Further, this guidance only pertained to “digital goods” as opposed to “digital automated services.”

⁵ While Taxpayer argues that Vendor A sent correspondence to Taxpayer stating that Vendor A’s “telecommunication services” were not subject to retail sales tax prior to July 31, 2014, the definition of retail sale included “telecommunication services” throughout the entire audit period. RCW 82.04.050(5). Therefore, even if Vendor A’s services properly fell under the definition of “telecommunication services,” they were, nevertheless, subject to retail sales tax or [deferred sales tax] throughout the audit period.

⁶ Taxpayer makes no argument regarding the sampling method employed by the Audit Division, and therefore, we need not address that issue.

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2. Five-Percent Assessment Penalty Waiver

Taxpayer argues on review that the five-percent assessment penalty should be waived because it has never intentionally underpaid⁷ its taxes. RCW 82.32.105 provides the only circumstances under which the Department may waive penalties. Waiver of the five-percent assessment penalty is required when the Department finds that a taxpayer's failure to pay the proper amount was the result of circumstances beyond the taxpayer's control. RCW 82.32.105(1).

"Circumstances beyond the control of the taxpayer" 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). In order to justify a waiver of penalties, Rule 228(9)(a)(i) states that a taxpayer bears the burden of establishing (1) the circumstances that were beyond its control, and (2) that those circumstances "directly caused" the substantial underpayment or delinquent payment.

Here, Taxpayer offered no evidence of circumstances which were "immediate, unexpected, or in the nature of an emergency." Instead, Taxpayer asserts only that it "never intentionally underpaid" its taxes. Yet, there is no requirement that the underpayment be "intentional" under RCW 82.32.090(2). Under that statute, if the Department "determines that any tax has been substantially underpaid, there is assessed a penalty of five percent of the amount of the tax" determined to be due. *Id.* As such, Taxpayer's lack of intent is not a basis on which we are authorized to waive the five-percent assessment penalty. We, therefore, affirm on this issue.

3. Future Reporting Instructions on B&O Tax Classification

Washington imposes a B&O tax on "for the act or privilege of engaging in business" in this state. RCW 82.04.220. The B&O tax "is 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." *Id.* The B&O tax rate used is determined by the nature of the business activity in which a taxpayer engages. *See generally* Chapter 82.04 RCW. If a taxpayer is engaged in an activity "other than or in addition to an activity taxed explicitly" under Chapter 82.04 RCW, that activity is subject to the "catch-all" service and other activities B&O tax. RCW 82.04.290(2)(a).

Taxpayer does not dispute that its gross income is subject to B&O tax; instead, Taxpayer disputes the B&O tax rates under which the Audit Division directed Taxpayer to report certain portions of

⁷ Taxpayer also originally argued that the five-percent assessment penalty should be removed as it relates to the purchases it made from Vendors A and B, but since we affirmed the tax assessment as it relates to those purchases, there is no adjustment to the tax assessment, and therefore, no basis for a corresponding adjustment to the assessed penalty.

its gross income. Taxpayer maintains that all of its gross income should be classified under the stevedoring and associated activities B&O tax classification pursuant to RCW 82.04.260(7), which states the following:

Upon every person engaging within this state in the business of stevedoring and associated activities pertinent to the movement of goods and commodities in waterborne interstate or foreign commerce; as to such persons the amount of tax with respect to such business is equal to the gross proceeds derived from such activities multiplied by the rate of 0.275 percent. Persons subject to taxation under this subsection are exempt from payment of taxes imposed by chapter 82.16 RCW for that portion of their business subject to taxation under this subsection.

RCW 82.04.260(7) goes on to define “stevedoring and associated activities pertinent to the conduct of goods and commodities in waterbourne interstate or foreign commerce” as follows:

[A]ll activities of a labor, service or transportation nature whereby cargo may be loaded or unloaded to or from vessels or barges, passing over, onto or under a wharf, pier, or similar structure; cargo may be moved to a warehouse or similar holding or storage yard or area to await further movement in import or export or may move to a consolidation freight station and be stuffed, unstuffed, containerized, separated or otherwise segregated or aggregated for delivery or loaded on any mode of transportation for delivery to its consignee.

See Olympic Tug & Barge, Inc. v. Dep’t of Revenue, 188 Wn. App. 949, 954-55, (2015).

In its final sentence, RCW 82.04.260(7) provides a list of specific activities included within the definition of “stevedoring and associated activities pertinent to the conduct of goods and commodities in waterbourne interstate or foreign commerce” as follows:

Wharfage, handling, loading, unloading, moving of cargo to a convenient place of delivery to the consignee or a convenient place for further movement to export mode; documentation services in connection with the receipt, delivery, checking, care, custody and control of cargo required in the transfer of cargo; imported automobile handling prior to delivery to consignee; terminal stevedoring and incidental vessel services, including but not limited to plugging and unplugging refrigerator service to containers, trailers, and other refrigerated cargo receptacles, and securing ship hatch covers.

See Olympic Tug & Barge, 188 Wn.App. at 955.

The Court of Appeals, in *Olympic Tug & Barge*, made clear that any specific activities expressly included in the final sentence of RCW 82.04.260(7) must, nevertheless, still be provided in conjunction with services that fall within the general definition of “stevedoring and associated activities” contained in that same subsection. *Id.* at 957. This is consistent with our past decisions. In Determination No. 91-107, 11 WTD 155 (1991), we held that the stevedoring and associated activities B&O tax classification applied to other activities beyond just traditional stevedoring. However, in that case, the taxpayer, in addition to the “associated activities” that it offered to its

customers also provided actual stevedoring services in the form of “off-loading” of automobiles. *Id.*

Here, while Taxpayer arguably provided some services contained in the final sentence of RCW 82.04.260(7), it is undisputed that Taxpayer does not conduct “activities of a labor, service or transportation nature whereby cargo may be loaded or unloaded to or from vessels or barges, passing over, onto or under a wharf, pier, or similar structure,” as required under the general definition in RCW 82.04.260(7). Because Taxpayer does not offer any services that qualify under the general definition of stevedoring and associated activities, it is precluded from classifying any other business activity under RCW 82.04.260(7).

Taxpayer argues that because its facility in Washington is part of an FTZ, all of Taxpayer’s business activity is properly classified under the stevedoring and associated activities B&O tax classification. We interpret Taxpayer’s argument as being that all activities that occur in an FTZ automatically constitute part of the “process of importation,” and therefore, qualify for the stevedoring and associated activities B&O tax rate under RCW 82.04.260(7) and Rule 193D.

We disagree with Taxpayer’s argument. There is nothing in RCW 82.04.260(7), or the corresponding administrative rule, WAC 458-20-193D, to suggest that all activities that occur in an FTZ would automatically qualify as stevedoring or associated activities. Indeed, we note that under RCW 82.04.610(2), which addresses import and export commerce, the legislature chose to recognize no special exception to the general taxation liability when a business activity occurs within an FTZ:

[P]roperty is no longer in the process of import transportation when the property is:

...

(c) Processed, handled, or otherwise stopped in transit for a business purpose other than shipping needs, if the processing, handling or other stoppage of transit occurs within the United States . . . **regardless of whether the processing, handling, or other stoppage of transit occurs within a foreign trade zone.**

(Emphasis added.) [No adjustment is made in the audit because the incorrect reporting was accepted in the prior audits. However in the future, you must report “Handling Income” under the Warehousing tax classification; “Reconfiguration Projects,” “Pallet Charges,” “Overbox Charge,” “Cartage – Warehouse,” and “Brokerage – Ocean Freight” income under the service and other activities tax classification;]

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 13th day of September 2016.