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Tax

William F. Lenihan

Robert D. Green

TAX

Retail Sales Tax—Construction of Home by Speculative Builder Not a Retail Sale. In *Century Builders, Inc. v. State* and *Rigby v. State*,[1] the retail sales tax was held to be not applicable to the sale of a newly constructed home by a speculative builder. Speculative builders, as distinguished from custom builders, purchase real property, plat and subdivide it, and offer for sale homes then under construction or later to be constructed on lots chosen by the purchasers. Custom builders contract to build homes on land already owned by the purchasers. In the case of speculative builders the purchaser selects the lot and type of house to be constructed thereon, and enters into an agreement with the builder for the purchase of the house and lot. Under the terms of the earnest money agreement, the right of possession is reserved in the builder-vendor until the transaction is *closed*. A specific date for the completion of the construction of the house is set in the agreement. The completion date usually corresponds with or is prior to the date of closing. The builder pays the retail sales tax on the materials which he uses in the construction of the house.

In the *Century Builders* case the Tax Commission contended that retail sales tax on the difference between the purchase price of the house and the cost of materials, less the cost of the lot, is properly payable by the purchaser. The state's theory was that under RCW 82.04.050 the construction of improvements on real property for a consumer is a sale at retail. Further, under RCW 82.04.190(4) a consumer is defined, *inter alia*, as one having a right of possession of real property. The contract purchaser has a right to possession under his contract with the builder. Thus, it was asserted, all of the elements of a taxable sale at retail were present.

On the other hand, the taxpayers contended that the right of possession to realty usually follows the legal title. This is true unless a purchaser is expressly given the right of possession by contract or is put into possession by the vendor. The parties stipulated that the purchasers were not consumers within RCW 82.04.190 by virtue of being owners, lessees or easement holders.

That the state's position was untenable is indicated by the court's opinion which gives judgment for the taxpayers without any citation of authority. On the facts of this case, there would be a retail sale only if the prospective purchasers had a right of possession in the

[1] 49 Wn.2d 707, 306 P.2d 216 (1957).

realty gained either under the earnest money agreement or by the vendor having actually put them into possession. The facts clearly indicate that the latter did not occur. In *Litel v. Marsh*[2] our court held that:

> The right to possession of realty ordinarily follows the legal title, and the vendee under an executory contract of purchase is not entitled to possession of the property unless the contract so provides, or unless he is placed in possession by the vendor....

In this case, since the right of possession is reserved in the builder until closing, it follows as a matter of law that the purchasers do not fit within the statutory definition of *consumers.*

By the time the purchasers do gain the right to possession in the realty, the houses have been completed and have become a part of that realty. As real property, the only taxable event arising from the sale of houses is a sale of real property. The only tax properly collectible is the one per cent county real estate excise tax.[3] This tax is borne by the vendor-builder. But, in fact, it is probably passed on to the purchaser as a part of the builder's costs. The real estate excise tax is levied without regard to any retail sales taxes which have been already paid. The amount of the tax levied is calculated solely on the sale price of the real property.

The end result of this case is that it affords speculative builders a successful plan of tax savings for themselves and their purchasers. If the builder withholds the right of possession from his purchaser until the house is completed and becomes a part of the real property, a retail sales tax on the difference between the sales price of the house and the cost of the materials and the lot is avoided.

The tax saving is substantial. This type of tax planning is beneficial to everyone except the state. The tax saving is beneficial to the purchasers in that their total purchase costs are reduced. It is beneficial to the builders because of the reduced costs and overhead. The building materials supplier is primarily liable for and must report to the Tax Commission concerning the sales tax on the building materials.[4] The builder need only pay the tax as does any other

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[2] 33 Wn.2d 441, 446, 206 P.2d 300, 30 (1949); see also Welch v. Hoover-Schiffner Co., 75 Wash. 130, 134 Jac. 526 (1913); White v. Coates, 17 Wn.2d 686, 137 P.2d 113 (1943).

[3] RCW 28.45 and King County Resolution No. 13317, as amended. Conveyance stamp taxes of $0.50 per $500.00 pursuant to RCW 82.20.010 and $0.55 per $500.00 pursuant to 53 STAT. 425, 26 U.S.C. § 3482, are also payable by the vendor-builder. Presumably the taxes are passed on to the purchaser as a part of the builder's costs.

[4] RCW 82.08.050.

retail purchaser. Thus, there is a further benefit to the builder because of reduced administrative expenses in not having to account to the Tax Commission on the sales tax which would otherwise be collected by him from his purchasers. Counsel for speculative builders, if not already aware of the device, should avail themselves of it for the benefit of their clients. The holding of the *Rigby* and *Century Builders* cases is clear and concise. It appears that a contrary result can be reached only through amendatory legislation.

Taxation—Retail Sales Tax as Tax on Gross Sales of Vendor. Although the average layman believes that the Washington retail sales tax is imposed upon the buyer and that the amount of the tax is determined by calculating a specified percentage of the purchase price, our court in *White v. State*[1] indicated that this view is legally inaccurate. A tax of three and one-third percent is imposed on the selling price of each retail sale.[2] The tax is to be paid by the buyer and collected by the seller on behalf of the state. If the seller fails to collect the tax or to pay it to the state, he is personally liable to the state for the amount of the tax.[3] However, the amount of the retail sales tax which the seller must remit to the state is computed on the seller's gross sales, at retail, during the reporting period, without regard for the actual amount which the seller has collected, or is entitled to collect, from those who made purchases at retail from him during the period.[4]

It is apparent that the statutory pattern of the retail sales tax is anomalous. Although the tax is imposed on the buyer, calculated on a percentage of the purchase price, the actual tax impact falls on the seller on the basis of his gross sales, much in the manner of a business and occupation tax. However anomalous the sales tax may be, the administrative advantage gained from the Washington tax structure is apparent. Payment of the tax based on a percentage of the seller's gross sales is far easier to administer than some alternative method under which each retail sale must be separately accounted for.

The *White* case points out the legal anomaly referred to above. The case further indicates an unfortunate situation concerning vending machine operators which is produced by this anomaly. The case involved an action to recover retail sales paid pursuant to RCW 82.32.180. All of the taxpayer's sales were made through the medium

[1] 49 Wn.2d 716, 306 P.2d 230 (1957); *appeal dismissed* 2 L. Ed.2d 21, 78 Sup. Ct. 23 (1957), for want of a substantial federal question.
[2] RCW 82.08.020.
[3] RCW 82.08.050.
[4] RCW 82.08.070.

of automatic vending machines. None of the sales exceeded the amount of thirteen cents. The constitutional issues raised by the taxpayer, regarding an application of the retail sales tax in a manner which denied equal protection and due process of law under the Fourteenth Amendment of the United States Constitution, are beyond the scope of this note.

The taxpayer unsuccessfully contended that the retail sales tax was imposed exclusively upon the purchaser, and that the seller was only a collection agent for the state. The taxpayer argued that the statutory abolition of tax tokens and the adoption of a bracket system to determine the amount of tax to be collected by the seller from the buyer on each sale[5] indicated a legislative intent to exempt purchasers from paying tax on sales of from one to thirteen cents. From this it was further argued that the legislature did not intend that the seller be liable to the state for tax on any sales in the one to thirteen cent bracket because the tax is imposed upon the buyer by RCW 82.08.050.

The court held that the seller must pay the sales tax, computed upon the seller's gross sales, even though the seller did not collect, and in fact could not have collected, any tax from his buyers. Nowhere in Chapter 82.08 is there any indication that sales of less than thirteen cents are to be exempted from the retail sales tax. The court recognized the distinction between the tax imposed on the seller and the tax to be paid by the buyer and collected by the seller. The retail sales tax is imposed on all retail sales not otherwise specifically exempted.[6] If the seller fails to collect the tax or cannot collect it from the buyer, he is still liable for payment of the tax calculated on his gross sales.[7] The Tax Commission has consistently interpreted the taxing statute in accord with the court's opinion. The legislature has several times amended the statute without disturbing this administrative construction. However, vending machine sellers are allowed to make the tax a part of the sales price or to absorb it.[8]

The statute thus puts vending machine operators at a disadvantage, taxwise. Whenever the individual sales of this type of vendor are all within the one to thirteen cent bracket (and they are, in the case of many such vendors) they must absorb the three and one-third per cent

[5] RCW 82.08.060, enacted as Wash. Sess. Laws 1951, c. 44, § 2. Tax Commission Rules Relating to the Revenue Act, Rule 237, provides the tax collection schedule in accord with the requirements of the statutory provision. In this schedule no tax is to be collected from the buyer on sales of 13 cents or less.

[6] RCW 82.08.020 and 030.

[7] RCW 82.08.050.

[8] Washington Tax Commission Rule No. 187.

sales tax.[9] On the other hand, retail vendors making some sales in the 1¢-13¢ bracket and other sales between 14¢ and 25¢ or at 50¢, to cite only two examples, collect from their buyers a tax of not less than four per cent—thus making up for the non-collection in the bottom bracket sales. Vending machine operators, all of whose sales are in the bottom bracket, do not have the advantage of breakage, which is the normal incident of a full-cent bracket system of tax collection.

The only available solution that will aid the vending machine sellers seems to be amendatory legislation. It has come to this writer's attention that such a bill is now in the formative stage.

Use Tax—Consumer and Exceptions Thereto Defined—Taxation of Property Consumed During Manufacturing Process. The case of *Pacific Northwest Alloys Inc. v. State*[1] involved an action by a taxpayer to recover payment of use taxes, pursuant to RCW 82.32.180. The plaintiff manufactured ferrosilicon. Ferrosilicon is produced by placing scrap iron, quartz, coal, coke and wood chips, in proper quantities, into an electric furnace. Electric current, introduced into the furnace by carbon electrodes, produces great heat which causes a chemical reaction resulting in the formation of ferrosilicon. Carbon monoxide is a useless by-product of the reaction. The carbon electrodes, which contribute two per cent of the total carbon used, are consumed in the process. Carbon electrodes are used because they add no impurities into the furnace during their oxidation, and because they oxidize at a much slower rate than other electrode materials.

The use tax is levied upon the act of consumption. RCW 82.04.190 (1) defines a consumer, *inter alia*, for the purposes of the use tax, as follows:

> Any person who... uses an article of tangible personal property other than for the purpose... (c) of consuming such property in producing for sale a new article of tangible personal property, or a new substance, of which such property becomes an ingredient or component or as a *chemical* used in processing, *when the primary purpose of such chemical* is to produce a chemical reaction directly through contact with an ingredient of a new article being produced for sale;... (emphasis added)

Based on the above quoted provision, the plaintiff contended that the carbon electrodes were a chemical used in processing and that their

[9] A possible alternative, of course, is to reduce the size or quantity of the commodity dispensed through the vending machine, and thus, indirectly, effect collection of the tax.

[1] 49 Wn.2d 702, 306 P.2d 197 (1957).

primary purpose was to produce a chemical reaction directly through contact with the ingredients of the ferrosilicon which was being produced for sale. The trial court held that the consumption of the carbon electrodes by the plaintiff fell within the purview of the above quoted provision of the statute which exempts such consumption from the use tax imposed by RCW 82.12.020.

Our supreme court reversed the judgment of the trial court. In deciding that the primary purpose of the electrodes was not to create a chemical reaction, the court defined *primary purpose* as that which is the first intention. The first intention of the electrodes was to convey electric current into the furnace which in turn produced the heat necessary to cause a chemical reaction producing ferrosilicon. The court found it difficult to conceive that carbon electrodes could be classified as a *chemical* within the exemption allowed by RCW 82.04.190(1)(c). The mere introduction of the electrodes into the furnace causes no reaction to occur. In order for the necessary chemical reaction to occur which produces ferrosilicon, not only must the electrodes directly contact the ingredients, but electric current is also required to produce the heat necessary to cause the reaction. However, the court continued, assuming that the electrodes are not a chemical within the above quoted statutory provision, they furnish only two per cent of the carbon required in the manufacturing process. The court ascertained from the stipulated facts that the primary purpose of the electrodes was to furnish heat; the fact that the electrodes were consumed in the process and did furnish some of the required carbon is incidental. The court then stated that the primary purpose of the electrodes was not to furnish carbon as an ingredient of the ferrosilicon.

In analyzing the *Northwest Alloys* decision, it is interesting to note that the previously quoted statutory provision affords two exemptions from the use tax, namely: consumption of property "... which becomes an ingredient or component ...",[2] and consumption of a chemical "... used in processing, when the primary purpose of such chemical is to produce a chemical reaction . . ."[3] The former refers to anything which is consumed during the manufacturing process, but merges with or becomes an *ingredient* or *component* of the article being produced for sale. The latter refers to catalytic agents or the like. The primary purpose clause refers only to *chemicals, not to*

[2] RCW 82.04.190(1)(c).
[3] *Ibid.*

ingredients or components. Yet our court, in construing the language, apparently applied the primary purpose clause to all terms. By applying the primary purpose to all terms, the electrodes were made subject to the use tax. If the primary purpose clause had not been applied to *ingredients or components*, the consumption of the electrodes by the taxpayer should have escaped the tax. This follows because a portion of the electrodes became an ingredient of the ferrosilicon during the manufacturing process.

The following cases lend support to the court's decision. However, it should be noted that the statutes being construed and applied in these cases are dissimilar to the Washington statute. In *Androscoggin Foundry Co. v. Johnson*[4] coke, which was used by the taxpayer to smelt scrap iron for casting, had as its primary purpose the furnishing of heat for the process. Also carbon in the coke merged with the iron during the process, making the iron softer and more workable. The taxpayer contended that the coke became an ingredient of the casting and was therefore exempt from the use tax. The Maine court stated that "The fact that in using it as fuel in smelting iron a portion of the carbon becomes an ingredient of the iron in the process does not deprive the coke of its character as a fuel."[5] Under the Maine statute fuel was subject to the use tax when purchased by a consumer whether or not it became, in whole or in part, an ingredient or component part of, or loses its identity in the manufacture of, tangible personal property.

Another case relied upon as authority by our court was *Union Portland Cement Co. v. State*.[6] In this case coal (which produced heat for cement kilns), fire brick (which lined the kilns), and iron grinding balls (which were used to grind cement klinkers into the finished product) were consumed during the process of cement manufacturing. The taxpayer maintained that coal ash, fire brick and grinding ball particles were all introduced into and became a part of the cement. The court held that the above additions to cement, while contemplated, were an incidental occurrence. Since the articles were consumed by the manufacturer as the last user, the court held that the use tax was applicable as in those cases where machinery is consumed during a manufacturing process even though some of the materials incidentally become an ingredient of the finished product.

[4] 147 Me. 452, 88 A.2d 158 (1952).
[5] 88 A.2d at 160.
[6] 110 Utah 135, 170 P.2d 164 (1946).

Another case in point is *Smith Oil and Refining Co. v. Dept. of Finance.*[7] A sales tax assessment on the sales of core oil to foundries was upheld. Core oil was used in foundries to bind sand used as cores in the molds of castings. Under high temperatures some of the oil decomposed into carbon and became a part of the iron castings. The court held that the core oil was not purchased for the purpose of adding carbon to the finished castings. It was incidental that some of the oil became a component of the finished product. The tax was held applicable despite statutory language exempting property for resale in any form.

A literal reading of the statutory provision at issue in this case indicates that the primary purpose clause can refer only to chemicals, not to ingredients or components of the article being produced for sale. If the court's decision is to be construed as applying the primary purpose clause to the ingredient or component exception, then the decision of the *Northwest Alloys* case is in error. If the court was attempting to remedy what it conceived to be a defective definition of consumer, it should have required the Tax Commission to seek its remedy with the legislature. However, the construction given to the statutory definition of consumer is consistent with the trend of decisions which construe statutory language against the taxpayer rather than liberally in his favor.[8] If, on the other hand, the court intended *only* to hold that the consumption of the electrodes did not constitute a chemical used in processing, the language used in the decision was confusing, inappropriate and far too broad.

WILLIAM F. LENIHAN

State Taxation of Exports. In *Eardley Fisheries Company v. City of Seattle*[1] the court sustained the findings of the trial court that seafood sold to the federal government for export had not yet entered the "stream of export" at the time of the sale and that its vendor was therefore subject to the Seattle business tax on his gross sales. The government's purchase orders provided that the food was "For Export," and that the food was to be packaged and marked as required for export purposes. Delivery was not to a carrier but to designated cold storage depots provided by the purchaser. The sale took place

[7] 371 Ill. 405, 21 N.E.2d 292 (1939).
[8] *But cf., e.g.,* Weyerhaeuser Timber Co. v. Henneford, 185 Wash. 46, 53 P.2d 308 (1936).

[1] 50 Wn.2d 566, 314 P.2d 393 (1957).

and the tax accrued at the time of delivery. The food was kept in cold storage by the purchaser for three to four months, then shipped overseas, as contemplated by the parties.

U.S. Const. art. I, § 10, cl. 2 provides:

> No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports ... [except for inspection fees].

In order that the constitutional prohibition apply, the tax must accrue while the goods are in the "stream of export." In order for goods to be in the "stream of export," the cases require that, at the time the tax accrues, there must be a "certainty" that the goods will be exported. A contractual duty or a plan to export is not enough. The certainty required may be established either by (1) the act of delivering the goods to the carrier for shipment out of the country, or (2) the fact that the goods are of such a nature that they may not be used in this country.

The test of the validity of state taxes applied here is not the same as in commerce clause cases, where the restriction on state taxes is inferred from the grant of power to the federal government to regulate interstate commerce. In commerce clause cases, the state is not allowed to *burden* interstate commerce, while in the import-export clause cases the prohibition against state taxes on exports is absolute (except for inspection costs).[3]

The seller relied upon *A. G. Spaulding v. Edwards*[4] and *Richfield Oil v. State Board.*[5] In the former, the court held that U.S. Const. art. I, § 9, cl. 5, prohibited Congress from levying an excise tax on a sale made to an agent for a foreign buyer where the sale was consummated by delivery to the carrier for export, because the very act taxed was the one which established the "certainty" of export. However, the bill of lading was forwarded to the buyer's agent who could have diverted the goods. In the *Richfield* case, the court held a state sales tax invalid as applied to a sale made by delivery of oil into a tank ship provided by the foreign buyer. In both of these cases, there could have been diversion, but the U.S. supreme court held that the certainty of export test had been met.

The Washington court distinguished the above cases on the ground that the goods had been delivered to the carrier for export at the time

[2] Empresa Siderugica v. County of Merced, 337 U.S. 154 (1949).
[3] See Richfield Oil v. State Board, 329 U.S. 69 (1946).
[4] 262 U.S. 66 (1923).

the tax accrued, while in the instant case delivery was to storage depots. The court relied on the rule stated in *Empresa Siderurgica v. County of Merced*,[6] where the U.S. supreme court said, "So in this case it is not enough that on the tax date there was a purpose and plan to export this property. Nor was it sufficient that in due course that plan was fully executed."[7] In that case the supreme court sustained a property tax levied on a cement plant which was being dismantled for shipment to a foreign country, as levied on parts still in the country, even though part had already been exported and the dismantling was being done by a common carrier.

The court also distinguished a prior Washington case[8] which held invalid the tax on the sale of a ship to a foreign purchaser, even though the ship was not transferred to foreign registry until after the sale took place. The court pointed out that the registry could not be transferred until after the sale, and that the ship was its own carrier for export.

In the principal case, the tax was a business tax measured by gross sales. It might be questioned whether it was a tax on exports at all. A property tax is directly on the goods which are exports. A sales tax, where the sale is completed by delivery to a carrier, accrues by the very act which puts the goods into the stream of export, and is construed to be a tax on the export. A business tax, as in the principal case, seems more remote from the export, but if it is measured by the amount of the sale, and the sale puts the goods into the stream of export, it is probably invalid.[9] ROBERT D. GREEN

Inheritance Tax—Estate Planning. In *In re Miller's Estate*, 151 Wash. Dec. 72, 316 P.2d 124 (1957), a method of inheritance tax saving was approved by our supreme court. In this case the testator directed in his will that the amount of federal estate tax due and payable should be deducted from the respective specific bequests. The Tax Commission contended that the federal estate tax should be deducted from the residuary estate as is any other debt of the decedent, thereby resulting in a larger inheritance tax.

The court held that the intention of the testator must govern since there is nothing in the Code, RCW 83.08, which prohibits testamentary direction for the payment of federal estate tax from any asset other than the residuary estate. In this case the testator clearly expressed his intention that certain gifts were to go to the named beneficiaries subject to pro rata contribution for payment of the federal taxes. The court gave effect to that intention because it is universally recognized that a person has a right to dispose of his property in any manner which is legally proper.

[5] *Supra*, note 3.
[6] *Supra*, note 2.
[7] 337 U.S. 154, at 157.
[8] Alaska Steamship Co. v. State, 31 Wn.2d 328, 196 P.2d 1001 (1948).
[9] See Crew Levick Co. v. Pennsylvania, 245 U.S. 292 (1917).

The tax saving was produced because the specific legatees were Class B and C beneficiaries, while the residuary legatee was a Class A beneficiary. Charging federal taxes against the gross specific bequests resulted in smaller net bequests to which the state inheritance tax could be applied. The net residuary estate, on the other hand, was larger because the deduction for the payment of the federal taxes had been taken from the respective specific bequests. Since the inheritance tax rates for Class B and C beneficiaries are considerably more than those for Class A beneficiaries, the end result is a successfully executed plan for inheritance tax diminution.

Caveat: An amendment to the inheritance tax code, Wash. Sess. Laws 1957, c. 280, § 3, is currently being held in abeyance by Referendum No. 30. If this referendum is defeated and the amendment goes into effect, the deduction for payment of federal estate taxes will no longer be available. Thus, the tax saving plan outlined above would be ineffective.

Business and Occupation Tax—Frozen Food Processing as "Manufacturing." In *Stokely-Van Camp v. State*, 50 Wn.2d 492, 312 P.2d 816 (1957), the Washington supreme court was called upon to determine whether the state tax commission, by a recent ruling, properly classified the processing and freezing of foods as manufacturing for purposes of the state occupation tax. The court sustained the action of the commission by applying the definition of "manufacturing" set out in RCW 82.04.120. This definition requires that the activity in question result in "...a new, different or useful article of tangible personal property or substance of trade or commerce." Under this test, the canning of food products had been classified as "manufacturing" for some time. The court stated that, by similarly classifying the processing and freezing of foods, the commission was only recognizing the existence and growth of a new type of manufacturing.

The court reconciled the *Stokely* case with two recent Federal circuit court decisions (holding that the processing and freezing of certain foods was not manufacturing) by showing that the federal cases involved merely a determination for the I.C.C. in a carrier dispute and that in those cases the circuit courts did not have a specific statutory definition to apply.

TORTS

Strict Liability Disguised in Terms of Negligence. In *LeMaster v. Chandler*[1] the Washington supreme court made an unusual application of tort liability to a defendant common carrier. The result of the case is a holding of strict liability, disguised in terms of negligence law. Unfortunately, the negligence reasoning was not in accord with accepted tort law, and the disguise is easily uncovered.

The plaintiff was the owner of a truck loaded with apples, which was parked twenty-five feet from the bow of the defendant's ferry prior to a crossing of the Columbia River. The driver, who remained in the truck, neglected to put it in gear or to set the brakes. The defendant's employee neglected to block the wheels of the truck. During the crossing the truck rolled off the ferry with the driver still in the

[1] 50 Wn.2d 71, 309 P.2d 384 (1957).