Cite as Det. No. 13 WTD 126 (1993).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	F I N A L D E T E R M I N A T I O N
	)	No. 92-237R
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] MISCELLANEOUS: TAX DEDUCTIONS -- NARROWLY CONSTRUED. The Department of Revenue will narrowly construe statutes and rules that authorize tax exemptions and deductions.

[2] RULE 202: POOL PURCHASES -- PURCHASERS IN INDEPENDENT BUSINESS ACTIVITIES -- WHOLESALERS -- RETAILERS. Rule 202 contemplates that a pool purchase will be made by two or more persons engaging in independent business activities at the same level; e.g., retailers. Rule 202 was not intended to allow a taxpayer which engages in business essentially as a wholesaler to avoid the wholesaling B & O tax.

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.

TAXPAYER REPRESENTED BY: . . .

DATE AND PLACE OF CONFERENCE: . . .

FACTS AND ISSUES:

Gray, A.L.J. -- The taxpayer asked for reconsideration of Det. No. 92-237. The taxpayer claimed serious factual errors existed in the Determination. The Department of Revenue (Department) audited the taxpayer for the period January 1, 1987 through September 30, 1990. The audit resulted in an assessment against the taxpayer because the Department disallowed the deduction of the amounts received by it from its members as a pool purchase,

and taxed the amounts as subject to the wholesaling B&O. The taxpayer appealed.

The Department disallowed the deductions as a pool purchase because it believed there was no pool purchase agreement in place before the orders were made, and because the 4% fee charged by the taxpayer caused the purchasing members to pay more than their proportional share of the total bill paid by the taxpayer. The taxpayer acknowledged that it did not include the amounts received in its gross proceeds of sales, but argues that this failure is merely procedural, and is not a bar to claiming the deduction.

The taxpayer stated the facts to be as follows:

> The taxpayer is a cooperative organized in accordance with RCW 23.86. Its primary business is to acquire automotive parts and supplies (the "goods") for its members. These goods are acquired in large quantities in order to take advantage of price breaks for large volume orders. These purchases generally result in both the taxpayer and one or more of its members acquiring goods for their respective inventories. The taxpayer and its members have operated in this manner without significant deviation for several decades. The issue raised by the Department of Revenue (Department) audit is whether the acquisitions by the taxpayer for its members, and subsequent cost reimbursement by the members to the taxpayer, constitute tax-exempt pool purchases pursuant to WAC 458-20-202.
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> The acquisitions which the taxpayer claims as a pool purchase are accomplished by two slightly different methods. The first of these methods is used for certain initial stocking orders and with vendors who require orders to be communicated by one designated representative of the taxpayer. Under this method, the taxpayer will solicit each member as to how much of a particular supplier's product the member wishes to purchase. The taxpayer also commits to purchase a fixed quantity of the supplier's product. The taxpayer then communicates the order to the supplier. Once the order is placed, the member's portion of the goods is either delivered directly to the member by the supplier or is delivered in bulk to the taxpayer's warehouse. When the member's portion of the goods is delivered to the taxpayer's warehouse, that portion is never integrated or commingled with the taxpayer's own inventory. The taxpayer provided the following example:

> [Motor oil] is delivered in bulk on pallets to [the taxpayer's] facility. Upon delivery, [the taxpayer's] employees will break up the bulk shipment, putting [the taxpayer's] portion of the order in its inventory, and placing each member's portion on its designated shelf to await pick up or delivery.

The second method of acquisition allows the taxpayer's members, acting as authorized agents of the taxpayer[1], to telephone a supplier directly and order goods. As a general rule, these goods are "drop shipped" by the supplier directly to the member or the taxpayer, as appropriate. As with the first method, the specific portion of the goods ordered by each member and by the taxpayer is always determined in advance of placing the order, and prior to the warehousing of any commodities by a member or the taxpayer.

The billing arrangements and procedure for reimbursement of the taxpayer are the same under either of the methods for acquiring goods described above. Once per month each supplier of goods bills the taxpayer for all purchases made by the taxpayer during the preceding month. Through the use of its computer system, the taxpayer compiles those charges on to a single monthly bill for each member, showing all purchases made on behalf of that member during the month. The member is charged only the net amount invoiced to the taxpayer by a supplier for purchased items, and the members are given the full benefit (in proportion to each member's particular purchases) of any volume discounts, rebates or reduced prices given to the taxpayer on the invoice from the distributor. The members are required to reimburse the taxpayer for such billed changes each month.

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[1]As the taxpayer is solely liable to each supplier for the cost of the goods, regardless of whether those goods are destined for the taxpayer's or a member's inventory, the member's communications with a supplier are done only pursuant to authorization from the taxpayer. Accordingly, the member is acting as the taxpayer's agent when communicating orders to a supplier. In those cases where the supplier does not wish to speak directly to the members, or where administrative ease requires a single line of communication between the taxpayer and a supplier, the orders are made pursuant to the first method described above.

In order to defray the cost of administration of the purchasing program, each member is charged a monthly billing fee by the taxpayer equal to four percent of the member's purchases. This fee is charged to reimburse the taxpayer for administrative, bookkeeping, billing and computer expenses. The billing fee has remained constant at four percent for many years, and is not varied based on the supply and demand for the goods, the volume purchased by any particular member or any other market factors. The fee is kept at the minimum level necessary to cover the members' portion of the cost of administering the pool purchase program. However, the four percent fee collected from the members does not cover all the expenses of the program, reflecting the fact that a portion of the expense of the program is allocated to the taxpayer for administration of purchases that the taxpayer makes for its own inventory. During all years in question, the taxpayer reported the billing fees received as service income and paid the 1.5% B & O tax required by RCW 82.04.290.

The goods purchased by the taxpayer for its own account are placed in the taxpayer's warehouse inventory. From this inventory, the taxpayer will sell its members goods in smaller quantities than they could otherwise purchase them from a supplier through the pool purchase program. A member will also purchase items in this manner when an item is needed more quickly than an outside supplier would deliver it. Often the member can pick up the item the same day.

For goods purchased from the taxpayer's inventory, the taxpayer charges its members 106% of the taxpayer's direct cost of the item charged by the supplier. The markup is used to defray warehousing expenses and to pay for the taxpayer's portion of the pool purchase program, which is not covered by the member's billing fees. The taxpayer has reported all revenue received from items purchased out of its warehouse inventory as wholesaling revenue. The taxpayer and the Department are in agreement as to the treatment of these purchases.

Taxpayer's Argument:

The taxpayer argued that the two methods of purchasing car parts cannot be viewed as exclusive from each other, and that taken together, the taxpayer is entitled to the pool purchase

deduction. According to the taxpayer, both methods were used simultaneously, and together constitute pool purchases. For example, the taxpayer might place an order for a purchase in a large quantity from Supplier A on day one. One of the co-op members might place an order for a particular part from Supplier A on day two. The taxpayer might place another order for a large quantity purchase from Supplier A on day three, and so on. The bill submitted from Supplier A to the taxpayer would show all such purchases for the particular billing period. On this basis, the taxpayer argues that it qualifies for the pool purchase deduction in WAC 458-20-202.

The taxpayer also argued that its recapture of administrative costs (6% and 4% of purchase price for the two purchase methods respectively) do not disqualify it from the pool purchase deduction.

The taxpayer argued that the Department must not ignore commercial reality and must interpret its regulations in a "commercially reasonable manner." By "commercially reasonable," the taxpayer meant that the recapture of its administrative costs through the imposition of a service fee based on a fixed percentage of the purchase price either allocable to the co-op member (the first method) or as made directly by the co-op member to the supplier (the second method) should not be construed to be "an amount in excess of the proportionate amount paid by another member," which would disqualify the principal member from the pool purchase deduction. The taxpayer cited Yakima First Baptist Homes v. Gray, 82 Wn.2d 295, 301, 510 P.2d 243 (1973) in support of this argument.

The taxpayer also criticizes the Department's reliance on a "twenty-five year old excise tax bulletin" -- ETB 113.04.202.

The issue is whether the taxpayer is entitled to the pool purchase deduction in WAC 458-20-202.

DISCUSSION:

[1] We do not believe that the Yakima First Baptist case requires the Department to allow the pool purchase deduction to the taxpayer, nor do we believe that a denial of the pool purchase deduction to the taxpayer is an "absurd consequence." Yakima First Baptist Homes v. Gray, supra, was an action for an exemption from the property tax, for injunctive relief, and for a refund of taxes paid under protest. The taxpayer in that case argued that it was entitled to relief because funds for the operation of its home for the aged came from "miscellaneous donations." The taxpayer cited the decision at 82 Wn.2d at 301:

> To hold an exemption from taxation could result from any contribution, no matter how small, would open

> the door to fraud upon the public. Furthermore, such a construction would be contrary to the spirit of the law, and to the rules for the construction of tax exemption statutes as herein stated.
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> Absurd consequences are to be avoided in the construction of a statute.

(Emphasis supplied, referring to the language cited by the taxpayer here.)

We note that Yakima First Baptist says nothing about interpretation of statutes and rules in a "commercially reasonable" manner and that the taxpayer has not cited any cases that require tax exemption or deduction statutes or rules to be interpreted in a "commercially reasonable" manner or that explain what the phrase "commercially reasonable" means. The taxpayer wants the benefit of a tax deduction. In order to take advantage of the deduction from the taxpayer's gross proceeds of sales for pool purchases, the taxpayer must clearly show that it has satisfied the requirements of Rule 202. "Finally, it is important to remember that tax deductions must be narrowly construed. Cf. Evergreen-Washelli Memorial Park Co. v. Department of Revenue, 89 Wn.2d 660, 574 P.2d 735 (1978) (interpreting RCW 82.04.390, which exempts proceeds derived from the sale of real estate from the business and occupation tax)." Rainier Bancorporation v. Department of Rev., 96 Wn.2d 669, 674, 638 P.2d 575 (1982).

Having raised the argument about "commercial reasonableness," the taxpayer failed to establish a connection between "commercial reasonableness" and its service fee. The taxpayer's service fee, ostensibly to cover its costs, is not necessarily "commercially reasonable" itself, if "commercially reasonable" is intended to mean an amount to pay for a proportionate share of the taxpayer's overhead costs by a co-op member. As was pointed out in the reconsideration hearing, a 4% fee on a small purchase (e.g., $50.00) would be $2.00, while a 4% fee on a large purchase (e.g., $10,000) would be $400.00, but the actual services rendered by the taxpayer on bookkeeping, etc., might take essentially the same amount of time regardless of the dollar amount of the transaction. In the former example, the service fee might not cover the taxpayer's overhead costs whereas in the latter example, the fixed percentage service fee could result in a windfall to the taxpayer.

Additionally, the taxpayer has not shown why the imposition of the tax under these facts would be commercially unreasonable. The taxpayer has been formed as a separate entity to fulfil what is essentially a wholesaling function. The taxation of this entity is not unreasonable per se. It is not the Department's responsibility to exempt the taxpayer from taxation in order to

make it more competitive with larger businesses that can buy at bulk rates in their own right.

Rule 202 is the Department's administrative rule on pool purchases and it says, in full:

> The term "pool purchase" means the joint purchase by two or more persons, engaging in independent business activities, of commodities in carload or truck load quantities for the purpose of obtaining a purchase price or freight rate which is less than when purchased or delivered in smaller quantities.
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> The term "principal member" means that member of the pool to whom the goods are charged by the vendor of the commodities purchased.
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> In computing tax liability of the principal member under chapter 82.04 RCW, there may be deducted from gross proceeds of sales the amount received by him from other members of the pool of their proportionate share of the cost thereof of the commodities purchased.
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> This deduction is allowed only when all of the following conditions are met:
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> (1) The amount received is included in gross proceeds of sales.
>
> (2) The pool purchase agreement was entered into prior to the time of placing the order for the commodities purchased.
>
> (3) The pool purchase agreement provides that each member shall accept a specific portion of the shipment.
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> (4) Division of the shipment is made prior to warehousing of the commodities by a member of the pool.
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> In no event will a "pool purchase" deduction be allowed when an agreement relative to the amount of the share to be distributed to any member is made after the date of the purchase order, or where one member of a pool pays an amount for his portion in excess of the proportionate amount paid by another member.
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> Revised June 1, 1970.

[2] There is a basic problem with the taxpayer's arguments because Rule 202 contemplates that a pool purchase will be made by two or more persons doing substantially the same type of business; i.e., two or more retailers. Here, the members make retail sales to the public, but the principal member does not. We do not believe that Rule 202 was intended to allow taxpayer's to avoid the wholesaling B & O tax in RCW 82.04.270. Its business is more like that of a wholesaler in that it acquires the goods from suppliers on behalf, and for resale to, retailers, even though we acknowledge that the taxpayer's cooperative

structure is probably not representative of most wholesale-retail relationships.

We disagree with the taxpayer's argument that the Department's reliance on ETB 113.04.202 is misplaced because of its age. The Department has reviewed all of its excise tax bulletins and withdrawn those which it believed were no longer valid or were questionable. See, ETB 549 and 547. ETB 113.04.202 was reviewed but was not withdrawn.

Because of our holding, it is unnecessary to address the other issues the taxpayer raised.

DECISION AND DISPOSITION:

The petition for reconsideration is denied. Determination No. 92-237 is affirmed.

DATED this 18th day of June, 1993.