Cite as Det. No. 97-146R, 17 WTD 133 (1998)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment	)	F I N A L D E T E R M I N A T I O N
	)	No. 97-146R
. . .	)	Registration No. . . . FY . . ./Audit No. . . .
. . .	)	Registration No. . . . FY. . . ./Audit No. . . .
. . .	)	Registration No. . . . FY. . . ./Audit No. . . .

[1] RULES 114 AND 183; RCW 82.04.4282; RCW 82.04.050(3); ETB 503: HEALTH AND FITNESS CLUBS -- INITIATION FEES -- RETAIL SALES TAX -- RETAILING B&O TAX. Payments by new members to join health and fitness clubs were not deductible as bona fide initiation fees because the payments were in exchange for the use of exercise facilities and services.

[2] RULES 114 AND 183; RCW 82.04.050(3): HEALTH AND FITNESS CLUBS -- INITIATION FEES -- INSTRUCTIONAL LESSONS --SERVICE B&O TAX . The portions of initiation fees received by health and fitness clubs that pertain to instructional lessons are subject to service business and occupation tax.

NATURE OF ACTION:

Three related health and fitness clubs (the taxpayers) seek reconsideration of Det. No. 97-146, which sustained the assessment of retailing business and occupation (B&O) tax and retail sales tax on initiation fees they charged and collected from enrolling members.[1]

FACTS:

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

De Luca, A.L.J. -- The facts are stated in Det. No. 97-146 and will be restated only when necessary. To use any of the taxpayers' health club exercise facilities, individuals must become members through one of their various promotional plans. Each member must sign an agreement, such as a "12 Month Contract." An individual cannot become a member and use the exercise facilities without paying a one-time "initiation fee," unless the club waives the charge. However, the "initiation fee" by itself does not entitle the new member use of the club's exercise facilities. The members must also pay monthly membership dues in order to use those facilities. For example, the three taxpayers explain that paying an "initiation fee" allows a member to socialize in the lounge, (which consists of a television and chairs), the snack bar, and the vending machine area. Members also are entitled to participate at social events held at the club, such as Halloween and Christmas parties, but they are not entitled to use the exercise facilities unless they pay the monthly membership dues.

We note the three taxpayers could not recall any members who paid only the initiation fees and not the monthly dues when they joined the clubs. Furthermore, if members do not pay the monthly dues, whether the member use the facilities or not, the three taxpayers will cancel such memberships after 90 days. In order to re-join a club after cancellation of a membership, the former member must pay the "initiation fee" again.

After a year, the membership continues on a month-to-month basis until the member gives 30 days written notice to cancel it. Members cannot sell their memberships. The memberships do not give members proprietary interests or operational control in any of the facilities or properties of the health clubs. The membership contracts specify that the "privileges" granted to the members are "by license only," which the three taxpayers may cancel at any time, with or without cause or notice.

The Department of Revenue (the Department) examined the books and records of two of the three taxpayers for the period from January 1, 1992 through June 30, 1995. The Department reviewed the third taxpayer's books and records for the period from December 1, 1992 through June 30, 1995. We note that effective July 1, 1993 the definition of "retail sale " was amended to include physical fitness services, tanning salon services, steam baths, among others. Prior to that date, the Department's Audit Division (Audit) apportioned the three taxpayers' gross incomes between service business and occupation (B&O) tax and retailing tax classifications. After that date, Audit determined that all of the taxpayers' initiation fees and membership dues were for retailing activities and could no longer be apportioned between service B&O tax and the retailing tax classifications.

In Det. No. 97-146, we cited and extensively quoted Det. No. 95-239, 16 WTD 48 (1995) and declared that determination controlled the outcome of the case before us because of the similarity of facts between the two cases. We held that the three taxpayers' initiation fees were not deductible under RCW 82.04.4282 as "bona fide initiation fees" because, as in Det. No, 95-239, payment of the "initiation fees" did not entitle members to a proprietary interest or operational control of the clubs. The only consideration the three taxpayers provided the members was the right to use the facilities if they remained current on their monthly dues. Similarly, nonmembers

could not use the exercise facilities without paying the "initiation fee" unless the taxpayers waived the charge. Thus, the members paid both amounts in return for use of the facilities and services and, therefore, the deduction is not applicable.

We also found in Det. No. 97-146 that the membership rights that members of the health clubs in the present matter obtain by paying only an "initiation fee" were, in effect, non-existent. The right to socialize in the health clubs' lounges, snack bar, or vending machine areas, or to attend Halloween or Christmas parties at the clubs, is hardly a right for which a person would buy one of their memberships. Neither the taxpayer in Det. No. 95-239 nor the taxpayers in the present matter offered social memberships or any limited rights to dine or mix with members such as those offered by some country clubs. In fact, the three taxpayers do not recall anyone who merely purchased a membership without also paying the monthly dues. This fact is identical to the situation in Det. No. 95-239 where no club members paid only the enrollment or initiation fee and not the monthly dues.

Finally, we noted in Det. No. 97-146 that the three taxpayers concede that if a member does not pay his or her monthly dues the membership is canceled after 90 days. To reactivate their memberships, canceled members have to pay the "initiation fee" again. We found it difficult to conceive of anyone buying a new membership every 90 days merely to have the right visit a health club's lounge or vending machine area. Indeed, as we stated in the earlier determination, this policy is more restrictive than the one in Det. No. 95-239 where members in some situations could go on an inactive status for months without having to pay the enrollment fee to reactivate their memberships.

TAXPAYERS' EXCEPTIONS:

The taxpayers disagree with the decision in Det. No. 97-146 that all of the initiation fees were paid in exchange for taxable services or use of the exercise facilities. The taxpayers claim that they demonstrated at the hearing that at least a portion of the initiation fees were paid solely in exchange for memberships in their health clubs. The taxpayers claim that is all that former WAC 458-20-114 (Rule 114, which was in effect at the time of the audits) required. The taxpayers argue that Rule 114 specifically contemplated the situation where, as here, income from initiation fees consists of both deductible and non-deductible amounts:

> Many for profit or nonprofit entities may receive "amounts derived," as defined in this rule, which consist of mixture [sic] of tax deductible amounts (bona fide initiation fees and dues) and taxable amounts (payment for significant goods and services rendered).

The taxpayers further contend that Rule 114, in its discussion of the cost of production method of apportionment, explicitly supports the allocation of mixed income between taxable and deductible amounts so long as any portion of the initiation fee reflects an amount paid solely to admit a person as a member. The taxpayers believe that the Department erred in its decision in Det. No. 97-146 that no portion of the initiation fees are deductible under the statute and they request that apportionment be allowed under the cost of production method set forth in Rule 114.

The taxpayers also disagree with the decision that initiation fees paid after July 1, 1993 are not allocable between the service B&O and retailing B&O tax classifications. The taxpayers quote another part of Rule 114 in support of their argument that the rule specifically provides to the contrary:

> Persons who derive income from initiation fees and dues may find that they have incurred business and occupation tax liability under both the retailing and service and other activities classifications. For example, an organization may furnish golf as well as sauna bath facilities to its members in return for payment of dues. The former is a retailing taxable activity while the latter is taxable under the service business tax. These taxes are at different rates. Once the income has been apportioned between taxable and deductible amounts, the parts of taxable income attributable to either retailing activities or service activities must be reported on the excise tax return under the appropriate classification and under the prevailing tax rates.

The taxpayers conclude that under both former Rule 114 and WAC 458-20-183 (Rule 183) they have the absolute right to show the Department that "amounts derived" from initiation fees and dues are allocable between the service and retailing B&O tax classifications under the cost of production method.

ISSUES:

1. Were the payments by the new members to join the three respective taxpayers' health and fitness clubs deductible as bona fide initiation fees, or were they in exchange for the use of exercise facilities and services?

2. Were those payments at least partially deductible as bona-fide initiation fees, with such apportionment between the deductible and taxable amounts based on the cost of production method set forth in former Rule 114?

3. Were such payments that were made after July 1, 1993 allocable between the service B&O tax and the retailing B&O tax classifications?

DISCUSSION:

[1], [2] The statutory authority for the deduction at issue, RCW 82.04.4282, provides in part:

> In computing tax there may be deducted from the measure of tax amounts derived from (1) bona fide initiation fees, ... This paragraph shall not be construed to exempt any person, association, or society from tax liability upon selling tangible personal property or upon providing facilities or services for which a special charge is made to members or others. If dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if

> the dues are graduated upon the amount of goods or services rendered, the value of such goods or services shall not be considered as a deduction hereunder.

Rule 114 provided in part:

> RCW 82.04.4282 provides for a business and occupation tax deduction for amounts derived from activities and charges of essentially a nonbusiness nature. Thus, outright gifts, donations, contributions, endowments, tuition, and initiation fees and dues which do not entitle the payer to receive any significant goods or services in return for the payment are not subject to business and occupation tax. The scope of this statutory deduction is limited to situations where no business or proprietary activity (including the rendering of goods or services) is engaged in which directly generates the income claimed for deduction.
>
> The law does not contemplate that the deduction should be granted merely because the payments required to be made by members or customers are designated as "initiation fees" or "dues" The statutory deduction is not available for outright sales of tangible personal property or for providing facilities or services for a specific charge. Neither is it available ". . . if dues are in exchange for any significant amounts of goods or services rendered by the recipient thereof to members without any additional charge to the member, or if the dues are graduated upon the amount of goods or services rendered . . ." (RCW 82.04.4282). Thus, it is only those initiation fees and dues which are paid for the express privilege of belonging as a member of a club, organization, or society, which are deductible.

Rule 114 defined "bona fide initiation fees" as:

> . .. only those one-time amounts paid which genuinely represent the value of membership in a club or similar organization. It shall not include any amount paid for or attributable to the privilege of receiving any goods or services other than mere nominal membership.

Rule 114 defined "dues" as "those amounts paid solely for the privilege or right of retaining membership in a club or similar organization." As noted in Det. No. 95-239, supra, when interpreting this rule, the Court of Appeals stated, "[t]he purpose of the dues deduction is to exempt from taxation only revenue exacted for the privilege of membership." Automobile Club vs. Department of Rev., 27 Wn. App. 781, 786, 621 P.2d 760 (1980).

Furthermore, former Excise Tax Bulletin 503.04.114\183 (ETB 503, canceled 1/31/96, but which was in effect during the audit period) explained bona fide initiation fees and dues as follows:

> Thus, payments which are in fact consideration for and entitle a person to receive goods, services or use of facilities are subject to excise taxes even though they may be labeled "dues" or "initiation fees". Such payments are not bona fide initiation fees or dues within the meaning of the statute or Rule 114, i.e., they are not truly "dues" or

> "initiation fees". Thus, so-called "initiation fees" or "dues" paid for the use of recreational or amusement facilities of the kind referred to in Rule 183 (e.g., swimming, skating, tennis, golf, handball, dancing, et al) are subject to the retailing business tax, and the retail sales tax must also be collected thereon.
> . . . .
>
> An organization in which the membership has no proprietary interest and operational control and which performs business or commercial services, the charges for which would otherwise be subject to business and occupation tax, may not avoid tax liability by designating such charges as initiation fees, dues or contributions.
>
> It may be that a club or organization is structured in such a way that initiation and dues fees entitle the members to a combination of benefits, some of which are mere membership rights and others which constitute compensable commercial services. In such instances, the amount representing initiation fees and dues will be deductible only if they entitle the member to a proprietary interest and a voice in the operational control of the club or organization and in its facilities.

For the reasons and authorities explained and cited above and in Det. No. 97-146, we find that the taxpayers' initiation fees are not "bona fide initiation fees" because the payments were in exchange for services and use of the clubs' facilities. The payments were not merely for the privilege of membership. Before members can use the exercise facilities, they must pay both the initiation fees and the monthly dues. As noted, the members do not have proprietary interests or operational control in the clubs. There are no social memberships. We do not find that members would pay initiation fees merely to visit a vending machine area or a television lounge. In fact, there are no members who paid only the initiation fees and not the monthly dues. Therefore, we find that no part of the initiation fees are deductible under RCW 82.04.4282. Det. No. 95-239, supra.

The next issue is whether the initiation fees paid after July 1, 1993 are allocable between the service B&O tax classification and the retailing B&O tax and retail sales tax classifications. The taxpayers offer activities to their members, including basketball, racquet ball, tennis (formerly), swimming, weights, aerobic machines, etc. RCW 82.04.050, effective July 1, 1993, defines "retail sale" as including:

> (3) The term "sale at retail" or "retail sale" shall include the sale of or charge made for personal, business, or professional services including amounts designated as interest, rents, fees, admission, and other service emoluments however designated, received by persons engaging in the following business activities:
> (a) Amusement and recreation services including but not limited to golf, pool, billiards, skating, bowling, ski lifts and tows, day trips for sightseeing purposes, and others, when provided to consumers;
>
> . . .

> (g) The following personal services: Physical fitness services, tanning salon services, tattoo parlor services, steam bath services, turkish bath services, escort services, and dating services.

As discussed above, we have determined that none of the initiation fees are apportionable between taxable and deductible amounts because they are all taxable for the use of the exercise facilities and services. However, Rule 114 provided that once that determination was made, then the taxable income attributable to either retailing activities or service activities must be reported on the excise tax return under the appropriate classifications and tax rates.

Rule 183 defines "amusement and recreation services" to. . .

> include, but are not limited to: Golf, pool, billiards, skating, bowling, swimming, bungee jumping, ski lifts and tows, basketball, racquet ball, handball, squash, tennis, and all batting cages. "Amusement and recreation services" also include the provision of related facilities such as basketball courts, tennis courts, handball courts, swimming pools, and charges made for providing the opportunity to dance. <u>The term "amusement and recreation services" does not include instructional lessons to learn a particular activity</u> such as tennis lessons, swimming lessons, or archery lessons.

(Underling ours). Rule 183 also defines "physical fitness services" to . . .

> include, but are not limited to: All exercise classes, whether aerobic, dance, water, jazzercise, etc., providing running tracks, weight lifting, weight training, use of exercise equipment, such as treadmills, bicycles, stair-masters and rowing machines, and providing personal trainers (i.e., a person who assesses an individual's workout needs and tailors a physical fitness workout program to meet those individual needs). <u>"Physical fitness services" do not include instructional lessons such as those for self-defense, martial arts, yoga, and stress-management. Nor do these services include instructional lessons for activities such as tennis, golf, swimming, etc. "Instructional lessons" can be distinguished from "exercise classes" in that instruction in the activity is the primary focus in the former and exercise is the primary focus in the latter.</u>

(Underlining ours). Rule 183(3) provides in part:

> **Business and occupation tax.**
>
> (a) **Retailing classification.** Gross receipts from the kind of amusement, recreation, and physical fitness services defined to be retail sales in subsection (2)(m) of this section are taxable under the retailing classification.
>
> (b) **Service and other activities classification.** Gross receipts from activities not defined to be retail sales, such as tennis lessons, golf lessons, and other types of instructional lessons, are taxable under the service and other activities classification.

Rule 183(4) provides:

> (a) **General principles.** For the purposes of the business and occupation tax, all amounts derived from initiation fees and dues must be reported as gross income which then must be apportioned between taxable and deductible income. The following general principles apply to providing amusement, recreation, and physical fitness services when income is received in the form of dues and/or initiation fees:. . . .

Like former Rule 114, Rule 183(4) provides:

> (b) **Allocation of income.** Persons who derive income from initiation fees and dues may find that they have incurred business and occupation tax liability under both the retailing and service and other activities classifications. For example, an organization may furnish exercise equipment as well as provide lessons in martial arts to its members in return for payment of dues. The former is a retailing taxable activity while the latter is taxable under the service business tax. These taxes are at different rates. Once the income has been allocated between taxable and deductible amounts, the parts of taxable income attributable to either retailing activities or service activities must be reported on the combined excise tax return under the appropriate classification and under the prevailing tax rates. In addition, state and local retail sales taxes measured by the retailing portions must be separately collected from dues paying members, reported, and remitted with the same excise tax return.

(Underlining ours). Rule 183(4) then provides that there are alternative methods of reporting:

> (c) **Alternative methods of reporting.** Persons who receive any "amounts derived" from initiations fees and/or dues may report their tax liabilities and determine the amount of tax reportable under different classifications (retailing or service) by use of two alternative allocation methods. The taxpayer may only change its selected allocation method annually and all changes are prospective only.

The first, and apparently preferred, method is the "actual records of facilities usage." The alternative method is the "cost of production" method. The rule states that persons using this latter method are advised to seek the Department's review of the cost accounting methods applied.

From this discussion of RCW 82.04.050 and Rules 114 and 183, it is apparent that the present taxpayers must collect and report retail sales tax as well as report retailing B&O tax when they provide amusement and recreation activities and physical fitness services. The present taxpayers may report service B&O tax on the portion of their initiation fees that pertain to instructional lessons offered by or through them. Thus, we will remand this matter to the Department's Audit Division to allow it to determine which parts of the taxpayers' initiation fees are subject to retail sales tax and retailing B&O tax and which parts are subject to service B&O tax earned from

providing instructional lessons and other service activities, if any. We defer to the Audit Division's judgment whether the actual records of facilities usage method or the cost of production method applies.

DECISION AND DISPOSITION:

The taxpayers' petition is granted as to the right to allocate their initiation fees between 1) retailing B&O tax and retail sales tax from amusement and recreation activities and physical fitness services and 2) service B&O tax from instructional lessons and other service activities, if any. The remainder of the taxpayers' petition is denied, in particular, the right to deduct amounts from the initiation fees and dues as "bona fide" initiation fees and dues.

The reporting instructions in this Determination constitute "specific written instructions" within the meaning of RCW 82.32.090. Failure to follow the instructions would subject the taxpayer to the additional ten percent penalty mandated by that statutory section.

Dated this 31st day of March 1998.