

Cite as Det No. 07-0254, 28 WTD 1, (2009)

BEFORE THE APPEALS 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. 07-0254
)	
)	Registration No.
)	Document No. /Audit No.
)	Docket No.
)	

Rule 183; RCW 82.04.4283; ETA 2010.04.08.183: B&O TAX – INITIATION FEES AND DUES – DEDUCTION. The deduction under RCW 82.04.4282 for “bona fide” initiation fees and dues is available if the taxpayer can show the fees and dues are received solely for the privilege of membership and not in exchange for goods and services. Where a tennis club demonstrated there was a substantial social component to membership, a portion of the taxpayer’s initiation fees and dues income was deductible.

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.

Prusia, A.L.J. – A membership tennis and social club requests correction of an assessment that characterized the club as a fitness club and taxed 100% of its initiation fee and dues income. We find that the assessment incorrectly characterized the taxpayer as a fitness club, find there was a substantial social benefit associated with the privilege of membership, and conclude that a portion of the taxpayer’s initiation fees and dues income was deductible as “bona fide” initiation fees and dues under RCW 82.04.4282.¹

ISSUES

1. Was a portion of Taxpayer’s initiation fees and dues paid solely for the express privilege of belonging as a member of the club?

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

FINDINGS OF FACT

[Taxpayer] is a nonprofit corporation that operates a membership tennis and social club in [Washington] offering [various] facilities . . . at a single location. . . . It principally serves residents of [a neighborhood]. It also is the site of [a tennis tournament]. Taxpayer offers full memberships, which include use of the tennis facilities and all other facilities, and social memberships, which allow use of all facilities except the tennis courts. Taxpayer has approximately . . . full memberships and . . . social memberships. Members pay an initiation fee and monthly dues.

In 1996, the Audit Division of the Department of Revenue (“Department”) audited Taxpayer for the period 1992-1995. In the 1996 Auditor’s Detail of Differences and Instructions to Taxpayer, the Audit Division characterized Taxpayer’s business activity as follows: “consists of providing social and tennis activities to your members.” The 1996 audit allowed Taxpayer’s deduction of its initiation fees and dues under RCW 82.04.4282, and assessed no additional taxes. In the course of the 1996 audit, the Audit Division and Taxpayer agreed on a methodology for determining the amount of tax reportable on dues income, and under what classification it was reportable, using the actual records of facilities usage allocation method (“facilities usage method”) in WAC 458-20-183 (Rule 183). At the time of the 1996 audit, Taxpayer did not have any space dedicated to exercise equipment.

After the 1996 audit examination, Taxpayer apportioned its initiation fees and dues between taxable income and income that is deductible under RCW 82.04.4282, using, as Taxpayer understood it, the actual records of facilities usage method in Rule 183. Taxpayer continued to engage in the same activities, except that [it added] an exercise room. . . . Usage gradually increased to [just a few persons] per day by 2005.

The Audit Division of the Department of Revenue again examined Taxpayer’s books and records, for the period January 1, 2001 through June 30, 2005 (“audit period”).

At the time of the 2005 audit, Taxpayer’s facilities consisted of a . . . clubhouse . . . , tennis courts, [swimming] pools . . . and a children’s playground. The clubhouse contained . . . , a pro shop, locker rooms, an office, and an exercise room. . . . The exercise room had [various exercise equipment]. [The clubhouse also contained] a lounge room [a] social room . . . , and a kitchen. The clubhouse had [vending] machines....

During the audit period, Club members paid initiation fees of . . . to . . . , and monthly dues of . . . to . . . , depending on the type of membership (full or social). There was no additional charge to members for use of the facilities. . . .

The taxpayer employed tennis pros and tennis instructors, but did not have a social director. It did not have a fitness trainer, and did not have any staff for the exercise room. The majority of the club’s expenses consisted of the upkeep of the tennis courts and swimming pool area. The

majority of salaries paid were to the tennis pros and instructors. The vast majority of Taxpayer's revenues were used to cover tennis and pool-related expenses.

Throughout the audit period, Taxpayer hosted [tennis tournaments] which were open to the public, and both entrants and spectators were required to pay entrance fees for participating or watching.

Taxpayer states that it functions somewhat like a community . . . club with tennis courts. There is no other community facility in the neighborhood, and Taxpayer is the only place in the community where kids regularly met. Kids sometimes play tennis, but often just "hang out" in the lounge. . . . Taxpayer states the playground is a meeting place for members with small children and is used daily for child recreation and socialization and social interaction among adult members. Taxpayer describes use of the lounge and social room as follows. Members informally arrange get-togethers in the lounge, at the pool, and at the playground daily, particularly in the summer. There are small-group [gatherings] on the pool deck. Groups informally get together in the lounge to watch . . . television. Members sign up for use of the lounge or social room for a large number of events There is no charge for use of the facilities, unless the event is unusually large and will require cleaning up. Members contribute their time to maintain and plan the facility, and promote and organize . . . annual social events Members also organize and plan field trips

Taxpayer states the club has a very strong social element, and that most people in all membership categories attend social events at the club and arrange get-togethers at the club.

Taxpayer states the exercise room has been used mostly as a warm-up facility for members who come to use the tennis courts. It states no one has joined the club just to use the exercise room.

During the 2005 audit examination, the Department's auditor had occasion to use the lounge room for the audit work on three separate occasions. While she was using the room, no members used the room. On the basis of that observation, and a finding that the vast majority of Taxpayer's revenues were used to cover tennis and pool-related expenses, and Taxpayer had only minor costs for social events, the auditor concluded that Taxpayer's social component was minor. The auditor's write-up characterized Taxpayer's business activity as "operating a fitness club that includes tennis, swimming, and an exercise room." The Audit Division disallowed all deductions of initiation fees and dues that Taxpayer had taken during the audit period. The Audit Division classified the disallowed deductions as income subject to Retailing B&O tax and retail sales tax, and assessed additional tax on . . . in revenue. The audit examination also found some purchases of capital assets and consumables on which retail sales tax or use tax was due and not paid. On December 1, 2005, the Audit Division issued [an] assessment against Taxpayer, in the total amount of

Taxpayer appeals the disallowance of the deductions it took for initiation fees and dues, and the assessment of tax on the disallowed amounts. It requests that the Department correct the assessment by canceling the additional retailing B&O tax and retail sales tax assessed.

At hearing, Taxpayer provided a copy of its by-laws, lists of its summer and annual events, and many pictures taken at various annual events in the social room.

Taxpayer also provided membership survey forms completed by . . . members, as rebuttal to the Audit Division's conclusion that Taxpayer is a fitness club with little social element. The survey was performed in 2006, while Taxpayer and the Audit Division were continuing to discuss possible adjustment of the assessment. The form asks five questions: 1) Did the social aspects of [the taxpayer] influence your decision to join or remain a member? If so explain. 2) Why did you choose to join the [the taxpayer] and not [a physical fitness facility]? 3) Do you or members of your family come to the club for reasons other than playing tennis, swimming or fitness? If so for what? 4) Have you or your family had [an event] at the club? If not, is the ability to do this at the club of value to you. 5) What does the [the taxpayer] mean to you and your family? All but a few of the completed surveys indicate the members use Taxpayer for social reasons, and that the social aspects of Taxpayer were an important reason for joining and remaining a member.

Taxpayer also provided evidence of the usage of the pool and fitness room by members during the audit period. It provided periodic studies of the use of the pool from 2001 through 2005, consisting of a tallies of actual usage in sample weeks in June 2001; in June, July, and August 2002; in May, June, and July 2003; in June, July, and August 2004; and in June, July, and August 2005.

For the fitness (workout) room, Taxpayer had no actual tallies or periodic studies of usage during the audit period, but provided actual tallies of use during most weeks of November and December 2005 (shortly after the audit period), and the club manager's recollections of usage during the audit period, based on his personal observations. The club manager stated that he worked next to the fitness room and observed its usage. Based on his recollection, [the small number of members using] the workout room [increased little during the years 2001 through 2005].

Taxpayer has performed a market study of comparable charges for pool and fitness facility use. The study found that the median average fee for use of the pool at [various] facilities . . . was \$. . . per use. It was unable to survey facilities that had as few exercise machines and amenities as Taxpayer. It did survey facilities . . . which had more machines, exercise programs, and trainers available, and found that their median average fee for the use of fitness facilities was \$. . .

ANALYSIS

Washington imposes a B&O tax "for the act or privilege of engaging in business" in the State of Washington. RCW 82.04.220. Different B&O rates apply, depending upon the activity. Generally, the measure of the tax is gross receipts.

Washington levies a retail sales tax on each retail sale in this state. RCW 82.08.020 and 82.04.050. RCW 82.04.050(3) defines a "sale at retail" to include:

[T]he 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

Although the statute does not specifically list tennis, swimming, and the use of fitness equipment as services that are defined as retail sales, WAC 458-20-183 (Rule 183) clarifies that retail “amusement and recreation services” include these activities. Rule 183(2)(b) explains:

“Amusement and recreation services” include, but are not limited to: Golf, pool, billiards, skating, bowling, swimming, bungee jumping, ski lifts and tows, basketball, racquetball, handball, squash, tennis, and all batting cages. “Amusement and recreation services” also include the provision of related facilities

See also, Det. No. 87-348, 4 WTD 281 (1987).

Rule 183(2)(l) provides:

"Physical fitness services" include, but are not limited to: . . . use of exercise equipment, such as treadmills, bicycles, stair-masters and rowing machines

Thus, when Taxpayer provides tennis and swimming, or exercise equipment, it is engaging in activities that are defined as a “retail sale,” and taxable under the retailing B&O and retail sales tax classifications.

A potential problem arises in the taxation of revenue from the sale of amusement and recreation services and physical fitness services when the provider is a membership club, such as a country club or a golf club, that receives its income in the form of dues and initiation fees, and payment of the fees and dues entitles the member to the amusement and recreation services or physical fitness services for no additional charge or a reduced charge. By statute, “bona fide” initiation fees and dues may be deducted from the measure of the B&O tax, but “[i]f dues are in exchange for any significant amount of goods or services rendered by the recipient thereof to members without 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 under this section.” RCW 82.04.4282. Thus, a particular membership clubs that provides amusement and recreation services or physical fitness services may have both taxable and deductible revenue from fees and dues.

Rule 183 explains reporting instructions for persons who provide amusement, recreation, and physical fitness services, including persons who receive their income in the form of initiation fees and dues.

Rule 183(2) defines “initiation fees” and “dues,” following the distinction between deductible and taxable amounts set out in the statute:

(e) “Dues” are those amounts periodically paid by members solely for the purpose of entitling those persons to continued membership in the club or similar organization. It shall not include any amounts paid for goods and services rendered to the member by the club or similar organization.

(i) “Initiation fees” means those amounts paid solely to initially admit a person as a member to a club or organization. “Bona fide initiation fees” within the context of this rule shall include 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 the mere nominal membership.

Rule 183(4) explains that for-profit and nonprofit entities that receive a mixture of tax deductible amounts (bona fide initiation fees and dues) and taxable amounts (payment for significant goods and services rendered) must, for purposes of the B&O tax, report all amounts and then apportion them between taxable and deductible income. To distinguish between taxable and deductible income, the law requires that tax exemption provisions be construed strictly against the person claiming exemption. All persons claiming a deduction for bona fide fees and dues must keep adequate records sufficient to establish their entitlement. It is only those initiation fees that are paid solely and exclusively for the express privilege of belonging as a member of a club, organization, or society, which are deductible.

Rule 183(3) provides that persons who receive any amounts derived from initiation fees and/or dues may report their tax liabilities, and determine the amount of tax reportable under different classifications,² by the use of two alternative allocation methods. One method is labeled the “actual records of facilities usage method.” Under that method, persons may allocate their income based upon such actual records of facilities usage as are maintained; that method is explained in more detail below. The other alternative allocation method is labeled the “cost of production method,” and is explained in Rule 183(4)(c)(ii). The Department has noted that “[i]t is not uncommon that through the application of these formulary methods, a substantial portion of gross dues/fees receipts is entitled to a deduction.” Det. No. 81-104A, 8 WTD 19 (1989).

We will now apply the statutes, Rule 183, and Department decisions to Taxpayer’s situation. The Department has long allowed country clubs, golf clubs, and tennis clubs that have a substantial social component, and that derive their income from initiation fees and dues, to

² Rule 183(4)(b) explains that persons who derive income from initiation fees and dues may have B&O liability under both the retailing and service and other classifications. For example, an organization that furnishes exercise equipment and provides lessons in martial arts is performing a retailing activity (furnishing exercise equipment) and a service activity (lessons). Once income has been allocated between taxable and deductible amounts, the taxable portions must be reported under the appropriate classification.

allocate their initiation fees and dues income between taxable amounts (payment for goods or services rendered) and deductible amounts (bona fide initiation fees and dues). No. 85-178A, 3 WTD 387 (1987); No. 87-218, 3 WTD 295 (1987); Det. No. 87-348, 4 WTD 281 (1987); Det. No. 88-247, 6 WTD 105 (1988); Excise Tax Advisory 548.04.114 (ETA 548). The Department has held that a social and luncheon club that also has squash courts and pool tables for members' use for no additional charge has both deductible and taxable income from initiation fees and dues. Det. No. 91-002, 10 WTD 362 (1990).

On the other hand, the Department has held that a membership athletic club or fitness club that offers no social membership or any limited rights to dine or mix with members such as those offered by some country clubs, may not deduct any portion of its initiation fees. Det. No. 95-239, 16 WTD 48 (1995); Det. No. 03-0252, 23 WTD 223 (2004). In Excise Tax Advisory 2010.04.08.183 (ETA 2010), issued October 1, 2001, the Department addressed the taxation of health and physical fitness clubs receiving initiation fees and dues. ETA 2010 emphasized that the burden of proof is upon the taxpayer to provide evidence to support a deduction of initiation fees and dues, and gave the following example of evidence that did not satisfy that burden:

The fact that the club may have parties or other events for its members at no separate charge does not demonstrate that the member pays a portion of his or her dues for social benefits. Merely providing a juice bar or a lounge where members can sit, away from the exercise equipment, also does not meet the club's burden of showing that its members pay a portion of their membership solely for social benefits, as opposed to access to the club's exercise facilities. Finally, leave of absence policies that allow a member to pay reduced dues while the member is unable to use the services do not demonstrate the presence of a social benefits component.

In Taxpayer's case, there is no question that at least a portion of Taxpayer's initiation fees and dues income, both for tennis memberships and "social" memberships, is attributable to the privilege of receiving goods and services. Payment of the social membership entitles the member to use the swimming facilities during the months those facilities are open, and to use the exercise equipment, for no additional charge. *See* Det. No. 91-002, 10 WTD 362 (1990). Taxpayer does not dispute that at least a portion of its initiation fees and dues income is taxable.

The disputed question is whether Taxpayer has demonstrated that any portion of its initiation fees and dues is paid solely for the privilege of membership. *I.e.*, has Taxpayer demonstrated that there is a substantial social benefit component to membership?

We find, based upon the additional evidence submitted at hearing, that there was a substantial social benefit component to Taxpayer's memberships during the audit period. Taxpayer has a neighborhood focus, and has long served as a meeting place for residents of the neighborhood. Taxpayer has a lounge room, a . . . social room, a kitchen, and [an] area around its pool for events and socializing. Membership entitles members to use the kitchen and social room for . . . events, and members actually use the facilities for that purpose. Membership entitles them to gather and socialize in the lounge, and members do gather there to socialize. . . . Members have organized . . . clubs and . . . groups that regularly use the social room. Members promote and

organize . . . annual social events Members schedule a number of other events, especially during the summer months. In a survey of . . . members, most stated they use the facilities for social activities, and not just to for playing tennis, swimming or fitness. The observation of the Department's auditor that she observed little use of the lounge during the daytime, on the three days she used it to conduct the audit, does not outweigh the substantial evidence of a significant social component to membership.

During the audit period, Taxpayer's situation was very different from that of the health and physical fitness clubs addressed in ETA 2010. In the fitness clubs addressed in ETA 2010, what is primarily being purchased is access to the club's exercise facilities and fitness services. The club may provide a juice bar or lounge where members can sit, away from the exercise equipment, and possibly socialize, any may schedule a few parties or other events, but such opportunities generally are not a primary reason persons join the club. The social benefits members receive from membership are *de minimus* and incidental to what is being purchased. Taxpayer was not a health and physical fitness club. It was a tennis and social club that had exercise equipment that was little used. Use of the exercise equipment was not the reason members joined or used the club's facilities. The equipment was an incidental benefit to club membership. Moreover, the social benefits of membership were a primary reason members purchased memberships, rather than using facilities that offered only recreation services. The lounge and social room were not merely places where members took a break from fitness or recreation activities. There were a large number of social events organized by the members. There were significant social benefits from membership.

We conclude that amounts derived from Taxpayer's initiation fees and dues may be apportioned between taxable and deductible income. Accordingly, we do not sustain the assessment, which did not apportion any of the income to deductible income.

DECISION AND DISPOSITION

The taxpayer's petition is granted in part.

Dated this 19th day of September 2007.