Cite as 4 WTD 383 (1987)

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D E T E R M I N A T I O N

No. 87-355

Re: . . .
Registration No. . . .

Dear Mr. . . . :

I have your request for an advisory ruling regarding the appropriate excise tax classification for income of your above referenced client (taxpayer). There is no tax assessment or deficiency in issue and your request is for prospective application as well as for information upon which to advise the taxpayer concerning its taxability. Therefore, this matter is being treated as a request for prior determination pursuant to WAC 458-20-100(18).

[1] **RCW 24.32.030 AND RULE 214:** AGRICULTURAL COOPERATIVE ASSOCIATIONS --TAXABILITY -- AGENTS. Agricultural marketing associations organized under chapter 24.32 RCW are selling agents for their principal/grower members by operation of law. Such organizations are subject to Service business tax measured by commissions, fees, and their own, retained gross receipts.

[2] **RULE 214:** B&O TAX -- AGRICULTURAL COOPERATIVE ASSOCIATIONS -- SERVICE VIS-A-VIS WHOLESALE -- SUBSTANCE OVER FORM. The substance of the operating relationship between an agricultural marketing association and its grower-members is that of an agent selling on behalf of its disclosed or undisclosed principals. Such an association is not a "wholesaler" outright, in any independent capacity.

[3] **RULE 193A AND RULE 193C:** INTERSTATE/FOREIGN SALES -- TAX EXEMPTIONS -- UNIFORM COMMERCIAL CODE --

INAPPLICABILITY. The excise taxability of sales to buyers located outside this state is governed by the Revenue Act of Title 82 RCW, not the provisions of U.C.C. law, chapter 62A.2-319. Rules 193A and C contain the proofs of interstate/foreign deliveries required to perfect entitlement to tax exemption.

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.

NATURE OF ACTION:

During the course of a previous audit it was suggested that the taxpayer should be reporting tax upon its gross income from selling fruit under its cooperative marketing agreement with grower/members under the Wholesaling-Other classification rather than the Service classification measured by commissions income. Reporting as a wholesaler would entitle the taxpayer to B&O tax deductions for interstate and foreign sales which are not available for commissioned "cooperative marketing associations" under WAC 458-20-214 (Rule 214). The taxpayer seeks guidance in determining its correct tax reporting classification as well as instructions for restructuring so as to be entitled to report tax as a wholesaler of fruit.

FACTS AND ISSUES:

Faker, Sr. A.L.J. -- The taxpayer is organized under Chapter 24.32 RCW as an agricultural cooperative association. Its bylaws[1] and its marketing agreements with grower/members reflect the taxpayer's obligation to operate on a nonprofit, cooperative basis, providing specified fruit marketing services in an agency capacity. The taxpayer has, consistently and historically, reported tax upon its fees charged for services rendered under the Service and Other Business Activities classification as a commissioned agent. The taxpayer's services for members include the receiving, handling, grading, storing, packing, marketing, and selling of fruit produced by the members.

When members' fruit is received it is commingled and treated as fungible commodities. From that point, pursuant to its authority under the marketing agreements, the taxpayer acts as

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[1] Copies of the Taxpayer's Articles of Incorporation, Bylaws and Marketing Agreements were submitted for review.

if it owned the fruit. It deals directly with wholesale purchasers of the fruit in its own name and its own right. It does not disclose the names of its principals/member growers. Annually, the taxpayer establishes its charges for member services and, if its costs of operation are less than the established charges, it refunds the overages to members as patronage dividends.

The taxpayer's petition places the questions or issues for our consideration as follows:

> 1. As presently organized and operated, should . . . be reporting for B&O tax purposes as : (a) a "wholesaler" under RCW 82.04.060; or (b) a "cooperative marketing association" under Rule 214?
>
> 2. If you determine that . . . is presently a "cooperative marketing association" taxable for B&O purposes under Rule 214, then to what extent must . . . change its form of organization in order to be eligible to report as a wholesaler for B&O purposes?
>
> 3. If . . . either is or becomes a wholesaler, then will sales of fruit by . . . to persons in other states and in foreign countries be exempt from taxation for wholesale B&O purposes pursuant to Rules 193A and 193C regardless of whether the sale is F.O.B. [city] or F.O.B. destination if the buyer has the right to reject defective fruit upon receipt?

TAXPAYER'S ARGUMENTS

The taxpayer distinguishes between how it is organized (as an agent) and how it operates (as a wholesaler). As to the first issue presented the taxpayer's petition explains, in pertinent parts, as follows:

> . . . 's authority with respect to the fruit itself and the manner in which it accounts to its members for the fruit proceeds is spelled out in the Marketing Agreement. As you can see from . . . 's financial statements, the charges for providing services are reflected as . . . 's income. The sales proceeds from the fruit is not reported on the income statement.
>
> The Operation of . . . .

> Although . . . is organized on paper like an agent, in practice, once it receives the fruit and, after this fruit is commingled with other member's fruit, . . . acts as if it is the owner of this fruit. It has possession of the fruit. It insures the fruit against loss in its own name. It deals directly with the buyer and makes the sale. Finally, the sales documentation reflects . . . as the owner of the fruit. Nowhere in the sale process is the individual member's ownership of the fruit disclosed to the buyer. Thus, to the outside world, . . . looks and operates like any other wholesaler of fruit.
>
> . . . 's B&O Reporting Status.
>
> To date, . . . has reported to the State of Washington for B&O tax purposes as a "cooperative marketing association" under Rule 214. This rule requires . . . to report and pay B&O tax: (a) at the wholesale rate on its storage charges; and (b) at the service rate on its selling charges. No tax is payable on its packing charges so long as these services are performed for a grower.
>
> . . .
>
> Even though . . . is organized on paper as the agent of the grower, nevertheless, the world sees . . . as the owner of the fruit. Also, the sales documentation between . . . and the buyer does not show that the transaction was made in the name and for the account of . . . 's principal (i.e., the grower). As such, Rule 159 requires that . . . be deemed the seller (hence, the wholesaler) of the fruit. Thus, there seems to be a real question as to the proper reporting B&O classification for . . . . Hence the reason for our first question above.

As to the second issue the petition states,

> COMMENTS REGARDING QUESTION NO. 2.
>
> If you conclude, notwithstanding Rule 159, that . . . is a "cooperative marketing association" and taxable in accordance with Rule 214, to what extend must . . . change its form of organization in order

> to be eligible to report as a wholesaler for B&O purposes? Certainly . . . could revise its Articles of Incorporation, Bylaws and Marketing Agreement to state that . . . "buys" and "sells" the member's fruit instead of performing this services as his "agent". Also, . . . 's financial statements could be revised to reflect the value of the fruit sales on its income statement. However, notwithstanding this change in the terminology, as a cooperative, . . . would still be obligated to return the net proceeds of sale from the fruit to the member. In other words, the adoption of a "buy-sell" relationship instead of an "agency" relationship would not change the true financial relationship between . . . and its member. Also , there would be no change in . . . 's sales documentation. The buyers would still deal with . . . as the owner and seller of the fruit just as they presently do.
>
> Therefore, even though . . . could change its form of organization (if you deem that necessary in order for . . . to be able to report as a wholesaler), such a change would really not affect how it does business. Therefore, we question the need of incurring the expense of changing the form when there would be no real change in substance.

Regarding the third question the taxpayer seeks guidance concerning the taxable or exempt nature of sales to buyers outside this state under the provisions of WAC 458-20-193 Parts A and C. Its petition explains the "F.O.B." shipping terms under which fruit shipments are made and explains the rights of buyers to examine and accept or reject the fruit at the out-of-state destination points. The petition stresses,

> It would appear from Rule 193A that if . . . is taxable as a wholesaler and it sells fruit F.O.B. [city] to a purchaser in some other state (thereby passing ownership and risk of loss to the fruit to the purchaser <u>in</u> Washington), then the sale should be taxable for wholesale B&O tax purposes. Yet, . . . has been advised by Department representatives that it is the current policy of the Department to exempt such fruit sales from wholesale B&O taxes (even though they are F.O.B. at a point in Washington) because the buyer has a right to reject the fruit upon receipt. As far as export sales are concerned, the fact that a sale to a foreign

> purchaser is F.O.B. [city] would not appear to cause the sale to be taxable so long as "it is clear that the process of exportation of the goods has begun".

Finally, the taxpayer refers to an informal letter of May 18, 1987, from a Regional Audit Manager of the Department which advised the taxpayer that it was taxable upon its commissions income as a cooperative marketing association under Rule 214 (Service b&o tax), not as a wholesaler. However, the letter advised that the result would be different (presumably Wholesaling b&o tax) if the taxpayer's marketing agreement were revised to reflect a straight buy-sell arrangement between the taxpayer and its members/growers. The taxpayer infers that this change would merely elevate form over substance, but that it can make such a formalistic change, if need be, to convert its operation to that of a wholesaler.

DISCUSSION:

We have reviewed the Articles of Incorporation, Bylaws, and Growers Marketing Agreement, and the other accounting and shipping documents submitted by the taxpayer. As a matter of both fact and law these documents establish the agency relationship of the taxpayer to its grower/members.

The Marketing Agreement is not merely a pro-forma recitation of operational guidelines by which the taxpayer is to deal with its members' fruit. It is a legally binding and enforceable contract which creates a principal-agent relationship and establishes the consideration to be paid to the taxpayer for rendering its services as an agent.

[1] The taxpayer derives its income only pursuant to its agreements with members, as an agent for those members, not as a wholesaler of fruit. The taxpayer neither owns the proceeds from fruit sales nor treats this income as its own for any purposes. To do so would not only violate its marketing agreements but also would circumvent the very statutes and cooperative marketing purposes under and for which the taxpayer was formed. The taxpayer was formed and incorporated on a "cooperative basis as agent for its members," (Article II of Articles of Incorporation), as "an association formed under the provisions of the Cooperative Marketing Act of 1921" (page 1 of Bylaws). The taxpayer's very existence, purpose, and authority is circumscribed by the respective provisions of Chapter 24.32 RCW. The very "purpose of organization" of such associations is expressly provided by RCW 24.32.030 as being,

> . . . to engage in any activity in connection with the marketing or selling of the agricultural products of its members . . . (Emphasis supplied.)

RCW 24.32.050 enumerates the powers of an agricultural cooperative association, including,

> (3) To act as the agent or representative of any member or members in any of the above mentioned activities. (Emphasis supplied.)

The taxpayer is an agent by operation of law. Most importantly, it derives its income only from its grower/members and only as a commissioned marketing entity, not as an outright seller of fruit in its own right. While it is not the province of the Department of Revenue to administer the provisions of Chapter 24.32 RCW, we are advised by the Department of Agriculture that the intent of that body of law is to provide for well defined, nonprofit business associations to serve the interests of agricultural producers/growers, not to serve the interests of the associations themselves as distinct business entities. Thus, though there may be no outright legal prohibition against such associations dealing on a direct buy-sell basis, serious conflicts of interest would prevail. Moreover, the Courts have spoken concerning the nonprofit, agency status of agricultural marketing associations organized under Chapter 24.32 RCW, on numerous occasions. See Bowles v. Inland Empire Dairy Association, 53F. Supp. 210, at 214 (1943), citing Yakima Fruit Growers Assn. v. Henneford, 182 Wash. 437.

The key to understanding the taxpayer's taxable status and its appropriate B&O tax reporting classification is simply that, with respect to its members who pay the taxpayer's income, there is no distinction whatever between how the taxpayer is organized and how it operates. It is both organized and operates exclusively as an agent and that is the only activity for which it is compensated. Though it may be true that fruit buyers do not perceive the agency capacity of the taxpayer, it is commonplace for marketing coops and trade associations to act as agents for undisclosed principals. Moreover, the taxpayer is a unique entity which is organized and structured expressly for the exclusive purpose of marketing fruit which it does not own. It is for this very special reason that Rule 214 even exists. The Rule deals with a unique kind of business entity performing a unique kind of business activity. Since its inception this rule has provided that fruit and produce marketing cooperatives are subject to Service B&O tax

upon their gross receipts from commissions, fees, and all other charges recovered from members for handling and marketing their produce.

The taxability of business activities under the Washington B&O privileges tax system is generally determined by the kind of business activity being performed rather than the kind of person performing it. See RCW 82.04.220. Sometimes, however, the kind of activity joins together with and is dictated by the kind of person performing it. Such persons are organized, empowered, and regulated for the express purpose of performing a specific kind of activity which, as a matter of public policy and law, are uniquely governed. In this case the very substance of the relationship between the taxpayer and its members, as well as its form, is that of a cooperative marketing agent. Fruit marketing associations are not arm's length buyers and sellers in any real or traditional sense, regardless that the association may give the appearance of an independent wholesaler to fruit buyers or that the agency relationship is undisclosed. Again, it is never undisclosed to the grower/members, who are the only persons who pay the income in question to the taxpayer. The bylaws and marketing agreement reveal the actual, substantive, commercial capacity of the taxpayer in this case. As a fruit marketing association, the taxpayer's liability is ruled exclusively by Rule 214. The appropriate tax classification is that of Service and Other Business Activities (RCW 82.04.290) and the tax measure is the gross receipts retained by the taxpayer as its commissions, fees, and compensation for all of its own costs of doing business (RCW 82.04.080). This has been the uniform and consistent position of the Department throughout the many years of administration of the Rule, equally applied to all persons similarly situated with the taxpayer here.

Conversely, WAC 458-20-159 (Rule 159) is a procedural rule which explains the methods by which persons who act as agents for principals should keep their accounting records and report tax. This rule merely raises the rebuttable presumption that a person who has possession and the right to sell tangible personal property in its own name is deemed to be the "seller" for tax purposes rather than a mere commissioned agent of the seller. However, when the facts of the relationship establish otherwise, they are the substance of the transaction and the relationship, and will control. Rules 214 and 159 are not conflicting in their provisions. Notwithstanding the overlapping provisions of these rules, however, Rule 214 is the exclusive rule for application in this case.

Thus, as to the first issue presented, the taxpayer is a fruit marketing association which derives income from handling and marketing fruit as an agent for grower/members. It is subject to Service B&O tax, not Wholesaling-Other B&O tax.

[2] The second issue can be paraphrased as follows. What would the taxpayer have to do to be taxable as a wholesaler?

The answer is that it would have to stop being a fruit marketing association; dismantle its organization as such; and begin purchasing fruit outright from growers or suppliers for outright resale in its own right.

The Department of Revenue does elevate substance over form based upon all of the intrinsic and extrinsic evidence. However, to merely change the language of its bylaws and/or marketing agreements so that they say the taxpayer is an outright buyer/seller, without changing its substantive and legal relationship with members would be to elevate form over substance, contrary to all of the evidence. The taxpayer apparently seeks to do so, for obviously beneficial reasons, so that it may avail itself of tax exemptions for interstate and foreign sales which are not available to commissioned selling agents who provide their marketing services in this state. The Department has no authority or discretion to extend such exemptions beyond their clear and intended scope. It appears that the Department may have contributed to the taxpayer's impressions that a mere pro-forma change of language in its marketing agreement could legally and properly change its tax liability. Such an inference can be read in the letter from the Department of May 15, 1987. It contains the following statement:

> In order to be treated as other than an agent, . . . would have to change their marketing agreement to reflect a purchase of apples from the growers.

It was not the intent, however, to advise the taxpayer that a mere change in language would suffice. Clearly, the agreement would have to "reflect" the true relationship and the actual facts supporting the transactions. Again, substance controls form in such matters. As the letter also advises, "(t)ax liability is determined by the specific facts." The confusion, if any, caused by this letter could have arisen because the marketing agreement of another fruit packer was also examined in conjunction with that of the taxpayer, at the taxpayer's request. The other agreement spelled out a definite buy/sell arrangement, not any agency capacity.

Moreover, some fruit packers do purchase and sell fruit at arm's length, in their own right and capacity. It was assumed that these agreements reflected the actual facts.

In conclusion, as to the second issue, the mere amendment of language in the marketing agreements will not change the taxpayer's tax liability or tax reporting classifications. In order to be taxable as a wholesaler and enjoy the tax exemptions of a wholesaler, the taxpayer will have to become a wholesaler by purchasing fruit outright and selling it outright.[2]

As to the third issue presented, it now appears to be a moot. However, regarding the taxability or tax exemption of persons actually selling and delivering goods in interstate and foreign commerce, Rules 193A and 193C are clear and unambiguous. Moreover, these rules prevail for taxation purposes rather than the provisions of 62A.2-319 of the Uniform Commercial Code. See also, 2 WTD 397 (March 20, 1987) for a discussion of U.C.C. applications. If the taxpayer were to actually change both its organizational structure and its business operations so that it became a de-facto wholesaler, the Department would advise upon its entitlement to interstate and foreign sales exemptions based upon its actual contracts of sale and delivery methods.

It is important, however, to rectify an existing, apparent misunderstanding by the taxpayer concerning interstate fruit sales. The taxpayer's petition states that it has been advised by Department representatives that sales of fruit to out-of-state purchasers are exempt of B&O tax even though the fruit is sold, F.O.B. at a point in this state, with ownership and risk of loss passing to the buyer in this state. The exemption is supposedly allowed simply, "because the buyer has a right to reject the fruit upon receipt," after it reaches the out-of-state destination. This is not correct under the law or any stated policy of the Department. Neither the fact that the goods sold are fruits or any other agricultural commodity, nor the fact of entitlement of the buyer to out-of-

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[2] We note here, in passing, that the only way the taxpayer and similar cooperative associations may avail themselves of the B&O tax exemption for receiving, washing, packing, etc., horticultural products (RCW 82.04.4287), as well as avoid use tax upon all packing materials, is by being agents to pack the products of agricultural growers exempt of tax under RCW 82.04.330.

state inspection, acceptance, or rejection of the product, result in any B&O tax exemption for the seller. The entitlement to inspect or reject the fruit after it arrives at its out-of-state destination is strictly a U.C.C. application which governs the rights and liabilities of the parties to a sale. It has no bearing whatever upon the taxation of sales transactions which is exclusively governed by the Revenue Act and the rules related thereto.

DECISION AND DISPOSITION:

The tax ruling sought by the taxpayer is denied. The taxpayer must continue reporting its respective tax liabilities as it has in the past, as represented in its petition.

This legal opinion may be relied upon for reporting purposes and as support of the reporting method in the event of an audit. This ruling is issued pursuant to WAC 458-20-100(18) and is based upon only the facts that were disclosed by the taxpayer. In this regard, the department has no obligation to ascertain whether the taxpayer has revealed all of the relevant facts or whether the facts disclosed are actually true. This legal opinion shall bind this taxpayer and the department upon these facts. However, it shall not be binding if there are relevant facts which are in existence but have not been disclosed at the time this opinion was issued; if, subsequently, the disclosed facts are ultimately determined to be false; or if the facts as disclosed subsequently change and no new opinion has been issued which takes into consideration those changes. This opinion may be rescinded or revoked in the future, however, any such rescission or revocation shall not affect prior liability and shall have a prospective application only.

DATED this 30th day of December 1987.