BEFORE THE DIRECTOR
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessments of . . .	F I N A L D E T E R M I N A T I O N No. 81-104A Registration No. . . . Consolidated Reviews: . . . /Audit No. . . . . . . /Audit No. . . .

[1] RCW 82.04.050: RULE 114 -- . . . -- DUES -- SALE AT RETAIL -- PRIOR RULINGS OF DEPARTMENT OF REVENUE -- PROSPECTIVE LIABILITY. The payment of dues and fees in return for recreational . . . privileges is a sale at retail under law and revenue rules. A taxpayer who has received written instructions from the Department as to the reporting thereof may rely upon such advice for tax reporting purposes until such written instructions are rescinded. After receiving new written instructions, post-January 1, 1979 dues and fees for . . . are subject to retailing B&O tax and retail sales tax.

[2] RCW 82.04.430(2): DUES -- EFFECT OF FORMER LAW -- DEDUCTIBLE AMOUNTS. Under written instructions effective until January 1, 1979, entitling the taxpayer to report gross receipts under the Service classification of the B&O tax, the taxpayer could deduct gross membership fees/dues only in amounts which were not for, or graduated upon, the benefits or services rendered. A taxpayer may establish that portion of such gross receipts entitled to tax deduction which represent bona fide membership dues not received in return for taxable services or benefits.

[3] RCW 82.04.4282: BONA FIDE DUES -- DEDUCTIBILITY -- DETERMINATION OF VALUE -- PROOFS. A taxpayer who receives dues/fees from providing both taxable services and benefits as well as intangible, noncompensatory benefits may establish the taxable versus nontaxable portions for all tax reporting periods. Portions of income which are deductible bona fide dues for retailing B&O tax are also deductible for retail sales tax.

[4] RULE 114: DUES -- COMPUTATION OF DEDUCTIONS -- VALIDITY OF RULE -- VALUATION FORMULA -- USAGE OF FACILITIES METHOD. The optional formulary methods for computing the portion of gross dues/fees receipts entitled to tax deduction, as set forth in Rule 114, are fair, appropriate, and nonprejudicial. These alternative valuation methods are available to all dues receiving taxpayers for all periods. The actual usage of facilities method may be applied by using published external studies of average values tantamount to determining the value of comparable facilities under Rule 114.

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: . . .
. . .
. . .

HEARING CONDUCTED BY DIRECTOR DESIGNEES:
Greg Pierce, Former Deputy Director
Garry G. Fujita, Former Assistant Director, Interpretation & Appeals
Edward L. Faker, Sr. Administrative Law Judge

DATE OF HEARING: March 2, 1988

NATURE OF ACTION:

Two separate tax audits and assessments (consecutive audit periods) of a taxpayer's business receipts were submitted for Director review upon stipulation of all parties. The corporate taxpayer appeals the Department's imposition of pre-1979, and the classification and computation of 1979 and

subsequent year, B&O and sales taxes upon the taxpayer's receipt of taxpayer member initiation fees and dues.

Audit No. . . . : Following examination and audit of the taxpayer's business records for the period of July 1, 1978 through September 30, 1979, Audit No. . . . , the Department determined taxes due upon taxpayer's untaxed receipts of membership initiation fees and dues. The taxpayer petitioned for correction of assessment, a hearing was held on July 1, 1980 in Seattle, Washington, and a Determination (. . .) issued on June 4, 1981. The taxpayer has requested Director review.

Action thereon was deferred, however, pending the Department's consideration and review of methods and formulas for determining membership fees and dues deductibility. In 1984, the Department amended WAC 458-20-114, incorporating therein its duly formulated methods and formulas for use in such cases.

Assessment No. . . . : Following examination and audit of the taxpayer's business records for the period of January 1, 1983 through December 31, 1986, Audit No. . . . , the Department assessed the taxpayer for several deficiencies, including improperly reported and taxed receipts of membership initiation fees and dues. On September 15, 1987, this assessment was revised and reissued as Document No. . . . , Audit No. . . . . The taxpayer has requested Director review of the portion of said assessment relating to and imposed for reason of said receipts.

For reason of identity of issues involved during the two time periods in question, the parties stipulated to a consolidated hearing on the taxability of membership initiation fees and dues, and on the corollary issue of the correct classification and computation of any tax imposed.

FACTS AND ISSUES:

Faker, Sr. A.L.J. -- The taxpayer is a Washington for-profit corporation with its principal offices within the state. Its primary corporate purpose, as stated within its [organizational papers], is "(t)o acquire, design, construct, and operate . . . recreational facilities and to market rights to use these facilities in the form of family memberships." (. . .)

A substantial portion of the taxpayer's gross receipts is derived from "initiation fees" (either cash or deferred payment) and annual "dues" charged to its members. The initiation fee and dues obligation is a continuing debt the payment of which is prerequisite to continuing membership. Failure to pay any initiation fee installment or any dues may result in the loss of the member's rights to use recreational facilities . . . . (Certificate of Membership submitted by taxpayer)

In its membership certificates, the taxpayer defines a member's rights to be ". . . merely a contractual license to use such facilities as may be provided from time to time (by the taxpayer) at the [recreational facilities] in which Member has purchased membership rights." (Certificate of Membership submitted by taxpayer)

Memberships are geographically delineated as regional or system wide and entitle members to free use of "[recreational facilities]" within the boundaries of the membership area. The corporate taxpayer maintains a number of "[recreational facilities]" not just in the state of Washington, . . . , but also in other states and in Canada. For members duly subscribed and paid up, as provided hereinabove, no entrance fee or charge is levied at the time of a member's actual use of a "[recreational facility]" within that member's area.

Throughout the tax periods in question, the taxpayer has objected to the imposition of taxes upon the receipt of membership "initiation fees and dues." In the 1981 Determination (. . .) now under review, the Hearing Officer found that the taxpayer's billing and collection of "initiation fees and dues" constituted the sale of membership rights and entitlements, which met the definition for retail sales of licenses to use real property, and generated proceeds of an amusement and recreational business activity. Finding the legal requirements for bona fide "initiation fees and dues" to be lacking, the Hearing Officer disallowed any deductions from the taxpayer's gross income therefor.

By logical extension of that analysis, the Hearing Officer then ruled that receipts of fees and dues attributable to such retailing and retail sales activities would ordinarily be taxable in the Retailing classification business and occupation tax, subject also to retail sales tax. However, the Hearing Officer found, due to prior Department communications to the taxpayer, only the business and occupation tax for "Service and Other Activities" would be

assessed and collected on receipts for the period prior to January 1, 1979.

There being, from and after January 1, 1979, no conflict with prior Departmental communications or notices to the taxpayer, the Hearing Officer determined that from that date onward, the artificial categorization entirely in "Service" would end. Thereafter, any fees and dues produced from identifiable retailing activities would be taxed as such; all other fees and dues receipts would be assessed as "service" activities receipts for the imposition of business and occupation tax. The burden of proof would be upon the taxpayer to make those factual distinctions.

The issues presently raised by the taxpayer for Director review are extensions or developments of the prior issues and may best be summarized as follows:

1) What is the proper classification of the taxpayer's business activities for the purpose of determining the correct tax and tax rates to be applied to the measure of taxpayer's gross receipts?

2) Has the taxpayer demonstrated that its pre-January 1, 1979 receipts of membership initiation fees and dues qualified for partial or total deduction?

3) Has the taxpayer demonstrated that its post-January 1, 1979 receipts of membership initiation fees and dues qualified for partial or total deduction?

4) Has the Department provided a reasonable standard and acceptable method for establishing, tracing, and valuing non-deductible as well as deductible portions of initiation fees and dues?

TAXPAYER'S EXCEPTIONS:

A) The taxpayer argues that member initiation fees and dues are all deductible from the measure of its taxable income for reason of the provisions of RCW 82.04.430(2), and its successor statute, RCW 82.04.4282.

B) Alternatively, the taxpayer argues that, even were such to be non-deductible, the non-deductible portions of the initiation fees and dues would be taxed only in the category of "Service and other activities" for business and occupation

taxes, and that there would be no retail sales tax liability at all.

C) Finally, the taxpayer argues that the Department of Revenue's published methods, standards and practices for segregating and valuing non-deductible retailing and retail sales activity proceeds out of otherwise deductible "initiation fees and dues" are improper, contrary to law and fact, result in the wrongful denial of allowable deductions, and should be rejected.

DISCUSSION:

[1] Under the undisputed facts of this case, the Washington taxpayer, a closely held corporation organized for profit, has as its apparent major business activity and source of gain the sale of "use" licenses for specially provided recreational . . . areas.

This provision of benefits and services to its fees/dues paying members is distinctly and expressly included within the statutory definition of "sale at retail" (RCW 82.04.050). We consequently conclude that the taxpayer is involved in a business activity clearly taxable under the Retailing category of the business and occupation tax. Also, the taxpayer is obligated for the retail sales tax on any such sales.

We fully sustain the conclusions contained in Determination . . . on this legal issue. See also Final Determination No. 87-218, 3 WTD 295 (1987), which thoroughly explains the application of the taxing statutes with respect to clubs and organizations which provide retail services to their membership in return for payments designated as "dues" or "initiation fees."

Like the Hearing Officer in 1981, we also determine that, for all periods before January 1, 1979, and solely for reason of prior written instructions and advice by the Department of Revenue, the taxpayer's initiation fees and dues income was properly taxed under the "Service and Other Activities" classification of the business and occupation tax.

At the March 2, 1988 Director's level conference, however, the taxpayer stipulated that after January 1, 1979, the Retailing business and occupation taxes and sales taxes were and are appropriate. For the period from January 1, 1979 on, therefore, the Retailing business and occupation tax and

retail sales tax will be imposed and collected on all retailing and retail sales activities. No amount of the initiation fees and dues will be taxed under the Service category of business and occupation taxes.

[2] Next, we have reviewed and must reject the taxpayer's contention that all membership initiation fees and dues received prior to January 1, 1979 were automatically deductible from the measure of taxable amounts, under RCW 82.04.430(2). The taxpayer's premise is untenable under the facts in the record.

We find that, at best, only a portion of the taxpayer's fees/dues income received prior to January 1, 1979 constituted amounts derived from bona fide "initiation fees and dues." The bulk of the income came from dues which were ". . . for, or graduated upon, the amount of service rendered by the recipient
thereof . . ." and which under RCW 82.04.430(2), in effect before 1979, "shall not be considered as a deduction hereunder."

The Department has no objection in theory to the taxpayer's contention that some portion of the receipts of such fees and dues ought to be deductible. The burden of proof, however, is upon the taxpayer to go forward with evidence in support of its claimed deduction or exemption. Group Health v. Tax Commission, 72 Wn.2d 422, 433 P.2d 201 (1967).

The determination of deductibility is a two-step process: For each tax period, the taxpayer must first identify the gross income from member fees and dues. That gross income is then reduced by the total value of goods, services and benefits used and/or consumed by the members and not otherwise directly paid for. Finally, the taxpayer arrives at a net balance which is properly termed deductible bona fide "initiation fees and dues."

Derivation of the value of those goods, services and benefits is not simple. There is, for example, the question of how to value each [recreational use]. The issue is fairly complex; fees/dues payment not only entitles a member to a . . . site with the normal and expected features of . . . recreational facilities, but also includes such other retail service benefits as swimming pool use, tennis courts, miniature golf, athletic courts, etc., and a staff of persons to provide lessons in such amusement business activities.

All such amenities significantly enhance the value of a member's bundle of membership benefits. They are real, discernible, and valuable amusement and recreational services which clearly fall within the ambit of RCW 82.04.050 which includes charges made by persons engaged in the amusement and recreational business. Moreover, these amenities are paid for by the taxpayer's members, whether or not they are actually enjoyed by all the members' participation with any degree of regularity. Drayton Beverages, Inc. v. Department of Revenue, Thurston Co. Superior Court Cause No. 44319 (1971); and Crossroads Enterprises, Inc. v. Department of Revenue, Thurston Co. Superior Court Cause No. 44320 (1971).

Segregation and valuation of the deductible and non-deductible portions of membership fees and dues is distinctly a factual proof question. It is part of the auditing function. To provide the taxpayer with the opportunity to segregate/value, as requested, the file is hereby remanded for that purpose.

[3] Having answered the questions regarding full or partial deductibility of receipts of membership initiation fees and dues prior to January 1, 1979, under RCW 82.04.050 and 82.04.430, which latter section has been recodified as RCW 82.04.4282, we believe the same analysis holds true for receipts in periods following January 1, 1979. Accordingly, no further discussion is necessary.

We confirm those of the findings and conclusions contained in Determination No. . . . to the effect that the Retailing and retail sales tax classifications are appropriate for application post January 1, 1979. This conclusion pertains not just for the periods covered by audit deficiency assessments but also for all periods to the date of this Final Determination.

At the conclusion of the taxpayer's proof process, whatever amount has been shown to be deductible for business and occupation taxes under RCW 82.04.4282 will also be deductible for retail sales tax. This is because the deductible amount finally proven cannot represent charges or amounts derived from providing "goods" or "services." Rather, the deductible portion of income derives from providing only the benefit of membership in the organization which [has] intangible, esoteric, and non-compensatory values.

[4] The taxpayer has urged us to find that the Department's rules, standards and methods for determining and valuing deductibility, now set forth in WAC 458-20-114 (Rule 114) are

unfair, inappropriate, unrealistic and prejudicial to the taxpayer.

It is important to note here that the State Legislature has not found it necessary to define the term "bona fide dues" for purposes of the deduction statute. However, Rule 114 is flexible in the alternative valuation methods it affords for measuring the taxability and deductibility of income from membership dues and fees. It is not uncommon that through the application of these formulary methods, (which are optional to taxpayers), a considerable portion of gross dues/fees receipts is entitled to deduction. This concern is uniquely appropriate for legislative dialogue. (See also Determination No. 86-55A, 2 WTD 535 (1987), at page 360.)

Clearly, however such formulary valuation methods do not achieve exact values. Their very purpose is to establish values with reasonable certainty based upon the best available information. Thus, reasonable judgments are imperative within the area of expertise which is uniquely that of qualified accountants and economists. The Department's audit staff is distinctly qualified to develop these kinds of computational conclusions. We will not replace their judgments with our own.

Consequently, on the questions raised regarding the validity and accuracy of the established guidelines and published rules for valuation of non-deductible and deductible portions of initiation fees and dues, the Department unequivocally rejects any contention that such are inadequate, unfair or unlawful extensions of the legislative mandate. The rules are clarifications of established practice, are neither new nor unorthodox, they are within the legislative mandate for Department clarification and enforcement of the revenue codes, and are more beneficial to the taxpayer than detrimental. In short, the taxpayer shall determine and compute non-deductibility and deductibility under the guidelines provided in WAC 458-20-114 (RULE 114). Final Determination No. 87-218, 3 WTD 295 (1987)

The taxpayer has now represented to us that it possesses records from which its deduction computations can be performed utilizing an actual "usage of facilities" basis. Sample records . . . from the years 1978 through 1980, extracted from the taxpayer's annual reports, were submitted for our review: These records appear to be an adequate basis from which to derive reliable estimates of total . . . facilities usage for all periods in question.

Adoption of an actual "usage of facilities" valuation method is expressly allowed pursuant to Rule 114. Once adopted by taxpayer, however, it will be applied in precisely the same manner for both the period prior to January 1, 1979 and the period subsequent thereto. Thus, for both audit periods in question, the taxpayer shall demonstrate the portion of said receipts which is appropriately allocated to non-deductible proceeds and the portion of said receipts which is appropriate for deduction.

The taxpayer asserts that the full taxable value of its . . . memberships can be established by reference to the valuation methodology used in the . . . Directory. Pertinent excerpts were provided for our review. The study includes average values of [such] privileges, both with and without a range of additional amenities, including those kinds provided by the taxpayer. We agree that the use of this data to determine average . . . values appears to comport with the spirit and intent of Rule 114. It is tantamount to determining taxable value under the study of comparable facilities authorized for use by Rule 114.

The computation of total . . . usage is distinctly an audit function and the file is remanded for that purpose. Because the taxpayer seeks relief from certain tax liabilities predicated upon the application of statutory tax deductions and exclusions, the taxpayer bears the burden of clearly establishing its entitlement to such treatment. Determination No.86-55A, supra, at page 358.

Finally, this matter has remained unresolved for reasons mutually convenient to the taxpayer and to the Department, as well as for reason of unnecessary delays by both. The files reflect that the senior audit staff have visited the taxpayer's offices at least once during the course of the entire proceedings for the purpose of evaluating the records and other data said to be available at that time by the taxpayer. These efforts were fruitless because the pertinent necessary information could not then be discovered. The valuation computations are now sorely overdue.

The Department will not again entertain a petition or request for review of the valuation or frequency of "[member] usage" for the periods in question. Such requests are strictly within the discretion of the Department to grant or deny. See RCW 82.32.170 and WAC 458.20.100. Conversely, the Department will not issue adjusted assessments or refuse to process credit or

refund claims in this case which attribute no value to the deduction available under RCW 82.04.4282. In short, the application of Rule 114 principles, guided by the conclusions contained in the Final Determination will result in the Department's final action on this matter, appealable further only to the State Board of Tax Appeals or to the Superior Court.

DECISION AND DISPOSITION:

The taxpayer's petitions for correction of assessments are granted in part, and the matters are remanded to the Audit Section for application of the "actual usage of facilities" method of determining deductibility. At the conclusion thereof, revised assessments will be issued to be due on the date indicated thereon.

DATED this 14th day of June 1989.