Cite as 8 WTD 219 (1989)

Both WAC 458-20-118 and WAC 458-20-200 have been amended since the issuance of this determination. These rule changes will affect the holding of issue [2] in the determination.

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

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 89-458
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] RULE 231: B&O TAX -- INTERNAL DISTRIBUTIONS -- SMALL BUSINESS. A small retail business which distributes merchandise by private automobile from a central location, which is also a retail outlet, to two or more other retail outlets is subject to Internal Distributions B&O tax to the same extent as a large business.

[2] RULE 118 AND RULE 200: B&O TAX -- EXEMPTION -- REAL PROPERTY -- RENTAL OF -- LICENSE TO USE -- LEASED DEPARTMENT -- MANICURIST. A leased department is deemed to be the rental of real property, the income from which is exempt of B&O tax. The operation of an independent manicurist within a makeup store is found to be a leased department.

[3] MISCELLANEOUS -- RCW 82.32.070 -- SALES/USE TAX -- RECORDS -- DOCUMENTATION. A taxpayer who fails to keep documentary evidence that it paid sales tax on the purchase of consumable and capital items may not successfully challenge an assessment which asserts deferred sales or use tax on those purchases.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .
. . .

DATE OF HEARING: June 30, 1987

NATURE OF ACTION:

Challenge by retailer of B&O tax on internal distributions, of use/deferred sales tax on consumable and capital purchases, and of B&O tax on income from the alleged rental of real property.

FACTS AND ISSUES:

Dressel, A.L.J. -- . . . (taxpayer) sells and applies makeup. Its books and records were examined by the Department of Revenue (Department) for the period January 1, 1982 through December 31, 1985. As a result the above-captioned tax assessment was issued in the amount of $ . . . . The taxpayer appeals herein portions of the assessment.

During the audit period the taxpayer operated three or four different stores simultaneously. In the initial portion of the audit period, merchandise for sale by the taxpayer was delivered by manufacturers and wholesalers to the taxpayer's Bellevue store. There it was stored and then distributed to the Bellevue showroom and to the two or three other retail outlets owned by the taxpayer. Later in the audit period, the merchandise was delivered, stored, and distributed at the taxpayer's downtown Seattle store in the same manner. The storage area where the taxpayer initially received the merchandise, incidentally, was usually just a separate room within either the Bellevue or Seattle store.

The Department's auditor assessed B&O tax on the distributions from the storage locations to the retail outlets based on the authority of WAC 458-20-231 (Rule 231). The taxpayer objects by stating:

> It is [Taxpayer's] contention that receiving inventory at one location and distributing it from there is not a wholesale function. No fees are derived from this service, which is simply an issue of inventory control. Goods are transported to the other stores in personal vehicles. It is our feeling that this is double taxation of a small retailer who is struggling to remain in business and provide employment for Washington residents and was never the intent of the legislature.

At its retail locations the taxpayer has available a manicurist. The manicurist, who is an independent contractor, and the taxpayer entered into a "Sublease Agreement".[1] Under it, the manicurist performed manicures in the taxpayer's stores. She did so on an essentially independent basis. She made her own appointments, collected her own fees, furnished her own supplies, and maintained her own area within the store. The manicurist and/or her employees had their own keys to the taxpayer's several retail premises. Under the written, sublease agreement the manicurist paid the taxpayer a certain monthly rental amount for each location. The agreement also provided that the taxpayer got as additional rent 10% of gross income realized by the manicurist when that income exceeded $3,000 a month at a particular location.

In the audit this "rental" income was taxed under the Service B&O category. The taxpayer claims it is exempt in that this income is derived from the rental of real estate. It notes that the space utilized by the manicurist was specifically designed for manicuring and is in a particular location near the front of each small retail store.

The auditor's position is that in spite of the language of their agreement, the manicurist has a license to use real property as opposed to a lease of real property. This is because the agreement fails to designate a particular space within the taxpayer's premises and because the manicurist does not have exclusive control over the area she purportedly rents.

The final area of disagreement centers on the assessment of use or deferred sales tax against the taxpayer's purchase of both consumable and capital items. The taxpayer did not have invoices or other records available to demonstrate that it paid sales tax on some such purchases. It also did not have available evidence that it paid sales tax on telephone charges by . . . . Use/deferred sales tax was assessed on those charges as well.

In protesting use/deferred sales tax, the taxpayer states "It is difficult and not cost efficient to scrutinize each out of state invoice to determine if it has charged use tax...It is extremely difficult to avoid paying sales tax on retail purchases, many of which are under $100 and date back to 1982." The taxpayer states that it has other invoices from the same vendors whose invoices are missing. The present invoices show sales tax paid which the taxpayer suggests means sales tax must have been charged and paid

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[1] The taxpayer leases its several retail store premises from others, so chose with the manicurist to label the agreement between the two as a sublease.

on the missing invoices as well. The taxpayer closes its petition with "I found the entire tone of this supposed 'random' audit injurious to the small businessperson..."

The issues are: 1) Is the small-scale distribution of merchandise from a central receiving point to several retail outlets subject to Internal Distributions B&O tax? 2) Is the rental of space by a manicurist in a makeup store a B&O taxable license to use or a tax-exempt rental of real property? 3) May the Department successfully assess use/deferred sales tax against taxpayer purchases for which no documentation is available to show the payment of retail sales tax?

DISCUSSION:

> **WAC 458-20-231 Tax on internal distribution.** Persons engaged in the business of distributing in this state articles of tangible personal property owned by them from their own warehouse or other central location in this state to two or more of their own retail stores or outlets, though no change in title or ownership to such property occurs, are taxable under the internal distribution classification of the business and occupation tax on the value of the articles so distributed, the intent being to impose a tax equal to the wholesaler's tax upon persons performing functions essentially comparable to those of a wholesaler, but not actually making sales. The internal distribution tax is applicable to transfers of merchandise from a central location which were preordered for a receiving retail outlet even if there is no inspection or opening of cartons or boxes at or by the central location. The tax may also be applicable to transfers by a retail outlet to two or more other retail outlets which are under the same ownership.
>
> WAREHOUSE OR OTHER CENTRAL LOCATION
>
> The term "warehouse or other central location" generally means any facility regardless of the type of activity conducted there, which is operated in this state by a person who distributed tangible personal property from that facility to two or more of his own retail stores or outlets.
>
> The said term includes any retail outlet irrespective of how the distributed goods may be inventoried or stored at such outlet. The term includes any facility, central distributing point, building, loading platform and adjacent areas operated by the taxpayer where articles of tangible personal

> property are received and from which they are distributed. Such facilities, distributing points, buildings, platforms and areas are included within the term regardless of how long such property may remain at such places and regardless of the nature of the activity performed at such places with respect to such property.
>
> . . .

[1] The taxpayer fits the above description. Internal Distribution tax was properly assessed. It is noteworthy that the rule does not distinguish small-scale distributions, such as the taxpayer's by private automobile, from large ones. Nor does the Department distinguish small businesses from large ones[2] in administering the Revenue Act. The taxpayer should be assured that if the Department's auditors find a huge business which is not paying Internal Distribution or any other excise tax it should be paying, they tax it just like they did this small one.

It has come to our attention that a minor adjustment of the tax assessed on internal distributions may be in order. Rule 231 also states in part:

> TWO OR MORE RETAIL STORES OR OUTLETS
>
> The term "two or more of their own retail stores or outlets" means two or more retail stores operated within this state separate and apart from any "warehouse or other central location." *The term does not include a retail store or retail outlet, a part of which is operated as a warehouse from which distribution is made.* However, a retail store or outlet will be counted as separate and apart, even though it may be located within the same premises or under the same roof as a warehouse or central location, if it is operated separately, as evidenced for example by separate employee payrolls, accounting records, inventory control, or clearly defined work and retail sale areas. (Italics ours.)

The taxpayer claims that at both the Seattle and Bellevue locations, the "warehouse" was simply a separate room from what was otherwise a retail outlet. Under the rule, then, the retail

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[2] The only exception that comes to mind is in WAC 458-20-104, Exemptions--Volume of business. Under this authority taxpayers who gross less than a certain amount during their reporting period are exempt of the B&O tax.

space next door to the "warehouse" does not count as one of the "two or more . . . retail stores . . .". The Internal Distributions tax is imposed on the value of articles distributed to two or more retail outlets. Rule 231, paragraph one. Inasmuch, as the Seattle and Bellevue stores did not qualify under Rule 231 as retail outlets during the times they were also used as "warehouses," Internal Distributions tax is not appropriate on those articles moved from the warehouse rooms next door to the retail space. Distributions made to non-adjacent retail space are subject to the tax. Incidentally, from the taxpayer's testimony in this matter, we are convinced that the "warehouse" rooms were not operated separately from the stores to which they were attached. Had they been, they would be considered retail outlets per Rule 231.

It is not apparent from looking at the audit that "distributions" from warehouse room to adjacent retail space were excluded from the Internal Distributions tax. The taxpayer claims that such distributions were taxed. The Audit Division will re-examine its work and strike such tax, if, indeed, it was asserted in the first instance.

On the first issue, internal distributions, the taxpayer's petition is denied except for the re-examination referenced in the immediately preceding paragraph.

The matter of B&O tax on income alleged to be from the rental of real property is not so clear cut. The taxpayer contends that the rental of office space by the manicurist is a rental of real estate and, thus, exempt of B&O tax. The Department, on the other hand, contends that it is not a lease of real property but rather a taxable license to use real property.

WAC 458-20-118 (Rule 118) provides guidelines for distinguishing a rental of real estate from a license to use real estate. It also states in part, "It is further presumed that all rentals of apartments and *leased departments* constitute rentals of real estate." (Italics ours.) The first sentence of the same rule says, "Amounts derived from the sale *and rental* of real estate are exempt from taxation under the business and occupation tax." (Italics ours.)

[2] "Leased departments" are also addressed but not defined in WAC 458-20-200 (Rule 200). To the best of our knowledge, they are also not defined in RCW 82. When a term is used but not defined in a statute, it must be given its usual and ordinary meaning, usually ascertained from dictionaries. *Marino Property v. Port of Seattle*, 88 Wa.2d 822, 567 P.2d 1125 (1977). According to Webster's New World Dictionary (Second College Edition), the first definition of "department" is "a separate

part, division, or branch, as of a government, *business*, or school . . ." (Italics ours.) Based on that definition, we see no reason why the manicuring area of a makeup store should not be considered as a department of the store. In the instant case that department has been leased by the taxpayer to the manicurist. The activity of the department, manicuring, is related to the primary business activity of the taxpayer, the sale and application of makeup. The two activities complement one another. The result, most probably, is increased sales. The manicuring activity, however, is carried on separately, in a separate area of the store by a separate person. The dictionary definition requirement of separation is satisfied in our judgment.

Moving to the other operative word in the phrase "leased department", we have even less difficulty in concluding that the department is "leased". The written agreement between the parties is labeled "sublease". The effect of that agreement is that the manicurist has the use and possession of real and personal property for a specified time and for fixed payments. With that it also obtains the exclusive right to perform manicures on the premises. All of these elements are consistent with the characteristics of a lease. We conclude, therefore, that the manicuring area of the taxpayer's stores is leased, that it is a department, and that it qualifies as a "leased department."

Rule 200 states in part, "Where the lessor receives a flat monthly rental or a percentage of sales as rental for a leased department, such income *is* from the rental of real estate and is not taxable". (Italics ours.) That perfectly describes what the lessor (taxpayer) gets in the arrangement before us. The rule says that this is a non-taxable rental of real estate. Therefore, we need not proceed with a Rule 118 analysis to determine if this might be a license to use because Rule 200 has already told us this arrangement is the rental of real estate.

On the second issue, rental of real estate, the taxpayer's petition is granted.

Like the first one, the third issue, use or deferred sales tax on capital and consumer purchases, is easy to resolve. RCW 82.32.070 states in part:

> **Records to be preserved---Examination---Estoppel to question assessment.** Every person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of any tax for which he may be liable, which

> records shall include copies of all federal income tax and state tax returns and reports made by him . . . Any person who fails to comply with the requirements of this section shall be forever barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes made by the department of revenue based upon any period for which such books, records, and invoices have not been so kept and preserved.

[3] The taxpayer here has failed to keep receipts or invoices to demonstrate that it paid sales tax on the purchases at issue. Under the quoted statute, therefore, it is barred from questioning
this part of the tax assessment. We reject the taxpayer's suggestion that the fact that it has other receipts from the same vendors which show that sales tax was charged and paid is sufficient to prove that sales tax was paid on the particular transactions in dispute. The Department's standard of proof, as codified at RCW 82.32.070, requires greater precision than that.

Lastly, we wish to acknowledge a point raised by the taxpayer's attorney who questioned the applicability of use tax to telephone charges. Telephone charges are the result of a service rather than the sale of tangible personal property, yet they are statutorily defined as a retail sale at RCW 82.04.050 (5). Use tax is imposed on the use of tangible personal property. RCW 82.12.020. Thus, telephone charges are a rare item that is subject to sales but not use tax. The auditor did not limit the label for that part of the assessment to "use tax". Rather, she called it "Use and/or deferred sales tax". Her terminology, then, was broad enough to be correct. Even if it weren't, however, the taxpayer would still be liable for sales tax per RCW 82.04.050 (5) and in the same amount as the rates for sales and use tax are the same. RCW 82.12.020.

As to the third issue, use/sales tax on consumable and capital purchases, the taxpayer's petition is denied.

DECISION AND DISPOSITION:

The taxpayer's petition is denied in part and granted in part. The Audit Division will issue an amended assessment deleting tax as appropriate based on the above discussion of issue number two. It will also make the re-examination referenced in the discussion of the Internal Distributions tax (issue number one). The amended assessment will specify a new due date.

DATED this 15th day of September 1989.