

Cite as Det. No. 99-208, 19 WTD 810 (2000)

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. 99-208
	)	
	)	Registration No. . . .
	)	FY. . . /Audit No. . . .

- [1] RULE 182: B&O TAX – WAREHOUSING INCOME – Income (reimbursed costs) received from providing the physical warehousing of goods is subject to the Warehousing B&O tax classification.
- [2] RULE 231; RCW 82.04.270: B&O TAX – INTERNAL DISTRIBUTION B&O TAX – The Internal Distribution B&O tax is not due in those instances where goods have been sold and delivered to a retailer and then bought back by the seller and taken to the seller's "thrift" store outlet for sale at retail.

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:

Taxpayer protests the assessment of additional tax arising out of a tax audit.<sup>1</sup>

FACTS:

Lewis, A.L.J. (successor to Danyo, A.L.J.) – Taxpayer operates a large bakery in Washington. Taxpayer sells both the bakery products it manufactures, as well as, the bakery products it buys from others for resale. Taxpayer sells the bakery products to both grocery stores and restaurants. In addition, Taxpayer operates a number of “thrift” stores. The “thrift” stores sell both fresh and discounted “stale” bakery products. Taxpayer acquires the “stale” bakery products when it buys back bakery products from third party retailers that have been unable to sell the products. In addition, Taxpayer receives expense reimbursements from affiliated companies for operating warehousing and transportation services to service a very large [grocery] account.

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<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Taxpayer's books and records were audited by the Department of Revenue's Audit Division (Audit Division) for the period April 1, 1991 through March 31, 1995. On November 17, 1995 the Department issued a \$ . . tax assessment. Subsequently, on December 18, 1996, the Department issued a second assessment reducing the tax assessment to \$ . . . Taxpayer disagreed with portions of the assessment and the Department's denial of a refund for the internal distributions business and occupation (B&O) tax paid on the distribution of returned "stale" bakery products from its customers' retail stores to the thrift stores.

On January 17, 1997 Taxpayer filed a petition for correction of the assessment and issuance of an internal distributions B&O tax refund. Taxpayer requested: 1) that revenues received as expense reimbursements from affiliated companies be reclassified from the service other B&O tax classification to the warehousing B&O tax classification<sup>2</sup>; 2) that the ratio of goods manufactured to those that are bought and sold be reduced; and, 3) that the Department issue a refund for the Internal Distribution B&O tax that had been paid in error on "stale" bakery products returned from customers and taken to a thrift store for sale.

#### ISSUES:

- 1) Is Taxpayer's cost recovery of providing warehousing for goods sold to [grocery] subject to the warehousing or service B&O tax classification?
- 2) Was the ratio of sales of goods manufactured to those that are goods bought from others for resale overstated ?
- 3) Is the delivery of previously sold "stale" bakery products from third party retailers to Taxpayer's thrift stores subject to internal distribution B&O tax?

#### DISCUSSION:

**[1] ISSUE 1:** Taxpayer and its affiliates sell bakery goods to [grocery]. Taxpayer and its affiliates have a special arrangement wherein each affiliated bakery is considered to sell directly to [grocery].<sup>3</sup> Taxpayer's oral arrangement with [grocery] requires Taxpayer to rent warehousing space adjacent to the [grocery] facility and provide certain logistical support (including trucks, drivers, and warehousemen) to assist [grocery] in supporting sales to its members.

During the years audited, Taxpayer contracted for warehouse facilities, acquired the trucks, and hired the personnel necessary to maintain the warehouse and delivery fleet. For simplification, Taxpayer paid the rent and supplied the essential services to support the warehousing/logistical requirements of the [grocery] contract. Taxpayer collected the costs in a clearing account and intercompany charged all such costs to its affiliates on a revenue-based formula.

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<sup>2</sup> The reimbursements relate to the "warehousing" activities required to service the [grocery] account.

<sup>3</sup> This arrangement is unique. For sales other than those to [grocery], Taxpayer acts as the reseller, purchasing inventory from the other bakeries at a wholesale price for resale through its distribution channel.

According to Taxpayer there were two components to the activity: 1) the physical warehousing operation and 2) the logistical support. The reimbursement of costs related to the transportation activity has been taxed under either the motor or urban public utility tax classification.<sup>4</sup> The Audit Division taxed the remainder of the reimbursed costs under the service and other B&O tax classification. Taxpayer maintained that such income should be reclassified to the warehousing B&O tax classification.

WAC 458-20-182 (Rule 182) describes the taxation of warehouses. Rule 182 states:

Persons engaged in operating any "storage warehouse" or "cold storage warehouse," as defined herein, are subject to tax under the warehousing classification, measured by the gross income of the business. (See RCW 82.04.280.)

Rule 182 defines "storage warehouse as:

"Storage warehouse" means a building or structure, or any part thereof, in which goods, wares, or merchandise are received for storage for compensation, except field warehouses, fruit warehouses, fruit packing plants, warehouses licensed under chapter 22.09 RCW (which are agricultural commodities warehouses), public garages storing automobiles, railroad freight sheds, docks and wharves, and "self-storage" or "mini-storage" facilities whereby customers have direct access to individual storage areas by separate access.

Rule 182 declares the measure of tax as:

The gross income of the business of operating a warehouse includes all income from the storing, handling, sorting, weighing, measuring, and loading or unloading for storage of tangible personal property.

Taxpayer asserts that the revenues it receives are for either transportation or warehousing services. By way of an adjustment to the original audit, the Department reclassified that portion of Taxpayer's reimbursed costs for transportation services from service to either the motor or urban public utility tax. Now, Taxpayer is requesting the reimbursements for warehousing services be reclassified from service to the warehousing B&O tax classification. Based on the facts presented as applied to Rule 182, we find Taxpayer performs and receives revenues for providing warehousing activities. Thus, we find those revenues should be taxed under the warehousing B&O tax classification. Accordingly, we remand this issue to the Audit Division for adjustment consistent with this decision.

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<sup>4</sup> The original audit assessment taxed all the reimbursed cost under the service other B&O tax classification. An adjustment to the original audit reclassified trucking expense from the service other B&O tax classification to the motor or urban public utility tax classification.

**ISSUE 2:** The Audit Division determined, for purposes of the audit, that Taxpayer manufactured and should pay manufacturing tax on 85% of the goods sold.<sup>5</sup> Taxpayer asserted that the percentage is too high and that the Audit Division attempted “to push a greater percentage of the revenue reported under the retailing categories into the higher manufacturing rate.”

Taxpayer has now provided two (2) computations of the ratio of goods it sells that are manufactured by others. The first computation compares the wholesale value of goods manufactured by Taxpayer to all the goods manufactured by Taxpayer’s affiliates.<sup>6</sup> That computation resulted in a 48% of goods manufactured by Taxpayer. Taxpayer also computed the percentage of goods it manufactured by comparing the total cost of goods sold to the total cost of goods sold it manufactured. Such a comparison yields a 41% of goods that are manufactured and sold by Taxpayer. It is apparent that the figures Taxpayer presented are substantially different from those the assessment is based on. Taxpayer’s computations appear reasonable, particularly in light of the fact that we are unclear of the method that the Audit Division used to derive the 85% figure. We thus remand this issue to the Audit Division for verification of Taxpayer’s computations and if necessary an audit adjustment consistent with the verified percentages.

**[2] ISSUE 3:** RCW 82.04.270 imposed a tax equal to the wholesaler’s B&O tax upon persons doing functions essentially the same as those of a wholesaler, but not making sales. RCW 82.04.270 provides:<sup>7</sup>

(1) Upon every person except persons taxable under subsections (1) or (8) of RCW 82.04.260 engaging within this state in the business of making sales at wholesale; as to such persons the amount of tax with respect to such business shall be equal to the gross proceeds of sales of such business multiplied by the rate of forty-four one-hundredths of one percent.

(2) The tax imposed by this section is levied and shall be collected from every person 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, where no change of title or ownership occurs, the intent hereof 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: Provided, That the tax designated in this section may not be assessed twice to the same person for the same article. The amount of the tax as to such persons shall be computed by

<sup>5</sup> The method used to derive the 85% is unclear.

<sup>6</sup> Taxpayer determined that the percentage of goods actually manufactured by Taxpayer was 48.03% . . . . We are unsure as to whether Taxpayer’s figure for “All [Taxpayer] Affiliates” includes the sales by [Taxpayer]. If not, we believe the appropriate computation would be . . . [Taxpayer] plus Affiliates sales/ 55,098,033 [Taxpayer]. Thus, resulting in a 31.70 % ratio.

<sup>7</sup> RCW 82.04.270 quoted is the statute in effect from 1993-1994. RCW 82.04.270 was revised three times during the audit period (1981-1993; 1993-1994; and 1994-6/30/98). Despite the revisions to the statute, the requirements for the tax did not change. It should be noted that the last revision to RCW 82.04.270, effective 7/1/98, eliminated the internal distributions B&O tax.

multiplying forty-four one-hundredths of one percent of the value of the article so distributed as of the time of such distribution: Provided, That persons engaged in the activities described in this subsection shall not be liable for the tax imposed if by proper invoice it can be shown that they have purchased such property from a wholesaler who has paid a business and occupation tax to the state upon the same articles. This proviso shall not apply to purchases from manufacturers as defined in RCW 82.04.110. The department of revenue shall prescribe uniform and equitable rules for the purpose of ascertaining such value, which value shall correspond as nearly as possible to the gross proceeds from sales at wholesale in this state of similar articles of like quality and character, and in similar quantities by other taxpayers: Provided further, That delivery trucks or vans will not under the purposes of this section be considered to be retail stores or outlets.

(Emphasis Added.)

Based on prior audit instructions, Taxpayer self-assessed and reported internal distribution tax on 42.78% of its retail sales. Taxpayer's internal distribution tax resulted from the sales it made through its retail thrift stores. According to Taxpayer, it paid internal distributions B&O tax on all retail sales made from the thrift stores. In requesting a B&O tax refund, Taxpayer explained that:

Fresh bread is manufactured at the bakeries and sold to unrelated supermarkets for sale. Bread that does not sell within a narrow time frame (about 2 days) is removed from the supermarket shelf and returned by the store. The returned bread is picked up by the taxpayer's route trucks, and taken directly to the thrift stores for retail sale. This activity is not "essentially the same as those of wholesaler." This transaction, which is the foundation for the thrift stores' existence, does not constitute an internal distribution.

Taxpayer argued that:

When the Taxpayer's route trucks deliver bread to the thrift stores, the Taxpayer is not doing "essentially the same" activity as a wholesaler. The Taxpayer is merely avoiding a loss by dropping off "returned" inventory, which it was unable to place within unrelated retail outlets. There is no "internal distribution" from a "centralized warehouse" as defined under WAC 458-20-231.

Another component of "retailing" revenues which does not conform to the internal distribution tax are sale of "hand shop" items. Most of the depot/thrift shops are equipped with a kitchen for the production of donuts, pastries, pies, specialty breads and other items, which are distributed on the local routes and sold retail within the thrift shop. Each depot has its own hand shop. Each depot will supply inventory to no more than one thrift shop. Therefore, any such sales of hand shop items do not meet the "two or more retail outlets" requirement which would result in an "internal distribution" tax. ...

Another component of “retailing” revenues which do not conform to the internal distribution tax are the items acquired from unrelated bakeries. In most cases, the inventory acquired from unrelated bakeries are brought to the individual thrift stores by the seller’s own route trucks. Also, the retailing revenues include the revenues from the Taxpayer’s sandwich shop located [in Washington].

Taxpayer does acknowledge that the internal distribution tax does apply to the retail sales of “fresh bread” which is ordered by each thrift store manager directly from Taxpayer’s manufacturing facility.

Internal distribution B&O tax is due when:

1. The goods are distributed in the state;
2. The goods are tangible personal property;
3. The goods are owned by the Taxpayer;
4. The goods are distributed from Taxpayer’s central warehouse or central location to two or more of Taxpayer’s retail outlets, where no change of ownership or title occurs.

In this case, it is undisputed that the distribution occurs in Washington; that bakery products are tangible personal property and that the bakery products are owned by Taxpayer. Thus, the only question is whether the bakery products that Taxpayer delivers to its thrift store from retailers is a distribution from a central warehouse or location.

This inquiry is easily answered. The bakery products in question were originally sold and were delivered to a third party’s retail outlet i.e., . . . , . . . , etc.<sup>8</sup> Taxpayer, by agreement, repurchased the bakery products from its retail customers and took them from the retailers’ place of business to one of the thrift stores for sale. The transfer of the bakery products from a third party’s retail outlet to Taxpayer’s thrift store is not a distribution from Taxpayer’s warehouse or central location. Thus, the transfer of such bakery products is not subject to the internal distribution B&O tax.

As further clarification, we agree with Taxpayer that its transfer of “hand shop” items and bakery products purchased from unrelated bakeries are not subject to the internal distribution B&O tax because the items are not distributed to two or more retail outlets from a central location. Similarly, the internal distributions B&O tax does not apply to the revenues earned from the operation of a sandwich shop where the sandwiches are made and sold on premises.

#### DECISION AND DISPOSITION:

Taxpayer’s petition is granted as it relates to the issue of the reclassification of warehousing income from the service other B&O tax classification to the warehousing B&O tax classification. Similarly, Taxpayer’s petition is granted as it relates to the percentage of bakery goods subject to

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<sup>8</sup> That transaction while subject to wholesaling B&O tax is not subject to the internal distribution tax because it is to a retail outlet not owned by Taxpayer.

the manufacturing B&O tax. And finally, Taxpayer's petition is granted as it relates to the issuance of a refund of internal distributions B&O tax paid on bakery products returned from third party customers and sold in Taxpayer's thrift stores.<sup>9</sup> The matters will be referred to the Audit Division for an adjustment consistent with this determination.

Dated this 29<sup>th</sup> Day of June 1999.

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<sup>9</sup> No written request for internal distributions B&O tax credit was not filed with the Department until 1997 (the petition for correction of refund). For this reason, any internal distributions B&O tax credit would be limited to the period from January 1, 1993 through March 31, 1995.