

Cite as Det. No. 06-0230, 27 WTD 1 (2008)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petitions For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessments of)	
)	No. 06-0230
...)	
)	Registration No. . . .
)	Doc. No. . . . /Audit No. . . .
)	Docket No. . . .
)	
)	Registration No. . . .
)	Doc. No. . . . /Audit No. . . .
)	Docket No. . . .

RCW 82.04.220, RCW 82.04.080: SERVICE AND OTHER ACTIVITIES B&O TAX -- GROSS INCOME -- SUBSIDIES (CREDITS AGAINST ROYALTY PAYMENTS). Credits received by franchisee mini marts from their franchisor against royalty payments to promote the sales of selected products at prices set by the franchisor and the product manufacturers are part of the franchisee's gross income, and subject to service and other activities B&O tax, when the credits are intended to cover the difference between the franchisee's costs of the products and the below-cost sales prices of the products, plus a small profit on each sale.

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.

De Luca, A.L.J. – . . . mini marts protest the assessment of service and other activities business and occupation (B&O) tax on amounts received by (credited to) them from their franchisor to support the sales of [products] in promotion programs established by the franchisor and . . . manufacturers. We affirm the assessment.¹

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

ISSUE

Is the receipt of credits or payments (called “buydowns”) by franchisees from a franchisor to reimburse the franchisees for the costs of [products] they incur that are in excess of the selling prices of the [products] part of the franchisees’ gross income and subject to service and other activities B&O tax?

FINDINGS OF FACT

The taxpayers are two . . . mini-marts. The taxpayers sell gasoline, food items, beer, soft drinks, cigarettes, etc. The taxpayers are franchisees that have a common ownership. The Audit Division of the Department of Revenue (DOR) audited each franchisee. The first franchisee . . . was audited for the period January 1, 2000 through December 31, 2003 and was assessed \$. . . in taxes, interest, and a five percent assessment penalty. The taxpayer has paid \$. . . towards the assessment for uncontested items. The balance remains unpaid. The Audit Division audited the second franchisee . . . for the period January 1, 2000 through December 31, 2000 and assessed that taxpayer \$. . . in tax, interest, and a five percent assessment penalty. The assessment remains unpaid.

Service and other activities B&O tax comprises, by far, the largest amount of each assessment. The Audit Division described these amounts in each assessment as “display allowances” received from the franchisor for participating in promotions of beer, soft drinks or cigarettes. . . . The promotion programs work as follows. The taxpayers by agreement with the franchisor pay the franchisor . . .% of their monthly gross income. . . . The taxpayers explained if they do not participate in the monthly promotions (whether soft drinks, beer, or cigarettes) their royalty payments will rise to . . .% of their gross income. Consequently, there are strong economic incentives to participate in the promotions.

Each month, the franchisor will inform the franchisees which [products] . . . to promote. The taxpayers purchase [products] at wholesale from . . . distributors. The taxpayers do not purchase them from the franchisor or the . . . manufacturers. . . . The taxpayers state that nearly all . . . promotion sales are sold at below the taxpayers’ costs.

By participating in the . . . promotions, the taxpayers sell their [products] at prices that are set by the franchisor and the . . . manufacturers. The franchisor receives payments from the . . . manufacturers for the promotions and, in turn, pays the taxpayers the difference between their costs and the retail selling prices of the [products] and a small additional amount of profit on each sale. The franchisor, in a . . . letter to the Audit Division, explained that the term “Display Allowance” meant the amount credited to the taxpayers against their respective royalty payments each month:

Subsidy to cover excess costs for . . . promotions, where the franchisee, [the taxpayer], was required to sell [products] at a sales price that did not cover the cost of [products].

These subsidy payments and only these payments are distinguished as “buydowns” to reimburse [the taxpayers] for excess costs

The Audit Division found that these monthly credits against the royalty payments were part of the taxpayers’ gross income and subject to B&O tax.

ANALYSIS

The B&O tax is “extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State.” *Analytical Methods, Inc. v. Department of Rev.*, 84 Wn. App. 236, 241, 928 P.2d 1123 (1996), *quoting*, *Palmer v. Department of Rev.*, 82. Wn. App. 367, 371, 917 P.2d 1120 (1996). For purposes of the B&O tax, “business” is broadly defined to include “all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly.” RCW 82.04.140. RCW 82.04.220, in turn, imposes the B&O tax on persons engaged in business. It provides:

There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

“Gross income of the business” is broadly defined by RCW 82.04.080 as:

. . . the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

(Underlining ours.) Under these definitions and provisions, the taxpayers are engaged in business in Washington by buying, promoting, and selling products Their object is gain, benefit, or advantage for themselves and their franchisor. Their gross incomes, including compensation for the rendition of services or other emoluments, are subject to B&O tax. As noted above, gross income is defined broadly to include “emoluments however designated.” RCW 82.04.080. Further, in determining whether the taxpayers are entitled to an exemption or deduction for subsidies received, we must narrowly construe the exemption and deduction statutes. *See Lacey Nursing Center, Inc. v. Department of Rev.*, 128 Wn.2d 40, 49, 905 P.2d 338 (1995); *Analytical Methods*, 84 Wn. App. at 241. Unless either (1) the franchisor’s subsidies do not constitute gross income or (2) the subsidies qualify for deduction, the taxpayers are subject to B&O tax on the subsidies.

The taxpayers argue that the term “display allowance” is an out-dated term used by the franchisor that does not accurately describe the . . . sales promotions. The taxpayers contend the payments are not income because they are not performing services in return for payment.

We note the taxpayers are not putting the [products] on special floor or shelf displays Thus, there are no slotting or placement fees as described in Det. No. 98-183, 18 WTD 220 (1999). Likewise, the credits against their royalty payments are not bona fide discounts taken off the purchase prices by the wholesalers who sold the [products] directly to the taxpayers as described in Det. No. 98-183 and Det. No. 98-172E, 18 WTD 387 (1999).

Instead, the taxpayer cites *Fisher Flouring Mills Co. v. State*, 35 Wn.2d 482, 213 P.2d 938 (1950), as precedent where the court ruled in favor of a person who received subsidies from the federal government to cover the difference between the cost of manufacturing and the sale price by deciding that the payments were not taxable. Det No. 98-172E explained *Fisher* as follows:

In that case, a flour mill sold flour subject to World War II price regulations. The sales price did not cover the costs to manufacture the flour. The United States paid the miller a subsidy to cover excess costs. The case involved the measure of manufacturing B&O tax. Specifically, was the subsidy part of the value of the products manufactured? The Court held the subsidy payments were not “the proceeds of bona fide sales,” and therefore, not “gross proceeds derived from the sale thereof.” *Id.*, at 486.

Det. No. 98-172E then noted that the legislature subsequently amended the law where the “value of products” definition now includes subsidies and is determined by the gross proceeds of sale of the products. RCW 82.04.450. *See also* RCW 82.04.220, *supra*, which, as noted, imposes the B&O tax by applying appropriate tax rates against the value of products, gross proceeds of sale, or gross income of business, as the case may be. Thus, the holding in *Fisher* has been nullified by subsequent legislative action.

We find a more pertinent decision is contained in Det. No.98-035, 17 WTD 174 (1998), which held that labor union subsidies (to subsidize wages paid) were part of the gross income of a contractor and subject to the service and other activities B&O tax because the subsidies were received as a direct result of the contractor being awarded a particular job, and thereby engaging in business activities. Det. No. 98-035 cited Det. No. 93-136, 14 WTD 15 (1993) (holding amounts that independent contractors received as subsidies from the person for whom they performed work were subject to service and other activities B&O tax).

Likewise, the subsidies the present taxpayers received from the franchisor are subject to B&O tax. The taxpayers purchase [products], promote them with specified signage, and sell them. The taxpayers are engaged in business. The franchisor, through its credits against the royalty payments, induces or requires the taxpayers to purchase the [products] and price them lower for consumers. The buy-downs constitute gross income for engaging in business because they are received as a direct result of promoting and selling specific [products]. *See* Det. No. 98-172E, and Det. No. 98-183, *supra*, holding that various allowances and payments from manufacturers

to grocers for services rendered were part of the grocers' gross income and subject to service and other activities B&O tax.

Other third-party payments to entice particular purchases or behavior regarding transactions between two other parties have been held taxable by DOR. For instance, builders who construct energy efficient structures for new homebuyers include payments from electric companies in their measure of tax. Det. No. 93-078, 12 WTD 599 (1993). In our case, the franchisor paid (credited) the taxpayers with buy-downs to encourage the taxpayers to buy, promote, and sell particular [products].

We conclude no legal authority exists for the taxpayers to deduct or exclude the subsidies from the franchisor from their gross incomes.

Finally, the taxpayers argue that other mini marts are not paying tax on the franchisor subsidies. However, a correct assessment cannot be overturned on grounds of selective enforcement. *See* Det. No. 98-035, *supra*; Det. No. 93-16, 13 WTD 170 (1993); Det. No. 92-4, 11 WTD 551 (1992). In those determinations, we explained that the responsibility for properly reporting taxes rests on persons in business, not on the state, and that the fact that another taxpayer may not be properly reporting its taxes are not sufficient grounds for overturning a valid assessment. Thus, in this case, because we have determined that the assessments by the Audit Division were correct, we cannot overturn them based on a claim of selective enforcement.

DECISION AND DISPOSITION

The taxpayers' petitions are denied

Dated this 20th day of September 2006.