

Cite as Det. No. 01-143, 24 WTD 324 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of:)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 01-143
)	
...)	Registration No. . . .
)	FY . . . /Audit No. . . .
)	Docket No. . . .
)	
)	
)	

RULE 115; RULE 211; RCW 82.08.020: RETAIL SALES TAX -- CONSUMER -- BAILMENT -- PALLETS. If a manufacturer uses pallets to transport goods to buyers, who temporarily possess the pallets under a bailment arrangement, the manufacturer is a consumer of the pallets and owes retail sales tax or use tax. If a manufacturer uses the pallets as part of its packaging of goods and does not retain title to the pallets, the pallets are purchased for resale, and it does not owe retail sales or use tax. When a taxpayer has the right to have the pallets returned and by agreement accepts like-kind pallets the transaction involves a bailment, rather than a series of sales and repurchases of like-kind pallets.

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.

Mahan, A.L.J. – Manufacturer seeks a refund of retail sales tax paid on the purchase of pallets.¹

ISSUE

Whether the taxpayer purchased pallets for resale or for its own use. . . .

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

FACTS

The taxpayer . . . manufactures and distributes a variety of canned and bottled food products.

The Department of Revenue (Department) audited the taxpayer's records for the 1993 through 1996 period. One issue in the audit was a possible refund of retail sales tax the taxpayer had paid on its purchase of pallets. The taxpayer based its refund claim on the manufacturing machinery and equipment (M&E) exemption under RCW 82.08.02565. On appeal, the taxpayer also asserted, in the alternative, that the pallets were purchased for resale. At the hearing, the taxpayer withdrew its original claim based on the M&E exemption.

The taxpayer purchases heavy-duty pallets from third-party vendors. The pallets must meet the Grocery Management Association standards for strength and size. According to the taxpayer, such pallets last one to two years with repeated use and, after five uses, typically require some repair. Also, according to the taxpayer, the pallets it uses are "generic" and its name or logo is not imprinted onto the pallets. Its products are placed into cardboard boxes, which are shrink-wrapped to the pallets for storage and ultimate delivery to the taxpayer's customers. Customers are not charged a pallet deposit and are not separately invoiced for the pallets.

[In] 1992, the taxpayer entered into a written [Agreement] with six of its customers, which together accounted for 22% of the taxpayer's annual sales. Under these agreements, its customers are obligated to return the taxpayer's pallets or a "like pallet" for every pallet delivered to the customer. The agreement contains a detailed description of the type and condition of the pallets to be returned to the taxpayer.

In the early part of the audit, taxpayer's prior representative addressed the pallet issue in a letter to the Department. . . . [T]he taxpayer's prior representative stated:

Recall also that the Company's practices with respect to pallets changed in . . . 1992. As a result, we concluded that the Company was no longer reselling its pallets after . . . 1992 . . . the Company has been paying use tax on all pallets under its new operating practices.

Consistent with this statement and its understanding of its written agreements, the taxpayer treated the pallet purchases as not being for resale during the audit period.

Although the taxpayer does not have written return or exchange agreements with its other customers, the taxpayer endeavors to have its pallets or like-kind pallets returned by its customers. The taxpayer maintains a record of all pallets that are delivered to its customers. It sends out monthly statements to its customers reporting the number of pallets delivered to them and the number of pallets that were returned to the taxpayer. Carriers are also encouraged to pickup one pallet from customers for each pallet they deliver to the customers and return the pallets to the taxpayer.

When customers have failed to return pallets to the taxpayer, the taxpayer has on occasion billed its customers for pallets. During a four year period, the taxpayer billed its customers \$. . . for pallets. The taxpayer also may raise prices or deny discounts to customers who do not return pallets. The taxpayer's program to get pallets returned to it has been successful. The taxpayer reports that 97% of its pallet-related expenses are for repairs, rather than for the purchasing of new pallets.

ANALYSIS

All sales of tangible personal property to consumers in the state of Washington are subject to retail sales tax unless the sales are otherwise exempt from taxation. RCW 82.08.020; RCW 82.04.050. The term "retail sale" is defined, through RCW 82.08.010(4), at RCW 82.04.050(1). There, the statute provides that a retail sale does not include "purchases for the purpose of resale as tangible personal property in the regular course of business without intervening use by such person." RCW 82.04.050(1)(a). The term "consumer" is defined, through RCW 82.12.010(5), at RCW 82.04.190. There, a consumer is any "person who purchases, acquires, owns, holds or uses any article of tangible personal property irrespective of the nature of the person's business . . . other than for the purpose resale in the regular course of business"

Under RCW 82.04.040, a "sale" means a transfer "of the ownership, title to, or possession" of property for "valuable consideration." In contrast, the temporary transfer of possession without consideration is considered a bailment for tax purposes. *See* WAC 458-20-211(2)(b); Excise Tax Advisory 314 (ETA 314).² The taxpayer contends the pallets were packaging material purchased for resale and that it repurchased pallets from its customers. At issue is whether the transfers of pallets between the taxpayer and its customers constituted a series of sales and repurchases of the same or like-kind pallets or a bailment of the pallets.

In general, a manufacturer's purchase or use of pallets is taxed in one of three ways. If the manufacturer uses the pallets in warehousing goods and for other non-sale purposes, the manufacturer would be a consumer, and retail sales tax or use tax would be due, unless the goods

² Under the common law, a bailment "arises generally when personalty is delivered to another for some particular purpose with an express or implied contract to redeliver when the purpose has been fulfilled." *Gingrich v. Unigard Sec. Ins. Co.*, 57 Wn. App. 424, 431-32, 788 P.2d 1096 (1990) (quoting *Freeman v. Metro Transmission, Inc.*, 12 Wn. App. 930, 932, 533 P.2d 130 (1975)). Bailments commonly involve a mutual benefit to the bailor and bailee. A bailment for mutual benefit arises

when both parties to the contract receive a benefit flowing from the bailment. 8 C.J.S. *Bailments* § 16 (1988). The benefit to the bailee need not be in the form of cash. Rather, the benefit may derive from

a bailment [which] is a mere incident to the performance of services for which the bailee receives compensation or to the conduct of business from which the bailee derives profit, or where the bailment is motivated by the bailor's desire to promote a sale

American Nursery Products, Inc. v. Indian Wells Orchards, 115 Wn.2d 217, 232, 797 P.2d 477 (quoting 8 C.J.S. *Bailments* § 16, at 239 (1988)); *see also* *White v. Burke*, 31 Wn.2d 573, 583, 197 P.2d 1008 (1948). A mutual benefit running between the bailor and bailee is not consideration for purposes of Rule 211.

are otherwise exempt from taxation.³ If the manufacturer uses the pallets to transport goods to buyers, who temporarily possess the pallets under a bailment arrangement, the manufacturer would also be a consumer of the pallets, and retail sales tax or use tax would be due. If the manufacturer uses the pallets as part of its packaging of goods and does not retain title to the pallets, the pallets are purchased for resale, and retail sales or use tax would not be due. *See* WAC 458-20-115 (Rule 115).⁴

Rule 115 provides that retail sales tax is not imposed on the sale of the packaging materials to a manufacturer because such materials are purchased for resale. Rule 115 also provides that containers are not purchased for resale and are subject to tax when title does not pass to the purchaser and the containers are customarily returned to the seller:

Sales of containers to persons who sell tangible personal property therein, but who retain title to such containers which are to be returned, are sales for consumption and subject to tax under the retailing classification. This class includes wooden or metal bottle cases, barrels, gas tanks, carboys, drums, bags and other items, when title thereto remains in the seller of the tangible personal property contained therein, and even though a deposit is not made for the containers, and when such articles are customarily returned to the seller.

(Emphasis added.)

The taxpayer contends that its pallets should be treated the same as other packaging materials that remain with products sold to consumers. It relies on Det. No. 90-302, 10 WTD 101 (1990), and Det. No. 91-019, 10 WTD 385 (1990), for the proposition that generic or fungible pallets included with goods being sold are purchases for resale and are not subject to retail sales tax.

In Det. No. 91-019, 10 WTD 385 (1990), a manufacturer used wooden pallets imprinted with its name to transport beer and wine products to its wholesale distributor. The manufacturer billed an amount to the distributor for the pallets, which amount was refunded upon the return of the pallets. The Audit Division assessed the distributor with use tax on the pallets because it considered the distribution of the pallets to be a sale of the pallets. We reversed and held that there was no sale of the pallets to the distributor because title did not pass. After examining Rule 115, we concluded that title did not pass because the parties had an “oral agreement” that the

³ *See generally* WAC 458-20-13601(9)(b).

⁴ Subsection (6)(c) of Rule 115 further provides a specific example of how pallets may be taxed:

XY uses three types of pallets in its manufacturing operation. One type of pallet is used strictly for storing paper which is in the manufacturing process. A second type of pallet is returnable and the customer is charged a deposit which is refunded at the time the pallet is returned. The third type of pallet is nonreturnable and is sold with the product. XY is required to pay retail sales or use tax on the first two types of pallets. The third type of pallets may be purchased by XY without the payment of retail sales or use tax since these pallets are sold with the paper products.

customers would return the pallets to the distributor and, upon return, the amount originally charged for the pallets was refunded or credited to the distributor's account.

In Det. No. 90-302, 10 WTD 101 (1990), a manufacturer included a separate pallet charge on invoices to some of its customers, at the request of those customers. The Audit Division assessed use tax or deferred sales tax on all purchases of pallets by the manufacturer. It concluded that the manufacturer did not purchase the pallets for resale, because it considered the pallet charges to be part of a deposit-return program rather than a sale of the pallets. However, the evidence showed that the taxpayer's customers were "under no obligation whatsoever to return the pallet to the taxpayer." Further, the pallets used by the manufacturer were "generic," and were not imprinted with the manufacturer's name, and the manufacturer would grant credit even for pallets that did not originate with the manufacturer. Under the facts of that case, we concluded that title to the pallets had passed to the manufacturer's customers and, accordingly, the manufacturer did not owe use tax or deferred sales tax.

Whether customers were required, through the use of a deposit arrangement or by an agreement, to return the pallets was an underlying factual issue in both cases. To the extent a party retains the right to control the use or return of an item provides evidence on whether title passes. In one case, we found that, by oral agreement and by the use of a deposit, the manufacturer retained the right to have the pallets redelivered and title did not pass. In the other case, the manufacturer was found not to have retained the right to require the pallets to be redelivered, either through a deposit arrangement or by agreement, and we found title to have passed.

In the later case, the generic or fungible nature of the pallets and the fact that the same pallets were commonly not returned supported the conclusion that the parties intended to transfer title, rather than only temporary possession under a bailment arrangement. In this regard, it is usually necessary for a bailee to return the identical property to the bailor in a bailment arrangement:

With the exception of securities such as stock certificates, the bailee generally can discharge his or her duty to redeliver the bailed property to the bailor only by returning the identical item of property that he or she received in its original or an altered form, according to the terms of the bailment. In the absence of an agreement to do so, a bailor ordinarily cannot be compelled to accept other property of the same kind and of equal value in lieu of that which was given to the bailee.

8A Am. Jur. 2d, *Bailments* § 143 (2000).

However, when the commingling of fungible goods is required by the needs of the trade and is done with the consent of the parties, a bailment is established if that is the intent of the parties. For example, warehousemen are generally permitted to commingle fungible goods and to return goods of like quality and amount. *Id.* It may also occur in the transportation of fungible goods. *See, e.g., Public Service Elec. & Gas Co. v. Federal Power Commission*, 371 F.2d 1 (3rd Cir. 1967), *cert. denied*, 389 U.S. 849 (1967) (where the court examined the economic and legal substance of a transportation agreement involving commingling, and concluded that it was really

a bailment of a fungible commodity (gas) rather than a sale and repurchase). It may also occur with respect to the return of fungible items sent to a processor. *See, e.g., In re Bristol Industries Corp.*, 690 F.2d 26, 30-31 (2nd Cir. 1982) (concurring opinion); Det. No. 98-157, 19 WTD 753 (2000).

Accordingly, to the extent we find the taxpayer had the right to have the pallets returned, the fact that by agreement it accepted like-kind pallets would not preclude us from finding the transaction involved a bailment, rather than a series of sales and repurchases of like-kind pallets. Here, the pallets at issue meet specific industry standards and had a useful life, value, and utility to the taxpayer beyond the initial delivery of the packaged goods being transported on the pallets. Consistent with this value and utility to the taxpayer, the taxpayer had a written agreement with some of its customers requiring the return of either the same pallets or like-kind pallets. The evidence points to similar oral agreements with its other customers. The taxpayer carefully kept an accounting of the transfers of pallets to its other customers, and it exercised the right to charge or penalize customers who do not return either the same pallets or like-kind pallets. Consistent with its prior statements, the evidence shows that the taxpayer was the consumer of the pallets, and the pallets were not purchased for resale.

The taxpayer has not sustained the burden, essential to its case, of proving that title to and ownership of the pallets passed to its customers, as opposed to possession being transferred under a bailment arrangement. Accordingly, the Department's denial of a refund is sustained.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 26th day of September, 2001.