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**COURT OF APPEALS, DIVISION II  
OF THE STATE OF WASHINGTON**

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ADVANCED H2O, LLC & TYSON FRESH MEATS, INC.,

Appellants,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

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**OPENING BRIEF OF RESPONDENT  
DEPARTMENT OF REVENUE**

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## I. INTRODUCTION

Businesses that rent pallets for their own use must pay sales or use taxes on the rental fees. Here, the undisputed facts show that Advanced H2O, LLC, and Tyson Fresh Foods, Inc., rented pallets from CHEP USA for their own use in delivering their products. This Court should reverse the Board of Tax Appeals because it misapplied the law in holding the pallet rentals are exempt from sales or use tax. Specifically, the Board erroneously concluded that H2O and Tyson rented the pallets for the purpose of “resale” or “sublease.”

The record provides no plausible basis for inferring that H2O or Tyson resold or subleased the pallets to their customers. To the contrary, the clear terms of their rental agreements with CHEP specifically prohibited H2O and Tyson from selling the pallets or dealing with them in any way inconsistent with CHEP’s exclusive ownership interest in the pallets. The rental fees they paid to CHEP were in exchange for H2O and Tyson’s own possession and control of the pallets during the rental period ending when they transferred the pallets to a customer. Because H2O and Tyson had no property interest in the transferred pallets, they could not “resell” or “sublease” them.

The sole factual basis for the Board’s erroneous conclusion that H2O and Tyson “subleased” the pallets is the undisputed fact that they

“factored” their pallet rental costs into the price they charged for their products. The fact that H2O and Tyson were able to recoup their own pallet rental costs in the price of the products they sold does not mean they “subleased” the pallets they used to ship their products to market. At best it means they recovered their own rental costs for a past rental period. But that is not a “sublease.”

The Board also erred by holding that the pallet rentals qualified as sales for resale of “packing materials” within the meaning of WAC 458-20-115. When the Department’s interpretive rule is read as a whole and in the context of the statutes it implements, it is clear the rented pallets are subject to sales or use tax because CHEP’s customers acquire the pallets for their own use, and not for the purpose of reselling the pallets to their own customers. The Board’s erroneous interpretation of the Department’s rule results in a broader tax exemption than statutorily authorized.

In sum, the Board’s rulings are contrary to the evidence and inconsistent with the governing tax statutes, Washington case law regarding lease transactions, and the well-established principle that tax exemption statutes are to be construed narrowly, not broadly. If the Board’s broad interpretation of the sale for resale and lease for sublease exemptions is allowed to stand, these exemptions will swallow the rule that the sales or use

tax applies to each item of tangible personal property sold or used in Washington, including successive sales of the same property.

The Superior Court correctly ruled that the Board's decisions erroneously interpreted and applied the law to the facts and this Court should affirm.

## **II. ASSIGNMENTS OF ERROR**

1. The Board misinterpreted and misapplied the law when it concluded that a manufacturer's rental of pallets for use in shipping its products to customers qualifies as a lease "for the purpose of sublease" within the meaning of RCW 82.04.050(4)(b).

2. The Board misinterpreted and misapplied the law when it concluded that a manufacturer's rental of pallets for use in shipping its products to customers qualifies as a sale "for the purpose of resale" of packing materials under RCW 82.04.050(1)(a)(i) and WAC 458-20-115.

## **III. ISSUES PRESENTED**

1. Does a manufacturer's rental of pallets for use in shipping its products to customers qualify as a "lease for the purpose of sublease" under the sales tax exemption in RCW 82.04.050(4)(b), where the manufacturer paid rental fees only for the period of time it had possession of the pallets, and the transferred pallets were subject to a preexisting rental agreement between the manufacturer's customer and the lessor?

2. Does a manufacturer's rental of pallets for use in shipping its products to customers qualify as a sale "for the purpose of resale" under the sales tax exemption authorized by RCW 82.04.050(1)(a)(i) and WAC 458-20-115, where the pallets remained the exclusive property of the lessor, which was entitled to either retrieve the pallets or demand rental payments from the manufacturer's customer for the customer's own possession of the pallets?

#### IV. STATEMENT OF THE CASE

H2O manufactured bottled water and other beverage products in Burlington, Washington. AR-H2O 91 at ¶ 4, 139.<sup>1</sup> It sold its beverage products to various retailers in the State. AR-H2O 91 at ¶ 5. Tyson operated a beef processing plant near Pasco, Washington. AR-Tyson 88 at ¶ 3. Tyson sold its beef products to distributors and supermarkets in the State. AR-Tyson 135-36. Both businesses rented pallets from CHEP USA, Inc. for use in their business operations. AR-H2O 91 at ¶ 7; AR-Tyson 88, at ¶ 5.

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<sup>1</sup> The Administrative Record for Advanced H2O, LLC is numbered AR-1 through AR-291, and that of Tyson Fresh Meats, Inc. is numbered AR 1-292. For clarity, this brief refers to the respective administrative records as "AR-H2O" and "AR-Tyson."

## A. CHEP's Pallet Rental Program

CHEP is an acronym for the Commonwealth Handling Equipment Pool.<sup>2</sup> The Australian government formed CHEP at the end of World War II to make use of the millions of pallets left behind by the United States military, which used the pallets to move equipment and supplies overseas. The use of a standardized, fork-lift ready pallet to move goods through the supply chain became a staple of post-war industry. Private industry quickly recognized the efficiencies to be gained by incorporating the pallets into the global chain of distribution of goods.

CHEP, a subsidiary of Brambles Limited, is the largest pallet business in the world.<sup>3</sup> CHEP owns and operates a global pallet pooling service for manufacturers, distributors, and retailers. AR-H2O 130. CHEP describes its pallet pooling service as “the shared use of high quality pallets and containers throughout the supply chain.”<sup>4</sup> AR-H2O 110 (Hire Agreement, ¶ 1.1). Each pallet is colored blue and marked with the CHEP

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<sup>2</sup> See <https://www.chep.com/us/en/consumer-goods/about-us/global-chep/history-chep>.

<sup>3</sup> For an in depth discussion of the pallet industry and CHEP's role in it, see Jacob Hodes, “Whitewood Under Siege,” *Cabinet Magazine*, available at <http://www.cabinetmagazine.org/issues/52/hodes.php> (last viewed August 10, 2018).

<sup>4</sup> CHEP's innovative pallet leasing business model was featured in an episode of NPR's Planet Money program titled “The Blue Pallet,” which is available at <https://www.npr.org/sections/money/2018/02/21/587674942/episode-545-the-blue-pallet> (last heard on August 10, 2018).

logo and the words “Property of CHEP” or “Owned by CHEP” to identify it as property belonging to CHEP. AR-H2O 118 at ¶ 6(d).

Every CHEP pallet is subject to the standard terms and conditions of CHEP’s pallet rental program. AR-H2O 130; AR-Tyson 125. CHEP customers ordered pallets from CHEP by the truckload. AR-H2O 129. CHEP delivered the pallets to its customers’ facilities for use in manufacturing and distributing goods.

CHEP permitted its customers to use the pallets to ship goods only to other manufacturers, distributors, or retailers that had a separate rental agreement with CHEP. AR-H2O 115 at ¶ 5(c); AR-Tyson 98 at ¶ 4.1(I).

Absent CHEP’s consent, customers were prohibited from transferring pallets to persons who were not under contract with CHEP, referred to as “non-participating distributors.” AR-H2O 115 at ¶ 5(c), 117 at ¶ 5(d). In exchange for granting such consent, CHEP imposed surcharges to compensate it for the burden and expense of retrieving the pallets. AR-H2O 114 at ¶ 5, 124 at ¶ 6(c).

CHEP’s customers agreed to accept transfers of CHEP pallets from other CHEP customers and to assume responsibility to CHEP for every pallet they received. AR-H2O 110 at ¶ 1.1, 1.3; AR 117 at ¶ 5(e); AR-Tyson 112 at ¶ 5.2 (defining “Quantity of Equipment on Hire”). For example, if Tyson placed some of its beef products on a CHEP pallet and

then transferred the pallet and products to a Costco warehouse, that pallet would no longer be included in Tyson's "quantity of equipment on hire" and it instead would be added to Costco's "quantity of equipment on hire" in CHEP's books and records.

H2O and Tyson used the CHEP pallets to ship their products to customers. AR-H2O 91 at ¶ 5; AR-Tyson 88 at ¶ 4. After a pallet was offloaded by H2O's or Tyson's customers, it was either returned to a CHEP depot for repair and reconditioning or transferred to another pool participant for further use. AR-H2O 130.

CHEP's customers were required to notify it of all transfers, returns, and movements of the pallets within 7 days. AR-H2O 117 at ¶1(j), 3; AR-Tyson 112 at ¶ 5.2. CHEP tracked the movement of the pallets throughout the supply chain through a computerized system that matched the pallets with a unique code assigned to each customer. AR-H2O 117.

On a weekly basis, CHEP provided an invoice to each customer detailing all inbound and outbound movements of pallets. AR-H2O 117 at ¶ 3(b), 139-50. The invoices stated the total number of pallets multiplied by the number of "rental days" a customer had possession of each pallet during the billing cycle. AR-H2O 139; AR-Tyson 131-38.

CHEP charged an "issue fee" for every pallet it provided to a customer. AR-H2O 113. The issue fee was based on the quantity of pallets

on hire and the average number of days a customer retained possession before transferring a pallet to another CHEP customer or returning it to CHEP. *Id.* For example, Tyson paid an issue fee of \$5.50 per pallet based on its 56-day “average cycle time.” AR-Tyson 115-16 at ¶¶ 2, 5 (Appendix 1 to the Rental Agreement effective April 25, 2008). In contrast, H2O paid an issue fee of \$3.85 per pallet based on the expectation it would rent more than 400,000 pallets each quarter and retain them for fewer than 30 days on average. AR-H2O 113 (Exhibit B to Hire Agreement dated March 24, 2010).

The issue fee was subject to quarterly adjustment according to each customer’s usage history. AR-H2O 113 at ¶ 2; AR-Tyson 116 at ¶ 5. Customers who actually rented fewer pallets or kept them longer than expected were subject to higher issue fees during the subsequent quarter. AR-Tyson 116 at ¶ 5 (providing that CHEP would “adjust the succeeding quarter’s fixed-fee per pallet price by \$0.035 per day above or below 56 days based on the previous quarter’s cycle time”). CHEP also reserved the right to switch its customers from a flat rate fee to a variable pricing structure with daily rental charges and transfer fees if a customer’s usage fell below negotiated thresholds. AR-H2O 113 at ¶ 2.

CHEP retained legal title and ownership of the pallets at all times, even of lost pallets its customers paid for in full:

## 6. OWNERSHIP OF EQUIPMENT

(a) CHEP never sells or transfers ownership of its Equipment. Customer acknowledges and agrees that each item of Equipment has a special value to CHEP and that CHEP repairs, maintains, handles and otherwise administers the circulation of all Equipment as part of a pool.

(b) Customer acknowledges and agrees that despite any other clause in the Agreement, CHEP remains the owner of the Equipment at all times. Neither Customer nor any other person is entitled to purchase or sell the Equipment or use, dispose of or otherwise deal with Equipment in any way that is inconsistent with CHEP's ownership of the Equipment or the terms of this Agreement. Payment of a Lost Equipment fee or any other circumstance or event does not constitute or result in any transfer of any property right or other interest in the Equipment by or from CHEP.

AR-H2O 118 at ¶ 6; *see also* AR-Tyson 99 at ¶ 6.

CHEP took care to protect its exclusive property interest in the pallets. For example, an advertisement announcing the availability of the pallets for rent explained: "CHEP never sells its pallets or containers and retains ownership of them at all times," "under no circumstances may CHEP pallets or containers be bought or sold," all CHEP equipment "remains the exclusive and inalienable property of CHEP," and "[a]ll pallets are rented under CHEP USA's standard terms and conditions."

AR-Tyson 123. Other CHEP advertisements announced "It is illegal to buy, sell or otherwise dispose of CHEP Blue Pallets," and "Never buy or

sell CHEP Blue Pallets.” AR-Tyson 123 (“Keep Count of The Blue Pallet”); AR-Tyson 124 (“Save the Blue Pallet”).

Each and every invoice CHEP issued reminded the customer that CHEP “is the exclusive owner of all CHEP equipment” and the payment of any fee does not result in “any transfer of any property right or other interest in any CHEP Equipment by or from CHEP.” AR-H2O 137; AR-Tyson 134.

CHEP has aggressively litigated its right to retrieve its pallets from whomever takes possession of them for whatever reason in federal court actions brought against pallet recyclers and resellers. *See CHEP USA v. Mock Pallet Co.*, 138 Fed. Appx. 229 (11th Cir. 2005). In litigation, CHEP has explained:

CHEP pallets are never sold, and CHEP pallets are not sold with the goods they transport. Instead, CHEP leases its pallets to manufacturers, who then ship their goods on the leased pallets. The recipient of the goods (a distribution center, for example) then generally returns the CHEP pallet to a CHEP service center. CHEP then inspects each pallet, cleans, paints, and repairs it if necessary, and returns it to a manufacturer to transport another load of goods. CHEP’s agreements with manufacturers and distributors that use CHEP pallets expressly provide that CHEP owns the pallets and that the CHEP pallets may never be bought and sold.

*CHEP USA v. Pallet Services, Inc.*, No. 05-CV-00238, 2005 WL 461983, Complaint at ¶ 11 (W.D. Wash. 2005); *see also CHEP USA v. American Pallet, Inc.*, Case No. 03-CV-00067, Complaint at ¶ 15 (E.D. Va. 2003).

**B. The Administrative Review and Appeal Proceedings**

H2O paid sales taxes on the pallet rental fees it owed to CHEP for the January 2008 through December 2011 tax periods. AR-H2O 162. It subsequently filed a refund request with the Department of Revenue to recover the sales taxes. AR-H2O 92 at ¶ 10. H2O argued it was entitled to a refund because the pallet rentals qualified as either a wholesale purchase of “packing materials” under WAC 450-20-115, or a lease “for the purpose of sublease” under RCW 82.04.050(4)(b). AR-H2O at 166-67. The Department’s Audit Division denied the refund request, and the Department’s Appeals Division affirmed Audit following an informal administrative appeal. *Id.*

The Department’s Audit Division audited Tyson for the period January 1, 2007 through December 31, 2010. AR-Tyson 147. Audit found that Tyson did not pay sales or use taxes on the pallet rental fees it owed to CHEP. AR-Tyson 150. The Department assessed Tyson use taxes on the pallet rental fees. AR-Tyson 152. As in the H2O matter, the Department’s Appeals Division affirmed Audit’s conclusion that the pallet rental transactions are retail sales as defined in RCW 82.04.050, and rejected Tyson’s argument they qualified as wholesale sales under either the sale for resale or lease for sublease exemption. AR-Tyson 165-66.

H2O and Tyson filed notices of appeal with the Board challenging the Department's determination that the pallet rental transactions are retail sales. AR-H2O 279-91; AR-Tyson 267-92). The parties submitted the cases to the Board on cross-motions for summary judgment. AR-H2O 80, 172; AR-Tyson 78, 168. The Board held a single hearing and subsequently issued decisions granting summary judgments to the taxpayers and denying the Department's motions for summary judgment. AR-H2O 22; AR-Tyson 21. The Board ruled that the pallet rental transactions qualified as an exempt "lease for the purpose of sublease" under RCW 82.04.040(4)(b) and as a sale "for the purpose of resale" under RCW 82.04.050(1)(a)(i) and WAC 458-20-115(3)(c), (6)(c). AR-H2O 22-33; AR-Tyson 21-31.

The Department filed timely petitions for judicial review in the Thurston County Superior Court. AR-H2O 3-21; AR-Tyson 3-20. The Superior Court granted the Department's petition in the H2O matter on January 19, 2018, and in the Tyson Foods matter on January 26, 2018.

The Superior Court ruled that the BTA erred in concluding that H2O and Tyson subleased the pallets to their customers and in concluding that the pallet rentals were exempt sales of non-returnable "packing materials" under WAC 458-20-115. The Superior Court further ruled that as a matter of law the rented pallets do not qualify as a lease for the

purpose of sublease under RCW 82.04.040(4)(b) and remanded the matter to the Board with instructions to grant the Department's motions for summary judgment and to dismiss H2O's and Tyson's appeals.

This Court's Commissioner ordered consolidation of the appeals. As the party challenging the underlying agency actions (i.e., the Board's summary judgment orders granting H2O's and Tyson's tax appeals), the Department is responsible for filing the opening brief in this Court. General Order 2010-1.

## V. ARGUMENT

### A. The Board's Summary Judgment Order Is Reviewed De Novo.

The Administrative Procedure Act (APA), RCW 34.05, governs judicial review of a final order entered by the Board. RCW 82.03.180. Under the APA, the burden of demonstrating the invalidity of an agency action is on the party asserting the agency erred. RCW 34.05.570(1). In an appeal of a Superior Court order granting a petition for judicial review, the burden remains with the party challenging the underlying agency action. General Order 2010-1. Thus, the Department has the burden of demonstrating the Board's decisions were erroneous.

Because the Board decided this matter on summary judgment, its final orders are subject to the standard of review ordinarily applicable to a summary judgment. *Verizon Nw., Inc. v. Employ. Sec. Dep't*, 164 Wn.2d

909, 916, 194 P.3d 255 (2008). Thus, the court reviews the facts in the record in the light most favorable to the non-moving party and the law in light of the “error of law” standard. *Id.* at 916; RCW 34.05.570(3)(d).

Here, the parties did not dispute the facts, only the legal conclusions to be drawn from them. Specifically, the parties disputed whether the pallet rentals qualified for the sales tax exemption applicable to a “lease for the purpose of sublease” under RCW 82.04.050(4)(b) or a “sale for the purpose of resale” under RCW 82.04.050(1)(a)(i) and WAC 458-20-115. This dispute presents a question of statutory interpretation subject to de novo review under the APA’s error of law standard. *See Judd v. American Tel. and Tel. Co.*, 152 Wn.2d 195, 202, 95 P.3d 337 (2004).

Under the error of law standard, the reviewing court may substitute its own interpretation of the statute for the agency’s interpretation. *Verizon*, 164 Wn.2d at 915. A court, however, accords “considerable deference” to the interpretation made by the agency charged with enforcing a statute or implementing its own rules. *Dep’t of Revenue v. Nord Nw. Corp.*, 164 Wn. App. 215, 229-300, 264 P.3d 259 (2011). In reviewing a Board decision, this Court accords such deference to the Department, not the Board, because the Department is the agency charged with assessing and collecting “all taxes” and administering “all programs relating to taxes” enacted by the Legislature. *Sprint Spectrum, LP v. Dep’t*

*of Revenue*, 174 Wn. App. 645, 657, 302 P.3d 1280 (2013); RCW 82.01.060(1); *see Port of Seattle v. Pollution Control Hearings Bd.*, 151 Wn.2d 568, 593-94, 90 P.3d 659 (2004) (court defers to the agency charged with administering a particular statute rather than a quasi-judicial body's interpretation of the statute). The Department also is the agency entitled to deference with respect to the proper interpretation of its own interpretive rules. *Nord Nw.*, 164 Wn. App. at 223.

Finally, “[t]axation is the rule and exemption is the exception.” *TracFone Wireless, Inc. v. Dep’t of Revenue*, 170 Wn.2d 273, 296-97, 242 P.3d 810 (2010). Thus, “a taxpayer who claims an exemption carries the burden of proving [it] qualifies.” *Activate, Inc. v. Dep’t of Revenue*, 150 Wn. App. 807, 813, 209 P.3d 524 (2009) (quoting *Glen Park Assocs., LLC v. Dep’t of Revenue*, 119 Wn. App. 481, 486, 82 P.3d 664 (2003)). Moreover, in any case where a tax exemption statute is susceptible to more than one reasonable interpretation, that statute must be construed “strictly, though fairly and in keeping with the ordinary meaning of [the statute’s] language, against the taxpayer.” *Id.*

**B. The Board Misapplied the Law in Ruling that the Pallet Rental Transactions Qualify as a Lease-for-the-Purpose-of Sublease Under RCW 82.04.050(4)(b).**

Washington imposes a retail sales tax on “each retail sale,” including “successive retail sales of the same property.” RCW

82.08.020(6). Washington also imposes a use tax, which is a complementary tax applicable to each retail sale on which the sales tax was not previously paid for whatever reason. RCW 82.12.020(1)(a); *Glen Park Associates*, 119 Wn. App. at 494, n.1. The use tax incorporates by reference most of the same statutory exemptions applicable to a retail sale. *Activate*, 150 Wn. App. at 814. The legislative intent of the sales and use tax scheme is to tax each item of tangible personal property that is sold or used in Washington as a consumer, absent a specific statutory exception.

A “retail sale” means “any sale, lease, or rental for any purpose other than for resale, sublease, or subrent.” RCW 82.08.010(11). More specifically, RCW 82.04.050 describes many different types of business transactions that qualify as a “retail sale.” Subsection (1)(a) defines as “retail sales” all sales of tangible personal property “of or for consumers,” but exempts sales to a person that purchases “for the purpose of resale as tangible personal property in the regular course of business without intervening use.” RCW 82.04.050(1)(a)(i). Subsection (4) also includes within “retail sale” “the renting or leasing of tangible personal property to consumers,” except “where the lease or rental is for the purpose of sublease or subrent.” RCW 82.03.040(4)(b).

A “sale” is statutorily defined as “any transfer of the ownership of, title to, or possession of property for a valuable consideration,” including a

“lease or rental.” RCW 82.04.040(1). “Lease or rental” means “any transfer of possession or control of tangible personal property for a fixed or indeterminate term for consideration.” RCW 82.04.040(3)(a).

H2O’s and Tyson’s rental of CHEP pallets were taxable “retail sales” within the plain meaning of the sales and use tax statutes. The Board erroneously ruled that the pallet rental transactions qualified as exempt sales “for the purpose of resale” under RCW 82.04.050(1)(a)(i) or leases “for the purpose of sublease” under RCW 82.04.050(4)(b).

First, the pallet rentals were not sales for the purpose of resale because CHEP’s customers, like H2O and Tyson, did not have “title to” or “ownership of” the pallets, so they did not acquire them “for the purpose of resale.” Property cannot be “resold” if it wasn’t sold for resale in the first instance. CHEP emphatically did not sell its pallets for resale.

Second, the pallet rentals were not leases “for the purpose of sublease” because H2O’s and Tyson’s own rental periods ended when they transferred possession to their customers. Property that is no longer under lease cannot be subleased. CHEP’s customers rented the pallets from CHEP, not from one another.

The Superior Court correctly reversed the Board’s decision, and this Court should affirm.

**1. CHEP's customers lease the pallets for their own use, not for the purpose of "sublease."**

The Board misapplied the law in ruling that H2O and Tyson rented pallets for the purpose of "resale" or "sublease." A taxpayer's purpose for purchasing property is "an important consideration because to be exempt from retail sales tax the product must be purchased for resale." *Seattle Filmworks, Inc. v. Dep't of Revenue*, 106 Wn. App. 448, 457, 24 P.3d 460 (2001). CHEP's customers acquired the pallets on an "as-needed" basis for their own use in manufacturing, processing, or distributing their products. AR-Tyson 155 at ¶ 2.

Every CHEP pallet is leased and re-leased by CHEP to each successive transferee in its pallet rental program. *See* AR-H2O 117 at ¶ 1(c) (defining customer "as entity with whom CHEP has an agreement for use" of the pallets), 130. CHEP expressly prohibited its customers from assigning their contractual rights and obligations with respect to the rented pallets absent express written consent. AR-H2O 118 at ¶ 14; AR-Tyson 113 at ¶ 10.2. There is no evidence in the record H2O or Tyson ever sought or obtained such consent. Each successive transferee was liable to CHEP for its possession and use of a CHEP pallet, not to the business that previously rented the pallet from CHEP and from whom it might have

received the pallet. Under the clear terms of their rental agreements, H2O and Tyson could not “re-sell” or “sublease” the pallets.

**2. H2O and Tyson’s customers did not re-sell or sublease the pallets.**

In concluding that H2O and Tyson “subleased” the pallets to their customers, the BTA ignored the essential element of a lease transaction. The taxable incident of a lease differs from that of an ordinary sale in that consideration is paid in exchange for the right of possession and use for a period of time, rather than “title to” or “ownership of” the transferred property. RCW 82.04.040(3)(a) (defining “lease or rental”).

The Washington Supreme Court addressed the nature of a lease transaction in *Gandy v. State*, 57 Wn.2d 690, 359 P.2d 302 (1961). In *Gandy*, the Court held that the Legislature intended the leasing of property to be treated as a “series of sales” for state excise tax purposes. *Id.* at 694-95. That is, each successive rental period for which the lessee owes consideration in exchange for the continued enjoyment of possession is a separate retail sale. *Id.* at 698. The measure of the tax, i.e. the “selling price,” is the amount owed for the “enjoyment of possession” during the period of time covered by the lease payment.

Following *Gandy*, the retail sales tax applies as each successive rental payment comes due. *Lakewood Lanes, Inc. v. State*, 61 Wn.2d 751,

752, 380 P.2d 466 (1963); RCW 82.08.090 (sales tax applies to consideration owed in exchange for each rental period); RCW 82.08.020(6) (sales tax applies to successive retail sales of the same property); WAC 458-20-211 (leases or rentals of personal property).

The rental fees H2O and Tyson paid to CHEP covered the rental period during which they were using the pallets themselves, i.e. the rental period *preceding* the transfer of possession to their customers. There was no overlap in their own rental period and the rental period commencing when their customers took possession. Because their own rental period ended with the transfer of possession, the amount H2O or Tyson charged its customers for the products they sold was not “consideration” for the right to possess or control the transferred pallets. RCW 82.04.040(3)(a) (defining “lease or rental”). CHEP is the person that rented the pallets to each successive transferee. The Board erred in ruling H2O and Tyson leased the pallets “for the purpose of sublease.”

**3. A lease transaction qualifies as a lease-for-sublease only if the lessee does not itself “use” the property during the rental period.**

The Department adopted an interpretive rule to explain how the state’s excise taxes apply to leases or rentals of tangible personal property. WAC 458-20-211 (Rule 211). In administering the “lease-for-sublease” exemption, the Department applies the same principles ordinarily

applicable to retail sales. WAC 458-20-211(5)(a)(ii). Thus, Rule 211 explains that when a lessor purchases tangible personal property for rental or lease, the transaction is a wholesale sale. WAC 458-20-211(5)(a)(i). Accordingly, CHEP's own purchase of the pallets qualified as an exempt sale for resale because CHEP acquired the pallets for the purpose of renting or leasing them to its customers "in the regular course of business," as required by RCW 82.04.050(1)(a)(i) (sale or resale).

Consistent with the *Gandy* court's ruling that the leasing of property is taxable as a "series of sales," Rule 211 explains that persons who rent personal property to "users or consumers" are required to collect and remit sales tax on the rental transactions when "the rental payments fall due." WAC 458-20-211(6). The rental fees paid by CHEP's customers covered the rental period beginning when they received a pallet from CHEP and ending when they transferred the pallet to another CHEP customer (or returned it to a CHEP depot). The sales or use tax applied to the rental fees each successive transferee owed to CHEP for the pallets they received from CHEP or from another CHEP customer.

Rule 211 explains that the retail sales tax does not apply to persons who purchase property "solely for the purpose of renting or leasing such property," but that it *does* apply to those "who intend to make some use of the property other than or in addition to renting or leasing." WAC 458-20-

211(6)(a). CHEP's customers, the manufacturers, distributors, and retailers that used the pallets to move their goods through the supply chain, are the "users" or "consumers" of the pallets. *See* RCW 82.04.190(1) (defining "consumer" as "[a]ny 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 an exempt purpose).

The principal advantage of the pallet pooling arrangement is that pool participants pay rental fees only for the pallets within their possession and control on "any given day." AR-H2O 117 at ¶ 3 (charges and invoicing), 1(j) (quantity of equipment on hire). By providing this pooling arrangement, CHEP relieves its customers from the burden and expense of purchasing, repairing, reconditioning, tracking, and retrieving the pallets from their own customers. CHEP's customers lease the pallets for their *own use* in their manufacturing, distributing, and retailing operations, not for the purpose of "resale, sublease, or subrent" within the meaning of RCW 82.08.010(11).

The Board deemed it immaterial that H2O's and Tyson's customers were bound by a preexisting rental agreement with CHEP governing their own possession and use of the pallets. AR-H2O 27; AR-Tyson 25. The Board considered CHEP's contractual relationship with

H2O's and Tyson's customers a "red herring," reasoning that it pertained only to the taxability of a subsequent transaction between CHEP and the transferees. *Id.* This ignores the fact that H2O and Tyson had the burden of demonstrating that their own rental of the pallets was "for the purpose of sublease," and not for their own use in distributing their products. *Cf. Seattle Filmworks*, 106 Wn. App. at 456 ("A sale is a sale for resale...only if the taxpayer purchases the personal property for resale and the taxpayer does not put the property to an intervening use.").

The fact that every CHEP pallet was subject to a preexisting rental agreement between CHEP and H2O and Tyson's own customers precludes H2O and Tyson from establishing that they rented the pallets for the purpose of sublease. The same item of tangible personal property cannot be subject to multiple lease agreements at the same time. Even if their customers' right to shared use of the CHEP pallets on the date of delivery—the only day that overlaps with H2O's and Tyson's own pallet rental periods—conceivably falls within the broad definition of "sale" or "lease" of the transferred pallet, it does not follow that H2O's and Tyson's pallet rentals qualified as a sale or lease "for the purpose of" resale or sublease. H2O's and Tyson's true purpose was not to resell or sublease the CHEP pallets, but to use them in delivering their products. They rented the

pallets only for so long as they needed them to conduct their own business operations.

Tyson had possession and control of a typical pallet for an average of 56 days. AR-Tyson 116 at ¶ 5. During that period of time, Tyson was free to use the pallets to transport items between its various facilities, which included warehouses, freezers, distribution centers, “co-processing” plants, producing plants, and shipping containers. AR-Tyson 122 (“CHEP Pallet Process Flow”). H2O typically held onto a pallet for fewer than 30 days. AR-H2O 113 at ¶ 2. In both cases, Tyson and H2O had possession and control of the CHEP pallets during the entire rental period covered by the fees they paid to CHEP. In contrast, their customers merely had the shared use of the rented pallets on the date of delivery, which was the final day of H2O’s and Tyson’s pallet rental period. Clearly, their customers’ use of the rented pallets was overshadowed by H2O’s and Tyson’s own possession and control of the pallets during the rental periods at issue.

The Board’s conclusion that CHEP customers lease the pallets “for the purpose of sublease” flies in the face of the undisputed facts. No plausible basis exists for inferring that H2O and Tyson intended to re-sell or sublease the pallets given that the fees they paid to CHEP only covered the rental period during which H2O and Tyson had physical possession of the pallets and used the pallets for their own purposes, and CHEP alone

had the contractual right to sell, rent, or retrieve the pallets from H2O's or Tyson's customers.

**4. Each successive transfer of possession of a CHEP pallet results in a separate retail sale by CHEP to the transferee.**

The sales or use tax applies to each person's own purchase or use of tangible personal property "as a consumer." RCW 82.04.050(1)(a); RCW 82.12.020(1)(a). Sales and use taxes apply not only to purchases by individual consumers of household goods but also to businesses that purchase goods or services for use "as a consumer" in their business activities. RCW 82.04.050(1)(a) ("retail sale" means "every sale" of tangible personal property "to all persons irrespective of the nature of their business"). *See, e.g., Riley Pleas, Inc. v. State*, 88 Wn.2d 933, 568 P.2d 780 (1977) (construction contractor owed sales taxes on materials and labor purchased for use in constructing on land it owned); *Lakewood Lanes, Inc. v. State*, 61 Wn.2d 751, 380 P.2d 466 (1963) (bowling alley owner owed sales taxes on rental fees it paid for pin-setting machines installed for customer use); *Activate*, 150 Wn. App. 807 (retail seller owed use taxes on cellular telephones it purchased for use in promoting the sale of wireless service plans); *Mayflower Park Hotel, Inc. v. Dep't of Revenue*, 123 Wn. App. 628, 98 P.3d 534 (2004) (hotel owed sales taxes on its purchase of amenities placed in hotel rooms for guest use).

In the CHEP pallet pooling system, the “consumer” of the leased pallets is the manufacturer, distributor, or retailer deemed to have the pallet “on hire” on “any given day.” AR-Tyson 290 at ¶ 5.2, ¶ 5.4 (“The period of rent shall be from calendar day to calendar day.”). The CHEP pallets are never sold to the ultimate consumer of the goods manufactured, distributed, or sold by CHEP’s customers. If the Board’s interpretation of the tax statutes is allowed to stand, the sales or use tax will never apply to CHEP pallets at any step in the chain of distribution. This is not a reasonable interpretation of the sales and use tax statutes.

The purpose for exempting sales for resale (or sublease) is to mitigate the tax pyramiding that occurs when the sales tax is applied to multiple intermediate transactions as goods move through the supply chain before reaching the actual “consumer,” i.e. the person that purchases the goods “for any purpose other than resale, sublease, or subrent.” RCW 82.04.190(1)(a). *See* W. Hellerstein & J. Swain, *State Taxation* ¶ 12.04[3] (3d ed. 2017) (explaining legislative purpose for exempting wholesale sales).

The sale or use of each item of tangible personal property in Washington is exempt from tax only if “the present user or his or her bailor or donor has already been subjected to the [sales or use tax] and the tax has been paid by the present user or by his or her bailor or donor.”

RCW 82.12.020(3)(b). CHEP's own purchase of the pallets it rented to pool participants clearly was an exempt wholesale purchase. *See* WAC 458-20-211(5)(a)(i) (explaining that when a lessor purchases tangible personal property for rental or lease, the transaction is a wholesale sale). It is just as obvious the retail buyer of the products sold by H2O or Tyson did not use or consume the pallets. No retail customer left the grocery store with a CHEP pallet after purchasing a bottle of water or a sirloin steak.

The pallets were "used" and "consumed" by each manufacturer, distributor, or retailer that successively took possession and used the pallets to perform its own function in the chain of distribution.

The retail sales tax applies to successive sales of the same property. RCW 82.08.020(6). In the context of a lease transaction, a successive sale of the same property occurs each time the rental period covered by a rental payment ends and a new rental period begins. *See Gandy*, 57 Wn.2d at 694-95 (a lease is an executory contract taxable as a "series of sales" in which retail sales tax applies to each rental period for which payment is due). Properly applied, the sales or use tax applies to each successive transfer of a pallet from one CHEP customer to another. *See* AR-H2O 117 at ¶ 2(a) (each pallet received by a CHEP customer is added to its "quantity of equipment on hire" and removed from that of the

transferor). The rental period commencing when H2O's or Tyson's customer took possession of the pallet was a separate retail sale transaction between CHEP and the transferee. It was not a "resale" or "sublease" of the pallet by H2O or Tyson.

H2O and Tyson properly paid sales and use taxes on their pallet rental fees, and they were not entitled to a sales or use tax refund. The Board's contrary ruling creates an ultra vires tax exemption and was correctly reversed by the Superior Court.

**5. The amount CHEP's customers charged their own customers for the products they sold was not "consideration" for the transferred pallets.**

The sole factual basis for the Board's conclusion that H2O and Tyson acquired the pallets "for the purpose of sublease" was that they "factored" their pallet rental costs into the price of the products they sold. AR-H2O 15; AR-Tyson 15. Every (viable) business will pass on its costs of doing business to its customers. That does not mean it is "reselling" the goods or services it used in producing something for sale.

Washington courts interpreting the resale exemption have consistently held that items a seller uses to provide a service or sell a product are not resold to the customer, regardless of whether the expense is factored into the selling price. *See, e.g., Black v. State*, 67 Wn.2d 97, 103, 406 P.2d 761 (1965) (corporation which leased a cruise ship did not

resell it by leasing out individual cabins); *Activate*, 150 Wn. App. 807 (seller of cellular phone services did not “re-sell” phones it provided at no extra charge); *Mayflower Park Hotel*, 123 Wn. App. at 630 (hotel did not “re-sell” room furnishings and amenities when it incorporated their cost in the rate charged for each room); *Glen Park Associates*, 119 Wn. App. 481 (purchaser of an apartment building did not acquire the appliances included in the rental units for purposes of resale).

The fact that H2O and Tyson recovered their pallet rental costs in pricing their products did not convert their wholesale sales of beverage and beef products into a “resale” or “sublease” of the pallets they used to ship their goods to market. At best, it shows they recouped their expenses for *past* rental periods.

A sale transaction is a contract in which the buyer agrees to pay, and the seller agrees to accept, “valuable consideration” in exchange for the goods sold. *Inland Empire Dairy Ass’n v. Dep’t of Revenue*, 14 Wn. App. 592, 594, 544 P.2d 52 (1975). In concluding the amounts H2O and Tyson charged their customers was “consideration” for the transferred pallets, the Board reasoned that under the ordinary law of contracts, the promise to pay a lump sum can supply consideration for multiple promises. AR-Tyson 15. That is true. But there is no evidence in the

record that H2O's or Tyson's customers agreed to pay any amount for the pallets.

If, in fact, H2O or Tyson "subleased" the pallets to their customers, the material terms of that transaction are unascertainable. There is no rental period stated. There is no identification of the subject matter of the lease. There is no way to infer the "selling price" of the leased property.

The Department does not contend that a separate statement of charges always is required to establish that pallets (or any other packing materials) are sold along with the products they contain. But there must be *some* evidence of a bona fide resale transaction. Here, there is none. To the contrary, the undisputed evidence in the record demonstrates that CHEP's customers do not, in fact, resell or sublease the pallets to their customers. Pool participants understood and agreed that all CHEP pallets are subject to a rental agreement with CHEP. CHEP strictly prohibited its customers from re-selling the pallets or dealing with them "in any way" that is inconsistent with its ownership interest. AR-Tyson 112 at ¶ 6. Trying to add to or vary the terms and conditions of CHEP's own rental agreement with another CHEP customer plainly would have been inconsistent with CHEP's ownership of the pallets.

In fact, H2O and Tyson did not charge their customers any amount for the transferred pallets. AR-H2O 131-33 (invoices); AR-Tyson 138-46

(invoices). Nor did they try to enforce any conditions respecting the use or return of the pallets. H2O invoiced its customers for the number of cases of beverage products they purchased multiplied by the “unit price” of the product. AR-H2O 131-33. The invoices did not state any information about the pallets H2O used to deliver its beverage products. Tyson invoiced its customers based on the weight of the beef products it sold, multiplied by the price per pound of each particular cut (rib-eye, sirloin, brisket, etc.). AR-Tyson 138-46. Tyson’s invoices noted the number of CHEP pallets used in transporting each bulk shipment but did not state any charges for the pallets.

No plausible basis exists for inferring that H2O or Tyson resold or subleased the pallets they used to ship their products. The trial court correctly held that the clear terms of the CHEP rental agreement and the evidence of H2O’s and Tyson’s actual usage of the pallets were inconsistent with the Board’s conclusion that H2O and Tyson acquired the CHEP pallets for the purpose of resale or sublease.

**6. The Board’s decision is contrary to decisions from other jurisdictions addressing the same issue.**

In addition to being contrary to Washington law, the Board’s decision is out of step with rulings specific to CHEP in other states. The taxing authorities of a number of other states have ruled that CHEP’s

pallet rental transactions do not qualify as wholesale sales under statutes similar to Washington's. See *Brambles Indus., Inc. v. Indiana Dep't of Revenue*, 892 N.E.2d 1287 (2008) (rental of CHEP pallets does not qualify as an exempt sale-for-resale of "nonreturnable" containers); *In the Matter of the Appeal of Imperial Sugar Company from a Decision by the Department of Revenue*, 2002-108, 6/11/2003 (Wyo. Bd. Eq.) (rented pallets are not "components" of products sold by CHEP lessee); Advisory Opinion No. S080811A, 10/18/2011, N.Y. Dep't of Taxation & Finance (leased pallets in a pooling arrangement are not sales-for-resale or sales of exempt packaging materials); Private Letter Ruling #04-015, 5/31/2005, Utah Tax Comm. (CHEP lessee is "the final consumer of the pallets for that period for which it is entitled to the right of possession or use under the lease"); California Sales Tax Counsel Ruling No. 195.1526 (1/2/98; 5/14/98) (a manufacturer's lease of pallets in a pooling arrangement "is subject to use tax measured by rentals payable"). AR-H2O 220-250.

Even the case on which H2O and Tyson chiefly relied undercuts their claims. In support of their summary judgment motions, H2O and Tyson argued that a decision of the Missouri Supreme Court was "highly instructive." AR-H2O 87 (citing *Brambles Indus., Inc. v. Director of Revenue*, 981 S.W.2d 568 (Mo. 1998)). The Department agrees the

decision is instructive. But H2O and Tyson failed to draw the correct lessons from it.<sup>5</sup>

*Brambles* involved a tax refund action brought by CHEP to recover the sales taxes it collected on pallets leased to Proctor & Gamble, a manufacturer that used the pallets to ship products to its customers. CHEP argued the lease transactions qualified as wholesale sales. An administrative hearing officer denied the refund request on the ground that CHEP did not transfer ownership or title of the pallets to its customers. The Missouri Supreme Court reversed that decision, reasoning that a lease transaction was taxable to the same extent as an outright sale under the taxing statutes. The Court previously had held that the sale of packaging materials qualifies as a wholesale sale under certain circumstances, and it deemed that decision controlling:

Just as packaging material is purchased for resale when it is purchased for the purpose of transferring the right to use it in return for consideration, leases of packaging material are excluded from sales tax where the material is leased for the purpose of transferring the right to use the packaging material to a subsequent purchaser for valuable consideration.

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<sup>5</sup> In its summary judgment orders, the Board did not address the *Brambles* decision even though both parties discussed it. Instead, the Board cited to a decision from Pennsylvania addressing whether pallets were exempt under a specific statutory exemption for containers. AR-H2O 18; AR-Tyson 17. The Pennsylvania statute has no application here.

*Brambles Indus.*, 981 S.W.2d at 570 (citing *Sipco, Inc. v. Director of Revenue*, 875 S.W.2d 539 (Mo. 1994)).

Missouri's Revenue Director did not disagree with the *Brambles* court's analysis, but he argued that CHEP's lease transactions did not qualify as sales for resales of packaging materials under the court's precedent because there was no evidence CHEP's customer was entitled to receive valuable consideration from its own customers in exchange for the transferred pallets. *Brambles*, 981 S.W.2d at 570-71. Notably, the Missouri Supreme Court acknowledged that if the evidence did, in fact, establish that P & G was not free to demand consideration in exchange for its own customers' possession and use of the transferred pallets, the sale for resale (or lease for sublease) exemption would not apply. *Id* at 571 (stating that the dispositive question was "did the transfer of the right to use from P & G to its customers occur in return for consideration").

The Revenue Director hinted that CHEP had a separate contractual relationship with each of P & G's customers that negated the existence of a sublease. *Brambles*, 981 S.W.2d at 571. But the record did not include a copy of the pallet rental agreement or any other documentary evidence of the standard terms and conditions of CHEP's pallet rental program. Thus, the Court held that the State failed to present sufficient evidence to defeat CHEP's "prima facie" case: "If there is evidence inconsistent with the

theory put forth by the taxpayer [*i.e.*, that CHEP's customers subleased the pallets to their own customers], the Director did not present it to the AHC, and Chep adduced sufficient evidence to establish a prima facie case that it is entitled to the packaging materials exclusion described in *Sipco*." *Id.*

Here, the undisputed evidence establishes that H2O and Tyson did not, and could not, sublease the pallets to their customers. The rental fees on which they paid sales and use taxes covered the rental periods ending upon the transfer of possession of the pallets to their customers. CHEP reserved the right to demand consideration from the transferee for its possession and use of the transferred pallets. Consistent with *Brambles* and numerous decisions from other jurisdictions that have considered the issue, this Court should hold that CHEP's pallet rental transactions do not qualify as either a purchase-for-resale or lease-for-sublease under the sales and use tax statutes.

**C. The Board Misapplied the Law in Ruling that the Pallet Rental Transactions Qualify as a Wholesale Sale of "Packing Materials" Under WAC 458-20-115.**

The Board also erred in ruling that H2O's and Tyson's pallet rentals qualify as a lease-for-sublease of "packing materials" under WAC 458-20-115 (Rule 115). AR-H2O 18. The Department correctly interpreted and applied its own rule in determining H2O and Tyson leased the pallets for their own use in delivering their products, not for the

purpose of sublease. The Superior Court correctly ruled that the Board misapplied and misinterpreted Rule 115 in reaching a contrary decision, and this Court should affirm.

**1. Rule 115 is an interpretive rule that cannot expand or reduce tax liability.**

The Department has authority to enact “interpretive rules” that give effect to the taxing statutes. *Association of Wash. Bus. v. Dep’t of Revenue*, 155 Wn.2d 430, 445, 120 P.3d 46 (2005). But it is axiomatic that the Department’s rules cannot operate to expand or reduce tax liability. *Coast Pac. Trading, Inc. v. Dep’t of Revenue*, 105 Wn.2d 912, 917-18, 719 P.2d 541 (1986). Thus, a taxpayer cannot seize on rule language to obtain a tax exemption broader than is statutorily authorized. *See, e.g., Tesoro Ref. and Mktg., Inc. v. Dep’t of Revenue*, 164 Wn.2d 310, 323-24, 190 P.3d 310 (2008) (rejecting “plausible interpretation” of language in a rule that would result in an ultra vires tax exemption); *Budget Rent-A-Car of Wash.-Ore., Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 176, 500 P.2d 764 (1972) (rejecting taxpayer’s reading of an interpretive rule that would expand scope of statutory exemption for casual sales); *Mayflower Park Hotel*, 123 Wn. App. at 638 (rejecting taxpayer’s reliance on rule language because “the statute trumps the regulation”). The Board disregarded this principle in concluding that the “plain language” of Rule 115 exempts the

rented pallets from sales and use taxes. AR-H2O 18. As a result, the Board carved out a broader sale for resale (or sublease) exemption for the pallet rentals than the statute authorizes.

**2. The pallet rental transactions are properly viewed as purchases of “returnable” packing materials under Rule 115.**

The Department promulgated Rule 115 to explain how the sales and use taxes apply to purchases of packing materials by product sellers. The rule implements the wholesale sale exemption, RCW 82.04.050(1)(a), and the statutory exemptions applicable to specific uses of packing materials, i.e., RCW 82.08.0282 (containers for food and beverages), RCW 82.08.0311 (materials used in packing produce), and RCW 82.08.820 (pallets used at retail distribution centers).

The main types of wholesale sales are purchases “for the purpose of resale as tangible personal property in the regular course of business without intervening use,” RCW 82.04.050(1)(a)(i), and purchases of items that become an “ingredient or component” of “a new article of tangible personal property” produced for sale by the purchaser. RCW 82.04.050(1)(a)(ii)-(iii).<sup>6</sup> Such purchases are excluded from the definition of “retail sale” because the ultimate purchaser is considered to be the

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<sup>6</sup> The statutory definition of “retail sale” identifies three other subcategories of wholesale sales, each involving a specific type of product not at issue here. *See* RCW 82.04.050(1)(a).

person that actually “uses” and “consumes” the item purchased by the product seller.

The author of the leading treatise on state and local taxes has explained that the key issue in determining whether the sale of packaging materials to a product seller qualifies as a wholesale sale is “whether the taxpayer is *using* the container or packaging in the course of delivering its product or is *reselling* the container or packaging *along with its product.*” See W. Hellerstein & J. Swain, *State Taxation* ¶ 14.06[1] (3d ed. 2017) (emphasis added). In deciding the issue, courts distinguish purchases of returnable or reusable packing materials from those that will become the property of the product seller’s customer along with the goods it sells in the regular course of business.<sup>7</sup>

Consistent with case law from other jurisdictions, Rule 115 draws a distinction between packing materials a product seller intends to sell along with its products from those that must be returned by the product seller’s customer.

The purchase of packing materials a product seller intends to sell along with its products qualifies as a purchase-for-resale because the packing materials are a component of the product sold and become the

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<sup>7</sup> See 4 A.L.R. 4<sup>th</sup> 581 (1981), *Sales or use tax upon containers or packaging materials purchased by manufacturer or processor for use with goods he distributes* (collecting cases from various jurisdictions).

property of the product seller's customer, who may dispose of them as he or she likes. Rule 115(3)(a) (sales of packing materials that will be sold along with the goods they contain are sales for resale).

For example, the plastic bottles and caps H2O purchased for use in manufacturing the beverage products it sold qualified as exempt wholesale purchases of packing materials under Rule 115(3)(a). This is because the plastic bottles and caps became an integral component of the item sold to the ultimate retail customer.

On the other hand, the purchase of packing materials a product seller intends to use in the course of its business operations, including in delivering its products, does not qualify as a purchase-for-resale if the packing materials must be returned by the product seller's customer. Rule 115(3)(b) (sales of containers that will be used to deliver products but must be returned by the customer are retail sales); Rule 115(6)(c) (same with respect to pallets that must be returned by the customer). The sales or use tax applies to the transaction because the product seller consumes the packing materials itself and does not re-sell them.

That is the situation here. The CHEP pallets H2O and Tyson used to deliver their products were not "resold" to either their own customers or to their customers' customers. As previously discussed, each transferee rented the pallets from CHEP, not from another CHEP customer. And the

ultimate retail purchaser of the products sold by pallet pool participants never takes ownership or possession of the pallets. The leased pallets are simply part of the equipment CHEP's customers need to move their products through each stage in the chain of distribution.<sup>8</sup>

The Board correctly rejected H2O's and Tyson's argument that the rented pallets qualified under the "ingredient or component" subcategory of a wholesale sale, RCW 82.04.050(1)(a)(ii). AR-H2O 19; AR-Tyson 28-29. But the Board's misapplication of Rule 115 had the effect of treating the rented pallets as if they were, in fact, ingredients or components of the bottled water and processed beef products sold by H2O and Tyson.

In its summary judgment order, the Board stated that "a product-seller who purchases packing materials that travel with its product and are retained or discarded by the customer has purchased the packing materials for resale." AR-H2O 18. While this is a correct statement of the law, it does not address the situation here, where packing materials are leased by the current user of the materials, and ultimately returned to the owner rather than retained or discarded by the product-seller's customer.

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<sup>8</sup> Before CHEP offered its pallet pooling service, manufacturers and distributors typically entered into barter arrangements in which they traded the pallets they acquired for use in delivering products for an equal number of empty pallets from their customers. In a number of published determinations, the Department has explained that the sales or use tax applies to a manufacturer or distributor's purchase of pallets for use in such barter transactions. *See* Det. No. 01-143, 24 WTD 324 (2005). AR-Tyson 71-76 (manufacturer is the "consumer" of pallets it purchases for use in a pallet exchange arrangement with its customers).

Leased property is by definition “returnable.” Such property cannot be “resold” with the goods they contain. Unlike the goods actually sold, the ultimate purchaser does not obtain title to or ownership of the rented property and is not free to dispose of it as it likes. H2O’s and Tyson’s customers were not, in fact, free to dispose of the pallets. Rather, they were liable to CHEP for their possession and use of the pallets. It makes no sense to treat packing materials that are rented for use in delivering goods as if they were a nonreturnable part of the thing sold.

Rule 115 explains that the use tax “applies to the use of pallets by a manufacturer or seller *where the pallets will not be sold with the product, but are for use in the manufacturing plant or warehouse.*” WAC 458-20-115(5)(c) (emphasis added). That is the case here. The rental fees H2O and Tyson paid to CHEP covered the rental period during which they had possession and use of the pallets for their own business purposes. They had no intention of re-selling the pallets and, in fact, lacked the legal capacity to do so. AR-H2O 118 at ¶ 6; AR-Tyson 99 at ¶6 (“Neither Customer nor any other person is entitled to purchase or sell the Equipment or use, dispose of or otherwise deal with Equipment in any way that is inconsistent with CHEP’s ownership of the Equipment or the terms of this Agreement.”).

The Superior Court correctly ruled that the Board erred in concluding the pallet rentals were exempt from sales tax as sales for resale of “packing materials” under Rule 115.

**3. The Board misapplied Rule 115(6)(c) in ruling the leased pallets are like “nonreturnable” pallets that are “sold with the product.”**

Rule 115 provides an example specifically addressing how the sales and use taxes apply to different types of transactions involving pallets:

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.

WAC 458-20-115(6)(c).

The example describes three types of transactions involving pallets: (1) pallets acquired strictly for use by the manufacturer, (2) “returnable” pallets used in delivering goods to customers, and (3) “nonreturnable” pallets that are “sold with the product.” WAC 458-20-115(6)(c). The rule explains that the first two types of transactions are retail sales, while the third qualifies as a wholesale sale.

The Board misapplied Rule 115(6)(c) in concluding the rented pallets are akin to “nonreturnable” pallets “sold with the product.” AR-H20 30. As a consequence, the Board granted tax immunity to a category of sale transactions the Legislature intended to tax.

The pallet rental fees paid to CHEP are for the rental period during which each manufacturer, distributor, or retailer participating in the pallet pool has possession and use of the pallets for its own purposes. For example, the rental fees Tyson paid CHEP were based on an average cycle time of 56 days per pallet. Its customers only had the shared use of the pallets on the date of delivery, the last day of Tyson’s rental period. Thus, the leased pallets are most similar to the first category of pallets described in Rule 115(6)(c), those used strictly by the manufacturer in its own operations.

The leased pallets also are properly viewed as “returnable” pallets as in the second category. Leased property is by definition “returnable,” albeit not to the seller in this case, but to CHEP. Finally, the pallets are not similar to “nonreturnable” pallets that are “sold with the product.” As previously discussed, CHEP’s customers did not “sell” or “sublease” the pallets to their customers. The customers were required to return the pallets. CHEP never relinquished its ownership of a pallet, not even of lost pallets for which it was paid in full.

The Department correctly interpreted and applied its own rule in concluding the rented pallets are most akin to the first two types of transactions described in Rule 115(6)(c).

## VI. CONCLUSION

The Board misinterpreted and misapplied the purchase-for-resale and lease-for-sublease exemptions in ruling that H2O and Tyson were entitled to a refund of the sales and use taxes they paid on their pallet rental transactions. The undisputed facts in the record establish as a matter of law that H2O's and Tyson's pallet rentals do not qualify as leases "for the purpose of sublease" under RCW 82.04.050(4)(b) or as sales "for the purpose of resale" under RCW 82.04.050(1)(a)(i) and WAC 458-20-115, respectively. The Superior Court correctly reversed the Board's summary judgment orders and correctly remanded these matters to the Board with instructions to grant the Department's motions for summary judgment, to deny H2O's and Tyson's motions for summary judgment, and to dismiss their appeals. This Court should affirm.

RESPECTFULLY SUBMITTED this 10<sup>th</sup> day of August, 2018.

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I certify under penalty of perjury under the laws of the State of  
Washington that the foregoing is true and correct.

DATED this 10<sup>th</sup> day of August, 2018, at Tumwater, WA.

  
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Jamie Falter, Legal Assistant

**ATTORNEY GENERAL'S OFFICE - REVENUE & FINANCE DIVISION**

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