NO. 45223-5-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

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STEVE KLEIN, INC., d/b/a KLEIN HONDA,

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

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# KLEIN HONDA'S OPENING BRIEF

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## I. INTRODUCTION

A vehicle manufacturer has three main avenues open to it when it wishes to stimulate sales. First, it can offer a price reduction to the ultimate consumer in the form of a rebate, coupon, or the like. Second, it can pay the retailer to engage in specified advertising or other sales promotional activities. And third, it can offer a price reduction on goods sold to the retailer in order to give the retailer greater bargaining power. Each of these approaches is treated differently for state tax purposes under published guidance from the Department of Revenue ("Department").

The first approach has no effect on retailer income. The consumer gets the rebate savings, and the retailer gets the same amount it would have received had there been no rebate. The amount of the rebate is part of the selling price and thus taxable under the retailing classification. The second approach requires the retailer to perform extra services and therefore results in increased income to the retailer, taxable at the B&O rate for services. The third approach simply reduces the retailer's cost of inventory and thus is not taxable.

At issue here are amounts received by Steve Klein Inc., d/b/a Klein Honda ("Klein") from American Honda Motors Company ("Honda" or "factory") in the form of cash back for the sales of certain vehicles during specified time periods (referred to herein as "dealer cash"). No additional

services were performed by Klein other than the sale of the vehicle. The sole issue in this case is whether dealer cash is a rebate that reduces the dealer's vehicle cost, in which case it is not taxable, or whether dealer cash is a payment for service.

These distinctions between these types of payments are not new, yet the Department has ignored its own published guidance. The Department has told taxpayers that the test for taxability is whether the retailer is required to provide a service in exchange for the payment or merely sell the product. Excise Tax Advisory ("ETA") 3173.2013 (Jan. 2013). Where, as here, the payment is an incentive to sell more product, the payment simply reduces the retailer's cost and is not taxable.

In the original determination in this matter, the Appeals Division found that, even though Klein performed no additional services in exchange for the rebates it received, merely selling cars was sufficient to make the rebate income from services. AR 227. On executive level appeal, the Director affirmed this holding, stating that dealer cash is a payment for "action." AR 786. Neither addressed the fact that this "action" is already required by the dealer's franchise agreement, dealer cash or no.

The Board of Tax Appeals ("BTA") went one step farther than the Department, holding that, in the case of dealer cash, "a taxpayer can have

taxable income from business activity without providing any specific services." AR 27. [1] This position was not argued by the Department and is contrary to law and to the Department's own longstanding precedents.

## II. ASSIGNMENTS OF ERROR AND ISSUES

The BTA erred as a matter of law in holding that payments of dealer cash by Honda to Klein are subject to B&O tax.

1. Did the BTA err in stating that "the taxpayer can have taxable income from business activity without providing any services"?

2. Did the BTA err in failing to consider whether dealer cash was part of gross income?

3. Can the BTA's result can be upheld on the alternate ground argued by the Department, i.e., that Klein did provide service to Honda in exchange for dealer cash, despite the fact that the BTA made no such finding and no evidence supports it?

## III. STATEMENT OF THE CASE

Klein is an automobile dealership conducting business in Washington State. VTP 31.[2] The taxpayer sells new and used vehicles, provides automobile repair services and sells automobile accessories. *Id.* Klein is a Honda franchisee. *Id.* The relationship is governed by the Sales and Service Agreement between the parties. AR 309.

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[1] The Administrative Record is referred to herein as "AR."
[2] The Verbatim Transcript of Proceedings is referred to herein as "VTP."

Klein and other Honda dealers must purchase vehicles from Honda. AR 314. They have little discretion over their inventory. As Tom Hunt, the general manager at Klein, testified, Honda sends the dealer a presumptive order. VTP 38-39. The dealer may remove vehicles from the order but it cannot add them. *Id.* The order is based on prior sales history. VTP 39. Honda then ships the ordered vehicles to the dealer, issuing an invoice to the dealer for each vehicle when it ships. VTP 41, 43. AR 765, 767, 769. The invoice states a price, and the dealer remits that amount to Honda. *Id.*, VTP 43.

The invoice also states: "Dealer's invoice may not reflect dealer's ultimate vehicle cost given any rebates, allowances, collections, discounts, holdback, incentives, etc." AR 765, 767, 769, VTP 49. These adjustments to the dealer's cost come in several forms. Dealer cash is credit from Honda to Klein that is predicated on the sale of a particular vehicle model during a particular period of time. AR 285. Honda tracks the sale of Honda vehicles by model. On a regular basis, Honda will issue a marketing bulletin to its dealers offering credit back on the sale of certain models within a specified time frame. AR 723 et seq. At the hearing, witness Tom Hunt described the theory behind dealer cash:

> Dealer cash is a means by which American Honda kind of puts more momentum behind a particular vehicle line or model. And

> when I say that, I mean that what they do is they adjust the vehicle's presence in the marketplace, usually as a reaction to competitive action, which typically would be rebates, consumer rebates, and allowing the Honda dealers to remain in a competitive position on that particular model.

VTP 50.

For instance, the bulletin at AR 727 shows that Honda offered the dealers $500 back for each Civic Coupe sold between June 3, 2003 and September 30, 2003. The rebate is contingent only upon selling the designated car within the designated time. *Id.*, AR 285. Klein does not have to do any marketing or advertising or even pass the savings along to customers. At any given time, Honda may offer dealer cash on several models. VTP 51.

Klein does not market cars differently when they carry dealer cash. As Tom Hunt testified:

> In the sales process, it comes down to ultimately being competitive in the marketplace. And that's what the dealer incentives allow the Honda dealer to do, allows Klein Honda to do. If, for example, Toyota puts a significant rebate on a Corolla, and we have a customer cross shopping with a Civic, without the dealer incentive, you can have a $1,000, $1,500 difference in acquisition costs. And having the dealer incentive to the Honda dealer allows us to reprice our cars so they can be competitive. So it essentially allows us to

> lower our price to be competitive in the market.

VTP 52.

There are minimal, if any, additional clerical tasks associated with dealer cash. Klein is already required to report ***all*** sales to Honda on a daily basis by VIN number, using Honda's proprietary network. VTP 53-54, AR 771. Honda computers recognize the specific models from the VIN numbers. On a monthly basis, Honda prepares a miscellaneous credit advice for the dealer showing the amount of dealer cash earned by VIN number. VTP 71, AR 779. The actual credit is made via the balance forward statement that summarizes every transaction between the factory and the dealer for the month, except for new car purchases. AR 772, *see also*, e.g., AR 728. This statement, prepared by Honda, offsets items purchased by the dealer, like parts, against credits for warranty work, holdback, flooring, and dealer cash. AR 772. It is used by the dealer to prepare a monthly reconciliation between it and the factory.

Two other credits that lower the dealer's cost are holdbacks and flooring assistance. The so-called "holdback" refers to a credit that Honda provides for every vehicle. VTP 44. The amount of the credit is actually listed on the invoice in a somewhat obscure fashion. For instance, the invoice at AR 769 shows a MSRP of $17,310.00 and in the same line

shows the number 51930. Adding a decimal point makes this number $519.30 or exactly three percent of the MSRP. This three percent is the holdback paid by Klein, then credited back by Honda.

Similarly, Honda provides a "flooring" credit for each vehicle. It is intended to help offset the dealer's cost of financing inventory. VTP 45. Like the holdback it is paid as a credit on the monthly statement. The Department recognizes that these credits reduce the dealer's purchase price for the vehicle and does not subject them to B&O tax. *See* Auto Dealers Industry Guide, AR 172-74.

There are also payments by Honda to Klein that are taxable payments for services, such as pre-delivery inspection, warranty work, and advertising. VTP 48, 51.

## IV. ARGUMENT

### A. The BTA Did Not Engage in the Proper Analysis.

Car dealers, like other businesses, are taxed on the "gross income of the business," which is defined 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.

When the car dealer sells a vehicle, it engages in the business activity of retailing, requiring it to pay retailing B&O and collect sales tax on the first category of income in the above statute, gross proceeds of sale. *See* RCW 82.04.250. The Department does not contest that Klein Honda properly paid tax on its retailing activity.

Car dealers also have income that comes from the manufacturer for performing services such as preparing the car for sale or doing warranty work, as well as non-taxable rebates from the manufacturer that help the dealer finance its inventory. The Department taxes only the payments that fall within the second category of "gross income" in the statute, "compensation for the rendition of services." This income is a business activity taxable under RCW 82.04.290 as services.

The issue before the BTA was whether dealer cash is a taxable payment for services or whether dealer cash is a payment from the manufacturer for selling a vehicle, in which case, it is simply a non-

taxable rebate on the dealer's wholesale purchase. The BTA[3] did not address this question, instead holding that Klein Honda could have taxable income without providing services, a position that was not argued by the Department. AR 27. The BTA did not state what category of "gross income" dealer cash constituted, nor did it make any factual findings that would support a particular category.

The BTA's decision is fairly terse, but it analyzes dealer cash as if the payment itself were a business activity, instead of considering what Klein Honda does in exchange for the payment and what the proper measure of tax therefore is. The decision ignores the definition of gross income and categorizes dealer cash as "other" business activity, failing to recognize that this does not answer the question of whether dealer cash is part of the gross income of the car dealer.

### B. The Proper Analysis Takes Into Account Both the Nature of the Business Activity and the Measure of Tax.

The proper analysis requires identification of the business activity and, based on that activity, the proper measure of tax. Receiving dealer cash—or any other payment—is not a business activity. Selling cars is a business activity. So are preparing vehicles for sale and servicing and repairing vehicles. Washington law defines a variety of business activities

[3] The BTA is a three person board, but the decision was issued by a single board member, apparently because of an illness and a retirement. AR 18.

and subjects them to varying levels of B&O tax. Besides retailing (RCW 82.04.250) and services (RCW 82.04.290), other business activities include extracting, wholesaling, manufacturing, and other more narrow categories. *See, e.g.*, RCW 82.04.230, RCW 82.04.240, RCW 82.04.260, RCW 82.04.270. The services category includes "other" activities not enumerated, but refers only to other activities, not other payments.

Selling cars falls within the retail classification, for which tax is measured by RCW 82.04.250(1):

> Upon every person engaging within this state in the business of making sales at retail, except persons taxable as retailers under other provisions of this chapter, as to such persons, the amount of tax with respect to such business is equal to the ***gross proceeds of sales*** of the business, multiplied by the rate of 0.471 percent.

Under RCW 82.04.070, "'Gross proceeds of sales' means the value proceeding or accruing from the sale of tangible personal property. . ." In turn, "Value proceeding or accruing" means the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. . ." RCW 82.04.090. Reading these definitions together, "gross proceeds of sales" refers to the consideration paid by the car buyer to the dealer. The "tax applies to everything that is earned, received, paid over to, or acquired by seller from purchaser or

latter's alter ego. *Engine Rebuilders, Inc. v. State*, 66 Wn.2d 147, 401 P.2d 628 (1965). Because dealer cash does not come from the consumer or an agent of the consumer, it does not fit this category.[4]

There is no dispute that Klein Honda has paid B&O tax on the gross proceeds of its sales. Therefore, if dealer cash is a payment for selling cars, dealer cash is not part of the tax base for this business activity, which is measured by sales proceeds from ***customers***.[5] Because the source of dealer cash is the manufacturer from which the dealer purchased the vehicle, it is treated as a reduction in the wholesale price, which has no effect on the dealer's tax.

If, on the other hand, dealer cash were a payment for services (or some other activity) in addition to selling, then RCW 82.04.290(2) would apply:

> (a) Upon every person engaging within this state in any business activity other than or in addition to an activity taxed explicitly under another section in this chapter or subsection (1) or (3) of this section; as to such persons the amount of tax on account of such activities shall be equal to the ***gross income of the business*** multiplied by the rate of 1.5 percent.

[4] If dealer cash were part of the gross proceeds of sale of a vehicle, it would also be subject to retail sales tax, a position the Department has never taken.
[5] The Department concedes this point. *See* Respondent's Brief at 15, n. 8 (CP 59).

> (b) This subsection (2) includes, among others, and without limiting the scope hereof . . . persons engaged in the business of rendering any type of service which does not constitute a "sale at retail" or a "sale at wholesale. . . ."

The tax base for the services and other category of business activity is gross income of the business, which is broader than the retailing tax base and would include dealer cash as "compensation for the rendition of services" if services were in fact rendered. Here the Department appears to be arguing that dealer cash is exchanged for some extra effort to sell a vehicle. But selling cannot be the "other activity" under the services category. Selling is its own category with its own statutory tax base.

Thus, the issue in this case is, what does Klein Honda do in exchange for dealer cash? The Court cannot avoid the issue, as the BTA did, by reciting that most business activity is taxable without articulating the nature of the business activity. If Klein Honda simply sells the car, there is no additional tax. If it performs some sort of additional service, the payment is taxable.

### C. The Department's Own Guidance to Taxpayers Does Not Support the BTA Analysis.

The Department has long published taxpayer guidance that distinguishes between the various payments made by auto manufacturers to dealers. According to the Auto Dealers Industry Guide published by

the Department, "[p]ayments that are bona fide cash discounts taken by the dealer or represent an adjustment to the dealer's purchase price are not subject to tax." AR 174. The Guide distinguishes these reductions in purchase price from payments for services such as inspection and repair.

The Department elaborated on this principle in a recent Excise Tax Advisory[6] directed to grocery stores, which also have various discounts from manufacturers or distributors:

> A *bona fide* discount is, for example, when the distributor grants the grocer either a discount or some form of payment for doing nothing more than purchasing products from the distributor. The Department of Revenue's long standing position is that a discount is not *bona fide* if it is in exchange for a service or benefit, whether this is done pursuant to a written contract, business practice, or oral agreement. Generally a *bona fide* discount negotiated by the grocer upon purchase of the goods does nothing more than encourage the grocer to make sales they were already going to make. However, if a grocer performs a service <u>in addition</u> to selling the goods in exchange for the discount, then the discount is not *bona fide.*

ETA 3173.2013 at 1, dated January 7, 2013 (underline added), (Appendix A). The advisory goes on to use an example that is analogous to dealer cash:

[6] An Excise Tax Advisory is an official interpretive statement by the Department authorized by RCW 34.05.230.

> Examples of discounts that are bona fide when the distributor providing the allowance does not receive a service of benefit from the grocer in return include, but are not limited to . . .[s]can down allowance. An example of a scan down allowance is when a distributor gives the grocer a payment or credit for selling a specific volume of products during a specific timeframe.

*Id.* at 2.

The Department of Revenue's long-standing position is that a discount is not *bona fide* if it is in exchange for a service or benefit, whether this is done pursuant to a written contract, business practice, or oral agreement." ETA 3173.2013. The ETA uses the adjective "long-standing" and cites to Det. No. 98-172E, 18 WTD 387 (1999) (AR 189), which also deals with grocery discounts. It could also have pointed to Det. No. 98-183, 18 WTD 220 (1999), Det. No. 93-078, 12 WTD 599 (1993), or Det. No. 91-263, 11 WTD 263 (1991) which all articulate this principle. *See also* Det. No. 01-080ER (AR 181) (discussing prior cases). The Department's auto dealer-specific guidance also states that bona fide discounts are not taxable, while payments "for providing any services to the manufacturer are subject to B&O tax." AR 174.

The analysis used by the Department for retailers is consistent with case law regarding "business activity" in other contexts. *Peshastin Lumber & Box, Inc. v. State*, 61 Wn.2d 413, 414, 378 P.2d 420 (1963),

involved an effort by the state to impose additional tax on a lumber company because its contracts required it to build logging roads for which it received an allowance. The court disagreed: "There was no showing by the [Department], in other words, that the [taxpayer] was required to do any more under these contracts than it would do, as a prudent operator, if there were no specifications." *Id.* at 417.

This Court should not allow the Department to abandon this analysis simply because the BTA failed to use it. The BTA test, now being championed by the Department, is no test at all. It simply assumes that a manufacturer's ***payment*** itself constitutes a business activity and that all business activity is taxable. Neither the BTA nor the Department even tries to articulate the nature of the business activity. If this is the test, then any rebate given in the form of a payment back to the purchaser is taxable, including categories the Department has long recognized as nontaxable. There is no limiting principle.

### D. If This Court Applies the Proper Test, It Must Reverse the BTA.

If the test for taxability is whether Klein Honda performed extra services in exchange for dealer cash, then this Court must find that dealer cash is not taxable because the BTA did not make a finding of fact that

any services were performed. By omitting such a finding and looking for some new test, the BTA implicitly found that services were not performed.

Even the Department cannot point to specific services. The Appeals Division actually found that the payments made to Klein did not require any additional services in return:

> [I]t is not the case here that Taxpayer must provide an additional service to [Honda] whenever it applies for and receives the cash back incentive. It is not directed to reduce prices. It need not engage in special advertising. It need not even know that the discount exists at the time it sells a vehicle to a consumer.

Determination at 5 (AR 227). At the Superior Court, the Department stated:

> The Board did not specifically decide whether Klein Honda performed a service to earn dealer cash, but under the definition of "gross income of a business" in RCW 82.04.080 it had no need to do so. The terms of the marketing bulletins do require Klein Honda to perform a service, which is selling the identified model of vehicle within the specified time period, properly documenting the sale, and performing a self-audit of the list of qualifying vehicle sales.

Respondent's Brief at 15 (CP 59). Thus, the Department concedes that the only business activity here is selling. Klein Honda sells a vehicle carrying dealer cash in exactly the same way it sells other vehicles and it

documents those sales in the same way it does for other vehicles—by transmitting a Retail Delivery Registration form containing the VIN number to American Honda. VTP 50-53, AR 772. The invoice for the dealer cash payment is actually prepared by American Honda and reflected on the monthly Balance Forward Account Statement, which reconciles all of the payments going back and forth between the dealer and factory during the month. VTP 75, AR 773,780. The self-audit, which testimony showed that Honda "rarely" requested, consisted simply of checking the list of qualifying vehicles prepared by American Honda. VTP 77. The self-audit duplicated the monthly statement reconciliation that Klein Honda performed as a matter of course. VTP 71-72. Thus Klein Honda did nothing extra to obtain dealer cash.

Dealer cash cannot be consideration for the sale because Klein is already required to sell Honda vehicles under the terms of the Sales and Service Agreement ("Dealer Agreement"). AR 309. The purpose of the agreement is stated as: "Dealer and American Honda seek to effectively promote, sell and service Honda Products..." AR 314. Under "Rights Granted to Dealer," the agreement states: "Dealer agrees to . . . resell or lease the Honda Products identified in the Product Attachment." *Id.* Under "Responsibilities Accepted by Dealer," the agreement states

"Dealer . . . agrees to . . . promote, sell and service Honda Products." AR 315.

Section 12 of the Dealer Agreement details the dealer's obligations. The dealer is required to "effectively promote and sell, at retail to end user, Honda Products. AR 322. The dealer agrees that "its sales . . . obligations for Honda Products will be evaluated by American Honda on the basis of such Policies and Procedures containing such reasonable criteria as American Honda may develop from time to time." *Id.* Tom Hunt testified that Honda has adopted a "Dealer Sales Performance Evaluation Policy" that requires that a dealer achieve "Expected Retail Sales" in order to show that it is "effectively promoting and selling" under the terms of the Dealer Agreement. AR 56-57, AR 61. ("In order to meet Dealer's sales performance obligations under the Honda Automobile Sales and Service Agreement, Dealer's Retail Sales musts not be less than Dealer's Expected Retail Sales . . . .") Under Section 20.4.O, the failure to perform sales responsibilities adequately is grounds for termination of the Dealer Agreement. AR 342.

Moreover, the Dealer Agreement requires that Klein follow Honda's marketing strategies. Section 12.9 provides that "[a]ll written directives, suggestions, Policies and Procedures contained in any of its bulletins, manuals, or other written or electronic communication . . . which

are in effect as of the date of the Dealer Agreement or are issued thereafter, will be deemed a part of the requirements of this Article 12.9." AR 324.

The Department's insistence that some "extra" action was taken here conflicts with its determinations in other cases. Det. No. 01-080ER (2002) (unpublished) dealt with payments by an auto manufacturer to a dealer in exchange for maintaining a high customer satisfaction score and selling an automobile. AR 176. The determination found that both these conditions were already required by the franchise agreement and thus the payments were reductions in the wholesale purchase price.

> [W]e agree that the Best Practices program did not require Taxpayer to perform any more duties than already required by the terms of the franchise agreement. . . . WAC 458-20-108(1) ("Rule 108") explains that for state tax purposes, when goods are sold subject to a cash or trade discount, the gross proceeds of the sale and selling price are determined by the "transaction as finally completed." In this case, we find that the manufacturer is holding back 2% of the wholesale price until it confirms that the dealer has met its contractual requirements regarding customer satisfaction. The 2% that the manufacturer returns to the dealer is an adjustment to the purchase price, albeit a delayed adjustment subject to a condition precedent.

AR 180-81. Similarly, Klein is already obligated to sell Honda automobiles. AR 322 ("[I]t is the obligation of the Dealer to effectively promote and sell, at retail to the end user, Honda Products. . .") The original invoice from Honda indicates that the wholesale price is subject to further adjustments. AR 765. When dealer cash is "earned" on the sale of a particular vehicle, Honda issues a credit invoice for that vehicle and credits the amount against parts and other items that Klein has purchased from the factory that month. AR 772-79. The completed transaction reduces the original invoice amount.

Det. No. 91-263, 11 WTD 263 (1991) treats holdback and floor plan protection program payments as reductions in the dealer's purchase price because no services are required in exchange. AR 184-87. In the determination, the amount of flooring credit for a particular vehicle varied according to the number of days the vehicle was inventory, so that the amount could only be determined when the vehicle was sold. In some cases, where the vehicle sold quickly, there might be no flooring credit. The determination expressly stated that the variable character of the flooring credit did not defeat the deduction. AR 187

In Det. No. 98-172E, 18 WTD 387 (1999), the Department dealt with manufacturers' rebates in the grocery store context. AR 189-203. The determination acknowledges that off-invoice purchase allowances and

scan-down purchase allowances are reductions in the retailer's purchase price.[7] AR 191-92. This is true even though the scan-down purchase allowance, like dealer cash, is based on the volume of product sold during a specified time period. The manufacturer issues a "temporary price reduction" on a product and the grocer receives a credit on each unit of that product it sells during the designated time. App. A at 2.

### E. The Department Cannot Distinguish Dealer Cash Based on the Timing of the Payment.

The Department will argue that dealer cash is different from non-taxable rebates because it is not "pre-arranged" at the time the dealer makes its wholesale purchase, citing WAC 458-20-108. However, this rule is targeted to retail, rather than wholesale transactions, and neither the courts nor the Department have interpreted it in the way now suggested by the Department. And in any event, American Honda ***expressly*** makes the original vehicle sale "subject to revision" by subsequent dealer cash offers, as the Department argues is required under the rule.

Rule 108 provides, in relevant part:

> (1) When a contract of sale is made subject to cancellation at the option of one of the parties or to revision in the event the goods sold are defective or if the sale is made subject to cash or trade discount, the gross proceeds actually derived from the contract

[7] The Department's interpretation has since been codified in ETA 3173.2013, discussed in the prior section.

> and the selling price are determined by the transaction as finally completed.
>
> (5) **Discounts.** The selling price of a service or of an article of tangible personal property does not include the amount of bona fide discounts actually taken by the buyer and the amount of such discount may be deducted from gross proceeds of sales providing such amount has been included in the gross amount reported.

The Department has argued that Rule 108 applies here, but the application is by analogy only, in that the rule deals with retail, not wholesale transactions—i.e., how sellers determine the proper tax base for retail sales tax and retailing B&O when they give discounts to retail customers. Even assuming that the rule applies in the wholesale context, it would govern how American Honda recognized income on a sale, not how Klein Honda recognized income.

This distinction is important because the Department has argued that the first sentence requires that the original contract be "subject to" a discount in order for that discount to be used to revise the purchase price to the seller. In many wholesale transactions, however, there is no single "original" contract. Instead, there is a complex, ongoing relationship evidenced in hundreds of different documents.

In the case of Klein Honda, there is a franchise agreement governing the entire relationship, but the purchase of individual vehicles

involves an allocation by American Honda. VTP 38. The vehicle arrives at the same time as an invoice that states a price, but also states that "dealer's invoice may not reflect dealer's ultimate vehicle cost given any rebates, allowance, collection, discounts, holdback, incentives, etc." AR 765. Some of these adjustments to cost, like the holdback and flooring allowances, are known amounts, but the amounts do not necessarily appear on the invoice. *Id.* At the end of each month, American Honda prepares a Balance Forward Account Statement summarizing all the transactions between the dealer and factory during the month. AR 773. This statement reflects the final price adjustments between the parties.

In the context of wholesale relationships, it is unreasonable for the Department to require that all price adjustments be prearranged. Moreover, the first paragraph of Rule 108, containing the "subject to" language, deals with returned merchandise, not just discounts, and allows price adjustments when sellers take back items previously sold. These adjustments are never known in advance.

The courts have previously rejected a similar effort by the Department to unreasonably restrict the application of its rule. In ***Discount Tire Co. v. Dept. of Revenue,*** 121 Wn. App. 513, 85 P.3d 400 (2004), the Department argued that Discount Tire could not adjust the sale price to reflect returns of defective tires under an extended warranty

program because the extended warranty was not in the original contract and was separately priced. The court disagreed:

> It is irrelevant to our analysis whether Discount Tire's extended warranty is a contract separate from or part of the contract for the sale of the original tire. In our view, the Department's reading of WAC 458-20-108 is both strained and contrary to the plain language of the rule and to the rule's obvious purpose to allow retailers credit for sales tax refunded to customers on defective goods. Rather, WAC 458-20-108(3) clearly allows credit for refunds of sales price and tax on defective goods such as the refunds given by Discount Tire under the extended warranty.

*Id.* at 526-27. Here, the similarly "obvious purpose" of the rule is to allow credit for discounts. There is no requirement of prearrangement.

The Department itself does not always require prearrangement. ETA 3173.2013 allows grocers to reduce their cost of goods when they receive "scan-down" payments from manufacturers. The ETA does not define scan-downs, but they are described in Det. No. 98-172E, 18 WTD 387 (1999) (AR 190):

> The manufacturer agreed to pay the taxpayer an allowance based on the volume of the product sold during a specified time period. During this allowance period, the taxpayer temporarily reduced the price of the item (referred to as a temporary price reduction or T.P.R.). The manufacturer based the allowance on the number of items run across the taxpayer's scanner (a "scan-down"). At

> the end of the allowance period, the taxpayer determined the allowance and billed the manufacturer (a "bill-back"). According to the taxpayer, these transactions were generally documented by "deal sheets," "item proposals," or some other form of written agreement.

Thus scan-downs are operationally identical to dealer cash. They are not negotiated up front and taken as a discount on the original purchase. Instead, they are incentives paid by the manufacturer to the retailer for sales in a given time frame pursuant to a document like the marketing bulletins here. AR 724. At the end of the time frame, the parties settle up and the manufacturer issues a credit to the retailer.

The Department's effort to require an exact, prearranged amount in order to have a non-taxable rebate is particularly strange since all that Rule 108 literally requires is that the original sale price is "subject to" revision. Here each invoice indicates that the cost of the vehicle may be revised by rebates or discounts. The express terms of the rule are met.

## V. CONCLUSION

For the above reasons, this Court should reverse the Board of Tax Appeals and order a refund of the tax paid by Klein Honda on dealer cash.

RESPECTFULLY SUBMITTED this 28th day of October, 2013.

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