NO. 45223-5-II

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

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

Appellant,

v.

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Respondent.

KLEIN HONDA'S REPLY BRIEF

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I. INTRODUCTION

In trying to justify taxing dealer cash, the Department of Revenue relies on the same generalizations as the Board of Tax Appeals: all business activities are subject to the B&O tax; Klein Honda is engaged in some sort of unnamed business activity in exchange for dealer cash; therefore dealer cash is taxable. The hole in this logic is that the business activity Klein Honda engages in in exchange for dealer cash is selling vehicles. As the Department's brief admits at page 23, dealer cash is conditioned on "(a) selling the identified model of a vehicle within the specified time period, (b) properly documenting the sale to American Honda, and (c) performing a self-audit of the list of qualifying vehicle sales." These activities are a normal part of selling any vehicle, and the Department admits that Klein Honda properly paid its retailing B&O tax, which is measured by the gross proceeds of sales to customers. RCW 82.04.250.

If the Department is allowed to characterize selling vehicles as a "service" to the manufacturer or distributor, or as an unnamed "other" activity, then all payments by the manufacturer or distributor to a retailer can be similarly characterized and taxed because all retail sales ultimately benefit the manufacturer and distributor as well as the retailer. There is no limiting principle. This scheme destroys the Department's own long-

standing efforts to distinguish between payments for services, like performing warranty work, and rebates or other adjustments in the wholesale price.

Both parties originally asked the Board of Tax Appeals to apply this long-standing test. The Board of Tax Appeals did ***not*** find that dealer cash was a payment for service and tried to justify the tax by using the catch-all "other" activity. This Court should reject the Board's approach because it is analytically bankrupt and provides no guidance to taxpayers or the Department. Using the receipt of cash to infer "other" business activity rather than analyzing the nature of the activity will always result in additional tax whether or not there is taxable business activity.

II. ARGUMENT

A. The B&O Tax Is Imposed on a Specific Business Activity.

The classification of business activity is crucial to Washington's B&O tax scheme. RCW 82.04.220 (1) imposes the B&O tax:

> There is levied and collected from every person that has a substantial nexus with this state a tax for the act or privilege of engaging in business activities. The tax is measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

Thus the tax is levied on "engaging in business activities" and the amount of tax is determined by multiplying the applicable rate against the applicable base. Under this legislative scheme, different activities are taxed at different rates and on different bases. For instance, retailing is taxed at 0.471 percent on the "gross proceeds of sale." (RCW 82.04.250(1)), manufacturing is taxed at 0.484 percent on the "value of products" (RCW 82.04.240) and service and other activity is taxed at 1.5 percent on the "gross income of the business" (RCW 82.04.290(2)). Rather than relying the "other" category, the legislature has painstakingly provided specific rates and bases for extractors (RCW 82.04.230), manufacturers of semiconductors (RCW 82.04.2404), real estate brokers (RCW 82.04.255), sellers of digital goods and services (RCW 82.04.257), food processors, stevedoring companies and travel agents (RCW 82.04.260), radioactive waste cleanup contractors (RCW 82.04.263), resellers of prescription drugs (RCW 82.04.272), and horse race tracks (RCW 82.04.286), to name only a few.

Because the classification determines both the rate and the base, it greatly impacts the amount of tax. For instance, many food processors qualify for a rate of 0.138 percent on the "value of products." If instead a food processor were swept into the "other" category, it would pay 1.5

percent on the "gross income of the business," or over ten times as much on a larger base.

This classification system gives rise to hundreds of administrative rules governing specific business activities and is responsible for much of the complexity of Washington's B&O tax system. *See generally* WAC 458-20. The amount of detail indicates that neither the Legislature nor the Department ever intended that many non-service business activities would be categorized as "other" and subjected to the highest of the state's tax rates on the broadest of its bases.

B. The Only Business Activity Associated With Dealer Cash Is Retailing.

The only activity exchanged for dealer cash is retailing. The Department concedes that the business activity at issue consists of selling vehicles within a given timeframe and documenting the sale. Respondent's Brief at 23. The Department first argues that selling the vehicle is a service to American Honda. The only difference between this activity and selling any other vehicle, however, is that it has to occur within a particular time period. The sale of ***any*** vehicle at ***any*** time benefits American Honda "by moving vehicles out of Klein Honda's inventory and putting Klein Honda in a position to make more wholesale purchases from American Honda." *Id.* The Department makes no effort

to explain what "extra" benefit American Honda receives from Klein Honda when dealer cash is involved. Moreover, the Department is precluded from arguing that a service was exchanged when the Board of Tax Appeals implicitly found to the contrary, holding that that dealer cash was taxable even if no services were provided. *See* AR 27.

The Department's second argument is that selling a particular vehicle during a particular timeframe is "other" business activity. Again, the Department makes no effort to explain how this activity is different from selling vehicles without dealer cash. Klein Honda is obligated by contract to sell Honda vehicles—including vehicles without dealer cash. The benefits that accrue from this contract are not materially different when the factory temporarily offers dealer cash. In fact, all retail sales benefit wholesalers and/or manufacturers in pretty much this same way. The Department is actually arguing that it has the right to categorize the ***same*** retail sale as both "retailing"—because the Department and Klein Honda agree that Klein Honda must pay taxes on the gross proceeds from sales involving dealer cash--and "other." Under this theory, all rebates by manufacturers or distributors are taxable. The Department is overreaching.

The Department points to the fact that the definition of "gross income of a business under RCW 82.04.080 includes "other emoluments

however designated." Respondent's brief at 22, 24-28. This argument does not save the Department's position for two reasons. First, the activity in question must be classified as "service or other" in order to use gross income of the business as the tax base. If the activity in question is retailing, the proper base is gross proceeds of sale, which even the Department admits does not include dealer cash. Respondent's Brief at 27. Second, relying on "other emoluments" paid for "other" activity as a base for taxation is a ridiculously vague hook (within a hugely detailed tax scheme) for taxing something as commonplace as a manufacturer's incentive payment.[1] If the Legislature had intended to tax manufacturers' incentives even when no service was performed in exchange, it would have said so.

Though the Department argues to the contrary, *Peshastin Lumber & Box, Inc. v. State of Washington*, 61 Wn.2d 413, 378 P.2d 420 (1963) is instructive. Peshastin Lumber built roads and cut trees on Forest Service land, as part of its purchase of lumber. The Forest Service calculated the amount Peshastin was required to pay by subtracting the cost of road building from the appraised value of the lumber, resulting in much lower price for Peshastin, in effect, paying Peshastin the cost of building the

[1] The Department's assertion that interest earned by banks is taxed in this way is false. Banks are taxed under RCW 82.04.290(2) as service providers not "other" and the definition of gross income of a business expressly includes "interest."

roads. Peshastin indisputably received value from the road building allowance and the Department sought to impute income to Peshastin for this business activity. At issue was the definition of "gross income of a business" including "other emoluments however designated." The court did not seize on the catch-all language to sustain the tax, but instead analyzed the form and substance of the transaction, deciding that the activity was buying lumber and not road building, even though roads were built.

C. Dealer Cash Is Properly Considered a Rebate.

Both the form and substance of the dealer cash transaction support the fact that dealer cash is a rebate or adjustment to the dealer's purchase price. There is no statutory definition of "rebate" within the tax code, but the dictionary defines "rebate" as a "return of part of a payment." Webster's Ninth New Collegiate Dictionary 981 (1987). This simple definition is easily satisfied. Klein Honda indisputably pays American Honda for the vehicles that subsequently qualify for dealer cash. When Klein Honda notifies American Honda that it has sold a particular vehicle (identified by VIN) that qualifies for dealer cash, American Honda generates a statement showing a credit for that vehicle. The Department argues Klein Honda's own accounting expert testified that this was not relevant. Respondent's Brief at 32. But the testimony the Department

uses does not support that conclusion. The Department asked Klein Honda's accounting witness whether a reference to the VIN on an invoice ***required*** that the invoice payment be treated as a reduction in the wholesale purchase price. VTP 126-27. The witness correctly stated that it depended on the nature of the payment. *Id.* That answer in no way negates the fact that dealer cash applies to a specific vehicle and is a factor to be considered in determining whether a payment is a true rebate, in the same way that holdback and floor plan assistance are reported and received by the dealer.

The other factor cited by the expert in determining whether a payment is a rebate is whether additional services were performed in exchange for the payment. *Id.* As discussed above, no additional services were performed beyond selling the vehicle.

The Department's main argument for not considering dealer cash to be a rebate is that it is not prearranged. However, nothing in the definition of a rebate requires prearrangement. And even a cursory consideration of common forms of rebate show that some are prearranged and others are not. Rebates based on sales volume cannot be determined prior to knowing the sales volume. Similarly, rebates based on product defects are not prearranged. Rebates based on prompt payment are

normally advertised or would not achieve their purpose. Appellant's Opening Brief fully discusses this issue at pages 21 to 25.

The Department also ignores the fact that adjustments to the purchase price, such as dealer cash, are contemplated at the time Klein Honda purchases a vehicle from the factory. The Department repeatedly states that the wholesale transaction is not made "subject to" a cash or trade discount for dealer cash. Respondent's brief at 34, 44. This assertion is contradicted by the evidence. Every vehicle arrives at the dealer an invoice that states the wholesale purchase 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.* Thus the original wholesale invoice clearly provides that incentive payments like dealer cash may lower the "ultimate vehicle cost" to the dealer.

Neither is the discussion of accounting methods determinative. Respondent's Brief at 14-15. As ETA 3173.2013 states, general ledger entries are, at most, indicators of whether a service is being performed in exchange for a payment. Where, as here, the other factors all clearly indicate that no service is being performed, it is not important whether the

taxpayer places the dealer cash on a miscellaneous income line or not. This is particularly true where there was expert testimony that the factory statement used by the American Honda does not reflect a presentation that is consistent with GAAP, and that, if financial statements were presented in accordance with GAAP, dealer cash would be reported as a reduction of inventory cost, not as other income. VTP 105.

D. The Department's Position Here Is At Odds With Its Own Guidance to Taxpayers.

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. Yet the gist of the Department's argument here is that all payments must be subject to tax.

The Department differentiated taxable payments from non-taxable ones in a 2013 Excise Tax Advisory[2] 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

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

> 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 in addition 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 (Appendix A to Klein Honda's Opening Brief). The Department here emphasizes that a non-taxable payment must be "for doing nothing more than purchasing products from the distributor." Respondent's brief at 35. Yet the Department fails to recognize that the ETA analysis differs from its own. The ETA focuses on whether additional services are performed in exchange for a payment from a distributor to a retailers and it does not discuss or endorse the BTA's theory that no services are necessary. Once the proper test is applied, it is evident that dealer cash is not taxable. Dealer cash is an incentive payment from the distributor to give the dealer more latitude in pricing and selling a vehicle, and its whole purpose is to move inventory and allow the distributor to sell more vehicles to the dealer. Like the grocer discussed in the ETA, the vehicle dealer does nothing other than sell more product at retail in order to buy more product at wholesale.

III. CONCLUSION

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

RESPECTFULLY SUBMITTED this 10th day of January, 2014.

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Declared under penalty of perjury under the laws of the state of Washington dated at Seattle, Washington this 10th day of January, 2014.

Elaine Huckabee