Cite as 5 WTD 161 (1988)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petitions For Correction of Assessments of)		D E T E R M I N A T I O N
	)	No. 88-151
	)	
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .
	)	
	)	
and	)	
	)	
	)	Registration No. . . .
. . .	)	Tax Assessment No. . . .
	)	

[1] **RULE 107:** B&O AND RETAIL SALES TAX -- EXTENDED AUTOMOBILE WARRANTIES -- IDENTIFICATION OF SELLER. An automobile dealer who sells extended warranty coverage at the same time he or she sells the auto to which the warranty applies is taxable under Retailing B&O and retail sales tax on gross income from the warranty where the dealer is contractually bound to his customer to make the warranty repairs. The fact that the dealer is compensated for the warranty expenses by an insurance company does not make the latter the seller of the warranty.

[2] **RULE 107 AND MISCELLANEOUS:** B&O AND RETAIL SALES TAX -- ESTOPPEL -- INCORRECT LETTER ADVICE -- SUBSEQUENT RULE AMENDMENT -- EFFECT OF. Where Department gave incorrect letter advice and a subsequent rule amendment clarified the subject of the advice, the Department is not bound by the incorrect advice, at least from the effective date of the amendment forward.

[3] **RULE 107:** RETAIL SALES TAX -- EXTENDED AUTOMOBILE WARRANTIES -- DEDUCTIBLE AMOUNTS -- REIMBURSEMENTS TO DEALERS FOR WARRANTY REPAIRS. Income from auto dealer sales of extended warranties, deductible amounts paid by customers, and compensation by insurance companies to dealers for warranty repairs are all subject to retail sales tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

TAXPAYER REPRESENTED BY: . . .
. . .
. . .
. . .

Present at the hearing in this matter with the consent of both taxpayers were:
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. . .
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DATE OF HEARING: August 19, 1987

NATURE OF ACTION:

Petitions by two auto dealers protesting the reclassification of income from the sales of extended warranties. Taxpayers had reported the income under the Service & Other Activities classification. The Department reclassified it to Retailing B&O and subjected it to retail sales tax.

FACTS AND ISSUES:

Dressel, A.L.J. -- . . . (taxpayer I) and . . . (taxpayer II), collectively referred to as taxpayers, are automobile dealers. The books and records of taxpayer I were examined by the Department of Revenue (Department) for the period January 1, 1983 through September 30, 1986. As a result the above referenced tax assessment was issued in the amount of $ . . . which includes interest. The books and records of taxpayer II were examined for the same period. As a result the second above referenced tax assessment was issued for excise tax and

interest totaling $ . . . . Both taxpayers are now appealing portions of said assessments and have agreed that their individual cases be consolidated inasmuch as both involve the same single issue.

The taxpayers offer to their customers extended warranty coverage on the automobiles they sell. This coverage is in addition to the manufacturer's warranty which is included in the purchase price of a new automobile. Generally speaking, the extended warranty picks up where the manufacturer's warranty leaves off. There is a charge for the extended coverage. In fact this charge or income is the sole subject being debated in this appeal. The warranty fee is normally added on to the purchase price of or down payment on the automobile and a single check is written by the customer for both. After receipt the taxpayers deposit the money from the check into two separate bank accounts. Funds for the automobile per se go into one account and funds for the extended warranty coverage go into the other. Of the warranty income the taxpayers retain up to 40%[1] as their "commission" for selling the coverage, and then forward the balance to . . . , an insurance broker. The taxpayers have reported the income they retain under the Service & Other Activities classification for purposes of the state business and occupation (B&O) tax.

In its audits of these taxpayers the Department has reclassified this income to Retailing B&O subject to retail sales tax. In so doing it is saying, in effect, that the income from the extended warranty sales is part of the consideration paid for tangible personal property (the automobile) so is part of a retail sale transaction and, thus, subject to Retailing B&O and retail sales tax.

It is the position of the taxpayers that the warranty portion of the transaction is separable from that attributable to the automobile per se. The taxpayers contend that under WAC 458-20-107 (Rule 107) they are selling the warranty coverage on behalf of a third party, the insurance broker, and, therefore, the taxpayers are to be B&O taxed only on the commissions they retain. Further, because they themselves are not selling the warranty coverage, such sales are not of the retail variety and are not subject to retail sales tax.

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[1] The figure varies according to amount for which the extended warranty coverage is sold.

Additionally, the taxpayers have posed an estoppel argument. They cite an April 7, 1981 letter from the Department's Interpretation and Appeals Division which states that for this type of extended warranty coverage where a third party insurer is involved, automobile dealers need only report the commissions they retain and at the Service B&O rate. The representatives of the insurance broker, which representatives attended the hearing of this appeal, also brought up a meeting between Department officials, the Washington State Auto Dealers Association, and the same insurance broker, at which they allege the Department advised that even after the February 6, 1986 amendment to Rule 107, dealers were to report Service B&O on commissions only. The date of this meeting was February 11, 1986. The insurance broker then relayed this instruction to a number of auto dealers through which the broker's extended warranty coverage was sold. Based on this, the taxpayers suggest that if sales of these extended warranties are, in fact, determined to be retail sales, such construction should be on a prospective only basis because reliance was placed by the broker and the dealers on the Department's allegedly errant instructions.

The issues, then, are two in number. (1) Is the sale by automobile dealers of an extended automobile warranty in which a third party insurance company is involved a retail sale? (2) If so, is the Department estopped from imposing Retailing B&O and retail sales tax on such transactions because of erroneous advice imparted to the taxpayers and other automobile and insurance industry representatives?

Before launching into our discussion of the issues, we should point out that in both assessments, the warranty income was reclassified only as of the effective date of the amendment to Rule 107 or February 6, 1986. Only such income from that point to the end of the audit periods, September 30, 1986, is at issue. Also, the reclassification of income resulted in tax being asserted against the full selling price of the warranties, not just on the commissions retained by the dealers.

DISCUSSION:

Prior to its amendment effective February 6, 1986, Rule 107 read in part:

> WARRANTY OR SERVICE CONTRACTS. When a warranty or service contract is sold along with a sale of tangible personal property the entire charge is

taxable as gross proceeds from the sale of tangible personal property. However, the sale of a warranty or service contract by itself is a transaction subject to business tax under the service classification upon gross income therefrom. A person performing repair work pursuant to a warranty or service contract is taxable as a retailer or wholesaler upon amounts received for performance of such work, including amounts received from another who may have sold the warranty or service contract and amounts received from the owner of the property. If the repairman himself issued the warranty or service contract, he is taxable as a retailer or wholesaler upon any additional amounts received at the time repair work is done. The sale of a maintenance contract which calls for regular or periodic maintenance, repair, or adjustment of tangible personal property is taxable as a retail or wholesale sale, as the case may be.

After its amendment on February 6, 1986, Rule 107 reads in pertinent part:

WARRANTIES, MAINTENANCE AGREEMENTS, AND SERVICE CONTRACTS

For purposes of this rule, the following definitions apply:

Warranties, sometimes referred to as guarantees, are agreements which call for the replacement or repair of tangible personal property with no additional charge for parts or labor, or both, based upon the happening of some unforeseen occurrence, e.g., the property breaks down.

. . .

Manufacturer's warranties are generally included within the retail selling price of the property and no additional charge is made. However, when any additional charge is made for any warranty protecting tangible personal property sold, additional tax liability is incurred depending on how the warranty is sold. *If it is sold by the retail seller of the property protected by the warranty and concomitant with the sale of that property, the entire charge, including the charge for the warranty, is subject to retailing business*

> *tax and retail sales tax.* This is so even though the warranty charge may be separately billed or separately itemized on any billing. Such warranty sales are deemed to be "for labor and services rendered in respect to . . . installing, repairing, cleaning, altering, imprinting, or improving tangible personal property of or for consumers . . ." and therefor they are "retail sales" under RCW 82.04.050.
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> *Warranties which are sold by any person who was not the seller of the property protected by the warranty or which are purchased subsequent to and distinct from the original warranty purchased concomitant with the property,* are deemed to be services rather than retail sales. Charges for such warranties are subject to the service business tax and are not subject to retail sales tax. (Emphasis added.)

[1] In not reclassifying extended warranty income for periods prior to February 6, 1986, the Department is apparently taking the position that prior to the rule amendment it was either correct for auto dealers to report Service B&O on commissions only or the Rule was ambiguous enough that it would be unfair to tax these transactions as retail sales, but with the Rule amendment the ambiguity was eliminated and thereafter the transactions are clearly retail sales to be taxed accordingly.

All warranties at issue were sold by automobile dealers at the same time that the automobiles covered by the warranties were sold. Indeed, the customers generally wrote one check to their auto dealer which included amounts for both the car and the warranty. Under such circumstances it seems reasonable to conclude that the dealer is the seller of the warranty. If that is the case, because the warranty was sold concomitantly with the property it purports to cover, under Rule 107 the charge for the warranty is subject to Retailing B&O and retail sales tax.

The taxpayers, however, contend that they were not really the sellers of the warranties and that they were simply acting as agents for the real sellers, the insurance brokers. Some further explanation of the relationship of the various parties involved in these transactions is appropriate before further discussion of who will be recognized as the seller of the warranties. When the purchaser of an automobile opts for the extended warranty coverage, he or she signs a four page document titled "Mechanical Breakdown Coverage Declarations."

This document is both the application for and contract of extended warranty coverage. It identifies the person(s) and automobile which are covered under the extended warranty. It tells which mechanical breakdowns are covered, which deductibles apply, if any, the number of miles or months for which the coverage is good, what is not covered, what routine maintenance must be performed as a condition of coverage, cancellation provisions, how to submit a claim, etc. Of particular note is the section of the contract on definitions. "You," as used in the contract, is defined as the purchaser of the service contract (the automobile buyer). "We" is identified as "the dealer who sold you this service contract."[2] Throughout the contract the party named as obligated to provide protection and make automobile repairs is "we" or the dealer who sold the contract. . . . (the broker) is identified in the contract as the "administrator." At the end of the contract this statement is written: "This vehicle service contract is not a policy of insurance. However, we have an insurance policy in effect with: . . . Insurance Co. . . ."

At the hearing a copy of that policy was provided. It states that . . . (the insurance company) will pay all sums the dealer becomes legally obligated to pay the customer under the terms of an "approved service contract." It was explained that when a dealer effects repairs for a covered individual it bills the insurance company through the broker. The dealer is, in turn, reimbursed for the total cost of the repair including sales tax. Because the costs of warranty repairs are ultimately paid for by the insurance company, the taxpayer-dealers perceive that they are not at risk and that any contractual relationship is between the customer and the broker or between the customer and the insurance company.

The critical factor in determining who the seller of such warranty coverage is, is the identification of the party who has the legal responsibility for making the mechanical repairs. The Department takes the position, and we agree, that if the dealer was primarily and legally obligated to the warranty buyer, it had sold its own warranty with the property warranted and charges for the warranty were subject to

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[2] At the hearing the insurance broker advised that "we" as it appears on the contract would be defined as the insurance company were it not for insurance regulations which would then require dealer employees who sold the warranty coverage to be licensed as insurance agents.

Retailing B&O and retail sales tax. Here, the only two parties directly obligated under the Mechanical Breakdown Coverage Declarations are the auto/warranty buyer and the dealer. The latter's obligation is to make the covered repairs for the customer. While the broker and the insurance company may be obligated to the dealer, the party that contracts with the customer is the dealer. If the dealer declines to effect a covered repair, the customer has a plausible legal claim against the dealer regardless of the fact that compensation is ultimately passed down from the insurance company. There is a relationship of privity between the customer and the dealer as contracting parties that does not exist between the customer and the broker and/or insurance company. If "we" was identified in the contract as the broker and/or insurance co., some credence could be given to the taxpayer's argument that it was acting in an agency capacity. That is not the situation, however, so we conclude that the taxpayers have sold their own warranties the gross income from which is subject to Retailing B&O and retail sales tax.

We next address the question of estoppel. Quoting with approval Wasem's Inc. v. State, 63 Wn.2d 67 (1963), the Washington Supreme Court said in Kitsap-Mason Dairymen's Assoc. v. Wa. State Tax Commission, 77 Wn.2d 825 (1970):

> The doctrine of estoppel will not be lightly invoked against the state to deprive it of the power to collect taxes. The state cannot be estopped by unauthorized acts, admissions, or conduct of its officers.

It is recognized that at least on one occasion, incorrect information was dispensed by the Department on the subject of automobile extended warranties. Specifically, we refer to the April 7, 1981 letter from the Department's Interpretation and Appeals section to attorneys representing the insurance broker. The amendment to Rule 107 which become effective February 6, 1986 provides clear notice, however, that the sale of extended warranties made concomitant with the sale of an automobile is regarded as a retail sale. The applicable language of the rule as amended is repeated below:

WARRANTIES, MAINTENANCE AGREEMENTS, AND SERVICE CONTRACTS

> For purposes of this rule, the following definitions apply:

> Warranties, sometimes referred to as guarantees, are agreements which call for the replacement or repair of tangible personal property with no additional charge for parts or labor, or both, based upon the happening of some unforeseen occurrence, e.g., the property breaks down.
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> . . .
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> Manufacturer's warranties are generally included within the retail selling price of the property and no additional charge is made. However, when any additional charge is made for any warranty protecting tangible personal property sold, additional tax liability is incurred depending on how the warranty is sold. *If it is sold by the retail seller of the property protected by the warranty and concomitant with the sale of that property, the entire charge, including the charge for the warranty, is subject to retailing business tax and retail sales tax.* This is so even though the warranty charge may be separately billed or separately itemized on any billing. Such warranty sales are deemed to be "for labor and services rendered in respect to . . . installing, repairing, cleaning, altering, imprinting, or improving tangible personal property of or for consumers . . ." and therefor they are "retail sales" under RCW 82.04.050 . . . (Emphasis ours.)

The underlined portion of the rule corresponds to the transactions in question in which we have previously determined that the auto dealers are the sellers of the extended warranties. It is difficult to conceive of how that language could be construed to the effect that Service B&O is applicable and only on commission amounts retained by a selling dealer. If the same person sells both the automobile and the warranty at the same time, the entire transaction is considered a retail sale. It is therefore, our ruling that any misleading or estoppel effect of the Department's April 7, 1981 letter was eliminated by the amended rule and that, thereafter, all taxpayers were put on notice as to the correct manner in which income from extended warranty sales is to be reported for state excise tax purposes.

Furthermore, as to notice it is to be observed that Rule 107 was amended pursuant to the Washington Administrative Procedure Act, Title 34 RCW. A public hearing was held, prior

to the effective date of the amendment, at which interested taxpayers were given the opportunity to express their views on the proposed rule amendments. Notice of the hearing was published in conformance with the Act. The specific additions and/or changes to the portion of the rule that pertains to extended warranties were discussed. It is assumed that the taxpayers were not present at the hearing. Had they been, they would have received an oral explanation as well of the Department's intent vis a vis extended warranties in addition to their being permitted to speak on the rule changes. The burden to keep current as to their responsibilities under the Revenue Act is placed on each taxpayer. ETB 310.32.101.230 (. . .). Had the two before us here attended that hearing, they likely would have helped themselves in meeting that burden.

In closing our discussion of estoppel, we note that the taxpayers raised the allegation of inconsistent advice emanating from the February 11, 1986 meeting mentioned in the first section of this Determination. After reviewing the related correspondence between the Washington Auto Dealer's Association and the Department which followed that meeting, we conclude that any seemingly inconsistent advice from the Department was the result of not getting all the facts from the association. Only after receiving a copy of the subject warranty agreement between the dealer and customer were all the particulars of the true warranty arrangement made plain to the Department and, from that point, its advice was consistent and completely in line with the amended version of Rule 107.

Lastly, we will address an ancillary question raised by taxpayer II. Taxpayer II has suggested that if "Mechanical Breakdown Insurance premiums" are subject to retail sales tax, then either compensation received from the insurance broker for warranty repairs made by a dealer should be exempt of sales tax or any deductible paid by the customer ought to be exempt or both ought to be exempt of retail sales tax. The latter portion of this question is addressed specifically in the current version of Rule 107 which states in part:

> In the cases of both warranties and maintenance agreements, any actual additional charge made to the consumer because of the providing of materials or the performance of actual labor pursuant to such agreements is separately taxable under the retailing business tax and retail sales tax. *This includes so-called "deductible" amounts not covered by the warranty or service agreement.* (Emphasis added.)

[3] Clearly, deductibles paid by customers are subject to retail sales tax. So are charges submitted by repairing dealers to the insurance broker or company for warranty repairs. Such charges are deemed to be for the installing, repairing, cleaning, altering, etc., of tangible personal property which activity is defined as a retail sale under RCW 82.04.050(2). The fact that there may be some duplication in that the customer has paid a premium for extended warranty coverage which premium has also been subjected to retail sales tax, does not mean that the costs for parts and labor recovered by the repairing dealer are not also subject to retail sales tax. Those charges are deemed to be a retail sale transaction between the dealer and the insurance company separate from the retail sale transaction between the customer and the dealer under which the customer obtained the extended warranty coverage. There are two retail sales and retail sales tax is due on each per RCW 82.08.020. Parts acquired by dealers for purposes of effecting the warranty repairs are purchased for resale, and the dealer's purchase of same from suppliers is exempt of sales tax if a properly executed resale certificate is tendered to the supplier. WAC 458-20-102 (Rule 102).

The position of the Department on the estoppel issue is as above-stated in Discussion section [2]. While the undersigned does not necessarily agree with that position, nevertheless, it stands as the law of this case.

DECISION AND DISPOSITION:

The taxpayers' petitions are denied.

DATED this 9th day of March 1988.