Cite as Det. No. 00-004, 20 WTD 348 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 00-004
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

Rule 257; RCW 82.04.190(2)(a), RCW 82.04.290, RCW 82.12.020: USE TAX -- EXTENDED WARRANTIES. A retail tire dealer is subject to use tax on new replacement tires it provides customers who return defective tires pursuant to extended warranties the dealer sold to the customers.

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.

NATURE OF ACTION:

A retail tire dealer (the taxpayer) protests the assessment of use tax on new replacement tires it provides its customers who return defective tires pursuant to an extended warranty sold by the taxpayer.[1]

FACTS:

De Luca, A.L.J. – The taxpayer is foreign corporation with retail tires stores in numerous states, including the state of Washington. The taxpayer sells, installs, and repairs automobile tires. When the taxpayer purchases tires for sale to customers, it issues resale certificates to its suppliers and does not pay Washington sales tax. When the taxpayer buys parts, such as valves, patches, etc. for use in repairing tires, it pays sales tax or use tax on those parts. When the taxpayer sells tires to a customer in Washington, the taxpayer collects sales tax on the entire purchase price, which includes the value of the manufacturer's warranty. The taxpayer remits the sales tax to the state of Washington.

For a separate charge, the taxpayer offers its customers the right to purchase a "Certificate for Free Repair, Refund, or Replacement" when they purchase tires. In effect, this certificate is an extended warranty above and beyond a manufacturer's limited warranty. The certificate entitles a customer whose tire has been damaged to present the damaged tire for a repair if the tire is

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

repairable, or obtain a refund of the full purchase price and the retail sales tax if it is not repairable. If the tire can be repaired in the taxpayer's opinion, the taxpayer will repair it free of charge. The taxpayer pays sales tax or use tax without protest on the parts it uses on, or incorporates in, the repair of tires. If a tire is not repairable, according to the certificate, the customer can take the refund and leave the premises. The certificate also states "At the election of the purchaser, [the taxpayer] will sell a replacement tire to the purchaser at the same price paid for the damaged tire, plus the required sales tax."

When non-repairable tires were returned, the taxpayer took a credit for the purchase price of the original tire from its gross proceeds of sale. If the customer opted for a replacement tire, the taxpayer states the invoice reflected that the taxpayer charged the retail sales price of the new tire, plus sales tax, while allowing a credit in the amount of the refunded sales price and sales tax for the returned tire. The Audit Division of the Department of Revenue (the Department) found the taxpayer offset the price of the replacement tire with a credit for the damaged tire, with the invoices generally showing both the credit for the damaged tire and the sales price of the replacement tire as zeros. Customers rarely took refunds, but nearly always opted for replacement tires.

The Audit Division reviewed the taxpayer's books and records for the period January 1, 1994 though December 31, 1997. Document No. FY. . ./Audit No. . . . . Only Schedule 4 of the audit report is in dispute. In that schedule, the Audit Division assessed $. . . in use tax on the taxpayer's purchase price of the replacement tires the taxpayer provided to customers pursuant to the extended warranties. Citing the Department's rule on warranties, WAC 458-20-257 (Rule 257), the Audit Division stated when a product is repaired or replaced by a warrantor under an extended warranty, the warrantor (the taxpayer in this case) is the consumer of the repair parts or replacement product. In such cases, the repair parts or replacement products are subject to use tax as measured by the warrantor's costs.

The Audit Division instructed the taxpayer for future reporting periods not to take a credit for retailing B&O tax and retail sales tax purposes in those rare instances when customers accepted cash refunds instead of replacement tires. The Audit Division found the refunds were not bona fide refunds for defective goods pursuant to WAC 458-20-108 (Rule 108). Rather, the Audit Division determined the refunds were in the nature of insurance payments in case of tire failure because customers purchased the extended warranties for a fee at the times of the original tire purchases.

TAXPAYER'S EXCEPTIONS:

The taxpayer makes a three-prong argument why it believes it is not subject to use tax on the cost of the replacement tires. One, the taxpayer asserts it is not subject to use tax on the sale of tires pursuant to the extended warranty certificates it sold. Two, the taxpayer claims it is entitled to the deduction from the selling price provided by Rule 108 for refunds and credits given its customers pursuant to the certificate. Three, the taxpayer argues the Department has unlawfully double-taxed these transactions because the taxpayer has collected and remitted sales tax on the entire selling price, yet the Department has assessed use tax on the taxpayer's costs of purchasing the tires.

We will present the taxpayer's argument in more detail. The taxpayer contends the issue is the sale of a new tire pursuant to its extended warranty. The taxpayer argues no taxable event occurs until after a customer receives a refund under the extended warranty and decides to buy a new tire. The taxpayer believes the taxable event is the purchase of the replacement tire by the customer that falls squarely within statutory and regulatory definitions of "retail sale" found in RCW 82.04.020, .040, and .050, rather than any taxable use of the tire by the taxpayer. The taxpayer argues it is not a "consumer" of tires either under the statutory definition of that term as found in RCW 82.04.190, or under RCW 82.12.020 and WAC 458-20-178 (Rule 178), which impose use tax on consumers. Rather, the taxpayer states all of the tires it purchased were for resale in the ordinary course of business, including those tires it sold pursuant to its extended warranties.

By contrast, the taxpayer concedes when it makes a repair to a tire pursuant to the extended warranty, it is the consumer under both RCW 82.04.190 and Rule 257. Accordingly, the taxpayer pays sales tax or use tax on the parts it purchases to use for repairs pursuant to the extended warranty. However, the taxpayer contends the Audit Division has misconstrued Rule 257 because the rule does not dictate that the refund of the purchase price and sales tax, along with the subsequent purchase of a new tire pursuant to the extended warranty, constitutes a taxable use by the taxpayer. To the extent the rule may be ambiguous, the taxpayer urges the ambiguity must be construed in the taxpayer's favor. The taxpayer insists even if the rule required imposing use tax, the result would be invalid because it is inconsistent with the above-referenced statutory scheme of retailing.

Furthermore, the taxpayer argues Rule 257(3)(b)(ii) provides that when a repair is made by the warrantor under its own separately-stated warranty, the value of the labor and/or parts provided is not a retail sale and sales tax is not collected. Consistently, Rule 257(4)(b)(i) provides when a warrantor makes a repair under a separately-stated warranty, the warrantor is the consumer of the parts and the parts are subject to use tax as measured by the warrantor's costs. The taxpayer declares these two provisions address only "repairs." On the other hand, the taxpayer notes, Rule 257(1)(a) defines "warranties" as agreements that call for the replacement or repair of tangible personal property. Thus, the taxpayer argues the limitation to repair in Rule 257(3)(b)(ii) and (4)(b)(i) must be presumed deliberate rather than inadvertent. The taxpayer believes this limitation supports its position. That is, when a warrantor repairs merchandise

pursuant to an extended warranty, Rule 257 deems the warrantor the consumer, or user, of parts used in the repair. However, when a customer elects to use a refund to purchase a new tire, there is no taxable use by the taxpayer. Rather, the taxpayer makes a taxable retail sale. The taxpayer concludes Rule 257 simply does not address use tax or sales tax on new replacement goods rather then repairs of goods.

The taxpayer next argues it is entitled to the deduction provided by Rule 108 for refunds and credits given its customers pursuant to its extended warranty. The taxpayer contends when a customer returns a defective tire for a refund under the extended warranty, the transaction falls squarely within Rule 108 and the taxpayer believes it is entitled to deduct an amount equal to the tire's selling price from its gross proceeds. The taxpayer states Rule 108 is unambiguous and absolute and the taxpayer asserts it meets the rule's requirements because the tires returned under the extended warranty are returned within a guarantee period established by contract, and the purchase price and sales tax are refunded. The taxpayer claims Rule 108 does not distinguish between a manufacturer's warranty and a retailer's extended warranty for bona fide refunds, credits, or allowances for the return of defective goods. In either case, the taxpayer argues the rule allows for a deduction of the refund in computing its tax liability. In sum, the taxpayer declares simply because Rule 257 applies to a sale of an extended warranty does not preclude the provisions of Rule 108 from applying if the goods are returned.

Finally, the taxpayer contends the Department has unlawfully double-taxed these transactions. The taxpayer notes the use tax and the sales tax are complimentary. The use tax is intended to tax the use of tangible personal property by a consumer when the sale of that property has not been subject to retail sales tax. The taxpayer states the sale of a new tire to a customer pursuant to the extended warranty constitutes one taxable sale, and not a sale and also a use of the same tire by the taxpayer. The taxpayer argues it collects and remits sales tax on the sale of the tire to a customer, but the taxpayer should not also be liable for use tax on its cost of that tire.

ISSUES:

Upon return of a defective tire pursuant to an extended warranty sold by the taxpayer to a customer, is the taxpayer the consumer of the replacement tire and subject to use tax on the cost of the tire?

Upon return of a defective tire pursuant to an extended warranty sold by the taxpayer to a customer, may the taxpayer deduct the refund or credit given from the tire's selling price?

DISCUSSION:

Rule 257 is the Department's administrative rule pertaining to warranties and maintenance agreements. The rule provides in pertinent part:

> (1) DEFINITIONS. For the purposes of this section, the following terms will apply:

(a) Warranties. 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 needs repair within the warranty period.

. . .

(2) B&O TAX.

. . .

(b) Nonmanufacturer's warranties and manufacturer's warranties not included in the retail selling price of the article being sold.

(i) When a warranty is sold for a charge separate from the charge of the product, e.g., a warranty extending the manufacturer's warranty, the charge is reported in the service and other activities classification of the B&O tax.

(ii) When a repair is made by the warrantor under a separately stated warranty, the value of the labor and or parts provided are not subject to B&O tax.

(3) RETAIL SALES TAX.

. . .

(b) Nonmanufacturer's warranties and manufacturer's warranties not included in the retail selling price of the article being sold.

(i) When a warranty is sold for a charge separate from the charge of the product, e.g., a warranty extending the manufacturer's warranty, the sale is not a retail sale and no retail sales tax is collected on the amount charged.

(ii) When a repair is made by the warrantor under its own separately stated warranty, the value of the labor and/or parts provided is not a retail sale and no retail sales tax is collected.

(4) USE TAX.

. . .

(b) Nonmanufacturer's warranties and manufacturer's warranties not included in the retail selling price of the article being sold.

(i) When a repair is made by the warrantor under a separately stated warranty, the warrantor is the consumer of the parts and the parts are subject to use tax measured by the warrantor's cost.

(ii) When a person other than the warrantor makes a repair for the warrantor, the person making the repair is making a retail sale to the warrantor. Retail sales tax, not use tax, is collected.

Rule 257 makes it clear that income from the sale of an extended warranty sold for a charge separate from the charge of the product is reported in the service business and occupation (B&O) tax classification. Accordingly, the rule provides sales of such extended warranties are not retail sales and no retail sales tax is collected on the amount charged. Likewise, the rule adds that

when a warrantor makes repair under such an extended warranty, the warrantor is the consumer of the parts and the parts are subject to use tax measured by the warrantor's costs.

The taxpayer argues that Rule 257 addresses use tax only in the context of repairs to the tires it sold under extended warranties. The taxpayer concedes it must pay use tax on the repair parts because it is the consumer of those parts according to the rule. However, the taxpayer disputes that it must pay use tax on the replacement tires because the rule does not expressly address that situation. Therefore, the taxpayer contends it is not the consumer of the replacement tires, but merely the retailer of them.

We disagree. We acknowledge that Rule 257 does not expressly address this issue, but the basis of the rule is important in deciding the issue. As noted, the rule provides gross income from the sale of extended warranties is not a retail sale. Instead, the income is reported under the service B&O tax classification, as provided in RCW 82.04.290. Moreover, RCW 82.12.020 imposes use tax on every person using tangible personal property as a "consumer." In light of these laws, we refer to the definition of "consumer" in RCW 82.04.190(2)(a), which states a consumer is "[a]ny person engaged in any business activity taxable under RCW 82.04.290; . . . ." Because the taxpayer is engaged in selling extended warranties that are taxable under RCW 82.04.290, the taxpayer is a "consumer." Consequently, a warrantor such as the taxpayer is not only a consumer of repair parts, but it is a consumer of the replacement tires that it uses to honor its warranty obligations. Therefore, we find the assessment of use tax on the replacement tires to be consistent with the statutory scheme in Title 82 RCW and with Rule 257. *See also* Det. No. 93-270, 13 WTD 385 at 389 (1993), which declares:

> Rule 257 provides that [extended] warranty agreements are service taxable. Accordingly, persons providing services under a warranty agreement are retail sales/use taxable on the materials they purchase which become a part of the required repairs or services. (Underlining added.)

Accordingly, part of the taxpayer's required services under the extended warranty it sells is providing the replacement tires. Therefore, the taxpayer is liable for use tax on the tires it purchased and used in fulfilling its extended warranty services. Otherwise, it is inconsistent with RCW 82.04.190(2)(a) and Rule 257 to report income from sales of warranties under the service B&O tax classification on one hand, and then treat the service of replacing the tire pursuant to the warranty as a retail sale.[2]

Furthermore, we do not find construing Rule 257 in this manner is inconsistent with Rule 108. The Audit Division found the credits or refunds given by the taxpayer to its customers for the return of the defective tires under the extended warranties were not bona fide refunds or credits

[2]As discussed, the taxpayer relies on language in its certificate that it will refund the purchase price and sales tax if a tire is not repairable. However, as noted, refunds rarely occur and non-repairable tires are nearly always replaced with new tires under the extended warranty certificate, which is entitled "Certificate For Free Repair, Refund or Replacement." (Underlining ours.)

per Rule 108, but were in the nature of payment on an insurance policy claim. Rule 108 provides in pertinent 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 and the selling price are determined by the transaction as finally completed. (Underlining ours.)
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> . . .
>
> (3) DEFECTIVE GOODS. When bona fide refunds, credits or allowances are given within the guarantee period by a seller to a purchaser on account of defects in goods sold, the amount of such refunds, credits or allowances may be deducted by the seller in computing tax liability, if the proportionate amount of the sales tax previously collected from the buyer has been refunded by the seller.

According to Rule 108, if a defective product is returned, the gross proceeds actually derived from the selling price are determined by the transaction as finally completed. Thus, the seller in computing tax liability may deduct the amount of the bona fide refund or credit allowed from the selling price.

We review this rule in light of Rule 257, which provides in pertinent part:

> (2) B&O TAX.
>
> (a) Manufacturer's warranties included in the retail selling price of the article being sold.
>
> (i) When a manufacturer's warranty is included in the retail selling price of the property sold and no additional charge is made, the value of the warranty is a part of the selling price. The value of the warranty is included in the "gross proceeds of sale" of the article sold and reported under the appropriate classification, e.g. retailing, wholesaling, etc. (Underlining ours.)
>
> . . .
>
> (3) RETAIL SALES TAX.
>
> (a) Manufacturer's warranties included in the retail selling price of the article being sold.
>
> (i) When a manufacturer's warranty is included in the retail selling price of the property sold and no additional or separate charge is made, the value of the warranty is a part of the selling price and retail sales tax applies to the entire selling price of the article being sold. (Underlining ours).

In contrast to a manufacturer's warranty, Rule 257(2)(b)(i) and (3)(b)(i), *supra*, provide that income from an extended warranty sold for a separate charge is not part of the product's selling price and no retail sales tax is collected. Instead, the seller of the extended warranty reports the income under the service B&O tax classification.

Thus, refunds or credits for defective goods returned within the guarantee period under a manufacturer's warranty would qualify under Rule 108 for the deduction from the selling price as bona fide refunds or credits because the warranty was included in the retail selling price. However, refunds or credits for defective goods returned pursuant to an extended warranty, such as the taxpayer's, would not qualify under Rule 108 for the deduction from the selling price because the extended warranty was not included in the retail selling price. . . . [N]o credit should be taken for the these types of extended warranty refunds in computing retailing B&O tax and retail sales tax liability.

Finally, we do not agree that the Department has double taxed these transactions. The transactions consisted of retail sales of tires with sales tax properly collected and remitted. With the return of a defective tire pursuant to the extended warranty, the taxpayer is not making another retail sale. Instead, the taxpayer, as the consumer, is using the replacement tire to fulfill its contractual obligation under the warranty. A consumer's use of tangible personal property results in a use tax obligation when the consumer has not paid retail sales tax on the item. Rule 178.

DECISION AND DISPOSITION:

The taxpayer's petition for correction of assessment is denied.

DATED this 26th day of January 2000.

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

[1]As discussed, the taxpayer relies on language in its certificate that it will refund the purchase price and sales tax if a tire is not repairable. However, as noted, refunds rarely occur and non-repairable tires are nearly always replaced with new tires under the extended warranty certificate, which is entitled "Certificate For Free Repair, Refund or Replacement." (Underlining ours.)