

Cite as Det. No. 17-0315, 38 WTD 141 (2019)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of) Assessment of))) . . .))	<u>D E T E R M I N A T I O N</u> No. 17-0315 Registration No. . . .
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[1] RCW 82.04.070: GROSS PROCEEDS OF SALE – REDUCTION OF SELLING PRICE. Amounts by which Taxpayer reduced the selling price of its products sold to distributors constituted gross proceeds of sales, where Taxpayer was originally entitled to receive the higher price, and only later provided distributors with partial credits on such sales.

[2] RULE 108; RCW 82.04.4283: BONA FIDE DISCOUNTS – CONDITIONS. Partial credits that Taxpayer gave to its distributors after certain types of sales did not constitute bona fide discounts where distributors were required to provide certain services to receive the credits.

Yonker, T.R.O. – A seller of cleaning and maintenance products at retail and wholesale (Taxpayer) protests a tax assessment based on unreported sales. Taxpayer argues that the amounts at issue were the result of price adjustments that either (1) did not constitute part of Taxpayer’s gross proceeds of sale, or (2) constituted bona fide discounts that are deductible from Taxpayer’s taxable income. We deny the petition.¹

ISSUES

1. Do amounts by which Taxpayer reduced the selling price of its products sold to distributors constitute gross proceeds of sales under RCW 82.04.070, where Taxpayer originally charged the higher price, and later provided distributors with certain partial credits on such sales?
2. Do certain partial credits for electronic reporting, product stocking, and general safe handling that Taxpayer gave to its distributors after certain types of sales constitute bona fide discounts under RCW 82.04.4283 and WAC 458-20-108?

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

FINDINGS OF FACT

. . . (Taxpayer) is [an out-of-state] corporation headquartered [out-of-state]. During the relevant time period, Taxpayer leased commercial property in Washington, and also sent employees into Washington to train Taxpayer's Washington customers' employees on "achieving safety and cleanliness standards." Taxpayer further described its business activity as follows:

Throughout the Audit Period, [Taxpayer] was engaged in the business of selling cleaning, sanitizing, pest elimination, and maintenance products to the hospitality, institutional, and industrial markets, including restaurants, hotels, food-service, healthcare, and educational facilities.

These sales are the business activity at issue here. To accomplish this business activity, Taxpayer entered into agreements with two classes of customers: (1) large consumers such as hospitals and hotel chains (Corporate Accounts), and (2) various product distributors (Distributors).

Under the agreements with its Corporate Accounts, Taxpayer agreed to fixed unit selling prices (Consumer Prices) for selling its products to such Corporate Accounts. Taxpayer represented that it sometimes sold products itself directly to Corporate Accounts, and sometimes sold products to Distributors, who then resold those products to Corporate Accounts and provided delivery to those Corporate Account consumers. Distributors, in turn, agreed with Taxpayer to sell products to the Corporate Accounts at the same Consumer Prices. Thus, regardless of whether a Corporate Account purchased a product directly from Taxpayer or from a Distributor, that Corporate Account paid the same Consumer Price.

Under the agreements with its Distributors (Distributor Agreements), Taxpayer and its Distributors agreed to the following standard terms:

Distributor acknowledges and agrees that [Taxpayer] enters into direct written or verbal supply agreements with end users/corporate accounts (collectively, "Corporate Accounts") and that [Taxpayer] is the seller to those Corporate Accounts under such agreements and that deliveries of Products to those accounts will be on a deviated pricing basis. Distributor acknowledges and agrees that [Taxpayer] may delegate [Taxpayer's] performance as to delivery and related matters to a distributor chosen by [Taxpayer] from time to time and may assign to that distributor the right to receive payment by those customers of those Products that are delivered by the distributor and Distributor may only service those Corporate Accounts if and so long as [Taxpayer] authorizes Distributor to do so. [Taxpayer] reserves the right to control Distributor's performance of such delegated duties as to such matters as [Taxpayer] in its discretion deems advisable. Under these authorized arrangements, Distributor will be refunded the difference between Corporate Account end-user pricing and [Taxpayer's] standard distributor purchase price (that difference being the "Corporate Account Price Differential").

Thus, Distributors received an "Edge Refund" on each Corporate Account sale where there was a "Corporate Account Price Differential," meaning the original price the Distributor paid to Taxpayer for a product was higher than the ultimate price for which the Distributor resold that

product to a Corporate Account. The Distributor Agreements allowed for the following additional refunds when a Distributor made sales to Corporate Accounts:

In addition, [Taxpayer] will pay a handling fee for Corporate Account contract business of up to 10%. The basic [Taxpayer] handling fee equals 8% of the Corporate Account contract end-user price (the “Handling Fee”). The Handling Fee will be increased by 1% if the Electronic Reporting Requirement is met for the time period covered by the monthly report and by an additional 1% if the Product Stocking Requirement is met for the same period of time. Notwithstanding the foregoing to the contrary, with respect to the Corporate Accounts listed in Exhibit B, [Taxpayer] will pay a Handling Fee at the rates shown on that exhibit. Finally, with respect to Handling Fees generally, if [Distributor] and a particular Corporate Account agree that [Distributor] may invoice that Corporate Account for any charge in excess of the unit price agreed to between [Taxpayer] and that Corporate Account, no Handling Fee or other incentive will be paid on any such charge.

The “Product Stocking Requirement” is met so long as the Distributor, for Corporate Account customers serviced by Distributor, stocks and delivers the [Taxpayer] Products which each Corporate Account customer has committed to purchase.

Once Distributor’s sales information is processed, [Taxpayer] provides documentation to support the calculation of the monthly net refund due to Distributor. Refunds are issued on a monthly basis in the form of a credit memo and forwarded to the designated refund contact at the Distributor location. Distributor deduction of refunds and handling fees, without [Taxpayer] consent, are prohibited.

On review, Taxpayer described the three components of the Handling Fee as follows:

1. The “General Handling Fee,” which accounted for eight percent of the Handling Fee, was given to Distributors for “handling goods and ensuring that they are safely delivered from the [Distributor] to the retailer or end-user.” Taxpayer represented the Distributors “would still have been under a general obligation to safely handle and deliver [Taxpayer’s] products” even without the General Handling Fee.
2. The “Product Stocking Requirement,” which accounted for one percent of the Handling Fee, was given to Distributors for “stock[ing] and deliver[ing] products that certain consumers commit to purchasing.” Taxpayer represented that even without this requirement, Distributors would still have done this.
3. The “Electronic Reporting Requirement,” which accounted for one percent of the Handling Fee, was given for preparing and submitting a monthly Product Movement Report in “an electronic format approved by [Taxpayer].” Taxpayer represented that even without this requirement, most Distributors were “sophisticated companies that most likely prepared these reports using computer software and would submit the forms electronically for convenience.”

In other words, Distributors could potentially get a Handling Fee of up to ten percent, but depending on whether Distributors complied with the Product Stocking Requirement and the Electronic Reporting Requirement, the Handling Fee could be eight or nine percent. Taxpayer

represented on review that the Handling Fee, which included all three components in most cases, essentially represented an industry standard ten percent profit for Distributors.

These agreements with Corporate Account customers and Distributors resulted in the following general process steps:

1. Taxpayer contracted with Corporate Account customers, establishing a Consumer Price for which Corporate Accounts could purchase Taxpayer's products.
2. Taxpayer separately contracted with Distributors to purchase Taxpayer's products and resell and deliver such products to Corporate Account customers. Taxpayer would provide a selling price (Standard Distributor Price) for such products sold to Distributors.
3. Distributor would order, twice monthly, products from Taxpayer at the Standard Distributor Price.
4. Taxpayer invoiced Distributor for the products Distributor ordered during the month, with a due date of 30 days after the invoice date. Distributor resold those products to Corporate Account consumers at the Consumer Price at a later point. The Consumer Price for which the Distributor resold a product to a Corporate Account was sometimes lower than the Standard Distributor Price for which the Distributor originally purchased that product. This meant there was a Corporate Account Price Differential in such cases, entitling the Distributor to an Edge Refund.
5. On a monthly basis, Distributor reported its Corporate Account sales to Taxpayer, generally in an electronic format.
6. Taxpayer issued a credit invoice for any Corporate Account sales made during the previous month where the Consumer Price was lower than the Standard Distributor Price. The amount of credit issued was calculated by reducing the Standard Distributor Price by (1) Corporate Account Price Differential, and (2) the applicable Handling Fee. In the example credit invoices provided by Taxpayer, the credit invoice date was later than the due dates on all of the monthly purchase invoices.
7. Taxpayer reported its gross proceeds of sales to the Department based on the accrual accounting method.

In 2013, the Department's Audit Division commenced a review of Taxpayer's books and records for the time period of January 1, 2009, through December 31, 2013 (audit period). Specifically, the Audit Division reviewed books and records for a sample period within the audit period, and then extrapolated the results of its review to the entire audit period.

As part of that review, the Audit Division found that, during the audit period, Taxpayer had not reported the total selling price for which Taxpayer had originally sold its products to Distributors. Instead, Taxpayer had reduced the selling price by the amount of (1) the Corporate Account Price Differential and (2) the Handling Fee, as applicable to each individual sale to Distributors, and had reported its net amount after those reductions as its gross proceeds of sales on its combined excise tax returns. The Audit Division found that Taxpayer should have included the full selling price without reductions for the Corporate Account Price Differential or the Handling Fee in its gross proceeds of sales as reported in its combined excise tax returns, and without any other deduction.

On January 1, 2017, as a result of the Audit Division's review, the Department issued a tax assessment for \$. . . , which included \$. . . in additional tax, a \$. . . delinquent penalty, and \$. . . in interest. Taxpayer subsequently sought review of the portion of the additional tax associated with the Audit Division's inclusion of the Corporate Account Price Differential and the Handling Fee in Taxpayer's gross proceeds of sales when calculating the tax assessment.

ANALYSIS

1. Do Edge Refunds and Handling Fee Amounts Constitute Part of Taxpayer's Gross Proceeds of Sales?

The B&O tax is imposed on every person that has substantial nexus with Washington for the privilege of engaging in business in Washington. RCW 82.04.220. Here, the parties do not dispute that Taxpayer has substantial nexus Washington, and is, therefore, generally subject to B&O tax. The B&O tax is measured by the application of rates against the value of products, gross proceeds of sales, or gross income of the business, as the case may be. *Id.* Taxpayer does not dispute that its business activity in Washington is subject to various B&O tax classifications, including retailing B&O tax and wholesaling B&O tax, which are both measured based on "gross proceeds of sales." RCW 82.04.250; RCW 82.04.270. RCW 82.04.070 provides the following definition of that phrase:

"Gross proceeds of sales" means the value proceeding or accruing from the sale of tangible personal property, digital goods, digital codes, digital automated services, and/or for other services rendered, without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount paid, delivery costs, taxes, or another expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.090, in turn, defines the "value proceeding or accruing" to mean the following:

[T]he consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of accounting is regularly employed in keeping the books of the taxpayer.

Here, Taxpayer regularly employs the accrual basis method in keeping its books. Thus, the term "value proceeding or accruing" must likewise be applied on an accrual basis. WAC 458-20-197 (Rule 197), the Department's administrative rule relating to when tax liability arises, addresses the accrual basis method of accounting as follows:

(2) **Accrual basis.**

- (a) When excise tax returns are made upon the accrual basis, value accrues to a taxpayer at the time:
 - (i) The taxpayer becomes legally entitled to receive the consideration, or,
 - (ii) In accord with the system of accounting regularly employed, enters as a charge against the purchaser, customer, or client the amount of the consideration

agreed upon, whether payable immediately or at a definitely determined future time.

- (b) Amounts actually received do not constitute value accruing to the taxpayer in the period in which received if the value accrued to the taxpayer during another period. It is immaterial if the act or service for which the consideration accrues is performed or rendered in whole or in part, during a period other than the one for which excise tax return is made. **The controlling factor is the time when the taxpayer is entitled to receive, or takes credit for, the consideration.**

(Emphasis added).

Based on the record here, Taxpayer restricts Distributors to two orders of goods per month. Further, according to the record, Taxpayer invoiced Distributors for its purchases with a due date 30 days from the invoice date. While not explicit in the record, we presume Taxpayer enters charges into its accounting system for the goods contained in such orders at the time of those orders.

Therefore, under Rule 197(2)(a), the value of Taxpayer's sales to Distributors accrues either at the time of the orders when Taxpayer enters the charges in its accounting system, or at the latest, 30 days after the invoice date. Either way, the Standard Distributor Price, as opposed to the Consumer Price, is the "accrued" amount at either of those points in time. Further, as Rule 197(2)(b) makes clear, the "controlling factor" in determining the value for accrual basis taxpayers "is the time when the taxpayer is entitled to receive" the consideration. Here, Taxpayer was entitled to receive the full Standard Distributor Price no later than 30 days after the invoice date. Therefore, the Distributor Price constitutes that "value proceeding or accruing" from Taxpayer's sales under RCW 82.04.090 and Rule 197(2). It follows that the full Standard Distributor Price must be included in Taxpayer's "gross proceeds of sales" pursuant to RCW 82.04.070.

While Taxpayer maintains that the lower Consumer Price is the proper amount to be included for Taxpayer's sales to Distributors, we disagree. Based on the record, it is only after Taxpayer is entitled to receive the full Standard Distributor Price from the Distributor that Taxpayer gives a credit to the Distributor. This is because the Distributor must first resell the products to a Corporate Account and report such sales to Taxpayer on a monthly basis. Then, only after it receives such report will Taxpayer calculate the Corporate Account Price Differential and give a credit to the Distributor for the Edge Refund and Handling Fee. Accordingly, since the Standard Distributor Price was the amount Taxpayer was originally entitled to receive, Taxpayer must include that price in its gross proceeds of sales to Distributors.

2. Do Handling Fee Amounts Qualify as Bona Fide Discounts?

As stated earlier, RCW 82.04.090 defines "value proceeding or accruing" as the "consideration" received, including not only money, but also "credit, rights, other property expressed in terms of money." Thus, a taxpayer is liable for retailing or wholesaling B&O tax on the full consideration, or full selling price, of the property or services sold, unless some specific deduction or exemption applies. The taxpayer has the burden of showing qualification for any tax deduction, exemption or credit. *Budget Rent-A-Car of Wash.-Oregon, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 174-175,

500 P.2d 764 (1972); *Group Health Co-Op v. Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967).

Taxpayer argues that it is entitled to claim cash and trade discount deduction to reduce its taxable gross proceeds of sales. RCW 82.04.4283 states that, “[i]n computing tax there may be deducted from the measure of tax the amount of cash discount actually taken by the purchaser.” RCW 82.04.160, in turn, defines “cash discount” as “a deduction from the invoice price of goods or charge for services which is allowed if the bill is paid on or before a specified date.” WAC 458-20-108 (Rule 108) further explains the deduction for cash discounts:

(7) **Bona fide discounts.** When a sale is made subject to cash or trade discount, the gross proceeds actually derived from the selling price are determined by the transaction as finally completed. A sale is made subject to a discount when the sales price is reduced under terms known to the buyer and seller at the time of the sale, and the price reduction occurs at the time of the sale or within a time agreed and understood by the parties at the time of the sale.

We held in Determination No. 05-0142, 26 WTD 256 (2007) that “[t]he Department recognizes that ‘discounts’ qualify as bona fide when they are merely ‘reduced prices,’ i.e., the seller's selling price was merely reduced before the sale is made.” *See also Steven Klein, Inc. v. Dep’t of Revenue*, 183 Wn.2d 889, 357 P.3d 59, 64 (2015) (holding that where alleged discounts “are not necessarily quantified or even knowable” at the time of purchase, they do not qualify as bona fide discounts).

Here, the Handling Fee, like the alleged discount in *Steven Klein*, is not “quantified or even knowable” at the time of Taxpayer’s sales to the Distributors because the Distributors themselves do not specifically know to whom they will resell the products they purchased from Taxpayer. Only later, when the Distributors report their sales for a given month is the Handling Fee calculable. Thus, consistent with Rule 108(7), our past decisions, and *Steven Klein*, we conclude that the Handling Fee cannot qualify as a bona fide discount.

Further, the Department has long recognized that discounts are “bona fide” only when the buyer is not required to do anything in return for that reduced price. As we stated in Determination No. 83-180, 11 WTD 5 (1983):

The Department has been uniform and consistent in its position that this deduction for bona fide discounts is never available if the purchaser is required to provide any service or benefit to the seller in return for the price reduction. In such cases the discount simply is not “bona fide.” It has . . . “strings attached.”

We have upheld this position on multiple occasions. *See* Det. No. 14-0159, 34 WTD 257 (2015); 26 WTD at 256; Det. No. 98-172E, 18 WTD 387 (1999); Det. No. 98-183, 18 WTD 220 (1999). This position was more recently reiterated by the Department on January 7, 2013, when it issued Excise Tax Advisory (ETA) 3173.2013, which addresses “Distributor Discounts/Allowances to Grocery Stores” and states the following:

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'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 in addition to selling the goods in exchange for the discount, then the discount is not bona fide.

Here, Taxpayer concedes that all three components of the Handling Fee include some form of "strings." The eight-percent General Handling Fee requires Distributors to handle goods and make sure they are safely delivered to the Distributor's customers. The one-percent Product Stocking requirement is met only if the Distributor stocks and delivers products that certain consumers commit to purchasing. The one-percent Electronic Reporting Requirement is met only if the Distributor submits a monthly Product Movement Report in an electronic format. If these requirements are not met, Taxpayer may withhold the corresponding Handling Fee component. Accordingly, these requirements on Distributors' performance preclude us from finding that any portion of the Handling Fee constitutes a bona fide discount under RCW 82.04.4283 and Rule 108.

Taxpayer argues that Distributors would do all these things regardless of whether Taxpayer required them in order to receive the Handling Fee. While that may be the case, Taxpayer specifically saw fit to place these "strings" on receiving the Handling Fee. It makes no difference if those strings are difficult or simple for Distributors to achieve. Taxpayer also argues that the Handling Fee simply allows Distributors to make a profit on sales to Corporate Accounts. Again, while that may be true, the fact remains that there are conditions that Taxpayer has placed on Distributors to receive the Handling Fee. Therefore, we conclude Taxpayer is not entitled to deduct any amount of the Handling Fee as bona fide discounts.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 28th day of December 2017.