A Musical Review of 2018 in Washington and Oregon

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By

MICHELLE DELAPPE

Michelle DeLappe is a principal with Garvey Schubert Barer in Seattle. She can be reached at mdelappe@ gsblaw.com.

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In this installment of Skookum Tax News, DeLappe reviews significant court decisions from Washington and Oregon in 2018, along with an accompanying music soundtrack.

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In keeping with this column's New Year's tradition, its review of the year's state and local tax developments is accompanied by an eclectic soundtrack. As usual, our focus is on a part of the country where some still use words like "skookum" (which means many things in Chinook Jargon, including "big" and "true"[1]). The article first discusses several Washington appellate decisions, followed by a few from the Oregon Supreme Court.

"Video Games" (Lana Del Rey)

Lessons on Taxing Trade-In Credit

First, we turn to a recent Washington Court of Appeals decision involving the sales tax exclusion for trade-in credit for video game hardware and software.[2] The taxpayer, GameStop Inc., has a retail business of video game systems and software. As part of that business, it buys used merchandise from customers in exchange for cash or store credit. When customers applied store credit toward the purchase price of a product, GameStop identified the merchandise traded in only when the

credit was applied at the time of the trade-in. When customers used the credit at a later date, sale records did not show what merchandise had been traded in, though the information was in the computer system. Either way, GameStop did not collect sales tax on the trade-in credit.

Washington excludes a trade-in credit if the merchandise is "property of like kind," the trade-in property is "separately stated," and the trade is "a single transaction."[3] The Department of Revenue assessed the sales tax on all three grounds:

- that the trade involved gaming hardware for software or vice-versa as not property of like kind;
- that the sales documents did not separately identify the property traded in when the credit was applied toward merchandise on a later date; and
- that applying the credit toward a purchase on a later date was not part of a single transaction with the delivery of the property traded in.

GameStop challenged the sales tax assessment and prevailed before the state Board of Tax Appeals. The board reasoned that gaming hardware and software were like-kind property because they are gaming components that are interdependent and often packaged together. It further concluded that separately stating the value of the trade-in met the separately stated requirement for sales documentation, and that applying the credit at a later date did not violate the single transaction requirement. The court of appeals disagreed with the like-kind property and separately stated parts of the board's decision. But it rejected the DOR's imposing additional requirements by rule: Since the statute does not require that the trade-in be a single transaction or on the same day, that requirement was invalid.

Assuming the Washington Supreme Court does not review the case, this appellate decision provides valuable lessons for retailers who take trade-ins. First, retailers should be careful that the property qualifies as "like kind" under the DOR's rule since the court did defer to the department on that requirement. Second, sales documents must separately state the specific property traded in, not just the value of what was traded in. The sales documents should include a level of detail that will enable determining whether the like-kind requirement is met even when multiple items are traded. It is not sufficient that the information is on the retailer's computer system; it must be on the sales documentation itself. If these requirements are met, retailers should not need to collect sales tax — even if the customer is applying trade-in credit at a later date.

"Lost in the Supermarket" (The Clash)

Taxing Free Food Samples

Another recent decision also reversed the Board of Tax Appeals on an issue that often arises in Washington's gross receipts tax regime: the exemption for reimbursements paid to an agent.[4] Warehouse Demo Services Inc., the taxpayer in the case, provides demonstrations and free food samples at Costco stores. Usually, Washington's business and occupation (B&O) tax applies to all income without any deduction for costs of doing business. But if a taxpayer, solely in its capacity as an agent for another, advances funds and receives repayment, the taxpayer need not pay tax on the repayment it received. This case shows how difficult it is for taxpayers to meet the requirements of this exemption, however.

Warehouse Demo had agreed with Costco to provide demonstrations at Costco locations for vendors. Warehouse Demo would buy the vendor's product at Costco to perform the demonstration, then invoice the vendor for repayment of the cost of the product. It included the repayments in its gross receipts for B&O tax purposes. Later, after unsuccessfully requesting a refund of that tax, Warehouse Demo persuaded the Board of Tax Appeals that the refund was warranted. The board reached this result by inferring that Warehouse Demo acted as the vendors' agent based on these facts: The vendors directly contacted Warehouse Demo to perform the demonstrations, provided the promotional and marketing materials for the demonstrations, selected the product to be demonstrated, and authorized the purchase of the product.

In an unpublished decision, the court of appeals ruled that these facts did not create an agency relationship. The court explained that the taxpayer would have to prove that the vendors controlled how the taxpayer conducted the demonstrations, such as by managing or supervising them. Since the board's findings contained no facts showing its control over the demonstrations, Warehouse Demo could not prove it acted as an agent to the vendors. The Washington Supreme Court denied review, so this unpublished decision stands. The result is that the taxpayer had to pay tax on the repayments — an especially painful result given that it had charged the vendors no more than the cost it had itself paid for the vendor's products, without including the additional tax as part of the overhead of that cost.

"The Debt I Owe" (Lou Reed)

Taxing Bad Debt

Lowe's Home Centers LLC petitioned the Washington Supreme Court and should receive review in a case involving retail sales tax credits and B&O tax deductions on bad debts.[5] Washington gives a credit or refund of sales tax and a deduction of B&O tax previously paid on bad debts (as defined

under IRC section 166).[6] Here, the debts were incurred by customers using Lowe's private-label credit cards, which can be used only at Lowe's. Lowe's had an agreement with two banks for these credit cards. The banks fully paid Lowe's for the purchases (including sales tax and B&O tax) within a few days of the purchases. Lowe's in turn remitted sales and B&O taxes on the purchases. The banks and Lowe's shared profits and losses generated by the credit cards. Lowe's had a contractual obligation to pay the banks for defaulted amounts (purchase prices and taxes) up to a specified cap. Lowe's, not the banks, would then have the right to claim sales tax deductions associated with those losses. But the banks would have the authority to write off uncollectible debts on its books. Lowe's deducted the bad debt for federal income tax purposes.

The court of appeals issued two opinions: a majority and a dissent. The two-judge majority ruled against Lowe's for three reasons. First, the majority noted that the statutes required that the tax on the bad debts had to have been "previously paid." Because the banks reimbursed Lowe's for the taxes, the majority concluded that Lowe's had not previously paid the tax. The majority also framed Lowe's guarantee to pay the banks for losses as "profit-sharing reductions" that Lowe's bargained for. As such, they were not debts on tax previously paid. Nor did the agreements giving Lowe's the right to the sales tax deductions overcome this defect. The dissent, however, emphasized Lowe's contractual obligation to pay the banks for losses as a guaranty, not as profit-sharing reductions. Although Lowe's initially received reimbursement, it had to repay the taxes when a customer defaulted, so Lowe's had previously paid the tax on the bad debts.

Second, the majority pointed to another case involving Home Depot USA Inc., in which its reimbursements were not directly attributable to retail sales because the bank reimbursements in that case were offset by a service fee. Though Home Depot suffered a loss when customers defaulted, it was not sufficiently connected to the sales to be eligible for the tax refund. The dissent distinguished that case because unlike Home Depot, Lowe's guaranteed the bad debts and the amounts were directly related to the sales. The majority rejected that position, arguing that the "profit-sharing reductions were from a guarantee of credit accounts and not 'directly attributable' to the retail sale."

Third, the fact that the banks, not Lowe's, had the authority to write off uncollectible debts on their books made Lowe's ineligible for the sales tax credit and B&O tax refund under the DOR's rules (Wash. Admin. Code section 458-20-196), according to the majority. The dissent noted that this rule formerly referenced the bad debt being written off as uncollectible in the taxpayer's books, but only as a timing requirement. According to the dissent, since no such requirement was in the

statute or IRC section 166 or related regulations, it should not apply. (Had the court of appeals followed its decision only a few months earlier in *GameStop*, discussed earlier, it should have rejected this additional regulatory requirement not imposed by statute.) The dissent also emphasized the rule's failure to address bad debt situations involving a guarantor. The timing of Lowe's guarantee payments should suffice to determine the timing for the tax credits and deductions.

The majority addressed Lowe's constitutional arguments as well. But given the carefully reasoned dissenting opinion on the three main points, the state's highest court should review this case in 2019.

"Call the Doctor" (Sleater-Kinney)

Taxing Medicine

In 2018 taxpayers lost two court of appeals tax decisions on prescribed drugs — one regarding the more conventional type and one regarding medical marijuana. Consonant with their frustration, here is a dissonant riot grrrl track by a band named after a freeway exit not too far from the DOR's offices.

In the first case, two wholesalers who sold prescription drugs to other wholesalers, Aventis Pharmaceutical Inc. and Sanofi-Aventis US LLC, argued for a lower B&O tax rate available for warehousing and reselling prescription drugs to retailers or healthcare providers.[7] The key here was the definition of "reselling drugs for human use pursuant to a prescription." The statute included in the definition that the resale must be "to persons selling at retail or to hospitals, clinics, health care providers, or other providers of health care services."[8] The court rejected the argument that "the chain of sale must merely culminate in a sale to a retailer or health care provider" and held that the sale to a wholesaler could not qualify for the lower tax rate.

Two taxpayers that managed collective gardens fared no better with their arguments that they were not subject to retail sales tax on medical marijuana.[9]

"Hydrogen Peroxide" (Max Bernstein)

Chemicals as Machinery and Equipment

The Washington Court of Appeals gave one taxpayer, Solvay Chemicals Inc., a total win.[10] The state provides a sales tax exemption for sales to a manufacturer of machinery and equipment used

directly in a manufacturing operation.[11] Solvay sought a sales tax refund based on applying an exemption for manufacturing machinery and equipment to a working solution of chemicals that serves as a catalyst for producing hydrogen peroxide. Specifically, Solvay argued that the working solution was an industrial fixture and a device, both included in the statutory definition of machinery and equipment. The court agreed based on the common dictionary definition of device.

"School" (Nirvana)

Taxing School Bus Revenue

First Student Inc., a company providing school bus services under contracts to various school districts, unsuccessfully sought to pay public utility tax (PUT) as a motor and urban transportation business instead of the higher "services and other activities" B&O tax.[12] The crux of the case was the meaning of "for hire" as a statutory requirement for qualifying for PUT.

The court of appeals found the term ambiguous. The taxpayer argued for the plain meaning as "available for use or service in return for payment," which would include the contracts with school districts. But the court rejected using a modern dictionary and instead referred to dictionaries contemporary to when the statute was drafted, from which the court concluded that the meaning was "engagement or purchase of labor or services for compensation or wages." In the end, the court deferred to the DOR's argument based on a legal meaning in which the compensation was to be paid by the passengers, thus excluding school buses from PUT.

"Electricity" (Orchestral Manoeuvres in the Dark)

A Victory for Cogen

In Oregon, parties have a right to a state supreme court review of any decision by the regular division of the tax court. The Oregon Supreme Court reviewed a half-dozen decisions, all from recently retired Judge Henry Breithaupt. In every one as of this writing, the supreme court affirmed the tax court. One of the last of the year was a property tax case involving an electric biomass cogeneration facility belonging to Seneca Sustainable Energy LLC.[13] The case, involving various procedural and appraisal arguments, ultimately affirmed the valuation of the facility at $38 million and $19 million instead of the $60 million concluded by the Oregon DOR.

"Piece of the Pie" (Jimmy Cliff)

Income Tax Apportionment

The Oregon Supreme Court decided two important income tax apportionment cases in 2018. The first involved Health Net Inc.'s effort to compel the state to allow apportionment formulas set forth in the Multistate Tax Compact.[14] Those following compact litigation know very well the result of the case, which is that Oregon followed suit with the California Supreme Court in recognizing no obligation to depart from its single-sales-factor apportionment formula.

The second income apportionment case, specific to the statutory formula for apportioning interstate broadcasting income, was brought by Comcast Corp.[15] This formula is based on the taxpayer's total gross receipts from broadcasting multiplied by the ratio of the subscribers in Oregon to the total subscribers inside and outside the state.

The dispute centered on what "gross receipts from broadcasting" includes. The taxpayer argued that it is limited to receipts from broadcasting activities — that is, "the activity of transmitting any one-way electronic signal." The DOR argued that it is the receipts from all business activities of an interstate broadcaster in the regular course of its trade or business. Underscoring the broader definition used by the legislature for purposes of the apportionment formula, the court agreed with the department that the formula includes receipts from all business activities (except sales of real property or tangible personal property), not just broadcasting.

Conclusion

Tax authorities, taxpayers, and the courts continue to hammer out the laws in the very different tax regimes and tax appeal systems that make up this two-state swath of the Wild West. In several cases, the Washington DOR pushed rules or guidance beyond the scope of the governing statutes. Sometimes the courts agree; sometimes they don't — and they are not always predictable. Meanwhile, Oregon seems to have at least put to rest for now some of the uncertainty about its income apportionment formulas. We'll see what 2019 brings.

FOOTNOTES

[1] *See, e.g.*, Diane Selkirk, "North America's Nearly Forgotten Language," BBC, Oct. 4, 2018.

[2] *Department of Revenue v. GameStop Inc.*, 428 P.3d 1269 (Wash. 2018).

[3] Wash. Rev. Code section 82.08.010(1)(a)(i) and Wash. Admin. Code section 458-20-247.

[4] *Department of Revenue v. Warehouse Demo Services Inc.*, 2 Wash. App. 2d 1065 (2018), *review denied*, 428 P.3d 1183.

[5] *Lowe's Home Centers LLC v. Department of Revenue*, 425 P.3d 959 (Wash.) (2018), *petition for review pending*, Case No. 963835.

[6] Wash. Rev. Code section 82.08.037(1); Wash. Rev. Code section 82.04.4284(1).

[7] *Aventis Pharmaceutical Inc. v. Department of Revenue*, 428 P.3d 389 (Wash. 2018).

[8] Wash. Rev. Code section 82.04.272(2)(b).

[9] *Green Collar Club v. Department of Revenue*, 3 Wash. App. 2d 82, 413 P.3d 1083 (2018).

[10] *Solvay Chemicals Inc. v. Department of Revenue*, 4 Wash. App. 2d 918, 424 P.3d 1238 (2018).

[11] Wash. Rev. Code section 82.08.0256(1)(a).

[12] *First Student Inc. v. Department of Revenue*, 4 Wash. App. 2d 857, 423 P.3d 921 (2018).

[13] *Seneca Sustainable Energy LLC v. Department of Revenue*, 363 Or. 782 (2018).

[14] *Health Net Inc. v. Department of Revenue*, 362 Or. 700, 415 P.3d 1034 (2018).

[15] *Comcast Corp. v. Department of Revenue*, 363 Or. 537, 423 P.3d 706 (2018).

END FOOTNOTES

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