

**CALIFORNIA STATE BOARD OF EQUALIZATION**  
**APPEALS DIVISION SUMMARY FOR BOARD HEARING**

In the Matter of the Petition for Redetermination )  
Under the Sales and Use Tax Law of: )  
FIVE FRIENDS ) Account Number: SR JHF 100-373296  
Petitioner ) Case ID 472975  
Vacaville, Solano County

Type of Business: Cigarette retailer  
Audit period: 10/01/04 – 09/30/07

<u>Item</u>	<u>Disputed Amount</u>
Unreported cigarette rebates	\$860,064
Tax, as determined and proposed to be redetermined:	\$64,895.71
Less concurred	<u>- 300.42</u>
Balance, protested	<u>\$64,595.29</u>
Proposed tax redetermination	\$64,895.71
Interest through 11/30/10	<u>26,517.07</u>
Total tax and interest	\$91,412.78
Payments	<u>- 1,055.76</u>
Balance Due	<u>\$90,357.02</u>
Monthly interest beginning 12/1/10	<u>\$ 372.40</u>

**UNRESOLVED ISSUE**

**Issue:** Whether the cigarette rebates at issue constitute taxable gross receipts. We find they do. Petitioner operates several retail stores selling cigarettes and tobacco products. During the audit, the Sales and Use Tax Department (Department) noted petitioner had received rebates from Phillip Morris USA (PM). The Department obtained copies from PM of the agreements between PM and petitioner for 2006 and 2007. The Department found that PM paid rebates to petitioner under two different plan codes, and it determined that the rebates paid pursuant to Plan Group C were allowances related to shelf space and merchandising, which were not subject to tax. However, the payments by PM to petitioner under Plan Group P were based on petitioner’s sales of PM products. Also, in order to receive the rebates under Plan Group P, petitioner was required to reduce its retail selling prices to

1 its customers by at least the amount of each rebate. The Department concluded that the rebates  
2 petitioner received from PM under Plan Group P represented taxable gross receipts, which petitioner  
3 had not reported.

4         Petitioner contends that the disputed payments from PM should not be considered part of its  
5 gross receipts because they were purchase discounts based on the amount of products purchased, rather  
6 than on the amount of products sold. Thus, petitioner argues that the disputed receipts were purchase  
7 discounts that are not subject to tax. Petitioner notes there is no mechanism for PM to oversee whether  
8 retailers who receive rebates sell their cigarettes at a discount and argues that the rebates are not given  
9 by PM to reduce the retailers' selling prices. Instead, petitioner asserts that the rebates are given as an  
10 incentive to purchase more cigarettes from PM. As support, petitioner provided an unsigned contract,  
11 entitled "Phillip Morris USA Retail Leaders 2004 Agreement."<sup>1</sup> In addition, petitioner contends that  
12 the sales tax treatment of manufacturers' rebates is being inconsistently applied to the industry because  
13 the rebates given to large retailers, who are able to buy directly from the manufacturers, are regarded as  
14 purchase discounts that are not subject to tax.

15         In a three-party discount situation, as here, the manufacturer pays a portion of the sale price to  
16 the retailer so the purchaser does not have to pay that portion of the retail price, but the retailer receives  
17 the full sale price from the combined sources. Thus, the payments by the manufacturer are paid in  
18 connection with the retail sales and are regarded as part of the retailer's taxable gross receipts when  
19 such amounts are paid in connection with particular taxable retail sales. This arrangement is  
20 distinguishable from a two-party discount situation, in which a retailer reduces its selling price or a  
21 vendor gives the retailer a purchase discount on the vendor's sale of tangible personal property to the  
22 retailer. Therefore, we reject petitioner's argument that the rebates at issue should be regarded as  
23 purchase discounts. Further, we note that, while PM may have paid the rebates to petitioner based  
24 upon the amount of petitioner's purchases, petitioner was nonetheless required to reduce its selling  
25 prices in order to receive the rebates. In other words, regardless of how PM calculated the amount of

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27 <sup>1</sup> Petitioner relies on the 2004 PM Agreement, while the Department based its conclusions on its review of the 2007 PM  
28 Agreement. While the language in the agreements is not identical, petitioner agreed in both to reduce its selling prices in  
exchange for the receipt of promotional allowances from PM.

1 rebates, petitioner received specific payments from PM in exchange for making retail sales of  
2 cigarettes for a reduced price. Therefore, for each such taxable retail sale, petitioner received a portion  
3 of the retail sale price from the purchaser and the remainder from PM. The total amount received by  
4 petitioner is consideration for the sale and is subject to sales tax.

5 Petitioner's contention that the sales tax treatment of manufacturers' rebates is being  
6 inconsistently applied to the industry concerns the tax practices of a third-party taxpayer. There is no  
7 authority for allowing relief for one taxpayer premised on the alleged taxing practices, or the Board's  
8 alleged tax treatment, of another taxpayer. Further, since the adoption of California Code of  
9 Regulations, title 18, section 1671.1, applicable on and after October 1, 2007, even rebates received  
10 directly from one's vendor are now included within taxable gross receipts, thereby treating small and  
11 large retailers equally. (Reg. 1671.1, subd. (c)(1)(C).)

12 **OTHER DEVELOPMENTS**

13 None.

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15 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III  
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