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Taxation aspects of marketing strategies employed in car sales

On the basis of one case study for each, two basic strategies ("pull" and "push") aimed at achieving extensive expansion in car sales are analysed here from taxation aspects. These demonstrate cases that do not follow the mainstream practice of corporate value creation in Hungary – an example is the loan designs with zero-percent THM [Total Annual Loan Cost Indicator]. However, in the case of the tax impacts of these designs, the tax authority often questions the justification for lowering the taxable amount on one side, while does not object the increase in the taxable amount on the other side of the transaction. As a result, when the objected issues have been decided – irrespective of which party has been awarded – there are no changes in the total tax revenue, but the tax authority has created market disturbances of various direction and strength in the process.

As world economy is being globalised, the fact that a fluctuating demand often faces a steady oversupply is evident in numerous markets. As a result, sales incentives have been given a major role in the sales process in the market of confidence products (consumer durables, for example). Sales incentives could be focused on consumers – loan designs with zero-percent THM is a fine example – or any player in the sales channel. As the debt portfolio and debt ratio of Hungarian households have not dropped in spite of declining real wages, and have even showed an increase according to the data released by the National Bank of Hungary, competition in this scope is expected to intensify, which we believe will lend the aforementioned trend yet another boost.

These marketing tools, however, have considerable tax impacts, primarily regarding VAT and corporate tax. As these two taxes account for a considerable ratio in the government's revenues, the stance the tax authority takes when auditing corporate entities is, therefore, an important issue for market players, especially with regard to opportunities to reduce taxable income. As the headcount at the tax authority is expected to increase and tax audits are likely to be more frequent in an attempt to fight black economy, this issue is going to be even more significant. By selecting a concrete segment, namely new car sales, we aim to demonstrate the impairments the government could, through its tax policy, cause either willingly, or, by interpreting statutes in a disharmonic way, unwillingly.

SITUATION OF NEW CAR SALES

The sales of new vehicles saw the start of a very dynamic expansion in the late 1990s and the early 2000s in Hungary. This was primarily a growth in quantity, which, however, halted in

2002. A constantly declining growth was seen until 2005, followed by a slight increase in 2006. As a result, the annual growth rate of 22.1 per cent recorded in 2002 dropped to 1.6 per cent by 2005, which then advanced slightly to 4.1 per cent *(See Chart 1)*.

These conditions call for intensifying competition as well as the introduction and expansion of new, unorthodox marketing strategies in Hungary. Of course, it has direct impacts on the players of the sales channel. Prior to the accession to the European Union, new car sales were typically organised in such a way that a major international carmaker established an affiliate in Hungary to import and distribute the vehicles. The affiliate contracted dealerships in Hungary that sold the vehicles to end-users. The dealerships were contracted in terms of annual target numbers, their bonuses and discounts were subject to the achievement of these figures, and have been ever since.[1]

As the growth of sales dropped and competition intensified, dealers – being part of the sales channel – have come into the foreground of considerations. Wholesale affiliates have two strategies to maintain their competitive edge. One is the strategy named *"pull"*, when consumers are enticed to buy the product in question. Typical forms include lower prices and the addition of various related products[2], and also loans with eased conditions. The other direction is the strategy dubbed *"push"*, which aims to influence dealers to take greater efforts to meet target figures.

Of course, both designs have tax impacts, in which regard the tax authority has made remarkable resolutions recently. Two will be showcased here, one for each marketing strategy. We deem it important to underline that both cases demonstrate actual events, and not some probable theoretic assumptions. The ultimate conclusions to be reached are, however, universal.

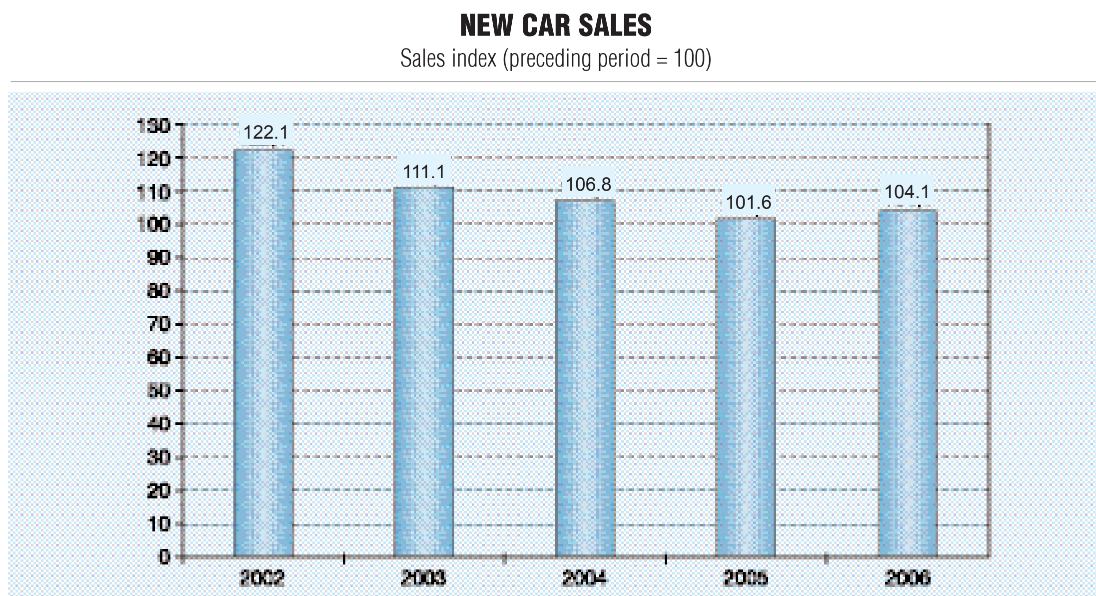
Pull strategy: Sales incentive by lower interest rates

A car dealership made a contract with its partner bank, and, consequently, bilateral transfers of funds were made between the parties. On

Chart 1

NEW CAR SALES

Sales index (preceding period = 100)



Source: KSH [Hungarian Statistical Office]

the one hand, the retailer was eligible for a management fee to be paid by the bank because of contributing to the bank's business of financing the cars that were sold by the retailer by making the bank's loan offer available, calling customers' attention to the offer and contracting them, etc. On the other hand, the bank provided the customers of the car dealer with loans at an interest rate lower than the market rate, or in some cases free of interest. The credit institution was reimbursed for the income loss by the car dealer at a price defined for each individual offer, a certain percentage of the gross purchase price of the vehicle. Both activities were invoiced as service provision.

The tax audit questioned these deals and made two main arguments. Accordingly, the second transaction – the reimbursement of the bank's income loss – was not a service provision (nor a goods sale) because it was not included in the Register of Services. Hence, said the tax audit, it did not fall under the effect of the VAT Act, in other words the retailer was ineligible for the VAT refund on the basis of the invoice issued by the credit institution.

The dealership, however, said that the concept of service provision as defined by the VAT Act was not identical to service provision in a statistical sense as the former was a much wider scope, and therefore this issue had no impact on taxability. On the other hand, the bank had taken an obligation – by participating in the deal – to provide customers of the dealership with loans at interest rates that were lower than the current market rate, incurring losses in interest income. On the basis of the VAT Act, however, such a pledge is classified as service provision, and in this case the VAT was justified to be invoiced and refunded, because payment had been made. The status quo is described by *Table 1* below.

The issues that had been raised were not scrutinised in the course of the tax audit because in its appeal the dealer had referred to Section 130 of the Act on Taxation, which says "In the course of tax audit into taxable entities with contractual obligations (contracts, transactions) that generate tax payment obligations, the tax authority cannot assess the very same legal obligation differently for various taxable entities, therefore the tax authority shall, when scrutinising one of the taxable entities of a legal obligation, adhere to the resolutions made in the case of the other taxable entity of the legal obligation". The credit institution in question, however, had been subjected to a tax audit and the tax authority had not challenged the transactions in question, thus the dealership concerned was not penalised. However, the core issue – the tax considerations of the transaction – has not been resolved.

Table 1

CONSIDERATIONS REGARDING THE "PULL" STRATEGY

Business event	Tax authority position	Taxpayer position
The bank provides customers of the dealership with loans at lower rates than the current market rate; the difference is reimbursed by the dealership	• The business activity cannot be classified under the Register of Services, thus it is not regarded as service	• The concept of service as defined by the VAT Act is not identical to the statistical concept.
	• Cannot be classified as service provision, hence the VAT cannot be refunded	• The bank pledged obligation against a surcharge, hence it is service provision

The "push" strategy: Sales increase by motivating dealers

The second case is built on the possible strategy when the retail unit is given incentives by the wholesaler to sell more products. In this design the contract is established by and between the dealership and the wholesaler according to which the retailer is given a bonus at the end of the period if a number of interrelated parameters are met. These parameters are linked to payment before due date and certain quantity limits.

Contrary to the first scenario above, the tax authority did not question the fact of tax provision, but underlined that payment before due date was the decisive factor, which raises the issue of payment allowance and discount.

Section 85, Sub-section (3), Paragraph *o)* of The Act on Accounting[3] stipulates that "The amount of any discount given in case of financial settlement prior to the term of payment (maturity) defined by the contract – in correlation to the interest on late payment and not included in the invoice – shall be accounted among other expenditures of financial transactions". Based on this stipulation, the tax authority decided, by way of a mathematical formula devised by it, that for each deal the discount – in cases when given against payment prior to deadline – shall be divided into a part that's proportionate to the interest on late payment and therefore regarded as payment allowance and into the remaining part, regarded as discount".[4]

The wholesaler, however, argued that although the tax authority's opinion -that the financial performance before the due date was a precondition to being eligible for the discount – was true, but the exact opposite of the statement was also true, because all the other parameters of the design worked similarly. Accordingly, these conditions were equal, and none of them could be picked out and regarded as a decisive factor. The status quo is described by *Table 2* below.

Summary: In the core deal the retailer sold new cars imported by the wholesaler, and it is regarded by the VAT Act as goods sale. The wholesaler pledged a bonus for the event that the retailer was willing to put in extra efforts to meet tight target figures set by the wholesaler. In accordance with the VAT Act, this extra effort is regarded as service provision, and the tax authority did not challenge it. Both deals were taxable on these basis, and the parties consigned the tax to one another and filed for tax deduction. But after the consequent tax

Table 2

CONSIDERATIONS REGARDING THE "PUSH" STRATEGY

Business event	Tax authority position	Taxpayer position
The wholesaler pays the dealership commission when certain parameters are met (payment before due, quantity limits).	• Service provision was effected. • Although several conditions are to be met to be eligible for the commission, payment before due date is the decisive factor. • The Act on Accounting says payment allowance shall be separated from discount and the deal divided accordingly.	• Service provision was effected, because additional efforts to meet the targets were rewarded by the wholesaler. • Emphasis is on simultaneous achievement of several requirements, none of them can be singled out • Although the deal can be divided mathematically, it should be regarded in its entirety.

audit at the wholesaler the tax authority challenged the deductibility of part of the tax on the service provision, but, on the other side of the very same deal, it did not question the tax payment. As a result, a similar situation developed after the appeals than in the first case: In reference to Section 130 of the Act on Taxation, the wholesaler was absolved. The issues have not been resolved.

THEORETICAL CONSIDERATIONS

The issue of taxability

Both designs outlined above deliver a number of intriguing lessons. The first, the issue of taxability. To put it simply, what has to be scrutinised in each case is whether there exists some cause-and-effect connection between the work done and the money received. This is necessary because work means different things in everyday life, or from a statistical aspect, and still something else on the basis of the VAT Act. In everyday life, work is a conscious, purpose-driven activity, an effort[5] that produces something; it is value creation in the corporate sense, but what's decisive from the aspect of VAT is the issue of the price, which is a qualitative feature. According to Section 13, Sub-section (1), Paragraph 1, "Price: material asset transferred as the settlement of a debt, including material assets to reduce existing accounts payables but excluding indemnity. In the case of contribution in kind, its value as approved by the auditor, or, in lack of it, the value of the non-pecuniary contribution to be made by the member of the company". To put it simply, the question is whether one gets paid for one's work, or one works to get paid. If this connection is valid, then the transaction in question is taxable.

In accordance with the VAT Act, there are two instances where work is done in the case of loans offered with reduced interest rates. One, the credit institution developed a loan design that facilitated loans with lower rates than the current market rate[6], and, secondly, the credit institution pledged to charge customers less than the usual market rate. The dealership paid this price, and, consequently, work was done on both sides, it did have a price, and there was a clear cause-and-effect connection between them, hence it was taxable.

Of course, the question arises what would happen if the court reached a verdict that countered the reasoning above. In this case the transaction would be released from the force of the VAT Act, and the tax to be deducted should be paid by the dealership, the credit institution would conduct a self-review to reclaim the tax it already paid, and the government would be left with the amounts of fines and interest only. But the court decides in given cases only, and, consequently, both taxpayers would correct their tax returns by way of self-review and would continue the transactions without displaying tax. As a result, the government could expect "revenues" from the imposed financial sanctions only.

The issue of payment allowance

The issue of payment allowance is raised in the second case. The Act on Accounting is unambiguous with regard to the maximum amount to be accounted as other expenditures of financial transactions. But this statute is not entirely clear in two points. First, the term "at least" in the statute defines an upper limit for the amount to be accounted as such and it does not express that is shall be accounted. The other problem: Does the emphasis on payment discipline refer to payment allowance? Defining the principle of reality, the Accounting Act might provide a solution, as Section 4, Sub-section (4) of said Act

allows for a deviation for the rule, provided the application of the rule does not ensure a realistic image.

According to the tax authority, the amount of discount given in the case of payment before due date shall be divided into a part in correlation with the interest on delayed payment (payment allowance) and another, uncorrelated part (discount).[7] But which market player would lose or gain what if the tax authority's logic were to be applied?[8] It is clear in a mathematical sense that in the case of a HUF 1 million invoice with 30 days of payment and 15 days of payment allowance date with 2 per cent of payment allowance, the tax amounts will be somewhere around HUF 3,200 and HUF 3,300. Ironically, the amount of tax to be paid to the tax authority does not change after this apparently unproductive dispute, as described by *Table 3* below.

Evidently, only the title changes, neither the amount of corporate tax, nor the amount of the VAT changes. A tax audit will establish legal violation at one party, which party then will refer to Section 130 of the Act on Taxation, or the invoices will be modified, and all the tax authority gains is the total of fines and interest on late payment.

CORPORATE VALUE CREATION IN AN INNOVATIVE WAY

The law – saying there's no free lunch – is enforced in these cases as well. Customers may be convinced that they are obtaining a big loan with unrealistically low or even zero-percent THM, but the economic reality is indeed present in these deals too. Of course, the bank never deploys its loans without charging interest, because it would be an illogical conduct, the bank would be consuming its own equity and destroying corporate values. The bank's return is indeed evident: It is paid by the dealership, which, in turn, creates value for its owners and the society by increasing its sales, a faster turnaround of its inventories, and an upswing in related services (vehicle repair, for example). Actual value creation is happening in the course of the work of both parties. This path of value creation, however, differs from the mainstream as far as some of its components are concerned.

The case where the payment allowance is present is less innovative. All there is to this case is that the wholesaler, in order to boost its own sales, gives the retailer incentives to make extra efforts. When the retailer has met these

Table 3

TAX IMPACTS OF HUF 100 PAYMENT ALLOWANCE

Service provision		Corrective invoice		Results of financial transactions	
Wholesaler	Retailer	Wholesaler	Retailer	Wholesaler	Retailer
User of services; with HUF 100 of increase in material-like expenses, accounts HUF 20 of tax deduction	Provider of service; pays HUF 20 tax on HUF 100 of increase in sales	Issues corrective invoice, its sales drop by HUF 100, accounts the HUF 20 tax paid earlier as deduction now	Receives corrective invoice, reduces material-like expenses by HUF 100, pays the HUF 20 tax accounted as deduction earlier.	The total of sales and VAT remains unchanged, result of financial transaction is reduced by HUF 100.	The total of material-like expenses and VAT remains unchanged, result of financial transaction increases.
The total of corporate tax and VAT paid or to be paid remains unchanged.					

requirements, discount are given, which will reduce the retailer's operational costs. But value creation is apparent here as well. The wholesaler creates value by increasing sales and speeding up the turnaround of its inventories, and the retailer reduces its costs as a result of its efforts, which, in turn, also creates corporate value.

Hence, it is evident in both cases that rational corporate values are created. Of course, these have tax impacts, because value-added tax and corporate tax are imposed on added value in nearly all the countries of the world. A common characteristic of these deals is that a situation develops in the course of business activities between the parties to the deal where one of the parties becomes entitled to reduce its taxable amount, while its counterpart increases its own taxable amount concerning the very same taxes. Consequently, there are no changes in the total tax revenue.[9]

In the aforementioned cases, the tax audit consistently found against the reduction of the taxable amount. Eventually, both parties challenged these decisions, and finally the court was asked to settle the dispute. A common feature of the verdicts was that the tax audit should have been made on the basis of Section 130 of the Act on Taxation and should have regarded the issue as an organic whole. No matter which solution is accepted as mandatory for all subsequent cases, the economic content will not change: Market players are forced by the market to devise newer and newer ways to create value. If consensus is reached that a certain deal is not taxable, that deal will disappear from view, but when it is taxable, market entities will have to accept that an increase in the taxable income at one party will generate a reduction in the taxable income of the other party.

That a dispute arises when a new issue emerges is not the real problem. Developed Western countries often take years or even decades to reach a consensus that is approved by all. The problem is the one-track-minded approach: That an increase in the taxable income of one party is not challenged, but when the other party reduces its taxable amount accordingly is immediately challenged. This single-mindedness causes unneeded disturbances in the operation of the market, and unproductive litigation destroys corporate and social values.

Transactions are to be regarded in their entirety

Two possible marketing strategies that are employed in car sales have been described in the paragraphs above. The "pull strategy" was used to encourage customers to consume more by loan designs with lowered interest rates or even zero-percent THM. The push strategy was employed by the wholesaler to motivate the retailer by pledging a bonus.

The common lesson learned from both cases is that the approach that scrutinises only one of the two parties to a certain deal and leaves the other out of the consideration is inappropriate, because as far as the issue of taxability is concerned an increase in the taxable income of the one party generates a similar decrease in the taxable income of the other party, provided the deal in question is taxable. When the issue of taxability is excluded, the issue loses relevance.

In our analysis, we stripped both resolutions of the tax authority to components, scrutinised the positions of the parties, and tried to formulate a clear opinion. More importantly, the conclusion was reached that it's not the specific case of a specific enterprise what counts. There is a problem in attitude, because the reduction of a taxable income is challenged whereas the increase of a taxable income on the other side of the deal is not. However, deals should be regarded in their entirety, because the total of tax revenue is independent of the consensus.

Notes

1 With the EU accession, the positions of exclusive wholesalers were terminated. Today, audited brand dealerships and service garages are operated, but the structure of the aforementioned supply chain has not changed.

2 In the present case, it's free air conditioner in the spring and winter tyres in the autumn.

3 Act C of 2000

4 When regarded as payment allowance, it does not affect either the VAT base or the VAT amount, but when it is seen as discount, the tax could be lowered by issuing a corrective invoice [Section 45, Sub-section (1), Paragraph *a)* of the Act on Accounting].

5 Magyar Értelmező Kéziszótár [Concise Dictionary of the Hungarian Language].

6 Of course, the loan design may have existed, and the only addition is that the customers of the dealership in questions are allowed to access it.

7 It should be noted that the issue of service provision, the core problem in the first case, was not even raised here!

8 It should be noted that the tax authority's method has not been available to the author, thus the most convenient solution is studied here.

9 Solutions can be created mathematically that show discrepancies of a couple of thousandths or ten thousandths per cent of the gross amount, and some of them would even cause losses for the government when the path suggested by the tax authority is taken.