

Cite as Det No. 12-0260, 32 WTD 156 (2013)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 12-0260
)	
. . .)	
)	Registration No. . . .
)	Document No. . . .
)	Audit No. . . .
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)	Document No. . . .
)	Audit No. . . .
)	Docket No. . . .

RCW 82.08.037: RETAIL SALES TAX – BAD DEBT DEDUCTION – PRIVATE LABEL CREDIT CARDS. A retail store whose customers purchased retail goods and services from the store using banks’ private label credit cards, could not take a bad debt deduction under former RCW 82.08.037 when the customers failed to pay the banks amounts due on their accounts because no debt existed between the customers and the store.

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.

Pree, A.L.J. – A retailer protests the denial of a bad debt deduction for sales tax paid that it received from private label credit card sales. The customers purchased retail goods and services from the taxpayer using banks’ credit cards, but failed to pay the banks the amounts due on their accounts. Because the banks held the debt, the taxpayer was not entitled to claim a credit for bad debts on their customer’s purchases using the banks’ credit cards. Petition denied.¹

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

ISSUE

Under RCW 82.08.037, is a retailer entitled to a retail sales tax credit or refund for sales taxes received from customers using banks' private label credit cards, after the customers failed to pay the banks the amounts due on the accounts?

FINDINGS OF FACT

[Taxpayer] is a corporation headquartered outside of Washington. The taxpayer sells . . . merchandise at [its] stores The taxpayer charges retail sales tax on retail sales in its Washington stores, which the taxpayer reported on its combined monthly excise tax returns and paid the retail sales tax to the Department of Revenue (Department). Many customers used private label credit cards issued by [banks] for their purchases. The banks paid the taxpayer the amount charged. Later, some customers defaulted, and did not pay the banks the amount due on their private label credit cards. The taxpayer deducted the amounts due the banks as credit card bad debts on its excise tax returns.

The Department's Audit Division reviewed the taxpayer's books and records for the period from January 1, 2006, through December 31, 2009. On January 6, 2012, the Audit Division issued Document Number . . . , which assessed \$. . . in additional retail sales tax and \$. . . business and occupation (B&O) tax on the credit card bad debt deduction taken by the taxpayer. With \$. . . interest, the assessment totaled \$. . . and was due February 6, 2012. The taxpayer appealed the assessment. . . .

The taxpayer states that it paid for each credit loss as the loss rose, up to a cap, which was a percentage of average net receivables. The taxpayer deducted the credit loss from its gross income. The taxpayer contends it was entitled to the disallowed bad debt deduction on the credit card debt because it was ultimately responsible for the credit losses. The taxpayer notes that it also claimed the private label credit card losses on line 15 of its federal income tax returns (form 1120) as bad debts. . . .

The customers signed credit card agreements with the banks to whom they were liable. The banks were the sole and exclusive owner of the accounts under the contract. . . . The banks charged the taxpayer a fee based in part on "Net Write-Offs" subject to a cap. The taxpayer agreed to be responsible for net write-offs (up to ...%), . . . which were taken in to account in projecting annual performance when determining the monthly fee. During the audit period, the ". . . Net Write-Off Percentage" used to project the monthly fee was the lesser of the percentage of the actual Net Write-Offs for the immediately prior year or . . .%. Therefore, the credit card losses were factored into determining the service fee, which funded the loss reserve. The taxpayer compensated the banks by paying the service fee, which was increased the year following credit card losses and for other projected administrative costs incident to the credit card program. . . .

According to the taxpayer, when customers defaulted on their obligation to the banks, the taxpayer became responsible for the credit losses or “Net Write-Offs.” The banks established loss reserves, funded by the monthly fees, which were calculated by the banks and the taxpayer, and projected for each year on a month to month basis. The “Net Write-Offs” reduced the loss reserve funded by the monthly fees, resulting in an increased service fee the year following credit losses. . . .

The banks provided the taxpayer the gross amount of defaults, which the taxpayer assigned to specific stores based on gross revenue. The taxpayer did not attempt to determine the individual debtors, and if or where they paid sales tax. The taxpayer’s arrangement was portfolio-wide, not an account-by-account charge. The banks did not assign their contracts back to the taxpayer if the customers defaulted. There is no evidence that the taxpayer ever pursued any collection action against customers who had defaulted on the banks’ credit card accounts. However, under the agreement with the banks, the taxpayer states it retained the right to seek sales tax refunds. The banks agreed that the taxpayer had the right to claim sales tax deductions related to “Net Write-Offs.” . . .

The Audit Division relied on [a prior determination] issued to the taxpayer involving the denial of bad debts claimed on private label credit cards for the periods prior to the current assessment. We denied the taxpayer’s appeal in [that determination] because the banks, not the taxpayer, were the owners of the accounts. While we have the same situation here, the taxpayer contends that we erred by finding the cost of the bad debts were built into the service fee, rather than finding that the taxpayer, “paid for each credit loss as it rose (up to a cap set by the agreements)”. . . We disagree. Because the taxpayer only paid the service fees, and did not hold the debt or pay on individual defaults, we find that the taxpayer did not pay for each credit loss as customers defaulted to the banks.

ANALYSIS

RCW 82.08.020 imposes retail sales tax on retail sales. Sales tax is computed without regard to the seller’s expenses and losses. RCW 82.08.010(1). As required by RCW 82.08.050, the taxpayer collected the sales tax as trustee, and remitted the sales tax to the Department. A retail sale is consummated for sales tax purposes when a seller transfers property in exchange for a buyer’s promise to pay, even though a buyer pays nothing at the time of purchase. RCW 82.04.040; WAC 458-20-103; *Olympic Motors, Inc. v. McCroskey*, 15 Wn.2d 665, 132 P.2d 355 (1942). A buyer’s default does not negate a sale. *See id.* at 669-670. In our case, the taxpayer received the amounts charged including retail sales tax from the banks shortly after the sales, and remitted the taxes to the Department.

The failure of the taxpayer’s customers to repay the banks does not affect the State’s right to retain the retail sales tax any more than it affected the taxpayer’s right to retain its share of the sales proceeds. In *Olympic Motors*, the Court recognized the statutory measure of tax, together with the seller’s personal liability for the tax, clearly express the legislature’s intent that sales taxes are payable without regard to the seller’s profits, losses, and failure to collect. 15 Wn.2d at 669. Absent statutory authority, sellers could not receive a credit or refund on bad debts.

The taxpayer seeks a credit or refund for sales taxes on bad debts under former RCW 82.08.037(2008), which provided:²

- (1) A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003.
- (2) For purposes of this section, "bad debts" does not include:
 - (a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;
 - (b) Expenses incurred in attempting to collect debt; and
 - (c) Repossessed property.
- (3) If a credit or refund of sales tax is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.
- (4) Payments on a previously claimed bad debt are applied first proportionally to the taxable price of the property or service and the sales or use tax thereon, and secondly to interest, service charges, and any other charges.
- (5) If the seller uses a certified service provider as defined in RCW 82.32.020 to administer its sales tax responsibilities, the certified service provider may claim, on behalf of the seller, the credit or refund allowed by this section. The certified service provider must credit or refund the full amount received to the seller.
- (6) The department shall allow an allocation of bad debts among member states to the streamlined sales tax agreement, as defined in RCW 82.58.010(1), if the books and records of the person claiming bad debts support the allocation.

This version of RCW 82.08.037 entitled a seller to recover sales taxes it advanced to its customers from its own funds as debts, not sales taxes it merely collected and remitted as the state's trustee. The taxpayer did not finance its customers' purchases. Nor did the taxpayer advance the sales taxes from its own funds. The banks advanced the funds, paid the taxpayer the purchase price with the sales tax, and the banks expected to collect the tax from the buyers. The customers' debts for the taxes were not owed to the taxpayer. The taxpayer's contracts expressly provided that the banks were the sole and exclusive owners of the accounts.

In *Puget Sound National Bank v. Dep't of Revenue*, 123 Wn.2d 284, 291, 868 P.2d 127 (1994),³ the Court recognized under WAC 458-20-198 and WAC 458-20-235 that while the lender may

² RCW 82.08.037 was amended in 2010, effective May 1, 2010. . . .

collect the tax over installments, the tax must be remitted in the period in which the sale occurs. Here, the banks advanced the sales taxes to the taxpayer, who remitted the taxes to the Department. The customers owed the taxes to the banks, not to the taxpayer. When they failed to pay the banks, they defaulted on their obligation to the banks. The customers owed nothing to the taxpayer on the banks' accounts, and the taxpayer never pursued collection from the customers for the banks' credit card debt.⁴ The Court in *Puget Sound National Bank* recognized that under RCW 82.08.037, when installment contracts were assigned to a bank, the bank thereupon stepped into the retailers' shoes and assumed the retailers' status with respect to all the rights and liabilities related to those contracts. 123 Wn.2d at 293. In our case, the banks always held the contracts. Because no debt existed between the customers and the taxpayer, the taxpayer was not entitled to a credit under former RCW 82.08.037 when the customers failed to pay their banks.

The Washington Court of Appeals recently addressed whether a retailer could take a bad debt deduction in a situation where a third party credit card bank paid the retailer for the purchase, and then wrote off as uncollectable the amounts it could not collect from its customer. *Home Depot USA, Inc. v. The Dep't of Revenue*, 151 Wn. App. 909, 922; 215 P.3d 222 (2009). In *Home Depot*, the Court noted that: "the party seeking the deduction must be the one holding the bad debt as well as the one to whom repayment on such debt would be made." *Id.* This critical fact in the *Home Depot* decision matches the taxpayer's situation. Because Home Depot sold its rights in the credit card account to the bank, it could no longer collect unpaid sums from the customers:

Put differently, the buyer no longer owed anything to Home Depot and Home Depot could not legally seek repayment from the buyer from any loss, direct or indirect, due to the buyer's later default.

Home Depot, 151 Wn. App. at 922.

Home Depot, like our taxpayer, argued that that the bank's service fees were linked to the bank's bad debts. The bank's increased service fees transferred the loss back to the retailer. The Court of Appeals recognized that the service fees were not deductible as a bad debt. *Id.* at 923.

The taxpayer attempts to distinguish itself from *Home Depot*, noting that unlike Home Depot, it deducted the bad debt loss on its federal income tax return. The Court of Appeals, while recognizing Home Depot did not take the bad deduction and meet that requirement of former RCW 82.08.037 stated:

³ While RCW 82.08.037 was previously amended in 2004, we note from the statement of intent the legislature did not intend that the revised statute to affect the holding of the supreme court of the state of Washington in *Puget Sound National Bank v. the Department of Revenue*, 123 Wn. 2d 284 (1994). Laws of 2004 c 153 § 301.

⁴ While the taxpayer argues that under common law subrogation it was entitled to collect the banks' debts from its customers, it was unable to prove that it ever attempted to do so.

Simply because someone can deduct the bad debt deduction does not transform an ordinary business expense or loss into a refundable sales tax debt under former RCW 82.08.037. This conclusion is amply supported by the sales tax scheme, which excludes overhead and other costs of doing business from sales tax calculations. Former RCW 82.08.010(1). The mere existence of any economic loss to the refund claimant is simply not sufficient to allow it to invoke former RCW 82.08.037 to cover these losses.

Home Depot, 151 Wn. App. at 924.

The taxpayer's contracts with the banks factor in the credit losses to determine the service fee, but the accounts do not transfer to the taxpayer. The service fees are the taxpayer's costs of doing business, which are not deductible from the taxpayer's sales tax calculations even if the banks pass their credit losses to the taxpayer. We should not confuse the taxpayer's contractual obligations used to project its service fees with the taxpayer's non-existent bad debt. The banks, not the taxpayer, were the sole and exclusive owners of the accounts under the contract.

A bad debt is an involuntary loss, not a voluntary, contractual expense. The taxpayer attempts to equate its service fee expenses as bad debts. The taxpayer's business decision to voluntarily contract with the banks clearly established the banks' charges as the taxpayer's service fees, and the banks as exclusive owners of the accounts. A taxpayer may operate its business in whatever form it deems appropriate for its own business reasons, but if the chosen form has adverse tax consequences, the Department is not required to disregard the form to avoid or minimize those adverse consequences. A business must bear the tax consequences that come with its choice of form. *American Sign & Indicator v. State*, 93 Wn.2d 427, 610 P.2d 353 (1980); *Sav-Mor Oil v. State Tax Commission*, 58 Wn.2d 518, 364 P.2d 440 (1961); Det. No. 89-447, 8 WTD 175 (1989). Here, the taxpayer contracted to have the banks finance its customers' purchases. The banks paid the taxpayer's charges plus retail sales taxes, after which the customers owed the banks. The taxpayer agreed to pay the banks a service fee. The taxpayer chose to operate its business by having banks finance customers' purchases and pay the banks a fee rather than having customers indebted to the taxpayer. The taxpayer must bear the tax consequences of the arrangement it chose.

Former RCW 82.08.037 entitled a seller to recover sales taxes it advanced to its customers from its own funds, not sales taxes it merely collected and remitted as the state's trustee under RCW 82.08.050(2). Unlike the automobile dealer in *Puget Sound National Bank v. Dep't of Revenue*, the taxpayer did not finance its customers' purchases. Nor did it advance the sales taxes from its own funds. Rather, the taxpayer merely remitted amounts it collected from the buyer's lenders, the banks, and held as the state's trustee. Because the taxpayer did not finance the private label credit card transactions, it never had a legal right to the amounts remitted to the Department on the transactions.

Finally, the legislature amended former RCW 82.08.037, effective July 1, 2004 in accordance with the Streamlined Sales and Use Tax Agreement (SSUTA). The purpose of the SSUTA was to simplify and modernize sales and use tax administration nationwide through the adoption of

uniform rules and procedures. SSUTA § 102; RCW 82.02.210(1). The SSUTA includes “Uniform Rules Of Recovery Of Bad Debts,” which requires in § 320C that each member shall:

Allow bad debts to be deducted on the return for the period during which the bad debt is written off as uncollectible in the claimant’s books and records and is eligible to be deducted for federal income tax purposes.

(Emphasis supplied).

The accounts do not list the debts on the taxpayer’s books and records as required by RCW 82.08.037(6). The taxpayer, as the claimant of the credit, did not write off the bad debts because the taxpayer never owned them or carried the receivables on its books. The banks were the exclusive owners of the accounts. The amounts due from the customers were never carried on the taxpayer’s books as accounts receivable. The “Net Write-Offs” were only a factor used to project service fees for the subsequent year. Therefore, when a customer defaulted on its credit card debt to the customer’s bank, there was nothing for the taxpayer to write off. Because there was no debt to the taxpayer, we conclude the taxpayer could not take a bad debt deduction.

DECISION AND DISPOSITION

We deny the taxpayer’s petition.

Dated this 25th day of September 2012.