

Cite as Det. No. 01-075, 23 WTD 55 (2004)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of)	<u>D E T E R M I N A T I O N</u>
)	
)	No. 01-075 ¹
)	
...)	Registration No. . . .
)	Docket No. . . .
)	

- [1] RULE 196; RCW 82.08.037: RETAIL SALES TAX -- CREDIT FOR BAD DEBTS -- ASSIGNMENT -- PUGET SOUND CASE -- ACTUALLY INCURRED THE LOSS. An assignee of account receivables originating from the sale of retail goods was allowed a credit for bad debts only to the extent that the assignee actually incurred a financial loss and the amounts actually reflected uncollected retail sales tax.
- [2] RULE 196; RCW 82.08.037: RETAIL SALES TAX – CREDIT FOR BAD DEBTS -- FINANCING ACTIVITIES: A financing company that extended credit directly to a store’s customers was not entitled to a retail sales tax credit for bad debts.
- [3] RULE 229; RCW 82.32.060: RETAIL SALES TAX – EXTENTION OF NON-CLAIM PERIOD – EXECUTED WAIVER. A Taxpayer’s petition for refund of overpaid taxes was filed timely where the taxpayer filed its refund request within the extended deadlines of written waivers executed pursuant to RCW 82.32.050.

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.

¹ The reconsideration determination, Det. No. 01-075ER, is published at 23 WTD 64 (2004).

NATURE OF ACTION:

A provider of financing services for private label credit card programs protests a denial of its refund claim relating to unclaimed bad debt credits.²

FACTS:

Okimoto, A.L.J. -- . . . , (Taxpayer) is a financing business with its administrative office located in [State A]. On December 31, 1996 Taxpayer filed a refund claim for unclaimed bad debt deductions covering the period January 1, 1990 through November 30, 1996 in the amount of \$. . . Taxpayer explains the basis for the deduction in its petition for refund dated December 31, 1996 as follows:

[Taxpayer] provides financing services for private-label credit card programs involving sellers in many industries. [Taxpayer] purchases consumer revolving charge accounts from sellers.

The transactions, which give rise to the bad debt sales tax refund in this claim, begin with the sale of tangible personal property or taxable services by a seller to a purchaser on a credit basis. Immediately following this sale the seller pays the sales tax on the entire amount of the sale to the Washington Department of Revenue. The retailer subsequently assigns the account to [Taxpayer]. The purchase price [Taxpayer] pays for the account includes the amount of sales tax paid by the seller to the Department of Revenue. The retailer subsequently assigns the account to [Taxpayer]. The purchase price [Taxpayer] pays for the account includes the amount of sales tax paid by the seller to the Department of Revenue, which is then collected by [Taxpayer] from the consumer.

The retailer assigns the account to [Taxpayer] on a nonrecourse basis. [Taxpayer], therefore, has all of the rights, title and interest of the retailer in the account. When a consumer defaults, [Taxpayer] will not be able in most instances to recover the outstanding balance. At that time, the unrecovered portion of the debt becomes a worthless debt for federal income tax purposes.

Taxpayer states that it purchases the account receivable from [Store] at full face value and receives all rights regarding those accounts. In addition, Taxpayer receives an account service fee of \$. . . for each active account during the service period. [Store] pays an account collection service fee because Taxpayer purchases the receivables at full face value and not at a discount. The contract also requires Taxpayer to allocate a portion of its service fee to fund a Loss Reserve Account in the name of [Store]. This account is set at the level of estimated bad debts. As accounts go bad, they are charged against the Loss Reserve Account. [Store] is also obligated to

² Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

pay Taxpayer a Loss Supplement Fee of \$. . . for each settlement period. Any unused balance in the Loss Reserve Account at termination belongs to [Store].

CONTENTIONS AND ARGUMENTS:

Taxpayer argues that since it purchases the account receivables on a nonrecourse basis, it receives all the rights under the contract as an assignee. When an account becomes uncollectible, it is charged off as a bad debt on Taxpayer's federal income tax return. Consequently, Taxpayer argues that it is entitled to take a bad debt credit pursuant to RCW 82.08.037 and WAC 458-20-196 (Rule 196). Taxpayer relies on *Puget Sound National Bank v. Department of Revenue*, 123 Wn.2d 284, 868 P.2d 127 (1994), in support of its position.

Audit considered Taxpayer's refund claim and denied it by letter dated July 20, 1999. In the letter, Audit stated:

The contract between [Taxpayer] and [Store] shows that in the State of Washington, [Taxpayer] does not purchase installment contracts from [Store], but provides a private label credit card to [Store] customers for the purchase of [Store's] merchandise. . . . In this case, [Taxpayer] is not buying installment contracts. [Taxpayer] is providing a service for [Store] in which it gets paid a fee. The contract is clear on the fact that the bad debts are written off against the fees charged to [Store]. It is [Store], not [Taxpayer] who bears the economic burden of the bad debts. Even [Taxpayer] admits that the fee structure in the contract is negotiated to yield [Taxpayer] a certain return on their investment. The Supplement Loss Reserve Fee of \$. . . per month (adjusted), is other indication that [Store] is reimbursing [Taxpayer] for its losses.

In addition, Audit maintained that the years 1990 and 1991 were barred by the non-claim statute. In response to this, Taxpayer states that it is not barred by the non-claim statute because it had previously timely filed extension requests tolling the non-claim period. Taxpayer explains its position in its June 21, 2000 letter as follows:

[Taxpayer]'s position is that a refund claim was timely filed before the waiver expired....

. . .

There were three waivers executed involving the sales and use tax, and the business & occupation tax audit of [Taxpayer]. The first waiver was executed on December 8, 1994, and extended the year 1990 to December 31, 1995. . . . The second waiver was signed on October 13, 1995 and extended the years 1990 and 1991 until December 31, 1996. . . . The final waiver was executed by the taxpayer on July 26, 1996, and extended the refund period for years 1990 through 1992 until June 30, 1997. .

. . .

[Taxpayer] filed its refund claim with the Department by certified mail on December 31, 1996. . . . [Taxpayer]'s refund claim was filed within the time frame covered by the above referenced waivers.

Taxpayer relies on RCW 82.32.060 in support of its position.

Audit also stated that Taxpayer had incorrectly computed the amount of retail sales tax "written off" as a bad debt because it understated the total amount of bad debts recovered from customers by not including amounts retained by collection agencies as their fees.

Taxpayer acknowledges that it currently provides a private label [Store] credit card program in its own name to [Store] customers. As such, Taxpayer itself advances the money, runs, and operates the credit card program. [Store] is not directly involved in the program. Taxpayer states, however, that this contract did not go into effect until . . . , 1994, and prior to that time, [Store] offered its own credit card program, and sold all of its customer accounts to Taxpayer. Taxpayer supplied a copy of the pre-1994 contract to corroborate its statement.

ISSUES:

- 1) Is an assignee of account receivables entitled to a retail sales tax bad debt credit on amounts written off as bad debts on its federal income taxes when the bad debts are reimbursed by the assignor through the payment of a fee or supplemental reserve? Does this result change if Taxpayer is not reimbursed?
- 2) Is Taxpayer's petition for refund of taxes overpaid for the years 1990 & 1991 barred by the non-claim statute?
- 3) Is Taxpayer entitled to a retail sales tax bad debt credit for periods after . . . , 1994?

DISCUSSION:

Periods Prior to . . . , 1994:

RCW 82.08.037 and WAC 458-20-196 (Rule 196) allow the bad debt credit and provide:

A seller is entitled to a credit or refund for sales taxes previously paid on debts, which are deductible as worthless for federal income tax purposes.

The case upon which Taxpayer relies, *Puget Sound National Bank v. Department of Revenue*, 123 Wn.2d 284, 868 P.2d 127 (1994), is the most recent pronouncement in this area. In *Puget Sound*, car dealers had entered into installment contracts with retail car buyers to allow them to purchase cars over a period of time. At the time of purchase, the dealers collected retail sales tax from their customers on the full sales price of the automobile and remitted that amount to the State. Puget Sound National Bank (Bank) purchased these installment contracts at full face

value on a non-recourse basis from the dealers who had sold the vehicles. In return, the dealers assigned to Bank all of the dealers' rights under the installment contract. After the assignment, many buyers defaulted on their contracts and Bank repossessed the automobiles and usually sold them at a loss. That loss was then written off as a worthless debt on Bank's federal income tax return. The Department denied Bank's refund request for retail sales taxes previously paid on contracts written-off as bad debts, and Bank appealed to court.

The Washington Supreme Court interpreted RCW 82.08.037 as having three requirements:

. . . (1) The seller must be a person, (2) making sales at retail, and (3) entitled to a refund for sales taxes previously paid on debts which are deductible as worthless for federal income tax purposes. *Puget Sound* at 287.

It was undisputed that Bank satisfied requirements one and three, and the controversy centered on requirement two. In finding that Bank satisfied the second requirement through its status of assignee, the court stated:

Here, the dealers assigned their installment contracts to the Bank. The Bank thereupon stepped into the dealers' shoes and assumed the dealers' status with respect to all the rights and liabilities related to those contracts. Under RCW 82.08.037 the status of the Bank includes the dealers' prior tax attribute of "making sales at retail". Since the assignment of the installment contracts carried with it the "making sales at retail" requirement, the Bank is entitled to a sales tax refund under RCW 82.08.037. *Puget Sound* at 293.

It is undisputed that Taxpayer is a person under the Revenue Act.³ The second requirement is whether Taxpayer is "making sales at retail." In this case, Audit does not dispute that [Store] was making sales at retail. Under the holding of *Puget Sound* if Taxpayer is an assignee of [Store]'s credit card sales contracts, it steps into [Store]'s shoes and assumes [Store]'s status with respect to all rights and liabilities related to those contracts. For purposes of RCW 82.08.037, this includes [Store]'s status of "making sales at retail."

Taxpayer's contract prior to . . . , 1994 stated in part:

2.1. Purchase of Accounts and Indebtedness.

Parent and each Operating Subsidiary agrees to offer to sell, assign, and transfer all Accounts and all Eligible Indebtedness originated from time to time thereon to [Taxpayer] and [Taxpayer] agrees to purchase and acquire from Parent and each

³ RCW 82.04.030 defines person or company as meaning any "individual, receiver, administrator, executor, assignee, trustee in bankruptcy, trust, estate, firm, copartnership, joint venture, club, company, joint stock company, business trust, municipal corporation, political subdivision of the state of Washington, corporation, limited liability company, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof." (Underlining added.)

Operating Subsidiary all Accounts and all Eligible Indebtedness that are approved by [Taxpayer] as set forth in Section 3.1 hereof. . . .

Section 5.1. of the contract further clarifies that:

The parties hereto intend that the transactions contemplated by Section 2.1 hereof shall be treated as a purchase and sale of Accounts and Indebtedness for all purposes. The parties do not intend that the transactions contemplated by this Agreement be deemed a loan from [Taxpayer] to Parent and the Operating Subsidiaries.

Based on the above contract, we find that Taxpayer is an assignee of [Store]'s credit card sales contracts and therefore "steps into the shoes" of [Store] as to its status as a person "making sales at retail." Accordingly, we find that Taxpayer meets the second requirement of RCW 82.08.037.

The third requirement is that Taxpayer must be "entitled to a refund for sales taxes previously paid on debts which are deductible as worthless for federal income tax purposes." Subsequent to the *Puget Sound* case, the Department issued Excise Tax Advisory 574.08.198 (ETA 574) on March 15, 1996. It explains the Department's interpretation of the *Puget Sound* ruling and states in part:

The Court allowed the refund claims because the bank, as assignee, "stepped into the dealers' shoes and assumed the dealers' status with respect to all the rights and liabilities related to those contracts." Thus, banks, financial institutions, and other persons purchasing installment contracts are entitled to a bad debt credit when the retail seller paid the full amount of retail sales tax owed, and the assignee incurred a bad debt because the buyer defaulted on the contract. An assignee may claim a bad debt credit whether the contract was purchased on a recourse or nonrecourse basis, provided that assignee actually incurs the loss and is entitled to the federal income tax bad debt deduction. (Underlining added.)

We find ETA 574 correctly states the Department's interpretation of *Puget Sound* and is based on the concept of recovered funds. [Recovered funds are reported as gross proceeds of sale or gross income to offset a previously taken bad debt credit.] See Rule 196 (Stating that for purposes of bad debt B&O tax deductions, funds recovered on previously charged off debts must be included in gross proceeds of sale or gross income in the period received).

We similarly conclude that under RCW 82.08.037, for purposes of the bad debt retail sales tax credit, amounts recovered on previously written-off bad debts must also be included in gross proceeds of sale or gross income in the period received. In the alternative, they may be offset against a current bad debt credit. This is because, in those cases where Taxpayer received reimbursements from [Store] through its Loss Reserve Account, or where Taxpayer recovered funds directly from the debtor, Taxpayer did not "actually incur the loss" and the *Puget Sound* case [does not aid the taxpayer]. Taxpayer's petition for refund is denied on this issue.

During a supplemental hearing, however, Taxpayer stated that [Store]'s contributions to the Loss Reserve Account covered only a portion of the worthless accounts assigned by [Store] to Taxpayer. Consequently, Taxpayer contends that for the majority of cases, the Loss Reserve Account was insufficient to cover the bad debt write-offs and Taxpayer received no reimbursements. Taxpayer argues that in these cases, it actually did incur the financial loss.

After considering Taxpayer's supplemental testimony, we agree that to the extent that the Loss Reserve contributions were insufficient to cover all of Taxpayer's bad debt write-offs, it actually did incur the financial loss and is entitled to a retail sales tax credit under the holding of *Puget Sound* and RCW 82.08.037. We do note, however, that only a portion of the total amount written off as worthless on Taxpayer's federal income tax return would be entitled to a Washington retail sales tax credit. Such total amounts must first be reduced by recoveries and then further adjusted to reflect charges to accounts derived from non-Washington sales, non-taxable sales, exempt sales, finance charges, and other non-retail sales taxable charges. Because Washington retail sales tax would not have been previously paid on these amounts, Taxpayer is not entitled to a retail sales tax credit. We further note that the burden is on Taxpayer to keep and maintain records sufficient to determine the validity and amount of any claimed credit, which records must include specific transaction level data that proves the sale took place in Washington and that Washington retail sales tax was paid. In the absence of such documentation, Taxpayer's claimed credit will be denied. RCW 82.32.070 and WAC 458-20-254 (Rule 254). This issue is remanded to Audit to allow Taxpayer additional time to procure and present the necessary documentation. Taxpayer is directed to present to Audit all records substantiating its claimed credits by July 31, 2001 or such date as the Audit Division in its sole discretion may extend.

1990 and 1991 Non-Claim:

RCW 82.32.060(2)⁴ provides in part:

(2) The execution of a written waiver under RCW 82.32.050 or 82.32.100 shall extend the time for making a refund or credit of any taxes paid during, or attributable to, the years covered by the waiver if, prior to the expiration of the waiver period, an application for refund of such taxes is made by the taxpayer or the department discovers a refund or credit is due.

Based on the above facts, we find that Taxpayer had timely executed a series of written waivers under RCW 82.32.050 that extended the time for making an application for refund of taxes overpaid during the years 1990 and 1991 until June 30, 1997. Taxpayer's application for refund for those years was filed on December 31, 1996, well before the extended deadline. Accordingly, we find that Taxpayer's petition for refund of overpaid taxes for the years 1990 and 1991 was timely filed and not barred by the non-claim statute.

⁴ RCW 82.32.060 was amended in 1997 & 1999, but those changes did not effect the above quoted portion of the statute.

Recovered bad debts:

WAC 458-20-196 describes how bad debt recoveries are to be reported. It states:

Recoveries. Amounts subsequently received on account of a bad debt or on account of a part of such debt previously charged off and allowed as a deduction for business tax purposes, must be included in gross proceeds of sales (including value of products when measured by gross proceeds of sales) or gross income of the business reported for the taxable period in which received. This is true even though the recoveries during such period exceed the amount of the bad debt charge-off.

We agree with Audit that customer payments to collection agencies on their delinquent account are a recovery of a bad debt. Even though Taxpayer may only receive 50% of the funds, 100% of the funds were recovered from the original debtor in payment for its original obligation to Taxpayer. The 50% fee retained by the collection agency is a fee paid to the collection agency for providing collection services. Such fees are a cost of doing business to Taxpayer and may not be deducted from gross proceeds of sale or gross income of the business. RCW 82.04.070, RCW 82.04.080. Taxpayer's petition is denied on this issue.

Periods after . . . , 1994:

As stated above, the Washington Supreme Court has interpreted RCW 82.08.037, as having three requirements before the bad debt credit will be allowed:

. . . (1) the seller must be a person, (2) making sales at retail, and (3) entitled to a refund for sales taxes previously paid on debts which are deductible as worthless for federal income tax purposes. *Puget Sound* at 287.

In *Puget Sound*, even though Bank was not making sales at retail, it satisfied the second requirement because the original seller had assigned all of its rights and obligations regarding the receivables to Bank. As a result, Bank was held to satisfy the requirement of "making sales at retail" because it "stood in the shoes" of the original seller who satisfied that requirement. For periods after . . . , 1994, however, Taxpayer is neither making sales at retail in its own right, nor is it the assignee of all rights from the original seller, [Store]. Instead, during this period, Taxpayer is only loaning or extending credit directly to [Store]'s customers so that they can purchase goods and services from [Store]. Taxpayer acts only as a financing company and makes no retail sales.⁵ Consequently, Taxpayer does not satisfy the second requirement of

⁵ Taxpayer explained the differences between the [Store] Washington credit card program before and after . . . , 1994 as follows: "For the period January 1, 1990 through . . . , 1994, [Taxpayer] purchased accounts at face value from [Store]. [Store] assigned all its rights, title and interest in the accounts to [Taxpayer]. Starting . . . , 1994, the [Store] agreement was amended to provide that for Washington cardholders only, [Taxpayer] would extend credit directly to [Store] cardholders rather than purchase the accounts from [Store]." Taxpayer's Letter dated May 25, 2000.

“making sales at retail” within the meaning of RCW 82.08.037 and is not entitled to the credit. Accordingly, Taxpayer’s petition is denied on this issue.

DECISION AND DISPOSITION:

Taxpayer’s petition for refund is remanded in part and denied in part.

Dated this 5th day of June 2001.