

Cite as Det. No. 03-0097E, 24 WTD 156 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of)	<u>F I N A L E X E C U T I V E</u>
)	<u>L E V E L D E T E R M I N A T I O N</u>
)	
)	No. 03-0097E
...)	
)	Registration No. . . .
)	FY . . . /Audit No. . . .
)	Docket No. . . .

- [1] RULE 196; RCW 82.08.037: RETAIL SALES TAX -- BAD DEBTS -- DEDUCTABLE BY A THIRD PARTY LENDER. Third party lenders may take a retail sales tax bad debt deduction when the seller assigns to the lender all its rights under the conditional sales contract. No bad debt deduction is allowed a third party lender where the seller did not assign its full rights under the contract to the lender.
- [2] RULE 178, RULE 190: USE TAX -- CAPITAL ASSETS -- FEDERAL TO STATE CHARTERED CREDIT UNION. The use tax exemption on the acquisition and use of capital assets is lost by a federally chartered credit union when it converts to a state chartered credit union. Use tax is due because on conversion a new entity is formed that does not have exempt status.

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.

NATURE OF ACTION:

Taxpayer requests a refund of the retail sales tax under the provisions of RCW 82.08.037, which allow for a *seller* a refund of retail sales tax previously paid on bad debts. Taxpayer also requests cancellation of use tax assessed on Taxpayer's tangible personal property when it changed its credit union charter from federal to state.¹

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

FACTS:

Lewis, A.L.J. -- Taxpayer is now a state-chartered credit union. Prior to . . . 1997, Taxpayer was a federally-chartered credit union. During November 2000, Taxpayer filed with the Department of Revenue's ("Department") Audit Division a request for retail sales tax credit for bad debts incurred from auto loans claimed to have been financed by auto dealers. Taxpayer claimed the loans had been reported by the automobile dealer as retail sales. The amount of the sale financed was then acquired by Taxpayer from the auto dealer. A portion of the loans financed proved to be uncollectable.

As part of the refund request, the Audit Division audited Taxpayer's books and records for the period February 1, 1997 through March 31, 2001. On October 26, 2001, the Department issued a \$. . . assessment.² The Audit Division allowed the bad debt credit in instances where the Auto Dealer's Conditional Sales Contract and Security Agreement contained language allowing for assignment. At the in-person hearing, Taxpayer presented an example of a contract that contained such language. The Document included the following provision:

Assignment. The Seller may assign this contract to _____Credit Union. The credit union assumes all seller's rights. If the Property is primarily for personal, family or household use, another person will still have a right to assert my actions or defenses against the Seller, despite assignment. If the Property is for business or commercial use, I agree not to set off or assert against the credit union any claims I have against the Seller. The credit union is not required to perform the seller's contractual duties. I understand that the heirs and legal representatives of all parties are bound by these contract terms.

Thus, by the language of the contract the automobile dealer/seller was allowed to assign its right to the contract to the credit union/lender. The Audit Division did not allow the requested sales tax credit where the loan was directly between the credit union and the credit union member who purchased the automobile from the automobile dealer. By the nature of those contractual agreements, there was no evidence of the dealer/seller's rights being assigned to the credit/union/lender. Taxpayer, at the in-person hearing, presented an example of the language of two documents that the Audit Division found did not contain language of assignment and thus did not qualify for the retail sales tax refund. One document entitled "Vehicle Buyers Order" stated:

Purchaser further agrees that this order shall not become binding until accepted by the dealer or dealer's authorized representative. If the purchase price of the vehicle is to be financed or leased, dealer's acceptance of this order is specifically conditioned upon and subject to (1) receipt of credit approval from the financial institution which is financing purchaser's purchase of the vehicle and (2) assignment of the retail installment contract or security agreement to a financial institution. If for any reason purchaser does not

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qualify for financing or if the financial institution refuses to accept the assignment, then this transaction shall be null and void and all funds and any trade-in shall be returned to purchaser.

The other document entitled “Vehicle Buyers Order and Bill of Sale” stated:

This order is not a binding contract. Dealer shall not be obligated to sell until approval of the terms hereof is given by a bank or finance company willing to purchase a retail installment contract between the parties based on such terms.

The audit examination also found that a substantial amount of use tax was due on previously untaxed equipment. Taxpayer had not paid retail sales tax or use tax on the equipment during the time it was a federally-chartered credit union. However, when it became a state-chartered credit union, it gave up the sales and use tax exemption it previously enjoyed. The Audit Division reasoned that use tax was due because the equipment was used in Washington, by a new entity, and there was no exemption. Taxpayer disagreed with the audit assessment and filed a petition requesting allowance of all the bad debt credit that had been disallowed and cancellation of the use tax on equipment.

ISSUES:

1. Whether a credit union/lender is allowed to take retail sales tax bad debt deductions on automobile loans that are not repaid by its member/borrowers?
2. Whether the Department properly assessed use tax on the value of tangible personal property belonging to a credit union that changed its charter from federal to state?

DISCUSSION:

[1] **ISSUE ONE:** RCW 82.08.037 and WAC 458-20-196 (“Rule 196”) allow a *seller* “a credit or refund for sales tax previously paid on debts, which are deductible as worthless for federal tax purposes.”

This law is clear and easy to apply when you have a two-party transaction, only a buyer and a seller. Unfortunately, application of the law is less clear when you have not only a buyer and a seller, but also a third party. In 1994, the Washington Supreme Court in *Puget Sound National Bank v. Department of Revenue*, 123 Wn.2d 284, 868 P.2d 127 (1994), was asked to decide whether a third-party lender could take a retail sales tax credit for bad debts written off.

In *Puget Sound*, car dealers signed installment contracts with retail car buyers. At the time of sale, the dealers collected retail sales tax from their customers and remitted that amount to the Department. Puget Sound National Bank (“Bank”) purchased these installment contracts at full face value on a non-recourse basis from the dealers. In return, the dealers assigned to Bank all of the dealers’ rights under the installment contract. After the assignment, some 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. Bank appealed the Department's decision. In making its ruling, the Washington Supreme Court interpreted the retail sales tax deduction allowed by RCW 82.08.037 as having three requirements: (1) The seller must be a person, (2) making sales at retail, and (3) for debts which are deductible as worthless for federal income tax purposes. *See, Puget Sound* at 287.

In *Puget Sound*, it was undisputed that Bank satisfied requirements one and three. 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 contacts. 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.

The Audit Division correctly allowed a retail sales tax credit in those instances where the Taxpayer produced a "Conditional Sales Contract and Security Agreement" that contained specific language of assignment. This contract allowed the lender to step into the shoes of the seller just as in the case of Puget Sound Bank.

The Audit Division correctly disallowed the retail sales tax credit in those instances where the Taxpayer did not produce a contract that contained language of assignment. Both examples of non-qualifying documents were only a "Vehicle Buyers Order," recording nothing more than the agreed upon price for which a vehicle would be sold. The documents presented are not contracts of assignment. Taxpayer has argued that "all contracts are assignable" *Puget Sound Bank* at 286. Unfortunately, though requested to do so, Taxpayer has not presented any documentation to support its contention that the disputed transactions were ever the subject of an assignment by the seller.³

Taxpayer is required to present records to the Department to support exemptions and credits. WAC 458-20-254(2)(a)(ii). Failure to provide these records bars the taxpayer from questioning the correctness of the assessment. RCW 82.32.070.

Regarding exemptions and deductions *Group Health Coop. Of Puget Sound, Inc. v. State Tax Comm'n*, 72 Wn,2d 422, 429, 433 P.2d 201 (1967) states:

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In connection with each, the burden of showing qualification for the tax benefit afforded likewise rests with the taxpayer. And, statutes which provide for either are, in case of doubt or ambiguity, to be construed strictly, though fairly and in keeping with the ordinary meaning of their language, against the taxpayer.

Group Health v. Department of Rev., 106 Wn.2d 391, 401-402, 722 P.2d 787 (1986). *See also*, Det. No. 89-268, 7 WTD 359 (1989).

Taxpayer has failed to provide documentation supporting its entitlement to the exemption. Accordingly, Taxpayer's petition in regards to this issue is denied.

[2] **ISSUE TWO.** In 1997, Taxpayer converted its operation from a federal charter to state charter. The Audit Division assessed use tax on the value of tangible personal property owned at the time of the conversion, reasoning that use tax was due when the new entity, a non-exempt state-chartered credit union, first used the property. WAC 458-20-178 ("Rule 178").⁴ Taxpayer argued that the use tax was assessed in error because the first use of the assets occurred under the federal charter.

The Audit Division does not challenge Taxpayer's ability, as a federally-chartered credit union, to purchase tangible personal without payment of retail sales tax or use tax. It is well-settled that a state may not, consistent with the Supremacy Clause of United States Constitution, "lay a tax directly upon the United States or upon any agency or instrumentality so closely connected to the United States that the two cannot realistically be viewed as separate entities, at least insofar as the activity being taxed is concerned." *United States v. New Mexico*, 455 U.S. 720 (1982). That principle has been incorporated into Washington law under WAC 458-20-190 (Rule 190) which provides a retail sales tax and use tax exemption for federally-chartered credit unions.

Here, the Department maintains that use tax is due because . . . use occurred after the once exempt assets were transferred to a non-exempt new entity. Taxpayer disagreed, maintaining that it simply changed its charter and that no new entity was created with the conversion from a Federal Charter to a State Charter. Taxpayer argued that under both charters it had the same owners, officers, employees, insurance, and even Federal I.D. Number. Taxpayer likened the change of charters to hotel changing from a Holiday Inn to a West Coast Inn or a Double Tree Inn changing to a Red Lion Hotel.⁵ We disagree with Taxpayer that the change of its charters was nothing more than changing a "brand affiliation." The Department's Audit Division assessed use tax on the transfer of the capital assets because they were transferred to an entity that was not legally entitled to the use tax exemption.

⁴ Rule 178(1) provides:

The use tax supplements the retail sales tax by imposing a tax of like amount upon the use within this state as a consumer of any article of tangible personal property purchased at retail or acquired by lease, gift, repossession, or bailment, or extracted, produced or manufactured by the person so using the same, where the user, donor or bailor has not paid retail sales tax

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When Taxpayer switched from a federal charter to a state charter, it formed a different entity. Washington law found at RCW 31.12.467(1) explains how a federally-chartered credit union located in this state may convert into a state-chartered credit union. Specifically, RCW 31.12.467(2) clarifies that a different entity is formed by the conversion:

The board of the federal credit union shall file with the director proposed articles of incorporation and bylaws, as provided by this chapter for organizing a new credit union. If approved by the director, the federal credit union becomes a credit union under the laws of this state, and the assets and liabilities of the federal credit union will vest in and become the property of the *successor* credit union subject to all existing liabilities against the federal credit union.

(Emphasis added.)

Thus, under Washington law the federal credit union dies when the new, state-chartered credit union is organized. All assets and liabilities vest in and become the property of the successor credit union, and the state-chartered credit union is referred to as the “successor.” Accordingly, Taxpayer formed a new entity when it switched from a federally-chartered credit union to a state-chartered credit union.⁶

Federal law supports the Department’s position that state tax exemptions enjoyed by a federally-chartered credit union do not continue after the credit union becomes state chartered.⁷ 12 U.S.C. 1771(a)(4) states:

A Federal credit union may be converted into a State credit union after the laws of any State, the district of Columbia, the several Territories and possessions of the United States, the Panama Canal Zone, or the Commonwealth of Puerto Rico, by complying with the following requirements:

...

(4) Upon ceasing to be a Federal credit union, such credit union shall no longer be subject to any of the provisions of this Act [12 U.S.C. 1751 et seq.]. The successor credit union shall be vested with all the assets and shall continue responsible for all of the obligations of the Federal credit union to the same extent as though the conversion had not taken place.

⁶ This is not a case, where there was a use tax-exempt transfer of assets and adjustment of the beneficial interest in the business. *See*, WAC 458-20-106 (“Rule 106”). In this instance there was no exchange of assets for stock.

⁷ 12 U.S.C. 1768 provides that:

The federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and other income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority

Taxpayer also argued that the Department made the use tax assessment in error because the first use of the property in Washington was made when the property was exempt. We disagree. First, Washington law contains no prohibition from successive assessments of use tax on the same piece of equipment used by a succession of entities. It is very common for the same item of personal property to be taxed over and over as it is successively sold and bought. The taxation of vehicles is probably the most common example of use tax being paid to the state each time the vehicle is sold.⁸ . . .

DECISION AND DISPOSITION:

Taxpayer's petition is denied on both issues.

Dated this 31st day of July, 2003.

⁸ Retail sales tax is collected by the vendor if the used car is sold by a registered business, otherwise the purchaser pays use tax directly to the Department.