

Cite as Det. No. 13-0095, 35 WTD 582 (2016)

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. 13-0095
)	
...)	Registration No. . . .
)	

RULE 196; RCW 82.08.037; RCW 82.04.04284: RETAIL SALES TAX – CREDIT – B&O TAX – DEDUCTION – BAD DEBT – PRIVATE LABEL CREDIT CARDS. A taxpayer that claims a bad debt deduction is not entitled to the deduction unless it is the entity that actually holds the bad debt. When the bad debt is held by the taxpayer’s affiliate entity, the taxpayer is not entitled to a retail sales tax credit or B&O tax deduction for the bad debt.

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.

De Luca, A.L.J. – A [retail] store chain (the taxpayer) protests the assessment of retail sales tax and retailing business and occupation (B&O) tax due on disallowed bad debt deductions. Holding: The taxpayer is not entitled to the bad debt deductions. Petition denied.¹

ISSUES

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Is a retailer entitled to a B&O retailing tax deduction for bad debts under RCW 82.04.4284 and WAC 458-20-196 (Rule 196) when customers purchased goods using credit cards issued by a separate, but affiliated banking corporation of the retailer, and the purchasers failed to pay the bank the amounts due on the credit card purchases although the retailer and the bank filed a consolidated federal income tax return?

Is a retailer entitled to a retail sales tax credit under RCW 82.08.037, or a retailing B&O tax deduction under RCW 82.04.4284, on bad debt losses incurred by an affiliated banking institution that extended credit to the retailer’s customers, where the bad debts were deducted on a consolidated federal income tax return that included the retailer?

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

FINDINGS OF FACT

The taxpayer is a retailer that owns and operates several [retail] stores in the state of Washington. During the audit period the taxpayer was a wholly-owned subsidiary of [Parent Corporation.] Another wholly-owned subsidiary of [Parent Corporation] was . . . Bank . . ., which issued private label credit cards used by the taxpayer's customers to purchase items sold in its [retail] stores. The taxpayer, [Parent Corporation], and . . . Bank were all part of a consolidated group of corporations that filed a single consolidated federal income tax return each year, which was the only federal income tax return filed by the taxpayer. That return includes the income and expenses of the taxpayer's retailing activities, the bank's banking activities, and the parent corporation's business activities. Pursuant to 26 USC § 166, that group deducted bad debts belonging to the bank on the combined federal income tax return that resulted from unpaid credit card charges billed to card holders.

The bad debts in question resulted from the taxpayer selling merchandise to customers who used the private label credit card issued by . . . Bank. The bank then paid the taxpayer for the merchandise. Consequently, the taxpayer was paid in full for the goods it sold. But when the customers defaulted on their payments for the merchandise, it was the bank that did not receive the money it had advanced on behalf of the credit card holders. In short, the credit card accounts were owned by the bank and not the taxpayer. Nonetheless, the taxpayer, the bank, and the parent corporation deducted bad debts on their consolidated federal income tax return, and the taxpayer deducted some of the same bad debts on its own Washington excise tax returns.

The Audit Division of the Department of Revenue (DOR) audited the taxpayer for the period January 1, 2004, through December 31, 2005, and issued an assessment. The taxpayer appealed the assessment and the Appeals Division remanded the matter to the Audit Division for a post assessment adjustment (PAA). The Audit Division ultimately issued two PAAs. The taxpayer appealed the second PAA, issued February 16, 2012, which is before us. The remaining issues, which are stated above, resulted from the Audit Division's disallowance of the deductions that the taxpayer claimed on its excise tax returns for some of the bad debts that were deducted on the consolidated federal income tax return. The assessed amount of retailing B&O tax, retail sales tax, plus interest and penalties, was \$. . ., plus extension interest. The assessment remains unpaid.

ANALYSIS

The statutory authority for a B&O tax bad debt deduction is provided by RCW 82.04.4284:

In computing tax there may be deducted from the measure of tax bad debts, as that term is used in 26 U.S.C. Sec 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid.²

² The statutory language in effect prior to July 1, 2004 provided: "In computing tax there may be deducted from the measure of tax the amount of credit losses actually sustained by taxpayers whose regular books of account are kept upon an accrual basis."

The statutory retail sales tax bad debt deduction is provided by RCW 82.08.037(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, 2003.³

The deduction provided by RCW 82.08.037 during the subject audit period had 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 National Bank v. Dep't of Revenue*, 123 Wn.2d 284, 287, 868 P.2d 127 (1994)⁴; *Home Depot USA, Inc. v. Dep't of Revenue*, 151 Wn. App. 909 at 918-19, 215 P.3d. 222 (2009).

The taxpayer meets the first and second requirements. It is a person, and made sales at retail. In dispute, is whether the taxpayer satisfies the third requirement of RCW 82.04.037 because the affiliated bank, not the taxpayer, incurred the bad debts and wrote them off under 26 U.S.C. §166. The taxpayer counters that it meets the statutory requirement because the bank's bad debts were written off on their consolidated federal income tax return.

Rule 196 is the rule that DOR adopted to administer the bad debt statutes.⁵ The rule in pertinent part declares:

(6) Private label credit cards. If a business contracts with a financial company to provide a private label credit card program, and the financial company becomes the exclusive owner of the credit card accounts and solely bears the risk of all credit losses, the business that contracted with the financial company is not entitled to any bad debt deduction if a customer fails to pay his or her credit card invoice.

³ The statutory language in effect prior to July 1, 2004 provided: "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 2004 amendment and subsequent amendments to this portion of RCW 82.08.037 did not materially alter the language or meaning of the 2002 statute. *Home Depot USA, Inc. v. Dep't of Revenue*, 151 Wn. App. 909, 912, 215 P.3d. 222 (2009), *infra*.

⁴ The version of RCW 82.08.037 that became effective July 1, 2004, which was during the subject audit period, notes the following:

For the purposes...of this act, the legislature does not intend by any provision of this act relating to bad debts, and did not intend by any provision of chapter 168, Laws of 2003 relating to bad debts, to affect the holding of...*Puget Sound National Bank v. Dep't of Revenue* 123 Wn.2d 284 (1994)."

But the current version of RCW 82.08.037, effective May 1, 2010, notes the following:

The legislature intends with sections 1502 and 1503 of this act to supersede the holding of the supreme court of the state of Washington in *Puget Sound National Bank v. Dep't of Revenue*, 123 Wn. 2d 284 (1994).

See also RCW 82.08.037(7). Consequently, the holding in *Puget Sound*, that an assignee of an original seller was considered a seller for purposes of RCW 82.08.037(1), was in effect during the subject audit period, but it is no longer in effect as of May 1, 2010. We do not cite *Puget Sound* for that holding because there were no assignments of debt in the present matter. Instead we cite the case for the reasons it was cited in *Home Depot* that denied Home Depot the bad debt deductions. *Infra*.

⁵ The current rule was adopted on November 7, 2010, which was after the audit period.

Example. Hot Shot Ski Equipment (Hot Shot) is a sporting equipment retailer. Hot Shot contracts with ABC Financial Institution (ABC) to issue a Hot Shot private label credit card. ABC has the authority to accept or reject an applicant's credit card application. After Hot Shot transmits the credit card sales records to ABC, ABC pays Hot Shot the proceeds of the sales including the retail sales tax minus any applicable service fees. Hot Shot remits the retail sales tax to the Department of Revenue. If a customer using the Hot Shot credit card fails to pay ABC the outstanding amount on the credit card invoice, ABC suffers the loss. Hot Shot is not entitled to a bad debt deduction or credit as it has no bad debt loss when a customer defaults on a debt to ABC.

. . . Under Rule 196(6), the taxpayer may not deduct the bad debts because the affiliated bank is the exclusive owner of the credit card accounts and solely bears the risk of all credit card losses.

But our holding is the same even without reference to Rule 196(6). Here, the taxpayer, made the retail sales and the affiliated bank paid for the merchandise. The taxpayer (the retailer) did not write off its own receivables, nor did it assign receivables. The taxpayer made the sale when it honored the credit cards issued by the affiliate bank. The bank honored the charge slips authorized by the holders of the credit cards and paid the taxpayer for the charges. The taxpayer received full payment for the goods purchased, and it was the bank that did not receive payment of the money advanced on behalf of the credit card holders. The taxpayer's claim for qualification of the deduction rests with the fact that the taxpayer files a consolidated federal income tax return, which includes the income and expenses of both its retail activities and the bank's activities, and those of the parent corporation. The taxpayer argues that since the bad debts of the affiliate bank are taken on their consolidated federal tax return, the requirement that the debt be written off for federal tax purposes is satisfied. While the federal tax return is consolidated, the companies are separate legal entities

The Court of Appeals addressed a similar issue in *Home Depot, supra*, where Home Depot unsuccessfully sought a refund of sales tax it paid on defaulted transactions made on its private label credit card that was issued by General Electric Capital Corporation (GECC). Home Depot contracted with GECC to establish the private label credit card and it sold its entire interest in the accounts to GECC in return for payment of the full amount of the sale made on the card plus the sales tax, minus a service fee. Like the present matter, under their contract, GECC was the exclusive owner of the credit card accounts. GECC bore the risk of credit losses on the accounts and Home Depot had no interest in the accounts or indebtedness that the credit card program created. 151 Wn. App. at 913. The court ruled that Home Depot was not entitled to the bad debt deductions for reasons explained below.

The court in *Home Depot* also ruled that RCW 82.08.037 is a tax preference statute and that any statute establishing the preference must be read:

[N]o more broadly than necessary to fulfill its legislative purpose. Consequently, if we determine that a tax preference statute is ambiguous, the statute should be construed in favor of the State. *Auto Club of Wash. v. Dep't of Revenue*, 27 Wn. App. 781, 621 P.2d 760 (1980).

151 Wn. App. at 916.

The present taxpayer argues *Home Depot* is not applicable because Home Depot and GECC were not affiliates and did not file a consolidated federal income tax return. We disagree and conclude that the analysis in *Home Depot* is applicable. The court in *Home Depot*, 151 Wn. App. at 918-920, discussed *Puget Sound*, *supra*, at length. It explained that the bank in *Puget Sound* purchased installment contracts from automobile dealers. Each time a contract was signed, the dealership paid the full amount of sales tax due on the full purchase price of a car to DOR. When the bank purchased a contract, it paid the dealer the balance due on the installment contract, including the uncollected portion of the sales tax. In return, it received an assignment of all of the dealer's rights in the contract. If a purchaser defaulted on the contract, the bank wrote off the loss as a worthless debt for federal income tax purposes.

The issue in *Puget Sound* was whether the bank qualified as a “seller” making sales at retail for purposes of the refund statute RCW 82.08.037 and the definitional statute RCW 82.08.010. The Supreme Court held that the bank was a “seller” because it was the dealership's assignee and under general assignment law the dealers could transfer both contractual and statutory rights and liabilities, including the tax attributes, thereby making the bank/assignee eligible for a sales tax refund. *Id.*⁶

In *Home Depot*, like the present matter, there was no assignment of contract between Home Depot and GECC. Nonetheless, Home Depot argued that it qualified for the bad debt deduction as long as the sales tax was deductible by some party, but not necessarily by the seller-claimant. 151 Wn. App. at 919. DOR countered by arguing that only the seller-claimant that incurred the deductible debt was eligible for the refund. *Id.* The court in *Home Depot* agreed with DOR by citing *Puget Sound* where the court considered it material that the bank, the refund claimant, not the retailer, took the bad debt deduction. 151 Wn. App. at 920. Then the court in *Home Depot* declared:

Here, Home Depot sold all of its interest in the Home Depot card accounts to GECC. Following *Puget Sound* to its logical conclusion, Home Depot surrendered both its right to deduct these losses as bad debt and its ability to claim a refund for this defaulted debt. 123 Wash.2d at 287, 868 P.2d 127

Id. The court in *Home Depot* then noted that DOR argued that the portion of the sales tax refund statute that refers to debts that are deductible as worthless for federal income tax purposes should be read as applying to debts owed to the seller. 151 Wn. App. at 921. The court agreed with DOR:

DOR's analysis persuades us. At the time a buyer purchased an item on his or her Home Depot card, Home Depot paid the sales tax due to DOR. This created a statutory “debt” due from the buyer to the seller under former RCW 82.08.050.

⁶ As noted, current RCW 82.08.037(7) superseded this holding in *Puget Sound*.

Immediately after the sale, however, Home Depot submitted the charge to GECC and GECC reimbursed Home Depot for the purchase price and the sales tax payment. This statutory sales tax debt between Home Depot and the buyer, therefore, ceased to exist; the buyer no longer owed anything to Home Depot. Former RCW 82.08.050. At this point, because the buyer's statutory debt, as well as the underlying debt for the purchase price, was discharged, Home Depot no longer held any “debt”—either as defined by state law under former RCW 82.08.050 or by federal law under 26 U.S.C. § 166—directly attributable to its sales tax payment to DOR.

Moreover, because Home Depot sold its rights to the Home Depot card account, it no longer had any right to collect any unpaid sums from the buyer, further demonstrating that the statutory sales tax debt, as former RCW 82.08.050 defined, was no longer connected to Home Depot. 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.

Although the tax refund statute at issue does not explicitly contain a requirement that bad debts be deductible by the refund claimant, analysis of related federal and state tax laws demonstrates that the party seeking the deduction must be the one holding the bad debt as well as the one to whom repayment on such a debt would be made. *See Home Depot U.S.A., Inc. v. Alabama Dep't of Revenue*, No. S. 06–1079, at 7, 10 (Ala. Dep't of Revenue, Admin. Law Div.2008). . . .

151 Wn. App. at 921-22.

In the present matter, the taxpayer, like Home Depot, claims the bad debt deduction, but it does not hold the bad debt and is not the one to whom repayment on such debt would be made. Therefore, it cannot rightfully claim the bad debt deduction. *Id.* A tax preference should be read no more broadly than necessary to fulfill its legislative purpose. And if a tax preference statute is ambiguous, the statute should be construed in favor of the State. *Home Depot*, 151 Wn. App. at 916, *supra*. . . .

The court in *Home Depot* next addressed the argument raised by Home Depot that it and GECC qualified as a single “unit” allowing Home Depot to seek the sales tax refund. Because the issue was raised too late, the court declined to consider it, but it did discuss a prior decision with a similar issue, *Nordstrom Credit, Inc. v. Dep't of Revenue*, 120 Wash.2d 935, 942, 845 P.2d 1331 (1993).

Moreover, were we to consider the argument, the single unit argument fails under *Nordstrom Credit*, 120 Wash.2d at 942, 845 P.2d 1331 (“[N]or do Nordstrom and Credit constitute a unitary business. Rather, Credit and Nordstrom engage in ‘arm's length’ sales transactions within the state of Washington.”); *see also* *Linnehan Leasing v. State Tax Assessor*, 898 A.2d 408, 413 (Me.2006) (declining to consider an automobile dealer and a finance company a single entity). Like the two *Nordstrom Credit* companies, GECC and Home Depot did not act as one another's agents nor did they act with any singularity of purpose; rather, they are two separate companies bound only by a negotiated contract.

151 Wn. App at 925.

Similarly, the present taxpayer and its affiliate bank did not act as one another's agent nor did they act with any singularity of purpose. They were two separate companies. The separate treatment of separately incorporated entities is fundamental to Washington's tax system. This is true regardless of the corporation's affiliation. In Washington, affiliated corporations are separate "persons" and separate taxpayers. WAC 458-20-203 ("Rule 203"):

Each separately organized corporation is a "person" within the meaning of the law, notwithstanding its affiliation with or relation to any other corporation through stock ownership by a parent corporation [or] by the same group of individuals.

Accordingly, transactions between them are fully subject to tax. "The tax liability of a corporation must be considered without regard to its relationship to a parent or subsidiary company or to the existence of common officers, employees, facilities, or stock ownership." Det. No. 96-046, 16 WTD 74, 77, (1996) (citing Rule 203 and quoting *American Sign & Indicator v. State*, 93 Wn.2d 427, 429, 610 P. 2d 353 (1980) and *Rena-Ware Distribs., Inc. v. State*, 77 Wn.2d 514, 463 P. 2d 622 (1970).)

Additionally, unlike the federal tax provisions, Washington's Revenue Act contains no provisions that allow a taxpayer to combine tax reporting of different entities. We conclude that the federal tax treatment of income for this taxpayer and for the various affiliated companies, including the bank and the parent corporation, is not controlling for state tax purposes. *See also* Det. No. 88-383, 7 WTD 11 (1988) ("The federal tax treatment of retirement contributions and payments is not controlling for state tax purposes.").

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 8th day of April, 2013.