

Cite as Det. No. 13-0178, 33 WTD 109 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of) D E T E R M I N A T I O N
Assessment of) No. 13-0178
) Registration No.
 ...)

[1] RULE 196; RCW 82.08.037: RETAIL SALES TAX – BAD DEBT DEDUCTION – PRIVATE LABEL CREDIT CARDS. A retail store whose customers purchased retail goods and services using the store's private label credit cards is not entitled to a sales tax refund for bad debts on those purchases when the store had sold its private label credit card accounts to a bank and the bank bore the risk of all credit card losses.

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.

Weaver, A.L.J. – A retail store chain petitions for the correction of assessment of retail sales tax, assessed as a result of the Department of Revenue (Department) disallowing bad debt deductions based on defaulted transactions made by customers on the retailer's private label credit card. The retailer sold its credit card accounts to a financing institution that now runs the retailer's private label credit card program. Cardholder indebtedness on the books of the financial institution is taken into account in calculating the service fee the retailer receives from the financial institution. However, the retailer is no longer the owner of the credit card accounts and ultimately the indebtedness for credit card charges, including the sales tax, is owed by the cardholder to the bank. Since the financial loss incurred by the retailer is in the form of reduced service income and does not actually reflect uncollected retail sales tax, the retailer does not qualify for the refund provided in RCW 82.08.037. The petition is denied.¹

ISSUE

Whether, under RCW 82.08.037, the retailer is entitled to a refund of retail sales taxes paid on defaulted transactions made by customers on its private label credit card, after the retailer sold its

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

credit card accounts to a financing institution but continues to recognize a financial loss due to the bad debts in the form of reduced servicing income.

FINDINGS OF FACT

[Taxpayer] is a retail[er] . . . that currently owns and operates [multiple] stores in Washington. Taxpayer issues private label credit cards to its customers to purchase items sold in its stores. Taxpayer entered into a Private Label Credit Card Program Agreement on March 5, 2006 (the "Agreement"), and a purchase and sale agreement on April 1, 2006, each with [Bank], pursuant to which Taxpayer sold to Bank its private label credit card accounts and associated accounts receivable. Section 4.4 of the Agreement states that Bank is the sole owner of the accounts [as follows]:

Ownership of Accounts.

- (a) Bank shall be the sole and exclusive owner of all Accounts and Account Documentation and shall have all rights, powers, and privileges with respect thereto as such owner; provided that Bank shall exercise such rights consistent with its obligations under this Agreement.... All purchases of Goods and/or Services in connection with the Accounts and the Cardholder Indebtedness shall create the relationship of debtor and creditor between the Cardholder and Bank, respectively. [Taxpayer] acknowledges and agrees that (i) it has no right, title or interest...in or to, any of the Accounts or Account Documentation or any proceeds of the foregoing, and (ii) Bank extends credit directly to Cardholders.

Based on its agreement with Bank, Taxpayer makes sales to its cardholder customers and then submits daily settlement statements to Bank for those charges, which include the purchase price of the merchandise and the applicable retail sales tax. As a result of this daily settlement process, Bank pays Taxpayer in full for those charges made on the private label credit card. Bank effectively advances the sum of the purchase price and the sales tax from its own funds, and then Taxpayer remits the sales tax to the Department of Revenue. Bank then collects the amounts it advanced from the cardholders. The indebtedness for the charges made using the credit card, including the retail sales tax, is solely between Bank and the cardholder. Section 4.4 of the Agreement also addresses indebtedness between Bank and the cardholder [as follows]:

- (b) Except as expressly provided herein, Bank shall be entitled to (i) receive all payments made by Cardholders on Accounts, and (ii) retain for its account all Cardholder Indebtedness and such other fees and income authorized by the Credit Card Agreements and collected by Bank with respect to the Accounts and Cardholder Indebtedness.
- (c) Bank shall fund all Cardholder Indebtedness on the Accounts.
- (d) Bank shall have exclusive right to effect collection of cardholder indebtedness

....

While Bank is the sole owner of the credit card accounts and cardholder indebtedness, Taxpayer receives a “Service Fee” from the Bank, based upon the income generated by the private label credit card sales. Schedule 9.2 of the Agreement provides the calculation for the Service Fee. Pursuant to that provision, each month, Bank must pay Taxpayer 72% of the “Risk Adjusted Yield” for the month, defined in Schedule 1.1 of the Agreement as an amount equal to “Financing Income” minus “Program Net Losses.” “Financing Income” includes items such as finance charges, late fees, and accrued interest. “Program Net Losses” is the aggregate amount of cardholder indebtedness written off by Bank, less any amounts previously written off that have been recovered. Since cardholder indebtedness written off by Bank is subtracted in the calculation of the service fee, Taxpayer argues that it continues to bear a risk of loss for a portion of the bad debt resulting from uncollectible credit card charges in the form of reduced service income.

On its federal income tax return, Taxpayer claimed a bad debt deduction under [Section] 166 [of the Internal Revenue Code], ostensibly a portion of which related to the bad debt resulting from uncollectible credit card charges. In addition, throughout the audit period, Taxpayer claimed deductions with respect to the total amount of bad debt resulting from uncollectible credit card charges on its Washington excise tax returns.

The Audit Division of the Department of Revenue audited Taxpayer for the period January 1, 2007, through March 31, 2010, during which Taxpayer owned and operated [multiple] stores in Washington. The audit was submitted as two partial audits. The first pertains to the bad debt deduction. The Audit Division disallowed the bad debt deductions that Taxpayer claimed on its Washington excise tax returns and issued an assessment on January 18, 2012. The assessment, Document No. . . . , totaled \$. . . included \$. . . in retail sales tax, \$. . . in retailing business and occupation (“B&O”) tax, and \$. . . in interest.² On appeal, Taxpayer maintains that it is entitled to the sales tax bad debt deduction but suggests that rather than taking a deduction based on the total amount of uncollectible credit card charges, it should have taken a deduction with respect to only 72% of the unpaid charges, calculated using the service income formula from Schedule 9.2 of the Agreement

ANALYSIS

The amount of retail sales tax on a purchase, until it is paid from the buyer to the seller, constitutes a statutory debt owed by the buyer to the seller. *See RCW 82.08.050(8).* If that sales tax debt remains unpaid and is uncollectible from the buyer, but the seller has already remitted the amount of the tax to the Department of Revenue (Department), RCW 82.08.037(1)³ provides relief to the seller by granting a refund of the sales tax:

² Taxpayer’s appeal of the second partial audit is the subject of a separately issued determination.

³ RCW 82.04.037 was amended in 2007, but that amendment did not alter the operative statutory language. *See RCW 82.04.037 (2007).* RCW 82.04.037 was later amended, effective May 1, 2010, after the conclusion of the audit period at issue in this matter.

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. § 166.

WAC 458-20-196 (Rule 196) articulates the “general rule” with respect to the treatment of the retail sales tax paid on bad debts:

Under RCW 82.08.037 and 82.12.037, sellers are entitled to a credit or refund for sales and use taxes previously paid on “bad debts” under section 166 of the Internal Revenue Code.... Taxpayers may claim the credit or refund for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer’s books and records and would be eligible for a bad debt deduction for federal income tax purposes.

Rule 196(2)(a) (emphasis added.) The reference in the statute to the federal bad debt deduction under § 166 ties the sales tax refund to a debt between a seller and a buyer that becomes uncollectible, based on the federal standards for worthlessness as defined in § 166. See Rule 196(1)(c). Accordingly, the Washington Supreme Court in *Puget Sound Nat'l Bank v. Dep't of Revenue*, 123 Wn.2d. 284, 868 P.2d 127 (1994), identified three requirements to qualify for the refund under RCW 82.08.037: the seller must be (i) a person, (ii) making sales at retail, and (iii) entitled to a refund for sales taxes previously paid on debts that are deductible as worthless for federal income tax purposes. *Id.* at 287, 868 P.2d at 129.⁴

Rule 196(6) also provides a more specific rule that relates to bad debt arising from 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 card 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.

Rule 196(6) (emphasis added.)

Thus, in order to determine whether the seller is entitled to a sales tax refund under RCW 82.08.037, the seller must satisfy the three requirements identified in *Puget Sound* (with the critical issue being whether the seller took or was entitled to take the federal bad debt deduction under § 166), and, in the context of private label credit cards where the seller has contracted with a financial company, it must be determined whether or not the financial company is the exclusive owner of the credit card accounts and solely bears the risk of all credit card losses.

⁴ The central holding of *Puget Sound Bank* was that a bank, which was the assignee of nonrecourse installment sales contracts for automobiles, was entitled to a refund under RCW 82.08.037. *Puget Sound*, 123 Wn.2d at 293. Effective July 1, 2010, the Legislature amended RCW 82.08.037 to supersede the *Puget Sound* holding and preclude nonrecourse assignees from obtaining refunds under RCW 82.08.037. Laws of 2010, 1st sp. sess., ch. 23, §§ 1501-02.

Here, Taxpayer easily meets the first two requirements. It is a “person” and it is “making sales at retail” *See RCW 82.04.030, -.050*. Taxpayer asserts that it also satisfies the third requirement because it took a bad debt deduction pursuant to § 166 on its federal income tax return. However, line 15 on the IRS Form 1120 provided by Taxpayer includes the sum of total bad debt held by the company at large, and we cannot determine solely based on that form whether or how much of that deduction includes bad debt arising from uncollectible charges on the private label credit card. We cannot affirmatively determine that Taxpayer is “entitled to a refund for sales tax previously paid on debts that are deductible as worthless for federal income tax purposes.” However, as discussed below, even if Taxpayer could meet its burden that it actually took a federal bad debt deduction for the Washington sales in question, Taxpayer must also prove that the Taxpayer owns the defaulted credit card debt and that it solely bore the risk of all credit card losses to be entitled to the retail sales tax bad debt deduction. *See Rule 196(6)*.

Home Depot USA, Inc. v. Dep’t of Revenue, 151 Wn. App. 909, 215 P.3d 222 (2009), dealt with the issue of bad debt write-offs with respect to private label credit cards. In that case, Home Depot sought a refund of state sales tax it paid on defaulted transactions made on its private label credit card. Home Depot contracted with General Electric Capital Corporation (GECC) (a financing company) to establish the private label credit card and sold its entire interest in the accounts to GECC. Under the contract between Home Depot and GECC, GECC was the exclusive owner of the credit card accounts and bore the risk of all credit losses on the accounts, and Home Depot had no interest in the accounts or indebtedness the credit card program created. At the end of each day, Home Depot transmitted that day’s Home Depot credit card sales to GECC, and then GECC paid Home Depot in full for the charges made on the card, including retail sales tax, minus a service fee. The amount of the service fee was based on the forecasted amount of profit GECC expected to earn on various categories of credit card sales in the form of interest, late fees, and other charges, balanced against expected losses from uncollectible debts and other expenses. Home Depot did not take a bad debt deduction on its federal income tax return; instead, it deducted the service fees as an ordinary business expense.

The Court of Appeals held that Home Depot was not entitled to the sales tax refund because “*Home Depot cannot obtain a sales tax refund for bad debts its customers owe to a third party.*” *Home Depot*, 151 Wn. App. at 913, 215 P.3d at 224 (emphasis added). The court reasoned that since Home Depot had sold its interest in the credit card accounts to GECC, “Home Depot surrendered both its right to deduct these losses as bad debt and its ability to claim a refund for this defaulted debt.” *Id.* at 920, 215 P.3d at 227. The court’s analysis focused on the fact that the statutory sales tax debt was no longer “connected” to Home Depot:

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.

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. 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...was no longer connected to Home Depot.

Id. at 922, 215 P.3d at 228 (emphasis added). Finally, the court also stated: “[T]he 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.” *Id.* at 922, 215 P.3d at 229 (emphasis added).

This case is similar factually to the *Home Depot* case. In this case, in a manner similar to the taxpayer in *Home Depot*, Taxpayer sold its interest in its private label credit card accounts to Bank. Taxpayer submits daily settlement statements to Bank for charges made by customers on Taxpayer's private label credit card, including the purchase price of the merchandise and the applicable retail sales tax. Bank pays Taxpayer in full for those charges, and then Taxpayer remits the sales tax to the Department. Bank then collects the amounts it advanced to Taxpayer from the cardholder. Thus, ultimately the indebtedness for the charges made using the credit card, including the retail sales tax, is owed by the cardholder to Bank, and not to Taxpayer. The provisions of Section 4.4 of the Agreement between Taxpayer and Bank make clear that Bank is the sole owner of the credit card accounts and that Taxpayer cannot seek repayment from its customers for any loss due to unpaid credit card charges. Taxpayer cannot bear the risk of loss for cardholder debt that is owed to Bank.

While Taxpayer does incur a financial loss in the form of a reduced service fee as a result of the service income calculation, which includes indebtedness that is attributable to uncollectible credit card accounts, Taxpayer does not actually bear the risk of credit card losses. Taxpayer has already been paid by Bank for the tax and the purchase price of the merchandise. Bank advances those amounts with the expectation that it will be repaid by the cardholder. As a result, any financial loss incurred by Taxpayer in the form of reduced servicing income does not actually reflect uncollected retail sales tax. Taxpayer no longer holds any debt that is “directly attributable” to its sales tax payment made to the Department.

The *Home Depot* case also addressed the issue of bad debt write-offs being factored into service fee rates. In *Home Depot*, since the parties “incorporated the anticipated bad debt expenses into the pricing,” Home Depot argued that it actually bore the loss for the defaulted debts and thus should be entitled to a refund. But the court held that the losses incorporated into the service fees rates were not deductible as bad debts. The court said:

Home Depot's position regarding risk re-allocation would have us allow it to take a sales tax refund for ordinary business expenses. Simply because *someone* can deduct the unpaid sales tax as a bad debt does not transform an ordinary business expense or loss

into a refundable sales tax debt . . . 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.

Id. at 924, 215 P.3d at 229 (emphasis added).

We conclude that Bank is the exclusive owner of the credit card accounts and solely bears the risk of all credit card losses, and so Taxpayer is not entitled to any bad debt deduction pursuant to Rule 196(6). Taxpayer is not entitled to the sales tax refund pursuant to Rule 196(6) because it sold its private label credit card accounts to Bank and because Bank solely bears the risk of all credit card losses. The reduced service fee does not qualify Taxpayer for the retail sales tax refund provided in RCW 82.08.037, because Bank owns the credit card debt and bears the risk of credit card losses.

DECISION AND DISPOSITION

[Taxpayers petition is denied.]

Dated this 13th day of June 2013.