04-0919
TAX TYPE: SALES TAX REFUND
TAX YEAR: 1-1-2000 to 7-31-2003
DATE SIGNED: 11-13-2006
COMMISSIONERS: P. HENDRICKSON, B. JOHNSON, M. JOHNSON, D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,	) **FINDINGS OF FACT**,	
	) **CONCLUSIONS OF LAW,**	
Petitioner,	) **AND FINAL DECISION**	
	)	
v.	) Appeal No.	04-0919
	) Account No.	#####
TAXPAYER SERVICES DIVISION	)	
OF THE UTAH STATE TAX	) Tax Type:	Sales Tax Refund/Credit
COMMISSION,	) Tax Period:	January 1, 2000 to July 31, 2003
	)	
Respondent.	) Judge:	Bruce Johnson/Rees

Presiding:
Marc B. Johnson, Commissioner
Irene Rees, Administrative Law Judge

Appearances:

For Petitioner:	REPRESENTATIVE-1 FOR PETITIONER, Legal Counsel
	REPRESENTATIVE-2 FOR PETITIONER, PETITIONER Legal Counsel
	REPRESENTATIVE-3 FOR PETITIONER, ACCOUNTING FIRM
For Respondent:	REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General

STATEMENT OF THE CASE

On December 18, 2003, PETITIONER applied for a refund of sales tax in the amount of $$$$$. Petitioner claims that the tax credit is due on bad debt transactions from January 1, 2000 to July 31, 2003, pursuant to Utah Code Section 59-12-107(7). On May 14, 2004, the Taxpayer Services Division denied Petitioner's claim for credit. The matter came before the Commission in an Initial Hearing on January 30, 2006. After receiving the Commission's Initial Hearing Order, Petitioner filed a petition for a Formal Hearing. The matter was heard on September 25, 2006.

As a preliminary matter, the parties agree that the amount of the refund claimed had not been audited prior to the Formal hearing. The parties only addressed the legal issue of whether PETITIONER is entitled to a refund on bad debts claimed by a third party credit card bank. The Division

reserved its right to audit the refund claim and to challenge the amount of the claim, if necessary. Petitioner had no objection. A letter was mailed to each party's legal counsel on October 2, 2006 advising the parties to move forward immediately so that any challenges to the amount at issue can be resolved in a timely manner.

STIPULATED FACTS

1. Petitioner, PETITIONER, ("PETITIONER") is a national retailer that sells various types of home improvement products and services.

2. PETITIONER provides its customers the option of purchasing merchandise and services through a private label credit card owned and issued by FINANCIAL INSTITUTION ("FINANCIAL INSTITUTION").

3. Customers wishing to obtain a PETITIONER credit card fill out a PETITIONER credit card application.

4. Pursuant to the Credit Card Application, PETITIONER forwards the credit card application to FINANCIAL INSTITUTION. FINANCIAL INSTITUTION then determines if the applicant is creditworthy and issues the PETITIONER credit card to the applicant.

5. When a customer purchases merchandise using a PETITIONER credit card, PETITIONER electronically transmits the transaction data to FINANCIAL INSTITUTION and delivers the physical charge slips to FINANCIAL INSTITUTION within seven days of the purchase.

6. FINANCIAL INSTITUTION processes the transaction information and pays PETITIONER for the purchase and applicable Utah sales tax, less a credit card discount fee that is calculated for each transaction.

7. On its monthly sales tax return, PETITIONER remits to the Tax Commission sales tax money received from private label credit card sales, along with sales tax PETITIONER receives from cash, check, and other transactions.

8. The credit card discount fee is payment for FINANCIAL INSTITUTION'S services. It is calculated through an analysis of credit risk and it is based on various administrative costs associated with managing credit accounts, including finance revenue, service and collection costs, interest and funding costs, and bad debt loss ratio.

9. PETITIONER pays the discount fee to FINANCIAL INSTITUTION on each transaction and deducts these fees as expenses on its Federal Form 1120 income tax return, line 26, as an "other deduction."

10. Pursuant to the Credit Card Agreement, FINANCIAL INSTITUTION owns the accounts associated with the PETITIONER credit cards as well as any cardholder information, transaction data accounts written off as uncollectible, and receipts and documentation of payments and purchases.

11. FINANCIAL INSTITUTION is also responsible for managing the risk associated with allowing customers to purchase on credit. FINANCIAL INSTITUTION sets the fees, interest rate and credit line for each customer. FINANCIAL INSTITUTION also monitors and services the accounts, issues credit card statements, accepts payments and takes any necessary collection action.

12. Credit losses are borne by FINANCIAL INSTITUTION and it writes off uncollectible amounts on its Federal Form 1120 tax return by claiming a bad debt deduction on line 15 as "bad debts."

13. PETITIONER'S and FINANCIAL INSTITUTION'S general practice is to not repossess PETITIONER merchandise purchased with a PETITIONER credit card.

14. PETITIONER filed a request for refund of sales tax for the period of January 1, 2000 through July 31, 2003 in the amount of $$$$$. PETITIONER states that this amount represents the sales tax paid on accounts deemed uncollectible by FINANCIAL INSTITUTION and written off by FINANCIAL INSTITUTION for income tax purposes as set forth above.

APPLICABLE LAW

1. Utah Code Ann. §59-12-107(7)(Supp.2002) states:

> Credit is allowed for prepaid taxes and for taxes paid on that portion of an account determined to be worthless and actually charged off for income tax purposes or on the portion of the purchase price remaining unpaid at the time of a repossession under the terms of a conditional sales contract.

2. Utah Admin. Rule R865-19S-20(4)(Supp.2002) states:

> Sales tax credits for bad debts are allowable only on accounts determined to be worthless and actually charged off for income tax purposes. Recoveries made on bad debts and repossessions for which credit has been claimed must be reported and the tax paid.

3. Utah Admin. Rule R865-19S-20(6)(Supp.2002) states:

> Credit for tax on repossession is allowed only to the selling dealer or vendor.
>
> a. This does not preclude arrangements between the dealer or vendor and third party financial institutions wherein sales tax credits for repossessions by financial institutions may be taken by the dealer or vendor who will in turn reimburse the financial institution.
> b. In the event the applicable vehicle dealer is no longer in business and there are no outstanding delinquent taxes, the third party financial institution may apply directly to the Tax Commission for a refund of the tax in the amount that would have been credited to the dealer.

DISCUSSION

Under the version of Utah Code Section 59-12-107(7) in place during the period at issue here, a credit is allowed for prepaid taxes on the portion of an account that is deemed worthless and actually written off as bad debt for income tax purposes. Petitioner claims that it is entitled to a refund for sales tax paid on credit transactions that have been written off as uncollectible by FINANCIAL INSTITUTION ("FINANCIAL INSTITUTION")[1]. The Division argues that PETITIONER can only claim the credit or refund for its own bad debt write offs.

PETITIONER'S contractual link to FINANCIAL INSTITUTION

There is no dispute here concerning underlying facts. During the period in question, PETITIONER had a direct lending agreement with FINANCIAL INSTITUTION[2]. Under the agreement, FINANCIAL INSTITUTION issued private label PETITIONER credit cards for use on credit purchases in PETITIONER'S stores.

Under the PETITIONER/FINANCIAL INSTITUTION contract,[3] PETITIONER was obliged to display the credit card applications and to make reasonable efforts to promote the credit card program. Application materials were required to "clearly disclose" that FINANCIAL INSTITUTION was the owner and creditor on all accounts and PETITIONER was prohibited from implying otherwise.

Card applications were forwarded to FINANCIAL INSTITUTION. FINANCIAL INSTITUTION determined the creditworthiness of each applicant, individual credit limits, the interest rate and other payment terms associated with the cards and credit transactions. FINANCIAL INSTITUTION extended credit and service directly to the cardholder. It owned the credit accounts, the cardholder information, transaction data and all receipts and documentation of payments and purchases.

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1 The bad debt statute, section 59-12-107(7) allows a credit for prepaid taxes on credit transactions that are written off. PETITIONER claims that the amount at issue here exceeds its sales tax obligation, so they ask for a refund in lieu of a credit.

2 PETITIONER no longer contracts its private label credit cards out to FINANCIAL INSTITUTION. It currently uses a different credit card bank.

3 See Petitioner's Exhibit 5.

FINANCIAL INSTITUTION issued the cards, monitored and serviced the accounts, issued the credit card statements, and accepted payments. PETITIONER retained no interest in the proceeds or indebtedness on the accounts.

> FINANCIAL INSTITUTION held a security interest in all goods purchased with the cards, including any merchandise returned after FINANCIAL INSTITUTION reimbursed PETITIONER for the purchase. Credit losses on PETITIONER credit purchases were borne by FINANCIAL INSTITUTION. FINANCIAL INSTITUTION never attempted to repossess merchandise, but it pursued other collections actions before writing the bad debts off for tax purposes.

Functionally, PETITIONER transmitted credit card transactions to FINANCIAL INSTITUTION daily for reimbursement via wire transfer. FINANCIAL INSTITUTION reimbursed PETITIONER immediately for the full amount of the purchase, including sales tax, minus the merchant discount fee, which was an offset against the reimbursement. In most cases, PETITIONER was reimbursed for the sales tax prior to filing its monthly returns, except that PETITIONER may have received its reimbursement for transactions on or near the due dates of the returns after filing its returns for that period. In any event, FINANCIAL INSTITUTION was contractually obligated to reimburse PETITIONER for the sales tax. The credit purchasers were contractually obligated to FINANCIAL INSTITUTION for the amount of the tax.

PETITIONER was obliged to pay the discount fee on every credit transaction, regardless of whether the account was eventually deemed uncollectible by FINANCIAL INSTITUTION. The fee compensated FINANCIAL INSTITUTION for accepting the risk associated with the credit transactions and for the administrative costs of processing the transactions. The amount of the fee was determined through standard underwriting analysis and it was negotiated as part of the PETITIONER/FINANCIAL INSTITUTION contract. In essence, the fee was PETITIONER'S cost of outsourcing its credit card business and PETITIONER wrote the fee off as a business expense for tax purposes.

The private label credit arrangement was mutually beneficial to PETITIONER and FINANCIAL INSTITUTION. The cards generated additional sales for PETITIONER without subjecting PETITIONER to state or federal banking regulations. FINANCIAL INSTITUTION owned a valuable portfolio of interest-bearing accounts, it earned a discount fee on every transaction, and it mitigated bad debt losses by tax write-offs on uncollectible accounts.

PETITIONER'S theories for recovery

PETITIONER offers various theories of the case. First, PETITIONER states that it is entitled to a refund of the sales tax because it remitted the sales tax on the transactions that were later determined to be worthless.

Under Utah law, sales tax is due on the entire purchase price at the time of the transaction, even if the purchase is financed over time. Because the retail vendor is required to collect and remit the tax on its next sales tax return following the transaction, the vendor selling on credit remits the sales tax to the Commission immediately, then awaits reimbursement from the customer through payment on the account. In this case, PETITIONER reported the sales tax on its monthly returns, but it was FINANCIAL INSTITUTION that paid the tax through its reimbursements to PETITIONER. It was FINANCIAL INSTITUTION that awaited reimbursement from the customers through payments on the accounts.

Nevertheless, PETITIONER suggests that its involvement in reporting the tax entitles it to write off bad debts of a third party. Under Utah Code Ann. §59-12-107(7)(Supp. 2002) and Utah Admin. Rule R865-19S-20(4)(Supp. 2002), a credit is allowed for prepaid taxes on any portion of an account determined to be worthless and actually charged off for income tax purposes. PETITIONER suggests that the statute and rule cannot be read narrowly to limit the credit to the party who owned the accounts or who actually wrote off the bad debts. It argues for a more expansive reading which would allow PETITIONER to take a credit or refund or prepaid taxes on purchases in its store so long as someone wrote off the accounts. In fact, when asked to explain why PETITIONER did not also ask for refunds on purchases made on CARD-1, CARD-2, or other cards, PETITIONER'S witness indicated that

it is testing the waters with the PETITIONER credit card purchases before moving for an even broader reading of the statute.

The Division argues, and the Commission agrees, that tax exemption and refund statutes must be narrowly construed in a manner consistent with the purpose of the statute. See, e.g. Union Pacific R.R. v. Auditing Div., 842 P 2d 876, 880 (Utah 1992). The statute is intended to offer relief to a vendor who is required to collect sales tax on behalf of the state. Where the vendor is required by law to prepay the tax on a credit transaction and the account is subsequently deemed to be uncollectible, the vendor could suffer additional financial harm if it were not allowed a credit for the prepaid tax. That is not the case here. PETITIONER was reimbursed for the tax, so it did not suffer the economic harm that this statute is intended to relieve. PETITIONER does not meet the criteria for a credit or refund under the statute or rule.

PETITIONER next argues that the Commission should grant the refund because the circumstances of the bad debt accounts at issue are "functionally identical" to repossessions. Repossession is mentioned in Utah Admin. Rule R865-19S-20 (Supp. 2002). Petitioner particularly relies on Subsection (6), which states:

> Credit for tax on repossession is allowed only to the selling dealer or vendor.
> a. This does not preclude arrangements between the dealer or vendor and third party financial institutions wherein sales tax credits for repossessions by financial institutions may be taken by the dealer or vendor who will in turn reimburse the financial institution.
> b. In the event the applicable vehicle dealer is no longer in business and there are no outstanding delinquent taxes, the third party financial institution may apply directly to the Tax Commission for a refund of the tax in the amount that would have been credited to the dealer.

The administrative rule discusses at length how repossessions offset claims for refund, and it anticipates that a dealer or third party financial lender may claim refunds under certain circumstances involving repossessions. PETITIONER acknowledges that issues pertaining to repossessed vehicles were the catalyst for the rule's repossession provisions, but points out that the rule is not specifically limited to vehicle repossessions. PETITIONER asserts that the rule (1) allows a refund

for those who bore the tax burden on a bad debt; (2) recognizes that third party financers, rather than vendors, would incur the bad debt; and (3) intended to allow vendors to collect a refund "on behalf of financial institutions. . . ." See Pet. Pre-Formal Hearing Brief, p. 11. If this is true under circumstances of repossession, Petitioner argues, it must also be true in other credit scenarios.

Respondent points out that FINANCIAL INSTITUTION never repossessed merchandise. The type of merchandise involved typically does not hold its value, so it would not have been cost effective to do so. Respondent also argues that the rule draws a clear distinction of repossessions, and that distinction must be meaningful. To better understand this rule, we look back at the Commission's publications that explain the intent of the rule. Tax Bulletin 11-91,[4] issued January 28, 1991, read as follows:

> Tax Commission Rule R865-19-20S dealing with the basis for sales tax reporting was recently revised to include an explanation of the required method of claiming a sales tax credit on repossessions.
>
> Effective on January 28, 1991, only the vendor who made the sale and collected and remitted the sales tax to the Tax Commission is eligible for a credit on his sales tax return. On non-recourse financed repossessions, financial institutions may arrange with the selling vendor for the selling vendor to take a credit and forward the funds to the financial institution.
>
> In cases where a selling vendor is no longer in business, financial institutions may file a claim for refund of sales tax directly with the Tax Commission. If the original selling vendor went out of business owning sales tax, no refund will be made because it is assumed the tax in question was never paid to the Tax Commission.
>
> In some instances, a person purchases an item from someone other than a vendor licensed to collect sales tax and uses a direct loan from a financial institution. In other cases, a customer may obtain a direct loan even though he purchases from a dealer. If a repossession occurs involving a product purchased using a direct loan, the financial institution is not eligible to apply for a refund.

4 See also, Commission Appeal Decision 01-1271 .

In Private Letter Ruling 92-016, the Commission also issued instructions for figuring refunds in situations involving repossessions. In that Letter Ruling, the Commission stated:

> 1. Utah Code section 59-12-107(8) allows a refund (credit) of taxes paid on the portion of the purchase price remaining unpaid at the time of the repossession. Tax Commission Rule R865-19-20S specifies that this credit is allowed only to the selling dealer, but that this right to a refund may be passed on to a financial institution through the assignment of a non-recourse loan.
>
> 2. A direct loan on a vehicle purchased from a dealer is a loan arranged for by the borrower directly with the financial institution. If a repossession occurs involving a product purchased using a direct loan, the financial institution is not eligible to apply for a refund.
>
> 3. A non-recourse loan is a loan from a dealer to the customer that is subsequently assigned or sold to a financial institution. The dealer has no further responsibility to the financial institution after the loan is assigned or sold. The dealer's rights under this loan are transferred to the financial institution including the right to a refund upon repossession.
>
> 4. In summary, where a dealer makes a loan and assigns it to a financial institution, that financial institution may request a refund through the dealer upon making a repossession. If a buyer goes to his own bank or credit union and obtains a loan, the bank or credit union may not request a refund when a repossession occurs.

The bulletin and letter ruling explain that a vendor who extends credit to a customer can apply for a refund if the merchandise is later repossessed. Additionally, it allows that vendor to apply for the refund even if the vendor later sold or assigned the credit account to a third party. This makes sense. If the vendor sold the credit contract, its rights to the refund may be transferred with the account. However, the bulletin and letter ruling also make clear that these provisions do not apply in direct lending arrangements, which also makes sense. Where the third party finance institution makes a direct loan to the customer, the vendor

> retains no interest in the merchandise, nor does it have any right to repossess the merchandise. Therefore it cannot transfer that right to the third party lender.

The situations are not "functionally identical," as Petitioner claims. Because FINANCIAL INSTITUTION makes direct loans to PETITIONER'S customers, the provisions of the rule preclude PETITIONER'S claim for refund.

PETITIONER next argues that it is inequitable and unfair for the Commission to deny the refund to PETITIONER when FINANCIAL INSTITUTION is also precluded from obtaining a refund. In a prior decision, the Commission found that the third party financer was not the taxpayer and it could not receive a refund or credit of taxes remitted by the vendor. Petitioner concludes from that decision that if FINANCIAL INSTITUTION cannot claim the credit, the vendor *must* be eligible for it. Petitioner argues, then, that the vendor is always eligible for a credit for transactions that a third party financer writes off.

> For reasons already explained, a third party direct lender is not eligible to claim a refund for sales tax on its uncollectible accounts. Nor is the vendor, who was fully reimbursed for the sales tax by the lender. There is no "windfall" here. The sales tax was due at the time of the transaction. The fact that the purchaser later defaults on its obligation to the third party direct lender does not convert the sales into a non-taxable transaction. As we have already stated, the refund provisions are in place so that a vendor who is required by state law to prepay the tax on behalf of a credit purchaser is not unduly disadvantaged by its legal obligations to collect sales tax for the state. PETITIONER was not disadvantage, as FINANCIAL INSTITUTION reimbursed it for the tax.

> PETITIONER reminds us that it paid a discount fee on each transaction, so it claims it was not reimbursed for the tax. However, the discount fee was compensation to FINANCIAL INSTITUTION to induce it to accept the credit risk on the accounts and to pay for the cost of processing the accounts. It has no relation to sales tax paid on the transactions. In fact, one could say that PETITIONER

collected the taxes from FINANCIAL INSTITUTION through its reimbursement agreement and forwarded the taxes to the State. If PETITIONER discounted its receivables under its agreement with FINANCIAL INSTITUTION, that was its business decision. It certainly had no right to discount sales tax held in trust for the State.

Next, Petitioner argues that PETITIONER is entitled to a refund on FINANCIAL INSTITUTION'S uncollectible accounts because it acted "as a unit" with FINANCIAL INSTITUTION. In support of this position, PETITIONER refers to Utah Code Ann. Section 59-12-102(42)(Supp. 2002), which defined "vendor" as "any person receiving payment or consideration for tangible personal property." "Person," defined in subsection (27) of that statute, includes "any group or combination acting as a unit." Therefore, Petitioner concludes, FINANCIAL INSTITUTION and PETITIONER comprise a "collective person" within the meaning of the term "vendor."

PETITIONER urges that its relationship with FINANCIAL INSTITUTION is so closely intertwined that they must be viewed as one for purposes of the refund provisions at issue. In fact, PETITIONER claims that it “likely had a legal ‘agency’ relationship” with FINANCIAL INSTITUTION because PETITIONER customers did not understand that they were dealing with a separate entity on the accounts. In response, the Division points out that all credit application material clearly informed credit card holders that they were dealing with FINANCIAL INSTITUTION, not PETITIONER, on the credit accounts. Additionally, FINANCIAL INSTITUTION also had control of the credit accounts and accepted the risk associated with those accounts. PETITIONER has no interest in the accounts. The Commission agrees with the Division here. Although PETITIONER and FINANCIAL INSTITUTION acted in conjunction with one another to fulfill the terms of their contract, they were not "a unit" for purposes of these refund provisions. Moreover, as explained elsewhere in this opinion, the Utah law specifically sets third lenders apart from the vendors for purposes of these provisions.

Finally, Petitioner states that it has filed for refunds in every state in which it operates and that some states have agreed with their position. It urges the Commission to follow the lead of those states that have found in its favor. Under cross-examination, the PETITIONER

witness also admitted that its claims have been denied in many states and that they have appeals pending in those states. Whatever the outcome of the appeals under the laws of other states, the Commission is bound by Utah law and the actions of other states on this issue are not relevant to this determination.

DECISION AND ORDER

Based on the foregoing discussion, the refund request is denied. It is so ordered.

DATED this _____ day of _____, 2006.

_____
Irene Rees
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2006.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601 and 63-

46b-13 et. seq. "In order to appeal to the District Court or the Utah Supreme Court, you must post security or obtain a waiver under Utah Code Sec. 59-1-611."

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