08-0588
TAX TYPE: REFUND REQUEST
TAX YEAR: 11-4-04 through 10-31-06
DATE SIGNED: 11-30-2012
COMMISSIONERS: B. JOHNSON, M. JOHNSON, M. CRAGUN
RECUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER, Petitioner, vs. TAXPAYER SERVICES DIVISION, OF THE UTAH STATE TAX COMMISSION Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 08-0588 Account No. ##### Tax Type: Sales Tax Tax Year: 11/4/04 – 10/31/06 Judge: Phan

Presiding:
Michael Cragun, Commissioner, Commissioner
Jane Phan, Administrative Law Judge

Appearances:

For Petitioner:	REPRESENTATIVE-1 FOR TAXPAYER, Attorney at Law REPRESENTATIVE-2 FOR TAXPAYER, Vice President
For Respondent:	REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General RESPONDENT-1, Deputy Director, Taxpayer Services Division RESPONDENT-2, Compliance Manager, Taxpayer Services Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on September 25, 2012, in accordance with Utah Code §59-1-501 and §63G-4-201 et seq. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioner ("Taxpayer") filed this action to appeal a decision issued by Respondent ("Division") to deny the issuance of a refund to the Taxpayer. The refund claim had

been for the period of November 1, 2004 through October 31, 2006. The amount of the refund requested was $$$$$.

2. The Division had denied the refund claim by Statutory Notice dated February 26, 2008. The Taxpayer timely appealed and the matter eventually proceeded through the administrative process to this Formal Hearing.

3. Taxpayer is a corporation organized and existing under the laws of STATE-1. Its commercial domicile is in CITY-1, STATE-2.

4. Taxpayer is in the business of selling tangible personal property at retail and operates DEPARTMENT STORES throughout the United States, with several retail locations in Utah.

5. Taxpayer remits sales tax to Utah on a monthly basis, which is calculated on the purchase price of the taxable merchandise. This includes sales tax on the purchase price of credit sales.

6. During the period at issue in this appeal, Taxpayer had a contract with a CREDIT BANK to provide a Private Label Credit Card (PLCC) program to Taxpayer's customers. The Private Label Credit Card Program Agreement between Taxpayer and the Credit Bank that was in effect during the period at issue had been dated August 7, 2004 ("Agreement").[1]

7. The witness for Taxpayer, REPRESENTATIVE-2 FOR TAXPAYER, Vice President, OF TAXPAYER, gave the opinion that the relationship between Taxpayer and the Credit Bank was similar to a partnership. He testified that having the PLCC program helped Taxpayer by facilitating retail sales in its stores. In turn, the Taxpayer actively marketed the PLCCs in its stores. REPRESENTATIVE-2 FOR TAXPAYER testified that based on the arrangement between Taxpayer and Credit Bank, and also as dictated by the Agreement[2] a Marketing Committee was established to market the PLCC program. Three members of the committee were from the Credit Bank and three from Taxpayer. Additionally, because of the interrelated nature of the PLCC program, he testified that several employees of the Credit Bank worked in Taxpayer's corporate offices. Taxpayer shared in the revenue generated by the PLCC program.

8. Although the credit cards were issued by the Credit Bank, they did state Taxpayer's name on the card and on the credit card bills. The witness for Taxpayer testified that when a customer received the billing statement for the PLCC, it would have Taxpayer's name on

[1] Petitioner's Exhibit A.
[2] Petitioner's Exhibit A, pg. 20.

the statement, but in the fine print on the bill it would identify that the card was issued by the Credit Bank. If they wrote a check for payment on the cards it was made out to the Taxpayer. Additionally, he stated that if a customer called in to the customer service numbers, which are operated by the Credit Bank, the telephone would be answered "TAXPAYER." Collection calls, also provided by Credit Bank, would identify the caller as from "TAXPAYER." He indicated that customers on Taxpayer's website could access the PLCC program, but it was actually a link on Taxpayer's website that would take them to the credit card information site provided and operated by the Credit Bank.

9. Applications for the PLCC program were available at Taxpayer's retail locations and they were actively promoted at those locations.

10. The Credit Bank would consider the credit worthiness based on its own standards of the customers who applied for the PLCCs. However, Taxpayer mandated as part of the program that Credit Bank allow a %%%%% approval rating of applicants. The Credit Bank managed the risk by setting credit limits and authorization of the approvals. Approval provided customers the option of purchasing merchandize on credit using a PLCC.

11. The Credit Bank was responsible for the operations and services required for the credit cards, including issuing billing statements and collections. The Credit Bank also provided customer service, daily settlement of the accounts by reimbursing Taxpayer for amounts charged and monthly reports including those used to determine the revenue sharing between Taxpayer and Credit Bank.

12. If a customer purchased items at the retail store on credit, Taxpayer would include the credit sale as part of its total sales and pay the tax on these sales with its monthly returns.

13. The Credit Bank would reimburse Taxpayer for the total amount charged, including the sales tax, by noon the day after the purchase had been charged to the PLCC.

14. When customers failed to pay their credit card bills, it was the Credit Bank that directly bore the loss. For accounts it deemed uncollectable, the Credit Bank would write off the loss and take the federal bad debt deduction on its federal income tax return.

15. Although the direct risk of loss was born by the Credit Bank, pursuant to the terms of the Agreement between Credit Bank and Taxpayer, Taxpayer is affected by the write-off due to its revenue sharing provisions. Under the terms of the Agreement, Taxpayer was entitled to %%%%% of what was termed the "Risk Adjusted Margin." The Risk Adjusted Margin was determined by taking the financing income which was generated from finance charges, late

charges and other fees and subtracting the program net losses and funding costs.[3] For those credit card accounts where the losses are written off, the amounts of the losses were included in the program net losses which were subtracted from the financing income.

16. Taxpayer provided the monthly settlement statements issued by Credit Bank for each month throughout the period at issue in this appeal.[4] These confirmed Taxpayer's position that its revenue sharing amount was reduced by %%%%% of the losses written off by the Credit Bank. The Credit Bank was required and did provide Taxpayer with these monthly settlement sheets[5] that set forth the calculation of Taxpayer's financing income revenue share, including the amounts of customer accounts written off as bad debt during the month.

17. The Agreement also provided that Taxpayer would pay when due any sales tax relating to the purchase charged to the PLCC accounts. If any amounts were written-off by the Credit Bank, the Taxpayer was to use "commercially reasonable efforts to recover" the amounts of sales tax charged to accounts that were written off by the Credit Bank. The Credit Bank was to pay reasonable out-of-pocket costs incurred in doing so.[6] Sales tax recoveries were to be added back, so included in the Risk Adjusted Margin.

APPLICABLE LAW

The applicable statutory provisions were amended effective July 1, 2004 prior to the audit period and are set out at Utah Code §59-12-107(8) (2003). The law was re codified effective July 1, 2005, to Utah Code §59-12-107(9) (2004) but the provisions appear to be substantially the same. Utah Code §59-12-107(8) states as follows:

> (a) For purposes of this Subsection (8):
> (i) Except as provided in Subsection (8)(a)(ii), "bad debt" is as defined in Section 166, Internal Revenue Code.
>
> * * * *
>
> (b) A seller may deduct bad debt from the total amount from which a tax under this chapter is calculated on a return.
> (c) A seller may file a refund claim with the commission if: (i) the amount of bad debt for the time period described in Subsection (8)(e) exceeds the amount of the seller's sales that are subject to a tax under this chapter for that same time period; and (ii) as provided in Section 59-12-110.
> (d) A bad debt deduction under this section may not include interest.

[3] Petitioner's Exhibit A, pg. 118; Petitioner's Exhibit B.
[4] Petitioner's Exhibit B.
[5] Petitioner's Exhibit B.
[6] Petitioner's Exhibit A, pg. 19.

> (e) A bad debt may be deducted under this Subsection (8) on a return for the time period during which the bad debt: (i) is written off as uncollectible in the seller's books and records; and (ii) would be eligible for a bad debt deduction: (A) for federal income tax purposes; and (b) if the seller were required to file a federal income tax return.
> * * * *

Two different Administrative Rules were in effect during the audit period. For the portion of the period prior to July 1, 2005, Utah Administrative Rule R865-19S-20 (2004) provided in pertinent part:

> C. Justified adjustments may be made and credit allowed for cash discounts, returned goods, bad debts, and repossessions that result from sales upon which the tax has been reported and paid in full by retailers to the Tax Commission.
> * * * *
>
> 4. 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.
> * * * *

Effective July 1, 2005, Utah Admin. Rule R865-19S-20 (2005) was amended in pertinent part to the following:

> * * * *
> C. Adjustments may be made and credit allowed for cash discounts, returned goods, and bad debts that result from sales upon which the tax has been reported and paid in full by a seller to the Tax Commission.
> * * * *

Utah Code Ann. §59-1-1417 provides, "[i]n a proceeding before the commission, the burden of proof is on the petitioner…"

DISCUSSION

Utah Code Sec. 59-12-107(8) provides for a bad debt deduction from sales tax imposed under that section. The facts were not disputed at this hearing. The issue is one of statutory interpretation. As this matter involves a deduction rather than a tax imposition statute the provisions are strictly construed based on the plain language of the statute. See *Parson Asphalt Products, Inc. v. Utah State Tax Comm'n, 617 P.2d 397* (Utah 1980)." See also *SF Phosphates Limited Company v Auditing Division*, and *Utah State Tax Comm'n*, 972 P.2d 384 (Utah 1998). In *MacFarlane et al. v. Utah State Tax Comm'n*, 134 P.3d 1116 (Utah 2006), the Utah Supreme explains, "While we recognize the general rule that statues granting credits must be strictly

construed against the taxpayer, the construction must not defeat the purposes of the statute. The best evidence of that intent is the plain language of the statute." (Citations Omitted.) Therefore, the Commission must review the facts and construe the statute based on its plain language.

Utah Code Sec. 59-12-107(8)(b) provides that a seller may deduct bad debt from the total amount from which a tax is calculated on a return. At Subsection 107(8)(e)(i) it provides further that the bad debt may be deducted on a return for the time period during which the bad debt is written off as uncollectible in the seller's books and records. Under a plain reading of this statute, Taxpayer does not qualify for this bad debt deduction. Taxpayer is the seller. The bad debt is not written off from Taxpayer's books as uncollectible. Taxpayer, in fact, received direct payment of the total purchase price charged on the credit card including the tax, regardless of whether the credit account was actually paid in full or written off as uncollectable. It was the Credit Bank, who is not the seller, that wrote the bad debt off as uncollectible and it was the Credit Bank which was eligible for a bad debt deduction under federal provisions. The statute does not provide that a third party lender would receive this credit, nor does it provide that a seller may take this credit if it is written off as uncollectible from a third party lender's books and records. There is simply no reading based on the plain language of this statute that would allow a bad debt deduction for the amounts at issue in this appeal.

Taxpayer did not provide Utah case law or prior Tax Commission decisions that support its position that the bad debt deduction of Utah Code 59-12-107(8) be extended to sellers, where a third party lender wrote off the debt as uncollectible. There is a prior decision from the Utah State Tax Commission dealing with the bad debt deduction and it supports the Division's position in this matter. In *Utah State Tax Commission Appeal No. 04-0919* there were a number of facts very similar to this appeal. The petitioner was a national retail chain. It offered its customer's private label credit cards which were provided and managed by a third-party lender. For purchases made using the credit card, the third-party lender would pay the retail chain the full amount of the charge which included the sales tax. Then if the credit card accounts became uncollectible, the third-party lender might write them off as uncollectible from the third-party lender's books and records.

In *Appeal No. 04-0919* the Commission rejected a number of arguments made by the Petitioner, including that the Petitioner and third-party lender should be viewed together as one entity because they were operating in concert. The Commission denied the refund, even though the applicable law at that time, a prior version of Utah Code 59-12-107, was less clear than the current version on the point that this was limited to a seller who had written off the account on the

seller's books as uncollectable. In the current appeal before the Commission, the fact that Taxpayer had contracted with the Credit Bank for the credit services and pursuant to that contract there were various obligations and benefits on both sides, does not mean the Credit Bank could be considered the seller for purposes of the statute.

Taxpayer, undisputedly the "seller" in this matter, argues that despite being reimbursed directly by Credit Bank for the total amount of the charged purchases regardless of whether the credit account was paid or written off, Taxpayer did suffer a loss from the bad debt. Pursuant to the Agreement with the Credit Bank Taxpayer receives %%%%% of the Risk Adjusted Margin as a revenue sharing provision. The Risk Adjusted Margin is determined on a monthly basis taking the financing income received during that month and subtracting out losses and funding costs. When an account is written off as uncollectible by Credit Bank, that loss is part of the loss subtracted so it does reduce the risk adjusted margin and reduces the amount Taxpayer would receive in revenue sharing. The losses are shown on the Monthly Settlement Sheet that Credit Bank prepared and provided to Taxpayer.[7] Taxpayer argues that because write off by the Credit Bank of the credit accounts did reduce the amount the Taxpayer recovered under the revenue sharing provisions, the provisions of Utah Code 59-12-107(8) should be considered to have been met.

Taxpayer points out that the sales tax is imposed on the consumer and not the seller and argues that denying the refund unfairly and illegally shifts the burden of paying the tax to the retailer. However, in this matter this argument is unfounded because the burden was not shifted to Taxpayer. Sales tax is a transaction tax due at the time the consumer makes its purchase. If the consumer used the PLCC to make the purchase, Taxpayer was reimbursed the total price including the sales tax from the credit bank by noon the next day, regardless of whether the consumer ever paid the credit card account balance or not. Taxpayer received an amount for the tax from the Credit Bank and remitted that amount to the state. Taxpayer fails to note that there are two separate types of transactions. The first is the actual sale between the Taxpayer and the consumer. The second transaction is based on the contractual profit sharing arrangement between Taxpayer and the Credit Bank.

Taxpayer argues that the Division's interpretation of the bad debt refund statute violates the United States and Utah Constitution because it is an arbitrary distinction and there is no rational basis between sellers such as Taxpayer who have a third party provide the private label credit card financing and between retailers who issue their own credit. Taxpayer points to

[7] Petitioner's Exhibit B.

Williams v Vermont, 472 U.S. 14, 23 (1985) and *United States v Carlton*, 512 U.S. 26, 30 (1994), in which the Court had stated a tax regulation would violate the Due Process Clause of the U.S. Constitution when it is "harsh or oppressive or "arbitrary and irrational." Taxpayer argued as well that it would be local retailers who would provide their own financing and national retailers who would use a third party credit provider,[8] but there was not testimony or evidence that supported this assertion.

Regardless, Taxpayer's argument on this point is without merit. There is a clear distinction between a retailer that issues its own credit and a retailer that contracts with a third party in the manner that Taxpayer has contracted with the Credit Bank. The retailer that issues its own credit bears the direct loss when a consumer fails to pay the account. The facts in this appeal show that Taxpayer does not, because Taxpayer receives a full, direct reimbursement from the Credit Bank regardless of whether the account becomes uncollectable. Although, there will be some harm to Taxpayer in its separate credit financing transaction with the Credit Bank, it is not the direct loss of the payment for goods a consumer has acquired and taxes paid for that first transaction. A retailer that provides its own credit directly suffers the loss of the uncollectable account by not receiving reimbursement for goods that it sold or tax that it has paid. In addition, for a retailer providing its own credit, there may also be losses of financing revenue due to the uncollectable account.

Taxpayer had also pointed out that if Taxpayer was not allowed to take the bad debt deduction, neither was the Credit Bank and argued that this was an unfair windfall to the state. However, as noted by the Utah Supreme Court in *MacFarlane et al. v. Utah State Tax Comm'n*, 134 P.3d 1116 (Utah 2006), ft. 10, "Presumably, the reason for the rule of strict statutory construction is because it serves a guide in determining legislative intent. Because tax credits and exemptions are "matters of legislative grace," [citing] *Team Specialty Prods., Inc.*, 2005-NMCA-020, Prg. 9, 107 P.3d 4, courts may rightly infer that the Legislature would not want to extend that grace too far, but rather would seek to limit its application to a select group for a specific reason." From the plain language of the statute, the bad debt deduction may be claimed by sellers who extend credit to customers, it was not granted to third party banks which are in the business of providing credit for purchases and are subject to both the benefits and the risks of providing credit.

[8] Prehearing Brief of Petitioner, pg. 7.

CONCLUSIONS OF LAW

1. The issue before the Commission is one of statutory interpretation in determining whether the Taxpayer is entitled to a bad debt deduction or refund under Utah Code Sec. 59-12-107(8). In issuing its decision the Commission must strictly construe the statute based on its plain language. See *Parson Asphalt Products, Inc. v. Utah State Tax Comm'n, 617 P.2d 397*, (Utah 1980); *SF Phosphates Limited Company v Auditing Division*, and *Utah State Tax Comm'n*, 972 P.2d 384 (Utah 1998); *MacFarlane et al. v. Utah State Tax Comm'n*, 134 P.3d 1116 (Utah 2006); and *Jensen v Intermountain Health Care, Inc.*, 679 P.2d 903,905. (Utah 1984).

2. Utah Code Sec. 59-12-107(8) (b) provides that a seller may deduct bad debt from the total amount from which a tax is calculated on a return. At Subsection (e)(i) it further provides that the bad debt may be deducted on a return for the time period during which the bad debt is written off as uncollectible in the seller's books and records. Under a plain reading of this statute Taxpayer does not qualify for this bad debt deduction. The Taxpayer is undisputedly the seller. However, the bad debt is not written off the Taxpayer's books as uncollectible. There is no reading based on the plain language of this statute that would allow a bad debt deduction for the amounts at issue in this appeal.

3. The Taxpayer argues that it did suffer a loss from the bad debt in the form of a reduction in the amount of its revenue sharing payments. Pursuant to the Agreement with the Credit Bank, when an account is written off as uncollectible by Credit Bank, that loss reduced Taxpayer's revenue share. This is not sufficient to constitute a write off of a debt as uncollectible in the Taxpayer's books and records under Utah Code Sec. 59-12-107(8).

4. The Taxpayer argues that the Division's interpretation of the bad debt refund statute violates the United States and Utah Constitution because it is an arbitrary distinction and there is no rational basis between sellers such as the Taxpayer who have a third party provide the private label credit card financing and between retailers who issue their own credit. The Taxpayer's argument on this point is without merit. There is a clear distinction between a retailer that issues its own credit and a retailer that contracts with a third party to have the third party provide credit. The retailer that issues its own credit bears the direct loss when a consumer fails to pay the account. The Taxpayer did not bear the direct loss because the Taxpayer received a full, direct reimbursement from Credit Bank.

5. The Taxpayer argued that not allowing the bad debt deduction caused an unfair windfall to the state. However, as noted by the Utah Supreme Court in *MacFarlane et al. v. Utah State Tax Comm'n*, 134 P.3d 1116 (Utah 2006), ft. 10, "tax credits and exemptions are "matters

of legislative grace"" (citation omitted). The bad debt deduction was not extended to third party banks which are in the business of providing credit for retail purchases.

The Taxpayer's appeal in this matter should be denied.

_____
Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission denies the Taxpayer's appeal. It is so ordered.

DATED this _____day of _____, 2012.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

RECUSED

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
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. §63G-4-302. 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 et seq. and §63G-4-401 et seq.