STATE OF ARIZONA

Department of Revenue
Office of the Director
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The Director's Review of the Decision of the Administrative Law Judge Regarding:	)	**O R D E R**
[redacted]	)	**Case No. 200500034 - S**
ID No. [redacted]	)	

On October 24, 2005, the Administrative Law Judge issued a decision regarding the protest of [redacted] ("Taxpayer"). The Taxpayer appealed this decision on November 22, 2005. As the appeal was timely, the Director of the Department of Revenue ("Director") issued a notice of intent to review the decision.

In accordance with the notice given the parties, the Director has reviewed the Administrative Law Judge's decision and now issues this order.

STATEMENT OF CASE

Taxpayer submitted a refund claim to the Transaction Privilege Tax Section of the Audit Division ("Division") of the Arizona Department of Revenue ("Department") in the amount of [redacted] for the period of [redacted]. In its refund claim, Taxpayer argued that it is entitled to a bad debt deduction related to its private label credit card sales. The Division denied Taxpayer's refund claim and Taxpayer protested the denial. The matter went to hearing and the Administrative Law Judge ("ALJ") affirmed the refund denial. On appeal, Taxpayer argues that it suffered financial losses due to bad debts on customers' credit card accounts and that it meets all requirements for a bad debt deduction under the Arizona Administrative Code. The Division argues that Taxpayer is not entitled to a refund concerning bad debts based on A.R.S. §§ 42-1118 and 42-5001 and A.A.C. R15-5-2011.

FINDINGS OF FACT

The Director adopts from the findings of fact in the decision of the ALJ and makes additional findings of fact based on the record as set forth below:

1. Taxpayer is a [redacted] retailer selling goods and services at several Arizona store locations.

2. Taxpayer offers its customers a private label credit card that can only be used to finance purchases in Taxpayer's stores. Pursuant to a consumer credit card program agreement of [redacted] ("Agreement") between Taxpayer and a third-party credit card bank ("Bank"), Bank reviews all credit card applications of Taxpayer's customers, determines their creditworthiness, sets credit limits, issues the credit cards, and establishes, finances and manages the cardholders' accounts.

3. The purchases under the credit card program are debited to the cardholders' accounts and involve extensions of credit directly from Bank to the cardholders.

4. Bank owns all cardholder accounts established under the credit card program and is entitled to receive all payments made by cardholders on those accounts. Taxpayer does not have any rights in any of the accounts unless it purchases such accounts from Bank.

5. Per the Agreement and as between Bank and Taxpayer, all losses on cardholder accounts are borne solely by Bank without recourse to Taxpayer, with certain exceptions expressly specified in the Agreement that are not at issue here.

6. Bank's payments to Taxpayer for the cardholders' purchases are adjusted for anticipated customer defaults. Bank pays Taxpayer an amount calculated on the basis of a formula that is applied to the financed transaction charges. The economic loss of written-off accounts is a contributing factor when determining that formula and the credit criteria for individual cardholders.

7. When a customer made a purchase with the use of the private label credit card, Taxpayer charged the customer the net purchase price plus the retail transaction privilege tax and remitted the tax to the Department. Bank then paid Taxpayer the amount financed, as adjusted for anticipated customer defaults.

8. When Bank was unable to collect the financed amount from a customer, it would write off the debt and treat it as a loss. Bank would not seek payment from Taxpayer for the uncollected amount.

CONCLUSIONS OF LAW

The Director adopts from the conclusions of law in the Decision of the ALJ and makes additional conclusions of law as follows:

1. A.A.C. R15-5-2011.A provides that the deduction of a bad debt shall be allowed from gross receipts if: "(1) The gross receipts from the transaction on which the bad debt deduction is being taken have been reported as taxable; (2) The debt arose from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money; and (3) All or part of the debt is worthless."

2. A.A.C. R15-5-2011.B provides that a debt "shall be considered worthless if: (1) The surrounding circumstances indicate that the debt is uncollectible; and (2) Legal action to enforce payment has not or, in all probability, would not result in the satisfaction of the debt."

3. A.A.C. R15-5-2011.E provides that a bad debt deduction "shall be allowed, pursuant to the provisions in this rule, on conditional or installment sales if: (1) The tax liability is paid on the full sales price of the tangible personal property at the time of the sale; or (2) A contract or other financial obligation is sold to a third party as a sale with recourse and principal payments are made by the vendor to the third party, pursuant to the default of the original payor. Such principal payments may be taken as a bad debt deduction if the tax was paid by the

vendor on the original sale of the tangible personal property or on the subsequent sale of the financing contract. (3) For purposes of the bad debt deduction in situations of default on conditional or installment sales, a "sale with recourse" means that a vendor sells a contract or other financial obligation to a third party but retains liability for payment upon default of the original payor."

4. The requirements in A.A.C. R15-5-2011.E for bad debt deductions on conditional or installment sales apply in addition to the general requirements for bad debt deductions in A.A.C. R15-5-2011.A.

5. A debt that is not worthless as a whole or in part is not a bad debt. A.A.C. R15-5-2011.A.3.

6. A contractual agreement to accept payment for a sales transaction from a third party in an amount that is less than the total face value of the sales transaction debt does not render that debt, or any part thereof, uncollectible or worthless.

7. A retailer who receives from a finance company the full payment agreed upon in a merchant agreement as the payment for financed sales transactions, even when that payment is discounted to reflect the risk of customer default, has no accounts that may become uncollectible. See *Linnehan Leasing v. State Tax Assessor*, 898 A.2d 408, 2006 ME 33 (Me. 2006).

8. Bank did not purchase debts from Taxpayer with recourse and Taxpayer did not make principal payments to Bank pursuant to the default of credit cardholders.

9. The amounts by which Bank's payments to Taxpayer are adjusted for anticipated customer defaults do not qualify as bad debts.

10. Taxpayer is not entitled to a bad debt deduction.

DISCUSSION

Taxpayer argues that it reported tax on the full sales amount of all transactions upon consummating the sale, that the debts arose from a debtor-creditor relationship

between Bank and the cardholders, and that the debts subsequently became worthless. Taxpayer argues that as a result, it meets the requirements of A.A.C. R15-5-2011, specifically those of Subsection E.1 of the rule, and should be entitled to a bad debt deduction irrespective of who owns or maintains the credit accounts or bears the risk of loss.

The Division argues that the intent of A.A.C. R15-5-2011 is to permit a bad debt deduction by the party that incurs the bad debt, that Taxpayer made a business decision when it contracted with Bank to receive less than full value on the sales Taxpayer made through the credit card program, and that there is no bad debt to Taxpayer upon customer default.

A.A.C. R15-5-2011 provides a deduction of bad debts from gross receipts for Arizona transaction privilege tax purposes. Generally, the principles of construction that apply to statutes apply with equal force to administrative rules and regulations. *DaimlerChrysler Services North America v. Ariz. Dept. of Revenue*, 210 Ariz. 297, 301, 110 P.3d 1031, 1035 (App. 2005). A.A.C. R15-5-2011.A lists conditions that must apply for a bad debt to be deducted. Taxpayer argues that it is entitled to a bad debt deduction pursuant to Subsection E of the rule. A.A.C. R15-5-2011.E establishes requirements for bad debt deductions on conditional or installment sales and provides that a bad debt deduction on such sales "shall be allowed, pursuant to the provisions of this rule . . ." if the specific requirements in Subsections E.1 or E.2 are met. The reference to "the provisions of this rule" makes clear that the requirements in A.A.C. R15-5-2011.E apply in addition to the general conditions for all bad debt deductions pursuant to A.A.C. R15-5-2011.A. Taxpayer must therefore first meet those general conditions.

A.A.C. R15-5-2011.A lists three conditions for the deduction of a bad debt:

> (1) The gross receipts from the transaction on which the bad debt deduction is being taken have been reported as taxable; (2) The debt arose from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money; and (3) All or part of the debt is worthless.

In question here is the third condition. The Division argues that Taxpayer was made whole by Bank and that there is no bad debt. The term "worthless", as used in A.A.C. R15-5-2011.A.3, is explained in A.A.C. R15-5-2011.B, which provides that a debt shall be considered worthless if:

> (1) The surrounding circumstances indicate that the debt is uncollectible; and (2) Legal action to enforce payment has not or, in all probability, would not result in the satisfaction of the debt.

Under Taxpayer's Agreement with Bank, Bank pays Taxpayer the agreed upon amount for the financed purchases, which is calculated on the basis of a formula that is applied to the financed transaction charges to adjust the payments for anticipated customer defaults. Taxpayer does not argue that Bank ever failed to make such payments. Taxpayer's Agreement to accept a payment from Bank that is less than the total face value of the financed transaction charge does not render a debt, or any part thereof, uncollectible or worthless. Taxpayer and Bank merely assigned an economic value to Bank's acceptance of the risk of default. As a result, the cardholder is obligated to pay Bank rather than Taxpayer.

In *DaimlerChrysler*, the Arizona Court of Appeals noted that automobile dealers who sold retail installment contracts to a financial services company, and who were not responsible for reimbursing the finance company for defaults, were fully compensated and had no bad debt deduction. 210 Ariz. at 303, 110 P.3d at 1037. The decision in *DaimlerChrysler* does not address whether the dealers had agreed to any adjustments for customer defaults, and it is therefore not clear whether the court uses the term "fully compensated" to mean the full face value of the contracts or simply the full payments as agreed between the dealers and the finance company. The decision in *DaimlerChrysler*, therefore, does not resolve this matter.

The Supreme Judicial Court of Maine addressed the question whether a retailer who sells debts to a finance company at a discount has any uncollectible accounts receivable in *Linnehan Leasing v. State Tax Assessor*, 898 A.2d 408 (Me. 2006). There, a retailer assigned retail sale finance agreements to a finance company for a

price that was discounted to reflect immediate payment and acceptance of the risk of default. Loans that went into default were charged off by the finance company as worthless after unsuccessful collection attempts, and the finance company received the federal and state income tax benefits resulting from the charge-offs. The Court noted that the retailer, who had paid the required sales taxes on the purchases, had received from the finance company the full, although discounted, payment for the purchase price. The Court concluded that the retailer thus had no accounts receivable that could become uncollectible. *Linnehan Leasing*, 898 A.2d at 413.

As in *Linnehan Leasing*, there is no dispute here that it was Bank that charged off the uncollectible debts on its books. Taxpayer, on the other hand, has no uncollectible accounts receivable and therefore no worthless or bad debts. As a result, Taxpayer fails to meet the condition in A.A.C. R15-5-2011.A.3 for the deduction of a bad debt. Without meeting all three general conditions in A.A.C. R15-5-2011.A, Taxpayer cannot qualify for a bad debt deduction under A.A.C. R15-5-2011.E.1 or E.2.

In addition, to qualify under the alternative of A.A.C. R15-5-2011.E.2, Taxpayer would have to show that it sold contracts or other financial obligations to Bank with recourse and that it made principal payments to Bank pursuant to the default of the original payors. Taxpayer states that when a customer makes a purchase using the credit card, the liability is immediately established between Bank and the customer, that Taxpayer never owns the receivable and does not sell it to Bank. However, Taxpayer argues that there was “economic recourse” because the payments from Bank reflect anticipated and estimated bad debts and that the State would be unjustly enriched if it were allowed to keep tax paid on worthless accounts. The Division argues that Taxpayer’s transactions with Bank were non-recourse and that as a result of the chosen structure of those transactions, there is no party in a position to make a claim for bad debts.

A “sale with recourse” is defined in A.A.C. R15-5-2011.E.3 as a sale of a contract or other financial obligation by a vendor to a third party, with the vendor retaining liability for payment upon default of the original payor. Here, a cardholder’s default on a debt

does not require Taxpayer to pay the otherwise uncollectible amount to Bank. Taxpayer has not made any principal payments to Bank pursuant to a cardholder's default.

A.A.C. R15-5-2011.E.3 requires that the vendor retain liability for payment upon default of the original payor. Accordingly, the liability for payment must result from the default of the specific, original payor. Taxpayer's agreement to accept less than the full financed amount as payment by Bank for each financed transaction is not the result of a cardholder's default. Rather, the adjustment of Bank's payments to Taxpayer for anticipated cardholder defaults reflects the expectation that Bank will incur a loss in a certain portion of the financing transactions and therefore represents a risk valuation, not a form of recourse.

Specific language in the Agreement further supports the conclusion that Bank serviced the cardholders' accounts on a non-recourse basis. Concerning losses, the Agreement[1] provides that as between Bank and Taxpayer, all losses on cardholder accounts are borne solely by Bank without recourse to Taxpayer, except for certain specified losses. Taxpayer does not argue that any of those exceptions apply to the transactions at issue here. Taxpayer's transactions with Bank were therefore without recourse within the meaning of A.A.C. R15-5-2011.E.3. Taxpayer thus fails to meet the additional requirements for a bad debt deduction on conditional or installment sales under the second alternative of A.A.C. R15-5-2011.E.

The Administrative Law Judge properly held that Taxpayer had no bad debt on the Bank-owned accounts and that Taxpayer is not entitled to a bad debt deduction.

O R D E R

The Administrative Law Judge's decision is affirmed.

This decision is the final order of the Department of Revenue. Taxpayer may contest the final order of the Department in one of two manners. Taxpayer may file an appeal to the State Board of Tax Appeals, 100 North 15th Avenue, Suite 140, Phoenix, AZ

[1] [redacted]

85007 or may bring an action in Tax Court (125 West Washington, Phoenix, Arizona 85003) within sixty (60) days of the receipt of this order. For appeal forms and other information from the Board of Tax Appeals, call (602) 364-1102. For information from the Tax Court, call (602) 506-3763.

Dated this 26th day of July, 2006.

ARIZONA DEPARTMENT OF REVENUE

Gale Garriott
Director

Certified original of the foregoing
mailed to:

[redacted]

cc: Transaction Privilege and Use Tax Section
Office of Administrative Hearings
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