Sales Tax Refunds on Defaulted Credit Sales: Does Anyone Get a Refund?

By James M. Susa

James Susa analyzes the state tax statutory structures and major court decisions on bad debt deductions and concludes that in practice, the availability of such a deduction is limited in scope.

Each state that imposes some form of sales tax utilizes the gross receipts from sales as the tax base.[1] The term "gross receipts" is broadly defined to include the "total amount of the sale, lease or rental price, as the case may be, of the retail sales of retailers."[2] All works well so long as the purchaser pays the full purchase price at the time of purchase. Today, however, it is more common to have the purchaser buy on credit, extended from a credit card company, a charge card company, or a retailer-affiliated lender. The law generally treats these credit sales as normal retail sales with "gross receipts" as the sales price of the item. But what happens when the purchaser defaults on the credit obligation? The courts have generally held that the lender may not receive the sales tax refund because the lender is not a "retailer" who remitted the sales tax. The courts have also held that the retailer who remitted the sales tax does not receive a refund because the retailer was paid in full by the lender. Thus, the answer appears to be that the state keeps the sales tax collected on the full sales price even though that amount was never fully paid by the purchaser.

The lender is not the "retailer" and is therefore not entitled to a refund.

Beginning about 20 years ago, those who extended credit for the purchase of automobiles began filing

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refund requests with the various states. The fact scenario for each refund request was similar to the one described by the Michigan Court of Appeals as follows:

> Plaintiff financed consumers' purchases of motor vehicles from its affiliated dealers. If a consumer sought to purchase a motor vehicle, plaintiff would determine whether it would finance the purchase. If financing was approved, the consumer purchasing the motor vehicle entered into a retail installment sales contract with the dealer, and a security interest in the vehicle was retained by the dealer. Concomitantly, plaintiff had financing agreements with each of the dealers governing their relationship. The financing agreements provided that plaintiff would purchase qualifying contracts from the dealers in exchange for assignment of all the dealers' rights in the contracts. At or near the time of the sales of the vehicles from the dealers to the consumers, the dealers assigned to the plaintiff all rights, titles, and interest in the qualifying contracts, including the dealers' rights as secured parties. At the same time, plaintiff paid the dealers all amounts due under the contracts, including the sales tax on the full purchase price of each motor vehicle.[3]

In each case, the purchaser defaulted on their payment obligations and the lender was unsuccessful in repossessing the automobile, resulting in a complete loss to the lender of the unpaid amount. The lender claimed a bad debt deduction on a sales tax return, entitling it to a refund of the portion of the sales tax that was paid for which the purchaser defaulted on the ultimate payment.

A bad debt deduction is allowed in all states if "a retailer is unable to collect all or part of the sales price of a sale" or such similar language.[4] The principle is simple enough: if a retailer reported the sales price as gross receipts but was unable to collect the sales price, then the gross receipts from that sale were far less than originally reported. As a result, some portion of the sales tax remitted based upon the sales price should be returned to the retailer.[5]

The states denied the lender's bad debt deduction, and consequently denied the refund those deductions would have generated, based on a number of legal arguments. The most common, and successful, legal argument was that the lender was not a "retailer" and thus had no legal obligation to remit the sales tax on the original sale. Therefore, the proper person to obtain the bad debt deduction and lay claim to the refund was the retailer.[6]

> …cobbling together the various state sales tax statutory structures, the only person actually entitled to a refund is the retailer who has retained the debt (or a finance company that has recourse against the retailer should the purchaser default).

This argument was accepted by a number of courts.[7] Many of the bad debt deduction statutes or rules utilized the term "retailer" or "seller."[8] They also contained a requirement that the debt arose from a debtor-creditor relationship and that the relationship was from a transaction in which gross receipts leading to the payment of the tax arose.[9] Consequently, the courts ruled that the intended beneficiary of the bad debt deduction was the retailer—the seller of the tangible personal property, licensed with the state, and remitting sales tax pursuant to that license. The lender did not fit neatly into this box.

However, the courts were not uniform in this determination. Michigan granted the refund but took a long, twisting path to get there. Michigan law is similar to other states in that "a taxpayer may deduct the amount of bad debts from his or her gross proceeds used for the computation of the tax."[10] As a predicate matter, the court had to decide if the lender could be the "taxpayer" and thus eligible for a bad debt deduction. The court rejected the State's theory that the only person who could be a "taxpayer" was the person who actually sold the tangible personal property. Instead, the court looked to the statute defining a "taxpayer" as "a person subject to a tax under this act."[11] The court then went a step further analyzing the definition of "person" to include "any other group or combination acting as a unit."[12]

The Michigan court employed a stepping-stone approach. It reasoned that because motor vehicle sales frequently require financing, the lender and automobile dealer were "acting as a unit" to facilitate the sale of automobiles.[13] Thus, the lender

qualified as a "person." As a "person," it could be a "taxpayer." Finally, as a taxpayer, it was entitled to take a bad debt deduction. The court's analysis did not address the state's argument that to obtain a refund, you needed to be the person who originally paid the tax. The lender did not pay the tax, yet got the refund. Other states have chosen not to follow the Michigan lead.

The "retailer" is not entitled to a refund because it had no bad debt.

Having failed to convince most courts that the lender was entitled to a bad debt deduction, the retailers who sold the tangible personal property reasoned that they, if anyone, were entitled by statute to the deduction and refund. The retailer's efforts were similarly thwarted. The primary litigant in these retailer cases was Home Depot, the largest home improvement retailer in the United States.[14] Similar to the DaimlerChrysler cases seeking bad debt deductions as the lender, the *Home Depot* cases all have a similar fact pattern. The Arizona Court of Appeals describes the typical facts as follows:

> When a PLCC[15] customer makes a purchase from Taxpayer or one of its affiliated entities, the relevant Finance Company forwards to Taxpayer the amount of the purchase, including the amount of the transaction privilege tax that is built into the sales price, less a service fee. From this amount, Taxpayer pays the applicable transaction [sales] privilege tax to the State of Arizona. Taxpayer deducts the service fee on its federal income tax form as "other deductions," not as "bad debts." Meanwhile, the Finance Companies deduct losses from unpaid accounts as bad debts on their federal income tax returns.[16]

The court's mention of the nature of the deduction taken by the retailer as "other deductions" and not as a "bad debt" foreshadows the court's later reasoning that denies the sales tax refund. As noted above, state statutes allow for a bad debt deduction if "a retailer is unable to collect all or part of the sales price of a sale."[17] There was no dispute in the *Home Depot* cases that Home Depot was a retailer. The issue was whether it was "unable to collect" part of the sale price.

The court held that the payment by the lender to Home Depot of all amounts charged by the customer meant Home Depot was not "unable to collect" all or part of the sales price. The designation by Home Depot on its federal income tax return of the lender's service fee as an "other deduction" and not a "bad debt" effectively countered its argument that the service fee was intended to approximate the uncollected credit amounts. Therefore, Home Depot could not take a bad debt deduction on its monthly sales tax return because its sales prices were paid in full.[18] This result was similar to other *Home Depot* cases decided in other states as follows:

- 2008—Oklahoma, Indiana[19]
- 2009—Washington, New York, New Jersey[20]
- 2010—Ohio[21]
- 2011—Alabama[22]

The author was unable to locate any cases where Home Depot prevailed on its bad debt deduction quest.

Conclusion

In each instance where property has been sold on credit and the purchaser defaults on some portion of the sales price, sales tax has been remitted to the state on the assumption that the full sales price will eventually be paid. Logically then, some portion of the sales tax should be refunded, to somebody, when that assumption turns out to be in error. Yet cobbling together the various state sales tax statutory structures, the only person actually entitled to a refund is the retailer who has retained the debt (or a finance company that has recourse against the retailer should the purchaser default). Because few retailers retain the debt in today's business world, and because few retailers agree to some recourse by the finance company, the bad debt deductions and attendant sales tax refunds will be few and far between. Whether this results in a windfall to the government or not, the courts (except in Michigan) are uniform that no sales tax refund should be paid.

Endnotes

[1] Forty five states impose some form of sales tax. The five states that do not impose a sales tax are Oregon, Delaware, Alaska, New Hampshire and Montana.

[2] Arizona Revised Statutes § 42-5001(7). Identical language found in Nevada Revised Statutes § 372.025 (1).

[3] *DaimlerChrysler Services North America, LLC v. Dep't of Treasury*, 723 NW2d 569,

570-571 (Mich.App. 2006).

[4] Nevada Revised Statutes § 372.365 (5).

[5] One deficiency in this principle is that in those states with a pure sales tax, as opposed to those with a gross receipts tax, the legal incidence of the tax is upon the buyer with the retailer able to collect it from the buyer and remit it to the state. If a bad debt deduction is allowed for the retailer, and a refund is indeed provided from the state to the retailer, the retailer retains the money.

[6] However, as will be noted later, when the car seller attempted to take the bad debt deduction, that deduction was disallowed because the actual holder of the debt was the lender and there was no repayment obligation by the seller to the lender for unpaid installment obligations.

[7] *Chrysler Financial Co., LLC v. Wilkins*, 812 NE2d 948 (Ohio 2004); *DaimlerChrysler Servs. N. Amer., LLC v. State Tax Assessor*, 817 A2d 862 (Me. 2003); *In re appeal of Ford Motor Credit Co.*, 69 P3d 612 (Kan. 2003); *DaimlerChrysler Services v. CIR*, 875 A2d 28 (Conn. 2005).

[8] *See* Nevada Revised Statutes § 372.365 (5) (retailer unable to collect) and Nevada Revised Statutes § 372.055 (retailer is every seller who makes any retail sale).

[9] Arizona Administrative Code § R15-5-2011(A)(2) (the debt arose from a debtor-creditor relationship based upon a valid and enforceable obligation to pay).

[10] Michigan Code Law 205.54i. This provision was amended by later statute.

[11] Michigan Code Law 205.51(1)(m).

[12] Michigan Code Law 205.51(1)(a).

[13] *DaimlerChrysler Services North America, LLC v. Dep't of Treasury*, 723 NW2d 569, 575 (Mich.App. 2006).

[14] Home Depot's total revenues were $74.754 billion for 2012 according to the Form 10-K filed with the United States Securities and Exchange Commission.

[15] A PLCC was the private-label credit card program established between Home Depot and three related companies. The companies issued charge cards to Home Depot customers who completed credit applications.

[16] *Home Depot USA, Inc., v. Arizona Dep't of Revenue*, 230 Ariz. 498, 500, 287 P3d 97, 99 (App. 2012).

[17] *See* footnote 4, *supra*.

[18] "Because Taxpayer received the full amount it was owed, there were no debts—much less bad debts—that served to reduce the gross amount that it realized from its sales of goods." *Home Depot USA, Inc., v. Arizona Dep't of Revenue*, 230 Ariz. at 503, 287 P3d at 101.

[19] *In re Sales Tax Claim for Refund of Home Depot*, 198 P3d 902 (Okla. App. 2008); *Home Depot U.S.A., Inc. v. Indiana Dep't of State Revenue*, 891 NE2d 187 (Indiana Tax 2008).

[20] *Home Depot USA, Inc. v. State Dep't of Revenue*, 215 P3d 222 (Wash. App. 2009); *In re Home Depot U.S.A., Inc. v. Tax Appeals Tribunal*, 68 A.D.3d 1571 (N.Y. App. 2009); *Home Depot U.S.A., Inc. v. Director, Division of Taxation*, 25 N. J. Tax 221 (N.J. Tax 2009).

[21] *Home Depot USA, Inc. v. Levin*, 905 NE2d 630 (Ohio 2009).

[22] *Magee v. Home Depot U.S.A., Inc.*, 230 So3d 781 (Ala. App. 2011).