STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Amended:	**07/14/99**	Bill No:	**AB 599**
Tax:	**Sales and Use**	Author:	**Lowenthal**
Board Position:	**Support**	Related Bills:	

BILL SUMMARY:

This bill would enable a retailer to claim a bad debt deduction for sales or use tax paid on transactions which a retailer has assigned to an assignee when that assignee determines that the account is uncollectible, as specified.

ANALYSIS:

Current Law:

Under existing law, Sections 6055 and 6203.5 of the Sales and Use Tax Law relieves a retailer from the liability for sales or use tax on accounts which have been found to be worthless and written off for income tax purposes. If a retailer is not required to file income tax returns, the law allows a bad debt deduction if the amount has been charged off in accordance with generally accepted accounting principles. If the retailer has previously paid the tax to the Board on the sales amounts that have found to be uncollectible, the law allows the retailer to claim a bad debt deduction on his or her sales and use tax return for the amounts found to be worthless. The law specifies that if a retailer subsequently collects any amounts for which a bad debt deduction is claimed, the amount so collected is required to be reported and paid to the Board on the first return subsequently filed with the Board.

Proposed Law:

This bill would amend Sections 6055 and 6203.5 of the Sales and Use Tax Law to allow a retailer who assigns their accounts receivables without recourse to claim a deduction for the 6 percent state sales and use tax previously reported and paid when that account has been found worthless by the assignee and charged off for income tax purposes or charged off in accordance with generally accepted accounting principles. The bill would also require the retailer or the assignee to report and pay the tax on any amounts either of them, respectively, subsequently collected.

The bill would become effective January 1, 2000 and would apply to accounts assigned on or after that date.

In General:

Businesses involved with credit sales often sell their receivables. Accounts receivable can be sold with recourse or without recourse. "With recourse" means the purchaser of the debt may give the debt back to, or has recourse against, the retailer if the debt cannot be collected. Generally, sellers with recourse receive a better price as a percentage of the accounts receivable because there is much less risk to the purchaser. Accounts receivable sold with recourse and later returned to a retailer are allowable as a bad debt deduction to the retailer for any portion of the loss on the sale which represents a previously reported taxable sale.

Accounts sold "without recourse" are debts in which the purchaser of the accounts receivable (assignee) accepts all the risks for collecting the debt and cannot return the debts to the seller. The sale of the debt is a separate financial arrangement between a retailer and an assignee, and the Sales and Use Tax Law does not recognize any subsequent uncollectible amounts as qualifying "bad debts" of the retailer. In other words, since the retailer sells the debt and does not suffer any losses by virtue of nonpayment by the customer to the assignee, there can be no bad debt deduction claimed by the retailer, even if the customer fails to pay the full amount due to the assignee. Further, an assignee of an account is not entitled to a bad debt deduction for amounts uncollected because the assignee was not involved in the retail sales transaction.

Background:

A similar measure was considered in the 1997-98 Legislative Session. That measure, AB 1229 (Migden) was held in the Senate Appropriations Committee. The Board voted to support AB 1229.

COMMENTS:

1. **Sponsor and purpose of the bill.** According to the author's office, this bill is co-sponsored by GE Capital Corporation and the California Retailers Association. This bill is intended to correct the current competitive disadvantage for those retailers who sell their receivables without recourse. Since the selling price of the accounts includes the sales tax, an assignee's loss on the purchase of nonrecourse debt is, on average, 7.89% higher than the loss to a retailer, who can at least recoup the sales tax through a deduction or a refund of the sales tax on those accounts found to be worthless. This measure is intended to allow a retailer to obtain a refund of sales and use tax on accounts assigned without recourse, when the assignee advises the retailer that the account is worthless. Thereafter, the retailer would pass on the refunded sales tax back to the assignee. This effectively reduces the assignee's bad debt losses by an average of 7.89%, allowing the retailer to obtain a higher selling price for the nonrecourse debt it sells.

Further, the sponsors believe the state would not incur an actual revenue loss since their current accounts receivable purchase contracts could simply be drafted as a sale *with recourse*, thus allowing a retailer to claim a bad debt deduction on accounts which are not currently being claimed as bad debts.

2. **The July 14, 1999 amendments** would allow only the retailer to claim the deduction (rather than either the retailer or the assignee, as the previous version would have allowed) and would also limit the allowable deduction to the 6 percent state tax portion of the sales and use tax rate. These amendments were put in at the request of the Senate Revenue and Taxation Committee.

3. **Reasoning behind current bad debt provisions.** For the privilege of selling tangible personal property at retail, current law imposes a tax upon a retailer. The retailer is responsible for reporting and paying the retail sales tax. Current law allows a retailer to claim a bad debt deduction for previously reported taxable sales if he or she does not receive total compensation for the retail sale transaction. If a retailer only collected a portion of the amount reported as taxable, a partial deduction may also be claimed for that portion found to be uncollectible.

4. **Purchasers of accounts receivable are not required to register with the Board.** An assignee is a person who purchases the rights to a debt and thereby becomes the person to whom a debt is owed. The sales and purchases of accounts receivable fall outside the current registration and reporting requirements of the Sales and Use Tax Law. Current sales tax law does not impose a tax liability on an assignee of an account. Only retailers and consumers of tangible personal property have an obligation to register with the Board in order to report and pay sales or use tax.

5. **The purchase price of accounts receivable includes the risk.** Assignees of outstanding receivables purchase accounts with the full understanding that there is a risk that they may not collect the total amount due from the debtor. That risk factor is included in the purchase price paid by an assignee, including the amount representing sales tax reimbursement. As understood by the sponsor's intent, this measure would increase the selling price of the accounts by the retailer to an assignee since the risk of a loss would be reduced by the amount of the allowable sales tax refund.

6. **Sales tax refunds and deductions are allowed only to persons who actually paid the tax to the Board.** Under current law, an overpayment of sales tax to the Board can only be refunded or credited by the Board to the person who actually paid the tax to the state. Therefore, if a person discovers they have paid sales tax to a retailer on an amount which should not have been subject to the tax, or paid sales tax in excess of the amount of tax due, the law provides that such an overpayment can only be claimed by the retailer who actually paid the tax to the state. The refund would be issued by the Board directly to the retailer, with the condition that the refund be passed on by the retailer to the person from whom the tax was collected. Generally, the Board has no authority to refund the sales tax to someone other than the person who paid the tax to the state.

There is a practical reason why the law prohibits a person who has not paid the sales tax to the Board to claim a refund directly from the Board. It ensures a safeguard against the possibility of issuing a tax refund twice on the same transaction. Without this safeguard, the opportunity for both the retailer and the person who paid tax to the retailer to file a claim for refund would be available, thereby increasing the possibility of duplicate refunds being issued. As amended, this measure would preserve this safeguard by enabling only the retailer who actually remitted the tax to the Board to claim the bad debt deduction.

COST ESTIMATE:

Some costs would be incurred in notifying affected retailers and assignees (since the bill would require the assignee to report any sales or use tax subsequently collected), amending the Board's regulation, deleting annotations, and providing directives to staff. These costs are expected to be absorbable.

REVENUE ESTIMATE:

Credit can be obtained in many ways, e.g., through national credit cards such as Master Card or Visa, revolving lines of credit through charge accounts offered by retailers, and fixed term contracts on specific purchases. Only receivables resulting from credit extended by retailers, either in the form of revolving lines of credit or fixed term contracts on specific purchases, and then sold without recourse would be covered by the provisions of this bill. These receivables represent a relatively small portion of total credit extended. However, since the total amount of credit extended is so large, even a relatively small portion of that total can be in the millions of dollars.

We examined the deduction for bad debts claimed on the tax returns of a number of large retailers claiming this deduction. The bad debt deduction averaged 2.0% of the total taxable sales of those accounts. To illustrate the potential effect of this bill, consider the possibility of a major retailer assigning receivables without recourse. Major department store chains tend to have annual taxable sales in the $1 billion to $2 billion range, depending upon the number of locations they have. If the worthless accounts of one such chain, amounting to 2% of its annual sales of $1.5 billion, were to fall under the provisions of this bill, the annual reduction in sales and use tax revenue attributable to that one chain would be $2.4 million.

One of the larger assignees has indicated that they handle the receivables for two of the major department store chains and several other major retailers, whose 1995-96 taxable sales totaled $3,842 million. Applying the 2% bad debt ratio against those sales gives estimated bad debts of $76.8 million, the tax on which would be $6.1 million.

There are also many other consumer-oriented retailers selling "big ticket" items, such as electronics, appliances, and furniture, that extend substantial amounts of credit and are likely to sell their receivables, some of which would be without recourse. Most vehicle financing is done directly between the buyer and either a lending institution or the financing arm of the vehicle manufacturer. However, some financing is transacted between the buyer and the dealer. In addition to consumer purchases, sales to businesses by agricultural equipment dealers, building materials retailers, and manufacturers and wholesalers frequently involve credit, some of which may be assigned without recourse that would fall under the provisions of this measure.

Revenue Summary

We identify a minimum revenue loss of at least $6 million for accounts receivable handled by the assignee referenced above. Additional loss for other retail stores, vehicle dealers, agricultural equipment dealers, building material outlets, and manufacturers and wholesalers would most likely be incurred.

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