STATE OF CALIFORNIA

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December 4, 1995

[X]

Re: Third Party Sales Tax Refunds

Dear [X],

This is in response to your letter dated September 12, 1995, in which you inquire about the application of Section 6055, the worthless account sales tax deduction, on accounts that have been assigned to third parties.

This inquiry is made on behalf of your client, who you refer to as Company A. As I understand the facts, Company A enters into contracts with retailers, whereby Company A issues credit cards to that retailers' customers. Under the terms of the credit card agreement, the cardholders remit their payments to Company A. Pursuant to the contract with the retailer, Company A, reimburses the retailer, at a discounted rate, the purchase price, including sales tax, on purchases made by the credit card holders. The retailer is responsible for reporting and remitting the sales tax attributable to these sales. Company A takes full responsibility for collection, and, if the accounts become uncollectable, Company A takes the federal income tax "write-off' for bad debts.

The discount rate paid to the retailer is negotiated annually by balancing anticipated revenue against anticipated expenses. An important factor in calculating the discount rate is the magnitude of accounts that have become uncollectable. As you explained in your letter:

> "For example, if all other factors (program revenues and expenses other than bad debts) were to remain constant and the actual bad debt experience for the credit card sales exceeds the amount forecasted by Company A, the discount rate will increase. Alternatively, if the other factors are constant and their bad debt experience is less than the forecasted amount the discount rate will decrease."

Based on the weight assigned to bad debts in determining the discount rate, you have concluded that the retailers, "therefore bear the risk of economic loss associated with those accounts ultimately found to be uncollectable."

You specifically inquire:

> "Can [the retailer] claim [the worthless account deduction] for the sales tax paid on bad debts written off by Company A for federal income tax: purpose[s]? If [the retailer] is not allowed [the worthless account deduction] is Company A entitled to [the deduction] for such amounts?"

You then respond to your own inquiry, concluding that under California Revenue and Taxation (Rev. & Tax.) Code section 6055, neither Company A nor the retailer is entitled to the deduction for the sales tax remitted on accounts that have been written off as worthless. Section 6055 allows a **retailer** that (1) **has paid sales tax** measured by an amount which has been found to be worthless **and** that amount has (2) been **charged off for income tax purposes** to take as a deduction the amount of sales tax measured by the amount which has been charged off as worthless. Regulation 1642((h)(1) explains the application of section 6055 to persons other than a **retailer** as follows:

> **"(A)** A successor who pays full consideration for receivables acquired from the predecessor is entitled to a bad debt deduction to the same extent that the predecessor would have been entitled had the predecessor continued the business.
>
> **"(B)** A purchaser of receivables, other than a successor, cannot obtain a bad debt deduction on accounts which are not collected.
>
> **"(C)** A retailer who sells receivables with recourse so that the retailer will bear any bad debt loss on them is entitled to a bad debt deduction to the same extent as if the receivables had not been sold. The fact that a retailer sells receivables at a discount, however, with or without recourse, does not in itself entitle the retailer to a bad debt deduction to the extent of the discount."

Thus, as you have correctly concluded:

> "Based on California sales/use tax law, it appears that [the retailer] may not be entitled to the [worthless account deduction] since it is not claiming the bad debt loss for federal income tax purposes. In addition, Company A will not be entitled to [the worthless account deduction] for accounts found to be worthless, since it is not the retailer of the property."

However, it is your position this result causes "tax [to] be remitted in excess of the amount computed on 'gross receipts,''' a conclusion which you believe to be contrary to the intent of the California legislature. You have enclosed two cases, Chesapeake Industrial Leasing Company. Inc. v. Comptroller of the Treasury (1993)331 Md. 428, and Puget Sound National Bank v. The Department of Revenue (1994) 123, Wash 2d, 284, which you believe support your position that either your client, Company A, or the retailers it contracts with should be entitled to the worthless account deduction for accounts which have been written off as worthless. Since

these opinions are from other state courts interpreting their respective laws, they have no precedential effect in California. We have, however, considered whether these cases are relevant or persuasive on this issue and have concluded that they are not.

You assert that in Chesapeake Leasing the Maryland Court left open the possibility that Chesapeake may have been entitled to a bad debt deduction or refund for those leases which had been assigned without recourse if it had been shown that the financial institution had written the accounts off for federal income tax purposes. We disagree with this assertion. We believe that even if Chesapeake had proven that the accounts had been written off, the outcome would have been the same. We base our conclusion on the Court's observation that:

> "**Despite the plain language of the rule**, Chesapeake asserts that it ought to be entitled to an offset for those amounts written off by its assignee, in addition to the amounts it wrote off itself." (Emphasis added.)

However, despite conjectures on the outcome if Chesapeake had shown that the financial institution had written off the leases as worthless, the fact remains that this issue was not resolved by the Chesapeake Court. Thus, this decision by a Maryland court interpreting Maryland's law does not support your position that we should disregard the clear dictates of section 6055 and Regulation 1642.

In Puget Sound National Bank, the Washington Supreme Court interpreted the specific provisions of Washington state law. Under those provisions, it concluded that the assignment of the contracts placed the bank "in the shoes" of the assignors, thereby entitling Puget to a refund of the sales taxes paid by the retailer. Unlike Washington state law, California's Regulation 1642(h)(1)(B), explained above, specifically provides that purchasers of receivables, other than successors in interest, are not entitled to the bad debt deduction provided by section 6055. Accordingly, the rationale of Puget Sound is not applicable in the interpretation of section 6055 and Regulation 1642.

In summary, the cases you cite are not persuasive. Rather, as you have correctly concluded, under the provisions of section 6055 and Regulation 1642, neither company A nor the retailer is entitled to a bad debt deduction under the facts as presented in your letter. If you should have any further questions, please feel free to contact this office again.

Sincerely,

Patricia Hart Jorgensen
Senior Staff Counsel

PHJ:cl

cc: X---------- District Administrator