

STATE OF CALIFORNIA

130.0050

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
L--- N--- Y---, INC.) No. SY --- XX XXXXXX-010
)
)
Petitioner)

The Appeals conference in the above-referenced matter was held by Senior Staff Counsel H. L. Cohen on December 9, 1993 in San Francisco, California.

Appearing for Petitioner: Mr. P--- W---, Jr.
Attorney at Law

Ms. R--- H--- P---
Attorney at Law

Appearing for the Mr. A. Viripaeff
Sales and Use Tax Department: Supervising Tax Auditor
San Francisco District Office

Mr. A. Hoppe
Tax Auditor
San Francisco District Office

Protested Item

The protested tax liability for the period January 1, 1989 through March 31, 1992 is measured by:

<u>Item</u>	<u>State, Local and County</u>
Claimed bad debt deduction disallowed	\$5,211,837

Contention

Petitioner contends that the discount charged to it by the purchaser of its accounts receivable constitutes a deductible bad debt.

Summary

Petitioner is a corporation, which is engaged in operating a chain of women's apparel stores. The last prior audit was for the period through December 31, 1988.

Effective May 1989, petitioner entered into an agreement with a related corporation whereby all of petitioner's credit sales receivables were assigned to the related corporation. Petitioner received credit for 97 percent of the face value of the receivables assigned. The related corporation retained the three percent to cover uncollectible debts. Petitioner deducted from its reported sales the three percent charge by the related corporation as a bad debt deduction.

The auditor disallowed the claimed bad debt credit on the basis that only the party actually experiencing the bad debt losses can claim the deduction. The auditor's position is that a retailer can claim the deduction only if it holds an interest in the debt at the time that the debt becomes uncollectible or if the buyer of the receivables has recourse against the retailer for uncollectibles.

Petitioner points out that the statutory language does not include a requirement that only the person holding the receivables at the time it becomes uncollectible can claim the deduction. Petitioner contends that this interpretation is not reasonable because it would bar a retailer from taking a deduction even though the retailer is the only party with a tax relationship with the state. The state would receive a windfall because the retailer never gets the full payment. Petitioner also contends that whether or not the buyer of the receivable has recourse against the retailer is immaterial.

Analysis and Conclusions

Section 6055 of the Revenue and Taxation Code provides that a retailer is relieved of liability for sales tax insofar as the amount subject to tax is represented by accounts which have been found to be worthless and charged off for income tax purposes.

Subdivision (h)(1) of Sales and Use Tax Regulation 1642 provides in pertinent part:

"(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."

Petitioner contends in effect that the regulation does not mean what it says or is in conflict with the statute. I think the regulation is quite clear that the assignment of receivables at a discount does not in itself entitle a retailer to a bad debt deduction, and also that a purchaser of receivables cannot obtain bad debt deductions. Section 7051 empowers the Board to adopt regulations relating to the administration of the Sales and Use Tax Law. Clearly, adoption of definitions is within the power of the Board in situations in which the statute itself does not contain a definition. See also the back-up memo for Business Taxes Law Guide (BTLG) Annotation 130.0040 (1/8/65), copy attached herewith as Exhibit 1.

The rationale in deciding that a sale of receivables at a discount does not create a bad debt deduction is based on Section 6012. That section provides that gross receipts, which is the amount subject to tax, includes the cost of materials used, labor or service cost, interest paid, losses, or any other expense. The selling of accounts receivable is essentially a financing operation. It is equivalent to obtaining a loan secured by the receivables. The discount is the equivalent of interest paid on the loan. The statute explicitly includes interest as part of taxable gross receipts.

Recommendation

Deny the petition.

H. L. Cohen, Senior Staff Counsel

1/27/94

Date

Attachment: Exhibit 1