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## Features:

### July 15, 2004

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#### ■ SHORT LOOKBACK, SIGNIFICANT DOCUMENTATION

##### **For vendor or third party, bad debt deductions require state-by-state vigilance, updating**

**H**ow well does your company follow up on recovering sales tax paid on transactions that had to be written off as bad debts? One expert suggests that companies tend to run hot or cold, either vigilantly staying on top of the issue or relegating it to a seemingly perpetual status on the to-do list. Like many sales tax issues, laws and rules regarding bad debt deductions vary widely among states. Often, bad debt lookback periods are shorter than taxpayers might expect. And on partial recoveries, some states get all their money first.

Meanwhile, what applies to the vendor who collected and remitted the sales tax may not apply to a third party which assumes debts that later go bad. In fact, national efforts at simplification of sales taxes may affect some bad debt holders but not others.

#### **Either/or**

So how well does your company track and recover sales tax paid on debts that have gone sour? For many companies, it is often an either/or situation-diligent pursuit of deductions or little or no attempt to get sales taxes back.

"It's one of those things where they're either all over it," says **Ned A. Lenhart**, of **Sales Tax Advisors of Georgia, PC** in Atlanta, "or it's on their long term to-do list."

"A lot of companies will take monthly or quarterly adjustments, monitor it, not make a big deal of it," Lenhart continues. "Other companies don't have a good system in place."

A prime example of the latter often occurs in the telecommunications industry, an area vexed by a plethora of taxes to administer, among them utility, sales and use, and telecommunications taxes and surcharges. While big telecom companies usually have a system in place to recover sales tax on bad debts, many of the thousands of smaller telecoms don't have the ability to capture the level of detail necessary. Or the function is outsourced, and the consultant is not handling it. Keep in mind that some sectors of the telecom industry may have to deal with 15% to 20% of the customer base being uncollectible at any given time, Lenhart says.

#### **Less lookback**

And when companies do decide to go after bad debt deductions, they often learn they are too late. Many states do not have the same type of recovery period for bad debts as for other refunds. While many states have statutes of limitations of three years affecting sales tax refunds, their lookback period on bad debts may amount to only a year.

"You get a lot of companies that don't pay a lot of attention to this and look every three years," Lenhart notes. "Then lo and behold, it's too late."

South Carolina, for example, allows a lookback period of one year from the month that the amount was determined to be a bad debt. Other states, however, such as Ohio and Texas, have lookback periods of as much as four years. But be careful in your research. The lookback periods may be triggered by different dates in the various states, such as the date the tax was written off for federal tax purposes, the date the tax was originally paid to the state, or Dec. 31 of the year in which the bad debt occurred and was written off for federal tax purposes.

## **Documentation**

Taxpayers must offer evidence for the deductions they wish to take. Many states require the same documentation used in writing off the bad debt for federal income tax purposes.

"The burden of proof on some of these claims is quite substantial," Lenhart says.

Yet some states don't specify the documentation required. New York, though, serves as an example of a state that gives a clear listing, Lenhart says.

**Diane Yetter**, of **Yetter Consulting Services** in Chicago, notes that Illinois statutes seem mute on documentation requirements. That's because in Illinois, tax is due when the vendor receives payment, instead of at the time of the transaction, like many other states and therefore, there is really no bad debt provision in Illinois. If however, you report on an accrual basis, Illinois procedurally has allowed a bad debt deduction.

Massachusetts, however, requires that a special form be filed. Yetter recalls a client who claimed a refund for bad debts when filing a Massachusetts sales and use tax return without filing the form. The refund was disallowed under audit.

"You need to check the states to see how you can take that deduction," Yetter warns.

Some states allow taxpayers to recover sales tax on bad debts by statistical analysis, rather than tracking on a transaction-by-transaction basis. Many companies come up with a study that breaks out a percentage of transactions by state and by taxable amount.

But taxpayers must update that study every two to three years in order to satisfy state tax administrators. A change in law that affects taxability of the product could mean doing an update sooner.

"If you have a ten-year-old study, you're going to be in trouble," she says.

## **Recovered debts**

Sometimes a company may recover part or all of a debt after a bad debt deduction has been filed. Generally, the taxpayer must reverse the deduction and report it for partial or full recovery. But, particularly, in the instance of a partial recovery, states will treat this scenario differently. Most states will accept a pro rata payment based on the percentage of recovered debt.

However, some states demand their money up front-on the full amount of debt-regardless how much is collected, Yetter notes. For instance, if a customer that stopped paying begins to make payments again, the first dollars go to the state to pay back the tax.

New Jersey, for instance, gets its money first on recovered debts.

## **Third-party debts**

Much of the debate and litigation surrounding bad debt deductions have centered around third-party holders of debt. The issue grew as more retailers began offering credit cards for use solely in their stores. Here the retailer makes the sale, then sells the debt to a third-party credit card company. In some states, third parties are entitled to the same rights to deductions, credits or refunds as initial vendors or retailers. Many states, however, do not transfer rights.

The first major case in this debate was *Puget Sound National Bank v. Dept. of Revenue*, Washington Supreme Court, Dkt. Nos. 59444-9 and 90-2-03046-3, (1994). A bank purchased the installment sales contracts on a nonrecourse basis from local automobile dealers who had sold the cars at retail. The bank paid the dealer the balance due on the contracts and the uncollected portion of the state sales tax. In return, the dealers assigned all their rights in the installment contracts to the bank. Although the bank did not sell the autos at retail, the dealers undoubtedly did. The dealers' assignment of the installment contracts placed the bank "in the shoes" of the dealers. Because there are no statutory or public policy prohibitions against an assignment of a sales tax refund and both liabilities and rights were assigned to the bank, the assignment was valid. So the bank was entitled to the sales tax refunds.

**Jeff Hyde**, senior tax counsel for **GE Capital**, notes that since *Puget Sound*, a few other states have addressed the issue of third-party bad debt deductions: Georgia, Florida, Indiana and New York.

Not all these cases were taxpayer victories. But pay particular attention to these five states with respect to bad debt deductions, he says, because litigation points to something awry in those states.

### **New York**

In fact, the New York Court of Appeals recently ruled against the taxpayer in *General Electric Capital Corp. v. New York State Div. of Tax Appeals*, Dkt. No. 35, (2004). The court held that Reg. §534.7(b), which prohibits the assignment of sales tax refunds to third parties, was consistent with Tax Law §1132 (e), which sets forth categories of applicants eligible to seek a sales tax refund. The tax commissioner has power to determine what types of parties could qualify for tax refunds on uncollectible debts. Further, there was a rational basis for precluding refunds from those who had not paid the taxes and were removed from the taxable transaction, the court ruled. And the limitation was necessary to avoid excessive administrative burden.

The taxpayer, however, argued that the regulation was invalid because it violated assignment provisions of the General Obligations law.

"We stand in the shoes of the vendor if we haven't contravened the General Obligations Law," Hyde says. "We think that's a huge windfall for the state."

**Advice:** Hyde says the issue of third-party bad debt must be addressed by the taxpayer. Both the legislative route and the litigation route are extremely costly and unpredictable. That leaves the contractual route, dealing with the issue in contracts between the vendor and the financial company. This is not easy, but it offers the least costly and most efficient method.

"At least you can better predict what the outcome will be," he says.

### **SSTP**

The debate over deductions for third parties has carried over to the Streamlined Sales Tax Agreement. The agreement's §320 provides for bad debt deductions for sellers. However, the issue of whether to grant deductions to third parties was left to the individual states to decide. In essence, Hyde says, business and state administrators could not come to an agreement on the issue and left things stand as they were.

"We're kind of stuck in this situation; there's no federal issue," Hyde explains. "Bad debt (deduction) is legislative grace by the state.

"Once we run through all the state courts, we're done."

Still, Hyde stresses what he calls the moral high ground of the issue. If someone buys an article for \$100, then \$6 goes to the state for sales tax. If, over time, the purchaser pays nothing, the state is holding \$6 on a transaction that never occurred. Even if the seller collects \$20 on the transaction, in many states, the revenue department keeps the \$6.

"They've collected five times the amount of sales tax due," he points out.

However, **Harry Fox**, deputy director of the **New Jersey Div. of Taxation**, sees the issue in a different light. Third party bad debt deductions have nothing to do with streamlining sales tax collection, he says. An attempt was made to get the SSTP to address something that most state legislatures have chosen not to address.

"We don't hold the third party that buys the debt responsible for the sales tax," Fox, an SSTP steering committee member, says. "It's really a financial arrangement, not a retail sales tax issue, from our perspective."

Further, Fox offers an alternate scenario of third-party bad debts. Say half of a third-party credit card company's debt is subject to tax-not everything is taxable. Given a sales tax rate of 6%, multiply the company's total debts held by 3%. Then start tacking interest on that amount at rates of 12% to 24%. Many credit card companies accounts total billions of dollars. That means millions of dollars in profit by charging interest on the tax.

"If you're going to accept income on that debt, you have to accept the risk that goes with it," Fox says.

**Editor's note:** *Lenhart may be reached at (770) 985-9573; Yetter at (312) 701-1800; Hyde at 203 316 7032; Fox at (609) 633-3723.*

### BAD DEBT DEDUCTIONS CHECKLIST

- Find out the lookback period on bad debt deductions in the states you conduct business. Often, the lookback for bad debt deductions is shorter-as little as a year-in many states, contrasted to statutes of limitations on refunds of usually three or four years.
- Take a close look at the date that triggers the lookback period; it varies from state to state such as the date the tax was written off for federal tax purposes, the date the tax was originally paid to the state, or Dec. 31 of the year in which the bad debt occurred and was written off for federal tax purposes.
- Determine what type of documentation is necessary to back up a deduction. Many states require the same documentation used in writing off the bad debt for federal income tax purposes.
- In states which allow a statistical analysis rather than transaction-by-transaction proof, make sure your study is updated every two to three years. Update the study sooner if a law change affects taxability of your company's product.
- Remember to reverse the deduction on bad debts that are later recovered. Note that most states allow pro rata payments on partial recoveries. However, some states demand tax on the entire amount up front.
- Some states grant third parties the same rights to deductions, credits or refunds as

initial vendors or retailers. Many states, however, do not.

## Alabama taxpayer rights apply to local taxes

An Alabama Supreme Court decision guarantees that the state's Taxpayers' Bill of Rights applies not only to state taxes but to local and locally-administered taxes as well.

In *General Motors Acceptance Corp. v. City of Red Bay*, Dkt. No. 1021294, the court vacated a class action suit initiated by city officials of Red Bay on behalf of itself and other municipalities which levy a sales tax but no rental tax. City officials sought revenue from taxing auto leases.

"Red Bay had no standing to bring this case and represent all the others without giving GMAC due process," explains **David Rains**, a partner with Tanner & Guin, LLC, in Tuscaloosa. "Luckily, for corporations and individuals, when you've got a city or county or the Dept. of Revenue, there are fundamental procedures they must follow."

However, the court never went so far as to address the issue of whether Red Bay and other municipal jurisdictions could collect sales tax on the leases.

**Blake Madison**, also a partner with **Tanner & Guin**, notes that in Alabama the wholesale sale exemption covers cars sold wholesale to dealerships that will rent the autos to consumers. In response to the exemption, some localities began levying a rental tax. However, not all municipalities enacted a rental tax. Red Bay essentially sought sales tax in lieu of rental tax.

Why didn't Red Bay simply levy the rental tax? Rains recalls a moment before arguing the case. "I walked up to the podium," he says. "One of the justices said, 'Mr. Rains, why don't they just pass a rental tax?'"

"A mayor or council may not want to be the one who passed another tax."

Now, because of the decision, any jurisdiction that levies a tax must also allow administrative procedures for a taxpayer to dispute an assessment in accordance with the Alabama Taxpayers' Bill of Rights and Uniform Revenue Procedures Act.

In dealing with Alabama's notorious confusion of locally administered local taxes and state-administered local taxes, compliance won't be affected by the decision. Yet at least certainty exists that a disputed assessment can be litigated if necessary, Madison notes.

"I don't know that it makes it easier to comply, but taxpayers will know they have the Taxpayer Bill of Rights."

**Editor's note:** *Rains can be reached at (205) 633-0236; Madison at (205) 633-0246.*

## Senate Internet access tax ban differs from House version

The U.S. Senate's S150 adopts a new definition of "Internet access" to exclude telecommunications services except those used to provide Internet access. The new definition does not include Voice Over Internet Protocol services, leaving intact the ability of states and local governments to tax VOIP applications. Additionally, the Senate version includes two grandfather provisions allowing some states to continue taxing Internet access for a limited time.

The Senate in late April approved a four-year extension of the moratorium on Internet access taxes, but the

legislation differs significantly from a House version passed last year.

Under the Senate's amended S150, the ban on Internet access taxes would be reinstated as of Nov. 1, 2003, when the previous ban expired, and run through Nov. 1, 2007.

Like HR49, the version passed last year by the House, S150 applies the moratorium to DSL and wireless Internet access as well as dial-up and cable connections.

### Sorting out differences

But HR49, which mirrored the unamended version of S150, calls for a permanent extension of the tax ban and the elimination of the previous grandfather provision. In addition, HR49 does not include a measure on the bundling of Internet access services with taxable services, as does amended S150.

S150 and HR49 now must be reconciled. **Carol Guthrie**, a spokesperson for Sen. Ron Wyden, one of the sponsors of the pre-amended S150, says the two sides will try to resolve differences in the bills.

"The president has been ready to sign a bill for a long time," she notes.

#### HIGHLIGHTS OF S150

- Four-year extension of the moratorium
- Applies moratorium to DSL and wireless Internet access as well as dial-up and cable connections
- Four-year grandfather provision on the taxation of Internet access for states that taxed Internet access prior to October 1998
- Two-year grandfather provision on the taxation of DSL and wireless Internet access for states that taxed such access prior to November 2003
- Leaves intact the ability of states and local governments to tax VOIP applications
- Bundling rule allows for taxation of otherwise exempt Internet access service when bundled with taxable services

#### HIGHLIGHTS OF HR49

- Permanent tax moratorium
- Applies moratorium to DSL and wireless Internet access as well as dial-up and cable connections
- Grandfather provision eliminated
- No special tax treatment mentioned for VOIP
- No bundling provision

### Sales and Use Tax Incentives-Texas

The following is excerpted from the Business Incentives Guide, a CCH book and online service detailing state-by-state business exemptions, incentives and credits. Unless otherwise indicated, all statutory references are to the Texas Codes.

#### MANUFACTURING (§§151.317 AND 151.318)

Tangible personal property is exempt when used directly or consumed in or during the actual manufacturing, processing, or fabrication of tangible personal property for ultimate sale. But the use or

consumption of the property must be necessary or essential to the manufacturing process and directly make or cause a chemical or physical change to the product being manufactured. Examples of exempt equipment that are used to power, supply, support, or control equipment that qualifies for exemption under §151.318 are actuators, steam production equipment and its fuel, in-process flow through tanks, cooling towers, generators, heat exchangers, electronic control room equipment, computerized control units, compressors, and hydraulic units.

Exemptions cover the following:

- services performed directly on the manufactured product;
- certain chemicals consumed during the manufacturing operation;
- wrapping and packaging equipment and materials;
- certain equipment used to reduce water use and to reuse and recycle wastewater streams in the manufacturing process;
- certain purchases by a person overhauling or repairing jet turbine aircraft engines;
- free newspapers;
- semiconductor fabrication cleanrooms and equipment;
- qualifying pollution control equipment;
- qualifying manufacturing power tools driven by electricity, gas or steam;
- replacement parts or ancillary equipment; and
- electrical supply and control equipment, such as switch, wiring, and monitoring equipment used to power qualifying manufacturing equipment.

Gas and electricity used in processing a product for sale is also exempt. The sale, use, or other consumption in Texas of Internet access service is exempted from the taxes imposed by this chapter up to the first \$25 of a monthly charge. Effective Oct. 1, 1999, 20% of the total amount charged for data processing services is exempt.

Effective Oct. 1, 2001, divergent use of exempt manufacturing property is not taxed after the fourth anniversary of purchase. For any month prior to the fourth anniversary, divergent use taxed monthly at 1/48th of the purchase price multiplied by the sales and use tax rate at the time of purchase. The amount of monthly divergent use is the total time the property operates for divergent use during a month measured in hours or the total output. The percentage of divergent use for a month is determined by dividing the amount of divergent use by the amount of total use.

### **RESEARCH AND DEVELOPMENT (§151.348)**

Qualifying items for a joint research and development venture as defined by 15 U.S.C. §4301, if created or substantially modified by the joint research and development venture, are exempt. Also, any items purchased by the venture for its stated purpose are exempt if the venture's public disclosure notification of its purpose, filed as required by federal law, was published in the Federal Register on either Jan. 17, 1987, or May 19, 1988, and if the items have a useful life exceeding six months.

### **ADVERTISING (34 TAC §3.321)**

An advertising agency's "nontangible" services, acquisition of property from third-party suppliers and preliminary art are exempt. Examples of such "nontangible" services include the following activities: account supervision; account service; creative concept development; consultation service; public relations; setting up press conferences; copywriting; media placement charges to the client; individualized market research; postage or freight charges occurring after the sale; secretarial or clerical fees; telex and telegraph charges; and travel or transportation expenses.

### **PACKAGING (§151.322)**

Texas exempts containers sold with contents if the contents are not taxed. An empty non-returnable container sold to a person who fills and sells it is exempt. Filled returnable containers and those resold for refilling are also exempt.

### **ECONOMIC DEVELOPMENT (§§111.301 AND 111.302)**

A refund of sales and use taxes is allowed for ad valorem taxes paid to a school district on property located in a reinvestment zone when exempt from municipal or county ad valorem taxes under a tax abatement agreement and when a tax abatement agreement has not been entered into with the school district. To be eligible for the refund, a taxpayer must have: established a new business in the reinvestment zone; expanded an existing business there; or modernized an existing business to retain jobs. The business must also have increased its payroll by \$3 million or increased the appraised value of the business' property subject to the tax abatement agreement by at least \$4 million. The credit may not exceed net state sales and use and state franchise taxes paid, after any applicable tax credit, in that year. A taxpayer is eligible for refunds for the lesser of five years or the duration of the tax abatement agreement. Total refunds to all claimants may not exceed \$10 million.

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*Last modified on July 13, 2004*

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