STATE OF NORTH CAROLINA **COUNTY OF WAKE**	**BEFORE THE NORTH CAROLINA DEPARTMENT OF REVENUE** **OAH NO: 09 REV 4211**
[TAXPAYER], **Petitioner,** **v.** **N. C. DEPARTMENT OF REVENUE,** **Respondent.**	**FINAL AGENCY DECISION**

THIS MATTER came before the North Carolina Department of Revenue ("Department") pursuant to N.C. Gen. Stat. § 150B-36 for the Department to make a final agency decision. Upon consideration of Respondent's Motion for Summary Judgment, Petitioner's Motion for Summary Judgment, the parties' respective responses thereto, the parties' respective oral arguments, and for good cause shown, Administrative Law Judge ("ALJ") Melissa Owens Lassiter, granted summary judgment in favor of Respondent in the Decision Granting Summary Judgment for Respondent ("Decision") filed in the Office of Administrative Hearings ("OAH") on August 12, 2010. The official administrative record was transmitted by OAH to the Department on September 15, 2010. By letter dated September 16, 2010, each party was notified of the opportunity to file exceptions to the ALJ's Decision as well as file a supporting brief and proposed final order. By letter dated October 5, 2010, the parties mutually agreed to a response schedule which also extended the period within which the Department was to issue the final agency decision to and including January 14, 2011. Upon a full review of the entire record of this matter, including the official record as defined in N.C. Gen. Stat. § 150B-37(a), as well as the exceptions, written arguments, proposed orders, and other documents submitted by the parties, the Department makes the following Final Agency Decision:

APPEARANCES

For Petitioner: [Law Firm 1: Attorneys' names and law firm address]

[Law Firm 2: Attorneys' names and law firm address]

For Respondent: Tenisha S. Jacobs
Assistant Attorney General
North Carolina Department of Justice
9001 Mail Service Center
Raleigh, North Carolina 27699-9001

Deletions from the Procedural Background, Findings of Fact, and Conclusions of Law of the ALJ are marked with ~~strikethroughs~~ and additions/modifications are in **bold**.

PROCEDURAL BACKGROUND

The Department hereby adopts the Procedural Background, except as below modified, set forth in the Decision of the ALJ, as follows:

1. On February 21, 2006, Respondent issued a Notice of Sales and Use Tax Assessment to Petitioner, proposing that Petitioner's overall sales and use tax liability for the period of December 1, 2000 through November 30, 2003 was $[ ]. In letters dated February 28, 2006 and March 1, 2006, Petitioner requested redeterminations of separate portions of the assessment and an administrative hearing.

2. On March 1, 2006, Petitioner remitted a check for $[ ]:

> for tax and . . . for interest related to the audit period of December 1, 2000 through November 30, 2003 . . . for full payment for all undisputed areas of the sales and use tax audit[.]

3. In requests dated September 20, 2006 and February 20, 2007, Petitioner requested refunds for (1) $[ ] remitted during the August 1, 2003 through January 31, 2004 period, and (2) $[ ] remitted during the January 1, 2004 through January 31, 2007 period. Petitioner's requests for refunds were based solely on an assertion that Petitioner was entitled to the bad debt deduction. Respondent denied Petitioner's requests, and Petitioner requested review of those denials.

4. On May 15, 2009, Respondent issued a Notice of Final Determination to Petitioner indicating that the proposed assessment and refund requests were properly denied regarding the bad debt deduction issue.

5. On July 14, 2009, Petitioner filed a petition for a contested case hearing with the Office of Administrative Hearings appealing Respondent's May 15, 2009 Notice of Final Determination. In its Prehearing Statement, Respondent agreed to vacate the portion of the contested tax liability which did not pertain to the bad debt deduction issues.

FINDINGS OF FACT

The Department hereby adopts all Findings of Fact, except as below modified, set forth in the Decision of the ALJ, as follows:

1. Petitioner [Taxpayer] is a [State other than North Carolina] corporation with corporate headquarters in [City], [2nd State other than North Carolina]. Petitioner operates retail [type of retail] centers throughout the United States, including North Carolina.

2. During January 1, 2000 through ~~August 1~~ **January 31**, 2007 ("period at issue"), Petitioner offered its customers the option of using private label credit cards ("PLCC") to

purchase merchandise. Petitioner did not extend financing of its own to its customers, but relied on third-party credit card banks to finance and manage its PLCC program.

3. Petitioner's PLCC bears Petitioner's colors and logo, and was exclusively used to purchase items at Petitioner's business.

4. By contracting with third-party credit card banks to administer its PLCC program, Petitioner avoided being subject to various federal and state regulations regarding PLCCs.

5. Petitioner entered into agreements with the following third-party banks to finance and manage its PLCC program: (Bank A), (Bank B), (Bank C) [collectively "Bank 1"] and (Bank 2) ["Bank 2"].

6. From August 1997 through approximately July 27, 2003, the [Bank 1] financed and managed Petitioner's PLCC program. Thereafter, [Bank 2] financed and managed Petitioner's PLCC program.

7. Pursuant to the various agreements between Petitioner and the third-party banks, the third-party banks agreed to: (a) open a PLCC account, (b) issue a PLCC, (c) activate the customer's PLCC in accordance with certain operating procedures and (d) grant credit to the customers for their purchases at Petitioner for each applicant who qualified for credit under Petitioner's PLCC program.

8. Petitioner agreed to honor any valid PLCC issued by the third-party banks for purchases, including taxes.

9. Petitioner also agreed to: (1) display PLCC applications and agreements at its retail locations, and (2) use reasonable efforts to promote the PLCC program to its customers.

10. The third-party banks supplied the PLCC applications and agreements to Petitioner.

11. Under the various agreements between Petitioner and the third-party banks, the PLCC applications and agreements had to disclose clearly that the third-party bank was the owner and creditor on all PLCC accounts. No materials generated or displayed by Petitioner were to state or imply otherwise.

12. When determining whether to extend credit to an applicant, the third-party banks, in their sole discretion, determined the following: (a) the creditworthiness of the individual applicants under the PLCC program, (b) the range of credit limits made to individual cardholders, (c) whether to suspend or terminate credit of any cardholder, and (d) the credit criteria to be used in evaluating applicants in connection with the PLCC program.

13. The third-party banks were the sole and exclusive owners of all PLCC accounts.

14. Under the various agreements between Petitioner and the third-party banks, Petitioner acknowledged and agreed that it had no right, title, or interest in the PLCC accounts, and no rights to any payments made by cardholders on, or any proceeds from, such accounts.

15. For each sale made to a customer using a PLCC, Petitioner seeks reimbursement from the third-party bank for the customer's PLCC transaction. Petitioner did not record an account receivable from the customer.

16. To receive payment on the PLCC accounts, Petitioner, at the end of each day, transmitted that day's PLCC sales information to the third-party banks, including any applicable sales tax.

17. Upon receipt and verification of the PLCC sales information, the third-party bank paid Petitioner for the difference between the purchase price for each PLCC transaction, including the requisite sales tax, and any applicable service fee, which applied without regard to whether the customer ultimately defaulted.

18. Under the various agreements between Petitioner and the third-party banks, the third-party bank, in its sole discretion, may deduct from the remittance or invoice, amounts due from Petitioner to the third-party bank.

19. Amounts due from Petitioner to the third-party banks include chargebacks, costs of printing, customization and other incidental costs associated with the third-party banks' preparation of PLCC applications, PLCC agreements and other similar types of documents, and a "service" or "merchant" fee.

20. The "service fee" was a percentage amount that varied depending on the account type, and was applicable to each purchase amount charged to a cardholder's PLCC account.

21. Petitioner deducted the "service fees" as a business expense on Line 26, entitled "Other Deductions," of its federal income tax returns.

22. The third-party banks wrote off the receivables related to the PLCC accounts, after the receivables became uncollectible.

23. The third-party banks claimed a bad debt deduction for the uncollectible receivables related to the PLCC accounts on Line 15, entitled "Bad Debt," of their federal income tax returns.

CONCLUSIONS OF LAW

The Department hereby adopts all Conclusions of Law, except as below modified, set forth in the Decision of the ALJ, as follows:

1. Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories and admissions on file, together with the affidavits, if any, show that there

is no genuine issue as to any material fact and that any party is entitled to judgment as a matter of law." Forbis v. Neal, 361 N.C. 519, 523-24, 649 S.E.2d 382, 385 (2007) (citing N.C. Gen. Stat. § 1A-1, Rule 56(c)).

2. Pursuant to N.C. Gen. Stat. §§ 1A-1, 150B-36 and 26 N.C.A.C. 3.0115, the ~~undersigned~~ **ALJ** has the authority to grant summary judgment in this matter.

3. Because there are no genuine issues of material fact, the only question is whether Petitioner has satisfied its burden of bringing itself within the scope of the deduction authorized under N.C. Gen. Stat. § 105-164.13(15), the "bad debt" deduction.[1]

4. Under the North Carolina Sales and Use Tax Act ("Act"), N.C. Gen. Stat. § 105-164.1 *et. seq.*, a sales tax is imposed upon retailers engaged in the business of selling tangible personal property in the State as a privilege tax for the right to engage in that business. *See* N.C. Gen. Stat. § 105-164.4; *Piedmont Canteen Service, Inc. v. Johnson*, 256 N.C. 155, 161, 123 S.E.2d 582, 586 (1962) (holding that "it is clear the Legislature intended that the sales tax be primarily a privilege or license tax on retailers").

5. Pursuant to N.C. Gen. Stat. § 105-164.4(a), the sales tax is levied on a retailer's net taxable sales or gross receipts, as appropriate.

6. For purposes of the Act, "net taxable sales" is defined as "the gross retail sales of the business of the retailer taxed under this [Act] after deducting exempt sales and nontaxable sales." N.C. Gen. Stat. § 105-164.3(24).

7. When calculating net taxable sales, N.C. Gen. Stat. § 105-164.13(15) allows a retailer to deduct the following: "Accounts of purchasers, representing taxable sales, on which the tax imposed by this Article has been paid, that are found to be worthless and actually charged off for income tax purposes."

8. Although it is designed to be passed on to the consumer, the legal incidence of the sales tax is on the retailer. *Piedmont Canteen Service*, 256 N.C. at 161-162, 123 S.E.2d at 586 (holding that despite the retailer's ability to pass the sales tax on to and collect it from the purchaser, it is the retailer that remains liable for the sales tax).

9. Under N.C. Gen. Stat. § 105-164.7, a "retailer's failure to charge the tax to or to collect the tax from the purchaser does not affect" its sales tax liability.

10. The fact that a customer does not pay the sales tax is therefore irrelevant in determining a retailer's sales tax liability.

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[1] All statutory references are to those statutes in effect during the period at issue.

11. N.C. Gen. Stat. § 105-164.13(15) affords relief to a retailer that extends credit of its own to a customer that later defaults in repaying the credit by allowing the retailer to deduct such bad debt from its gross sales when calculating its net taxable sales.

12. Since N.C. Gen. Stat. § 105-164.13(15) allows a retailer to deduct bad debts from its gross sales, it represents a deduction from sales taxation. *See Midrex v. Lynch*, 50 N.C. App 611, 614, 274 S.E.2d 853, 855 (1981) (recognizing that a deduction is "something that is or may be subtracted").

13. As such, the bad debt deduction allowed under N.C. Gen. Stat. § 105-164.13(15) is a privilege and not a right; it is a benefit that "the [S]tate gratuitously confers" and "has the concomitant power to limit[.]" *Aronov v. Secretary of Revenue*, 323 N.C. 132, 138, 371 S.E.2d 468, 471-72 (1987)

14. Petitioner, therefore, bears the burden of bringing itself within the statutory provisions authorizing the bad debt deduction under N.C. Gen. Stat. § 105-164.13(15). *See Wal-Mart Stores East, Inc. v. Hinton*, __ N.C. App. __, 676 S.E.2d 634, 651 (2009) (recognizing that "a taxpayer claiming a deduction must bring himself within the statutory provisions authorizing the deduction") (internal citations omitted).

15. To properly claim a deduction under N.C. Gen. Stat. § 105-164.13(15), a taxpayer must first demonstrate the existence of "accounts of purchasers, representing taxable sales."

16. N.C. Gen. Stat. § 105-164.13(15) applies to those accounts between the retailer and customer; it does not apply to accounts held by a third party.

17. Because Petitioner did not have any accounts of purchasers and the PLCC accounts held by the third-party banks fail to qualify as accounts of purchasers, Petitioner fails to satisfy its statutory burden under N.C. Gen. Stat. § 105-164.13(15).

18. In addition to not having accounts of purchasers, Petitioner failed to charge off the PLCC accounts for income tax purposes on its federal income tax returns.

19. For a worthless account to be "charged off for income tax purposes," the account must be written off as uncollectible on the claimant's books and records. *See* North Carolina Sales and Use Tax Directive 03-2, Worthless Accounts/Bad Debts.

20. Petitioner's argument that it satisfied the "charge off" requirement under N.C. Gen. Stat. § 105-164.13(15), because it acted as "unit" with the third-party bank, is without merit, because:

    a. Both the [Bank 1] Agreements and [Bank 2] Agreements clearly stated the following: "Nothing contained in the Agreement shall be construed to constitute Bank and Retailer [Petitioner] as a partner, joint venturers, principal or *agent* or employer and employee." [Bank 1] Agreements, § 13.11; [Bank 2] Agreement, § 15.11 (emphasis added)

b. Petitioner did not act with any "singularity of purpose" with the third-party bank, nor did Petitioner and the third-party banks "act as one another's agents." *Home Depot USA v. Department of Revenue*, 51 Wn. App. 909, 925, 215 P.3d 222, 230 (2009) (rejecting Home Depot's argument that it acted as a "unit" with the third-party banks).

c. Only Petitioner, not the third-party banks, is the "taxpayer" liable for the payment of the sales taxes for purposes of the Act. *See* N.C. Gen. Stat. § 105-164.3(47) (a "taxpayer" is a person liable for sales tax).

d. Pursuant to N.C. Gen. Stat. § 105-164.4, the sales tax is levied on a "retailer." The term "retailer" includes "every person engaged in the business of making sales of tangible personal property at retail." N.C. Gen. Stat. § 105-164.3(35) Thus, only Petitioner, not the third-party banks, is the "retailer" making sales of tangible personal property.

21. Finally, Petitioner's contention that the service fees are evidence that it bore the risk of loss on uncollectible PLCC accounts is without merit.

a. In arguing that the cost of bad debt overhead was built into the service fees, Petitioner "mischaracterizes the nature of the [PLCC] contracts." See *Home Depot U.S.A., Inc. v. Levin*, 121 Ohio St. 3d 482, 485, 905 N.E.2d 630, 633 (2009).

b. By hiring the third-party banks to act as a lender, Petitioner "deliberately decided against extending credit to . . . customers itself." *Id*. At 486, 905 N.E.2d at 633. In doing so, Petitioner recognized numerous business benefits (e.g. avoiding evaluating customer creditworthiness, multiple state usury laws, etc.), and deducted the service fees as a business expense on Line 26, entitled "Other Deductions," of its federal income tax returns.

c. Thus, the "service fees" represented a business expense of Petitioner for hiring a third party to extend credit to its customers.

d. Assuming *arguendo*, that Petitioner bore some loss from the third-party banks' chargeoffs of the PLLC accounts, this would not convert the PLLC accounts into "accounts of purchasers" belonging to Petitioner within the meaning of N.C. Gen. Stat. § 105-164.13(15).

22. The North Carolina sales tax consequence of Petitioner's business decision, to contract with third-party banks to extend credit to its customers, is that Petitioner fails to qualify for a bad debt deduction under N.C. Gen. Stat. § 105-164.13(15) for PLCC accounts held and charged off as worthless by third-party banks.

23. Based on the foregoing, the uncontroverted evidence supports there are no genuine issues of material facts, and Respondent is entitled to summary judgment as a matter of law.

DECISION

The Department determines that the Findings of Fact and Conclusions of Law of the Administrative Law Judge, as adopted by the Department, support the ALJ's Decision granting summary judgment in favor of the Respondent. The Department hereby decides that Respondent was entitled to summary judgment as a matter of law and UPHOLDS and ADOPTS the Decision of the ALJ. Accordingly, the Notice of Final Determination ("Notice") issued by the Department to Petitioner on May 15, 2009 is sustained as to the tax, penalties, and interest shown due in Item 5 of the Notice, entitled "Additional sales tax due on disallowed bad debt deduction under N.C. Gen. Stat. § 105-164.13(15)," plus accrued interest until the tax is paid in full. In addition, Petitioner's refund claims as discussed in this Notice [August 1, 2003 through January 31, 2004 and January 1, 2004 through January 31, 2007 (incorrectly shown as January 1, 2007 in the Notice)] are hereby DENIED.

Tax and interest due by Petitioner to the Department as of January 14, 2011, plus the daily interest accrual rate, are as follows:

	Additional State Tax	**Additional County Tax**	**Total**
Tax Due	$[ ]	$[ ]	$[ ]
Add:			
Accrued interest due*	+[ ]	+ [ ]	+ [ ]
Total Due	[ ]	[ ]	[ ]
Less:			
Payment	- [ ]	- [ ]	- [ ]
BALANCE DUE	**$[ ]**	**$[ ]**	**$[ ]**

***Interest computed to January 14, 2011**

Daily Interest Accrual Rate: $[ ]

APPEAL

Pursuant to N.C. Gen. Stat. § 150B-45, a party wishing to appeal the final decision of the Department in a contested tax case arising under N.C. Gen. Stat. § 105-241.15 may commence such an appeal by filing a Petition for Judicial Review in the Superior Court of Wake County and in accordance with the procedures for a mandatory business case set forth in N.C. Gen. Stat. § 7A-45.4(b) through (f) within 30 days after being served with a written copy of this Final Agency Decision. Before filing a petition for judicial review, a taxpayer must pay the amount of tax, penalties, and interest that this Final Agency Decision states is due. N.C. Gen. Stat. § 105-241.16.

Under N.C. Gen. Stat. § 150B-47, the Department is required to file the official record in the contested case under review, any exceptions, proposed findings of fact, or written arguments

submitted to the Department, as well as the Department's Final Agency Decision, with the reviewing court within 30 days of receipt of the Petition for Judicial Review. Consequently, a copy of the petition must be sent to the following address: North Carolina Department of Revenue, ATTN: Janice W. Davidson, 1429 Rock Quarry Road, Suite 105, Raleigh, North Carolina 27610, at the time the appeal is initiated to insure timely filing of the record.

This the 13th day of January, 2011.

NORTH CAROLINA DEPARTMENT OF REVENUE

/s/ Janice W. Davidson

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Janice W. Davidson
Agency Legal Specialist, II.
North Carolina Department of Revenue