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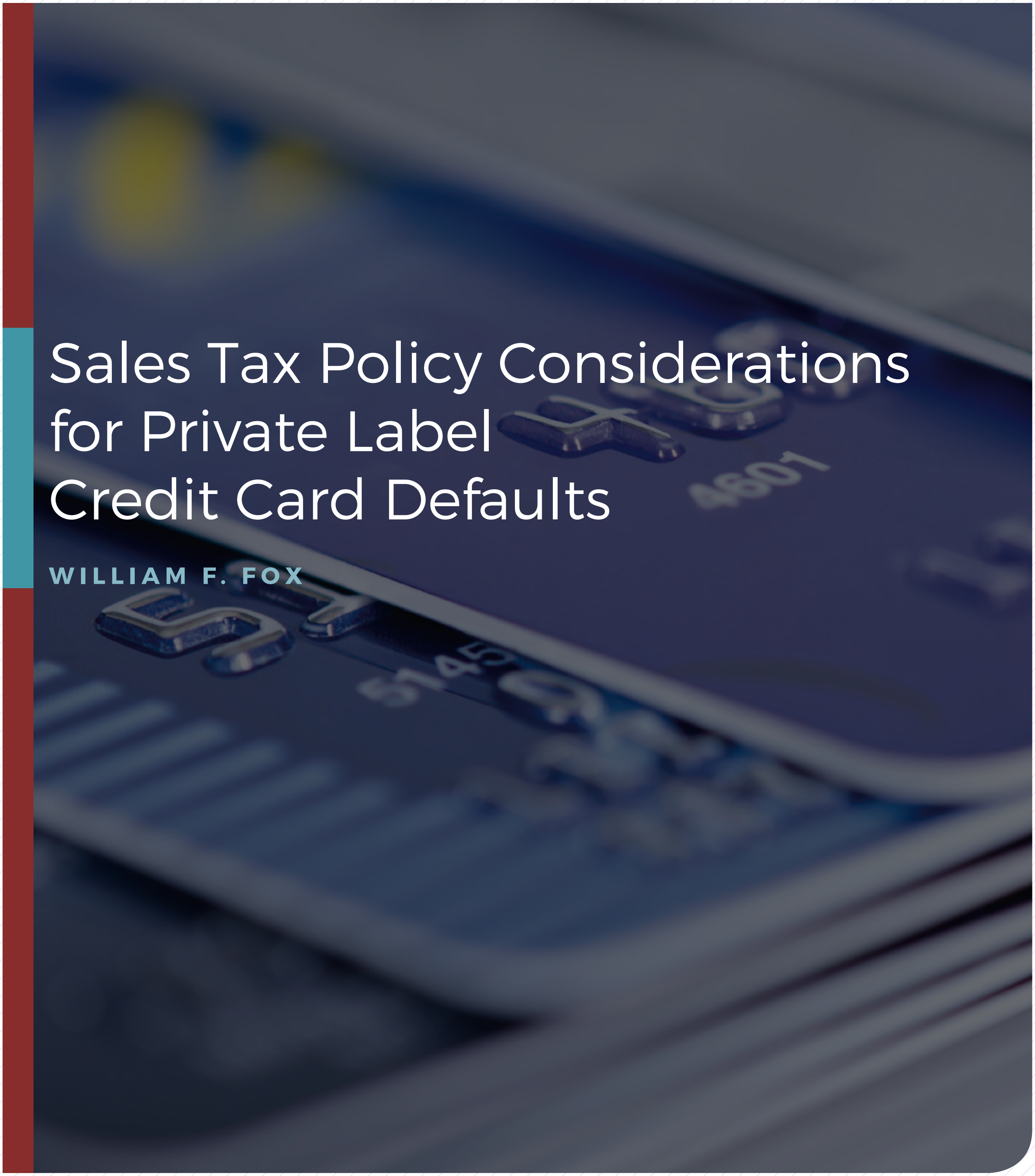

Sales Tax Policy Considerations for Private Label Credit Card Defaults

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ABOUT STRI

The State Tax Research Institute (STRI) is a 501(c)(3) organization established in 2014 to provide educational programs and conduct research designed to enhance public dialogue relating to state and local tax policy. STRI is affiliated with the Council On State Taxation (COST). For more information on STRI, please contact Douglas L. Lindholm at dlindholm@cost.org.

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EXECUTIVE SUMMARY

Many retailers have historically provided credit and credit cards for use by approved customers in their stores. More recently, retailers often work with financial institutions that issue private label credit cards, which are branded with the name of the retailer and can be used at the retailer and its affiliates. Private label and company credit cards differ in who processes the credit and who holds the portfolio, but otherwise are very similar in use and operation. Private label credit cards now dominate the issuance of retailer branded credit cards because of advantages for both retailers and financial institutions. In most cases customers use private label credit cards both to purchase goods and pay the associated sales tax, so the credit issuer is also financing sales tax payments. In many states, sales tax practices associated with default on credit card debt differ between the private label credit cards and company credit cards, despite the otherwise similarities of the credit. This paper examines good policy design for sales tax in cases of default on private label credit cards.

Best practice structures sales taxes in all states so that the tax base approximates *paid* consumption, though states differ legally whether the sales tax is levied on consumer expenditures or business receipts. Retailers remit almost all of the collections with both legal structures, and these distinctions have relatively few implications for policy design of the sales tax. Sales taxes begin with a tax on transactions and permit carefully selected exemptions and non-taxable sales to approximate the paid consumption base. Exemptions appropriately limit some taxation of business purchases since these intermediate transactions are intended for production activities and not for consumption. Also, states do not tax many forms of non-paid consumption, such as services produced at home or in cases where goods are stolen. Early on states demonstrated intent to return sales tax on purchases for which payment was not fully made as a result of credit default, because it violates the principle of taxing paid consumption.

Retailers normally remit sales tax in the month following the purchase, so states have the sales tax revenue in most cases before credit users pay for the item and the sales tax. Retailers receive refunds for sales tax they have remitted and for which the buyer defaults on payment when the *retailer* issues credit through company cards, but in most states do not receive refunds when *private label credit cards* are used.

Appropriate policy calls for refunding the sales tax in cases of default on private label credit card debt. First, refunds for default on private label credit cards ensure that the sales tax is levied on *paid* consumption, in harmony with broader sales tax policy. As a result state and local governments would not retain revenues associated with items for which paid consumption does not occur. Second, issuance of private label credit cards and company credit would be afforded neutral treatment so that neither is advantaged or disadvantaged by sales tax procedures. Current practice in most states results in excess sales tax associated with private label credit cards since no refund is made. Third, current practice inappropriately causes retailers and the cooperating financial institutions to be guarantors of sales tax payments on behalf of state and local governments. The states should not retain the tax unless the purchaser repays the credit. Finally, refunds of this excessive sales tax permits retailers to compete more effectively with and to not be disadvantaged relative to firms that do not pay the excess tax on behalf of non-paying customers.

At least seven states have adapted their sales tax statutes so that the sales tax is refunded similarly for both company credit and private label credit cards in the event of default. This policy is consistent with the intent of the sales tax and best practice. Other sales taxing state and local governments should adopt statutes similar to the seven states.

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INTRODUCTION

States adopted sales taxes[1] at differing times across many years between the 1930s and the 1970s, including in diverse economic and political environments and with differing objectives. Not surprisingly, sales taxes differ across the country. For example, some states legally impose their sales taxes directly on the consumer and others impose the tax on the sellers' revenues. To ease administration and compliance businesses collect and remit almost all sales tax revenues with each legal structure,[2] so in many ways the distinction is over form and not substance. In any event, the distinction does not change the broad intent of sales taxes—to forward shift the tax that is remitted by businesses to buyers, with the specific goal of taxing paid consumption. Analysts broadly discuss all state sales taxes as levies on consumption.

Practically, sales taxes are levies on a set of identified transactions, and the key policy task is determining which transactions in the economy should be taxed to approximate a tax on paid consumption. Two aspects of taxing paid consumption are emphasized here. Exemptions must be granted for a wide range of transactions to achieve this objective. Taxing paid consumption means limiting the taxation of intermediate purchases by businesses, since these purchases are used for producing and not for consuming. Many of the exemptions, such as sales for resale and manufacturing inputs, move the tax closer to one on consumption by reducing the tax on business purchases. Further, the tax is generally imposed only on *paid* consumption. States do not tax consumption without formal payment, such as when a household self produces home cooking or home repairs. These same services are often taxed if they are purchased. Consistent policy would have states not collect sales taxes unless consumers pay for the items. States do not collect tax on stolen items. Similarly, tax should not be retained by states when an item is legally purchased on credit but full payment is not made for the credit.

This paper addresses one aspect of appropriate sales tax policy: the sales tax treatment of bad debt associated with private label credit cards. Bad debt occurs when the borrower defaults on some or all of the liability that is incurred when making a

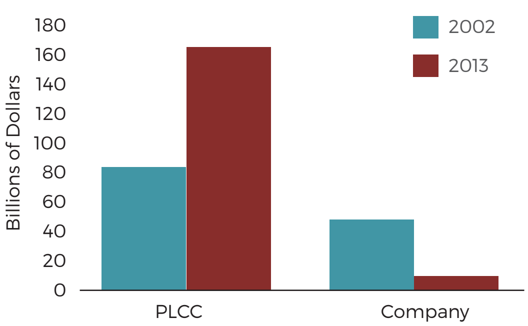
1 Unless otherwise noted, the sales tax is used in reference to both the sales and use taxes.

2 A modest number of exceptions exist, such as with consumer use taxes.

purchase and paying the sales tax with a credit card. The paper's six sections examine the relevant issues and describe good policy. The remainder of this introduction explains several forms of credit cards and discusses their relative importance and growth. The second section summarizes the broad policy issues that analysts consider when recommending policy on sales tax structures. Section three depicts current sales tax treatment when bad debt arises and section four analyzes appropriate policy regarding bad debt for credit cards. Section five provides examples of states that have recently adopted good policy associated with bad debt and section six briefly concludes the paper.

Three broad groups of credit cards are available. Financial institutions provide general purpose credit cards that can be used for a wide range of purchases and transactions.[3] Retailers issue company cards that can be used only at the retailer and its affiliates. Financial institutions, rather than retailers, offer private label credit cards that are branded with the name of a retailer.[4] In most cases these cards are used only at the branded retailer and its affiliates. Private label credit cards and company cards differ in who administers the card and which company carries the credit liability.

FIGURE 1: CREDIT CARD CHARGE VOLUME



Source: Nilson, 2014.

The use of private label credit cards has grown rapidly over the past decade, as the company cards have diminished in importance. Private label credit cards reached a charge volume of $161 billion in 2013 (see Figure 1), nearly double the $82 billion from a decade earlier. Company credit cards, on the other hand, declined by more than three-fourths to represent only $9 billion.[5] Nordstrom, for example, continues to operate company cards, whereas Macy's and Home Depot utilize third parties.

These trends have taken place despite the sales tax disadvantages for private label credit cards that are discussed below. Private label credit cards operate through agreements between the retailer and the issuing bank that differ somewhat in their details. Private label credit cards have likely grown so fast because of the advantages to the retailer and its customers. By contracting with a private label credit card company to administer its credit card program, the retailer can focus on its core business—selling goods and services to customers, and its credit card customers benefit from having their cards administered by a company whose core business is credit card administration.[6]

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3 Visa, MasterCard, American Express and Discover are examples.

4 GE Capital (currently Synchrony Financial), Citibank, and Capital One are major providers of private label credit cards, with combined purchase volume of $132.6 billion in 2013. See Nilson Report, 2014. The outstanding balance for PLCC cards was $93.7 billion in 2013.

5 The Nilson Report, April, 2014 Issue 1039.

6 See Eric Lindeen, "Why Private Label Credit Cards Have Defied the Doomsayers," *American Banker*, December 21, 2012 for more detail on advantages of private label credit cards.

CRITERIA FOR EXAMINING SALES TAXES

Good tax policy, including how bad debt associated with private label credit cards should be treated for sales tax purposes, should be designed using a set of criteria for the tax. Intent to create a consumption-based tax starts the policy decisions for a sales tax. From there, the set of criteria should drive policymakers' judgments between alternatives wherever necessary. Four factors dominate decisions for evaluating good sales tax policy. These factors frequently point in different directions, so policy must balance these considerations. The factors include:

Collections. Raising revenue is almost always the main purpose for taxation, but state governments have broad authority to tax if revenue is the only goal. Meeting the revenue expectations while structuring a tax on consumption and achieving the other criteria of a good tax system is the policymaker's challenge.

Neutrality. In this context, neutrality means levying the sales tax similarly on all related transactions and activity so that the tax system does not favor one type of business or product relative to another. This is often described as intent to create or maintain a level playing field. Non-neutral tax structures generally alter behavior by both businesses and households and worsen both economic performance and wellbeing.

Low compliance and administration costs. Compliance and administration costs divert resources from households, businesses and governments so that they cannot be used to purchase the goods and services people demand, increase profits, or provide public services. Thus, policy should keep compliance and administration costs low, while achieving effective and equitable administration of the tax.

Fairness. Fair distribution of tax burdens considers both across households with differing incomes (vertical equity) and across households with the same incomes (horizontal equity). Neutral taxation normally establishes a fair tax system for businesses, so that one set of firms is not tax subsidized or incentivized relative to another.

CURRENT SALES TAX PRACTICE

For administrative ease, states choose to tax transactions rather than imposing a tax directly on paid consumption, though consumption does not always occur coincidentally with the transaction.[7] The goal of a consumption base can only be achieved after a series of decisions are made on which transactions should be taxable.[8] Sales taxes generally allow a wide range of exemptions and non-taxable sales in an effort to convert a tax on transactions into a tax on paid consumption.

Transactions are often thought of as simple activities where a buyer exchanges payment for a good or service. The relationship between transactions and consumption can be usefully dissected to help understand when tax should and should not be imposed. Transactions are composed of several steps including provision of goods or services by retailers, receipt of the good or service by the buyer, payment by the buyer (which may in practice be made using a third party, such as a credit card company), receipt of the payment by the seller and retention of the goods by the buyer. Completion of these steps reasonably represents when paid consumption takes place.

Two very different actions during the transaction process may prevent the transaction from becoming paid consumption. Effectively this means transactions should not be regarded as taxable until all steps have been completed, though state administrative practices cause retailers to remit payment to the state earlier during the transaction process. First, customer service price markdowns may occur before the item is consumed. In this case, the buyer retains the item but pays less than the originally negotiated price. This may take place, for example, if a truck damages property at the time of delivery, and the vendor agrees to accept lower payment for the purchase. In a number of states the sales tax is only decreased if the price is lowered at the time of sale, so the sales tax would be paid on a price that is higher than the paid consumption value.

Second, the buyer may purchase with credit and subsequently default on the credit. Because the payment portion of the transaction is never consummated, the

7 For example, automobile services may accrue for many years after payment is made and taxes are collected.

8 Business purchases should be exempted because intermediate inputs are intended for production, not consumption. Sales for resale and component parts are widely exempted, but other intermediate purchases are frequently taxed, such as office supplies, vehicles, and shelves. Economists generally argue for exemption for these other purchases as well.

Sales taxes have long been structured with provisions that allow refunds to retailers for sales taxes implicit in bad debts.

transaction does not represent paid consumption when default occurs, regardless of whether the item is repossessed. With default, the retailer and/or the third party financial institution loses (1) the price of the item, (2) typically the item itself,[9] and (3) the sales tax remitted by the retailer to the state, unless the state refunds the tax. Many states retain the revenues when private label credit cards are used because statutes have not been updated to reflect the advent of private label credit cards as a means of issuing retailer credit. Effectively, sales tax is paid even though the transaction was never consummated. The following section describes state sales tax collection practices for these transactions.

SALES TAX COLLECTION

Sales tax structures overlap private sector transactions and seek to collect revenues at a point in the transaction process where compliance is relatively low cost and state taxation departments can effectively enforce the tax. Two broad legal structures levy sales taxes. Some states, such as Hawaii, New Mexico and Tennessee, impose their sales tax on the gross receipts of the selling businesses or the privilege of selling in the state. Other states levy the sales tax on consumer purchases. And, of course, another set of states combine the two approaches. As noted above, these distinctions have some legal implications but do not alter the intent to tax paid consumption, and therefore exemptions, non-taxable sales, refunds and so forth are similar with both approaches.

Businesses collect and remit almost all of the revenue, regardless of the legal structure for imposing the tax. Retailers in more than one-half of the states remit the sales tax on an accrual basis, which means the tax is due when the sales agreement is reached, regardless of whether paid in cash or with credit. Over the long term states have trended in the direction of an accrual approach.[10] The retailer normally remits the tax to the state during the month following the accrual. The remaining states determine tax liability on a cash basis, but payment with credit cards is generally treated the same as cash. Retailers in both sets of states often remit the tax on the entire transaction price before finalization of paid consumption since remittance of the tax occurs when credit is used, which is prior to when a default would occur.

BAD DEBT

State statutes and administrative practices accommodate bad debt and merchandise returns, but the bad debt policies were established for economic environments and business procedures prior to the development of private label credit cards. Retailers claim a credit (or reduce the amount of sales included in a subsequent period's tax returns) for returns of merchandise by consumers whether paid in cash or with any of the credit cards. The result is that no sales tax is paid when returns are made.

Sales taxes have long been structured with provisions that allow refunds to retailers for sales taxes implicit in bad debts. The obvious policy intent (consistent with a tax on paid consumption) was that the sales tax would only be paid when the buyer met obligations to pay the debt.[11] So, the retailer is entitled to a credit if the buyer defaults

9 The item may be repossessed by the vendor, but retailers are infrequently able to do so.

10 See John F. Due and John L. Mikesell, *Sales Taxation*, Urban Institute Press: Washington D.C., 1994.

11 No distinction is made in this report between actual refunds and credit against future tax liabilities.

on payment of store credit, including the use of company credit cards. Retailers normally must determine the credit card is bad debt according to IRS income tax statutes to ensure a strong probability that the debt will not be repaid. The result is states retain no sales tax on bad debts occurring with company credit cards.

But, as noted above, the evolution of credit has led to robust movement towards private label credit cards and away from traditional company issued credit cards. Only a small number of states have updated their legislation to reflect private label credit cards. The provisions for bad debt in most states apply to direct store credit but not general purpose or private label credit cards since the financial institution and not the retailer recognizes the bad debt for income tax purposes. Most states permit no refund for bad debt with either general purpose or private label credit cards. Retailers remit tax to the state and the state retains the revenue even though the buyer never pays or makes only partial payment for the item and the sales tax.

The private label credit card and company credit card transactions are essentially the same from the user's perspective, but retailers outsource the credit function rather than operate it internally with private label credit cards. Customers borrow the sales tax as well as payment for the good when making a transaction with both types of credit cards, but the ability to obtain a sales tax refund when default takes place depends on whether the sales tax was loaned to the customer directly by the retailer through a company credit card or by an outsourced financial institution with the private label credit card.

A simple example can illustrate sales tax treatment with these two types of credit cards and with cash. Think of the transaction as if two cashiers are present at the transaction, one working for the store and the other for the state. Suppose a $10 purchase is made and the combined state and local sales tax rate is 7 percent. First, consider the case where **cash** is used for the purchase. The retailer collects $10 for the item and the tax department collects $0.70 in tax. Both the retailer and the state retain their payment unless the item is returned. The retailer repays the $10 and the state refunds the $0.70 tax if a return is made. Defaults are not a concern here because payment is not borrowed.

Second, suppose the buyer uses a **company credit card** for purchasing the item and a credit card issued by the state to pay the tax. Now, assume the purchaser defaults on both credit cards. The tax department is never paid the $0.70 due in tax and the retailer never receives the $10 in payment (Figure 2 illustrates the similarities between the company and private label credit card transactions). In practice, the retailer loses the item, unless it can be repossessed. This logic is consistent with current state procedures for company cards. Neither receives payment from the buyer and the store does not guarantee payment of the sales tax to the state. So, no sales tax is paid on this item. Of course, in actual practice, the buyer finances both the item purchase and the sales tax with the company credit card (rather than the sales tax with a state credit card), but the retailer is reimbursed the sales tax so it works similarly to the example.[12]

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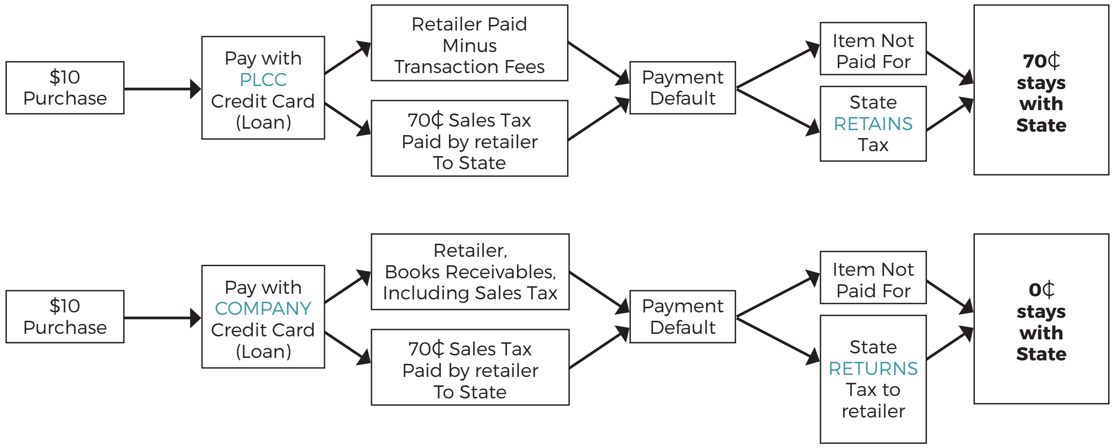
[12] The retailer does lose the opportunity cost of the resources used to finance the sales tax prior to the refund.

FIGURE 2: PLCC VS COMPANY CREDIT



The figure illustrates the differences in sales tax treatment between private label credit cards and company cards in most states and illustrates the extent of overpayment of tax.

Third, suppose the buyer uses a **private label credit card** issued by a financial institution for the $10 purchase and also for payment of the $0.70 in sales tax to the state (see Figure 2).[13] Now assume the buyer defaults. The retailer combined with the financial institution ultimately loses the $10 payment when the default occurs. With current sales tax practice the retailer has essentially guaranteed the $0.70 in tax when the default takes place. The state received payment of the sales tax in the month after purchase and retains the funds even after default. So the retailer and financial institution lose both the payment on the item and the sales tax.

In summary, the retailer effectively finances the sales tax payment for the buyer in both cases where credit is used in addition to financing the purchase of the product. With the private label credit card, the financing includes a guarantee for payment of the sales tax.

The question arises as to who absorbs the cost of default on the sales tax with private label credit cards. Retailers and private label credit card companies have specific agreements covering all aspects of the credit card arrangements including how they will treat bad debt, other expenses of the program, and so forth. The details of private label credit card agreements vary, but as a general rule card issuers pay retailers the day after the initial transaction for the purchase price plus sales tax minus several transactions' fees. The financial institution does not directly charge the retailer when bad debt occurs. However, the two companies typically share in bad debt expenses at the end of the year. Ultimately, the bad debt not directly charged back to the retailer will be reflected in higher transactions fees to the retailer or higher interest and other charges for paying credit card holders. Issuing banks will only issue the cards if they can earn a profit. So retailers are likely to bear much of the cost of sales tax default either through the year end settlements or through higher transactions' fees.

13 The required fee charged the retailer by the financial institution is left out for simplicity.

DESIGNING GOOD SALES TAX POLICY

Sales tax policy and procedures need to keep pace with changing business and buyer practices to ensure that the tax structure meets the criteria for a good sales tax and does not inhibit appropriate business systems. Good sales tax policy requires the state to refund the sales tax to the seller for default on private label credit card debt, as occurs with company credit cards, since paid consumption has not occurred.[14] The seller should receive the refund from the state to which the tax was initially paid. The retailer's sales tax payment to the state can be paralleled to income tax withholding when wages are earned. The withholding does not become payment of the tax until the final return is filed. Similarly, the sales tax should not be seen as final until 1) the retailer files a return, 2) the item is kept for consumption and 3) the debt is paid by the purchaser.

The goal for low compliance and administration costs suggests that the costs of identifying taxes associated with defaults should be considered when deciding whether and how refunds should be allowed for bad debt. Processing practices for private label credit cards are similar to company credit cards and should permit refunds with relatively low administration and compliance costs. Still, large retailers have high numbers of credit card accounts, so methods could be developed that allow the refunds to be calculated based on the types of sampling that is permitted elsewhere by many states during audits of sales tax compliance. The compliance and administration costs associated with finding and reporting every defaulted account and all of the included transactions can be reduced further with sampling methodologies. Of course, the sampling procedures need to accurately represent the actual extent of defaults within the state.

The following four points explain in detail why refund of the sales tax on bad debt is proper tax policy.

[14] Consumers can be thought of as using a continuum of payment mechanisms that goes from cash, to company credit cards, to private label credit cards, to general credit cards, to personal loans. The line has generally been drawn so that refunds are allowed for bad debt associated with company credit cards and, in all but seven states, none of the other loan mechanisms. Similar treatment for private label credit cards enhances sales tax practice without undue administrative and compliance cost burdens.

Current treatment of bad debt for private label credit cards creates non-neutral taxes since sales tax loaned by the retailer and sales tax loaned by the financial institution in the case of private label credit cards are treated differently when default occurs.

RETAINED SALES TAX ON BAD DEBT DEVIATES FROM A TAX ON PAID CONSUMPTION

As noted above, the sales tax begins with a tax on transactions[15] and through a series of exemptions and non-taxable sales seeks to impose a tax on final paid consumption. Many transactions do not represent consumption and adjustments are necessary to realize a consumption base. For example, most businesses are allowed exemption of purchases for resale and component parts used in manufacturing. Bad debt is not *paid* consumption and therefore should not be taxable with a consumption based sales tax. Bad debt has similarities to stealing in that the retailer does not collect the sales tax,[16] though the intent may be very different depending on whether the buyer expected to pay the debt. Failure to refund the sales tax on bad debt effectively imposes a tax on consumption plus non-payment and results in over-collection of tax. Revenues retained by the government on defaulted debt are paid by the businesses and deviate from a tax on consumption.

TAX TREATMENT SHOULD BE NEUTRAL

Tax law should be neutral with regards to how businesses operate, what buyers purchase, and how purchases are made. This requires all similar transactions be subject to the same tax treatment. Overall, consumers are better off and private resource costs are lower if taxation is neutral in its effects on behavior, which effectively means that businesses and consumers can make their best decisions and taxes are then levied without distorting these decisions.[17]

Current treatment of bad debt for private label credit cards creates non-neutral taxes since sales tax loaned by the retailer and sales tax loaned by the financial institution in the case of private label credit cards are treated differently when default occurs. No fundamental policy objective is consistent with providing a credit for taxes paid on defaulted company credit but not for private label credit card debt. But, the payment of tax on defaults disadvantages affected retailers relative to firms that use company credit cards, firms that operate more in cash, and the broader economy that is not responsible for paying this excess tax.

IT IS NOT SIMPLY A COST OF DOING BUSINESS

Some have asserted that overpayment of taxes associated with bad debt is simply a cost of doing business, implying that this should be accepted. It is true that this excess tax becomes a cost of business unless the tax is refunded by the state, but it is an expense that is not associated with the purchase of resources from the economy. Firms must earn less profit, raise prices for buyers, or make credit more expensive so that states can receive more tax than should be due.

15 The basic argument does not change in states where the tax is legally imposed on business revenues.

16 Of course, these also differ in that the retailer never receives the sales tax in the case of theft, and the debt taken to pay the sales tax is not repaid in the case of bad debt.

17 Compliance and administration costs and distortions in otherwise efficient behavior (often termed excess burdens) are the costs that taxation imposes on the economy. Tax dollars remitted to government are a transfer from the private to the public sector and do not represent a cost to the economy if the public sector uses them as effectively as the private sector, by ensuring that the return at least equals the opportunity cost in the private sector. For further discussion of excess burdens and other costs of taxation see Harvey S. Rosen and Ted Gayer, Public Finance, Tenth Edition, McGraw-Hill: Washington, 2014.

Further, it has been asserted that the retailer is unaffected by bad debt because the third party institution bears the cost. The reality is that private label credit cards exist by agreement between the retailer and the issuing financial institution. Most of the agreements include a yearend settlement or similar mechanism where bad debt is shared between the two based on a pre-existing agreement. These agreements will ultimately either require the retailer to pay this additional tax on bad debt through higher retailer fees or will require higher interest payments by buyers who do pay their bills or both. Of course, the retailer may seek to pass these costs to all buyers in the form of higher prices. The credit card agreements are periodically renegotiated and can be changed to reflect bad debt experiences because credit card issuers will only provide cards if they can earn a profit.

Imposition of this additional tax creates an uneven environment as it imposes a tax on retailers using private label credit cards that is not collected from other retailers and other businesses in the economy. These costs create non-neutralities across types of retailers, similar to those described in the previous section.

GOVERNMENT SHOULD ONLY RECEIVE SALES TAX ON PAID CONSUMPTION

Revenue is an obvious and appropriate goal for taxation. But, taxes should be levied in a systematic fashion and not capriciously imposed to obtain revenue however possible. Governments obtain revenues that are inconsistent with the intent of the tax when they do not refund taxes on bad debt with private label credit card. Otherwise, the retailers (and to some extent the private label credit card companies) become the guarantors of sales tax payments when credit card users default, since the tax is paid without reimbursement by the buyer or refund by the government. The goal is to tax consumption, and no public policy reason exists to charge tax to the retailer when paid consumption did not occur.

Excess payment of tax will result from many transactions purchased with a private label credit card. An approximation can be given on the overall amount. Assume a 5.96 percent default rate[18] on the $93.7 billion in private label credit cards charges in 2013 and a 6.5 percent national average state and local sales tax rate. This suggests defaults of $5.6 billion.[19] Approximately 30 percent of this represents finance charges and 10 percent will be recovered later, leaving $229 million in sales tax on defaulted purchases. Five states impose no sales tax and a number of larger states have reformed their sales tax law, but this still results in $132 million in excess sales tax payments to state and local governments.

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18 Credit card charge off rates are significant and the resulting impact on business costs large. For example, Fitch's Retail Credit Card Charge off Index was 5.96 percent in August 2014. See Fitch, U.S. Prime Credit Card Charge offs Now 75% off Recession Highs, August 5, 2014.

19 States without sales taxes represent 2.5 percent of U.S. population and the estimate was reduced accordingly. Seven states with 39.8 percent of the U.S. population have reformed their sales tax legislation to refund the sales tax on debt associated with private label credit cards. Fitch estimates between 10 and 25 percent of bad debt is later recovered.

RECENT STATE POLICY CHANGES

Seven states have recognized the importance of reforming sales taxes associated with private label credit cards by more closely aligning their sales tax policy and practice with current retail practices on providing debt. California was the first to act, passing legislation in 1999 that allows sales tax refunds or credit for bad debt. Texas, Michigan and Pennsylvania subsequently followed up with changes, and later Florida and Wisconsin enacted such provisions. Most recently, Illinois passed legislation in December 2014, and the bill is currently awaiting the Governor's signature.

Texas, for example, enacted legislation that brings the sales tax closer to paid consumption in two ways. First, it provides the seller a tax credit when price renegotiations take place. Second, it provides the retailer or an assignee with a credit for reimbursement of tax for the portion of debt that is determined to be bad. Texas permits the seller to withhold payment of the tax on the unpaid portion of an item if: "(1) …the seller determines that the unpaid portion will remain unpaid; (2) the seller enters the unpaid portion of the sales price in the seller's books as a bad debt; and the bad debt is claimed as a deduction for federal tax purposes during the same or a subsequent reporting period."[20] Further, Texas explicitly allows similar treatment for private label credit cards as it states, "a retailer or any person who extends credit to a purchaser under a retailer's private label credit agreement, or an assignee or affiliate of either, is entitled to credit or reimbursement for taxes paid on the portion of: (1) an account determined to be worthless and actually charged off for federal income tax purposes; or (2) the remaining unpaid sales price of a taxable item when the item is repossessed under a conditional sales contract."

Texas also permits retailers to use either detailed individual records to evidence the sales tax associated with unpaid debt or to use alternative statistical means based on sampling to determine the refunds. The latter could be cost reducing for big retailers with very significant amounts of bad debt that result in large overpayments of sales taxes, as well as for the state's auditors.

[20] Texas Tax Code Annotated section 151.426.

CONCLUSION

Good state sales tax policy allows retailers or their assignees, such as financial institutions that provide private label credit cards, credits or refunds for sales taxes on the unpaid portion of credit card debt. Such policy permits business procedures to develop and operate most effectively, ensures that state and local tax revenues are more consistent with a tax on paid consumption, and allows retailers to compete on a more level playing field since they will not be guarantors of sales tax liabilities. Seven states have led the way in reforming their legislation to be consistent with this best practice. Texas, among other states, illustrates how statutes can be revised to better reflect appropriate intent and application of the sales tax. Adoption of consistent treatment for company credit cards and private label credit cards that allows sales tax refunds when default occurs would be good policy for the remaining states as well.

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