THE OHIO COUNCIL OF

Retail Merchants

The voice of retail since 1922

SALES TAX BAD DEBT LEGISLATION (HOUSE BILL 104)
FREQUENTLY ASKED QUESTIONS

Q-1. <u>Why should we pass this bill?</u>

A-1. Passing this bill would fix a current inequity in the state's law. The sales tax is to be paid by the customer; the retailer is only supposed to collect the tax from the customer and remit it to the state. Under current law, if a customer who uses a credit card owned by the retailer fails to pay their bill, the retailer is entitled to a credit or a refund of the sales tax. However, if that same customer uses a private label credit card, neither the retailer nor the private label credit card company is entitled to a credit or refund of the tax. This unfairly makes the retailer and/or the private label credit card company the guarantors of the public fisc, and results in a windfall for the State.

Q-2. <u>Wouldn't this bill result in the state reimbursing the retailer for the cost of the merchandise?</u>

A-2. No. This bill only pertains to the sales tax that the retailer advanced to the state on the customer's behalf. The retailer and the private label credit card company will continue to bear the loss for the cost of the merchandise and services that were purchased on an account that is ultimately charged off.

Q-3. <u>The sales tax is levied on the transaction. Isn't the retailer's decision to grant credit for the transaction a separate event and, therefore, the tax should still be owed regardless of the default by the customer?</u>

A-3. Every state in the country that imposes a sales tax grants a credit or refund of the tax on charged off accounts when the retailer owns its own credit card accounts. This is a policy decision that the legislature of this state adopted decades ago. There is no fundamental difference between retailers that own their own accounts and retailers that contract with a private label credit card company to issue their credit cards, and there is no policy reason to justify different treatment of the two. By denying credits or refunds in a private label credit card situation, the State is inequitably increasing the cost for retailers to do business in the state.

Q-4. <u>How does the arrangement between the retailer and the private label credit card company work?</u>

A-4. Every contract between a retailer and a private label credit card company is a bit different; however, here is how they generally work:

- When a cardholder makes a purchase with a private label credit card, the credit card company pays the retailer for the price of the merchandise, plus the sales tax, on the day after the sale occurs. Sometimes there is a discount (like an interchange fee) at this point, and sometimes not, depending on the particulars of the agreement.
- When an account is charged off, there is no direct charge back to the retailer. (This is necessitated by securitization rules.)

- The bank and the retailer share in the expenses of the program. This can occur in many forms, such as the interchange fee described above or an annual reimbursement of a portion of the total program expenses. The sales tax on bad debts, as well as the underlying cost of the merchandise associated with bad debts, is one of the types of expenses they share. Thus, while the retailer is "paid" by the bank at the front end for the amount of the tax, the retailer is indirectly repaying a portion of the sales tax back to the bank once the account is charged off.
- In states that permit recovery of sales tax on bad debts, the retailer and the bank typically share in the recovery.

Q-5. <u>Doesn't this bill provide for "double dipping"? Isn't this just a cost of doing business?</u>

A-5. No. Consider the following:

- Is getting robbed a cost of doing business for banks? If so, then why criminalize bank robbery?
- If someone embezzles money from a business, the business is typically covered by insurance. Thus, is it "double dipping" for a court to order the embezzler to repay the business (or its insurance company) when they're caught since the insurance company already paid the business?
- Many of these bad debts are situations where the person never had any intention of paying their bill—it's just another form of shoplifting. Would anyone suggest that retailers should be forced to pay a sales tax when someone shoplifts from them?
- The tax is owed by the customer. If the customer does not pay the tax, then why should the retailer or the private label credit card company be required to pay the customer's tax liability out of their own pocket? If someone owes taxes to the IRS and they fail to pay, would it be fair for the IRS to require another person to pay their tax liability?
- Even if the private label credit card company fully reimbursed the retailer, someone other than the person on whom the tax is imposed (i.e., the private label credit card company) is still out the money.
- Retailers incur significant cost to collect sales tax. Requiring retailers to dip into their pockets to pay someone else's tax liability substantially increases the cost of collecting sales tax.

Q-6. <u>What other states provide sales tax refunds or credits on bad debts from private label credit cards?</u>

A-6. California, Florida, Illinois, Michigan, Pennsylvania, Texas and Wisconsin have all passed legislation permitting such credits or refunds on private label credit cards.

Q-7. <u>Are credit card charge off rates increasing or decreasing?</u>

A-7. According to an August 6, 2013, report from Fitch Credit Ratings, charge off rates in July 2013 hit an 84-month low (see graph on page 4).

Q-8. <u>Would this bill apply to general use cards such as American Express, Master Card and VISA?</u>

A-8. No. The bill would only apply to private label credit cards (i.e., cards that only can be used at the retailer whose name is on the cards, or the retailer's affiliates). No state in the country provides for bad debt credits or refunds on general use cards and this bill does not seek any credits or refunds for those cards. Moreover, neither the retailer nor the general use credit card company has adequate data to be able to quantify the amount of the sales tax associated with the bad debts; whereas retailers and private label credit card companies possess this data with respect to private label credit cards.

Q-9. <u>How will retailers be able to determine the proper amount of the tax credit or refund under private label credit card arrangements?</u>

A-9. Current state law permits retailers that own their own credit cards to seek a credit or refund of sales tax on accounts that are charged off. This law has been in place for decades. The manner in which the sales tax on bad debts will be determined under this bill is the same as it is under current law, and the Department of Taxation has the same ability to audit as it does under current law. This bill simply modernizes the state's law to keep up with current business practices (i.e., that many retailers now use private label credit card companies to manage their proprietary credit card programs).

Q-10. <u>How do you know if the customer made a purchase from a store in our state?</u>

A-10. As is the case under current law for retailer-owned accounts, the location of the store is irrelevant for multistate retailers. For example, if someone makes a purchase from a store in Kansas but has the merchandise sent to an address in Ohio, the retailer collects Ohio tax. Conversely, if someone makes a purchase from a store in Ohio but has the merchandise sent to an address in Kansas, the retailer collects Kansas tax. The bad debt credits and refunds are based on the particular state's tax that was actually remitted. Methods have been in place for many years to accurately capture this data.

Q-11. <u>What happens if the customer pays some or all of its account balance after the account is charged off?</u>

A-11. As is the case under current law with respect to credit cards owned by the retailer, whenever there is a recovery of some or all of the charged off amount, this bill would require the retailer to immediately remit to the state the portion of the recovery that pertains to sales tax that was previously refunded.

Q-12. <u>Why should the State be on the hook when retailers issue credit to people who aren't likely to pay their bills?</u>

A-12. Retailers do not issue credit to everyone who walks through the door. To the contrary, retailers and private label credit card companies utilize very strict credit-worthiness standards, in accordance with the Dodd-Frank Act, when issuing credit. However, customers who were credit-worthy at the time their credit cards were issued sometimes have unforeseen circumstances to occur after a credit card was issued (such as loss of job, divorce, illness, death of a spouse, etc.) that prevent them from paying their bills. Retailers and private label credit card issuers have an incentive to be selective when issuing credit—while this bill pertains only to the sales tax associated with bad debts, the retailer is out the entire cost of the merchandise when the customer does not pay their bill.

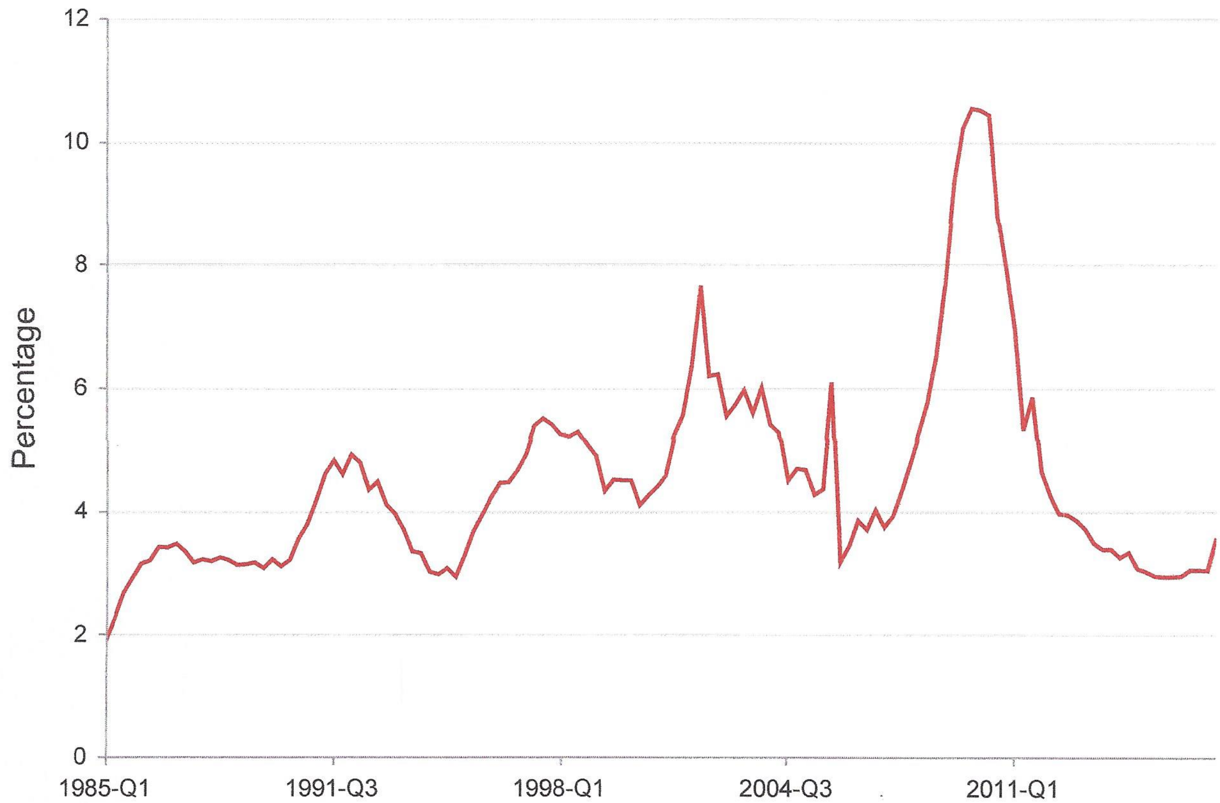
Data Download Program

Chart

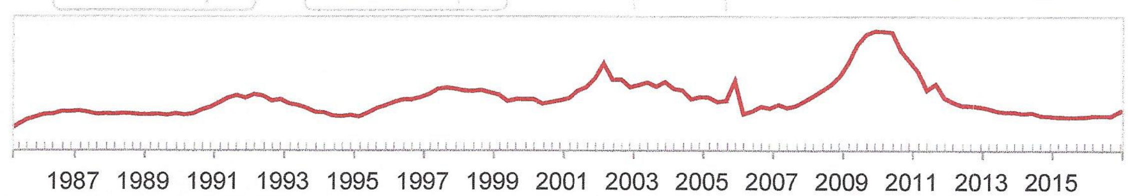
Charge-off and Delinquency Rates - last released Tuesday, February 21, 2017
RSS Help

Preformatted package: Charge-off rates/All banks [csv, All Observations, 197.4 KB]

☐ U.S. Recessions[1] ☐ Log Scale Style Linear Save Image Save PDF



From: 3/31/1985 To: 12/31/2016 1mo 3mo 6mo 1yr max



Legend ☐Show Series Name

Charge-off rate on consumer credit card loans, all banks, seasonally adjusted

TUESDAY, MAY 10, 2016

TESTIMONY OF WILLIAM A. FOX

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IN SUPPORT OF HOUSE BILL 473

Good afternoon Chairman Schaffer, Vice Chairman Scherer, Ranking Member Cera and members of the House Ways & Means Committee.

My name is Bill Fox. I appear before you today to offer support for the provisions of House Bill 473 that deal with the crediting of sales tax on bad debts associated with private label credit cards.

By way of background, I am currently a professor of economics and the Director of the Boyd Center for Business and Economic Research in the Haslam College of Business at The University of Tennessee, Knoxville. My educational roots, however, began in Ohio where I received my undergraduate degree from Miami University and both my Master's and my Ph.D. in Economics from The Ohio State University. I have held appointments as a visiting scholar for the Federal Reserve Bank of Kansas City, as a visiting professor at the University of Hawaii, and as Distinguished Fulbright Chair for American Studies at the University of Frankfurt, Germany. I have also served as a consultant on finance, taxation, and economic development in a number of states (including Ohio) and developing countries. I am a member of the American Economics Association and a past president of the National Tax Association. I recently edited the 2016 book "Sales Taxation" for the Institute for Professionals in Taxation that analyzes a very wide range of sales tax topics.

My goal in speaking with you today is to illustrate why return of sales tax on private label credit card bad debt is proper tax policy. There are four points to be made, which can also be found in the January 2015 policy paper I authored that you should have along with my testimony:

Retained sales tax on bad debt deviates from a tax on paid consumption

The sales tax 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 sales tax, 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 a 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.

Current treatment of bad debt for private label credit cards creates non-neutral taxes since sales tax loaned by the retailer using a company credit card and sales tax loaned by the retailer *and* the financial institution through use of a private label credit card 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 doing 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.

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 year-end 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 previously.

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 cards. 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 on the $93.7 billion in private label credit card charges in 2013 and a 6.5 percent national average state and local sales tax rate. This suggests defaults of $5.6 billion. 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.

Conclusion

Good state sales tax policy allows retailers credits or refunds for sales taxes on the unpaid portion of credit card debt, regardless of how the debt is financed. Such policy permits business procedures to develop and operate most effectively, ensures that state and local tax revenues are more consistent with a tax paid on 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 laws 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. Ohio should follow the Texas example and enact House Bill 473.

Thank you for the opportunity to testify today concerning the merits of House Bill 473. I would happy to answer any questions you may have.