

Legislative Analysis



SALES AND USE TAXES: BAD DEBT DEDUCTION

Mitchell Bean, Director
Phone: (517) 373-8080
<http://www.house.mi.gov/hfa>

House Bills 5096 and 5097
Sponsor: Rep. Steve Bieda
Committee: Tax Policy

Complete to 8-30-07

A SUMMARY OF HOUSE BILLS 5096 AND 5097 AS INTRODUCED 8-8-07

The bills would amend the Use Tax Act and the General Sales Tax Act. Each bill says that its intent is to be curative and be retroactively applied and to express the original intent of the Legislature that a deduction [from the two taxes] for a bad debt for a seller is available exclusively to those persons with legal liability to remit the taxes on the transaction for which the bad debt is recognized for federal income tax purposes. The bills say they intend to correct any misinterpretation of the term "seller" caused by the Michigan Court of Appeals in Daimler Chrysler Services North America LLC v Department of Treasury.

Under both the Use Tax Act and the General Sales Tax Act, firms are allowed a deduction for the amount of bad debt incurred. Generally, bad debt is any debt that has become worthless and uncollectible and is charged off as such on the books and records of the seller. To qualify for the deduction, the bad debt must be eligible to be a deduction for federal income tax purposes under the federal Internal Revenue Code (26 USC 166).

House Bill 5096 would amend the Use Tax Act (MCL 205.99a) to specify that a "seller" for the purpose of the bad debt deduction is a person who has remitted use tax directly to the Department of Treasury on the specific sales, rental, or service transaction for which the bad debt is recognized for federal income tax purposes.

Similarly, House Bill 5097 would amend the General Sales Tax Act (MCL 205.54i) to specify that a "taxpayer" for the purpose of the bad debt deduction is a person who has remitted sales tax directly to the Department of Treasury on the specific retail sales transaction for which the bad debt is recognized for federal income tax purposes.

FISCAL IMPACT:

The Department of Treasury estimates that the *DaimlerChrysler Services North America, LLC v. Department of Treasury* decision has a potential one-time cost of \$93 million, based on refund claims it has received, and projected on-going costs of \$30 million. To the extent the bills reduce refund claims and place further restrictions on the bad debt deduction, the state would realize cost savings on the order of the above cited figures.

BACKGROUND INFORMATION:

At issue in the Michigan Court of Appeals case referenced in the bill was whether DaimlerChrysler Services North America (the finance arm of DaimlerChrysler) could claim a bad debt deduction for sales tax paid for vehicles when the purchasers defaulted on loans DaimlerChrysler provided. In reversing the Michigan Court of Claims, the court of appeals held that DaimlerChrysler was a "taxpayer" under the General Sales Tax Act (including MCL 205.54i) even though it does not remit sales tax to the state for the sales of vehicles it finances. The following paragraphs, describing the financing transaction and the dispute at issue, are taken from the court's decision:

Plaintiff [DaimlerChrysler] financed consumers' purchases of motor vehicles from its affiliated dealers. If a consumer sought to purchase a motor vehicle, plaintiff determined whether it would finance the purchase. If financing was approved, the consumer purchasing the motor vehicle entered into a retail installment sales contract with the dealer, and a security interest in the vehicle was retained by the dealer. Concomitantly, plaintiff had financing agreements with each of the dealers governing their relationship. The financing agreements provided that plaintiff would purchase qualifying contracts from the dealers in exchange for assignment of all the dealer's rights in the contracts. At or near the time of the sales of the vehicles from the dealers to the consumers, the dealers assigned to plaintiff all rights, titles, and interests in qualifying contracts, including the dealers' rights as secured parties. At the same time, plaintiff paid the dealers all amounts due under the contracts, including the sales tax on the full purchase price of each motor vehicle. The dealers then remitted the sales tax revenue to defendant [Department of Treasury]. Plaintiff also assigned the right to repossess the vehicles when consumers defaulted on their contracts. These assignments provided in part: "In return for purchase of this contract, the Dealer sells to Assignee....the entire interest in this contract; and authorizes Assignee to collect and discharge obligations of the Contract and its assignment."

Subsequently, purchasers under several of the installment contracts defaulted. Despite plaintiff's efforts to repossess and resell the vehicles at issue, unpaid balances remained due to plaintiff on some of the contracts. Plaintiff determined that all the contracts that are the subject of this case became worthless and uncollectible. Plaintiff claimed such debts as bad-debt deductions for federal tax purposes. As plaintiff determined that certain contracts assigned to it were uncollectible, it also determined that, because of the bad debt, it had overstated its gross receipts and, therefore, had overpaid state sales taxes in the amounts of \$1,263,528.00 and \$2,554,729.13 on separate occasions. Consequently, plaintiff sought relief under the bad-debt provision by filing claims with defendant in January 1998 and March 2000, using the informal hearing process, and seeking a refund or deduction on its alleged overpayment.

The hearing referee recommended denying the claim, finding that DaimlerChrysler was not the seller of the motor vehicle, and the taxable moment attached when ownership of

the vehicle was transferred from the dealer to the purchaser. Since the seller is obligated to pay sales tax on retail sales, only the seller is entitled to the bad debt deduction. The deduction must be related to a retail sale when ownership transfers from the dealer to the purchaser.

Subsequently, DaimlerChrysler filed a claim with the court of claims. In granting the department's motion for summary disposition, the court held that the DaimlerChrysler was not permitted the bad debt deduction. In the court's view, to be eligible for the deduction, a taxpayer must have bad debt that is related to a sale at retail that is taxable under the act. The financing provided by DaimlerChrysler was not a taxable sale at retail. Moreover, the assignment to DaimlerChrysler of the dealer's rights does not mean DaimlerChrysler is the person subject to the act.

On appeal, however, the Michigan Court of Appeals held that DaimlerChrysler is a "taxpayer" under bad-debt provisions of the General Sales Tax Act. Under the General Sales Tax Act, prior to amendments made by 2004 PA 173, a "taxpayer" was a person subject to tax under the act, with "person" meaning, among other things, an individual, firm, partnership, joint venture, *or any other group or combination acting as a unit*. The court held that dealer and DaimlerChrysler were acting as a unit for the purposes of making automobile sales at retail.

Also, under the act prior to 2004 PA 174, the bad debt must have been "related to a sale at retail." The court further held that the debt was related to a sale at retail: "The sales would not have taken place without the financing plaintiff provided – that the purchasers who defaulted applied to plaintiff for financing is enough proof of this fact; i.e., it would be unreasonable to conclude that purchasers who did not need financing applied for it simply to pay more for the same motor vehicle. Therefore, while plaintiff did not "transfer" the motor vehicles to consumers, it was integral to the "transaction" and, thus, the sale at retail."

The court ruled in favor of DaimlerChrysler, holding that it was entitled to recover overpayment of sales tax under the bad-debt provisions of the General Sales Tax Act. On March 21, 2007, the Michigan Supreme Court issued an order denying the department's application for leave to appeal and, on June 26, 2007, denied the department's motion to reconsider the order of March 21, 2007.

Legislative Analyst: Mark Wolf
Fiscal Analyst: Jim Stansell

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