Interstate Tax INSIGHTS

Caryl Nackenson-Sheiber, Editor-in-Chief

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Be Careful What You Wish For—Illinois Wins What May Be Hollow Victory in Unitary Business Case

BRIAN L. BROWDY

In what may prove to be a fleeting victory for tax officials in Illinois, a federal appeals court recently blocked an Illinois taxpayer from including its steel manufacturing subsidiary—and its net operating losses—in the same unitary business group as its food packaging subsidiary because there was no functional integration between the companies in their two divergent lines of business.[1] But, in so doing, the court flatly repudiated the very unitary position that the tax agency has itself long embraced—that corporate affiliates form a single unitary business if there is common management by the parent company, even if there is no operational link between the affiliates themselves.

ENVIRODYNE'S MANAGEMENT OF WISCONSIN STEEL

Acquisition and Centralization

In August 1977, Envirodyne Industries acquired the assets of Wisconsin Steel. George Sealy and Ronald Linde served as directors for both companies and helped recruit a new management team for Wisconsin Steel. Envirodyne oversaw all major personnel decisions for Wisconsin Steel, hand-picked its officers and directors, and participated in interviews for new hires.

Envirodyne handled Wisconsin Steel's tax returns, assisted the company in obtaining financing, and provided it with free insurance coverage. The companies used the same legal and accounting firms, shared office space, and Envirodyne pro-

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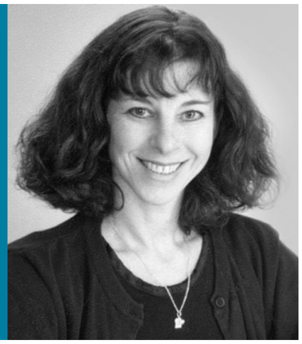
From the Editor



Welcome to Volume 4, Number 3 of *Interstate Tax Insights,* which reports on a significant unitary development in Illinois and offers a comprehensive analysis of how and whether the bad debt deduction applies to financial institutions. Brian Browdy examines a recent decision of the 7th Circuit Court of Appeals in which the Illinois Department of Revenue was successful in denying a taxpayer the right to file a combined return with a diverse subsidiary, thus preventing the taxpayer from taking advantage of its subsidiary's net operating losses. Mr. Browdy points out that the Department's insistence on genuine operational integration between the companies as evidence of unity in this case was a departure from its long-held view that only common management was required, and offers predictions on the future of unitary combination in Illinois. Elaine Bialczak looks at the dilemma sometimes presented to financial institutions after they've purchased installment contracts or credit card debts—whether they can seek refunds for sales taxes previously paid on such accounts if the customer defaults. The author surveys the states that have visited this issue and finds no consistency in their conclusions.

Listed on page 12 are the dates and locations for our Fall 2004 conference series, the brochure for which has been enclosed with this issue. If you have any questions, please do not hesitate to call us at (203) 854-0704. Until next time. . .

Caryl Nackenson-Sheiber
Editor-in-Chief

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vided office services and utilities at no cost. Envirodyne's officers set compensation for Wisconsin Steel's new management team; its CFO oversaw Wisconsin Steel's accounts, conducted internal audits, and oversaw and approved the company's budget and all significant purchasing decisions.

Envirodyne and Wisconsin Steel did not engage in joint marketing or joint advertising, nor did they have a coordinated procurement system. However, George Sealy, who was also Envirodyne's president, provided marketing services for Wisconsin Steel. Envirodyne reviewed wastewater management programs for Wisconsin Steel, and other Envirodyne subsidiaries provided Wisconsin Steel with a variety of consulting and technology services.

Bankruptcy

In March 1980, Maxine Linde, an Envirodyne director and officer, made the final decision to file a Chapter 11 bankruptcy petition for Wisconsin Steel. Linde provided Wisconsin Steel with bankruptcy consulting services and chose the company's bankruptcy counsel. Envirodyne provided the company with legal and consulting services in connection with creditor litigation. Envirodyne funded Wisconsin Steel's bankruptcy plan, and Envirodyne's general counsel, who was also a Wisconsin Steel director, handled the negotiation and implementation of Wisconsin Steel's bankruptcy reorganization.

THE DISTRICT COURT OPINION

Unitary Business Found

For anyone who has ever experienced a unitary examination by the Illinois Department of Revenue, or anyone who is even vaguely familiar with the body of unitary case law in Illinois, Envirodyne and Wisconsin Steel would appear to be the poster children for the unitary business law. Indeed, the District Court had little difficulty in concluding that the steel processing subsidiary was properly included in Envirodyne's unitary group.

Illinois Statute

The Illinois Income Tax Act provides in relevant part:

> "The term 'unitary business group' means a group of persons related through common ownership whose business activities are integrated with, dependent upon, and contribute to each other. * * * Unitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources, which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management

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1. *In re: Envirodyne Industries, Inc.,* 354 F.3d 646 (7th Cir., January 6, 2004), reversing, *Illinois Department of Revenue v. Envirodyne Industries, Inc.,* 2002 U.S. Dist. LEXIS 2403 (N.D. Ill., February 13, 2002).

(where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member)."[2]

The District Court found that the relationship between Envirodyne and Wisconsin Steel fit this description. In making this determination, the District Court invoked two cases where the Appellate Court of Illinois endorsed the argument—advanced by the Department of Revenue—that corporate affiliates form a single unitary business when the affiliates are under common parent company management, even when there are few or no functional links between the affiliates themselves.

Borden

The District Court first cited the Appellate Court's opinion in *Borden, Inc. v. Department of Revenue.*[3] There, the court held that Borden, a food products maker, was engaged in a unitary business with three of its Pepsi-Cola bottling subsidiaries. The appellate court found that there was "functional integration" between the parent and these subsidiaries because: Borden prepared tax returns for the subsidiaries, approved their operating budgets and capital expenditures, appointed their officers, and provided tax and accounting services at cost or no charge; Borden's auditors monitored the subsidiaries' activities and accounting procedures; and the companies filed consolidated financial reports and participated in a centralized cash management system.[4]

A.B. Dick

The District Court next cited *A.B. Dick Company v. McGraw,*[5] where the Appellate Court ruled over the Department's objection that A.B. Dick, an office equipment manufacturer, was engaged in a unitary business with its printing equipment subsidiary, Videojet, which had been spun off from A.B. Dick in 1985. The Department argued that A.B. Dick and Videojet were nonunitary—although, significantly, not because there was no functional integration between Videojet and A.B. Dick's other subsidiary, A.B. Dick Acceptance, which the Department conceded was unitary with its parent, but rather because the parent did not exercise managerial control over Videojet itself.[6] The Department made this argument in spite of the fact that Videojet had once been an integral part, and under the centralized management of, A.B. Dick before the parent carved it into a separate corporation.

The appellate court found that A.B. Dick had exerted sufficient managerial control over Videojet after the spin-off to be considered unitary because A.B. Dick's officers were actively involved in Videojet; A.B. Dick provided funding for Videojet acquisitions, approved Videojet's tax filings, maintained strict oversight over Videojet's accounting, and reviewed and approved all purchase requests over $500; A.B. Dick controlled the salaries of Videojet personnel; and A.B. Dick had final authority over the introduction and pricing of new Videojet products.[7]

Application to Envirodyne

The District Court found that Envirodyne's "centralized control" over Wisconsin Steel was closely analogous to these two cases. Specifically, the court found that Envirodyne recruited, engaged, and appointed Wisconsin Steel's officers and directors, assisted the subsidiary in obtaining financing, handled its tax returns, and provided accounting oversight and assistance. In addition, Envirodyne's officers were responsible for negotiating and forming the subsidiary's reorganization plan, and for recording and keeping the subsidiary's board minutes.[8]

Department Argument

In a departure from Department orthodoxy—namely, that centralized management is the hallmark of unity—the agency argued in the alternative that the unitary business test should be applied more narrowly. In other words, notwithstanding Envirodyne's "centralized control" over Wisconsin Steel, Wisconsin Steel could be a part of Envirodyne's unitary business only if there was some functional or operational interdependence between the steel processing company and Envirodyne's food packaging and service subsidiary.[9]

Comment

This reading of the unitary business law represented a departure from the "transitive theory" of unity that the Department itself has long advanced. This theory holds that if Company A has a unitary relationship with Company B, and Company B has a unitary relationship with Company C, then the

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2. 35 ILCS 5/1501(a)(27).
3. 295 Ill. App. 3d 1001, 692 N.E.2d 1335 (1st Dist. 1998).
4. 295 Ill. App. 3d at 1006-1007.
5. 287 Ill. App. 3d 230, 678 N.E.2d 1100 (4th Dist. 1997).
6. 287 Ill. App. 3d at 236-37.
7. 287 Ill. App. 3d at 236.
8. 2002 U.S. Dist. LEXIS at **10-11.
9. 2002 U.S. Dist. LEXIS at **18-19.

three companies are all engaged in a single unitary business. Under this view, centralized management by a common parent is the hallmark of unity, even though there may be few, if any, functional links between the subsidiary group members. Thus, for example, as the Department successfully argued in *Borden,* the three Pepsi-Cola bottling subsidiaries could be engaged in a single unitary business with their parent, even though there was no functional or operational link between the bottlers themselves.

Argument Rejected

The District Court rejected the Department's argument. The court found that the "key requirement" under the unitary business statute is simply that a parent company has actual, centralized, managerial control over its subsidiaries, and citing the "unitary business" definition in the Department of Revenue's own regulation, rejected the notion that there must be an interrelationship between "every entity in the business group."

The pertinent regulation provides that commonly-owned companies are engaged in a unitary business "when the trade or business activities of each of the other persons are integrated with, dependent upon, or contribute to the activities of *one or more* of the other persons."[10] In view of this regulation, the District Court reasoned that there was no basis for concluding, as the Department urged, that Wisconsin Steel could be included in Envirodyne's unitary group only if the steel processing company was functionally integrated with Envirodyne's food packaging subsidiary.

COURT OF APPEALS REVERSES

"Genuine" Functional Integration Required

The U.S. Court of Appeals for the Seventh Circuit reversed, flatly rejecting Envirodyne's view—a view long embraced by the *Department's own* audit and legal staffs—that corporate affiliates are made unitary by common parent company management, regardless of whether there is any functional or operational connection between the affiliates themselves. The Circuit Court observed that Illinois law requires would-be unitary affiliates to depend on and contribute to *each other,* and declared that "[i]t cannot be enough that each depends on and contributes to its parent."[11]

Central Office Functions Insufficient

The court acknowledged that the law does not require a transfer of goods between affiliates for the affiliates to be unitary, but found, as the Department itself urged, that there still must be *some* functional link between the companies if they are to be included in the same unitary business group:

> "[T]here has to be *some* integration beyond the bare minimum of central-office functions shared by virtue of the affiliates' having a common parent that has decided to file consolidated tax returns and, as a corollary of that decision, to perform the legal and accounting services required for the preparation of those returns."[12]

The court found that there was no such connection between Envirodyne's steel processing and food packaging subsidiaries, and refused to accept that Envirodyne should be allowed to include Wisconsin Steel—and its net operating losses generated outside the state—in the same unitary group as the food packaging subsidiary, simply because Envirodyne's officers and directors actively participated in Wisconsin Steel's management.[13]

The Department's Change of Heart—Principle or Opportunism?

In witnessing the Department demanding horizontal integration between would-be unitary affiliates, observers question whether the agency would have focused so keenly on the total lack of functional integration between Wisconsin Steel and its sister company, Envirodyne's food packaging subsidiary, if Wisconsin Steel had out-of-state profits, and not losses for the years at issue. Indeed, although perhaps not in so many words, the Circuit Court indulged in similar speculation:

> "Illinois may be shortsighted in urging a construction of 'unitary business group' that requires genuine integration, for that will make it harder for the state to reach out and tax income of affiliates of Illinois firms in other states. But that is a tactical decision for the state to make; it has no bearing on our interpretation and application of the statute."[14]

Old View Discredited

In any event, in accepting the Department's call

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10. Ill. Admin. Code tit. 86, § 100.3010(c)(1) (emphasis original in court's opinion).
11. 354 F.3d at 649.
12. 354 F.3d at 650.
13. 354 F.3d at 651.
14. 354 F.3d at 649.

How Sales Taxes Make Bad Debts Better—or Worse

J. ELAINE BIALCZAK

Installment and credit card sales are woven into the fabric of business, as is the purchase of the installment contracts and credit card debt by financial institutions. Typically, states require that all sales taxes on such sales be paid immediately, even though the customer will be paying for the item over a period of time. The seller obtains the funds for the sales tax either from the purchaser or from the financial institution that buys the contract, which pays the seller the balance due on the installment contract and any uncollected sales tax. When the financial institution purchases the agreement, the seller assigns all rights associated with the agreement and, when the assignment is "nonrecourse," all the responsibilities. This arrangement works if the customer continues to make the payments. If the customer defaults, however, the financial institution faces the loss of payments for both the cost of the item and the associated sales taxes. With a nonrecourse assignment, the financial institution may not turn to the seller for relief. While the financial institution may take a "bad debt" deduction for federal income tax purposes when all collection attempts have failed, it might not be able to do so for state sales tax purposes. This article examines the various state positions concerning financial institutions and the availability of sales tax bad debt credits or refunds.

The Right to a Refund

A common law rule accepted in many states provides that taxes paid voluntarily under a mistake of law are not refundable unless a refund is authorized by statute.[1] Generally, states subscribing to this rule have recognized a right to a refund of taxes paid under a mistake of fact (for example, a clerical error).[2] The right to a tax refund when taxes are paid erroneously under a mistake of law exists only through legislative largess. When the right to a refund or credit rests in a statute rather than common law, courts are prone to interpret such statutes strictly. This means that all the statutory requirements must be met specifically, and courts will hesitate to broaden any rights defined in these statutes.

REFUNDS OR CREDITS DENIED

The state decisions denying bad debt refunds or credits to financial institutions reflect this strict interpretation of statutorily created rights. Two main arguments characterize the financial institutions' positions. The first is that, as assignees, they acquired the vendor's right to the refund or credit when they acquired the vendor's contractual rights. The second, when the statutory definitions allow it, is that the financial institution qualifies as a retailer because a "retailer" is defined as a "person," and the definition of a "person" includes an assignee.

Specific Principles Prevail

The states rejecting the "assignment of all rights" argument have done so on three grounds. The first is that the specific principles of tax law should prevail over the general principles of assignment law. This is an expression of the traditional rule of statutory construction that a specific provision of law controls over a general provision of law.[3] Included within this ground is the principle that statutes granting tax exemptions are construed strictly against the taxpayer. (Refund and exemption statutes, viewed by the states as giving taxpayers a tax "break," are similarly strictly construed.) Applying these principles, the courts conclude that the financial institutions do not acquire the rights of the "dealer," "vendor" or "retailer" pursuant to the assignment because the tax provisions themselves do not provide for the assignment of tax refund claims, or the bad debt provision limits the ability to obtain a refund or credit specifically to the "dealer," "vendor" or "retailer." Because the tax provisions are considered "specific," and the assignment provisions "gen-

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1. *Atkins v. Dept. of Rev.,* 894 P.2d 449, 452 (Or. 1995); *Rutherford v. Barnes,* 847 S.W.2d 689, 691 (Ark. 1993); *Lingscheit v. Cascade County, et al.,* 817 P.2d 682, 689 (Mont. 1991); *First Bank of Deer Park v. Harris County, et al.,* 804 S.W. 2d 588, 593 (Tex. App. 1991).
2. *First Bank of Deer Park, supra.*
3. 73 Am. Jur. 2d Statutes §§ 135 and 170.

eral," the tax provisions prevail, thereby denying the financial institution the refund or credit.[4]

North Carolina, Georgia and Texas

In North Carolina, the assignment argument failed because the state has an anti-assignment statute barring the assignment of a claim against the state to a third party.[5] Georgia, on the other hand, has a statute specifically allowing bad debt deductions to assignees of credit card debt that use the accrual method of accounting.[6] However, the Georgia Court of Appeals did not allow an assignee of automobile debt to take the deduction, asserting that the legislature's specific provision of a bad debt deduction for assignees of credit card bad debt impliedly denied the deduction to others.[7] Presumably, if a purchaser charged the purchase of an automobile to a credit card, the assignee of the debt would be allowed a bad debt deduction if the purchaser defaulted. Texas, too, treats motor vehicle bad debt differently from other credit bad debt. A Texas regulation provides that if the dealer transfers its right to receive payment, the dealer must report in, and pay the total tax with, the return for the period in which the right is transferred, whether the transfer is with or without recourse. The regulation also provides that the assignee may not take a bad debt deduction against any motor vehicle sales tax for any amount that the assignee determines is uncollectible.[8] Another regulation allows assignees of other kinds of credit debt a bad debt credit or refund.[9]

Strict Construction

Further, applying a strict construction of the bad debt provisions results in the denial of a financial institution's claim to a refund because the institution was not the "dealer," "vendor" or "retailer."[10] Even registering as a retailer does not guarantee the financial institution a bad debt deduction. In Kansas, for example, the state supreme court turned down Ford Motor Credit Company's petition for a bad debt refund, even though the credit company was a retailer of repossessed vehicles, because it was not the retailer that collected and remitted the sales tax in question. According to the court, the definition of retailer was not broad enough to include a retailer's assignee, and the court was unwilling to expand the definition.[11] The Kentucky Board of Tax Appeals also strictly read and applied the Kentucky bad debt statute, concluding that only a retailer who paid the tax was entitled to a bad debt deduction under the "plain and unambiguous statutory language."[12] Because the statutory definition of "retailer" did not include assignees, the finance company could not qualify as a retailer and was not entitled to the deduction.

Maine

The Maine Supreme Judicial Court analyzed its state bad debt credit statute in great detail to justify its denial of the credit to Daimler Chrysler. The statute provided that sales tax paid on worthless accounts "may be credited against the tax due on a subsequent report filed within 3 years of the charge-off …."[13] The court observed that the words of the statute demonstrated that the credit was limited to retailers. First, the statute provided only for a credit, and only retailers were in a position to take a credit because they were the ones who made the sales, collected and reported taxes monthly, and had tax liabilities against which a credit could be taken. Second, the statute limited relief to a credit taken "on a subsequent report." Only retailers could file a "subsequent report," and only a retailer who filed an initial report showing payment of the sales tax could take a credit for this tax on a subsequent report. Third, the statute used the term "retailer" in one clause and thereafter used passive voice. Because the only actor mentioned in the statute was the retailer, a logical conclusion, according to the court, was that the legislature intended the retailer to be the actor for all of the

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4. *SunTrust Bank, Nashville v. Johnson,* 46 S.W.2d 216, 226-227 (Tenn. App. 2000); *Daimler Chrysler Services North America, LLC v. Comm'r,* 2003 Conn. Super. LEXIS 3601, *14 (Conn. Super. December 31, 2003); *Daimler Chrysler Services North America, LLC v. Tax Assessor,* 817 A.2d 862, 866 (Me. 2003), *General Electric Capital Corporation v. New York State Div. of Tax App., et al.,* 754 N.Y.S. 2d 84, 86 (A.D., 3rd Dept. 2003), *affirmed,* N.Y. Ct. App., No. 35 (April 1, 2004).
5. N.C. Gen. Stat. § 143-3.3; *Secretary of Revenue Decision,* No. 2001-276, N.C. Dept. of Revenue, 2002 N.C. Tax LEXIS 10 (February 28, 2002).
6. Ga. Code Ann. § 48-8-45(c) (2003).
7. *General Motors Acceptance Corp. v. Jackson,* 542 S.E.2d 538, 541 (Ga. App. 2000).
8. 34 Tex. Admin. Code § 3.74(e)(4) and (5) (2004).
9. 34 Tex. Admin. Code § 3.302(d)(1)(C) (2004).
10. *Daimler Chrysler Services North America, LLC v. Comm'r,* 2003 Conn. Super. LEXIS 3601, *8 (Conn. Super. December 31, 2003); *Dept. of Rev. v. Bank of America,* 752 So.2d 637, 638 (Fla. App. 2000); *General Motors Acceptance Corp. v. Jackson,* 542 S.E.2d 538, 541 (Ga. App. 2000); *Daimler Chrysler Services North America, LLC v. State Tax Assessor,* 817 A.2d 862, 865-866 (Me. 2003); *SunTrust Bank, Nashville v. Johnson,* 46 S.W.3d 216, 225 (Tenn. App. 2000); *Hollingsworth v. Johnson,* 2003 Tenn. App. LEXIS 799, **13-14 (Tenn. App. November 12, 2003).
11. *Matter of Ford Motor Credit Company,* 69 P.3d 612, 621 (Kan. 2003).
12. *Conseco Finance Corp. v. Revenue Cabinet,* Ky. B.TA., 2003 Ky. Tax LEXIS 179, *5, *Wells Fargo Financial Kentucky, Inc. v. Revenue Cabinet,* Ky. B.TA., 2003 Ky. Tax LEXIS 180, *5 (October 30, 2003).
13. Me. Rev. Stat. Ann., tit. 36, § 1811-A (2003).

verbs. Consequently, only the retailer who made the sale would be entitled to the credit.[14] This judge was well versed not only in rules of statutory interpretation, but also in rules of composition.

No Specific Assignment in Contract

The second ground for denial is that the contract did not specifically assign the right to a refund, only the rights to receive payment, repossess the property and sue the purchaser for any unpaid balance due.[15] The Tennessee Court of Appeals concluded that the right to a bad debt credit was not assigned even when the agreement provided that the dealer transferred all of its "right, title, interest and remedies" under the contract, and the dealer authorized the bank "to do every act and thing … advisable to enforce the terms of said contract."[16] This ground has never been the sole reason for denying the financial institution a credit or refund.

Right to Refund Did Not Exist at Transfer

The third ground for denial is that because the right to the refund did not exist at the time of the assignment, the dealer could not assign a right it did not possess. The Maine Supreme Judicial Court concluded that an assignment giving Daimler Chrysler the rights "in and to this contract" did not transfer the statutory right to a potential tax credit because, so far as the court was concerned, this was not a right "in and to this contract."[17] The Florida Court of Appeals pointed out that not only does the dealer <u>not</u> possess the right to a refund at the time of the assignment, but also, if the purchaser defaults after the assignment, the dealer, having assigned all its rights, cannot comply with Florida's statutory requirement that the dealer must retain a security interest in the underlying property.[18]

Qualifying As A Person Does Not Mean Qualifying As A Retailer

States also have rejected the financial institutions' second argument that a retailer is a person, and a person is an assignee. This argument arises from a particular state's statutory definitions of "retailer" or "vendor" and "person." Chrysler Financial Company argued in Ohio that it was entitled to a refund of sales tax on bad debts because it qualified as a "vendor." The statute defined "vendor" as "the person providing the service or by whom the transfer effected or license given by a sale is or is to be made or given …."[19] "Person" was further defined to include assignees.[20] The Ohio Board of Tax Appeals rejected this argument. An assignee might be a person, but every person does not qualify as a vendor. A vendor must be a person who effects a sale, and Chrysler did not effect the sales of the vehicles underlying the uncollectible debts.[21] Chrysler's argument, while initially appealing, ignored the remaining qualifiers in the statute. Daimler Chrysler encountered the same response to this argument from the Maine Supreme Judicial Court. While the Maine statutes defined "retailer" as a "person," and "person" to include an "assignee," the statute further stated that a retailer was one who makes retail sales.[22] Because Daimler Chrysler did not make retail sales, it could not qualify as a retailer.[23] Not all state statutes include "assignee" in the definition of "person"; Iowa does not, and this was one reason that GE Capital Corporation failed to obtain a bad debt sales tax refund in Iowa.[24]

New York

GE Capital also failed to obtain a bad debt sales tax refund in New York.[25] The New York tax law defined "vendor" as: "[a] person making sales of tangible personal property or services, the receipts from which are taxed by this article."[26] GE Capital was not the vendor with respect to the transactions that underlay the bad debts. This was one of the reasons, among others, used by the Tax Appeals Tribunal to deny GE Capital's request for a refund. Another was that a New York regulation specifically

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14. *Daimler Chrysler Services North America, LLC v. State Tax Assessor,* 817 A.2d 862, 865 (Me. 2003).
15. *See, e.g.,* Ala. Dept. of Rev., Admin. Law Div., Nos. S. 01-479, 01-510, 01-426, 2002 Ala. Tax LEXIS 53 (September 17, 2002).
16. *SunTrust Bank, Nashville v. Johnson,* 46 S.W.3d 216, 226 (Tenn. App. 2000). Tennessee has a regulation that denies the bad debt deduction to banks and other financial institutions. Tenn. Comp. R. & Regs. R. 1320-5-1-.52(2) (2003).
17. *Daimler Chrysler Services North America, LLC v. State Tax Assessor,* 817 A.2d 862, 866 (Me. 2003).
18. *Dept. of Rev. v. Bank of America,* 752 So.2d 637, 642 (Fla. App. 2000).
19. Ohio Rev. Code Ann. § 5739.01(C) (2003).
20. Ohio Rev. Code Ann. § 5739.01(A) (2003).
21. *Chrysler Financial Company, L.L.C. v. Zaino,* Ohio B.T.A., 2003 Ohio Tax LEXIS 24, **7-8 (January 3, 2003).
22. Me. Rev. Stat. Ann., tit. 36, §§ 1752(9) and (10) (2003).
23. *Daimler Chrysler Services North America, LLC v. State Tax Assessor,* 817 A.2d 862, 866-867 (Me. 2003).
24. *Re: General Electric Capital Corporation,* Iowa Dept. of Rev. and Fin., No. 01-30-2-0039, 2002 Iowa Tax LEXIS 8 (February 22, 2002).
25. *General Electric Capital Corporation v. New York State Div. of Tax App., et al.,* 754 N.Y.S. 2d 84, 86 (A.D., 3rd Dept. 2003), *affirmed,* N.Y. Ct. App., No. 35 (April 1, 2004).
26. N.Y. Tax Law § 1101(b)(8) (2003). The definition of "person" includes an assignee. N.Y. Tax Law § 1101(a) (2003).

denied refunds or credits for debts financed by third parties or assigned to third parties with or without recourse.[27] The tribunal employed an interesting analysis of New York sales tax law to find yet another reason for denying GE Capital the refund. According to the tribunal, a vendor could never turn an uncollectible receipt into an assignable right to a refund. Once a vendor remits tax to the state, it discharges its obligations as the state's trustee for sales tax collection purposes. Further, a vendor who assigns a credit account to a third party receives full payment at the time of the assignment, thereby removing its claim to a refund if that debt later becomes uncollectible.[28] A right to a refund under these circumstances, then, cannot be assigned because it does not exist in the first place.

Two Exceptions

The regulation establishes two exceptions concerning assigned debt. The first is that vendors who take assignments from leased departments will qualify as vendors for purposes of the bad debt deduction with respect to sales made by the leased departments or concessions. This exception has three requirements: the leased department must account for and remit all of its receipts to the lessor-vendor; the lessor-vendor must file the return and remit to the state the tax on all of the leased department's receipts; and the leased department must transfer its receivables to the lessor-vendor without any discount for any credit transactions involving the lessor-vendor's receivables and without recourse to the leased department.[29]

The second regulatory exception is that receivables transferred by a retailer-vendor to its captive finance company will not be treated as assignments to a third-party. The captive finance company must have recourse to the transferor, and no more than ten percent of the retailer-vendor's receivables may be derived from sales by other vendors other than the leased department and concessions described in the first exception.[30]

Alabama

An Alabama administrative law judge employed an analysis of Alabama law that was similar to the New York Tax Tribunal's analysis of New York law.[31] The judge observed that the statute authorized refunds only if a tax had been overpaid or erroneously paid. In the case of debt assigned to a financial institution by a retailer, the tax was not erroneously paid because the retailer had made retail sales, collected the associated gross proceeds and remitted the tax according to the law, which requires that sales tax be remitted on gross proceeds of credit sales when the proceeds are collected. That the retailer collected the proceeds from the financial institutions and not the purchasers was irrelevant. Because the taxes were paid correctly, the retailers were not entitled to a refund, and even if the retailers had assigned their rights to a refund, no refunds were due.[32] The judge also observed that the bad debt regulation was "superfluous."[33] Alabama law does not obligate a retailer to remit tax until it has collected the gross proceeds of the sale. Any retailer who remits sales tax on credit sales before collecting the gross proceeds has remitted the tax erroneously and is due a refund under the general refund provision. A bad debt deduction is logical only when a state requires prepayment of the sales tax on a credit sale, which Alabama does not.

Effect of Regulations

Both the New York Tax Appeals Tribunal and the Alabama administrative law judge also denied the financial institutions' request for refunds because the regulations disallowed deductions for debts assigned to third parties. The New York regulation states that: "[a] refund or credit is not available for a transaction which is financed by a third party or for a debt which has been assigned to a third party, whether or not such third party has recourse to the vendor on that debt."[34] The Alabama regulation excludes from "bad debt" those "debts sold or assigned to third parties."[35] Another equally viable reading of these provisions is that they merely clarify that vendors may not take the deductions for debts they no longer own but do not comment on the rights of third-party assignees.

REFUNDS OR CREDITS ALLOWED

Not all states have applied their laws as strictly as those discussed above. Five states in the group allowing a bad deduction to financial institutions are: California, Indiana, Nevada, Virginia and Washington.

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27. 20 NYCRR § 534.7(b)(3) (2004).
28. *Matter of General Electric Capital Corporation,* N.Y. Div. Tax App., Tax App. Tribunal, 2001 N.Y. Tax LEXIS 325, **25-26 (December 27, 2001).
29. 20 NYCRR § 534.7(b)(2) (2004).
30. 20 NYCRR § 533.7(b)(4) (2004).
31. Ala. Dept. of Rev., Admin. Law Div., Nos. S. 01-479, 01-510, 01-426, 2002 Ala. Tax LEXIS 53 (September 17, 2002).
32. 2002 Ala. Tax LEXIS 53 at *7.
33. 2002 Ala. Tax LEXIS 53 at *12.
34. 20 NYCRR § 534.7(b)(3) (2004).
35. Ala. Admin. Code r. 810-6-4.01(1) (2003).

California

The California State Board of Equalization allowed WFS Financial to take a bad debt deduction pursuant to the California bad debt rule. The rule at the time provided that successors paying full consideration for receivables were entitled to the bad debt deduction to the same extent as the seller, had the seller continued the business. The board decided that the financial services company qualified as a successor because it met three conditions. First, its representatives were either at the dealers' locations or immediately available at the time of the sale. Second, the financial institution paid full consideration (not at a discount) to the dealers for the receivables. Third, the dealers assigned the receivables substantially at the same time as the dealers executed the sales agreements with their customers.[36]

Amendments

After this decision, the rule was amended to limit a "successor" to a person required to withhold from the purchase price of the business enough to cover any sales taxes the business might owe.[37] The current regulation has a specific provision concerning a lender's right to a bad debt deduction. The deduction is subject to five conditions: 1) a deduction or refund previously has not been claimed or allowed on any portion of the account; 2) the account is worthless and has been charged off for income tax purposes; 3) the retailer has relinquished all its rights in the account irrevocably; 4) the sale for which the deduction is being claimed occurred after January 1, 2000; and 5) the retailer and the lender have filed an election with the board designating which one is entitled to the deduction.[38]

Indiana

Chrysler Financial Company's loss in Ohio was balanced by its victory in Indiana. The Indiana Tax Court accepted both the proposition that retailers were entitled to assign their rights to a deduction pursuant to the common law of assignment and that Chrysler "stood in the shoes" of the retailers. While the Indiana legislature had forbidden assignments expressly in such instances as claims for worker's compensation and permits to collect prepayment of motor fuel tax, it had not forbidden assignments of rights to a tax deduction. This indicated to the court that the legislature had not intended to derogate the common law of assignment with respect to tax deductions.[39]

Nevada and Virginia

The Nevada Attorney General also concluded that financial institutions registered as retailers with the state were entitled as assignees to take bad debt sales tax credits. According to the attorney general, the statutes defined a "retailer" as a "seller," a "seller" as a "person," and a "person" to include an assignee.[40] This, as well as the law of assignments, justified allowing financial institutions the credit. The Virginia Department of Taxation decided that an assignee was entitled to take the bad debt credit, but only if the assignee was a registered Virginia dealer and only in proportion to the percentage paid for the receivable.[41]

Washington

Probably the best-known decision regarding this issue is that of the Washington Supreme Court in 1994, *Puget Sound National Bank v. Department of Revenue*.[42] The court concluded that the bank acquired the tax attribute of "seller" when it accepted assignments of installment contracts from automobile dealers. In addition, the statutes did not prohibit the assignment of sales tax refunds; on the contrary, they included "assignee" in the definition of "person," and "person" in the definition of "seller." The court observed that permitting the assignment of tax refund claims furthered the important policy of ensuring the free exchange of commercial paper.[43]

Interestingly, when presented with the opportunity, the Washington Department of Revenue Appeals Division did not apply *Puget Sound* to bad debt credits for business and occupation tax. The department reasoned that the amount financed included the sales tax, which was the buyer's obligation, but not the business and occupation tax, which was the retailer's obligation, and therefore, the business and occupation tax was not included in the assignment to the financing company. The buyer's obligations could be assigned, but not the retailer's. Therefore, according to the department, the bad debt credit is available only to the entity upon which the tax is imposed for purposes of the business and occupation tax.[44]

[cont'd on p.10]

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36. *Matter of WFS Financial, Inc.,* Calif. S.B.E., Cal. Tax. Rep. (CCH) ¶ 403-140 (December 14, 2000).
37. 18 CCR § 1642(h)(1)(A) (2004).
38. 18 CCR § 1642(i)(2) (2004).
39. *Chrysler Financial Co., LLC v. Dept. of State Rev.,* 761 N.E.2d 909, 913 (Ind. Tax 2002).
40. *Opinion of the Attorney General,* No. AGO 2000-08, 2000 Nev. AG LEXIS 8, *6 (February 7, 2000).
41. *Ruling of Commissioner,* P.D. 99-37, 1999 Va. Tax LEXIS 35 (March 30, 1999).
42. 868 P.2d 127 (Wash. 1994).
43. 868 P.2d at 131-132.
44. Wash. Dep't of Rev. App. Div., No. 01-076, 2001 Wash. Tax LEXIS 248 (May 31, 2001).

FOUR STATES ON THE FENCE

Courts in three states, Maryland, Michigan and South Carolina, have issued decisions, one nearly a century ago, that are unclear as to the states' positions concerning assignments of claims for refund. A fourth state, Illinois, has decisions going in both directions, one denying such claims and one awarding them.

Maryland

In 1993, the Maryland Court of Appeals reviewed the assignment situation from the vendor's perspective.[45] Chesapeake Industrial Leasing Company leased office and industrial equipment. The company determined the creditworthiness of a customer seeking a lease of equipment, purchased and took title to the equipment, and then sold the lease to a financial institution. Some of the assignments were recourse transactions; some were non-recourse. The comptroller issued an assessment against Chesapeake for unpaid sales taxes, and Chesapeake argued that it was not required to remit the assessed tax because the lessees had defaulted on their rent and sales tax payments.

Chesapeake also argued that it did not owe the tax because it no longer was the vendor, having assigned this status, along with the lease, to the bank. The court rejected this argument, stating that a vendor's duty to collect and remit taxes to the state is absolute and may not be assigned to a third party. Permitting such an assignment would defeat the purpose of imposing this absolute liability on the vendor, which was to ensure the state's receipt of sales tax revenues.[46]

The court did allow Chesapeake a set-off for sales taxes on the defaulted leases assigned with recourse because Chesapeake could write off the uncollected receivables as bad debts on its federal tax return. The company, however, was not permitted an offset for sales taxes associated with bad debts arising from non-recourse assignments. Chesapeake argued that it should be entitled to this offset as well because, otherwise, the state would reap an unfair windfall. The court postponed answering this question to another time because Chesapeake did not prove that the bank actually had taken the write-off.[47] Who is entitled to the bad debt deduction in this instance remains unanswered in Maryland.

Something Old, Something New In Michigan

Over one hundred years ago, a group of Michigan taxpayers paid their property taxes under protest and assigned their right to sue the township for a refund to a firm that was not a taxpayer. The township challenged the subsequent suit filed by the firm, arguing that only a person who paid under protest was permitted to sue for a refund. The statute provided that the person paying under protest had the right to sue the township for refund within thirty days. The Michigan Supreme Court held that the statute did not limit "in any way action for the recovery of money thus paid under protest to the person actually assessed or actually paying the money, nor [did] it [interfere] with or [limit] the operation of the general statute regulating the assignment of rights of action and suits by assignees thereof."[48]

More recently, in 2002, Ultimate Outlet sought a bad debt deduction against its Michigan sales taxes for credit card debt that it had assigned to an affiliate, First Consumers National Bank. Ultimate Outlet, along with other retail establishments, and First Consumers were subsidiaries of Spiegel Holdings, which filed a consolidated federal tax return including all of these entities. Each retail entity assigned its credit card debt to First Consumers, and after this assignment, which subsidiary generated a bad debt was not determinable, because all the retail entities used the same private credit card, and the assigned debt became commingled. Further, First Consumers did not charge back a bad debt to the retailer. The bad debt that Ultimate Outlet sought to deduct represented a percentage of the group's bad debt shown on the consolidated return. The Michigan Tax Tribunal concluded that Ultimate Outlet could not take this deduction because it had not incurred any bad debt expense; First Consumers might have been able to write off the account as uncollectible for federal tax purposes, but Ultimate Outlet could not. The tribunal stated: "For a taxpayer to deduct bad debts from its gross proceeds for purposes of computing its STA liability, the amount of bad debt must have been the taxpayer's."[49] A retailer who assigns credit card debt without recourse, then, may not take the bad debt deduction. The Michigan bad debt statute excludes "accounts receivable sold to a third party for collection" from "bad debt."[50] The question in Michigan is whether the state will follow its supreme court decision, despite the decision's age, or, given the defini-

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45. *Chesapeake Industrial Leasing Co. v. Comptroller,* 628 A.2d 234 (Md. App. 1993).
46. 628 A.2d at 237-238.
47. 628 A.2d at 243.
48. *Laing v. Township of Forest,* 102 N.W. 664, 665 (Mich. 1905).
49. *Ultimate Outlet, Inc. v. Rev. Div.,* Mich. Tax Trib., 2002 Mich. Tax LEXIS 30, *15 (February 15, 2002).
50. Mich. Comp. Laws § 205.54i(1) (2004).

for "genuine" integration among would-be unitary affiliates, the court arguably foreclosed a return to the now discredited view—a view long held by the Department itself—that affiliates in the same, or even divergent industries, form a single unitary business group if they are under common managerial authority. In this connection, the court offered a pointed criticism of the *Borden* and *A.B. Dick* cases, the principal authorities anchoring the lower court's finding of unity. Specifically, the court stated:

> "We will not pretend that the course of decision in Illinois has run entirely true. Particularly troublesome is language in two decisions of the Illinois Appellate Court cited by Envirodyne that, in the teeth of the statute, equates common management to functional integration, *A.B. Dick Co. v. McGraw,* [citations omitted]; *Borden, Inc. v. Illinois Dep't of Revenue,* [citations omitted], which if taken literally—since wholly owned subsidiaries of the same parent corporation are normally considered under common management—would imply unconstitutionally that all such affiliated groups were unitary business enterprises."[15]

FINAL THOUGHTS

"But We Didn't *Really* Mean It"

Although the thought perhaps borders on the cynical, the Department's stance in *Envirodyne*—that centralized management alone is not evidence of unity—probably does not represent a doctrinal change of heart by Illinois tax officials. This case was decided by the federal appeals court,[16] and Illinois courts are not bound by the federal court's interpretation of the unitary business statute.[17] So, while "genuine integration" between would-be unitary affiliates may be good for the tax collector goose, it is not necessarily good for the taxpayer gander. ■

15. 354 F.3d at 652.
16. This case arose out of Wisconsin Steel's Chapter 11 proceeding, which was adjudicated in federal bankruptcy court. *See Illinois Department of Revenue v. Envirodyne Industries, Inc.,* 2002 U.S. LEXIS 2403, *2.
17. *See Sundance Homes, Inc. v. County of DuPage,* 195 Ill. 2d 257, 266, 746 N.E.2d 254, 277 (Ill. 2001) (observing that state courts are not bound by federal courts' interpretations of state law)

tion of bad debt, adopt New York's and Alabama's interpretation of the same language.

Too Soon To Tell In South Carolina

South Carolina's bad debt deduction did not become effective until January 1, 2000.[51] The South Carolina Court of Appeals considered the question of an assignment of a right to a claim for refund in 1984.[52] Slater Corporation, a food service company, claimed a refund for taxes it had paid to food suppliers. Although the tax commission agreed that a refund was due, it refused to grant the refund to Slater on the basis that only sellers were entitled to recover the taxes, and Slater, as a purchaser, was the wrong taxpayer. Slater then obtained assignments of the refund claims from its sellers and requested the refund once more. The commission again denied the refund, this time on the basis that a claim for refund could not be assigned. The South Carolina Court of Appeals disagreed, stating: "The law of South Carolina has long recognized that a chose in action can be validly assigned in either law or equity."[53] This decision suggests that financial institutions should be allowed the bad debt deduction in South Carolina.

An Inconsistency In Illinois

The Illinois Department of Revenue has denied assignees refunds.[54] This position appears to be inconsistent with an Illinois Supreme Court decision recognizing the validity of an assignment of a credit memorandum.[55] In the court decision, the assignee filed a mandamus action against the department requesting that a credit memorandum purchased from a trustee in bankruptcy be applied against the assignee's taxes. The credit memorandum stated on its face that it was not assignable. The department argued that the credit memorandum could be used only by the person paying the erroneous tax, citing the statute, which provided that an erroneously paid tax was to be credited against any tax due from the person making the payment. The court affirmed the assignee's right to the credit, observing that

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51. S.C. Code Ann. § 12-36-90(2)(h) (2003).
52. *Slater Corp. v. South Carolina Tax Comm'n,* 314 S.E.2d 31 (S.C. App. 1984).
53. 314 S.E.2d at 33.
54. *Private Letter Ruling,* Ill. Dept. of Rev., No. ST-98-0374-GIL, 1998 Ill. PLR LEXIS 549 (December 8,1998).
55. *Stone v. Nudelman,* 34 N.E.2d 851, 853 (Ill. 1940).

although tax refund statutes are construed strictly to protect the state, in this circumstance, the state was not harmed. The court also observed that absent a statutory prohibition, claims against the state are assignable. Despite this decision, the department has declared that only the retailer who actually paid the tax to the state may take a bad debt deduction.[56]

CONCLUSION

In litigation, financial institutions have lost more often than they have won their bids for bad debt credits or refunds. This results from a combination of strict construction of the bad debt statutes and the legislatures' failure to address assignments of refund rights. Perhaps the issue did not arise during the legislatures' deliberations, or maybe the legislatures believed that general assignment law would apply. The courts denying the refunds have concluded that the specific tax provisions limited or abrogated the general law of assignments. Some courts have interpreted their state statutes more broadly and allowed the refunds, seeing this as furthering the free transfer of commercial paper, which is economically beneficial. The issue remains unresolved in other states. ■

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56. *Private Letter Ruling,* Ill. Dept. of Rev., No. ST-98-0374-GIL, 1998 Ill. PLR LEXIS 549 (December 8,1998).