**Opinion Letter**

|  |  |
| --- | --- |
| **Letter Number:** | **O-2011-003** |

|  |  |
| --- | --- |
| **Tax Type:** | **Kansas Retailers' Sales Tax** |
| **Brief Description:** | **Comments on proposed sales tax regulations.** |
| **Keywords:** |  |
| **Approval Date:** | **04/19/2011** |

**Body:**

Office of Policy & Research

April 19, 2011

XXXX
XXXX
XXXX

RE: Your comments on proposed administrative regulations

Dear XXXX:

Thank you for taking time to comment on the departments proposed sales tax regulations. Your first comment is:

92-19-49b Goods returned when a sale is rescinded.
When a customer returns a vehicle, the vehicle has been used in a way that reduces its value (ex. added miles). But, we also incur time and money to get the car prepared for re-sale (restocking fee). These items could include detailing the interior, checking the engine, safety inspection, and topping off any fluids. Do we have to select between restocking fee and depreciation usage, or can both be considered in the tax calculation since both are real events? What support will be needed for the restocking fee?

A retailer that does not refund the entire purchase price that a customer originally paid for goods collects sales tax on the portion of the purchase price it retains rather than refund to the consumer. Under the regulation, whenever less than the full purchase price is refunded the entire amount retained by the retailer is taxable. This answer is grounded on a number of basic sales tax principles and the definition of "restocking or reshelving fee" contained in the draft regulation. *See K.A.R. 92-19-49b.*

Kansas sales tax does not apply to services or repair or replacement parts for vehicles that are held in a dealer's resale inventory. *See K.S.A. 79-3603(p) and (q), which taxes installation and repair services to tangible personal property that "is not being held for sale in the normal course of business."* a*nd K.S.A. 79-3602(jj), which provides retail sales do not include sales "for resale, sublease or subrent."* Nontaxable events includes services performed by a dealer's employees and the withdrawal of repair and replacement parts from the dealer's parts inventory for installation on a vehicle held for resale. If a dealer buys repair or replacement parts for a vehicle held for resale or hires a third-party service provider to repair or service the vehicle, the dealer can claim a resale exemption on its purchases of parts and services. The resale exemption applies because, in theory, any sales tax on dealer purchases that upgrade a vehicle held for resale will be recouped from the customer who ultimately buys the vehicle and pays more for it then would have been paid if the vehicle had not been serviced or repaired.

When a dealer accepts a vehicle returned by a customer and refunds the full purchase price, the dealer should report that amount on the line provided on its sales tax return for *"Returned goods, discounts, allowances and trade-ins."* *Line B, Part II of ST-36.*This deduction is claimed in the reporting period when retailer refunds the purchase price to its customer. The dealer is required refund the purchase price to the customer *plus the sales tax figured on that price*. The deduction the retailer claims on the line for *"Returned goods, discounts, allowances and trade-ins"* will reduce the tax amount the dealer pays to the State of Kansas by the same tax amount the dealer refunds to its customer.

When the full purchase price and the tax on the purchase price is refunded, retailers sometimes charge customers a reshelving or restocking fee. Dealers sometimes assess these charges when parts are returned to their parts department. Restocking or reshelving fees are treated as nontaxable reimbursement charges that pay the costs a retailer incurs when it returns goods to its resale inventory. The amount the retailer reports on the line *"Returned goods, discounts, allowances and trade-ins"* should not be reduced by the restocking or reshelving fee. Similarly, the fees do not reduce the amount of sales tax the retailer refunds to its customer since that tax amount is based on the purchase price originally paid. In other words, the total amount refunded to the customer will equal the sum of the original purchase price, plus sales tax computed on that price, minus the reshelving or restocking fee. The dealer will not report the reshelving or restocking fees it charges because the fees are not subject to Kansas sales tax. As a result, the retailer neither pays sales tax to Kansas on the restocking or reshelving fees nor charges sales tax to its customer on the fees.

A dealer sometimes accept a vehicle returned by a customer and, because of mileage or wear and tear, refund less to the customer than the full purchase price originally paid. The dealer should enter the reduced purchase price being refunded on the line provided for: *"Returned goods, discounts, allowances and trade-ins."* *Line B, Part II of ST-36.*The difference between the original purchase price reported and the smaller amount refunded remains on the dealer's return as reported taxable receipts, which is appropriate since the difference is being treated as a taxable customer charge for use or rental of the vehicle. The dealer should issue a refund to the customer equal to the sum of the reduced purchase price reported on Line B, Part II plus sales tax figured on that reduced price. The deduction the dealer claims on its return will reduce the sales tax the dealer pays to Kansas in an amount that equals the sales tax being refunded to the dealer's customer.

When the parties rescind the sale and the dealer refunds less than the full purchase price to the customer, the entire amount the dealer retains for mileage and wear and tear is treated as a taxable charge for the customer's use or rental of the vehicle. None of what the dealer retains for mileage and wear and tear can be treated as a nontaxable restocking or reshelving fee. This requirement stems from the definition of "restocking or reshelving fee" in K.A.R. 92-19-49b:

A restocking or reshelving fee shall be defined as a fee charged by a retailer to cover the time and expense incurred returning goods to resale inventory **if the consumer has not used the goods in a way that reduces their value**.

This definition means, for sales tax purposes, restocking or reshelving fees are only charged when the entire purchase price is refunded to the buyer. *By definition,* no part of the reduced refund amount can be treated as a nontaxable restocking or reshelving fee.

In other words, the entire amount of the refund reduction is treated as a taxable charge for the use of the vehicle even if a dealer issues a customer's receipt that lists a "restocking" or "reshelving" fee. These fees do not satisfy the definition of restocking or reshelving fees in K.A.R. 92-19-49b since less than the full purchase price is being refunded. Because listing a restocking or reshelving fee on a refund invoice can cause confusion, the department recommend that dealers not use the term "restocking or reshelving fee" when they retain part of the original selling price for mileage and wear and tear on a returned vehicle. Instead, dealers should list the fee as a "amount retained by dealer for use of the vehicle" or something similar.

Your second comment is:

92-19-3b Allowances for bad debts.
It appears the proposed reg allows the bad debt deduction only to the original seller. Can the deduction be expanded to allow the bad debt deduction for related parties with 100% common ownership? For example, our contracts are assigned from our sales company to our finance company. Both companies have the exact same ownership (established as S Corporations). Also, an agreement to purchase the contracts exists between the two companies. It seems like in this situation (exact same ownership), the right to the bad debt deduction should be assigned to the finance company because the underlying reason or intent for the deduction has not changed (meaning, the customer did not pay sales tax but the company/owner did pay the tax to the state). By requiring common ownership, the intent of the regulation is upheld and the state is protected from allowances for bad debts by third parties who were not involved in the original payment of sales tax.

The answer to your question "*Can the deduction be expanded to allow the bad debt deduction for related parties with 100% common ownership?"* is no. Kansas Administrative Regulation 92-19-72 forbids separate legal entities from being treated as a single legal entity for sales tax avoidance purposes. The legal basis for this rule was explained by the United States Supreme Court in *C. I. R. v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 94 S.Ct. 2129, 40 L.Ed.2d 717, (1974):

This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, *(citations omitted)* and may not enjoy the benefit of some other route he might have chosen to follow but did not. ‘To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty.

K.A.R. 92-19-72 was upheld in *Pemco v. Kansas Department of Revenue,* 258 Kan. 717, 907 P.2d 863 (1995). The Kansas Supreme Court observed: "A common theme in a number of decisions from other jurisdictions involving this issue is that a corporation, having chosen the legal form in which to exist and do business, should not be permitted to pierce its own corporate veil to gain a tax advantage."

A case directly on point is *South Carolina Dept. of Revenue v. Anonymous Co.,* 678 S.E.2d 255 (S.C. 2009), which relied on *Pemco,* id. In this case, the appellee owned 100% of a dealership and financing company. A representative of the appellee testified this arrangement allowed the dealership to recognize income on the discounted amount the financing company paid for the dealership's accounts receivable instead of the full amount of the dealership's sales contracts. The court stated:

We agree with the reasoning of the court in *Pemco* [258 Kan. 717, 907 P.2d 863 (1995)] in that “[t]here is nothing to indicate an intent that this catch-all phrase [taxpayer] was intended to alter the status of any of the specifically listed entities.” Id. Dealer and Finance Company are each “persons” within the meaning of § 12-36-30 since each is a corporation. To allow the two corporations to present themselves as one “person” by combining to form a unit would be to rewrite the statute.

While your suggestion was not incorporated into the regulation, it prompted the department to revise K.A.R. 92-19-3b. The revised language allows certain retailers to claim a bad deduction on an account receivable if the qualifying retailer transfers or assigns an account receivable *without receiving a discount of any kind* and the account receivable is later transferred back or reassigned to the qualifying retailer *without a discount of any kind*.

This revision should eliminate any audit concerns where there is 100% ownership of a retailer and a company established to provide accounting and collection services for that retailer, and the retailer's accounts receivable *that are not discounted in anyway* are routinely transferred back and forth between the retailer and the related company under an agency agreement for purposes of simplified accounting or collection. This provision does not allow a retailer or lender to claim a credit or refund for bad debts that arises from *discounted account receivables.*Such a provision would run afoul of *In re the Appeal of Ford Motor Credit Company,* 275 Kan. 847, 69 P.3d 612 (2001), and be contrary to the legislature's refusal to enact 2007 House Bill 2511 and 2008 Senate Bill No. 499. *See Home Depot USA, Inc., v. Arizona Department of Revenue*. Maricopa County Superior Court (Arizona), No. TX 2006-000028, December 9, 2010.

Sincerely,

Thomas E. Hatten
Attorney/Policy & Research

**Date Composed: 04/21/2011 Date Modified: 04/21/2011**