HOME DEPOT USA, INC. 2455 PACES FERRY ROAD, NW ATLANTA, GA 30339-4024,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
Taxpayer,	§	DOCKET NO. S. 06-1079
v.	§	
STATE OF ALABAMA DEPARTMENT OF REVENUE.	§	

FINAL ORDER

Home Depot USA, Inc. ("Home Depot") petitioned the Revenue Department for a refund of sales tax for September 2000 through July 2003. The Department denied the refund. Ernst & Young, LLP appealed to the Administrative Law Division on behalf of Home Depot pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a.[1] A hearing was conducted on November 20, 2007. Bruce Ely and Jimmy Long represented Home Depot at the hearing. Assistant Counsel Wade Hope represented the Department.

ISSUE

Alabama residents purchased goods at Home Depot stores during the period in issue using Home Depot private label credit cards ("Home Depot cards").[2] The cards had been issued by third party finance companies. The finance companies immediately paid Home Depot for the goods, including the applicable State and local sales tax. If the sale

[1]The Department moved to have the appeal dismissed as untimely. The Administrative Law Division initially granted the motion and dismissed the appeal. Home Depot applied for a rehearing. The Administrative Law Division granted the application and accordingly reinstated the appeal on the Division docket.

[2] Home Depot also accepted most major credit cards, i.e., Visa, Master Card, etc., during the subject period.

occurred at a Home Depot store in Alabama, Home Depot reported and remitted the State and Department-administered local Alabama sales tax to the Department.

Some of the Alabama-based Home Depot cardholders failed to pay the finance companies the full amounts charged on the cards. The companies subsequently deducted those amounts as bad debts on their federal income tax returns. The issue in this case is whether Home Depot is entitled to a refund of State and local Alabama sales tax based on the bad debt amounts that the Alabama-based cardholders failed to pay to the finance companies.

FACTS

Home Depot sells home improvement products and related items at retail stores in Alabama and throughout the United States. It had credit card agreements during the period in issue with three finance companies affiliated with General Electric (the "GE affiliates"), Monogram Credit Card Bank of Georgia, General Electric Capital Financial, Inc., and General Electric Capital Corporation. The agreements authorized the GE affiliates to issue Home Depot credit cards to qualified Home Depot customers, and thereby extend various types of credit to those customers. The agreements also required the affiliates to immediately pay Home Depot the amounts charged on the cards, including sales tax, less a negotiated service fee. The agreements stated the percentage amount of the service fees, but did not identify or specify how the percentages were determined.

The Home Depot cards could only be used at Home Depot stores. A Home Depot customer applied for a Home Depot card by submitting a written credit application to the GE affiliate. The affiliate evaluated the credit-worthiness of the customer and decided whether to approve or reject the application. If the application was accepted, the affiliate

issued the customer a card in due course.

The GE affiliates at all times owned and serviced the Home Depot card accounts. Home Depot was not liable to an affiliate if a customer failed to pay the amount owed. The affiliates retained all rights to charge interest and late fees in accordance with the card agreements entered into with their cardholders.

The parties used the following example to illustrate a typical Home Depot card transaction. A customer purchases a $100 lawnmower at a Home Depot store in Alabama at which the combined State/local sales tax rate is 10 percent. The customer presents his Home Depot card at the checkout counter and, if the sale is approved, the card is charged $110 for the cost of the lawnmower and sales tax. Home Depot reports and remits the full $10 in sales tax to the Department with its next monthly sales tax return.[3]

Home Depot electronically submits the card sale information to the GE affiliate. The affiliate immediately pays Home Depot the $100 for the lawnmower, plus the $10 in sales tax, less the agreed upon fee. For example, if the fee was 3 percent, the affiliate would pay Home Depot $106.70 ($110 less 3 percent, or $3.30, equals $106.70). Home Depot deducts the service fee paid to the affiliate as an ordinary and necessary business expense on its federal income tax return. As discussed, the customer is thereafter solely liable to the affiliate for the amount charged, plus any applicable interest, late fees, etc.

[3] This assumes, of course, that the Department administers the applicable county and municipal sales tax due on the transaction. If a local jurisdiction's taxes are self-administered, Home Depot would separately report and remit the applicable local tax due to the self-administered jurisdiction.

Some Alabama-based customers that purchased goods using a Home Depot card failed to pay the GE affiliates any or all of the amounts owed. The affiliates made various attempts to collect, but if an amount due was not paid in full within 180 days of the due date, the affiliates generally deducted the unpaid amount as a bad debt on their federal income tax returns.

Home Depot timely petitioned the Department in October 2003 for a sales tax refund for the period in issue. The refund was based on the uncollected amounts owed by Alabama-based cardholders that the GE affiliates had deducted as bad debts during the subject period. Home Depot computed the refund amount using bad debt information obtained from the GE affiliates.

In computing the refund, Home Depot netted out all amounts collected by the affiliates during the refund period on delinquent accounts that the affiliates had previously written off, and also those amounts collected up until the affiliates submitted the bad debt information to Home Depot. Any payments received by the affiliates after that time have not been considered or factored into the refund amount. Home Depot also estimated its sales to tax-exempt entities and sales of exempt products during the subject period, and removed those amounts from the calculation.

Home Depot's original petition claimed a refund of $610,449.84, but did not indicate that the amount included both State and local sales tax. The claim also included some local jurisdictions in Alabama that were not administered by the Department. Finally, the original claim was computed on the 4 percent State rate and a blended 3.8 percent local rate, for a combined rate of 7.8 percent.

Home Depot amended its refund claim at (or immediately before) the November 20, 2007 hearing. Home Depot now claims a refund of State and Department-administered local sales tax of $383,341.29. The amended claim is based on the 4 percent State rate and a reduced .76 percent blended local rate.

Other relevant facts are stated as necessary in the below analysis of the issues.

ARGUMENTS

Home Depot argues that it is entitled to a refund because the requirements of the Department's "bad debt" regulation, Reg. 810-6-4-.01, have been satisfied. It contends in the alternative that it is entitled to the refund because it fully compensated the GE affiliates for the bad debts when it paid the service fees, and consequently, it suffered the economic loss for the bad debts. It asserts that the State would be unjustly enriched if allowed to keep the sales tax on the unpaid accounts.

The Department counters that the bad debt regulation does not apply. It also contends that the agreements between Home Depot and the three GE affiliates do not specify that the service fees paid by Home Depot included a bad debt component, and consequently, there is no proof that Home Depot compensated the affiliates for the anticipated bad debts.

ANALYSIS

Retailers in Alabama are required to file monthly sales tax returns and remit the tax due on (1) cash sales in the month, and (2) payments received in the month on prior credit sales. But "in no event shall the gross proceeds of credit sales be included in the measure of the tax to be paid until collections of such credit sales have been made." Code of Ala. 1975, §40-23-8.

The Department, recognizing that some retailers may nonetheless report and remit sales tax on credit sales before the amounts are collected, promulgated the bad debt regulation in issue in this case, Reg. 810-6-4-.01. The regulation reads in pertinent part:

> (1) The term "bad debt or uncollectible account" as used in this rule shall mean any portion of the sales price of a taxable item which the retailer cannot collect. Bad debts include, but are not limited to, worthless checks, worthless credit card payments, and uncollectible credit accounts. Bad debts, for sales and use tax purposes, do not include finance charges, interest, or any other nontaxable charges associated with the original sales contract, or expenses incurred in attempting to collect any debt, debts sold or assigned to third parties for collection, or repossessed property.
>
> (3) The term "credit sale" shall include all sales in which the terms of the sale provide for deferred payments of the purchase price. Credit sales include installment sales, conditional sales contracts, and revolving credit accounts.
>
> (5) In the event a retailer reports and pays the sales or use tax on credit accounts which are later determined to be uncollectible, the retailer may take a credit on a subsequent tax report or obtain a refund for any tax paid with respect to the taxable amount of the unpaid balance due on the uncollectible credit accounts within three years following the date on which the accounts were charged off as uncollectible for federal income tax purposes.
>
> (6) If a retailer recovers in whole, or in part, amounts previously claimed as bad debt credits or refunds, the amount collected shall be included in the first tax report filed after the collection occurred. (Sections 40-23-8 and 40-23-68(e))

Home Depot claims it is entitled to a refund because the regulation's four requirements have been satisfied – "(1) the customer purchased an item on credit; (2) the retailer reported and remitted the applicable sales tax; (3) some portion of the credit account balance was subsequently determined to be worthless and uncollectible; and (4) the refund or credit is claimed within three years from the date the account is written off for federal income tax purposes." Home Depot's Post-Hearing Brief at 12.

I disagree that the bad debt regulation was satisfied, or even applies, in this case. Rather, §40-23-8 and related Reg. 810-6-4-.01 only apply where the retailer makes a credit sale by extending credit to the purchaser. The statute and regulation do not apply to credit card sales where credit is extended to the customer by a third party finance company, as in this case.

Section 40-23-8 applies to "[a]ny person taxable under this division (an Alabama retailer), having cash and credit sales, . . ." For the statute to apply, a retailer must make the credit sale. A sale by a retailer to a customer that uses a credit card issued by a third party finance company is not a credit sale by the retailer because the retailer is promptly paid in full, including all applicable sales tax, less a negotiated service fee. A purchaser that uses a credit card may be buying on credit (extended by the card issuer), but the retailer is not selling on credit, i.e., making credit sales, as required for §40-23-8 and Reg. 810-6-4-.01 to apply. Consequently, Home Depot's claim that the regulation applies anytime a customer purchases an item on credit (requirement (1) above) is incorrect. Rather, it applies only when the retailer sells on credit.

The above holding is supported by the Alabama Court of Civil Appeals' opinion in *Marks-Fitzgerald Furniture Company, Inc. v. State, Dept. of Revenue*, 678 So.2d 121 (Ala. Civ. App. 1995). The primary issue in *Marks-Fitzgerald* involved the taxpayer's sales tax liablity on credit accounts initially owned by the taxpayer but later discounted to a third party finance company. A discussion of that issue is not required because Home Depot never owned the credit accounts in issue, as did the taxpayer in *Marks-Fitzgerald*.

Marks-Fitzgerald also involved the taxpayer's sales tax liability on credit card sales. The specific issue was whether the taxpayer owed sales tax on the full sales price, or only

on the amount it received from the credit card company, i.e., the sales price less the service fee. The Administrative Law Division held that the entire sales price was taxable, and that the service fee could not be deducted from taxable gross proceeds. It also concluded that credit card sales were not credit sales within the purview of §40-23-8. The Final Order issued by the Administrative Law Division reads in pertinent part:

> The Taxpayer argues that §40-23-8 applies to both the credit card sales and the discounted account receivables, and that tax is owed only on the net amount received from the credit card or finance companies.
>
> First, in my opinion credit card sales are not credit sales governed by §40-23-8. Rather, on credit card sales the retailer receives payment immediately or almost immediately and in return pays the credit card company a fee for its services.
>
> 'Gross proceeds of sale' is defined at Code of Ala. 1975, §40-23-1(6) as the value proceeding or accruing from the sale of tangible personal property, without deduction for any expenses whatsoever. The credit card fee paid by a retailer to a credit card company is a non-deductible expense or cost of doing business. The fact that the credit card company deducts the fee before paying the retailer does not change the nature of the fee. The credit card fees paid by the Taxpayer in this case must be included in gross receipts subject to sales tax.

Marks-Fitzgerald, S. 91-203 at 3.

The Court of Civil Appeals affirmed that the fee was not deductible. Importantly, the Court also confirmed that credit card sales are not credit sales governed by §40-23-8 (or Reg. 810-6-4-.01).

> Furthermore, credit card sales are not credit sales governed by §40-23-8. Rather, on credit card sales the retailer receives payment immediately and, in return, pays the credit card company a fee for its service.

Marks-Fitzgerald, 678 So.2d at 124.

The bad debt regulation also indicates that the retailer must be the party extending credit to the purchaser. The entire regulation is prefaced by the first sentence in paragraph

(1) – "The term 'bad debt or uncollectible account' as used in this rule shall mean any portion of the sales price of a taxable item which the *retailer* cannot collect." That statement confirms that the retailer must extend the credit to the customer and be owed the amount due, and that only if "the retailer cannot collect" the amount does the bad debt regulation apply. The retailer in this case, Home Depot, collected the sales proceeds, albeit from the GE affiliates and not directly from the customers, but the sales proceeds plus the applicable sales tax was collected, and the sales tax was properly remitted to the Department.

Paragraph (3) of the regulation defines "credit sale" to include "all sales in which the terms of the sale provide for deferred payments of the purchase price." Home Depot cites that definition in support of its position because the credit card agreements between the cardholders and the GE affiliates allowed the cardholders to make deferred payments to the affiliates. Home Depot's Post-Hearing Brief at 12, 13. But the agreements between the affiliates and Home Depot required the affiliates to immediately pay Home Depot the sales proceeds and tax. Consequently, because the terms of the Home Depot card sales did not provide for deferred payment of the purchase price to the retailer, Home Depot, the transactions did not constitute credit sales by the retailer as defined by the regulation. Paragraph (3) also identifies credit sales to "include installment sales, conditional sales contracts, and revolving credit accounts." The regulation does not include credit card sales as a type of credit sale, which further confirms the Court's holding in *Marks-Fitzgerald* that credit card sales are not credit sales within the intended scope of §40-23-8.

Paragraph (5) specifies that if a retailer pays sales tax on credit accounts which are later determined to be uncollectible, the retailer may obtain a refund within three years from

when “the accounts were charged off as uncollectible for federal income tax purposes.” Home Depot argues that the regulation does not specify that the retailer must be the party that deducts the bad debt for federal tax purposes, and consequently, that the regulation was satisfied because the GE affiliates deducted the bad debts.

I agree that paragraph (5) does not directly state that the retailer must be the party that writes off the bad debt, but that requirement is implicit in the regulation. As discussed, paragraph (1) identifies a bad debt as any amount “the retailer cannot collect.” Also, paragraph (6) of the regulation, which is discussed below, specifies that “[i]f a retailer recovers” a previously written off amount on which it had received a bad debt sales tax refund, the retailer must report and pay sales tax on the amount. When read together and in context, the various paragraphs in the regulation clearly envision that the retailer must extend credit to the customer and own the account, and that if the account is not paid, the retailer must be the party that deducts the debt as uncollectible.[4]

Finally, as discussed, paragraph (6) provides in substance that “[i]f a retailer” subsequently collects on a previously written off debt concerning which it had received a sales tax refund, the retailer must report and pay sales tax on the amount collected. The reference to “retailer” in paragraph (6) is consistent with the fact that for purposes of §40-23-8 and Reg. 810-6-4-.01, a bad debt must be a debt owed to and subsequently written off by the retailer that made the sale.

[4] Home Depot notes in its Post-Hearing Brief at 17, that several other states have enacted statutes or issued regulations which require that the retailer must be the party that writes off the account as a bad debt. As discussed, that is consistent with how Reg. 810-6-4-.01 should be construed.

In this case, the GE affiliates subsequently recovered some of the delinquent accounts that they wrote off during the period in issue. Home Depot contends that it netted out all amounts that the affiliates collected on the previously written off accounts during the subject period, and also those amounts collected up until the affiliates submitted the bad debt information to Home Depot in mid-2003. A Home Depot witness testified, however, that the affiliates continue trying to collect on previously written-off accounts, and are sometimes paid two years or more after the amount is written off. (T. 109) Consequently, Home Depot's refund claim may be based on bad debt amounts that were collected after the affiliates provided the bad debt information to Home Depot. The affiliates have not and are not required to report and remit sales tax on those collections because they are not licensed Alabama retailers. Home Depot also has not removed those payments from its refund petition because the affiliates have not provided the information to Home Depot.

Home Depot's refund claim also presents various other problems. To begin, Home Depot's calculations are based on bad debts relating to Home Depot cardholders with Alabama billing addresses. The calculations are thus based on the assumption that the cardholders purchased the goods and paid the State and applicable local Alabama sales tax at a Home Depot store in Alabama. But some of the Alabama cardholders may have in many cases used their cards at a Home Depot location outside of Alabama. For example, an Alabama cardholder that lives in Phenix City, Alabama on the Georgia line may have used his Home Depot card to purchase goods at a Home Depot store in Columbus, Georgia because it was the closest store to his house; or a Birmingham cardholder may have visited his daughter in Tennessee and purchased lumber at a Home Depot location there to build his daughter a new deck. Obviously, State and local Alabama sales tax

would not have been paid on those transactions, yet Home Depot is seeking a refund of State and local Alabama tax on those out-of-state transactions.[5]

A related problem involves the local tax refund claimed by Home Depot. Home Depot has claimed a lump-sum local refund based on a .76 percent blended local tax rate, which is the average of the county and municipal rates in the Department-administered local jurisdictions in Alabama in which Home Depot stores were located during the refund period. But again, there is no way of determining if or how much the "bad debt" customers purchased in each local jurisdiction, and thus no way of knowing how much local sales tax Home Depot remitted to each local jurisdiction relating to the written off accounts.

Alabama law requires that if tax is refunded, the county or municipality that received the overpayment is required to pay the refund. Code of Ala. 1975, §40-2A-7(c)(4). In this case, even if a refund was due, the Department (and Home Depot) cannot determine how much local sales tax Home Depot "erroneously" paid to each local jurisdiction, and thus how much local tax the jurisdiction, through the Department, should be required to refund to Home Depot. In short, claiming a lump-sum local jurisdiction refund is not sufficient. Home Depot must establish the amount of sales tax it claims was overpaid to each local

[5] The Administrative Law Division raised this issue at the hearing in the case. Home Depot's attorney responded – "Your Honor, as best we can tell, that kind of situation (an Alabama cardholder buying at a Home Depot store outside of Alabama) would be de minimis." (T. 131) But as best I can tell, Home Depot has no way of knowing where the cardholders used their cards, or at least where they made the purchases that were defaulted on, and thus no way of knowing the dollar amount or number of out-of-state credit card sales, de minimis or not, that are included in its refund calculation. It could be argued that the out-of-state purchases by the Alabama cardholders were offset by the fact that some out-of-state cardholders also used their cards to purchase items at Home Depot stores in Alabama, but again, there is no way of knowing.

jurisdiction. It has failed to do so, and presumably cannot do so.

Finally, Home Depot also estimated its sales to tax-exempt entities and its sales of exempt products in computing its refund claim. Home Depot concedes that the amounts are estimated, but that reasonable estimates can be used to compute a taxpayer's sales tax liability. Home Depot's Post-Hearing Brief at 9, n. 5.

Alabama's courts have in certain limited circumstances allowed taxpayers to compute their sales tax liability based on projections and reasonable estimates. See generally, *State v. Ludlum*, 384 So.2d 1089 (Ala. Civ. App.), cert. denied, 384 So.2d 1094 (Ala. 1980). In this case, however, Home Depot has piled assumptions upon estimates in computing its refund claim. First, it assumes that if a Home Depot cardholder with an Alabama address defaulted on his or her debt to a GE affiliate, the underlying sale or sales were at a Home Depot location in Alabama, and that the 4 percent Alabama tax and the applicable local Alabama tax was paid on the sale or sales. As discussed, however, some Alabama cardholders that failed to pay may have, and surely did, purchase some items outside of Alabama. The amount, de minimis or not, cannot be determined. Home Depot also can only estimate the percentage of local tax that might have been paid on the worthless accounts by taking a blended average of the various local rates. And Home Depot has not, and presumably cannot, identify the amount of local sales tax that was paid on the bad debt amounts to each of the various local jurisdictions. Finally, the exempt and otherwise non-taxable sales also can only be estimated. "In a refund suit the taxpayer bears the burden of proving the amount he is entitled to recover." *United States v. Janis*, 96 S.Ct. 3021 (1976). Home Depot has failed to carry that burden in this case.

In *State Dept. of Revenue v. Moss Furniture, Inc.*, S. 90-152 (Admin. Law Div. 6/14/1991), a furniture company made credit sales and transferred the accounts receivable to a subsidiary corporation for collection. The Administrative Law Division held that the furniture retailer was obligated to keep or have access to records of the amounts subsequently paid by its credit customers, and was liable to report and pay sales tax on those amounts.[6] The Administrative Law Division also stated in *Moss* that "[i]n no event should the Department receive less tax than is paid by the customer." *Moss* at 3. Home Depot argues that "[c]onversely, in no event should the Department retain more tax than was paid by the customer." (underline in original) Home Depot's Post-Hearing Brief at 11.

The above-quoted statement by the Administrative Law Division in *Moss* was correct under the circumstances because in *Moss*, the customers were making the payments. A retailer is, however, required to report and remit sales tax when it receives the sale proceeds and tax due, whether the amount is paid by the customer directly, as in *Moss*, or by a third party finance company on behalf of the customer, as in this case. On a credit card sale, the customer is in substance borrowing the sale proceeds and sales tax from the card issuer, which in turn pays that amount to the retailer on behalf of the customer. From the retailer's perspective, the sale is a cash sale because the retailer is paid immediately. That is, the terms of the sale do not provide for deferred payments of the purchase price to the retailer, as required to be a credit sale pursuant to Reg. 810-6-4-.01. The Court of Civil Appeals recognized the above fact in *Marks-Fitzgerald*, when it held that "credit card sales

[6] The Alabama Court of Civil Appeals affirmed the Administrative Law Division's rationale in *Moss* in *Marks-Fitzgerald*, 678 So.2d at 123.

are not credit sales governed by §40-23-8. Rather, on credit card sales the retailer receives payment immediately. . . ." *Marks-Fitzgerald*, 678 So.2d at 124.

Home Depot argues that it is being penalized for using the GE affiliates instead of issuing its own private label cards, "resulting in discriminatory treatment of similarly-situated retailers and unjust enrichment to the Department." Home Depot's Post-Hearing Brief at 27. I disagree because if Home Depot had issued its own cards, the situation would not be similar, i.e., there would not be "similarly-situated retailers." If Home Depot had issued its own cards, it would have made credit sales within the purview of Reg. 810-6-4-.01 because it would have extended the credit to the cardholders, it would have owned the accounts receivable, and it would have been the party that could write off the bad accounts for federal tax purposes. Instead, however, it freely contracted for the GE affiliates to issue and service the cards, own the accounts receivable, and also bear the risk of loss. It is bound by the tax consequences of that decision. *Leavitt v. Commissioner of Internal Revenue*, 875 F.2d 420 (4th Cir. 1989) (Taxpayers "are bound by the 'form' of their transaction and may not argue that the 'substance' of their transaction triggers different tax consequences." *Leavitt,* 875 F.2d at 423.)

To summarize, Home Depot made the retail sales, it was paid the sales proceeds plus sales tax by the GE affiliates, on behalf of the customers, and it correctly remitted the sales tax due to the Department. Home Depot was thereafter not responsible or required to reimburse an affiliate if an account became uncollectible. Consequently, the sales tax was not "erroneously paid," as required for a refund to be due. Code of Ala. 1975, §40-2A-7(c)(1). And even if the tax had been erroneously paid, Home Depot has failed to carry its burden of proving the amount of State sales tax that was erroneously paid on the

underlying sales because it cannot show that the Alabama-based cardholders that failed to pay had purchased the goods and paid the sales tax in Alabama. Home Depot also cannot identify the amount of local tax that may have been paid on the bad debt accounts to the various local taxing jurisdictions in Alabama. The Department thus correctly denied Home Depot's refund petition.

Home Depot argues in the alternative that it is entitled to a refund because a bad debt component was included in the fees it paid to the GE affiliates, and consequently, it suffered the economic loss for the bad debts. Home Depot claims that it "fully compensated GE for worthless (Home Depot card) accounts through the service fee and other consideration." Home Depot's Post-Hearing Brief at 21. I disagree.

The agreements between Home Depot and the GE affiliates included only the fee percentages, and did not specify how the percentages were determined. Several witnesses testified, however, that the parties estimated and considered the expected bad debt amounts when negotiating the fee amounts. But there is no evidence showing the amount or what part of the fees constituted a bad debt component. Consequently, there is no proof that the fees included a bad debt component that fully compensated the affiliates for the actual bad debts.

The GE affiliates competitively bid against other finance companies for the right to issue the Home Depot private label cards. Gene Thorncroftt, the vice president of risk management for a GE division, explained how the GE affiliates determine the service fees they charge:

> A. Yeah. When – when we negotiate a deal, we make a series of assumptions. We take a look at what our through-the-door populations are going to look like, or what the customers look like when they come through.

> We make a determination of how they're going to spend. How many are going to revolve and pay interest so we can determine a cash flow. We'll know what our interest rates are. We'll know how many will go delinquent so we can know what our late fee stream will be. Any other sundry income stream would be incorporated into that. We also then take a look at what our costs are going to be. Money costs, operating expense, bad debts, et cetera. From that, we determine what our threshold of profitability should be. And based on that, we would assess fees to – we would set the service fee so we assess that fee to the retailer.

(T. 92, 93)

The above testimony shows that the affiliates considered several factors in determining the fee amounts it would charge Home Depot, including the anticipated bad debts and the substantial administrative costs associated with issuing and servicing the cards. Against those costs, however, the affiliates weighed the expected profits they would receive from the interest and late fees to be paid by the card holders. They then determined the level of acceptable profit, and set the fee accordingly. The affiliates may have, for example, estimated that its costs would approximate 8 percent (4 percent for bad debts and 4 percent for administrative costs). It may also have expected to receive 15 percent in profits from interest and late fees. Knowing that other finance companies were bidding for Home Depot's business, the affiliates could have decided to offer a fee of only 4 percent. The affiliates would thus have absorbed some of the bad debt and administrative costs, but still realized a substantial 11 percent profit on the deal. Consequently, while the affiliates may have considered the anticipated bad debts in computing the fee amounts, there is no way to determine the amount of the bad debt component actually included in the fees. As testified to by another GE witness, the agreements were the result of an "arms length negotiation . . . You sign up for the deal you sign up for. The service fee is (the percentage amount) it is . . . Why those fees are the way they are, I think in most contract

analysis would be surplusage . . . What all the various factors are that went into (the fees) would have been surplusage." (T. 68, 69)

Even if it is assumed that the fees included a bad debt component equal to the estimated bad debt amounts, which, as discussed, cannot be established, the bad debts actually incurred by the affiliates may have been (or could be in the future) much greater than anticipated. For example, assume that the affiliates estimated that during a given period x amount of the accounts would become uncollectible. Assume further that it included that x amount as a bad debt component in the fees. Due to an unexpected economic downturn, however, the actual bad debt amount was xxx. Applying Home Depot's rationale, it would be entitled to a sales tax refund based on xxx amount, even though it had paid the affiliates a bad debt component in the fee, i.e., had suffered an economic loss, of only x amount. Clearly, that cannot be allowed.

Home Depot asserts that the fees fully compensated the affiliates for the bad debts because the affiliates "covered all its costs and earned a profit during the period in issue." Home Depot's Post-Hearing Brief at 21. As discussed, however, the fees received from Home Depot were only one source of income for the affiliates. They also received substantial interest income and late fees from their cardholders.[7] Consequently, the fact that the affiliates made a profit during the subject period does not establish, or even suggest, that Home Depot fully compensated the affiliates for the expected bad debts. In short, there is nothing proving the amount of the bad debt component included in the fees,

[7] A Home Depot witness testified that a private label card issuer also benefits because "[t]here is dollar value that is assigned to (the issuer) having access to the names and addressed of all the cardholders for marketing purposes." (T. 67)

and nothing tying that undeterminable amount to the actual bad debts incurred by the affiliates.

Home Depot argues that other states have granted it sales tax refunds based on the bad debts incurred by the affiliates. But at least two states have also denied Home Depot's refund claim under identical facts. In *Home Depot U.S.A., Inc. v. Director, Division of Taxation*, Docket No. 006005-2005 (March 14, 2008), the New Jersey Tax Court, citing The New York Division of Tax Appeals opinion in *In re Home Depot U.S.A., Inc.*, DTA No. 821034 (NY Div. of Tax Appeals May 17, 2007) (appeal pending), stated as follows:

> In consideration of the services provided to petitioner [(Home Depot U.S.A., Inc.)], the credit card companies subtracted from all receipts a service charge. The service charge was not specifically defined in either the GECC or Monogram contract except to say that it was calculated in accordance with a formula set forth in an appendix. The parties to this matter stipulated that the service fees were determined by several factors, including the following: the bad debt experience of Home Depot's credit card customers; the interest incurred that Monogram or GECC anticipated they would earn and that Home Depot forwent on the credit card account; the value of Home Depot's credit card data base given to Monogram and GECC; and the administrative costs associated with the managed credit accounts by Monogram and GECC. However, it is particularly noteworthy that neither the agreements nor the stipulation apportioned the percentages of the service fee among the various components and that petitioner conceded it could not determine if the actual bad debts written off by Monogram and GECC were equal to, greater than or less than the anticipated bad debt figure used to estimate the bad debt component of the service fee. In sum, petitioner did not demonstrate and acknowledged that it could not accurately account that it had compensated GECC or Monogram for the accounts which ultimately became uncollectible.
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> In this appeal, just as in the New York litigation, plaintiff has failed to identify the portion of the service fees representing compensation to the Finance Companies for their respective anticipated bad debt losses. Although counsel for plaintiff asserted on oral argument that plaintiff could present proofs quantifying that portion, none of the certifications plaintiff submitted in opposition to the Director's summary judgment motion contained any factual or non-hearsay basis for such assertion. Because the New York Division of Tax Appeals cited a similar absence of proof in rejecting plaintiff's sales tax refund claims, plaintiff surely was on notice of the significance of such proofs.

> From plaintiff's failure to submit certifications identifying or quantifying the bad debt component of the service fees or describing the factors and process by which such component was determined, I infer that, in fact, no such identification or quantification was possible.
>
> Plaintiff has failed to establish, even on a prima facie basis, the relationship, if any, between the unmeasured, and apparently unmeasureable, component of the service fees representing the Finance Companies' projected bad debt losses and the actual bad debt losses incurred by the Finance Companies with respect to the private label credit cards issued to plaintiff's customers. As a result, plaintiff has failed to demonstrate that it suffered any losses attributable to bad debts. It received payment in full from the Finance Companies for each transaction in which a customer used plaintiff's private label credit card, subject to deductions from some payments in the amount of the service fees (the service fees under the Monogram Agreement could be zero) and, perhaps, other items not relevant to this appeal. Whether or not the customer eventually defaulted on the credit card obligation, plaintiff received the same payment with respect to the transaction, and paid the same service fee.

The New Jersey Tax Court's rationale also applies in this case. Home Depot has failed to establish the amount of the bad debt component, if any, included in the fees. Even if it could show what it had predicted or estimated that the bad debt amounts would be, those amounts may or may not have remained in the final negotiated fee amounts agreed to by the parties. The fees contained a number of cost and income components, and the bad debt component initially included or considered by the affiliates may have been reduced or eliminated altogether during negotiations with Home Depot. And because the bad debt components cannot be determined, it cannot be argued that Home Depot fully (or even partially) compensated the affiliates for the bad debts.

I also disagree that the State has been unjustly enriched. The GE affiliates paid the sales tax to Home Depot on behalf of their cardholders, and Home Depot correctly remitted

the tax to the Department.[8] There is nothing unjust with the State and the various local jurisdictions retaining those amounts.

Home Depot also will not be unjustly harmed because the refund is denied. While the parties may have considered many factors in negotiating the fee amounts, there is no evidence that Home Depot assumed or considered that it would receive a sales tax refund based on the subsequent bad debt amounts. That is, the parties did not consider and include a sales tax refund component in the fee amounts. Consequently, Home Depot cannot argue that it had anticipated or expected a refund.

If Home Depot had contracted to reimburse the GE affiliates for all subsequent uncollectible accounts, then Home Depot would have a better argument that it is entitled to a refund of the sales tax paid on the bad debts because it could identify the bad debt amounts that it repaid to the affiliates. But even in that case, Home Depot still could not prove the amount of Alabama sales tax paid on the bad debts because it cannot prove that the underlying sales occurred in Alabama. And for the same reason it also cannot establish the amount of local tax that was paid on the bad accounts to the various Department-administered local jurisdictions in Alabama. In any case, the parties agreed that the affiliates, not Home Depot, would be liable for any uncollectible accounts. As

[8] Home Depot claims that it "remits the applicable sales tax to the Department out of its own pocket. . ." Home Depot's Post-Hearing Brief at 6. I disagree because the GE affiliates remitted the sales proceeds and the applicable sales tax to Home Depot no later than a day or two after each card sale. Home Depot was not required to remit the sales tax to the Department until the 20th of the subsequent month. Consequently, Home Depot in all cases received the sales tax from the affiliates, on behalf of the customers, before it was required to remit the tax to the Department. It thus did not pay the sales tax on the card sales out of its own pocket.

stated by the New Jersey Tax Court – "Home Depot elected to use the services of the Finance companies in order to enable its customers to make purchases using its private label credit card. Home Depot is bound by the tax consequences of that election. 'It is not what might have happened nor what the taxpayer could have done but what actually occurred that determines tax consequences.'" *Home Depot U.S.A., Inc. v. Director, Division of Taxation*, *supra*, citing *General Trading Co., Inc. v. Director, Div. of Taxation*, 83 N.J. 122, 138 (1980).

The Department's denial of Home Depot's refund petition is affirmed.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered June 6, 2008.

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BILL THOMPSON
Chief Administrative Law Judge

bt:dr
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John Rhodes