



January 25, 2024

Mr. Joe Stephenshaw
Director
California Department of Finance
1021 O Street, Suite 3110
Sacramento, CA 95814

SUBJECT: OPPOSE: Governor's Proposal to Eliminate Bad Debt Deduction

Dear Director Stephenshaw:

The organizations listed above must respectfully oppose the Governor's budget proposal to eliminate a provision of the Revenue and Tax Code that allows a retailer or lender to take a deduction or refund of the sales or use tax previously reported and paid by the retailer. This proposal would only increase tax revenues by \$25 million, yet it would have a significant negative impact on California businesses, consumers, and the state's economy as a whole.

Most states that impose a tax on the sale of goods require the retailer to collect and remit the full amount of the tax at the time of a financed sale, even though the customer has financed the sales price for the goods. Many of these states have enacted "bad debt" statutes to provide for a refund of a pro rata share of the sales tax if the customer fails to pay the full price for the product. The intent of the bad-debt statutes is to ensure that tax is paid only on the actual purchase price paid by the customer, as opposed to the amount expected to be paid. Repealing the bad-debt statute would have the effect of increasing the tax rate on businesses by imposing the full tax rate on prices that were never paid.

Most major retailers do not self-finance the sale of goods, but rather contract with lenders to finance their sales. In many instances, the relationship between the retailer and the lender is blurred, particularly in the case of private-label credit cards where a store-branded card may prominently display the retailer's name but not the name of the lender that provides the financial underwriting. In some cases, the lender may even provide warranty or repair services for the product sold. Small retailers providing lines of credit to their customers are able to sell their accounts to lenders as a means to raise capital. In doing so, the retailer contractually assigns the right to claim a sales tax refund to the lender if the account is deemed uncollectible.

California's bad-debt statute recognizes these modern financial relationships, and importantly, current law acknowledges that when the purchaser of goods on credit fails to pay, the transaction is economically incomplete, and the lender or retailer is entitled to a sales tax refund. In 2000, the Legislature overwhelmingly passed *AB 599 (Lowenthal) [Chapter 600, Statutes of 2000]* to allow the assignee of an account to take the refund or deduction if the retailer has not done so before the account was sold. That measure allowed lenders and retailers to work out among themselves who would take the deduction.

The Governor's proposal would adversely impact California businesses. **As brick-and-mortar stores continue to close, this is not the time to change a policy that is fair and important to retailers and lenders.** For depository institutions, regulators require lenders to operate in a safe and sound manner and to employ risk-mitigating methods in the management of their loan portfolio and underwriting process. The refund on worthless accounts is one such method in which lenders can account for potential losses on purchased loans. If the account is deemed uncollectible and subsequently charged off, the lender can recover part of that loss through the sales tax refund. If the state eliminates the refund, non-recourse retailers will be forced to sell their accounts at a discounted price and, in some cases, the lender may forgo the purchase altogether if the risk of doing so cannot be offset by the sales tax credit. In the case of recourse lenders, the uncollectible accounts may be returned to the retailer. In either scenario, retailers will lose a valuable source of liquidity and will be required to hold on to risky loans that otherwise might be sold to well-capitalized lenders.

The proposal will be particularly harmful to small retailers facing financial difficulty. The existing bad-debt deduction allows smaller retailers to sell their accounts to generate funds to replenish their inventory. However, these retailers would receive considerably less for their accounts under this legislation because they would be forced to sell their receivables on a non-recourse basis.

Consumers also would be hurt by this measure. Lenders rely on the bad-debt statute to offset the risk of financing auto loans. Just as the interest rate on a loan is higher for borrowers with poor credit, lenders are likely to account for the elimination of the sales tax refund by increasing the interest rate for certain higher-risk auto loans. In some cases, borrowers who otherwise may have qualified for a loan may be declined credit if the auto dealer cannot find a lender willing to underwrite the increased risk.

This is just one example of how the availability of consumer credit would be negatively impacted by the enactment of the Governor's budget proposal. Higher interest rates, or the inability to qualify for a loan would simply drive some consumers out of the market altogether. In the current deficit environment, and with tax revenues declining, now is not the time to discourage consumer spending by enacting a policy that restricts credit availability.

In addition to the impact on credit, the measure also penalizes low-income consumers who purchase vehicles, rather than leasing them. This is due to the fact that California collects the sales tax on leased vehicles on a monthly basis, whereas the state collects the sales tax in its entirety at the time of purchase for financed vehicles. The bad debt deduction creates some level of parity for low-income purchasers who may not qualify for leases because if they default, the sales tax is deducted from the amount owed. In effect, the proposal will make it more difficult for consumers who are unable to lease vehicles.

The State Board of Equalization, in its analysis of prior efforts to repeal the bad deduction, recognized current law as *"a fair method of correcting the perceived double standard in the law where the state was able to retain sales and use tax dollars that would otherwise be refunded to a retailer had it not sold the debt to a lender or an assignee."*

For these reasons, we must respectfully oppose this part of the Governor's budget. Please do not hesitate to contact us if you have any questions.

Sincerely,

California Bankers Association
American Financial Services Association
California Business Roundtable
California Chamber of Commerce
Card Coalition
California Credit Union League
California Financial Services Association
California Retailers Association
California Taxpayers Association
Electronic Transactions Association

cc: All Members, Assembly Committee on Budget
Patrick Le, Consultant, Assembly Committee on Budget
Brent Finkel, Consultant, Assembly Republican Caucus
All Members, Senate Committee on Budget and Fiscal Review
Elisa Wynne, Staff Director, Senate Committee on Budget and Fiscal Review
Chantele Denny, Consultant, Senate Republican Caucus