



## The Minnesota Supreme Court Determines Retailer Cannot Claim a Sales Tax Offset Based on Uncollectible Debts

The Minnesota Supreme Court recently ruled that a large home improvement retailer cannot claim a sales tax offset based on uncollectible debts from purchases made on its private label credit card, in the case *Menard, Inc. v. Commissioner of Revenue*, case number A20-0241. The home improvement retailer, attempted to offset its sales tax liability pursuant to Minnesota Statutes § 297A.81, subd. 1 that allows a taxpayer to offset against its current sales tax liability taxes “previously paid as a result of any transaction the consideration for which became a debt owed to the taxpayer that became uncollectible during the reporting period.”

Menard operates home improvement retail stores in Minnesota and other Midwestern states under the name “Menards.” Menard has a private label credit card, issued by Capital One to Menard’s customers. Capital One determined who qualified for the private label credit card and the credit limit. Capital One also owned the cardholders’ accounts, collected the amounts due, and received all payments. Menard provided Capital One with daily data on what purchases were made on the private label credit card and any associated sales tax charged. Capital One reimbursed Menard for the purchase price and sales tax, less an agreed upon discount fee. Menard then reported and paid the sales tax to the state.

Pursuant to an agreement, Capital One shared financing income with Menard and Menard agreed to accept a share of the net losses incurred in the cardholder program. Capital One reduced the compensation paid to Menard by Menard’s share of the net program losses. While Capital One deducted the delinquent account balances on its federal income tax returns as bad debts under I.R.C. § 166(a)(1), Menard did not. Instead, Menard claimed its share of the net program losses on the

"other deductions" line. On its state tax filings, Menard claimed an offset against its current sales tax liability based on its share of the net program losses. The Minnesota Commissioner of Revenue audited Menard and disallowed the sales tax offsets, concluding that the bad debts belonged to Capital One, not Menard, and assessed Menard with additional sales tax and interest. The Minnesota Tax Court of Appeals affirmed the Commissioner's decision and Menard appealed.

It was uncontested that Menard previously paid the sale tax owed from transactions on its private label credit card. However, Menard was made whole within a matter of days by Capital One, including for the sales tax liability. After that point, there was no debt owed to Menard and Capital One had the sole right to any funds collected from the customers. Menard contended that the proper focus was not on Capital One's ownership of the account indebtedness but rather on Menard's share of the net program losses. Menard argued that by sharing in the program losses that Menard "essentially guaranteed" a portion of the cardholder's debts and therefore was entitled to offset the tax liability. Thus, as a guarantor Menard argued that it was "eligible" to take a bad debt deduction under I.R.C. § 166 for its share of the net program losses and thus able to claim an offset of the sales tax liability in the same amount under Minn. Stat. § 297A.81, subd. 1. The Court disagreed with Menard's argument.

While the parties' agreement allowed Menard to share in the profitability based on a formula that used both net profits and net losses, it was Capital One who was owed the debt by the cardholders. Nothing in the parties' agreement provided that Menard guaranteed any portion of the cardholders' debt and the record did not support that there was a guaranty. In addition, the conduct of the parties also influenced the Court's decision. The Court reasoned that if Menard was a guarantor of the debt, and Menard's share of the net program losses paid that debt, then Capital One would not have any debt to deduct as Menard's payment would have satisfied the debtors' obligation. Indeed, Capital One deducted the total amount of the defaulted accounts as bad debts under I.R.C. § 166 on its income tax returns and did not reduce that amount by Menard's share of the net program losses.

## Key Takeaway

The Court determined that because Menard was not a guarantor, and did not essentially act as a guarantor, of the account holders' debts that Menard was not owed an uncollectible debt that could be used to offset sales tax owed to the State of Minnesota.

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