PROPOSED RULE MAKING

CR-102 (June 2012)
(Implements RCW 34.05.320)
Do **NOT** use for expedited rule making

Agency: Department of Revenue

☒ **Preproposal Statement of Inquiry was filed as WSR 15-05-040; or**
☐ **Expedited Rule Making--Proposed notice was filed as WSR ; or**
☐ **Proposal is exempt under RCW 34.05.310(4) or 34.05.330(1).**

☒ **Original Notice**
☐ **Supplemental Notice to WSR**
☐ **Continuance of WSR**

Title of rule and other identifying information: WAC 458-20-196 *Bad debts* (Rule 196) provides information about the tax treatment of bad debts under the business and occupation (B&O), public utility, retail sales, and use taxes.

Hearing location(s):
Capitol Plaza Building
Fourth Floor Executive Conference Room
1025 Union Avenue SE
Olympia, Washington 98501

Copies of draft rules are available for viewing and printing on our website at Rules Agenda

Call in option can be provided upon request no later than 3 days before the hearing date.

Date: **June 17, 2015** **Time:** **9:30 AM**

Submit written comments to:
Name: Mark E. Bohe
Address: Department of Revenue
Interpretations and Technical Advice Division
Post Office Box 47453
Olympia, Washington 98504-7453

E-mail: markbohe@dor.wa.gov

By: June 17, 2015 at noon

Date of intended adoption: June 24, 2015
(Note: This is **NOT** the **effective** date)

Assistance for persons with disabilities: Contact Mary Carol LaPalm (360) 725-7499 or Renee Cosare (360) 725-7514 no later than 10 days before the hearing date. For Hearing Impaired please contact us via the Washington Relay Operator at (800) 833-6384.

Purpose of the proposal and its anticipated effects, including any changes in existing rules: Rule 196 is being amended to address a proposed change concerning the sale of repossessed property securing a bad debt with post-recovery repairs and improvements. Other changes include: (1) adding language in the introduction; (2) adding clarifying language throughout the rule; and (3) repositioning the examples to where the applicable law is interpreted.

Reasons supporting proposal: Explains tax consequences when repossessed property securing a bad debt is sold with post recovery improvements.

Statutory authority for adoption: RCW 82.32.300 and 82.01.060(2)

Statute being implemented: RCW 82.08.037, 82.12.037, 82.04.4284, and 82.16.050(5)

Is rule necessary because of a:

Federal Law?	☐ Yes	☒ No
Federal Court Decision?	☐ Yes	☒ No
State Court Decision?	☐ Yes	☒ No

If yes, CITATION:

DATE April 30, 2015

NAME
Dylan Waits

SIGNATURE

TITLE
Rules Coordinator

CODE REVISER USE ONLY

OFFICE OF THE CODE REVISER
STATE OF WASHINGTON
FILED

DATE: April 30, 2015
TIME: 1:59 PM

WSR 15-10-057

(COMPLETE REVERSE SIDE)

Agency comments or recommendations, if any, as to statutory language, implementation, enforcement, and fiscal matters: None

Name of proponent: Department of Revenue

☐ Private
☐ Public
☒ Governmental

Name of agency personnel responsible for:

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Has a small business economic impact statement been prepared under chapter 19.85 RCW or has a school district fiscal impact statement been prepared under section 1, chapter 210, Laws of 2012?

☐ Yes. Attach copy of small business economic impact statement or school district fiscal impact statement.

A copy of the statement may be obtained by contacting:
Name:
Address:

phone ()
fax ()
e-mail

☒ No. Explain why no statement was prepared.

The rules do not impose any new performance requirements or administrative burden on any small business not required by statute.

Is a cost-benefit analysis required under RCW 34.05.328?

☐ Yes A preliminary cost-benefit analysis may be obtained by contacting:
Name:
Address:

phone ()
fax ()
e-mail

☒ No: Please explain:

The proposed rules are not significant legislative rules as defined by RCW 34.05.328.

AMENDATORY SECTION (Amending WSR 10-21-012, filed 10/7/10, effective 11/7/10)

WAC 458-20-196 Bad debts. (1) **Introduction.** This ((~~section~~)) rule provides information about the tax treatment of bad debts under the business and occupation (B&O), public utility, retail sales, and use taxes.

(a) **Rule examples.** This rule includes a number of examples that identify a set of facts and then state a conclusion. The examples should be used only as a general guide. The department of revenue (department) will evaluate each case on its particular facts and circumstances and apply both this rule and other statutory and common law authority. Examples are numbered consecutively throughout this rule.

In all examples, an eight percent combined state and local sales tax is assumed. Figures are rounded to the nearest dollar. Payments are applied first against interest and then ratably against the taxable price, sales tax and other charges except when special provisions for subsequent recoveries on a bad debt apply (see subsections (2) and (3) of this rule). It is assumed that the income from all retail sales described has been properly reported under the retailing B&O tax classification and that all interest or service fees described have been accrued, reported, and state and local B&O taxes paid under the service and other activities B&O tax classification.

(b) **References to related rules.** The department has adopted other rules that readers may want to refer to:

(i) WAC 458-20-197 When tax liability arises;

(ii) WAC 458-20-198 Installment sales, method of reporting;

(iii) WAC 458-20-199 Accounting methods; and

(iv) WAC 458-20-247 Trade-ins, selling price, sellers' tax measure.

(c) **Bad debt deduction for accrual basis taxpayers.** Bad debt credits, refunds, and deductions occur when income reported by a taxpayer is not received. Taxpayers who report using the cash method do not report income until it is received. For this reason, bad debts are most relevant to taxpayers reporting income on an accrual basis. However, some transactions must be reported on an accrual basis by all taxpayers, including installment sales and leases. These transactions are eligible for a bad debt credit, refund, or deduction as described in this ((~~section. For information on cash and accrual accounting methods, refer to WAC 458-20-197 (When tax liability arises) and WAC 458-20-199 (Accounting methods). Refer to WAC 458-20-198 (Installment sales, method of reporting) and WAC 458-20-199(3) for information about reporting installment sales~~)) rule.

((~~(b)~~)) (d) **Relationship between retailing B&O tax deduction and retail sales tax credit.** Generally, a retail sales tax credit for bad debts is reported as a deduction from the measure of sales tax on the excise tax return. The amount of this deduction, or the measure of a recovery of sales tax that must be reported, may differ from the amount reported as a deduction or recovery from the retailing B&O tax classification due to exempt sales (for example: Sales of motor vehicles and trailers for use in interstate or foreign commerce (RCW 82.08.0263); and sales of manufacturing machinery and equipment (RCW 82.08.02565)).((~~)~~

~~(c)~~))

(e) **Relationship to federal income tax return.** Washington credits, refunds, and deductions for bad debts are based on federal standards for worthlessness under section 166 of the Internal Revenue Code of 1986 (26 U.S.C. Sec. 166), as amended or renumbered as of January 1, 2003. If a federal income tax return is not required to be filed (for example, where the taxpayer is an exempt entity for federal purposes), the taxpayer is eligible for a bad debt credit, refund, or deduction on the Washington tax return if the taxpayer would otherwise be eligible for the federal bad debt deduction.

(2) **Retail sales and use tax.**

(a) **General rule.** Under RCW 82.08.037 and 82.12.037, sellers are entitled to a credit or refund for sales and use taxes previously paid on "bad debts" under section 166 of the Internal Revenue Code of 1986 (26 U.S.C. Sec. 166), as amended or renumbered as of January 1, 2003. Taxpayers may claim the credit or refund for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes. However, "bad debts" do not include:

(i) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(ii) Expenses incurred in attempting to collect debt;

(iii) Debts sold or assigned by the seller to third parties, where the third party is without recourse against the seller (see (c) of this subsection for additional information about this restriction); and

(iv) The value of repossessed property taken in payment of debt.

(b) **Recoveries.** If a taxpayer takes a credit or refund for sales or use taxes paid on a bad debt and later collects some or all of the debt, the amount of sales or use tax recovered must be repaid in the tax-reporting period during which collection was made. The amount of tax that must be repaid is determined by applying the recovered amount first proportionally to the taxable price of the property or service and the sales or use tax thereon and secondly to any interest, service charges, and any other charges.

Example 1. Joe's Hardware, Inc. (Joe's Hardware) makes a retail sale of goods with a selling price of $500. Joe's Hardware pays $40 in retail sales tax to the department and accrued and paid state and local B&O tax on the interest and fees. No payment is received by Joe at the time of sale.

Bad debt. Assume that one and one-half years later, no payment has been received by Joe's Hardware, and the balance with interest is $627. Joe's Hardware is entitled to claim a bad debt deduction on its federal income tax return. It is also entitled to claim a bad debt retail sales tax credit or refund in the amount of $40, a B&O tax deduction of $500 under the retailing B&O tax classification, and a B&O tax deduction of $87 under the service and other activities B&O tax classification for the accrued interest.

Recoveries. Assume six months after the credit and deduction are claimed by Joe's Hardware, a $50 payment is received on the debt. Recoveries received on a retail sale after a credit and deduction have already been claimed must be applied first proportionally to the taxable price and retail sales tax thereon in order to determine the amount of tax that must be repaid. Therefore, Joe's Hardware must report $4, or $50 x ($40/$540), of retail sales tax on the current excise tax return and $46, or $50 x ($500/$540) under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $40 credit for retail sales tax is reduced to zero.

(c) **Assigned debt and installment sales.** Effective July 1, 2010, RCW 82.08.037 and 82.12.037 limit who can claim a credit or refund for retail sales or use tax. Only the original seller in the transaction that generated the bad debt, or a certified service provider (CSP) used by the seller, is entitled to claim a credit or refund on or after July 1, 2010. If the original seller in the transaction that generated the bad debt has sold or assigned the debt instrument to a third party with recourse, the original seller may claim a credit or refund only after the debt instrument is reassigned by the third party to the original seller. In the case where the seller uses a CSP to administer its retail sales tax responsibilities the CSP may claim, on behalf of the seller, the credit or refund allowed. ((~~See chapter 23, Laws of 2010, 1st sp. sess., (2ESSB 6143).~~))

(3) **Business and occupation tax.**

(a) **General rule.** Under RCW 82.04.4284, taxpayers may deduct from the measure of B&O tax "bad debts" under section 166 of the Internal Revenue Code of 1986 (26 U.S.C. Sec. 166), as amended or renumbered as of January 1, 2003, on which tax was previously paid. Taxpayers may claim the deduction for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes. However, the amount of the deduction must be adjusted to exclude amounts attributable to:

(i) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;

(ii) Retail sales or use taxes payable to a seller;

(iii) Expenses incurred in attempting to collect debt; and

(iv) The value of repossessed property taken in payment of debt.

(b) **Recoveries.** Recoveries received by a taxpayer after a bad debt is claimed are applied under the ((~~rules~~)) provisions described in subsection (2)(b) of this ((~~section~~)) rule if the transaction involved is a retail sale. The amount attributable to "taxable price" is reported under the retailing B&O tax classification. If the recovery of debt is not related to a retail sale, recovered amount is applied proportionally against the components of the debt (e.g., interest and principal remaining on a wholesale sale).

Example 2. Assume Joe's Hardware, Inc. (Joe's Hardware) makes a retail sale of goods on credit for $500. Joe's Hardware pays $40 in sales tax to the department and accrued and paid state and local B&O tax on the interest and fees. Assume no payment is received at the time of sale. Over the following year, regular payments are received and the debt is reduced to $345, exclusive of any interest or service charges. The $345 represents retail sales tax due to Joe's Hardware in the amount of $26, or $345 x ($40/$540), and $319 remaining of the original purchase price, or $345 x ($500/$540). Payments cease.

Example 3. Assume same facts as Example 2 above continue but now assume a bad debt. Six months after payments ceased the balance with interest and service fees is $413. Joe's Hardware is entitled to claim a bad debt deduction on the federal income tax return. Joe's Hardware is also entitled to claim a retail sales tax refund or credit on the current excise tax return of $26, a deduction under the retailing B&O tax classification of $319, and a deduction under the service and other activities B&O tax classification of $68 for the accrued interest and service fees.

Example 4. Assume the same facts in Example 3 above continue but before Joe's Hardware charges off the debt, it repossesses the goods. At that time, the goods have a fair market value of $250. No credit is allowed for repossessed property, so the value of the collateral must be applied against the outstanding balance. After the value of the collateral is applied, Joe's Hardware has a remaining balance of $163, or $413 - $250. The allocation rules for recoveries do not apply because a bad debt credit or refund has not yet been taken. The value is applied first against the $68, or $413 - $345, of interest and service fees, which is subject to service and other activities B&O tax, so the $163 remaining is attributable entirely to taxable price and sales tax. Any costs Joe's Hardware may incur related to locating, repossessing, storing, or selling the goods do not offset the value of the collateral because no credit is allowed for collection costs. Joe's Hardware is entitled to a sales tax refund or credit in the amount of $12, or $163 x ($40/$540) and deduction of $151, or $163 x ($500/$540) under the retailing B&O tax classification.

Example 5. Assume the same facts in Example 4 above continue but assume Joe's Hardware claimed a bad debt deduction and the sale of the repossessed goods occurred without subsequent repairs or improvements when the nonclaim statute limitations applicable to the original transaction had not expired. If Joe's Hardware later sells the repossessed goods, it must pay B&O tax and collect retail sales tax as applicable. If the sales price of the repossessed goods is different from the fair market value previously reported, then Joe's Hardware must report the difference between the selling price and the claimed fair market value as an additional bad debt credit or deduction or report it as an additional recovery, as appropriate. This is because the sales price establishes the correct value of the repossessed goods.

Example 6. Assume the same facts in Example 5 continue but assume Joe's Hardware claimed the bad debt deduction and the sale of repossessed goods occurred after subsequent repairs and improvements when the nonclaim statute limitations applicable to the original transaction had not expired. The sales price of the repossessed goods will be higher than the value of the goods when Joe first regained possession. Joe's Hardware must report the difference between the value of the goods upon repossession and the claimed fair market value as an additional recovery, as appropriate. Because the sales price of the goods was increased by the repairs and improvements made after repossession, it must determine the value of the goods after repossession by determining the value of the goods before the repairs and improvements. Joe's Hardware can establish the value of the goods after repossession before the repairs and improvements by using the greater of:

• The value using an established authoritative appraisal measure generally accepted by the industry; or

• The value by subtracting from the sales price the cost of the post-recovery repairs and improvements generally accepted by the industry as increasing the goods' value.

(c) **Extracting and manufacturing classifications.** Bad debt deductions are only allowed under the extracting or manufacturing classifications when the value of products is computed on the basis of gross proceeds of sales.

(4) **Public utility tax.** Under RCW 82.16.050(5), taxpayers may deduct from the measure of public utility tax "bad debts" under section 166 of the Internal Revenue Code of 1986 (26 U.S.C. Sec. 166), as amended or renumbered as of January 1, 2003, on which tax was previously paid. Taxpayers may claim the deduction for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt de-

duction for federal income tax purposes. No deduction is allowed for collection or other expenses.

(5) **Application of payments - General rule.** The special ((~~rules~~)) provisions for application of payments received in recovery of previously claimed bad debts described in subsections (2)(b) and (3)(b) of this ((~~section~~)) rule are not used for other payments. Payments received before a bad debt credit, refund, or deduction is claimed should be applied first against interest and then ratably against other charges. Another commercially reasonable method may be used if approved by the department.

(6) **Private label credit cards.** If a business contracts with a financial company to provide a private label credit card program, and the financial company becomes the exclusive owner of the credit card accounts and solely bears the risk of all credit losses, the business that contracted with the financial company is not entitled to any bad debt deduction if a customer fails to pay his or her credit card invoice.

Example 7. Assume Hot Shot Ski Equipment (Hot Shot) is a sporting equipment retailer. Hot Shot contracts with ABC Financial Institution (ABC) to issue a Hot Shot private label credit card. ABC has the authority to accept or reject an applicant's credit card application. After Hot Shot transmits the credit card sales records to ABC, ABC pays Hot Shot the proceeds of the sales including the retail sales tax minus any applicable service fees. Hot Shot remits the retail sales tax to the Department of Revenue. If a customer using the Hot Shot credit card fails to pay ABC the outstanding amount on the credit card invoice, ABC suffers the loss. Hot Shot is not entitled to a bad debt deduction or credit ((~~as~~)) because it has no bad debt loss when a customer defaults on a debt to ABC.

(7) **Reserve method.** Ordinarily, taxpayers must report bad debt refunds, credits, or deductions for specifically identified transactions. However, taxpayers who are allowed by the Internal Revenue Service to use a reserve method of reporting bad debts for federal income tax purposes, or who secure permission from the department to do so, may deduct a reasonable addition to a reserve for bad debts. What constitutes a reasonable addition to a reserve for bad debts must be determined in light of the facts and will vary between classes of business and with conditions of business prosperity. An addition to a reserve allowed as a deduction by the Internal Revenue Service for federal income tax purposes, in the absence of evidence to the contrary, will be presumed reasonable. When the reserve method is employed, an adjustment to the amount of loss deducted must be made annually to make the total loss claimed for the tax year coincide with the amount actually sustained.

(8) **Nonclaim statute ((~~of~~)) limitations for claiming bad debts.** No credit, refund, or deduction, as applicable, may be claimed for debt that became eligible for a bad debt deduction for federal income tax purposes more than four years before the beginning of the calendar year in which the credit, refund, or deduction is claimed.

((~~(9) **Examples.** The following examples identify a number of facts and then state a conclusion. These examples should be used only as a general guide. The tax results of other situations must be determined after a review of all of the facts and circumstances.~~

~~In all cases, an eight percent combined state and local sales tax rate is assumed. Figures are rounded to the nearest dollar. Payments are applied first against interest and then ratably against the taxable price, sales tax, and other charges except when the special rules~~

~~for subsequent recoveries on a bad debt apply (see subsections (2) and (3) of this section). It is assumed that the income from all retail sales described has been properly reported under the retailing B&O tax classification and that all interest or service fees described have been accrued and reported under the service and other activities B&O tax classification.~~

~~(a) **Scenario 1.** Joe's Hardware makes a retail sale of goods with a selling price of $500 and pays $40 in sales tax to the department. No payment is received by Joe at the time of sale.~~

~~(i) Bad debt. One and a half years later, no payment has been received by Joe, and the balance with interest is $627. Joe is entitled to claim a bad debt deduction on his federal income tax return. He is also entitled to claim a bad debt sales tax credit or refund in the amount of $40, a B&O tax deduction of $500 under the retailing B&O tax classification, and a B&O tax deduction of $87 under the service and other activities B&O tax classification.~~

~~(ii) Recoveries. Six months after the credit and deduction are claimed, a $50 payment is received on the debt. Recoveries received on a retail sale after a credit and deduction have already been claimed must be applied first proportionally to the taxable price and sales tax thereon in order to determine the amount of tax that must be repaid. Therefore, Joe must report $4, or $50 x ($40/$540), of sales tax on the current excise tax return and $46, or $50 x ($500/$540) under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $40 credit for sales tax is reduced to zero.~~

~~(b) **Scenario 2.** Joe makes a retail sale of goods on credit for $500 and pays $40 in sales tax to the department. No payment is received at the time of sale. Over the following year, regular payments are received and the debt is reduced to $345, exclusive of any interest or service charges. The $345 represents sales tax due to Joe in the amount of $26, or $345 x ($40/$540), and $319 remaining of the original purchase price, or $345 x ($500/$540). Payments cease.~~

~~(i) Bad debt. Six months later the balance with interest and service fees is $413. Joe is entitled to claim a bad debt deduction on the federal income tax return. He is also entitled to claim a sales tax refund or credit on the current excise tax return of $26, a deduction under the retailing B&O tax classification of $319, and a deduction under the service and other activities B&O tax classification of $68.~~

~~(ii) Recoveries. Before Joe charges off the debt, he repossesses the goods. At that time, the goods have a fair market value of $250. No credit is allowed for repossessed property, so the value of the collateral must be applied against the outstanding balance. After the value of the collateral is applied, Joe has a remaining balance of $163, or $413 - $250. The allocation rules for recoveries do not apply because a bad debt credit or refund has not yet been taken. The value is applied first against the $68, or $413 - $345, of interest, so the $163 remaining is attributable entirely to taxable price and sales tax. Any costs Joe may incur related to locating, repossessing, storing, or selling the goods do not offset the value of the collateral because no credit is allowed for collection costs. Joe is entitled to a sales tax refund or credit in the amount of $12, or $163 x ($40/$540) and deduction of $151, or $163 x ($500/$540) under the retailing B&O tax classification.~~

~~(iii) Sales of repossessed goods. If Joe later sells the repossessed goods, he must pay B&O tax and collect retail sales tax as ap-~~

~~plicable. If the sales price of the repossessed goods is different from the fair market value previously reported and the statute of limitations applicable to the original transaction has not expired, Joe must report the difference between the selling price and the claimed fair market value as an additional bad debt credit or deduction or report it as an additional recovery, as appropriate.~~

~~(c) **Scenario 3.**~~)) **Example 8.** Assume Phil, ((~~of~~)) doing business as Phil's Fine Cars, sells a car at retail for $1000 and charges Alice, the buyer, an additional $50 for license and registration fees.

((~~(i)~~)) **Trade-in accepted.** Assume Phil accepts trade-in property with a value of $500 in which Alice has $300 of equity. (The value of trade-in property of like kind is excluded from the selling price for purposes of the retail sales tax. Refer to WAC 458-20-247 for further information.) Phil properly bills Alice for $40 of retail sales tax, for a total of $1090 owed to Phil by Alice. Phil pays the department the $40 in retail sales tax. No payment other than the trade-in is received by Phil at the time of sale.

((~~(ii)~~)) **Bad debt.** Assume eight months later, Phil has not received any payment. Phil is entitled to claim a bad debt deduction on his federal income tax return. The equity in the trade-in is equivalent to a payment received at the time of purchase, reducing the balance remaining on the initial sale to $790, or $1090 - $300. Phil is entitled to claim a retail sales tax credit or refund of $29, or $790 x ($40/$1090) of retail sales tax, and a deduction of $725, or $790 x ($1000/$1090) under the retailing B&O tax classification, exclusive of any deduction for accrued interest.

((~~(d) **Scenario 4.** Phil~~)) **Assignment of contract.** Assume that immediately after the sale of the car by Phil, of Phil's Fine Cars, to Alice, the buyer, Phil assigns the contract to a finance company without recourse, receiving face value for the contract. The finance company may not claim the retail sales tax credit or refund. The finance company may not claim any deduction for Phil's B&O tax liability. No bad debt deduction or credit is available to Phil, as the contract was sold without recourse.

Example 9. Assume Phil, doing business as Phil's Fine Cars, sells a car at retail for $1000, and charges Jake an additional $50 for license and registration fees. Phil properly bills Jake for $80 of retail sales tax and remits it to the department. No money is received from Jake at the time of sale.

((~~(i)~~)) **Bad debt.** Assume eight months later Phil is entitled to claim a bad debt deduction on the federal income tax return. Further, assume Phil accrued and paid state and local B&O taxes on interest and fees. Phil claims an $80 retail sales tax credit, a $1000 retailing B&O tax deduction, and an additional amount under the service and other activities classification for accrued interest and fees.

((~~(ii)~~)) **Recoveries.** Assume six months after claiming a bad debt, Phil receives a $200 payment from Jake. Recoveries must be allocated first proportionally to the taxable price (the measure of the sales tax) and the sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Phil must report $15, or $200 x ($80/$1080) of retail sales tax and $185, or $200 x ($1000/$1080) of income under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $80 sales tax credit is reduced to zero.

((~~(e) **Scenario 5.** Phil~~)) **Example 10.** Assume Phil, doing business as Phil's Fine Cars, sells a car at retail for $1000, and charges Robin an additional $50 for license and registration fees.

((~~(i)~~)) **Trade-in accepted.** Assume Phil accepts trade-in property with a value of $500 in which Robin has $300 of equity. Phil properly bills Robin for $40 of retail sales tax for a total of $1090 owed to Phil by Robin. No payment other than the trade-in is received by Phil at the time of sale.

((~~(ii)~~)) **Bad debt.** Assume eight months later, no payment has been received by Phil. Phil is entitled to claim a bad debt deduction on the federal income tax return. The equity in the trade-in is equivalent to a payment received at the time of purchase, reducing the balance remaining on the initial sale to $790, or $1090 - $300. Phil is entitled to claim a retail sales tax credit or refund of $29, or $790 x ($40/$1090) of retail sales tax, and a deduction of $725, or $790 x ($1000/$1090) under the retailing B&O tax classification, exclusive of any deduction for accrued interest.

((~~(iii)~~)) **Recoveries.** Assume six months after that, Phil receives a $200 payment from Robin. Recoveries must be allocated first proportionally to the taxable price (the measure of the retail sales tax) and retail sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Phil must report $15, or $200 x ($40/$540) in retail sales tax, and $185, or $200 x ($500/$540) under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original $29 sales tax credit is reduced to zero.

((~~(f) **Scenario 6.** The facts are the same as in Scenario 3 (c) of this subsection, except that immediately after the sale, Phil assigns the contract to a finance company without recourse, receiving face value for the contract. The finance company may not claim the retail sales tax credit or refund. The finance company may not claim any deductions for Phil's B&O tax liability. No bad debt deduction or credit is available to Phil, as the contract was sold without recourse.~~)) **Example 11.** Assume Phil, of Phil's Fine Cars, sells a car at retail for $1000 and charges Alice, the buyer, an additional $50 for license and registration. At the time of sale, Alice pays $300 to Phil as a down payment. Phil properly bills Alice for $80 of retail sales tax, for a total of $1130 owed to Phil by Alice. Phil pays the department the $80 retail sales tax. No payment other than the $300 is received by Phil at the time of sale. Eight months later Phil has not received any payments and Phil is entitled to claim a bad debt deduction on his federal income tax return.

Bad debt. Assume eight months later the balance owed is $830 or $1130 - $300 from the initial sale, exclusive of any interest or service charges. Assuming interest and fees accrued during the eight months of $16 and that Phil paid state and local B&O tax on the interest and fees, Phil is allowed a bad debt deduction of $846. Phil is entitled to claim a bad debt deduction on his federal income tax return. Phil is also entitled to claim a retail sale tax refund or credit on the current excise tax return of $60, or $846 X ($80/$1130), a bad debt deduction under the retailing B&O tax classification of $749, or $846 X ($1000/$1130), and a bad debt deduction under the service and other activities B&O tax classification of $37, or $846 X ($50/$1130) for the accrued interest.

Recovery and sale of repossessed car without subsequent repairs or improvements. Assume the car was repossessed, incurring attorney's fees of $250, and the sale of the repossessed car occurred without subsequent repairs of improvements when the nonclaim statute limitations applicable to the original transaction had not expired. The $250 paid for attorney's fees is an expense incurred to collect debt that is not deductible as a bad debt or business expense. When Phil sells the repossessed car, he must pay B&O tax and collect retail sales tax as applicable. If the sales price of the repossessed car is different from the fair market value previously reported for purposes of the prior bad debt deduction, then Phil must report the difference between the selling price and the claimed fair market value as an additional bad debt credit or deduction or report it as an additional recovery, as appropriate. This is because the sales price establishes the correct value of the repossessed car.

Recovery and sale of repossessed car with subsequent repairs or improvements. Assume the car was repossessed, incurring attorney's fees of $250, and the sale of the repossessed car occurred with subsequent repairs of improvements totaling $425 when the nonclaim statute limitations applicable to the original transaction had not expired. The $250 paid for attorney's fees is an expense incurred to collect debt that is not deductible as a bad debt or business expense. When Phil sells the repossessed car, the sales price of the repossessed car will be higher than the value of the car when Phil first regained possession. Phil must report the difference between the value of the car upon repossession and the claimed fair market value as an additional recovery, as appropriate. Because the sales price of the car was increased by the repairs and improvements made after repossession, Phil must determine the value of the car repossessed by determining the value of the car before the repairs and improvements. Phil can establish the value of the car after repossession before the repairs and improvements by using the greater of:

• The value using an established authoritative appraisal measure generally accepted by the industry; or

• The value by subtracting from the sales price the cost of the post-recovery repairs and improvements generally accepted by the industry as increasing an automobile's value.