

This rule is being proposed under an expedited rule-making process that will eliminate the need for the agency to hold public hearings, prepare a Small Business Economic Impact Statement, or provide responses to the criteria for a significant legislative rule. If you object to this use of the expedited rule-making process you must express your objections in writing by December 5, 2005.

AMENDATORY SECTION (Amending WSR 05-04-048, filed 1/27/05, effective 2/27/05)

WAC 458-20-196 Bad debts. (1) Introduction.

(a) **New laws effective July 1, 2004.** This rule provides information about the tax treatment of bad debts under the business and occupation (B&O), public utility, retail sales, and use taxes, and reflects legislation enacted in 2003 and 2004 conforming Washington law to provisions of the national Streamlined Sales and Use Tax Agreement. See chapter 168, Laws of 2003 and chapter 153, Laws of 2004. The new laws related to bad debts are effective July 1, 2004.

(b) **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 rule. 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.

(c) **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, is the same as the amount reported as a deduction or recovery under the retailing B&O tax classification.

(d) **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. 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, 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, the amount of any credit or refund 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) Expenses incurred in attempting to collect debt; and

(iii) 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 and the sales or use tax thereon and secondly to any interest, service charges, and any other charges.

(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, 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) 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 described in subsection (2)(b) (~~above~~) of this section 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).

(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, 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. No deduction is allowed for collection or other expenses.

(5) **Application of payments - general rule.** The special rules for application of payments received in recovery of previously claimed bad debts described in subsections (2)(b) and (3)(b) (~~above~~) of this section 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) **Assigned debt and installment sales.**

(a) **General rule.** If a person makes a retail sale under an installment sales contract and then legally assigns his or her rights under the contract to another party, the assignee "steps into the shoes" of the person making the sale and may claim a bad debt credit or refund for unpaid retail sales tax to the extent a credit or refund would have been available to the original seller and to the extent that the assignee actually incurs a loss. The seller's B&O tax deduction for bad debt may not be claimed by an assignee. A retail sales tax bad debt credit or refund for unpaid sales tax is available only to the person who makes the retail sale or an assignee under the contract. For example, a bank that loans money to the purchaser of a vehicle may not claim a retail sales tax bad debt credit or refund. The bank did not sell the vehicle and is not an assignee of the dealer who made the retail sale.

(b) **Discounts.** A person who makes a retail sale on credit and then assigns the sales contract in exchange for less than the face value of the contract may not claim a bad debt credit, refund, or deduction for the difference between the face value and the amount received. The discount is a nondeductible cost of doing business, not a bad debt. An assignee of a retail sales contract that pays less than face value for the contract is not required to reduce the amount of a retail sales tax bad

debt credit or refund in proportion to the amount of the discount. The assignee may take a credit or refund for the amount that would have been available to the original seller if the original seller had retained the contract and received the payments made by the buyer.

(c) **Recourse financing.** An assignee who receives payment on a bad debt from the assignor must reduce the sales tax credit in proportion to the payment. The assignor may claim a sales tax credit and retailing B&O tax deduction in proportion to the payment if obligated to make the payment and otherwise qualified under this rule.

(d) **Documentation.** All persons claiming a bad debt credit for installment contracts must retain appropriate documentation, including documentation establishing:

(i) The amount of the original sale by the seller, and component amounts necessary to determine that amount, such as credits for trade-ins, down payments, and individual amounts charged for different products;

(ii) The buyer's equity in any trade-in property;

(iii) The contract principal owed at the time of repossession, if any; and

(iv) The deductibility of the debt as worthless for federal income tax purposes.

(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) **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 ~~(rule)~~ 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) Seller 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 Seller at the time of sale. One and a half years later, no payment has been received by Seller, and the balance with interest is \$627. Seller is entitled to claim a bad debt deduction on the federal income tax return. Seller is 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.

(b) The facts are the same as in (a) of this subsection ~~((9)(a) above)~~, except that 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, Seller must report \$4, or $\$50 \times (\$40/\$540)$, of sales tax on the current excise tax return and \$46, or $\$50 \times (\$500/\$540)$ under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original \$40 credit is reduced to zero.

(c) Seller 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 Seller in the amount of \$26, or $\$345 \times (\$40/\$540)$, and \$319 remaining of the original purchase price, or $\$345 \times (\$500/\$540)$. Payments cease. Six months later the balance with interest and service fees is \$413. Seller is entitled to claim a bad debt deduction on the federal income tax return. Seller is 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.

(d) The facts are the same as in (c) of this subsection (~~((9)(e) above~~)), except that before Seller charges off the debt, Seller 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, Seller 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 Seller 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. Seller 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. If Seller later sells the repossessed goods, Seller 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 and the statute of limitations applicable to the original transaction has not expired, Seller 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.

(e) Seller sells a car at retail for \$1000(~~(, Seller's extended service warranty for \$200,)~~) and charges the buyer an additional \$50 for license and registration fees. (~~((The amount received for the warranty is subject to service and other activities B&O tax. Refer to WAC 458-20-257 for information about the tax treatment of warranties.))~~) Seller accepts trade-in property with a value of \$500 in which the buyer 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.) Seller properly bills the buyer for \$40 of sales tax, for a total of (~~(\$1290)~~) \$1090 owed to Seller by the buyer. Seller pays the department the \$40 in sales tax. No payment other than the trade-in is received by Seller at the time of sale. Eight months later, Seller has not received any payment. Seller 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 (~~(\$990, or \$1290)~~) \$790, or \$1090 - \$300. Seller is entitled to claim a sales tax credit or refund of (~~(\$31, or \$990 x (\$40/\$1290))~~) \$29, or \$790 x (\$40/\$1090) of sales tax, and a deduction of (~~(\$767, or \$990 x (\$1000/\$1290))~~) \$725, or \$790 x (\$1000/\$1090) under the retailing B&O tax

classification(~~(, and a deduction of \$153, or \$990 x (\$200/\$1290) under the service and other activities B&O tax classification)~~), exclusive of any deduction for accrued interest.

(f) Seller sells a car at retail for \$1000, (~~(Seller's extended warranty for \$200,)~~) and charges the buyer an additional \$50 for license and registration fees. (~~(The amount received for the warranty is subject to service and other activities B&O tax. Refer to WAC 458-20-257 for information about the tax treatment of warranties.)~~) Seller properly bills the buyer for \$80 of sales tax and remits it to the department. No money is received from the buyer at the time of sale. Eight months later Seller is entitled to claim a bad debt deduction on the federal income tax return. Seller claims an \$80 sales tax credit, a \$1000 retailing B&O tax deduction, (~~(a \$200 deduction under the service and other activities B&O tax classification,)~~) and an additional amount under the service and other activities classification for accrued interest. Six months after that, Seller receives a \$200 payment from the buyer. Recoveries must be allocated first to taxable price (the measure of the sales tax), and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Seller must report \$15, or \$200 x (\$80/\$1080) of 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.

(g) Seller sells a car at retail for \$1000, (~~(Seller's extended warranty for \$200,)~~) and charges the buyer an additional \$50 for license and registration fees. Seller accepts trade-in property with a value of \$500 in which the buyer has \$300 of equity. Seller properly bills the buyer for \$40 of sales tax for a total of (~~(\$1290)~~) \$1090 owed to Seller by the buyer. No payment other than the trade-in is received by Seller at the time of sale. Eight months later, no payment has been received by Seller. Seller 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 (~~(\$990, or \$1290)~~) \$790, or \$1090 - \$300. Seller is entitled to claim a sales tax credit or refund of (~~(\$31, or \$990 x (\$40/\$1290))~~) \$29, or \$790 x (\$40/\$1090) of sales tax, and a deduction of (~~(\$767, or \$990 x (\$1000/\$1290))~~) \$725, or \$790 x (\$1000/\$1090) under the retailing B&O tax classification, (~~(and a deduction of \$153, or \$990 x (\$200/\$1290) under the service and other activities B&O tax classification,)~~) exclusive of any deduction for accrued interest. Six months after that, Seller receives a \$200 payment from the buyer. Recoveries must be allocated first proportionally to the taxable price (the measure

of the sales tax) and sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Seller must report \$15, or $\$200 \times (\$40/\$540)$ in sales tax, and \$185, or $\$200 \times (\$500/\$540)$ under the retailing B&O tax classification. Additional recoveries should be applied in the same manner until the original (~~(\$31)~~) \$29 sales tax credit is reduced to zero.

(h) The facts are the same as in (e) of this subsection (~~((9)(e) above)~~), except that immediately after the sale, Seller assigns the contract to a finance company without recourse, receiving face value for the contract. The finance company may claim the retail sales tax credit or refund of (~~(\$31)~~) \$29. The finance company may not claim any deductions for Seller's B&O tax liability. No bad debt deduction or credit is available to Seller.

(i) The facts are the same as in (h) of this subsection (~~((9)(h) above)~~), except that the Seller receives less than face value for the contract. The result is the same as in (h) of this subsection (~~((9)(h) above)~~) for both parties. The finance company may claim a (~~(\$31)~~) \$29 retail sales tax bad debt credit or refund, but may not claim a B&O bad debt deduction for Seller's B&O tax liability. No bad debt deduction or credit is available to Seller.