



State of Washington
Department of Revenue

Excise Tax Advisory

Excise Tax Advisories (ETA) are interpretive statements issued by the Department of Revenue under authority of RCW 34.05.230. ETAs explain the Department's policy regarding how tax law applies to a specific issue or specific set of facts. They are advisory for taxpayers; however, the Department is bound by these advisories until superseded by Court action, Legislative action, rule adoption, or an amendment to or cancellation of the ETA.

NUMBER: 574.08.198

CONVERSION DATE: July 1, 1998

FINANCIAL INSTITUTIONS INCURRING BAD DEBTS ON CONTRACT ASSIGNMENTS

Issued: March 15, 1996

This Excise Tax Bulletin explains the Department's position regarding contract assignments and retail sales tax bad debt credits as a result of the decision of the Washington State Supreme Court in Puget Sound National Bank v. Department of Revenue, 123 Wn.2d 284, 868 P.2d 127 (1994). The issue in this case was whether a bank which purchased installment contracts from dealers on a nonrecourse basis was, as assignee of the contracts, also assigned the statutory right to claim a sales tax refund if, after assignment, the buyers defaulted on their obligation to make payments.

The Court allowed the refund claims because the bank, as assignee, "stepped into the dealers' shoes and assumed the dealers' status with respect to all the rights and liabilities related to those contracts." Thus, banks, financial institutions, and other persons purchasing installment contracts are entitled to a bad debt credit when the retail seller paid the full amount of retail sales tax owed, and the assignee incurred a bad debt because the buyer defaulted on the contract. An assignee may claim a bad debt credit whether the contract was purchased on a recourse or nonrecourse basis, provided that assignee actually incurs the loss and is entitled to the federal income tax bad debt deduction.

RCW 82.08.037 provides "[a] seller is entitled to a credit or refund for sales taxes previously paid on debts which are deductible as worthless for federal income tax purposes." For federal income tax purposes, this generally means that a bad debt deduction may be claimed only after the repossessed property is disposed, and the proceeds of the disposal are applied to the outstanding account balance. However, the federal tax code does allow certain financial institutions to claim a bad debt deduction prior to the disposal of collateral. These institutions are entitled to claim a retail sales tax bad debt credit at the time they are entitled to the federal bad debt deduction.

ETBS have been made Excise Tax Advisories, and have retained their old number. Advisories with a 2 (plus three digits) are new advisories, ETBs that have been revised and readopted after review under the Department's regulatory improvement program, or advisories that have been revised and/or readopted.

Please direct comments to:
Department of Revenue
Legislation & Policy Division
P O Box 47467
Olympia, Washington 98504-7467
(360) 753-4161 eta@DOR.wa.gov

To inquire about the availability of receiving this document in an alternate format for the visually impaired or language other than English, please call (360)753-3217. Teletype (TTY) users please call 1-800-451-7985.

The federal tax code authorizes some financial institutions to establish a bad debt reserve account for determining bad debt losses. These institutions may be required to make certain year-end adjustments when claiming a retail sales tax bad debt credit. (See WAC 458-20-196.)

Financial institutions claiming federal bad debt deductions on the specific charge-off method may be entitled to make a bad debt conformity election. These institutions typically take a federal bad debt deduction at the time the property is repossessed. The repossessed property is typically "booked" to an asset account at wholesale blue book value. The difference between the outstanding contract balance and the wholesale blue book value is claimed as a bad debt deduction at that time. The institution later sells the repossessed property, and applies the proceeds to the "booked" blue book value. If these proceeds are less than this value, the difference is taken as an additional bad debt deduction. If these proceeds are greater than the blue book value, the difference should be applied as a reduction to the bad debt claim.

An institution selling repossessed property is required to remit B&O tax and collect and remit retail sales tax on the selling price of the collateral, unless specific exemptions apply. An institution receiving payment on a defaulted contract after claiming the retail sales tax bad debt credit must offset this recovery amount against any available bad debt deduction in the month of the payment.

Persons claiming a bad debt credit for installment contracts must retain appropriate documentation. This documentation must:

- 1) Provide the amount and components of original sale by the dealer;
- 2) Substantiate the buyer's equity in any trade-in property;
- 3) Provide the outstanding contract principal owed at the time of the repossession of the property;
- 4) Provide the amount and components of the sale of the repossessed property; and
- 5) Substantiate the debt as deductible as worthless for federal tax purposes.

Persons claiming a retail sales tax bad debt credit must complete the Department's Schedule B (Credit for sales taxes paid on bad debts), and attach this schedule to the Combined Excise Tax Return they file with the Department.

Example. The following example demonstrates how an institution purchasing installment sales contracts should compute the amount of its retail sales tax bad debt credit, when the institution claims bad debt deductions on the specific write-off method and has made a bad debt conformity election.

Components of original dealer sale to buyer:

Gross selling price prior to trade-in	\$12,000
Less: Trade-in:	<u>(\$10,000)</u>
Selling price net of trade-in	\$2,000
Sales tax at 8%	\$160
Excise tax and licensing fees	\$200

Cash or equivalent obligation due seller:

Gross selling price prior to trade-in	\$12,000
Less: Buyer's equity in trade-in*	<u>(\$2,000)</u>
Net before tax and license	\$10,000
Plus: Tax and license	<u>\$360</u>
Obligation due seller	\$10,360
Less: Cash down by buyer	<u>(\$1,000)</u>
Original installment contract principle	\$9,360

- Buyer has an \$8,000 underlying loan balance on trade-in property

Outstanding contract principal at time of repossession:	\$7,000
Wholesale bluebook value to asset account	<u>(\$6,000)</u>
Initial bad debt charge-off	\$1,000

Wholesale bluebook value to asset account	\$6,000	
Components of the sale of the repossessed property:		
Selling price:	(\$5,000)	Sales
tax collected at 8%:	\$400	
Second bad debt charge-off	<u> </u>	
	\$1,000	

Determining the amount of retail sales tax bad debt credit for each bad debt charge-off:

(Sales tax charged/Obligation due seller) x Bad debt charge-off

$$(\$160/\$10,360) \times \$1,000 = \$15.44$$

Note: The institution or person claiming the retail sales tax bad debt credit must code the local sales tax component of the credit to the location of the original sale.

Tax due on sale of the repossessed property:

Retailing B&O tax liability (\$5,000 X .471%):	\$24
Retail sales tax liability (\$5,000 X 8%):	\$400