

Cite as Det. No. 16-0360, 36 WTD 308 (2017)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION  
DEPARTMENT OF REVENUE  
STATE OF WASHINGTON

In the Matter of the Petition for Correction of	)	<u>D E T E R M I N A T I O N</u>
Assessment of	)	
	)	No. 16-0360
	)	
...	)	Registration No. ...
	)	

[1] Rule 196; RCW 82.08.037; RCW 82.12.037: RETAIL SALES TAX – USE TAX – CREDIT – BAD DEBT – REPOSSESSION. “Bad debts” do not include the value of repossessed property taken in payment of debt. A taxpayer overstated the amount of the tax credit, to which it was entitled, for sales and use tax it previously paid on bad debts for repossessions when it did not adjust the credit by excluding amounts attributable to the value of repossessed vehicles taken in payment of debt.

[2] Rule 196; RCW 82.04.4284: B&O TAX – DEDUCTIONS – BAD DEBT – REPOSSESSION. “Bad debts” does not include the value of repossessed vehicles taken in payment of debt. A taxpayer overstated the amount of its claimed business and occupation (B&O) tax credit for bad debts when it did not adjust its measure of B&O tax by excluding amounts attributable to the value of repossessed vehicles taken in payment of debt.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

LaMarche, T.R.O. – A used vehicle dealer disputes the Department of Revenue’s (Department) denial of a credit for sales and use tax it previously paid on bad debts for vehicles it subsequently repossessed. We deny the petition.<sup>1</sup>

ISSUES

1. Under RCW 82.08.037, RCW 82.12.037, and WAC 458-20-196, did Taxpayer overstate the amount of the tax credit, to which it was entitled, for sales and use tax it previously paid on bad debts for repossessions when it did not adjust the credit by excluding amounts attributable to the value of repossessed vehicles taken in payment of debt?

<sup>1</sup> Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

2. Under RCW 82.04.4284 and WAC 458-20-196, is Taxpayer entitled to a deduction from its measure of B&O tax for bad debts associated with vehicles it subsequently repossessed when it did not adjust its measure of B&O tax to exclude the value of the repossessed vehicles?

#### FINDINGS OF FACT

[Taxpayer] is a Washington limited liability company that owns and operates a used vehicle dealership that primarily makes retail sales of used automobiles and light trucks. The Audit Division (Audit) of the Department audited Taxpayer's business activities for the period of January 1, 2011, through June 30, 2015 (Audit Period). The Department issued an assessment for the Audit Period on October 29, 2015, Document No. . . . , totaling \$ . . . , which comprised \$ . . . in retail sales tax, \$ . . . in retailing B&O tax, \$ . . . in service and other activities B&O tax, \$ . . . in motor vehicle tax, and \$ . . . in interest. Taxpayer timely filed a petition for correction with regard to certain disallowed bad debt deductions for repossessed vehicles.

Taxpayer provided sales jackets for transactions occurring during the Audit Period, except for tax year 2011. However, Audit found that Taxpayer's records were often incomplete or missing, and were not well-organized. Taxpayer stated that it was unable to provide electronic records, and indicated that Taxpayer had suffered a loss from fire or theft and was unable to produce printed reports for some portions of the Audit Period.

Because of the issues with Taxpayer's records, time constraints, and the volume of records, Audit and Taxpayer agreed that the Department would use a test period to verify the bad debt deductions Taxpayer previously reported under the retailing and retail sales tax classifications. Audit's adjustments to retail sales tax are on Schedule 3, with Workpaper B, of the Audit Report. Schedule 4, with Schedule 3 and Workpaper B, asserts the motor vehicle sales/leases tax on the projected value of the disallowed bad debt deductions.

All bad debt deductions at issue were associated with repossessed vehicles. When customers of Taxpayer's in-house financing program failed to meet the terms of their contracts, Taxpayer repossessed the vehicles, wrote off the remaining balance due on the financed amount, and usually resold the vehicles. During the Audit Period, Taxpayer reported bad debt deductions using the amount it identified as "Charge Off Now" on its monthly Repossession Worksheet reports. The Charge Off Now amount was invariably the same as the balance due on the defaulted loans at the time of repossession. However, Taxpayer did not exclude the value of the repossessed property from its calculation of its bad debt deductions. At the telephone hearing, Taxpayer asserted that by calculating bad debt deductions this way, it recovers all of the amounts of retail sales tax it originally paid on the sales.

The total dollar amount of the bad debt deduction errors, detailed on Workpaper B, was stated as a percentage of the total dollar amount of Taxpayer's reported bad debt deductions for the tested period. Audit applied this percentage to the total dollar amount of Taxpayer's reported bad debt deductions to estimate the amount of tax liability.

Taxpayer included with its petition for correction a worksheet entitled "Workpaper Test/Review Retailing/Retail Sales Bad Debt Deductions for February and May 2015" (Taxpayer Worksheet).

The Taxpayer Worksheet has columns for vehicle Stock Number, Reporting Period, Charge-Off Date, Customer, Principal Balance Due Upon Repo, Total Fees, Licenses/Tax, and Bad Debt Remainder. These are followed by columns for Retail Sales Deduction Reported, Retail Sales Error Amount, and Sales Tax Adjustment Based on Resale Sales Price. Using the data on its worksheet, Taxpayer calculated a test percentage of approximately 9.3 to 9.4 percent, and applied these rates to \$ . . . , which represents the total amount of reported bad debt deductions. Taxpayer asserts that its calculation, which totals \$ . . . , is the more accurate estimate of its tax liability with respect to its bad debt deductions.

Audit responded to Taxpayer's petition for correction, stating that Taxpayer uses an incorrect method on the Taxpayer Worksheet to calculate the amount of allowable deductions. Audit points out that Taxpayer uses the fair market value (FMV) of the repossessed property at the time of repossession, which is the same amount it lists as the principal balance due upon repossession. Then, Audit states, Taxpayer deducts from the FMV the fees, licenses, and taxes collected on the original sale, and compares the result (which Taxpayer denotes the "bad debt remainder") to the deduction amounts reported on Taxpayer's tax returns for the vehicles in the test period. Taxpayer's error, asserts Audit, is that its calculation does not take recoveries, i.e., the value of the repossessed property, into account, which overstates the allowable bad debt deduction.

## ANALYSIS

### 1. Retail Sales Tax

RCW 82.08.037 provides expressly that a credit or refund for sales taxes paid on bad debts does not include repossessed property. Specifically, RCW 82.08.037 provides:

- (1) A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003.
- (2) For purposes of this section, "bad debts" does not include:
  - (a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;
  - (b) Expenses incurred in attempting to collect debt;
  - [(c) Debts sold or assigned by the seller to third parties, where the third party is without recourse against the seller; and
  - (d)] Repossessed property.
- (3) If a credit or refund of sales tax is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.
- (4) Payments on a previously claimed bad debt are applied first proportionally to the taxable price of the property or service and the sales or use tax thereon, and secondly to interest, service charges, and any other charges.

RCW 82.08.037 (2010) (emphasis added).<sup>2</sup>

It is undisputed that, during the Audit Period, Taxpayer claimed credit for retail sales tax paid on the outstanding balance of loans in default, with no reduction for the value of vehicles that Taxpayer repossessed in payment of the associated loans.

WAC 458-20-196 (Rule 196) is the Department's rule that addresses the bad debt tax credit and deduction. The relevant provisions of WAC 458-20-196 read as follows:

**(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, ["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; and
- (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.

Rule 196(2)(a) and (b) (emphasis added).

Here, when Taxpayer calculated the amount of its bad debt deduction, it used the entire balance remaining due on the accounts after it repossessed the associated vehicles, without excluding the value of those vehicles. Therefore, it failed to meet the requirements of RCW 82.08.037(2) and Rule 196(2)(a). *See, e.g.*, Det. No. 10-0201, 31 WTD 43 (2012). We conclude that Audit properly reduced Taxpayer's credit for sales taxes previously paid on bad debts by the value of the repossessed property.

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<sup>2</sup> RCW 82.12.037 has identical language with respect to use tax. For simplicity, we refer to the retail sales tax provisions of RCW 82.08.037 in our discussion, with the understanding that our discussion and conclusions therein apply equally to use tax.

Taxpayer argues that Rule 196(9)(e)(ii) supports its position that it should be allowed to take a sales tax credit on the full amount of the balance due at the time of repossession. Rule 196(9)(e) states, as follows:

**Scenario 5.** Phil sells a car at retail for \$1000, and charges Robin an additional \$50 for license and registration fees.

(i) Trade-in accepted. Phil accepts trade-in property with a value of \$500 in which Robin has \$300 of equity. Phil properly bills Robin for \$40 of 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. 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 sales tax credit or refund of \$29, or  $\$790 \times (\$40/\$1090)$  of sales tax, and a deduction of \$725, or  $\$790 \times (\$1000/\$1090)$  under the retailing B&O tax classification, exclusive of any deduction for accrued interest.

(iii) Recoveries. 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 sales tax) and sales tax thereon, and secondly to other charges. B&O tax consequences follow the same rules. Accordingly, Phil 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 \$29 sales tax credit is reduced to zero.

Rule 196(9)(e) (emphasis added). However, Taxpayer's reliance on the example in Rule 196(9)(e)(ii) is misplaced. The facts in Rule 196(9)(e)(ii) are distinguishable from the facts here, because that example does not include a repossession. In the case of a defaulted debt and a subsequent repossession, Taxpayer should look to Rule 196(9)(e)(iii) as well, which shows how recoveries, including repossessions, should be treated.

Taxpayer stated at the hearing that by disallowing a tax deduction based on the full amount of the balance due, the Taxpayer would not be able to offset all of the sales tax it paid on behalf of the defaulting customer. That might be true in some instances; however, Workpaper B of the Audit Report indicates that many of the repossessed vehicles were ultimately sold for amounts substantially more than the amount of debt remaining on them at the time of repossession. Moreover, the statute is clear on its face, and indicates that the term "bad debts" excludes repossessed property. RCW 82.08.037(2)(d).

## 2. B&O Tax

RCW 82.04.4284 also provides expressly that the amount of bad debt deductible from the measure of B&O tax must *not* include the value of the repossessed property. The statute states, as follows:

(1) In computing tax there may be deducted from the measure of tax bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid.

(2) For purposes of this section, "bad debts" do not include:

- (a) Amounts due on property that remains in the possession of the seller until the full purchase price is paid;
- (b) Expenses incurred in attempting to collect debt;
- (c) Sales or use taxes payable to a seller; and
- (d) Repossessed property.

(3) If a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made.

(4) Payments on a previously claimed bad debt must be applied under RCW 82.08.037(4) and 82.12.037, according to such rules as the department may prescribe.

RCW 82.04.4284 (emphasis added). Again, there is no dispute that Taxpayer deducted from the measure of its B&O tax the outstanding balance of loans in default, with no reduction for the value of vehicles that Taxpayer subsequently repossessed.

With respect to the B&O tax treatment of repossessed property, Rule 196 provides:

**(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) 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).

(Emphasis added.) Here, like the calculation of its bad debt deduction for retail sales tax, Taxpayer failed to exclude the value of the associated repossessed property. RCW 82.04.4284 requires that repossessed property be excluded from the bad debt deduction from Taxpayer's B&O tax measure. *See, e.g.*, 31 WTD 43. Therefore, Audit properly reduced the measure of Taxpayer's bad debt deduction by the value of the repossessed property.

Accordingly, we deny the petition.

#### DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 14th day of November 2016.