

SECOND DISCUSSION PAPER

Proposed Regulatory Changes to Clarify Bad Debt Deductions

Regulation 1642, Bad Debts

I. Issue

Should Regulation 1642, *Bad Debts*, be amended to incorporate the statutory changes in Assembly Bill 599 (AB 599)?

II. Staff Recommendation

In consultation with interested parties, staff will draft the necessary amendments to subdivision (h) of Regulation 1642 to incorporate the provisions of AB 599. Those provisions allow lenders to take deductions or claim refunds for bad debts from accounts receivable representing amounts that were included in the measure of tax, and require payment of tax on subsequently collected accounts.

III. Other Alternatives Considered

None.

IV. Background

Revenue and Taxation Code (RTC) section 6051 imposes sales tax on retailers for the privilege of selling tangible personal property at retail within the state. RTC section 6201 imposes use tax for the storage, use, or other consumption in this state of tangible personal property purchased from any retailer in a transaction that was not subject to the sales tax. The sales tax is imposed on the retailer but is generally passed through to the consumer as sales tax reimbursement. (Civ. Code § 1656.1, Reg. 1700(a)(1).) The use tax is imposed on the consumer; however, any retailer engaged in business in this state is required to collect the use tax and remit it to the state. (RTC §§ 6202, 6203.)

Since 1957, the Sales and Use Tax Law has provided tax relief for retailers that hold accounts receivable that had been included in the measure of tax, and become worthless prior to full payment of the account. These provisions are included in RTC sections 6055 and 6203.5 which provide that a retailer may take a deduction for that portion of the sales price of tangible personal property the retailer is unable to collect from the purchaser, provided the retailer previously remitted sales or use tax on such amounts. The right to take the deduction arises when the retailer writes off the debt for income tax purposes. In 1970, sections 6055 and 6203.5 were amended to relieve a retailer from tax liability in cases where, although not required to file income tax returns, the retailer charged off worthless accounts in accordance with generally accepted accounting principles. (Stats. 1970, p. 1056.)

Regulation 1642, *Bad Debts*, was adopted by the Board in 1965 to explain and apply the bad debt provisions of the Sales and Use Tax Law. Regulation 1642 has been amended several times to provide further clarification and to incorporate statutory changes. Regulation 1642 was last amended in 1995 to clarify that if a deduction is not taken in the period during which the debt

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was charged off, a claim for refund must be filed with the Board within the limitations period set forth in RTC section 6902.

In general, retailers selling tangible personal property on terms other than cash have several options with respect to the accounts receivable arising in the course of business. A retailer may retain an account receivable or may sell or otherwise dispose of it before it is fully collected. The sale of a debt (account receivable) is a financial arrangement between a retailer and another person (“lender”) separate from the original transaction creating the debt (i.e., the sale from the retailer to the customer). Accounts receivable can be sold with recourse or without recourse. “With recourse” means the seller of the debt (the retailer) will suffer any loss resulting from the inability to collect all amounts due. In essence, the retailer guarantees that the debt will be paid to the lender. “Without recourse” means that the lender will suffer any loss resulting from an uncollectible account. In essence, the lender accepts all the risks for collecting a debt acquired without recourse. Generally, retailers selling accounts with recourse receive a better price than when selling accounts without recourse because there is less risk to the lender.

As explained in Regulation 1642, a retailer who sells an account with recourse so that the retailer itself will bear any bad debt loss is entitled to a bad debt deduction to the same extent as if the account had not been sold. However, prior to the adoption of AB 599, if the retailer sold an account without recourse, the retailer was not entitled to take a bad debt deduction, nor could anyone else, such as the lender who purchased the account without recourse. Similarly, there was no bad debt deduction allowed when a retailer used a “private label credit card.” Private label credit cards are credit cards through which a financing company extends credit to the customers of a retailer with the name of the retailer shown on the face of the card. The financing company generally mails statements, collects payments, owns the receivables, and suffers any loss in the collection process. Prior to the amendments in AB 599, neither the retailer nor the financing company was entitled to claim a bad debt deduction for a worthless debt created through a private label credit card. Thus, there was a disparity in treatment between accounts retailers retained through collection or sold with recourse and accounts retailers sold without recourse or held under private label credit cards.

V. Discussion of Statutory Changes

AB 599 (Exhibit 1) amended the RTC to permit the taking of a bad debt deduction or claiming of a refund by either the retailer or the lender with respect to accounts sold without recourse provided sales or use tax had been reported and paid on the amount of the bad debt claimed. AB 599 defines the term “lender” to include: 1) any person who holds a retail account that the person purchased directly from a retailer who reported the tax; 2) any person who holds a retail account pursuant to that person’s contract directly with the retailer who reported the tax; and 3) any person who is an affiliated entity under section 1504 of Title 26 of the Internal Revenue Code of a person described in 1) or 2) or an assignee of a person described in 1) or 2).

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The provisions of AB 599 are effective January 1, 2001, and apply to accounts sold without recourse for which the tax was remitted on or after January 1, 2000. For such an account, the retailer and the lender must agree on whether the retailer or the lender is entitled to the bad debt deduction or refund and then file an election with the Board. As with other bad debt deductions, if a retailer or a lender obtains a tax benefit by deduction or refund for any amount it later collects, that person must report tax on the subsequently collected amounts.

VI. Discussion of Regulatory Changes

As a result of the first meeting of interested parties held on January 5, 2001, several key issues have been identified that must be addressed in any proposed regulatory language.

A. Registration of Lenders

When a lender purchases a retail account without recourse and the retailer and the lender file an election that the lender has the right to the sales and use tax benefits from bad debt losses on the account, the lender becomes responsible for reporting, and paying tax on, any recoveries of amounts for which the lender obtained a bad debt sales and use tax benefit. Accordingly, it is necessary for such lenders to be registered to report such recoveries. Staff recommends that all such lenders be required to register with the Board for a "Certificate of Registration – Lender," whether or not the lender might also hold a seller's permit for its own sales of tangible personal property. However, staff intends to identify lenders who are currently registered as retailers utilizing their existing permit number. Such lenders will not need to obtain a separate permit number and file a separate return to report recovered bad debts.

B. The Taking of the Sales and Use Tax Benefit for Bad Debts and Filing of Returns

When a retailer and a lender elect for the retailer to take the sales and use tax benefits from bad debts on accounts the retailer sells to the lender without recourse, then the rules currently specified in Regulation 1642 will remain applicable to the retailer's taking of such benefits. When the retailer and the lender elect for the lender to take such benefits, however, additional rules are required as discussed below.

A lender obtaining a sales and use tax benefit pertaining to bad debts on purchased accounts will likely incur tax liabilities due to recoveries of previously claimed bad debts. A lender may also hold a seller's permit and report and pay tax on its own sales of tangible personal property. Lenders will want to offset, to the extent possible, their benefit from bad debts on purchased accounts against their liability on recoveries and for their own retail sales of tangible personal property. However, bad debt deductions taken by a lender with respect to accounts purchased from a retailer must be segregated on the return from bad debts resulting from the lender's own retail sales. Staff believes that a lender should be able to offset bad debts incurred against other

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tax liabilities. Staff intends to design a schedule for use as an attachment to a lender's regular sales and use tax return for it to report its recoveries and to claim its bad debt benefits related to purchased accounts. However, bad debts derived from retail sales will continue to be claimed on line ten of the sales and use tax return. With respect to accounts purchased from a retailer, if the transactions were approved by the lender on a transaction-by-transaction basis or the lender has the necessary information to do so, local and district taxes must be allocated on the schedule on an actual basis. Local and district taxes related to all other accounts may be allocated on a pro-rata basis as prescribed by the Board.

If there is a net benefit remaining after offsetting liabilities for recoveries and for taxable sales of tangible personal property, the schedule will be designed such that the lender can sign it to act as a claim for refund with respect to the remaining benefit. The same schedule, with perhaps slight modification, will also be used as the return/claim for refund for those lenders who do not hold a seller's permit for their own sales of tangible personal property. Lenders will be required to file such returns to report their recoveries on a quarterly basis, unless otherwise required by the Board.

C. Required Elements for a Valid Election

AB 599 requires that when a retailer sells an account without recourse, prior to the claiming of any sales and use tax benefit for bad debts from the account, the retailer and the lender must file an election specifying which person has the right to take those benefits. Staff believes that such an election should be considered valid if it contains all of the following elements:

1. The name, address, and seller's permit number of the retailer who reported or will report the tax and the lender to whom the account(s) is (are) assigned.
2. An agreement that the retailer relinquishes all rights to the account to the lender.
3. A statement clearly specifying whether the person entitled to any (and all) deductions or refunds as a result of any bad debt losses on the account(s) covered by the election is either the retailer or the lender.
4. A list of accounts to which the election pertains. If the election is a blanket election intended to cover all accounts assigned by the retailer to the lender, the election must so state.
5. An agreement by the retailer to furnish any and all documentation required by the Board to support the claim for refund filed by the lender.

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6. An acknowledgement by the retailer and the lender that the Board may disclose relevant confidential information to the party to whom the bad debt is assigned in order to evaluate the claim.
7. A statement that the election may not be amended or revoked unless a new election is signed by both the retailer and the lender and filed with the Board.

D. Records

Lenders claiming benefits under AB 599 will be required to provide the Board with all the records required by subdivision (e) of Regulation 1642 as well as information supporting the proper allocation of local and district taxes.

E. Assignments

Under AB 599, the term “lender” includes all of the following:

1. Any person who holds a retail account which that person purchased directly from a retailer who reported the tax.
2. Any person who holds a retail account pursuant to that person’s contract directly with the retailer who reported the tax.
3. Any person who is an affiliated entity (under Section 1504 of Title 26 of the United States Code) or an assignee of a person described in subdivision (h)(1)(A).

The third definition includes certain affiliated entities or assignees of a person defined as a lender in the first or second definition. Only one person can be entitled to take the sales and use tax benefit for bad debt losses incurred with respect to any account. Thus, if a lender with the rights to the bad debt benefits thereafter assigns the account to an affiliate or other person, only the lender or the assignee can have the right to the sales and use tax benefits for bad debts from that account. If the lender and the assignee agree that the assignee will acquire those benefits, an election must be filed with the Board specifying that such is the case. That election must include a copy of the relevant election filed with the Board which was executed by the retailer and the lender, and must include the same information for the lender and the assignee as required in an election filed by a retailer and a lender. Upon the filing of such an election to transfer the rights to an affiliate or other assignee, that affiliate or assignee is a lender for purposes of the assigned account and subject to all the requirements of a lender, including the registration and reporting requirements. AB 599 does not permit an assignee from a lender (as defined in the first two definitions) to further assign the sales and use tax bad debt benefits.

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F. Sales at Discount

A person who holds an account may sell that account at a discount. The amount of the discount is not a bad debt. For example, a retailer with an account receivable of \$10,000 who sells it to a lender for \$9,500 cannot take a bad debt deduction of \$500. If the retailer sells that account without recourse, the parties may file an election transferring the right to the bad debt benefits to the lender. If the lender thereafter writes off the entire \$10,000 due under the account, based on the wording of AB 599, the lender has the right to bad debt benefits measured by that full \$10,000, not just the \$9,500 purchase price.

A retailer or a lender who has acquired the bad debt benefits for a retail account may write off the account and thereafter sell that account to another person. Persons who purchase such accounts usually pay very little for the account because of the minimal possibility of further collections. These sales of accounts are of a completely different character than the sale of an account for a discount when both the seller and the purchaser anticipate full collection on the account, such as the example in the previous paragraph. That is, the retailer or lender sells the account for pennies on the dollar because the retailer or lender continues to consider the account worthless and uncollectible. Sales of worthless accounts do not affect the retailer's or lender's right to the bad debt benefits; however, the amounts paid for these accounts are recoveries for purposes of subdivision (d) of Regulation 1642. The retailer or lender must include all recoveries on the first return filed after receiving payments and report and remit tax accordingly.

VII. Submissions From Interested Parties

In response to the first meeting of staff and interested parties on January 5, 2001, staff received two submissions from interested parties. In a letter dated January 22, 2001, Mr. Peter O. Larsen and Mr. David E. Otero of Akerman Senterfitt submitted their comments and suggested regulatory language (Exhibit 2). In addition, Mr. William J. McConnell of General Electric Company submitted his comments and suggested regulatory language in a letter dated January 22, 2001 (Exhibit 3). Some of the specific areas of concern that have been proposed verbally or in the written submissions by interested parties are summarized in the following subsections.

A. Memorandum Opinion – WFS Financial Inc.

WFS Financial, Inc. is a financial institution that filed a claim for refund for bad debt deductions for defaults on certain finance contracts purchased without recourse from various vehicle dealers. The dealers made taxable sales of vehicles, and reported and paid the tax to the Board. Each purchaser placed a down payment on the purchase, and entered into a financing contract with the dealer to finance the balance due at a specific interest rate. The agreements provided that the dealers held security interests in the vehicles until the purchasers paid off the vehicles. These financing agreements were immediately assigned to WFS Financial without recourse. Prior to entering into the financing agreements, the dealers always obtained prior approval from WFS

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Financial on all relevant terms, including the balance to be financed and the interest to be charged.

In the event of default, WFS Financial would repossess and resell the vehicle. WFS wrote off unpaid balances for income tax purposes when deemed uncollectible. The Board found that a bad debt deduction or claim for refund should be granted based on the following specific circumstances:

1. The claimant's representatives were either present on the dealers' premises or immediately available by telephone, facsimile, or computer connection at the time the vehicles in question were sold;
2. Claimant paid full consideration to the dealers for the receivables in question; i.e., claimant did not purchase the receivables at a discount; and
3. The dealers' assignments to claimant of the receivables in question were substantially contemporaneous with the execution of the sales agreements between dealers and the purchasers.

While the memorandum opinion in WFS Financial interprets the law prior to AB 599 (and thus applies to prior periods), the provisions of AB 599 are much broader than the memorandum opinion. Thus, staff does not believe that it is necessary to include the conclusions of the memorandum opinion in the regulation and believes that changes to Regulation 1642 should instead focus on fully and fairly implementing the provisions of AB 599.

B. Audit Issues

In their letter dated January 22, 2001 (Exhibit 2, page 2), Mr. Larsen and Mr. Otero state their belief that once a lender provides the name and address of the retailer who made the sales in question, the burden of proof should shift to the Board to audit the retailer to show that the tax was not paid. If the tax was not paid, the refund or deduction should be disallowed for that account. Staff generally concurs that if the lender provides the name and address of the retailer, the burden should shift to the Board on the issue of whether the retailer paid the tax on the subject sales.

C. Filing of Election

Mr. Larsen and Mr. Otero suggest that the Board should accept the filing of an election any time before an audit of the refund or deduction is complete so as long as it is clear that the parties intended the election to relate back to a date within the period covered by the refund or deduction. Not all claims for refund or deductions will be subject to audit. However, more importantly, AB 599 explicitly provides that the election must be filed *prior* to claiming the

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deduction or filing a claim for refund. (§§ 6055(b)(4), 6203.5(b)(4).) Therefore, staff does not agree that this election may be filed prior to completion of an audit of the refund. Rather, the statute specifies that a deduction or claim for refund is not perfected until an election is filed with the Board.

In Mr. McConnell's letter dated January 22, 2001, Mr. McConnell suggests that the election filed by the retailer and lender shall be effective until a new election is filed with the Board by the parties or the election is rescinded by one or both parties. (Exhibit 3, page 3.) An election filed pursuant to AB 599 is an agreement between two persons, and one person cannot unilaterally rescind it. To permit such action could lead to duplicate claims for refund for the same bad debts. AB 599 is clear on this issue. The statute requires that the election be signed and filed by both the retailer and the lender, and it further specifies that the election cannot be amended or revoked unless a new election, *signed by both parties*, is filed with the Board. However, staff agrees that either party may submit a fully executed election (or amendment or rescission of an election) with the Board. The party submitting such a fully executed document would be regarded as submitting the document for filing on behalf of both signatories.

D. Affiliate Claiming Bad Debt Deduction on the Retailer's Return

Mr. McConnell suggests (Exhibit 3, page 7) that the Board allow non-registered lenders who are affiliated with a registered retailer to claim the deduction on the affiliated retailer's sales and use tax return. Without regard to the potential benefits to either taxpayers or the Board, staff does not believe that statutory authority exists to permit the procedure suggested where the liabilities of one person would be offset by the refunds of another. Even with the express permission of both parties, credit and liability under the Sales and Use Tax Law cannot be assigned from one party to another without specific statutory authority to do so.

E. Appendix One

It has been suggested that Appendix One, *Examples of Computing Allowable Loss Using Pro-Rata Method*, be updated. In addition to the example being unclear in many aspects, it has been suggested that the reference to unearned finance charges be removed, as these are no longer incurred. Staff is currently working to revise Appendix One and welcomes any additional suggestions or comments.

VIII. Summary

AB 599 provides that when a retailer who paid the sales or use tax sells an account without recourse, the retailer and the lender may file an election pursuant to their agreement that either the retailer or the lender will have the right to a bad debt deduction or refund with respect to bad debt losses on the account. This requires implementation of specific rules applicable to such elections, the taking of the benefit by lenders, and the reporting of tax on recoveries of amounts

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for which a lender has obtained a sales and use tax benefit. This also requires implementation of a registration system for lenders to provide a means of reporting their recovered bad debts as well as for identifying and expediting claims for refund. In addition, the manner in which refunds of taxes imposed by local and special taxing jurisdictions are to be allocated must be clarified.

Staff intends to amend Regulation 1642 to implement AB 599 such that its provisions will be administered in an equitable manner and welcomes any comments, suggestions, and input from interested parties regarding this issue. Staff anticipates that a draft will be available and distributed at our next meeting of interested parties scheduled for Thursday, February 8, 2001.

Prepared by the Program Planning Division, Sales and Use Tax Department

Current as of 1/30/01

**Revenue and Taxation Code Sections 6055 & 6203.5
As Amended by AB 599 (Chap. 600) Stats. of 2000**

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 6055 of the Revenue and Taxation Code is amended to read:

6055. (a) A retailer is relieved from liability for sales tax that became due and payable, insofar as the measure of the tax is represented by accounts that have been found to be worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. A retailer that has previously paid the tax may, under rules and regulations prescribed by the board, take as a deduction the amount found worthless and charged off by the retailer. If these accounts are thereafter in whole or in part collected by the retailer, the amount collected shall be included in the first return filed after the collection and the tax shall be paid with the return. For purposes of this subdivision, the term "retailer" shall include any entity affiliated with the retailer under Section 1504 of Title 26 of the United States Code.

(b) (1) In the case of accounts held by a lender, a retailer or lender who makes a proper election under paragraph (4) shall be entitled to a deduction or refund of the tax that the retailer has previously reported and paid if all of the following conditions are met:

(A) No deduction was previously claimed or allowed on any portion of the accounts.

(B) The accounts have been found worthless and written off by the lender in accordance with the requirements of subdivision (a).

(C) The contract between the retailer and the lender contains an irrevocable relinquishment of all rights to the account from the retailer to the lender.

(D) The retailer remitted the tax on or after January 1, 2000.

(E) The party electing to claim the deduction or refund under paragraph (4) files a claim in a manner prescribed by the board.

(2) If the retailer or the lender thereafter collects in whole or in part any accounts, one of the following shall apply:

(A) If the retailer is entitled to the deduction or refund under the election specified in paragraph (4), the retailer shall include the amount collected in its first return filed after the collection and pay tax on that amount with the return.

(B) If the lender is entitled to the deduction or refund under the election specified in paragraph (4), the lender shall pay the tax to the board in accordance with Section 6451.

(3) For purposes of this subdivision, the term "lender" means any of the following:

(A) Any person who holds a retail account which that person purchased directly from a retailer who reported the tax.

(B) Any person who holds a retail account pursuant to that person's contract directly with the retailer who reported the tax.

(C) Any person who is either an affiliated entity, under Section 1504 of Title 26 of the United States Code, of a person described in subparagraph (A) or (B), or an assignee of a person described in subparagraph (A) or (B).

(4) Prior to claiming any deduction or refund under this subdivision, the retailer who reported the tax and the lender shall file an election with the board, signed by both parties, designating which party is entitled to claim the deduction or refund. This election may not be amended or revoked unless a new election, signed by both parties, is filed with the board.

SEC. 2. Section 6203.5 of the Revenue and Taxation Code is amended to read:

6203.5. (a) A retailer is relieved from liability to collect use tax that became due and payable, insofar as the measure of the tax is represented by accounts that have been found to be worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. A retailer that has previously paid the amount of the tax may, under rules and regulations prescribed by the board, take as a deduction the amount found worthless and charged off by the retailer. If these accounts are thereafter in whole or in part collected by the retailer, the amount collected shall be included in the first return filed after the collection and the amount of the tax shall be paid with the return. For purposes of this subdivision, the term "retailer" shall include any entity affiliated with the retailer under Section 1504 of Title 26 of the United States Code.

(b) (1) In the case of accounts held by a lender, a retailer or lender who makes a proper election under paragraph (4) shall be entitled to a deduction or refund of the tax that the retailer has previously reported and paid if all of the following conditions are met:

(A) No deduction was previously claimed or allowed on any portion of the accounts.

(B) The accounts have been found worthless and written off by the lender in accordance with the requirements of subdivision (a).

(C) The contract between the retailer and the lender contains an irrevocable relinquishment of all rights to the account from the retailer to the lender.

(D) The retailer remitted the tax on or after January 1, 2000.

(E) The party electing to claim the deduction or refund under paragraph (4) files a claim in a manner prescribed by the board.

(2) If the retailer or the lender thereafter collects in whole or in part any accounts, one of the following shall apply:

(A) If the retailer is entitled to the deduction or refund under the election specified in paragraph (4), the retailer shall include the amount collected in its first return filed after the collection and pay tax on that amount with the return.

(B) If the lender is entitled to the deduction or refund under the election specified in paragraph (4), the lender shall pay the tax to the board in accordance with Section 6451.

(3) For purposes of this subdivision, the term "lender" means any of the following:

(A) Any person who holds a retail account which that person purchased directly from a retailer who reported the tax.

(B) Any person who holds a retail account pursuant to that person's contract directly with the retailer who reported the tax.

(C) Any person who is either an affiliated entity, under Section 1504 of Title 26 of the United States Code, of a person described in subparagraph (A) or (B), or an assignee of a person described in subparagraph (A) or (B).

(4) Prior to claiming any deduction or refund under this subdivision, the retailer who reported the tax and the lender shall file an election with the board, signed by both parties, designating which party is entitled to claim the deduction or refund. This election may not be amended or revoked unless a new election, signed by both parties, is filed with the board.

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January 22, 2001

Mr. James C. Kuhl
State of California
Board of Equalization
Program Policy Specialist
Business Taxes Committee Team

Re: Initial Discussion for Issue Paper on Proposed Regulatory Changes to Clarify
Application of Bad Debt Deductions, Regulation 1642, Bad Debts

Dear Mr. Kuhl:

As you know, this law firm represents several banks and finance companies which own accounts that had been included in the measure of sales tax and which later became worthless prior to full payment of the accounts. In view of the discussion of the interested parties of the Board on January 5, 2001, we are sending you these revised comments.

As you know, this firm agrees with Staff that Regulation 1642 should be amended to incorporate the changes to Sections 6055 (Sales Tax) and 6203.5 (Use Tax) of the Revenue and Taxation Code contained in AB 599 and respectfully provides the following suggested changes and comments.

1. Effective Date.

In order to maintain consistency with AB 599 (which has an effective date of January 1, 2000), any proposed changes to Regulation 1642 should be effective solely for tax remitted by a retailer on or after January 1, 2000. The current version of Regulation 1642

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should continue to govern prior periods as required by the Board's Memorandum Opinion in the WFS Financial, Inc. case.

2. 1642(a).

This language should be amended to reflect the changes created by AB 599, such as clarifying that a refund is available, and specifically authorizing refunds and deductions for affiliates and lenders.

3. 1642(b), (d), (e), (f)(1), (f)(5), (f)(6).

The current text only discusses retailers. The Sections should be expressly made applicable to affiliates and lenders as well as retailers.

4. Audit Issue.

In Section 1642(e), the lender should be required to provide, upon request of the Board, the name and address of the retailers who made the relevant sales. This would show that the tax was paid and shifts the burden of proof to the Board to audit the retailer to show the tax was not paid. If the tax for any account was not paid, the refund or deduction should be disallowed for that account.

5. Filing of Election.

The amended regulation should provide that either the retailer or the lender may file the election regarding which party has the right to take the bad debt deduction or claim the refund. The election could either be a blanket election which, by its terms, could cover past and/or future loans. The election could also be for a specific list of loans (in which case the list must be specified).

The amended regulation should set forth a list of the items which must be covered by the election. Our proposed list of required elements is set forth in the attached proposed regulatory language. At any time before an audit of the refund or deduction is complete, the Board should accept an election as long as it is clear that the parties intended the election to relate back to a date within the period covered by the refund or deduction.

6. Deletion of 1642(h)(1)(A).

AB 599 does not make a distinction between accounts purchased by a lender for full consideration and accounts purchased by a lender at a discount. While the current text of 1642(h)(1)(A) does not currently expressly prohibit a successor who pays less than full consideration from obtaining a bad debt deduction or refund, it could be interpreted as doing so, especially given the current text of 1642(h)(1)(B). Therefore, the amended regulation should delete 1642(h)(1)(A) for tax remitted after January 1, 2000.

7. Deletion of 1642(h)(1)(B).

AB 599 clearly provides that affiliates and lenders meeting certain conditions may obtain a bad debt deduction or refund. Thus, the current text of 1642(h)(1)(B) should be deleted in its entirety for tax remitted after January 1, 2000.

8. Allocation of Refund or Deduction to Local Taxing Jurisdictions.

If this issue is addressed in the amended regulation, lenders should be allowed to satisfy this requirement by providing the address or location of the place of sale at retail of the property. A Lender should also be able to use alternative means of proof which would reasonably identify the place of sale.

9. Revise 1642 Appendix 1.

The current Appendix 1, which illustrates the allowable loss using the pro rata method, was created at a time when lenders and retailers made precomputed loans. However, the industry standard in California has changed to simple interest loans. Therefore, a new example should be created to illustrate this calculation for simple interest loans. For example, the finance charge and the unearned finance charge line items should be removed and earned financed charges should be added to the cash sales balance to calculate the contract balance for all simple interest loans because there never are unearned finance charges for simple interest loans.

10. Registration Requirements for Lenders.

(a) Lenders who are Retailers.

Lenders who are Retailers will already be registered with the State for purposes of claiming the deduction. If staff desires to separately track deductions taken as a Lender from deductions taken as a Retailer, the existing return form should be modified and/or a separate supplemental schedule should be attached to allow staff to track the deductions. However, a completely separate return should not be required because Lenders are entitled to take Lender bad debt deductions against sales made in a Lender's capacity as a Retailer.

(b) Lenders who are not Retailers.

As noted on page 3 of the Initial Discussion, "lenders are not necessarily engaged in the business of selling tangible personal property and, if not, would not be registered with the Board as retailers." Also, as you know, it is possible that Lenders who are not registered as retailers will have

subsequent recoveries from obligors after receiving a bad debt refund. AB 599 provides that the lender shall pay tax on such recoveries to the Board in accordance with Section 6451. Section 6451 requires “[t]he taxes imposed by this part are due and payable to the board quarterly on or before the last day of the month next succeeding each quarterly period.” However, Lenders should not have to register as retailers and file returns solely by virtue of making these payments if the lenders do not otherwise engage in or conduct business as a seller within the State.

These payments should instead be made by use of a special return form to be created for this purpose by the Board. Alternatively, a special Lender registration system could be implemented to register a Lender who is not a Retailer solely in the Lender’s capacity as a Lender for the sole and limited purpose of remitting tax on recoveries. The Lender’s federal tax identification number could be used as the Lender’s registration number.

(c) Lenders’ sale of Accounts.

AB 599 requires that in order for a retailer or Lender to take a bad debt deduction, the debt must have been found to be worthless and charged off for income tax purposes. Thus, the right to the deduction or refund arises under AB 599 when the worthless debt is charged off. A debt is considered charged off when the debt is written off on the Lender’s books. Under federal law, section 166(a)(1), IRC, allows a bad debt deduction when the debt has become worthless. Therefore, a Lender is eligible for a California bad debt deduction or refund at the time the account is worthless and has been charged off on the Lender’s books.

If a Lender sells an account prior to the time the account becomes worthless and has been charged off, the Lender is not entitled to the refund or deduction because the Lender never would have been able to charge off the account for federal income tax purposes. However, once an account becomes worthless and the Lender validly charges it off for income tax purposes, the Lender is allowed to take the federal bad debt deduction and the deduction or refund from California sales tax. If the Lender later sells the account, the Lender’s initial bad debt deduction or refund is not invalidated and the Lender is still entitled to the refund or deduction. Under federal tax law, a subsequent recovery (such as the sale of an account) does not destroy the validity of the original charge-off. See Treasury Regulation section 1.166-1(f). However, the Lender would have to report to the State and the Internal Revenue Service the sale proceeds from this subsequent sale as taxable sales to the State and as income to the Internal Revenue Service. See Merchants National Bank of Mobile v. Commissioner of Internal Revenue, 199 F.2d 657 (5th Cir. 1952) (recognizing that proceeds from sales are ‘recoveries’ of bad debts

legitimately charged off). Also, in West Seattle National Bank of Seattle v. Commissioner of Internal Revenue, 288 F.2d 47 (9th Cir. 1961), the court stated that “the price paid by a purchaser for accounts receivable will affect the extent to which he himself can write off bad debts or take deductions for a bad debt reserve upon the accounts purchased.”

For example, if a Lender who paid the full value for an account in the amount of \$100 did not collect on that account, the account became worthless, the Lender charged off the account and the Lender later sold that account for \$50, the Lender would be entitled to a bad deduction for \$100 under federal law and under California law. Upon sale of the account for \$50, the sales proceeds are treated as recoveries and must be included in income. For purposes of California sales tax, the lender would have to pay sales tax on a portion of the \$50 as a subsequent recovery. The portion represents the taxable loss percentage in the initial refund calculation multiplied by the recovered amount. The purchaser of the account could never, under the federal tax code, claim a bad debt deduction in excess of \$50 because that is the purchaser’s basis in the account. See Treasury Regulation section 1.166-1(d). This ensures that the State will never pay a refund twice on the same dollars which were charged off.

11. Suggested Language.

Based upon the above suggestions, in addition to the revisions to other parts of 1642, we recommend that the initial draft of regulation 1642(h)(1) be as follows:

(h) Special Situations.

(1) Bad Debt Deductions and Refunds to Persons Other Than The Retailer or An Affiliate.

(A) In the case of accounts held by a lender, a retailer or lender who makes a proper election under Section 1642(h)(1)(D) shall be entitled to a deduction or refund of the tax that the retailer has previously reported and paid if all of the following conditions are met:

- (i) No deduction or refund was previously claimed or allowed on any portion of the accounts.
- (ii) The accounts have been found worthless and written off by the lender in accordance with the requirements of Section 1642(a).

- (iii) The contract between the retailer and the lender contains an irrevocable relinquishment of all rights to the account from the retailer to the lender.
 - (iv) The retailer remitted the tax on or after January 1, 2000.
- (B) Payment of Tax on Subsequent Recoveries; Lender Registration.
- (i) Lenders who are registered. If a lender is required to register with the board pursuant to Section 6066 of the Revenue and Taxation Code and claims a deduction or receives a refund and later collects in whole or in part on any accounts determined to be worthless, the lender shall include the amount collected on the first return filed after the collection and pay tax on that amount with the return.
 - (ii) Lenders who are not registered. If a lender who is not required to register with the board pursuant to Section 6066 of the Revenue and Taxation Code and who claims a deduction or receives a refund and later collects in whole or in part on any accounts determined to be worthless, the lender shall pay tax on such amounts before the last day of the month following the quarterly period in which the recovery is received on a form to be prescribed by the board. The lender will be assigned a lender registration number identical to its federal employer tax identification number upon the receipt of its initial refund or deduction.
 - (iii) Sale of Accounts by Lender. If a lender sells an account before the account becomes worthless and has been charged off on its books for federal income tax purposes, the lender shall not be entitled to a refund or deduction with respect to such account. If the lender sells an account after the account becomes worthless and has been charged off on its books for federal income tax purposes, the lender is entitled to the refund or deduction based upon the full amount charged off, but any sale proceeds must be reported as provided in section (h)(1)(B)(i) or (ii) of this Regulation.
- (C) When claiming a deduction or refund, the lender shall provide to the board the amount of the refund or deduction to be allocated to each local taxing jurisdiction. Upon any audit of the claim for refund or deduction, the lender may satisfy this requirement by providing the address of the place of the sale at retail of the property or, if such information is not available, by providing

alternative means of proof which would reasonably identify the place of sale.

- (D) The retailer who reported the tax or the lender shall file an election with the board designating which party is entitled to claim the deduction or refund. The election shall include the following elements: (i) the retailer's name, (ii) the lender's name, (iii) a listing of the accounts unless the election is a blanket election, (iv) a statement that the lender has been assigned all rights and interests in the accounts, (v) a designation as to which party is entitled to the refund or deduction, (vi) a statement that the lender and retailer waive confidentiality with respect to the accounts, (vii) a statement that the election can not be revoked unless a new agreement signed by both parties is filed with the board and (viii) a statement that the document is an election required to be filed pursuant to section 6055 of the Revenue and Taxation Code. If the lender fails to file the election with the board at the time of the claim for refund or deduction, the election may be accepted at any time during an audit of the claim for refund or deduction, even if executed after the time the audit commences, as long as it is evident that the retailer and lender intended the election to relate back to a date within the audit period.

Thank you for the opportunity to present our suggested ideas and language to the Board. We look forward to working with you throughout this process.

Sincerely,

Peter O. Larsen

David E. Otero

January 22, 2001

FEDERAL EXPRESS

Ms. Charlotte Paliani
Program Planning Manager
Mr. James C. Kuhl
Program Policy Specialist
State of California
State Board of Equalization
Sales and Use Tax Department
Business Taxes Committee Team

**Re: Initial Discussion for Issue Paper on Proposed Regulatory Changes to Clarify
Application of Bad Debt Deductions, Regulation 1642, Bad Debts**

Dear Ms. Paliani and Mr. Kuhl:

This letter and the attached document constitute General Electric Company's (GE) response to the State Board of Equalization's (SBE) request for comments from interested parties dated December 15, 2000. That request solicited comments about issues that should be addressed regarding the *Initial Discussion for Issue Paper on Proposed Regulatory Changes to Clarify Application of Bad Debt Deductions, Regulation 1642, Bad Debts*.

In engaging in the rulemaking process involving the recovery of sales and use tax on bad debts, the SBE should stress: (1) the ability of taxpayers and the SBE to address voluminous records by reasonable and flexible approaches as the circumstances warrant; and (2) the reasonableness of such rules in terms of compliance costs.

Attached are our specific recommendations of language for the regulations followed by a discussion of the language.

GE is grateful for this opportunity to provide comments involving the drafting of the bad debt regulations. We are available to work with the SBE in connection with the drafting of these regulations. If there are any questions regarding these comments or you

would like to discuss further, please contact Scott Roberti at (203) 373 – 3413 or me.
Thank you for your consideration.

Sincerely,

General Electric Company

By: _____
William J. McConnell
Manager – Sales, Use and Excise Taxes
(941) 418 - 5186

Attachment

cc: Fred Pownall

GENERAL ELECTRIC COMPANY
Proposed Changes to Bad Debt Regulation 1642

I. Election Procedure

Regulation 1642.(a) should be amended to read as follows (underlined represents language to be inserted into the existing regulation):

(a) *In General.* A retailer is relieved from liability for sales tax (Section 6055 of the Revenue and Taxation Code) or from liability to collect use tax (Section 6203.5 of the Revenue and Taxation Code) insofar as the measure of the tax is represented by accounts found worthless and charged off for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. A retailer may claim a bad debt deduction provided that the sales tax, or amount of use tax, was actually paid to the state.

This deduction should be taken on the return filed for the period in which the amount was found worthless and charged off for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles.

Failure to take the deduction on the proper return will not in itself prevent the allowance of a refund measured by an amount for which a retailer could have taken a timely deduction provided a claim for refund is filed with the board within the limitation periods specified in Section 6902 of the Revenue Taxation Code.

(a)(1) In accordance with Section 6055.(b)(1)(E) and 6203.5(b)(1)(E), the retailer and lender are required to make an election as to which party will claim a deduction on a return filed with the Board or which party will file a refund claim with the Board. A letter should be jointly submitted by the retailer and lender to the Board, which contains the following information:

- (1) Name and address of retailer.
- (2) Sales tax registration of retailer.
- (3) Name and address of lender.
- (4) Sales tax registration number of lender if registered.
- (5) Statement as to which party will claim a deduction or file refund claim involving recovery of sale and use tax on bad debts.
- (6) Date and signature of an authorized representative of the retailer.
- (7) Date and signature of an authorized representative of the lender; and
- (8) Effective date of election.

The election filed by the retailer and lender shall be effective until a new election is filed with the Board by the parties or the election is rescinded by one or both parties.

Discussion of Proposed Regulatory Changes

Assembly Bill 599 amended Section 6055 and 6203.5 of the Revenue and Taxation Code to allow either the retailer or lender to recover sale and use tax on bad debts. Pursuant to Sections 6055.(b)(1)(E) and 6203.5.(b)(1)(E), the party electing to claim the deduction or refund must do so in a manner prescribed by the Board. Rather than using a specific form, the Board should require the retailer and lender to jointly submit a letter containing general information regarding the parties, which party will claim a deduction or file a refund, and be dated and signed by an authorized representative of the retailer and lender.

The regulation should state that the election filed by the retailer and lender is effective until the parties submit a new election or the election is rescinded by one or both parties.

At the initial meeting held on Friday, January 5, 2001, to discuss proposed amendments to the bad debt regulation, a representative from the SBE legal staff suggested the election between the retailer and lender should indicate which accounts are being acquired by the lender from the retailer. The Board should not include a requirement that every customer account be identified as this would be cumbersome and the amount of accounts to be listed could be voluminous.

In those cases involving a lender which extends credit directly to the customers of the retailer, the lender is the owner of the accounts and does not purchase any receivables from the retailer. The lender has all the information on whether the account is worthless. The retailer would not know to claim a bad debt since it does not know the credit status of the cardholder.

II. Nontaxable Receipts

Regulation 1642.(b) should be amended to read as follows:

(b) *Amount Subject to Deduction.* (1) Nontaxable Receipts. If the amount of an account found to be worthless and charged off is comprised in part of nontaxable receipts such as interest, insurance, repair or installation labor and other charges exempt from sales or use tax and in part of taxable receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the unpaid amount upon which tax has been paid. In determining that amount, all payments and credits to the account may be applied ratably against the various elements comprising the amount the purchaser contracted to pay (pro rata method), ~~or~~ may be applied as provided in the contract of sale (contract method) or other method approved by the Board which reasonably determines the amount of nontaxable receipts (alternative method). After having applied payments and credits by ~~either~~ the pro rata method, ~~or~~ the contract method, or alternative method and having filed returns or filed a refund claim based on such application of payments and credits, a retailer or lender shall not thereafter reapply the payments or credits by the other method so as to claim additional bad debts by way of deduction, credit or refund. A taxpayer may with the Board's approval change its method of computing nontaxable receipts.

(2) Expenses of Collection. No deduction is allowable for expenses incurred by the retailer in attempting to enforce collection of any account receivable, or for that portion of a debt recovered that is retained by or paid to a third party as compensation for services rendered in collecting the account.

Discussion of Proposed Regulatory Changes

Under the existing bad debt regulation, taxpayers are allowed to determine the amount of nontaxable receipts using either the pro rata or contract method. In regard to retailers and lenders involved in the credit card industry, these taxpayers will have voluminous records involving cardholders. The Board should allow taxpayers with credit card transactions to have flexibility in determining the amount of nontaxable receipts. It is proposed that a third method be included in the bad debt regulation which provides that taxpayers may submit to the Board for its approval an alternative approach for identifying nontaxable receipts. This approach should be called the “alternative method.” The regulatory language has been changed to allow taxpayers to seek approval from the Board to change the method for determining nontaxable receipts.

III. Special Situations

Regulation 1642.(h) should be amended as follows:

(h) *Special Situations.*

(1) Bad Debt Deductions to Persons Other Than the Retailer. (A) A successor who acquires a business ~~who~~ and pays full consideration for receivables, purchases receivables at a discount or purchases receivables at a premium acquired from his predecessor is entitled to a bad debt deduction to the same extent that the predecessor would have been entitled had the predecessor continued the business.

~~(B) A purchaser of receivables, other than a successor, cannot obtain a bad debt deduction on accounts which are not collected.~~

(B) A lender who holds a retail account can obtain a bad debt deduction or refund on accounts, which are not collected and have been found to be worthless and charged off for income tax purposes by the lender, or if the lender is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. The term “lender” means any of the following:

(i) Any person who holds a retail account which that person purchased directly from a retailer who reported the tax;

(ii) Any person who holds a retail account pursuant to that person’s contract directly with the retailer who reported the tax; or

(iii) Any person who is either an affiliated entity, under Section 1504 of Title 26 of the United States Code, of a person described in subparagraph (i) or (ii), or an assignee of a person described in subparagraph (i) or (ii).

(C) A retailer who sells receivables with recourse so that the retailer will bear any bad debt loss on them is entitled to a bad debt deduction to the same extent as if the receivables had not been sold. ~~The fact that a retailer sells receivables at a discount, however, with or without recourse, does not in itself entitle the retailer to a bad debt deduction to the extent of the discount.~~ A lender which purchases receivables from a retailer at a discount, originates receivables at a discount or originates a receivable at a premium, once a joint election is filed by the retailer and lender, the lender is entitled to recover the full amount of sales or use tax remitted by the retailer to the Board.

(2) Bad Debts of Construction Contractors. Subparagraph (b)(2)(A)2. of Section 1521 of Title 18 recognizes two instances when a contractor (other than a United States construction contractor as defined in section (b)(1)(A) of Section 1521 of Title 18) is considered to be selling materials prior to installation. In those two instances only, when the contractor reports and pays tax on the sales price of the materials and the receivable is thereafter found to be worthless and is charged off for income tax purposes, a bad debt deduction may be taken by the contractor.

Since a contractor (other than a United States construction contractor as defined in section (b)(1)(A) of Section 1521 of Title 18) is the retailer of fixtures, bad debt losses incurred in connection with the furnishing and installing of such fixtures are to be treated in the same manner as those resulting from other types of retail sales.

Discussion of Proposed Regulatory Changes

Regulation 1642(h)(1)(A) currently addresses the purchase of receivables by a successor for full consideration. This provision should be amended to clarify that a successor refers to a party purchasing a business. Additionally, the language of (h)(1)(A) should make clear that receivables purchased at a discount are allowed to be written off or claimed as a refund. The taxpayer purchasing the receivable at a discount is entitled to recover the full amount of the sales tax remitted by the retailer to the Board. Language has been included to cover those instances where a receivable is purchased at premium.

AB 599 amended Sections 6055 and 6203.5 to permit recovery of sales and use tax on bad debts by lenders. Consequently, regulation 1642.(h) must be amended to reflect the legislative amendments. The language found in Sections 6055.(b)(3) and 6203.5.(b)(3) defining a “lender” has been inserted. As discussed above, the regulation must clarify that a party acquiring receivables at a discount, receivables originated at a discount, or originated at a premium, once a joint election is submitted to the Board, the lender is entitled to recovery the entire amount of sales and use tax remitted to the Board.

IV. Method for Claiming Bad Debt Recovery

No language provided. See discussion below.

Discussion of Proposed Regulatory Changes

A retailer which is registered with the Board for sales and use tax purposes and files a return will be able to either claim a bad debt deduction on its sales and use tax return or can file a claim for refund with the Board. This is the case when the retailer and lender agree to elect the retailer to be the party which recovers the tax on worthless accounts. The existing statutory and regulatory provision in the sales and use tax area presently address the retailer recovering sales and use tax on bad debts and no additional changes are necessary.

In those cases where the lender is elected to recover the sales and use tax on bad debts, the method of recovery will depend on the sales tax registration status of the lender. In certain situations the lender will have a sales tax registration number and file sales and use tax returns with the Board. A sales tax registered lender will be able to claim a deduction for bad debts on its sales tax return or file a refund claim. Other lenders will not have a sales tax registration number because they do not sell tangible personal property in California or do not have operations in California which require the payment of use tax on purchases. Consequently, a nonregistered lender can file a refund claim with the Board.

It is suggested the Board allow nonregistered lenders who are affiliated with a registered retailer to allow the lender to claim the deduction on the affiliated retailer's sales and use tax return. This will save administrative cost to the Board because it will not have to issue a refund check on a periodic basis to the lender. Sections 6055 and 6203.5 as amended by AB 599 now include in the definition of a lender an affiliated entity as defined under federal income tax law.

V. Local Taxes

(i) Local Taxes:

(1) In determining the amount of local sales to be recovered from a deduction or refund of a bad debt, the place of the sale shall be used for motor vehicles and boats.

(2) In determining the amount of local sales tax to be recovered from a deduction or refund of a bad debt, for all transactions other than those described in (i)(1) above, taxpayers may use the place of sale or other reasonable method approved by the Board.

Discussion of Proposed Regulatory Changes

The current bad debt regulation does not have any guidance regarding the computation of local taxes. It is suggested that language be included to address motor vehicles and boats and that the local tax be based on the place of sale. In all other cases, taxpayer's may use the place of sale or other method approved by the Board. The "other method" category would allow taxpayers involved in the credit card industry some flexibility due to the voluminous nature of the cardholder's transaction history.