

State Board of Equalization

OPERATIONS MEMO

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SUBJECT: Bad Debts Incurred by Lenders on Purchased Accounts

I. PURPOSE

This operations memo provides guidelines and procedures required as a result of the revisions to Revenue and Taxation Code sections 6055 and 6203.5 enacted by Assembly Bill (AB) 599. (Stats. 2000, Ch. 600.) Sales and Use Tax Regulation 1642, *Bad Debts–In General* has been amended to incorporate these statutory changes. The provisions of AB 599 apply to transactions for which taxes were remitted on or after January 1, 2000. Since the taxes for the 4th quarter 1999 were, in most cases, remitted on or after January 1, 2000, with respect to this requirement bad debts incurred in connection with almost all transactions occurring on or after October 1, 1999, are eligible under the provisions of AB 599.

II. GENERAL BACKGROUND

An account receivable (“account”) may be sold with or without recourse. “With recourse” means the retailer must reimburse the purchaser of the account (“lender”) for any losses the lender suffers. “Without recourse” means the retailer has no obligation to reimburse the purchaser of the account (“lender”) even if the lender cannot recover the full amount of the debt. A lender who purchases an account with recourse may *not* take a bad debt deduction under the Sales and Use Tax Law with respect to any loss it suffers on that account (i.e., uncollectible debt for which it fails to obtain reimbursement from the retailer). However, a retailer who sells an account with recourse may take a bad debt deduction for the amount of uncollectible debt for which the retailer actually reimburses the lender pursuant to their contract, to the extent that such loss represents amounts on which the retailer reported and paid tax. The rules discussed in this paragraph remain the law, and have not been affected by the changes discussed below.

Prior to the adoption of AB 599, a lender who purchased an account was not entitled to claim a sales tax deduction or refund in connection with its losses on the account, whether purchased with or without recourse. In addition, when a retailer sold an account without recourse, the retailer was unable to claim a sales tax deduction or refund for losses suffered by the lender on the account. This meant neither party was eligible to claim a bad debt deduction or refund with respect to losses suffered on accounts sold without recourse. (As discussed below, the Board’s memorandum opinion in *WFS Financial, Inc.* (WFS) sets forth an exception allowing lenders, under specified conditions, to claim deductions or file claims for refund for their losses on accounts which were purchased without recourse and for which tax was paid prior to January 1, 2000.) Under the amendments to sections 6055 and 6203.5 adopted by AB 599, either the retailer or the lender, per their agreement, may now qualify to claim a deduction or refund for losses on an account the lender purchases without recourse, provided the retailer had remitted tax to the BOE on or after January 1, 2000.

For purposes of Regulation 1642, the term “lender” includes any person who purchases an account receivable without recourse directly from the retailer who reported and paid tax. This includes, for example, the purchase of an account where a retailer of automobiles has financed its own sale of a vehicle. “Lender” also includes a person who holds an account without recourse pursuant to that person’s contract directly with a retailer. This includes both general purpose credit cards and private label credit cards. A private label credit card is issued by a financial institution in the name of a retailer. Such a card usually has the name of the retailer on the front of the card, but since the card is actually issued by a third-party lender, this information is usually on the back of the card. These are not general-purpose credit cards. Rather they can be used to make purchases only from the retailer in whose name they are issued, or in some cases from retailers who are part of the same corporate family.

Under AB 2688, the election between the retailer and the lender specifying which party has the right to claim the bad debt deduction or refund for that account must be prepared and retained by the retailer and the lender. This election agreement may be in any form, but must contain the following elements specified in subdivision (i)(3)(A) of Regulation 1642:

- a. The name, address, and seller’s permit number of the retailer who reported or will report the tax and the name, address, and seller’s permit number, if any, or Certificate of Registration – Lender account number of the lender to whom the account(s) is assigned.
- b. An agreement that the retailer relinquishes to the lender all rights to the account.
- c. A statement clearly specifying whether the retailer or the lender is entitled to claim any (and all) deductions or refunds as a result of any bad debt losses charged off by the lender for the account(s) covered by the election, the effective date of that election, and a statement that the other party relinquishes all rights to claiming such deductions or refunds.
- d. A list of accounts to which the election pertains. If the election is a blanket election for all accounts assigned without recourse by the retailer to the lender or all accounts held by the lender without recourse pursuant to the lender’s contract directly with the retailer, the election must so state.
- e. The agreement of both the retailer and the lender to furnish any and all documentation requested by the BOE to support the deductions or refunds claimed.
- f. The acknowledgement by both the retailer and the lender that the BOE may disclose relevant confidential information to all parties involved in order to support and confirm any deductions or refunds claimed.
- g. If the lender is the person entitled to claim any deduction or refund for bad debts on the account, list the Lender’s Certificate of Registration – Lender account number. If the lender does not yet hold such a registration, the agreement of the lender that it will apply for the Certificate of Registration – Lender no later than on the date the lender first claims a deduction or refund for bad debts charged off on the account.
- h. A statement that the election may not be amended or revoked unless a new election is

signed by both the retailer and the lender.

- i. The date of the election and the signatures of the retailer and the lender, or their authorized representatives.

A retailer who has sold its accounts receivable to a lender without recourse may still have the right to the bad debt deduction or refund pursuant to an election agreement with the lender. A retailer with the right to the bad debt deduction or refund pursuant to its election agreement with the lender may claim the bad debt deduction or refund, or in turn, assign that right to an affiliate pursuant to a separate election agreement between the retailer and its affiliate. If a retailer with the right to the bad debt deduction or refund assigns that right to an affiliate, the retailer and the affiliate must retain a copy of the election agreement between the retailer and its affiliate. The election agreement between a retailer and its affiliate must include all the elements specified in subdivision (h)(3)(A) of Regulation 1642. The retailer must also retain the original election between the retailer and the lender. The right to the bad debt deduction or refund cannot be further assigned other than as described in this paragraph.

While a retailer with the right to a bad debt deduction or refund may assign that right only to an affiliate, a lender with the right to a bad debt deduction or refund may assign that right to an affiliate or *to any assignee (other person-whether an affiliate or not)* pursuant to a separate election agreement between the lender and its assignee. The election agreement between a lender and its assignee must include all the elements specified in subdivision (i)(4)(A) of Regulation 1642. The lender must also retain the original election agreement between the retailer and the lender. The affiliated entity or assignee cannot further assign the right to claim a deduction or claim a refund for the bad debts charged off on the account.

A lender who has the right to claim a bad debt deduction or claim a refund pursuant to an election agreement with a retailer (which includes an assignee of the lender) must register with the BOE for a Certificate of Registration – Lender to claim the deduction or refund. (See Regulation 1642(i)(5)(B).) A person registered as a Lender is required to file a return to report subsequent recoveries, and the return must be filed whether or not the lender makes any recoveries during that reporting period. Lenders may use an historical post charge-off recovery percentage to report taxable recoveries. The calculation of a percentage to report taxable recoveries is subject to verification. The lender must claim its bad debt losses on line 10(a)(2) of the return and if that amount exceeds the reported amount of taxable recoveries, the completed return will qualify as a claim for refund. Bad debt losses must not be netted on lender returns. For claims on accounts found worthless and written off prior to January 1, 2002, lenders will need to file separate claims for refund for amounts due them. For accounts found worthless and written off on or after January 1, 2002, lenders will use their returns to file their claims for refund.

WFS Memorandum Opinion

Prior to the passage of AB 599, the Board considered a claim by a financial institution, WFS, for a refund for bad debts incurred from accounts purchased without recourse, and issued a memorandum decision dated December 14, 2000, setting forth when such transactions can qualify for bad debt deductions. Although the property financed in WFS were automobiles, financing of other types of property, such as vessels and aircraft, may qualify if all requirements of the opinion are satisfied. The Board's decision in WFS provides that a financial institution can claim a bad

debt deduction or refund for accounts purchased without recourse if each of the following conditions is met:

- a. 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.
- b. Claimant paid full consideration to the dealers for the receivables in question, i.e., claimant did not purchase the receivables at a discount.
- c. The dealers' assignments to claimant of the receivables in question were substantially contemporaneous with the execution of the sales agreements between the dealers and the purchasers."

The Legislature's adoption of AB 599 superseded and replaced the WFS decision. The WFS decision applies through December 31, 1999, *but not after* the provisions of AB 599 became operative on January 1, 2000. As discussed above, AB 599 generally applies to bad debts incurred in connection with transactions occurring during the 4th quarter 1999 since the taxes on those transactions were generally paid after the January 1, 2000 date specified in AB 599. However, the WFS decision itself applied to a claim for refund that included the 4th quarter 1999. Accordingly, to ensure fair and uniform treatment of all lenders and for administrative ease, a lender may rely on the provisions of either WFS **or** AB 599 for bad debts incurred in connection with transactions that occurred during the 4th quarter 1999. The provisions of WFS and AB 599 are otherwise mutually exclusive.

It is imperative to note that the determination of whether WFS or AB 599 applies is based on the date the taxes were remitted (usually ascertained based on the date at which the sale occurred), not the date the bad debts were incurred. For bad debts incurred in connection with sales of tangible personal property during the 3rd quarter 1999 and earlier, only the provisions of WFS apply and *not* the provisions of AB 599. Generally for bad debts incurred in connection with sales of tangible personal property reported during the 1st quarter 2000 and later, only the provisions of AB 599 apply and *not* the provisions of WFS.¹

Since the determination of whether WFS or AB 599 applies is based on the date tax was paid; but the timing of the bad debt deduction is based on the date the loss is written off, there will be claims submitted which include losses covered by both WFS and AB 599 which were written off in the same reporting period. To illustrate, in the 2nd quarter 2002, a lender writes off two accounts as worthless, one for a sale that occurred in the 1st quarter 1999 and the other for a sale that occurred in the 1st quarter 2000. Tax had been paid for the first transaction prior to January 1, 2000, and the provisions of WFS apply to the loss from that account. Tax had been paid for the second transaction after January 1, 2000, therefore provisions of AB 599 apply to that loss. Since the lender's right to claim the losses from these two accounts was established during the 2nd quarter of 2002, the deduction for both accounts should be taken on the lender's return for that

¹ Due to reporting requirements of AB 599, it is *theoretically* possible to have an annual basis retailer sell account receivables to a lender, which would make AB 599 apply to sales made for the entire year of 1999.

reporting period. This means the statute of limitations for filing the lender's claim related to the losses on both accounts starts to run on July 31, 2002 (the due date of the return for the 2nd quarter 2002).

Indirect Loans

If a consumer wishes to make a purchase on credit without using an existing credit account, the consumer may apply for a loan for that particular purchase. This is the method used for most purchases of automobiles, aircraft, and vessels, as well as many other large purchases, such as jewelry. The retailer may coordinate the loan application process, with the consumer signing a credit contract with the retailer who thereafter assigns the account to a lender. This type of loan is commonly called an "indirect loan" because the consumer does not contract directly with the lender who will service the loan, but rather contracts with the retailer. Since the retailer will then assign the account to the lender, bad debts arising from these accounts may qualify for a deduction or refund under AB 599.

Direct Loans

Alternately, a consumer may arrange his or her own financing by contracting for a loan directly with a lender. This type of loan is commonly called a "direct loan" because the consumer contracts directly with the lender who will service the loan. In a direct loan situation, the consumer pays for his or her purchase with the proceeds from the loan (plus any down payment or other amounts paid out of the consumer's own funds). Methods of remitting the loan proceeds to the retailer include:

- a. a check issued by the lender in the retailer's name, which may be sent directly to the retailer or physically delivered by the consumer;
- b. a check issued in the names of both the retailer and the consumer which must be executed by both parties (and which may also be sent directly to the retailer or be physically delivered by the consumer, though the latter is more common because the consumer must also execute the check); and
- c. a direct electronic funds transfer from the lender to the account of the retailer.

The Board held in a separate case that bad debts incurred on certain direct loans are also eligible for deduction or refund under WFS guidelines. In that case, although the purchaser contracted for financing directly with the lender, the lender worked closely with the dealer and remitted payment directly to the dealer. If instead the loan proceeds were to come into the full possession of the consumer (e.g., the consumer deposits the funds into the consumer's own account and then draws from that account to pay the purchase price), the loan would not qualify under WFS. Furthermore, for a direct loan to qualify under WFS, the dealer must receive payment in a manner that is essentially the same as for indirect loans that qualify under WFS. While no specific time frame is required, this usually occurs within ten days of the date of sale. For example, when the loan is for the purchase of a vehicle, a qualifying direct loan would result in the lender's name being placed as lien holder on the ownership certificate as part of the initial registration of the vehicle in the consumer's name. Of course, the other conditions specified in WFS must also be satisfied.

The Board's decision that a lender making a direct loan might qualify for a bad debt deduction or refund under WFS is also applicable to claims for bad debt deductions or refunds under AB 599.

However, AB 599 applies only when the lender has purchased the account directly from the retailer, or when the lender holds the account pursuant to the lender's contract directly with the retailer. Thus, even if a lender providing a direct loan can convince the retailer to sign an election agreement with the retailer, that does not automatically mean that the losses on the account will qualify for deduction or refund under AB 599. For purposes of the requirements of AB 599 with respect to a direct loan, a lender claiming a bad debt deduction or refund will be regarded as satisfying these conditions if the transaction would have qualified for deduction or refund under WFS (as modified by the Board's ruling on direct loans).

For example, a consumer obtains a line of credit with a lender, perhaps secured by a second deed of trust on the consumer's home. The consumer then uses a check to access the line of credit to purchase a big-ticket item. The retailer receiving the check has no contact whatsoever with the lender except to deposit the check and obtain the funds. The lender and retailer thereafter enter into an election agreement. The loss on this account cannot qualify for deduction or refund under AB 599 since the lender cannot be regarded as having purchased the account from the retailer or holding the account pursuant to a contract with the retailer. On the other hand, a consumer applies for a loan from his or her credit union to purchase a vehicle. The consumer then purchases a vehicle under the normal vehicle sales contract giving him or her a stated number of days to pay the purchase price to the dealer. If the consumer does not make payment timely, the sales contract provides for the dealer to carry the loan (which the dealer could promptly assign to a lender, perhaps even the consumer's own credit union). During the completion of the paperwork and during the sale transaction process, the consumer provides information to the dealer regarding the credit union loan. The dealer contacts the credit union directly and after the necessary paperwork is completed, the credit union deposits the funds directly into the dealer's account. This direct loan will be regarded as satisfying the requirements that the lender purchased the account from the dealer, and if the other requirements of AB 599 are satisfied, the lender is eligible to claim a bad debt deduction or refund under AB 599.

Refinanced Loans

When a loan is refinanced with the original lender, there are two situations where a deduction for bad debts or claim for refund incurred on the refinanced loan will be allowed provided all other requirements for a deduction or refund are satisfied. One is when the refinancing is for the purpose of lowering the amount of the payment (through a reduced rate or extension of the term). The other is when the purpose of the refinancing is to obtain additional funds to pay for necessary repairs to the property purchased with the funds from the original loan, but only when the lender makes payment directly to the repair facility. When calculating the amount of the bad debt loss on qualified refinanced loans whose principal amount is increased to pay for repairs, the percentage of taxable loss must be reduced by the nontaxable portion of the repairs (in addition to the other adjustments for the nontaxable portion of the original loan). Losses incurred from refinanced loans through a different lender do not qualify for bad debt deductions or refunds, nor do losses from refinanced loans where the borrower withdrew any funds other than amounts paid by the lender directly to a repair facility for necessary repairs to the property originally financed.

Securitization of Loans

Securitization is a structured finance process that distributes risk by aggregating assets in a pool (often by selling assets to a special purpose entity), then issuing new securities backed by the

assets and their cash flows. The securities are then sold to investors. The securitization process through an affiliated family of the lender will not preclude the lender or designated affiliate from qualifying for the lender bad debt deduction or refund so long as the right to claim the lender bad debt deduction or refund was not assigned beyond the designee of the lender.

With respect to sales of assets within the affiliate family, provided the securitization process occurs entirely within the affiliate family, the process does not affect the original lender's ability to claim or assign the bad debt deduction or refund. Further, the sales of the assets within the affiliate family do not result in collections on the accounts, provided that the sales of the assets occur prior to the accounts being found worthless and charged off for income tax purposes. When all of the sales of the assets occur prior to the accounts being found worthless and charged off for income tax purposes, the securitization process does not result in any collections on accounts subject to the bad debt deduction. If, on the other hand, any assets were sold after they were found worthless and charged off for income tax purposes, that would be a recovery that must be reported by the lender and the applicable tax paid.

Computing the Amount of the Bad Debt Loss

A lender must provide a listing of all transactions (electronic or hard copy) for which it claims a bad debt deduction or refund, and will be required to provide source documents as described in Regulation 1642(e), as requested by the BOE staff. Transactions should be selected for review based on the auditor's discretion and not that of the lender. The amount of the bad debt for which the claim for deduction or refund is filed frequently includes some nontaxable elements (e.g., tax, license, interest, late fees, non-taxable food, etc.). It would thus be highly unusual for a lender to be entitled to a bad debt deduction for the entire amount of its losses on an account. Rather, the lender must adjust the amount of its losses so its claimed deduction or refund includes only the allowable taxable amounts. There are three basic methods of verifying the lender's claim for a bad debt deduction or refund; Actual Basis, Statistical Sampling and Mean Allowable.

Regardless of the method used, the claimant should retain and have available for review election agreements on each account being claimed as a bad debt even if sampling is being used. In addition, prior to beginning verification of a deduction or claim for refund, if sampling is being used, the 4 claimant(s) should be informed that it might later be necessary to expand the size of the sample to ensure a representative sample is taken so the accuracy of the deduction or claim for refund is assured. *A claimant must be able and willing to provide documentation to support all transactions included in the deduction or claim for refund, regardless of accessibility with the exception of credit card issuers, as discussed below.* Transactions for which the claimant, other than a credit card issuer, is not capable and willing to provide supporting documentation for must be disallowed, even in cases where the claimant purports to have documentation but cannot provide copies because it is not readily accessible.

a. Actual Basis

The lender provides a listing of accounts on an actual basis and computes the amount of the allowable bad debt loss on each account on a transaction-by-transaction basis. The information included in the listing must include the items in Appendix 2 of Regulation 1642. Under this method, the lender computes the claimed bad debt loss for sales and use tax purposes on an actual basis and staff is verifying the accuracy of the lender's listing.

Staff should utilize statistical sampling techniques to verify the accuracy of the lender's claimed refund. Staff must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13.

Audit Manual section 1303.00, *Determining Sample Size*, provides that auditors should use a minimum sample size of 300 sampled items. With respect to bad debt losses incurred by lenders only, auditors may now use a smaller sample size provided a minimum of 10% of the population is sampled. If a 10% minimum sample size is used, non-qualifying loans, such as loans to private parties, or out-of-state sales, will not be included in the sample and a replacement sample item will be selected. The sample must be determined by the auditor and not selected by the taxpayer. If after testing a sufficient portion of the sample, the auditor discovers no material discrepancies, the auditor, in his or her discretion, may terminate the test and allow the amount of bad debt loss claimed by the taxpayer. However, prior to terminating the test, the auditor must consider all factors relevant to the sample, the most important of which is the size and uniformity of the population. When the sample discloses material discrepancies among the lender's listing, the sample differences must be evaluated before projecting to the population. The BOE's Statistical Sampling Evaluation program will be used to evaluate the differences. If the sample evaluates well, a percentage of error should be computed and applied to the population of transactions included on the lender's listing to determine the allowable refund amount. If the sample discloses discrepancies and does not evaluate well, staff should consider expanding the sample.

b. Statistical Sampling

The lender provides a listing of the bad debt accounts written off per their books but they have not computed the allowable bad debt loss as described in Regulation 1642(d). The amount listed may include non-taxable elements such as tax, license, interest, late fees, repossession fees, etc. Staff must perform a statistical sample of the transactions to compute the allowable portion of the bad debt loss. Staff must follow the guidelines for performing a statistical sample set forth in Audit Manual Chapter 13. Audit Manual section 1303.00, *Determining Sample Size*, provides that auditors should use a minimum sample size of 300 sampled items. With respect to bad debt losses incurred by lenders only, auditors may now use a smaller sample size provided a minimum of 10% of the population is sampled. The sample must be determined by the auditor and not selected by the taxpayer. The lender must provide a listing for the sample that computes the allowable portion of the bad debt on a transaction-by-transaction basis in accordance with Regulation 1642(d). Staff must verify the accuracy of the sample data.

Under this method, the lender provides the total write off amount for the population. The write-off amount may include items not allowable under Regulation 1642. The sample is used to compute an audited allowable bad debt amount on a transaction-by-transaction basis. Thus every transaction examined in the sample will show a difference between the audited and claimed bad debt. These differences must be evaluated using the BOE's Statistical Sampling Evaluation program. When the sample evaluates well, it will be used to compute an audited allowable bad debt percentage. The allowable bad debt percentage is the audited allowable amount per the sample (computed in accordance with Regulation 1642) divided by the total bad debt claimed in the sample. The allowable bad debt

percentage will be applied to the total claimed bad debt to arrive at the total audited allowable bad debt amount. If the sample differences do not evaluate well, staff should consider expanding the sample.

For large lender bad debt audits or field billing orders that require sampling, auditors should seek the assistance of a Computer Audit Specialist. In cases where the taxpayer provides the full population of claimed lender bad debts, the auditor may seek the assistance of a Computer Audit Specialist to determine duplicate transactions if the auditor is not able to determine them through their own means.

c. **Mean Allowable**

The third method is similar to the second method described above. Under this method a mean allowable bad debt per account is computed in lieu of an allowable percentage. The verification procedures staff must perform are identical to those described in method two above. When the sample evaluates well, it will be used to compute an audited allowable mean bad debt per account.

The mean allowable amount per account is computed by taking the allowable write off amount per the sample (computed in accordance with Regulation 1642) divided by the total number of accounts examined in the sample. The mean allowable amount per account will be applied to the total number of accounts contained in the population to arrive at the total allowable bad debt. If the sample differences do not evaluate well, staff must expand the sample or provide adequate comments to support the application of the results of the sample.

III. PROCEDURES

A. General

Local Tax Verification

When reviewing a claim for refund under WFS or AB 599, it is imperative that staff confirm that the local and district taxes are properly deallocated. For example, when the claimed bad debt loss relates to sales of vehicles, the name and address of the dealer and consumer must be included for each transaction scheduled to properly deallocate the local and district taxes on an actual basis. For loans approved by the lender on a transaction-by-transaction basis, the lender should allocate the local and district taxes on an actual basis. In cases where transaction-by-transaction information is not available and the deallocation cannot be done on an actual basis, the regulation provides that the lender may allocate local and district taxes on an appropriate basis subject to approval by the BOE. When verifying the accuracy of such an alternative method, the audit comments must fully explain the basis for concluding whether or not the alternative method is accurate.

Required Documentation - Vehicles

Exhibit 1 "Listing of Documents and Information Needed to Support Bad Debt Deductions in Connection with Repossessed Vehicles" is a comprehensive list of information staff must review when verifying a claimed bad debt deduction or refund incurred in connection with the financing of a vehicle. However, to the extent this

information is not relevant to the actual computation of the allowable bad debt deduction or deallocation of tax, it need not be scheduled. For example, if a statistical sample uses the loan origination number as the basis for selection, this number must be available for all transactions within the population and must be scheduled. If there is a valid reason for not scheduling that information, adequate supporting comments must be included explaining how the information was made available and why it was impractical to include such information in the supporting schedules.

Disputed Claims for Refund

In cases where the lender (or retailer) disagrees with staff's findings regarding the disallowance of certain types of transactions or the amount of the allowable bad debt loss, the Audit Determination and Refund Section will process the concurred portion of the claim for refund only. The taxpayer will receive a Notice of Refund with an accompanying remittance for the concurred portion of the refund claim while the nonconcurring portion of the claim will be forwarded to the Appeals Section, when applicable.

Election Agreements

Pursuant to AB 242, persons entitled to claim bad debt losses are no longer required to file the elections with the BOE. Additionally, pursuant to AB 2688, to claim a deduction or refund of tax, the retailer who reported the tax and the lender are required to prepare and retain an election signed by both parties designating which party is entitled to claim the deduction or refund of tax.

The elections are subject to examination and verification by BOE staff to determine if they comply with the regulation requirements. Elections that do not contain all of the required elements may be disallowed along with all deductions or claims for refund associated with such elections.

For accounts under audit, a completed BOE-122, *Waiver of Limitation*, will hold the statute of limitations open for the filing of a claim for refund and the obtaining of elections, if necessary.

B. District Responsibilities

Audit Procedures

Audit staff will review claims for deduction or refund based on lender bad debts.

District audit staff will:

- a. Verify the accuracy of the claim for deduction or refund;
- b. Confirm the records provided adequately support the claim for deduction or refund;
- c. Verify the amount of tax the retailer collected from customers was remitted during the period of the original sale with a spot check of IRIS; if the retailer has not paid the tax to the BOE, the auditor should not allow the refund regardless of whether the lender wrote off the bad debt;

- d. Ensure the records provided by the claimant are complete, as required by Regulation 1642 (e);
- e. Confirm that for claims under AB 599 any claimant who is a lender holds a Seller's Permit (and is registered with account characteristic code 20 – see registration procedures on page 15) or a Certificate of Registration – Lender (SL account); registering the lender with account characteristic code 20 will not allow the lender to e-file—the lender should be notified of this restriction;
- f. Confirm for claims under AB 599, that the lender retains a valid election on each account specifying the claimant is the person entitled to claim the deduction or refund for that account;
- g. Confirm claimant's signed elections contain all of the prescribed elements;
- h. Verify local and district tax deallocation from the jurisdiction that received the original local or district tax allocation;
- i. Verify the effective date provided in each election. If no effective date is specified, presume the election applies only to lender bad debt losses incurred after the latter of the date the lender or retailer signed the election. The effective date provides the time period for which the bad debt losses have been assigned. The terms/dates of each election should be reviewed on a case-by-case basis;
- j. Ensure all claimed bad debts have been written off in accordance with applicable income tax provisions on the appropriate income tax returns *and* found to be worthless pursuant to Regulation 1642; (Note: this is an important procedure that must be completed without exception);and
- k. Provide *detailed* comments in the 414-Z program and related audit work papers pertaining to the methodology used in verifying the taxpayer's computation of the lender bad debt loss.

In the general comments section of the audit working papers, audit staff must include a comment as to whether the deduction or claim for refund qualifies under WFS or AB 599. In addition, both the lender's and retailer's accounts must be identified indicating whether the bad debt loss was claimed as a deduction or the taxpayer filed a claim for refund, the basis of the claim (WFS or AB 599), and the periods covered by each. The audit must include a review of the election agreement(s) to ensure each election is valid under subdivision (h)(3)(A), (i)(3), or (i)(4)(A) of Regulation 1642, as applicable, and pertains to the transactions under audit. Regardless if sampling is used, the lender must retain an election on each account being claimed as a bad debt deduction or refund. The Audit Summary Workbook will be updated to provide auditors a guide for comments and areas of verification for a lender bad debt audit.

For a lender to claim a bad debt deduction or refund, subdivision (i)(2)(B) of Regulation 1642 requires that “the account must have been found worthless and charged off by the lender for income tax purposes.” If the account is charged off by the lender for income tax purposes, the lender must use an approved method for charging off the debt, such as the “conformity method²” or other method approved by the Internal Revenue Service. The amount of the bad debt loss claimed on the income tax return(s) should coincide with the

² 2 Rev. Rul. 2001-59

amount claimed as a deduction or claim for refund in the period(s) under examination. If the amount of the bad debt losses differs in any period, the taxpayer should be asked to provide documentation reconciling the differences.

The standard practice of the lending/financial industry requires bad debts to be written off after a prescribed number of days regardless of any collection activity or payment arrangements made with the debtor, and without regard to whether the account is actually worthless. Thus, although accounts may be written off in accordance with industry standard practice, this does not necessarily mean they are worthless. For example, an account may be written off after the prescribed amount of time has passed, but the lender may have a payment plan in effect with a debtor. Although the account may be written off as a bad debt for other purposes, such an account would not generally be considered “worthless” for purposes of Regulation 1642 while the payment plan remains in effect. Thus, in these specific cases, the bad debt is not entirely worthless. However, the bad debt deduction or refund is permissible only on the amount that was written off (the difference between the original amount of the receivable and the amount of the payment plan). For example, when a payment plan includes a liquidated damages provision that calls for payment of the original amount of the receivable in the event of a missed payment, a bad debt deduction or refund is not permissible to the extent the provision is exercised by the lender. In addition, auditors should review the lender bad debt losses for any subsequent sales of the bad debts, such as the lender selling the bad debts on a secondary market and recording the sale as either cash or as an accounts receivable, as these also would not be considered “worthless.”

Audit staff must obtain and review transaction level detail to determine the recommended amount of the claim to approve/allow. This includes source or detail information to show the amount of tax that was collected by the retailer on the original transactions. (See below under “Transaction Level Detail Not Maintained by Credit Card Issuers” for exceptions pertaining only to credit card issuers.)

Elections must be retained by both the retailer and the lender for all bad debts claimed as a deduction or included as part of a claim for refund. When a statistical sample is to be performed in review of a deduction or claim for refund, and a specific election is missing or not available, the claimant should be allowed an opportunity to obtain the proper election. However, special attention should be paid to the effective date of the election agreement.

A valid election agreement contains a binding commitment for both parties to furnish “any and all documentation requested by the BOE to support the deduction(s) or refund(s) claimed.” This includes source or detail documents to show the amount of tax that was collected by the retailer on the original transaction.

With the exception of lender (credit card issuer) transactions as described below, it is important to note that while it may be presumed that tax charged on an invoice was *remitted* by the retailer, it is imperative that audit staff determine the amount of tax charged on the transaction being claimed as a bad debt by a review of transaction level detail, i.e., source level detail. The fact that the deduction or claim for refund pertains to a

known retailer whose transactions are almost exclusively subject to tax is insufficient to support the deduction or claim for refund as all retailers encounter non-taxable transactions (e.g., sales of gift cards, property shipped to an out-of-state address, or even property purchased at a location outside the state of a large chain). Further, the source documentation is essential in determining the proper deallocation of local and district taxes where applicable.

The alternate procedure, as described below, may be used when reviewing and examining deductions or claims for refund filed by lenders (credit card issuers) with respect to credit card bad debts where the lenders do not maintain transaction level detail.

Transaction Level Detail Not Maintained by Credit Card Issuers

Lenders (credit card issuers) that have deducted or filed a claim for refund on credit card bad debts under Regulation 1642 may not have secured all the required elections. They also may not maintain or have available "sales" transaction level detail (i.e., source documents showing the retailer's sales to its customers on a transaction level basis, such as bills, receipts, invoices, cash register tapes, or other documents of original entry, as well as the sales/use taxes charged on the specific transaction by the retailer) in support of the aged bad debt write-offs. In general, most lenders maintain credit history transaction level detail (also known as statement level detail) in their records and not sales transaction level detail.

Therefore, these alternate procedures are specific with regard to the election agreements and the review of transaction level detail. These alternate procedures may be used in addressing the examination and verification of lender bad debt deductions or claims for refund where the lenders do not maintain sales transaction level detail. The procedures are effective immediately and apply to all such lender bad debt claims regardless of when the deduction was taken or the claim for refund was filed.

Notwithstanding the provisions of Regulation 1642 and Audit Manual section 0419.17, for all lender credit card bad debt deductions or claims for refund, the BOE will allow the lender to secure and provide any missing elections in support of their bad debt deductions or claim for refund. However, special attention should be paid to the effective date on each election agreement that is secured after the deduction or claim for refund has been filed/claimed. Where questionable, the election should be verified with the retailer or assignor.

In addition, although sales transaction level detail may not be maintained by the lender, lenders must still provide credit history transaction level detail for each account being written off and claimed as a bad debt for sales tax purposes. Credit history transaction level detail will provide by customer, items included in the bad debt write-off such as principal, interest, and late fees, as well as other nontaxable charges based on the lender's written agreement with the customer.. Since only the principal amount is used to compute the amount on which a tax refund may be allowed, these other charges (e.g. late fees, penalties, interest, etc.) must be removed. The principal amount will generally include both taxable and nontaxable sales, as well as any sales taxes charged. Therefore, auditors must determine whether the principal amount includes sales taxes before making any adjustment for tax included. Credit history transaction level detail will show both charges

made to the specific customer's credit account and payments made by the customer on that account. Thus, credit history transaction level detail is important in that it is used to verify the computation of the bad debt.

Lenders claiming credit card bad debts may compute their bad debts using one of the following methods:

1. **Taxable Sales Percentage Method.** This method incorporates the principles of Audit Manual Section 419.15, "Bad Debts for Department Stores Using Formula under Regulation 1642 in Determining Sales Tax Credit for Bad Debts – Contract Method". The lender and retailer do not provide sales transaction level detail by customer if this method is used; but must provide credit history transaction level detail. Under this method, from each retailer for whom a bad debt loss is being claimed, the lender is required to obtain and retain a yearly statement showing the retailer's California taxable sales percentage for that calendar year. This statement must show the formula used to compute the taxable sales percentage pursuant to Exhibit 2, Column D. The statement must be signed and dated by an official of the retailer. The taxable sales percentage is subject to verification by BOE. Auditors must determine if the taxable sales percentage as provided includes sales taxes. The taxable sales percentage will be applied to the principal bad debt amount by retailer by year to compute the allowable bad debts for sales tax purposes. Exhibit 2 provides an example of the Taxable Sales Percentage Method calculation where sales tax is included in the net principal write-off (i.e., Total Sales, tax included) and in the taxable sales percentage.
2. **Sales Transaction Level Detail Method.** If the lender does not use the Taxable Sales Percentage method above, then this method must be used. It requires the lender and retailer to provide sales transaction level detail records by customer for the bad debts being written off. The bad debts will be computed using one of the methods identified earlier in this Operations Memo under the section "Computing the Amount of the Bad Debt Loss." Once the percentage of taxable sales is computed using one of the testing methods, this percentage will be applied to the principal amount to compute the allowable bad debts for sales tax purposes.

Auditors must determine if the principal amount includes or excludes sales taxes. Adjustments must be made for sales taxes if the principal amount includes tax.

It is still the lender's responsibility to provide credit history transaction level detail, as well as documentation to support the amount of the total bad debt write-off per year, the amount of total bad debt write-off per merchant/retailer (as applicable) and evidence that the bad debt was actually written off for income tax purposes or, if the lender is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. It is also the lender's responsibility to provide documentation on any subsequent bad debt recoveries or subsequent sales of accounts receivable which were written off, e.g., accounts receivables sold on the secondary market. Therefore, despite the exception with respect to the examination of sales transaction level detail, all other audit verification procedures relating to bad debts will remain the same and any alternative method

to compute the bad debt deduction or refund will be subject to review, testing and approval by the BOE.

Registered lenders are required to file a return when claiming a bad debt. Failure to file a return when claiming a bad debt may constitute carelessness and may result in a denial of credit interest if a claim for refund is filed at a later date.

Registration Procedures

Only a person registered with the BOE as a lender may claim a deduction or refund for bad debt lender losses on purchased accounts. There is no charge to register nor will any security deposit be required. To register, the lender must access eReg from the BOE website to apply for a Certificate of Registration – Lender, and must do so without regard to whether the lender may be registered with the BOE for another program or purpose. For example, a lender who holds a seller's permit must nevertheless register as a lender to claim a deduction or refund as a lender under AB 599. Registration as a lender will ensure the account is assigned the correct Account Characteristic Code (ACC) of "20" and that the lender receives the proper returns/schedules.

When registration is completed by the lender, a Taxable Activity Type (TAT) of "SL" will be assigned to a lender who is not currently registered with the BOE. A lender who currently holds a seller's permit will retain its current TAT (e.g. SR, SY, etc.). To identify the account as a lender, the registration system will create an assignment for district office staff to add an Account Characteristic code of "20" to the existing account. Staff should enter comments in TAR concerning the status of the lender's application and indicate any reason for delay. Once the application is processed, the district office will forward the application and supporting documentation (if any) to the Taxpayer Records Unit in headquarters.

Although the lender may have been operating prior to registering for a Certificate of Registration – Lender, permits are not to be issued with a start date beyond the three-year statute of limitations for filing a claim for refund (i.e., the permit should not be back-dated beyond the current three-year statute of limitations unless a valid waiver of limitation has been executed and is on file for prior periods.

Once a person (entity) is registered as a lender, the person is required to file periodic returns (generally quarterly) even if it will report no tax and claim no deductible losses. Lenders currently may not e-file their returns. This includes all SL accounts and all accounts designated with ACC 20. Therefore, periodic paper returns, including a *Schedule L* (BOE-531-L) and *Listing of City and Unincorporated County Codes for BOE-531-F, Schedule F and BOE-531-L, Schedule L* (BOE 531-FL1), will be mailed to the lenders. The lenders will use the Schedule L to make adjustments to the local or district tax associated with the bad debt deduction for the jurisdiction that originally received that tax from the retail sale of the financed property. As stated in Regulation 1703(b)(5)(B), failure to claim a deduction for bad debts on a periodic return may constitute carelessness and result in the disallowance of credit interest on a refund.

A. Headquarters Responsibilities

Return Processing Procedures**Mail Services Unit, Data Entry Unit, and Verification Unit**

The Mail Services Unit, Data Entry Unit, and Verification Unit will receive and process the sales and use tax returns, along with Schedule L, in accordance with established policy and procedures. Once processed, the returns will be forwarded to the appropriate section based on batch types, IRIS edit messages, or both.

Cashier Unit

The Cashier Unit receives the presorted returns from Mail Services Unit. The batch type for SL accounts will be "S." The batch type for sellers who are also lenders will remain the same as the current batch type according to their registered TAT information. During the sort process, those returns with a subsidiary Schedule L attached will be batched into miscellaneous batches. Cashier staff will process the returns in accordance with established policy and procedures. The processed batches will then be forwarded to the Data Entry Unit.

Return Analysis Unit

The Return Analysis Unit (RAU) is responsible for identifying taxpayers who have claimed a lender bad debt deduction on their returns to ensure such persons hold a Certificate of Registration – Lender, or are designated with ACC 20.

When the taxpayer is not registered as a lender but claims a deduction for lender bad debt loss on line 10(a)(2) of its return or files a Schedule L with its return, *RAU will contact the taxpayer to advise them the deduction is not allowable since the taxpayer is not registered as a lender entitled to the deduction. RAU will advise the taxpayer to access eReg on the BOE website and apply for a Certificate of Registration -- Lender, and provide a Schedule L (if one was not received with the return).* RAU will specify a reasonable amount of time in which the taxpayer must respond. If no response is received by the time specified, RAU will disallow the deduction. Lender returns which contain a bad debt deduction under Regulation 1642 but which do not result in a new credit return will be processed by the Return Analysis Unit. Lender returns resulting in a credit will be forwarded to the Audit Determination and Refund Section for further analysis and processing.

Local Revenue Allocation Section

The Local Revenue Allocation Section (LRAS) will receive all scheduled type return batches for processing, including those with Schedule L, for the adjustment of local and district taxes based on bad debt deductions. A taxpayer who is not registered as a lender will be identified by an IRIS edit. On returns so identified, LRAS will not key the adjustments of local tax reported on Schedule L. Those returns will be forwarded to Return Analysis Unit (RAU) for review and further processing. Lender credit returns will thereafter be forwarded to the Audit Determination and Refund Section for analysis and processing. Lender returns which contain a bad debt deduction under Regulation 1642 but which do not result in a new credit return will be worked by the Return Analysis Unit.

Audit Determination and Refund Section (ADRS)

It is anticipated most claims for refund will be filed in the form of credit returns which, as designed, will serve as basis for the claim(s) for refund. These claims will generally be routed from the Return Analysis Unit or Local Revenue Allocation Section to the ADRS for analysis and processing. Lender returns which contain a bad debt lender deduction under Regulation 1642 but which do not result in a net credit return will be processed as provided in this operations memo.

Upon receiving a claim for refund or net credit return, ADRS will send an acknowledgment letter to the claimant filing the claim for refund or net credit return. Lender returns resulting in a credit are to be routed to LRAS for processing of the Schedule L for subsequent forwarding to ADRS.

IV. OBSOLESCENCE

This operations memo will become obsolete when the information contained herein is incorporated into the appropriate manuals.



Susanne Buehler, Chief
Tax Policy Division

Distribution: 1-D

Exhibit One**Listing of Documents and Information to Support Bad Debt Deductions in Connection with Repossessed Vehicles:****Total Population of Claim on Electronic Media**

- Must exclude or readily identify loans that do not qualify
- Must identify loan origination date (Date contract entered into)
- Must include seller's/dealer's name and address (City and State)
- Must include California seller's permit number and DMV Dealer Number
- Must include consumer's name and address (City and State)
- Must include the following additional information:
 - Reference Number – Number assigned to each loan
 - Type of Vehicle/Property – e.g., vehicle, RV, mobile home, etc.
 - Full VIN - In case secondary verification with DMV records is required
 - Date of Repossession Charge Off – The date charged off for income tax purposes
 - Loan Number – Actual loan account number
 - Charge Off or Loss Per Records – Amount charged off for income tax purposes
 - Summarized number of transactions in each local tax and district tax area

Complete contract files must be available**Sample Selection**

- Audit Manual section 1303.00, *Determining Sample Size*, provides that auditors should use a minimum sample size of 300 sampled items. With respect to bad debt lender losses only, auditors may now use a smaller sample size provided a minimum of 10% of the population is sampled.
- For each loan in the sample - Evidence that the uncollectible portion has been charged off for income tax purposes or in accordance with GAAP. Printouts from taxpayer accounting system will suffice
- For losses claimed under AB 599, an election agreement for each loan as required by subdivision (i)(3)(A) of Regulation 1642 and, if applicable, the election agreement required by either subdivision (h)(3)(A) or (i)(4)(A) of Regulation 1642

Documentation and Information for Selected Sample

- Full VIN
- Complete contract file, including the “No Recourse” statement. If “No Recourse” statement is not available, copy of the contract/agreement between dealer and the financial institution establishing that the lender holds the account without recourse
- Reference Number – Number assigned to each loan
- Loan Origination Date – Date contract entered into
- Date of Repossession Charge Off – The date charged off for income tax purposes
- Loan Number – Actual loan account number
- Sales Price of Vehicle – Total amount subject to tax including document preparation charge and taxable smog
- Nontaxable Charges such as charges for optional service contracts, Smog Fee Impact, smog certificate fee, etc.

- Sales Tax – Tax reimbursement collected from the consumer on sale
- Vehicle License Fee
- Insurance – Net amount
- Down Payment
- Any Adjustments to the Principal
- Finance Charges – Net amount
- Payments on Principal
- Value of Repossession – Sales price for subsequent sale
- Charge Off or Loss Per Records – Amount charged off for income tax purposes
- Repossession Expense – Auctioneer's fees, reconditioning, etc.
- Recovery – Payments made after the loan is charged off on records
- Reversals – Adjustments for Non Sufficient Funds (NSF) checks, etc.
- Taxpayer must compute the amount of refund per Regulation 1642

Exhibit Two: Taxable Sales Percentage Method

Taxable Sales Percentage Application					
A	B	C	D	E	F
<Taxpayer Records>	<Taxpayer Records>	(A + B)	(C * 75%)	(D - D/(1 + 8.25%))	(D - E)
Gross write off for period related to retailer (on lender's books and records)* Tax Included	Less finance balance (late fees, interest, penalties, etc)	Net principal write off Tax Included	Retailer taxable percentage-tax included application(i.e. 75%)	Less tax included in principal (i.e. 8.25%)	Net principal measure subject to refund Ex-tax
1,000,000.00	(100,000.00)	900,000.00	675,000.00	(51,443.42)	623,556.58

* Amount must be included on Federal Income Tax Return.

Note 1: Additional adjustment(reduction) may need to be made to principal, for amounts included in principal, that were added by the lender during the financing process (i.e. late fees, penalties, etc.). See column B.

Note 2: Retailer's Taxable Percentage is subject to SBOE's review of retailer's records.

Note 3: Lenders are required to obtain and retain a yearly statement showing the retailers California taxable sales percentage for the calendar year at issue.

Note 4: In most cases, Column C, which is the net principal write off amount, will include sales tax. Thus, Column D, the retailer's taxable percentage, must also be tax included. The sales tax is then removed as shown in Column E to arrive at the net allowable refund measure, ex tax.