

PRIVATE TAXPAYER RULING LR94-014

November 17, 1994

The following private taxpayer ruling is in response to your letter dated September 20, 1994 and the receipt of the requested additional information dated October 31, 1994. Your letter requests a determination of the availability of a bad debt deduction to ... for a note which has been sold to a third party and is defaulted on by the purchaser. The following is a restatement of the facts in your letter.

Statement of facts:

... is an S corporation which operates a motor vehicle sales facility in Phoenix. As part of its business, ... sells both new and used vehicles. Sales of new vehicles are financed through non affiliated corporations and are not at issue. However, sales of used vehicles are financed through a 100 percent affiliated S corporation (Finance). All of the owners of Finance also own a majority of On most occasions, when ... sells a used automobile, its receives an initial cash payment from the customer and a note for the balance of the sale. ... then sells the note at a discounted rate to Finance. The sale of the note may or may not be with recourse. At this point, ..., who is reporting sales under the accrual method of accounting, has remitted the entire amount of transaction privilege tax due on the sale to the department. In repaying the note, the customer remits payments of principal and interest to Finance over a fixed period of time. In the event a customer defaults on a loan, Finance will repossess the vehicle, if possible, and resell it. Upon resale of this vehicle to the final customer, not a wholesaler, transaction privilege tax is remitted for the second time on the same vehicle. Your position: ... is entitled to a bad debt deduction for the entire bad debt recognized. In the alternative, ... should change its reporting method to the cash method. Under the cash method, ... and Finance will record and report gross proceeds to the department based upon principal payments actually achieved. This method will allow both ... and Finance to remit the correct amount of transaction privilege tax to the department on their respective taxable receipts and allow Finance to take a bad debt deduction on a defaulted loan.

Applicable statutory provision:

Arizona Revised Statutes (A.R.S.) 42-1310.01 levies the transaction privilege tax on the business of selling tangible personal property at retail.

A.R.S. 42-1310.01.P.3 defines "selling at retail" as a sale for any purpose other than for resale in the regular course of business in the form of tangible personal property.

Arizona Administrative Code (A.A.C.) rule R15-5-2011 provides when a taxpayer may take a bad debt deduction.

A.A.C. R15-5-2211 provides that a taxpayer may elect to report and pay taxes based on either the "cash

receipts" or the "accrual" method.

Discussion:

Arizona imposes a transaction privilege tax which differs from the sales tax imposed by most states. The Arizona transaction privilege (sales) tax is a tax imposed on the privilege of conducting business in the state of Arizona. This tax is levied on the vendor, not the purchaser. The vendor may pass the burden of the tax on to the purchaser; however, the vendor is ultimately liable to Arizona for the tax. Activities subject to tax are divided into 18 different business classifications.

A.R.S. 42-1310.01 levies the transaction privilege tax on the business of selling tangible personal property at retail. A.R.S. 42-1310.01.P.3 defines "selling at retail" as a sale for any purpose other than for resale in the regular course of business in the form of tangible personal property. All sales of tangible personal property are subject to tax unless specifically exempted by statute. The tax base for the retail classification is the gross proceeds of sales or the gross income derived from the business.

Pursuant to A.A.C. R15-5-2211, a taxpayer may elect to report and pay taxes based on either the "cash receipts" method or the "accrual" method. If the taxpayer elects to report on the accrual method, the sale is to be reported for the month in which it is made without regard to when payment is received. Under the cash receipts method, a sale is reported in the month in which payment is received. The election to report based on a particular method can not be changed without receiving written approval from the department.

A.A.C. R15-5-2011 provides that a deduction may be taken for bad debts if the income was originally reported as taxable for the month in which the sale took place. Therefore, only taxpayers who have elected to report on an accrual basis are entitled to a deduction for a bad debt. With regard to installment sales or conditional sales, a bad debt deduction is allowed if the tax liability is paid on the full sales price on the tangible personal property at the time of the sale or if a contract or other financial obligation is sold to a third party as a sale with recourse and principal payments are made by the vendor to the third party, pursuant to the default of the original payor. The principal payments may be taken as a bad debt deduction if the tax was paid by the vendor on the original sale of the tangible personal property or on the subsequent sale of the financing contract. A "sale with recourse" means that a vendor sells a contract or other financial obligation to a third party but retains liability for payment upon default of the original payor.

The following is an example of the availability of a bad debt deduction with regard to an installment or conditional sale: ABC Motor Company sells D a car. D gives a down payment and finances the remainder. ABC Motor Company provides the financing. ABC sells D's note to EF Financing. The sale of the note is a sale with recourse. D, after making several payments defaults on the note. ABC is liable to EF for the uncollectible amount; or ABC sells car to D for \$15,000 D gives down payment 2,000 Net due (Amount of note) \$13,000 ABC reports and pays tax on \$15,000. ABC sells note to EF. D makes several payments and then defaults. At the time D defaults there is \$8,000 remaining to be paid on the

note. Circumstances indicate that the debt is uncollectible. Pursuant to the contract between ABC and EF concerning the sale of the note with recourse, ABC is liable to EF for the \$8,000 remaining on the note. ABC is allowed a bad debt deduction equal to the amount which it has paid to EF as a result of D's default on the note (i.e. \$8,000). However, if the note is sold to EF without recourse, ABC is not liable to EF for the amount in default and therefore, is not entitled to a bad debt deduction.

Conclusion and ruling:

The following ruling is given based on the facts presented in your request. The department rules that ... is allowed a bad debt deduction equal to the amount which it pays to Finance upon the default of the original purchaser of the car pursuant to the sale of the purchaser's note with recourse. If a purchaser's note is sold to Finance "without recourse" no bad debt deduction is allowed to ... upon a default by the purchaser.

With respect to the alternative ruling you proposed, should ... determine that it wants to change its reporting method from an accrual method to a cash receipts method, written approval must be obtained from the Transaction Privilege and Use Tax Audit Section. The conclusion in this private taxpayer ruling does not extend beyond the facts as presented in the letters dated September 20 and October 31, 1994 in this request for a private taxpayer ruling.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department and is valid for a period of four years from the date of issuance except as set out herein. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.