WAC 458-20-196 Bad debts. (1) **Introduction.** This rule provides information about the tax treatment of bad debts when income is reported by a taxpayer, but that income is ultimately not received by the taxpayer.

(a) **References to related rules.** The department has adopted other rules that readers may want to refer to:

(i) WAC 458-20-197 When tax liability arises;

(ii) WAC 458-20-198 Installment sales, method of reporting;

(iii) WAC 458-20-199 Accounting methods;

(iv) WAC 458-20-229 Refunds.

(b) **Examples.** The rule includes a number of examples that identify a set of facts and then state a conclusion. These examples are only a general guide. The tax results of other situations must be determined after a review of all facts and circumstances. For each of the examples, assume an 8% retail sales tax rate.

(2) **Definitions.** The following definitions apply throughout this rule:

(a) "Bad debt" is an amount owed to the taxpayer as payment for the sale of goods, services, or digital products which is not actually received and is written off as a worthless debt on the taxpayer's books and records. For Washington excise tax reporting purposes, a bad debt is based on federal income tax standards of worthlessness under 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003. A bad debt may only be taken by the original seller of goods, services, or digital products.

(b) "Bad debts" do not include:

(i) Amounts due on property remaining in the seller's possession until the full purchase price is paid;

(ii) Expenses incurred in attempting to collect debt;

(iii) Sales or use taxes payable to a seller;

(iv) Debts sold or assigned by the seller to third parties, where the third party is without recourse against the seller (RCW 82.08.037 and 82.12.037. See subsection (6)(a) of this rule); and

(v) The value of repossessed property taken as payment of debt at the time the property is repossessed.

(3) **Reporting a bad debt.**

(a) Only amounts previously reported as gross income on the Washington excise tax return are eligible for reporting as bad debts to the state of Washington. The bad debts reported must meet the federal revenue code standards for worthlessness. However, if a taxpayer who is not required to file a federal return is otherwise eligible for a federal income tax bad debt deduction, credit, or refund, that taxpayer may claim a Washington bad debt deduction, credit, or refund on a previously paid Washington state tax. For taxpayers who file a consolidated federal return with controlled affiliates, the bad debt deduction, credit or refund is only available to the original seller or provider that incurred the loss from the worthless debt.

(b) Taxpayers who report using the cash method do not report income until it is received. For this reason, bad debts are most relevant to taxpayers reporting income on an accrual basis. However, some transactions must be reported on an accrual basis by all taxpayers, including installment sales and leases. These transactions are eligible for a bad debt deduction as described in this rule.

(c) Bad debts can be reported using one of the following methods:

(i) **Deductions:** Generally, a bad debt is reported as a deduction from the measure of the tax previously reported and paid on the excise tax return. The bad debts discussed in this rule are assumed to be reported as deductions unless otherwise stated.

(ii) **Credits:** A bad debt credit is most commonly taken when there is a change in the retail sales tax rate between the time of sale and the reporting of the bad debt. To claim the credit, a taxpayer must complete a Schedule B addendum to their excise tax return. This form is available on the department's website at dor.wa.gov.

(iii) **Refunds:** A taxpayer may also claim a bad debt by requesting a refund directly from the department using the process as described in WAC 458-20-229.

(d) **Reserve method.** Ordinarily, taxpayers must report bad debt deductions, credits, or refunds for specifically identified transactions. However, taxpayers who are allowed by the Internal Revenue Service to use a reserve method of reporting bad debts for federal income tax purposes, or who secure permission from the department to do so, may deduct a reasonable addition to a reserve for bad debts. What constitutes a reasonable addition to a reserve for bad debts will vary by business type and economic factors. The department presumes reserve methods allowed by the Internal Revenue Service for federal income tax purposes are reasonable, absent contrary evidence. When the reserve method is used, the amount of loss deducted must be adjusted annually to make the total loss claimed for the tax year coincide with the amount of actual loss.

(e) **Statute of limitations for claiming bad debts.** No deduction, credit, or refund may be claimed for debt that became eligible for a bad debt deduction for federal income tax purposes more than four years before the beginning of the calendar year in which the credit, refund, or deduction is claimed.

(4) **Claiming bad debt deductions for various taxes paid.**

(a) **Business and occupation (B&O) tax.** Taxpayers may deduct from the measure of B&O tax, bad debts on which B&O tax was previously paid. RCW 82.04.4284.

(b) **Retail sales and use tax.** Taxpayers may take a bad debt deduction for retail sales and use taxes previously paid on bad debts. RCW 82.08.037 and 82.12.037.

Example 1. Joe's Hardware, which reports on an accrual basis, sells $500 worth of goods to a buyer. Joe's Hardware receives no payment from the buyer at the time of sale. Joe's Hardware reports and remits $40 (8% of $500) in retail sales tax to the department. Joe's Hardware also reports $500 of gross income under the retailing B&O tax classification, and reports service and other activities B&O tax on the interest and fees accruing on the outstanding balance.

A year and a half after the sale, Joe's Hardware has still not received any payment, and the balance with interest and fees is $627 ($500 selling price + $40 retail sales tax + $87 accrued interest and fees). Joe's Hardware meets the requirements to claim a federal income tax bad debt deduction. Therefore, it may claim a $40 bad debt retail sales tax deduction, and a $500 bad debt deduction from gross income under the retailing B&O tax classification. It may also take a bad debt deduction of $87 for the accrued interest and fees previously reported under the service and other activities B&O tax classification.

(5) **Post bad debt reporting: Payments, recoveries and repossessions.**

(a) **Application of payments.**

If a taxpayer takes a bad debt deduction for a previously paid tax, and later collects some or all of the debt, the amount of tax recovered must be reported and paid in the tax-reporting period in which the collection was made. The amount of tax reported and paid on the recovery for B&O tax, retail sales tax, and use tax purposes is determined by first applying the recovered amount proportionally to the taxable price of the property or service and the retail sales or use tax thereon. Secondly, the recovered amount is applied to any interest, service charges, and any other charges. RCW 82.08.037(4).

Example 2. Joe's Hardware in Example 1 above receives a $50 payment on the $500 purchase six months after claiming the bad debt deduction. Joe's Hardware must report and pay an additional $3.70 of retail sales tax on its current excise tax return ($50 payment × ($40 retail sales tax/$540 selling price + retail sales tax)).

In addition, it must report $46.30 as gross income under the retailing B&O tax classification ($50 payment × ($500 selling price/$540 selling price + retail sales tax)).

Additional recoveries are reported in this same manner until the original $40 retail sales tax bad debt deduction reduces to zero.

(b) **Repossessions:**

(i) The value of any property repossessed from a buyer for nonpayment must be subtracted from the value of the bad debt. In determining the amount of the bad debt deduction for B&O tax, retail sales tax, or use tax purposes, the repossessed value must first be applied to any accrued interest and fees. Any remaining value must be proportionally applied to the original selling value and retail sales tax.

(ii) For bad debt purposes, the value of repossessed property is its fair market value on the recovery date (recovery value). If post-recovery repairs and improvements that increase the value of the property are made after recovery and prior to resale, the cost of these repairs may be subtracted from the selling price to establish its recovery value.

(iii) Only post-recovery repairs and improvements that increase the value of the repossessed property qualify to reduce its selling price to establish its recovery value. Repairs and improvements that are routine maintenance do not qualify to reduce the selling price of the repossessed property to establish its recovery value. In general, repairs and improvements considered routine in nature have a useful life of less than one year. Repairs with a useful life of more than one year are typically considered an improvement that increases the value of the property for the purpose of establishing recovery value.

In addition to routine maintenance costs, a taxpayer may not offset the value of repossessed property with any costs related to locating, repossessing, storing, or reselling the property, including associated attorney fees.

(iv) If the sales price of the repossessed property is less than the recovery value previously reported, the taxpayer must report the difference between the selling price and the claimed recovery value as an additional bad debt deduction. Alternatively, if the property resells for more than the recovery value previously reported, the taxpayer must report it as an additional recovery. This is because the sales price establishes the correct value of the repossessed goods.

Example 3. Phil's Fine Cars (Phil) sells a car to Alice on credit for $1,000. Initially, Phil reports $1,000 in gross income under the retailing B&O tax classification, and reports and remits $80 in retail sales tax (8% of $1,000). When Alice makes no payments, Phil repossesses the car. The recovery value of the repossessed car at the time of repossession is $700. Also, assume $63 in accrued interest at the time of repossession, resulting in an outstanding balance of $1,143 ($1,000 selling price + $80 retail sales tax + $63 accrued interest).

The $700 recovery value is first applied to the accrued interest, resulting in a selling price and retail sales tax balance of $1,080. The remaining recovery value of $637 ($700-$63 accrued interest) is applied to the balance of $1,080, resulting in an outstanding balance of $443 ($1,080-$637) eligible for a bad debt deduction. Phil can claim a bad debt deduction of $32.81 against the retail sales tax ($443 × ($80/$1,080)), and a $410.19 deduction against the measure of the retailing B&O tax ($443 × ($1,000/$1,080)).

Example 4. If Phil's Fine Cars later resells the car repossessed from Alice in Example 3 in this subsection, it must collect and remit retail sales tax, and pay retailing B&O tax on the sale to a new buyer. The payment of the retail sales tax and retailing B&O tax on the sale of the repossessed car does not affect Phil's tax liability regarding the reported bad debt deduction from the original transaction. Here, Phil resells the car for its $700 recovery value to a new buyer, Jim. Phil will collect and report $56 of retail sales tax on the sale ($700 × 8%), and report $700 in gross income under the retailing B&O tax classification.

Example 5. Phil's Fine Cars repossessed a car from Bob. Phil's estimate of the car's recovery value upon repossession for bad debt reporting purposes was $1,500. Phil reports a bad debt deduction based on this $1,500 value, the outstanding debt balance, and any payments Bob made. Later, Phil makes repairs and improvements to the car and resells it to Ron for $2,500. In order for Phil to know if he needs to adjust his prior bad debt reporting he must determine if his original estimate of $1,500 recovery value upon repossession was correct.

Phil made the following repair and maintenance expenditures after recovering the car from Bob, and before reselling it to Ron:

Post Repossession Expense:		Reduction of selling price?
Replace engine:	$350	Yes, increases value
Replace windshield:	$70	Yes, increases value
Replace filter:	$20	No, maintenance
Replace wipers:	$45	No, maintenance
Change oil filter:	$50	No, maintenance
Repair transmission:	$200	Yes, increases value
Detailing/cleaning:	$75	No, maintenance
Replace tires:	$130	Yes, increases value
Total expenses that increased value of the car: $750		
Total expenses for maintenance: $190		

Phil has repair and improvement costs of $750 that qualify to reduce the selling price to determine the car's recovery value before any repairs and improvements. After reducing the $750 of qualifying expenses from the $2,500 resale price to Ron, the recovery value of the car at the time of repossession is $1,750. Because the $1,750 recovery value is greater than Phil's bad debt reporting estimate of $1,500, Phil must adjust his bad debt reporting for the bad debt relating to the repossession from Bob. Phil must reduce his bad debt deduction previously taken by the $250 in increased recovery value ($1,750-$1,500).

If Phil's qualifying repair expenses had been $1,750, then the recovery value of the car repossessed from Bob would only have been $750 ($2,500 resale price - $1,750 repairs). The lower actual recovery value increases the amount of bad debt, which allows for a larger bad debt deduction than had been originally reported by Phil.

(6) **Assigned debt and private label credit cards.**

(a) **Assigned debt.** RCW 82.08.037 and 82.12.037 limit who can claim a bad debt deduction for retail sales or use tax. Only the original seller in the transaction that generated the bad debt, or a certified service provider (CSP) as defined in RCW 82.32.020 used by the seller, is entitled to claim a bad debt deduction. If the original seller in the transaction that generated the bad debt has sold or assigned the debt instrument to a third party with recourse back to the seller, the original seller may claim a bad debt deduction only if the debt instrument is reassigned by the third party back to the original seller. Alternatively, if the original seller has sold or assigned the debt instrument to a third party without recourse back to the seller, the original seller may not claim a bad debt deduction. Where the seller uses a CSP to administer its retail sales tax, the CSP may claim, on behalf of the seller, the bad debt deduction allowed.

Example 6. Immediately after Phil's Fine Cars sells a car, it assigns the contract to Finance Company ABC without recourse back to Phil. Phil receives face value for the contract from Finance Company ABC. If the buyer fails to make payments, Finance Company ABC may not claim a bad debt deduction because it is not the original seller. Phil is also unable to claim a bad debt deduction because Finance Company ABC purchased the contract without recourse back to the seller.

(b) **Private label credit cards.** A seller is not eligible for a bad debt deduction, credit, or refund for customers failing to pay credit card invoices if the seller:

• Contracts with a third party, such as a financial institution, to provide a private label credit card program;

• The third party becomes the exclusive owner of the credit card accounts.

Example 7. Mountaintop Ski Equipment (Mountaintop) is a sporting equipment retailing chain store. Mountaintop contracts with ABC Financial Institution (ABC) to issue Mountaintop private label credit cards. ABC has the authority to accept or reject an applicant's credit card application. After Mountaintop transmits the credit card sales records to ABC, ABC pays Mountaintop the proceeds of the sales including the retail sales tax less any applicable service fees. Mountaintop reports and remits the retail sales tax to the department. If a customer using the Mountaintop credit card fails to pay ABC the outstanding amount on the credit card invoice, Mountaintop is not entitled to a bad debt deduction because it has no bad debt loss when a customer defaults on a debt to ABC.

[Statutory Authority: RCW 82.32.300 and 82.01.060(2). WSR 18-14-042, § 458-20-196, filed 6/28/18, effective 7/29/18. Statutory Authority: RCW 82.32.300, 82.01.060(2), 82.08.037, and 82.12.037. WSR 10-21-012, § 458-20-196, filed 10/7/10, effective 11/7/10. Statutory Authority: RCW 82.32.300 and 82.01.060(2). WSR 06-01-005, § 458-20-196, filed 12/8/05, effective 1/8/06. Statutory Authority: RCW 82.32.300, 82.01.060(1), and 34.05.230. WSR 05-04-048, § 458-20-196, filed 1/27/05, effective 2/27/05. Statutory Authority: RCW 82.32.300. WSR 83-07-032 (Order ET 83-15), § 458-20-196, filed 3/15/83; Order ET 70-3, § 458-20-196 (Rule 196), filed 5/29/70, effective 7/1/70.]