

## B

### **130.0000 BAD DEBTS—Regulation 1642**

**130.0005 Cash Basis Records.** Regulation 1642 provides that all retailers must report sales tax liability on an accrual basis even if their financial records are maintained on a cash basis, and that a bad debt deduction will not be disallowed retailers solely for the reason that they are on a cash reporting basis for income tax purposes. When a taxpayer maintains its records on a cash basis, a bad debt deduction with respect to tax previously paid may be taken when all collection activities have ceased and the obligation is treated by the retailer as no longer subject to collection. In addition to the records required under Regulation 1642(e), evidence of the indebtedness should be marked as “uncollectible” or “bad debt” or the records of the sale transaction should otherwise be segregated and identified for audit verification. 11/10/97. (M99–1).

**130.0007 Claims for Refund for Earned Interest on Bad Debts.** Regulation 1642, as amended September 26, 2002, allows lenders under certain conditions to claim a bad debt loss on accounts that are found to be worthless and are written off for income tax purposes. The regulation references unearned interest charges as part of the calculation for a bad debt claim using the pro rata method because unearned interest charges are specifically excluded from the “net contract balance” when using the pro rata method. (Regulation 1642, Appendix 1.) The issue of unearned interest does not arise when the contract method is used. However, many claims for refund on bad debt losses include amounts for “earned” interest although that is contrary to the regulation. Claimants contend that in some cases, the accounts have remained on an active collection status for several years, thus the interest is “earned” and therefore included by inference in the measure of the bad debt loss being claimed.

Merely because the regulation specifically excludes “unearned finance charges” from the pro rata method, it does not follow that “earned finance charges” must be deductible. Lenders are not entitled to claim refunds of interest (referred to as finance charges in the regulation), earned or not, on bad debts. The regulation specifically provides that whenever a bad debt deduction is claimed, the loss is limited to amounts on which the retailer paid tax. Only the gross receipts or sales price is subject to tax; interest is not subject to tax. (Regulation 1642(b)(1) and (f)(1).) Lenders have no greater right than the retailers from whom they purchased the contracts to claim bad debt deductions. (Regulation 1642(i)(5)(C).) 1/9/03. (2003–3).

**130.0010 Counterfeit Money, Fraudulent Checks, Unauthorized Charge Plates.**

Sales paid for by counterfeit money, fraudulent checks or use of an unauthorized charge plate are allowable reductions in sales. Losses attributable to counterfeit money or fraudulent checks in excess of the original sales amount are not allowable. 5/27/71; 5/20/96.

**130.0040 Accounts Receivable, Purchase of.**

The allowance of a bad debt credit to reduce a taxpayer's liability for unpaid sales and use tax is not permissible if the losses on worthless accounts is suffered by a party other than the taxpayer. The purchaser of accounts receivable is not allowed to take a bad debt loss on accounts he cannot collect. 1/8/65.

**130.0050 Assignment of Accounts Receivable.**

A taxpayer assigns its accounts receivable to a related corporation at a 3 percent discount. There is no recourse against the taxpayer by the related corporation for uncollectibles beyond the 3 percent discount. The taxpayer cannot deduct the 3 percent as a bad debt. The selling of the accounts receivable is equivalent to a financing operation secured by the receivable. The discount is the equivalent of interest paid on a loan. 2/3/94.

**130.0060 Assignment of Notes and Accounts.**

A retailer who assigns an account or note receivable with recourse, and is required to pay it off, becomes a creditor as to the amount so paid by subrogation. As long as the accounts or notes represented the sale of goods by the retailer on which tax was paid, the retailer is entitled to a bad debt loss. The account or notes become worthless in his hands at the time he is required to pay his assignee. 6/25/65.

**130.0080 Assignment of Notes and Accounts.**

When a retailer sells his accounts receivable with recourse so that the retailer will bear the bad debt loss arising from his own sales, he may claim such losses as bad debt deductions to the same extent as if he had not sold his accounts receivable. 3/3/67.

**130.0085 Bad Debt Deduction.**

A bad debt is "charged off" within the meaning of Regulation 1642(a) when it is charged off in the taxpayer's records, with intent to take that bad debt on the appropriate income tax return and not when the actual income tax return is filed. 9/20/95.

**130.0090 Bad Debt Deduction is a Credit Only.**

Seller A sells equipment and reports tax on the sale. The purchaser defaults on payments on the promissory note given for the equipment and the equipment is repossessed. The equipment is then sold to a third party for the amount due on the note for the original sale.

Seller A may claim a bad debt deduction as specified in Regulation 1642 for the original sale. The fact that the second sale was for the balance of the promissory

note does not exclude a tax liability for the second sale. This is a separate transaction and tax is due on the gross receipts from the second sale. 8/4/94.

[130.0093](#) **Bad Debts.** The bad debt deduction is not limited to the retailer who reported (and paid) the tax on a sale resulting in the bad debt. The bad debt deduction extends to a successor who becomes liable for the tax on the original sale (and who suffered the bad debt) even if this person did not pay the tax resulting from that sale. Thus, a “successor” who is liable for any tax of the preceding retailer may take a bad debt deduction. In this way, the predecessor may make the sale and pay the tax while the sections 6811 and 6812 successor who suffers the bad debt is entitled to the deduction. 1/25/78.

[130.0093.500](#) **Bad Debts Arising After Close Out.** The Board’s practice has been to allow refunds on debts which become bad after close out. The justification for this interpretation can be found in the first sentence of section 6055, to the effect that the retailer “is relieved from liability for sales tax . . .” The rest of the section may be taken as describing a remedy which, though available, is not exclusive. 10/30/78.

[130.0094](#) **Bad Debts—Recovery Through Litigation.** The recovery through the process of litigation of amounts previously written off as bad debts has the same status as amounts recovered through any other process. The recovered amounts represent the sale elements in the transactions written off and are not damages recovered. Also, there is no offset for court costs or attorney’s fees when the recovered amount is reported for sales and use tax purposes. These are merely collection expenses, deduction for which is prohibited by Regulation 1642(b)(2). 9/14/72.

[130.0095](#) **Bad Debts—Retailer as Guarantor.** To facilitate the sale of equipment, the retailer agreed to guarantee the purchase note held by the bank financing the purchase. The purchaser defaulted on the note, and the retailer was required to pay it off in accordance with the terms of the guarantee. The bad debt was written off for income tax purposes. A sales tax deduction was not allowable in this situation since the loss was not the result of credit sale but rather from the guarantee contract. A retailer is entitled to a bad debt deduction for credit losses resulting from credit sales. In this transaction, the retailer received cash for the sale, with the subsequent loss resulting not from the sale but from the guarantee contract with the bank. 8/5/94.

[130.0098](#) **Cash Register Shortages.** Change error and theft or loss of moneys from the cash register are not allowable as adjustments to cash register sales. These errors in change, theft or loss or loss of moneys occurred after consideration for the merchandise had been recovered. 5/27/71; 5/20/96.

**130.0099 Charge Sales Checks.** The following are situations in which charge sales checks are considered to be bad debts under Regulation 1642:

(1) Charge sales checks having illegible or missing credit card imprints or handwritten customer names which are subsequently written off to cash register shortages.

(2) Charge sales checks which are lost prior to billing.

(3) Charge sales checks indicated by sales person as cash sales and therefore never billed to the customer. 5/27/71; 5/20/96.

**130.0100 Compromise Payment Made on Behalf of Debtor by Guarantor and Joint Venturer.** A corporation purchased tangible personal property on credit from a retailer, who reported sales tax measured by the full sales price of the property. The principal shareholders of the corporation executed a guaranty that the debt would be paid, in favor of the retailer, and the corporation executed an assignment of its share of profits which it expected to receive from a construction contract in which it had interest as a joint venturer with a second corporation.

When the retailer attempted to collect the amount of the debt, it was determined that the corporation and the guarantors were unable to pay, and that there were no profits forthcoming from the joint venture. However, the guarantors and the second corporation offered to compromise the debt by payment of an amount equal to one-sixth of the original debt. Under such circumstances, the retailer was entitled to claim a bad debt loss for the difference between the amount of the original debt and the amount of the compromise payment made by the corporation's guarantors and joint venturer. 10/8/66.

**130.0110 Computing Bad Debt Loss—Alternative Methods.** Regulation 1642(f)(1) allows a person claiming a bad debt deduction or refund to use an alternative method (alternative to the methods contained in the regulation) of computing bad debt loss subject to approval by the Board. If the Board concludes that a proposed alternative method does not fairly compute the bad debt loss, the Board will deny use of the method and inform the person of the reasons for the denial. If the Board representative is unable to provide a reason for denying the alternative method, that would mean that there is no basis for denial, in which case the alternative method would be approved. 04/19/01.

**130.0140 Default on Accounts Receivable.** A carpet manufacturer sells carpet to a dealer on credit and advances cash to cover the dealer's "profit, installation costs and sales tax." The dealer enters into a contract with a builder and agrees to furnish and install the carpet in a construction project. The dealer assigns the

contract without recourse to the carpet manufacturer. Subsequently the builder defaults on the contract. Inasmuch as the dealer suffers no loss by reason of the builder's default, he has no basis for claiming a deduction for bad debts. 1/31/01. (Am. 2002-1).

(Note: Revenue and Taxation Code sections 6055 and 6203.5 were amended operative January 31, 2001, to allow a "lender" as defined to claim a bad debt deduction or refund under specified circumstances.)

[130.0145](#) **Default on "No Recourse" Paper.** A retailer of sailboats sells to a bank chattel papers that the bank agrees to accept, without recourse. Although the bank establishes a Bankway Loss Reserve in the retailer's name and charges to the reserve any indebtedness or obligation of the taxpayer to the bank and any deficiency on any contract in default, the taxpayer is not entitled to any bad debt deduction for sales tax purposes on defaulted contracts because the paper was sold without recourse. The reserve functions as a kind of self-regulating discount provision and cannot be equated with a right of recourse. 11/3/72.

[130.0160](#) **Foreclosure Proceedings.** Where a vendor forecloses for the amount advanced to a purchaser to enable him to buy a house which is relocated from its original site to another location, and the advance included sums to defray sales tax and complete the relocation, and a promissory note is taken for the advance which is secured by a deed of trust on the real property where the house is located, the vendor may take a bad debt deduction to the extent authorized by Regulation 1642. A returned merchandise credit is allowable only where the full sale price (including tax) has been refunded or credited. 10/25/60.

[130.0180](#) **Franchise Tax Return.** A corporation is not entitled to a claim for refund for bad debts where the accounts were charged off on the personal income tax return filed by a stockholder and not on the franchise tax return of the corporation. 6/25/65. 3204

[130.0200](#) **Illegal Diversion of Funds by Officer.** A corporation which suffers loss due to the diversion of funds by a corporate officer does not furnish a basis for a bad debt deduction for sales tax purposes. Bad debt deductions are allowable only with respect to debts arising from retail sales. 9/28/64.

[130.0206](#) **Lease/Sale—Repossession and Subsequent Sale.** A firm "leases" equipment to a restaurant owner under terms which provide that ownership transfers to the lessee for \$1.00 at the termination of the lease. The restaurant owner defaults on the lease, and the firm enters into a contract with the former owner of the restaurant to "assume the lease." The second contract contained the

same provisions with respect to the transfer of ownership at the termination of the lease for \$1.00 with a price adjustment due to the prior use of the equipment.

The original contract is a sale, and tax applies on the full contract price in the period in which the contract sale took place. The subsequent reacquisition by the seller because of default may result in bad debt deduction in accordance with Regulation 1642. The subsequent contract is also a sale at inception, and tax applies to the full contract price as provided in Regulation 1641. 4/16/97.

**130.0212 Photo Canvassing.** A photographic firm obtains orders for home portraits through canvassers. The photographs are taken by the firm's photographer. The proofs are returned to the canvassers who take them to the customers and attempt to obtain additional orders. When the canvassers obtain additional orders for prints, a down payment is made and the customers receive an invoice showing the total sales price, down payment and amount due. The prints are made up and mailed C.O.D. to the customers. Sometimes the customers refuse to accept the prints which are returned to the firm. In such cases, the firm does not return the down payment.

Under the circumstances, since the photographs have been made to the special order of the customers and the down payment was made, the sales were consummated. Therefore, the invoiced amounts are taxable gross receipts but the firm is entitled to a deduction for bad debts with respect to the unpaid balances. 11/10/65.

**130.0215 Property Subject to Foreclosure Sold by Debtor.** A taxpayer sold property on a conditional sale agreement. Tax was reported and paid on the sale. Subsequently, the buyer became unable to make payments. With the taxpayer's agreement, the buyer transferred the property to a new entity subject to the taxpayer's security interest. The sale by the buyer to the new entity was an exempt occasional sale. The new entity encountered financial difficulties and became delinquent in its payments to the taxpayer. The taxpayer repossessed the equipment.

The transfer from the buyer to the new entity did not change the status of the taxpayer as the retailer who paid the tax to the state on the original sales price. Accordingly, the taxpayer is entitled to claim a repossession loss in accordance with the regulation. 5/15/75.

**130.0220 Repossessed Automobiles.** No additional credit for bad debts other than that based on the Kelly Blue Book values is allowed on repossessed automobiles which are reconditioned for resale, provided the automobiles are in average condition. However, an adjustment or additional allowance will be made to the

published wholesale prices where the automobile is not in average condition and requires more than the normal get-ready or reconditioning to prepare the vehicle for resale. 12/9/66.

**130.0225 Repossession Loss.** A sold equipment to B, taking a down payment for one-third of the price and a promissory note for the balance secured by the equipment. B subsequently declared bankruptcy and the automatic stay prevented A from proceeding under the security agreement. A and B entered into a stipulation in the bankruptcy which provided that the stay would be lifted if the terms were violated. The terms were violated and A sold the equipment to C, applying the proceeds to the debt of B.

The sale of the equipment to C was not pursuant to the order of the bankruptcy court, nor was it made on behalf of the original buyer, B. The violation of the stipulation lifted the stay and allowed A to exercise its rights under the promissory note. The sale was made on A's own behalf.

Any bad debt loss to which might be entitled on the sale to B is limited to the amount charged off for income tax purposes, and further limited by the repossession loss calculation pursuant to Regulation 1642(f). 4/6/90.

**130.0240 Rentals.** Lessors of tangible personal property who pay tax on rental receipts as they become due may properly deduct the amounts of such reported rentals as are found to be worthless and charged off for income tax purposes. 12/21/65.

**130.0250 Statute of Limitations.** The statute of limitations on bad debts starts from the time in which the book entry is made, not the time in which the account was found to be worthless. Thus, a taxpayer may legally claim a bad debt deduction on a return filed within the three year statute of limitation period from the date of the book entry, i.e., if a book entry is made in the fourth quarter of 1973, the taxpayer would have until the fourth quarter of 1976 to file a claim for refund. 5/17/77; 8/1/77.

**130.0260 Successors.** A successor who pays full consideration for accounts receivable acquired from the predecessor is entitled to take a bad debt deduction on account sales made by a predecessor, provided all other conditions for taking the deduction are complied with. 9/30/59.

**130.0269 Third Party Credit Card Sales.** Company A enters into contracts with a retailer, whereby Company A issues credit cards to the retailer's customers. Under the terms of the credit card agreement, the cardholders remit their payments to Company A. Pursuant to the contract with the retailer, Company A remits to the retailer, at a discounted rate, the purchase price including sales tax,

on purchases made by the credit card holder. Company A takes full responsibility for collection and, if the account becomes uncollectable, Company A takes the federal income tax “write-off” for bad debts.

The discount rate paid to the retailer is negotiated annually by balancing anticipated revenues against expenses. An important factor in calculating the discount rate is the magnitude of accounts that have become uncollectable.

The retailer is liable for sales tax on its sales. Under section 6055 and Regulation 1642(h)(1), the retailer is not entitled to the worthless account deduction for accounts found to be worthless since it is not claiming the bad debt loss for federal income tax purposes. Company A is not entitled to a bad debt deduction because it was not the retailer of the property and owed no sales tax against which to take the bad debt deduction. 12/4/95.

130.0280 **Worthless Check.** A loss attributable to a worthless check cashed for a sum in excess of the amount of the taxable sale is not allowable as a bad debt deduction to the extent of the excess. 12/29/59.