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M e m o r a n d u m

To : Ms. Charlotte Paliani (MIC:92)
Program Planning Manager

Date: January 9, 2003

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Tax Counsel IV

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Subject: Regulation 1642 – Claims For Refund For Earned Interest On Bad Debts

In your memorandum to Assistant Chief Counsel Janice Thurston dated November 4, 2002, you wrote:

> Regulation 1642, Bad Debts, contains two appendices that reference a deduction of "unearned interest charges" when computing the loss for sales and use tax purposes. These are found on line "o" of step one in Appendix One, and again in column "J" of Appendix Two.
>
> This adjustment has been of increasing concern since the statutory amendment to allow lenders to claim a bad debt loss were included in Regulation 1642. Claimants have filed claims for refund that include "earned" interest since the appendices reference a deduction for "unearned" interest.
>
> Staff was [led] to believe that there are federal statutes that require banks to write off bad debt losses after 90 days of no payments. Of course, in addition to having been written off for income tax purposes, the account must be "found to be worthless" in order to qualify for the bad debt deduction. However, there are claims for refund with, in the most egregious cases, accounts including several years' worth of "earned" interest. This may result in a claim for refund in excess of the amount originally reported. Claimants contend that in some cases, the accounts have remained on an active collection status for several years, even though a minimal amount of activity occurs. Thus, the interest is "earned" and therefore included by inference in the measure of the bad debts loss claimed. Staff has concluded that the formula appears to work in its intended manner when earned interest is interpreted as interest paid on the account.

Please provide a legal opinion regarding the definition of the term "earned interest" as used in the appendices. As there are numerous claims for refund involving millions of dollars pending, I would appreciate any effort to expedite your reply.

Background

As amended September 26, 2001, regulation 1642 provides in relevant part:

(b) AMOUNT SUBJECT TO DEDUCTION.

(1) TAXABLE RECEIPTS. If the amount of an account found to be worthless and charged off is comprised in part of **nontaxable receipts such as interest**, insurance, repair, or installation labor and in part of taxable receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the unpaid amount upon which tax has been paid. In determining that amount, all payments and credits to the account may be applied ratably against the various elements comprising the amount the purchaser contracted to pay (pro rata method), may be applied as provided in the contract of sale (contract method), or may be applied by another method which reasonably determines the amount of the taxable receipts (alternative method).

...

(f) ALLOWABLE METHODS OF COMPUTING LOSS.

(1) IN GENERAL. When there is a repossession, a bad debt deduction is allowable only to the extent that the retailer sustains **a net loss of gross receipts upon which tax has been paid.** This will be when the amount of all payments and credits allocated to the purchase price of the merchandise, including the wholesale value of the repossessed article, is less than that price. **If the pro rata method is used to apply payments,** a retailer incurs an allowable bad debt deduction if the wholesale value of the repossessed merchandise is less than the net contract balance (**after excluding unearned insurance and finance charges**) at the date of repossession. If the contract method is used to apply payments, a retailer incurs an allowable bad debt deduction if the wholesale value of the repossessed merchandise is less than the net contract balance at the date of repossession. An alternative method of computing a bad debt loss may be used subject to approval by the Board.

(2) METHOD OF COMPUTING LOSS—PRO RATA METHOD.

(A) Loss Per Records. The loss per records is the bad debt loss the retailer writes off for income tax purposes. An estimate of bad debt losses based in part upon the history of the business or industry averages, may not be used to claim bad debt deductions or refunds for sales and use tax purposes.

(B) Taxable Portion of Loss Per Records. **Only that portion of a bad debt loss attributable to the amount on which the retailer paid tax may be used to**

claim a bad debt deduction or refund for sales and use tax purposes…. Examples using the pro rata method are attached as Appendices 1 and 2.

(3) METHOD OF COMPUTING LOSS—CONTRACT METHOD. The allowable bad debt deduction is calculated by subtracting all payments and credits from the purchase price of the merchandise pursuant to the method of applying payments set forth in the applicable contract(s) with the customer and, to the extent the contract is silent on the method of applying payments, the loan accounting systems used by the retailer in the ordinary course of business, and from that amount subtracting the proceeds of the sale of any repossessed merchandise in accordance with (4) below.

¶…¶

(i)(5)(C) A lender who has the right to claim deductions or refunds for bad debts charged off pursuant to an election filed under subdivision (i)(3) and, if applicable, subdivision (i)(4), **is entitled to the same amount of deduction or refund, calculated in the same manner under the provisions of this regulation, as if the lender were the retailer** who had sold the tangible personal property for which the retailer had reported and paid tax.
[Emphasis added.]

Discussion

Our opinion is that lenders are not entitled to claim refunds of interest (referred to as finance charges in the regulation), earned or not, on bad debts. There are several reasons for our conclusion.

First, 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 sales price is subject to tax; interest is not subject to tax. (Reg. 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. (Reg. 1642 (i)(5)(C).)

Second, the issue of "unearned finance charges" does not arise when the contract method is used. Neither the regulation nor the appendices make any reference to finance charges, earned or unearned, on the contract method. I would assume that all the lenders who have filed claims for refund claiming earned finance charges are using the contract method. That is, either the contract with the purchaser or the lender's own accounting system will set out the allocation of payments between principal and interest.

Third, there may be rare instances where the pro rata method is used, and each payment is uniformly allocated between principal and interest, not amortized. But subdivision (b)(2)(B)

of the regulation nevertheless provides that only that portion of a bad debt loss attributable to the amount on which the retailer paid tax may be used to claim a bad debt. Thus, even in this unusual situation, a retailer or a lender would not be entitled to a refund of earned finance charges.

These refund claims are examples of a "false negative" argument. Merely because the regulation specifically excludes "unearned finance charges" from the pro rata method, it does not follow that therefore "earned finance charges" must be deductible. The regulation nowhere mentions "earned finance charges" or its treatment for tax purposes.

In fact, in appendix 1, the hypothetical transaction outlined does not even contemplate any earned finance charges at all. In explaining the pro rata method, not the contract method, appendix 1 uses an example of a repossessed vehicle, financed for $11,204:

j. Balance on contract	11,204	(h-i)
k. Finance charges/accrued interest	3,000	
l. Total contract value	14,204	(j+k)
m. Payments received on contract	2,100	
n. Balance on date of repossession	12,104	(l-m)
o. Unearned finance charges	2,750	
p. Net contract balance	9,354	(n-o)

In this example, there is no "earned finance charge." The balance on the date of repossession is simply the difference between the total contract value and the payments received. This implies that the repossession occurred immediately on default. Further, the example allocates only $250 of the $2100 in payments received to finance charges, indicating this is not an amortizing loan.

JA:ljt

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Ms. Laureen Simpson (MIC:50)
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