

Final Order Denying Refund: 04-20170118R
Sales Tax
For The 2014 Tax Year

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this document.

HOLDING

Dealership was not entitled to deduct the business bad debt because it used a "cash basis (cash receipts and disbursements)" accounting method to report its taxable income. Under the "cash basis" accounting method, the income concerning the unpaid installment payments for the sales of vehicles was not reported in its prior income tax returns; therefore, there was no adjusted basis in the receivable to deduct the claimed bad debt under Section 166 of the Internal Revenue Code.

ISSUE

I. Sales Tax - Sales Tax Bad Debt Deduction.

Authority: I.R.C. § 166; I.R.C. § 446; I.R.C. § 448; Treas. Reg. § 1.166-1; Treas. Reg. § 1.446-1; IC § 6-2.5-6-9; IC § 6-8.1-9-1; [45 IAC 2.2-6-4](#); [45 IAC 2.2-6-12](#); *IRS Publication 538* (2016); CCH, U.S. Master Tax Guide: Tax Accounting—Accounting Method (100ed. 2017); 8 Mertens Law of Fed. Income Taxation § 30:26 (Scott Shimick et al. eds. 2017).

Taxpayer protests the denial of its refund claim for 2014.

STATEMENT OF FACTS

Taxpayer, an out-of-state used car dealer, was incorporated as a limited liability company beginning January 1, 2012. Taxpayer has a business location in Indiana. For income tax purposes, Taxpayer has elected to file as a partnership using the "cash basis" accounting method in its first year (the 2012 tax year) as well as its subsequent years (the tax years 2013 and 2014) partnership income tax returns (Form 1065).

During the course of its business, Taxpayer sells cars to "high risk" individuals on a "buy here pay here" basis. Taxpayer's customers often have limited financial means. The customers pay very little cash as a down payment (or sometimes with zero down payment) and finance the remaining balance, including sales tax. Taxpayer offers the customers "interest-free loans." Although the customers pay the balance in installments with no interest, Taxpayer charges them a one-time "Lending Fee" at the time of the transactions when they sign the "installment contracts." Pursuant to the contracts, the customers make monthly payments to Taxpayer directly. Taxpayer does not sell or assign the installment contracts to others, whether affiliate or otherwise.

In 2016, Taxpayer filed a claim for refund, on a GA-110L Form, stating that it was entitled to a refund of \$4,114.03 in sales tax it had previously remitted to the Department. Taxpayer stated that some customers defaulted. As a result, Taxpayer claimed a deduction from its federal taxable income on its 2014 partnership income return (1065 Form) for the uncollectible amounts.

The Indiana Department of Revenue ("Department") reviewed and denied the claim, stating in relevant part, as follows:

IC [§] 6-2.5-6-9 allows for a deduction from gross retail income for uncollectible receivables. In order for the retail merchant to take the deduction the statute specifies that three requirements be met. Number [three] is that they were written off as an uncollectible debt for federal tax purposes. Being that the taxpayer used a cash basis accounting method, there is no valid bad [debt] expense per Section 166 of Internal Revenue Code.

Taxpayer protested the refund denial. An administrative phone hearing was held. This Final Order Denying Refund results. Further facts will be provided as necessary.

I. Sales Tax - Sales Tax Bad Debt Deduction.**DISCUSSION**

Taxpayer claimed that it was entitled to a refund of sales tax based upon the bad debt deduction for uncollectible receivables under IC § 6-2.5-6-9. The Department reviewed Taxpayer's refund claim and determined that Taxpayer was not entitled to the refund. The Department concluded that Taxpayer did not have bad debts under Section 166 of the Internal Revenue Code because it has used a "cash basis" accounting method to report its taxable income. Because it used "cash basis," Taxpayer did not report income items until the income was actually received and thus did not have adjusted basis in the debt supporting the deduction.

A. Accounting Methods

As a general rule, to determine a taxpayer's taxable income, the taxpayer is required to employ an accounting method—commonly known as "cash receipts and disbursements (cash basis)" or "accrual basis"—to maintain its books in a consistent manner for a fixed accounting period. I.R.C. § 446; Treas. Reg. § 1.446-1. See also *IRS Publication 538: Accounting Periods and Methods* (December 2016), available at <https://www.irs.gov/pub/irs-pdf/p538.pdf> (last visited July 26, 2017). A taxpayer is required to choose an accounting method when it files its first year return. Treas. Reg. § 1.446-1(e). For example, a partnership is required to check one of the three boxes; "(1) Cash," "(2) Accrual," or "(3) Other (specify)" under "H" of Form 1065. If a taxpayer in a later year wants to change its accounting method, such as changing from "cash basis" accounting method to "accrual basis" accounting method, it must file Form 3115, Application for Change in Accounting Method unless the change is specifically exempted. Treas. Reg. § 1.446-1(e)(3)(i). Treas. Reg. § 1.166-1(b).

For sales tax purposes, Indiana relies on the same general accounting principles and accounting methods to efficiently and effectively determine the Indiana sales tax that a retail merchant is required to report and remit. [45 IAC 2.2-6-4\(a\)](#). When a taxpayer uses the "cash basis" accounting method, the taxpayer generally reports income in the year the taxpayer actually or constructively receives payment in the form of cash or its equivalent. Treas. Reg. § 1.446-1(c)(1)(i); CCH, U.S. Master Tax Guide: Tax Accounting—Accounting Method 581-82 (100ed. 2017). Income is constructively received when it is within the taxpayer's control. *Id.* There is no constructive receipt, however, if there are substantial limits or restrictions on the right to receive the income. *Id.* Under the "cash basis" accounting method, a taxpayer takes deductions or credits during the year in which the related expenditures were actually paid. Treas. Reg. § 1.446-1(c)(1)(i). On the other hand, a taxpayer uses the "accrual basis" accounting method when "income is accounted for as and when it is earned, whether or not it has been collected." [45 IAC 2.2-6-4\(b\)](#); see also Treas. Reg. § 1.446-1(c)(1)(ii). Under the "accrual basis" accounting method, "[e]xpenses are deducted when they are incurred, whether or not paid in the same period." [45 IAC 2.2-6-4\(b\)](#).

It has been well established that "unreported income items cannot support a bad debt deduction when such income items are uncollectible because the law requires a taxpayer claiming a bad debt deduction to have a basis in the debt supporting the deduction." 8 Mertens Law of Fed. Income Taxation § 30:26 (Scott Shimick et al. eds. 2017); see also Treas. Reg. § 1.166-1(d)(1). Nonetheless "[i]f, in computing taxable income, a taxpayer values [its] notes or accounts receivable their fair market value when received, the amount deductible as a bad debt under [I.R.C. § 166] in respect of such receivables shall be limited to such fair market value even though it is less than their face value." Treas. Reg. § 1.166-1(d)(2)(i).

B. Refund at Issue

IC § 6-8.1-9-1(a) affords a taxpayer a statutory right to file a claim for refund. The refund at issue in this instance is stemmed from Taxpayer (a car dealer) who claimed that it was entitled to a bad debt deduction for sales tax on car sales it previously paid to the Department.

The Indiana sales tax bad debt deduction is found under IC § 6-2.5-6-9(a), which provides in relevant part:

In determining the amount of state gross retail and use taxes which a retail merchant must remit under section 7 of this chapter, the retail merchant shall, subject to subsections (c) and (d), deduct from the retail merchant's gross retail income from retail transactions made during a particular reporting period, an amount equal to the retail merchant's receivables which:

- (1) resulted from retail transactions in which the retail merchant did not collect the state gross retail or use

tax from the purchaser;

(2) resulted from retail transactions on which the retail merchant has previously paid the state gross retail or use tax liability to the department; and

(3) were **written off as an uncollectible debt for federal tax purposes under Section 166 of the Internal Revenue Code during the particular reporting period. (Emphasis added).**

See also [45 IAC 2.2-6-12](#).

The amount of the sales tax bad debt deduction is based upon the deduction provided in I.R.C. § 166 for uncollectible bad debts with a few adjustments excluding amounts relating to interest, charges for financing, charges for sales or use tax, property remaining in the possession of the seller, collection expenses, and repossessed property. IC § 6-2.5-6-9(d). To claim the deductions of "bad debts," under Section 166 of the Internal Revenue Code, first, the debt must be a "bona fide debt." Treas. Reg. § 1.166-1(c).

I.R.C. § 166 provides:

(a) General rule

(1) Wholly worthless debts

There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts

When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) Amount of deduction

For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

[(c) Repealed. Pub. L. 99-514, title VIII, § 805(a), Oct. 22, 1986, 100 Stat. 2361]

(d) Nonbusiness debts

(1) General rule

In the case of a taxpayer other than a corporation—

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

(2) Nonbusiness debt defined

For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(e) Worthless securities

This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

(f) Cross references

(1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

The "bad debts" shall be taken into account either as (1) a "deduction in respect of debts which become worthless in whole or in part" or as (2) a deduction for a reasonable addition to a reserve for bad debts. Treas. Reg. § 1.166-1(a). Treas. Reg. § 1.166-1(b)(1) further states:

A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

When a taxpayer elects one method for treating bad debts, the taxpayer is required to **"continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method."** Treas. Reg. § 1.166-1(b)(2)(**emphasis added**). In other words, when a taxpayer makes an election, the taxpayer must follow the same method going forward. A subsequent change must have the approval of the

Throughout the protest, Taxpayer argued that the Department erroneously denied its refund claim. Taxpayer asserted that it used an "accrual basis" accounting method to keep its books and was entitled to a "bad debt" deduction because some customers failed to make subsequent payments pursuant to the signed installment contracts. As a result, Taxpayer had written off the uncollectible debts on its 2014 federal partnership income tax return, Form 1065. To support its protest, Taxpayer submitted additional documentation, including signed copies of "Bill of Sale," "Precomputed Retail Installment Contract," and "Transaction History" for each customer who defaulted on payments and was written off by Taxpayer in 2014. Taxpayer also offered an amended 2014 partnership return, Form 1065X, to change to "accrual basis" accounting method.

Upon review, however, the Department is not able to agree that the documentation supports its protest. Specifically, the partnership income tax returns of Taxpayer's first year, 2012, and subsequent years, 2013 and 2014, showed that it has consistently checked "(1) Cash" box. Thus, Taxpayer has been a "cash basis" Taxpayer since January 1, 2012. In other words, when Taxpayer was formed in 2012, it has used "cash basis" accounting method to maintain its books for income tax reporting purpose. As a "cash basis" taxpayer, Taxpayer reported income in the year actually or constructively received in the form of cash or its equivalent. Since Taxpayer offered customers interest-free loans pursuant to the installment contracts, Taxpayer would have reported the income only when it received the subsequent payments from its customers. Taxpayer thus cannot claim a bad debt deduction under I.R.C. § 166 for the account receivables that are not collectible because the total income of the sales was not reported at the time of the transactions under the "cash basis" accounting method. Thus, "cash basis" Taxpayer did not have adjusted basis to claim the bad debt deduction.

Subsequently after the hearing, Taxpayer amended its 2014 partnership return. Its Form 1065X stated that its "Accounting Method should have been accrual, consistent with revenue and balance sheet reporting." Upon review, however, Taxpayer failed to substantiate that it has used the "accrual basis" accounting method. Specifically, Taxpayer's documentation demonstrated that it has used "cash basis" accounting method since January 1, 2012, the first year it began to do business. Without obtaining IRS approval, an amended income tax return is not proper to document a change of accounting method. Even if, for the sake of argument, assuming that Taxpayer used the "accrual basis accounting method" for 2014, it did not provide verifiable documents to support its changes in gross receipts and its election under Treas. Reg. § 1.166-1(a) and (b).

In short, given the totality of the circumstances, in the absence of verifiable documentation, the Department is not able to agree that "cash basis" Taxpayer used "accrual basis" accounting method for 2014 tax year and was entitled to the refund based on the bad debt deduction it claimed on its 2014 return under IC § 6-2.5-6-9.

FINDING

Taxpayer's protest of the refund denial is respectfully denied.

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