

DEPARTMENT OF STATE REVENUE

04-20140530R.MOD

Memorandum of Decision: 04-20140530R
Sales Tax
For The 2011 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 Memorandum of Decision or Final Order Denying Refund.

HOLDINGS

Finance company is allowed to utilize the "market discount method" when calculating sales tax bad debt deduction. The Department was correct in treating redeemed transactions as non-adjustments and will not be removed from the statistical sampling.

ISSUES

I. Sales Tax-Bad Debt Deduction.

Authority: IC § 6-2.5-6-9; I.R.C. § 166; I.R.C. § 1011; I.R.C. § 1276; I.R.C. § 1278; Treas. Reg. § 1.166; SAC Fin., Inc. v. Indiana Dep't of State Revenue, 24 N.E.3d 541, (Ind. T.C. 2014); SAC Fin., Inc v. Indiana Dep't of State Revenue, 894 N.E.2d 1116 (Ind. Tax Ct. 2008); Chrysler Financial Co. v. Indiana Dep't of State Revenue, 761 N.E.2d 909 (Ind. T.C. 2002); Indiana Dep't of Revenue v. 1 Stop Auto, 810 N.E.2d 686, (Ind. 2004).

Taxpayer protests the partial denial of its refund claim.

II. Sales Tax-Redeemed Transactions.

Authority: IC § 6-8.1-3-12.

Taxpayer protests the inclusion of redeemed transactions in the refund statistical sample.

STATEMENT OF FACTS

Taxpayer is a finance company for customers who buy used cars from its related Indiana car dealer ("Dealer"). Dealer sells cars to customers who cannot obtain financing through normal channels. Dealer's customers buy cars under retail installment sales contracts and security agreements. In some instances, the retail installment sales included the sales tax that Dealer remitted on the sales to the Indiana Department of Revenue ("Department"). Dealer assigned the retail installment contracts and security agreements, from their customers, to Taxpayer under terms of a separate agreement. The assignment was without recourse and was sold to Taxpayer from Dealer at a 27.8 percent discount. Taxpayer then serviced the contracts and collected payments directly from the customers.

Subsequently, some customers defaulted on their installment sale agreements and Taxpayer claimed a deduction from its federal taxable income for the uncollectible amounts. Taxpayer submitted a refund claim for the 2011 tax year to recover sales tax paid to the Department on these sales, but thereafter not collected from those customers who defaulted on their installment contracts. The Department reviewed the refund claim, granted \$128,558.46 of Taxpayer's refund claim, and denied \$345,512.85.

Taxpayer protested this partial denial of its refund claim. An administrative hearing was held, and this Memorandum of Decision results. Further facts will be provided as necessary.

I. Sales Tax-Bad Debt Deduction.

DISCUSSION

Taxpayer claimed a refund of sales tax based upon the bad debt deduction for uncollectible receivables under IC § 6-2.5-6-9. Taxpayer utilized the Market Discount accounting method as described in IRC §§ 1276-1278. With its

claim, Taxpayer submitted a calculation of its sales tax bad debt deduction that resulted in Taxpayer claiming a refund for amounts which the Department determined to be in excess of the statutory computation. The Department performed the statutory computation for calculating the sales tax bad debt deduction for the uncollectible installment contracts that Taxpayer included in its refund claim, granted a portion of Taxpayer's claimed refund, but denied 72.2 percent of Taxpayer's refund claim. Taxpayer protested the partial denial of the refund claim.

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

(a) 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.

...

(d) The following provisions apply to a deduction for a receivable treated as uncollectible debt under subsection (a):

- (1) The deduction does not include interest.
- (2) The amount of the deduction shall be determined in the manner provided by Section 166 of the Internal Revenue Code for bad debts but shall be adjusted to exclude:
 - (A) financing charges or interest;
 - (B) sales or use taxes charged on the purchase price;
 - (C) uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid;
 - (D) expenses incurred in attempting to collect any debt; and
 - (E) repossessed property.

...

(Emphasis added).

In summary, when a taxpayer has remitted sales tax on a sale for which the taxpayer has not collected the sales tax from its customer, and has written the amount off as a bad debt under Section 166 of the Internal Revenue Code, the taxpayer may report an Indiana sales tax bad debt deduction. The amount of the sales tax bad debt deduction is based upon the deduction provided in Section 166 of the Internal Revenue Code 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.

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]

In determining the amount of the deduction allowed under I.R.C. § 166, the Department refers to Treas. Reg. § 1.166-1(d)(2)(i)(b), which states:

A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is **based upon the price he paid for such receivables but not upon**

their face value. (Emphasis added).

Since I.R.C. § 166 refers to I.R.C. § 1011 the Department turns to that section to determine how to adjust the basis for gains or losses. Furthermore, I.R.C. § 1011(a) was relied on by the Indiana Tax Court to determine that I.R.C. § 166 allows market discount when calculating the bad debt. *SAC Fin., Inc. v. Indiana Dep't of State Revenue*, 24 N.E.3d 541, 544 (Ind. T.C. 2014). I.R.C. § 1011(a) provides:

The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

Indiana has a long history of allowing bad debt deductions for sales tax on vehicles. In *Indiana Dep't of Revenue v. 1 Stop Auto*, 810 N.E.2d 686, 688-90 (Ind. 2004), the Indiana Supreme Court determined that the language in IC § 6-2.5-6-9 indicates that the legislature intended to allow retail merchants who finance sales tax to be entitled to a bad debt deduction when their customers default; that deduction, however, was limited to an amount not greater than the debt that the retailer was unable to collect.

Chrysler Financial Co. v. Indiana Dep't of State Revenue, 761 N.E.2d 909 (Ind. T.C. 2002), furthered the bad debt deduction treatment to when the retail merchant sold the installment contracts at cost to its related finance company without recourse. The Indiana Tax Court determined that upon the sale of the installment contracts the finance company becomes the assignee and steps into the shoes of the dealership allowing the finance company a bad debt deduction. *Id.* at 914.

SAC Finance, Inc. v. Indiana Dept. of State Revenue, 894 N.E.2d 1116 (Ind. Tax Ct. 2008), transfer denied, 915 N.E.2d 988 (Ind. 2009), furthered Indiana's expansion of the bad debt analysis to allow retail merchants to sell installment contracts to their affiliate finance company at a discount. The Tax Court described the facts as follows:

During the years at issue, Superior Auto sold many of its installment contracts to SAC. Pursuant to their written agreements, Superior Auto assigned to SAC its rights and interests in the installment contracts. In return, SAC agreed "to buy those consumer sales-finance accounts receivable contracts" for the purchase price of 70[percent] of their balance.

Some of the vehicle purchasers ultimately defaulted on their contracts. As a result, in the Fall of 2004, SAC filed two claims with the Department seeking a refund of the Indiana sales tax that had been remitted on those now uncollectible receivables. After conducting a refund investigation, the Department allowed 70[percent] of SAC's combined refund claim; the Department denied the other 30[percent] of the claim on the basis that it represented the "discount" SAC received when it purchased the installment contracts from Superior Auto.

SAC Finance, 894 N.E.2d at 1117-18 (Internal footnotes and citations omitted).

After the Indiana Tax Court analyzed and interpreted I.R.C. § 166 and Treas. Reg. § 1.166-1(d), the Tax Court held that "SAC cannot write off as bad debt more than what it actually paid for the installment contracts at issue." *SAC Finance*, 894 N.E.2d at 1121.

In *SAC Fin., Inc. v. Indiana Dep't of State Revenue*, 24 N.E.3d 541, n. 9 (Ind. T.C. 2014), review denied, 31 N.E.3d 976 (Ind. 2015) ("SAC II"), the Indiana Tax Court held that SAC was allowed to use the "market discount" accounting method to calculate its bad debt as long as it did not write off more than what it actually paid for the installment contracts at issue. "Market discount," as defined under I.R.C. § 1278, means the excess (if any) of the stated redemption price of a bond at maturity over the basis of such bond immediately after its acquisition by the finance company. *Id.* at n. 5. The tax court stated that I.R.C. § 166 allows for market discount calculation:

First, the use of the Market Discount Rules to determine the amount of a federal bad debt deduction under IRC § 166 applies just to that federal calculation, which is just the starting place for calculating the Indiana deduction. See I.C. § 6-2.5-6-9(a)(3). The influence of these federal rules does not permeate the Indiana calculation further because neither the Indiana Bad Debt Statute nor Indiana's sales and use tax laws include the term "market discount" or the federal income tax concept of market discount.

...

Second, excluding market discount income from the Indiana bad debt calculation under Subsection (d) is

incompatible with the purpose of the Indiana exclusions from the federal bad debt deduction.

Finally, SAC's inclusion of market discount income in its Indiana bad debt calculation does not offend, as the Department claims, the limitation that bars an assignee like SAC from writing off more than it paid for the discounted installment sale contracts. This limiting principle is already guaranteed by the requirements that Indiana's bad debt calculation start with the amount written off for federal income tax purposes.

Id. at 546-547.

In an effort to harmonize SAC II with SAC Finance, to determine Taxpayer's refund, the Department must analyze Taxpayer's refund request under the IRC "market discount" rules. There are two different ways to calculate bad debt using the "market discount" method. IRC § 1276 in relevant part states:

(a) Ordinary income

(1) In general

Except as otherwise provided in this section, gain on the disposition of any market discount bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond. Such gain shall be recognized notwithstanding any other provision of this subtitle.

(2) Dispositions other than sales, etc.

For purposes of paragraph (1), a person disposing of any market discount bond in any transaction other than a sale, exchange, or involuntary conversion shall be treated as realizing an amount equal to the fair market value of the bond.

(3) Treatment of partial principal payments

(A) In general

Any partial principal payment on a market discount bond shall be included in gross income as ordinary income to the extent such payment does not exceed the accrued market discount on such bond.

(B) Adjustment

If subparagraph (A) applies to any partial principal payment on any market discount bond, for purposes of applying this section to any disposition of (or subsequent partial principal payment on) such bond, the amount of accrued market discount shall be reduced by the amount of such partial principal payment included in gross income under subparagraph (A).

The second method is described in IRC § 1278, which states in relevant part:

(a) In general. For purposes of this part—

(1) Market discount bond

(A) In general

Except as provided in subparagraph (B), the term "market discount bond" means any bond having market discount.

(B) Exceptions The term "market discount bond" shall not include—

(i) Short-term obligations

Any obligation with a fixed maturity date not exceeding 6 months from the date of issue.

(ii) United States savings bonds

Any United States savings bond.

(iii) Installment obligations

Any installment obligation to which section 453B applies.

...

(2) Market discount

(A) In general The term "market discount" means the excess (if any) of—

(i) the stated redemption price of the bond at maturity, over

(ii) the basis of such bond immediately after its acquisition by the taxpayer. . . .

(3) Bond

The term "bond" means any bond, debenture, note, certificate, or other evidence of indebtedness.

...

(b) Election to include market discount currently

(1) In general If the taxpayer makes an election under this subsection—

(A) sections 1276 and 1277 shall not apply, and

(B) market discount on any market discount bond shall be included in the gross income of the taxpayer for the taxable years to which it is attributable (as determined under the rules of subsection (b) of section 1276).

Except for purposes of sections 103, 871(a), [1] 881, 1441, 1442, and 6049 (and such other provisions as may be specified in regulations), any amount included in gross income under subparagraph (B) shall be treated as interest for purposes of this title.

I.R.C. § 1276 concerns the gain recognition on the disposition of a "market discount bond." Under I.R.C. § 1278(a)(1)(A) "the term 'market discount bond' means any bond having market discount." I.R.C. § 1278(a)(1)(B) lists what does not constitute a "market discount bond." Under I.R.C. § 1278(a)(1)(B)(iii) a market discount bond does not include "[a]ny installment obligation to which section 453B applies." I.R.C. § 453B(a) applies to Taxpayer's installment contracts. However, according to SAC II, n.7, the Tax Court stated that:

IRC § 453B applies to the party that disposes of the installment obligation and the Department has provided no authority that IRC § 453B must apply to a buyer that is an assignee in an installment obligation disposal transaction. Moreover, the Department misconstrues the relationship of SAC to the installment obligation. SAC is not a party to the installment obligation, but is "the assignee stand[ing] in the shoes of the assignor." Consequently, if IRC § 453B does not apply to Superior Auto, it cannot apply to its assignee, SAC. Superior Auto is ineligible for IRC 453B treatment because its sales are specifically excluded from the definition of installment sale under IRC § 453.

(Internal citation omitted).

Thus, because Taxpayer is an assignee to the installment contract, and not a party to it, the exclusions under IRC § 1278 do not apply.

Thus, since SAC II allows Taxpayer to use the market discount methods, the Department looks to the calculation and application of the methods to Taxpayer's bad debt. The first method, IRC § 1278, starts with the full face value amount of the receivable less any amount that helps make Taxpayer whole, such as principal payments and redemption proceeds (market discount income must be recognized when it is received and any interest received will be considered interest income). The other method, IRC § 1276, is to start with the Taxpayer's fair market value of the receivable less any payments that make Taxpayer whole (market discount income is treated as ordinary income). However because SAC I and IRC § 166 limit Taxpayer's bad debt write off to the fair market value, not face value, of the installment contract, Taxpayer can only use IRC § 1276 to calculate its market discount.

According to Taxpayer's calculations, Taxpayer starts with the face value of the loan less the discount balance. The remaining amount is Taxpayer's basis in the loan, which is the fair market value. The loan, at its fair market value, is then amortized throughout the lifetime of the loan, whether the loan is paid in full or the customer defaults. Taxpayer was able to trace each customer payment for each loan and parse out which part of the payment was principal, interest, and market discount interest, as required by IRC § 1276. This trace allowed the Department to validate Taxpayer's market discount method. The Department, however, has not been able to determine that Taxpayer properly accounted for market discount income as required by IRC § 1276 to be treated as ordinary income. Thus, in order to sustain Taxpayer, the Department must conduct an income tax refund investigation to determine that Taxpayer is properly recognizing market discount income.

FINDING

Taxpayer's protest is sustained subject to the results of an income tax refund investigation.

II. Sales Tax-Redeemed Transactions.

DISCUSSION

Taxpayer also protests the inclusion of redeemed transactions in the refund claim sample. Taxpayer argues that these transactions do not accurately represent Taxpayer's claim for refund. Taxpayer states that by including the redeemed transactions, the sample is skewed. IC § 6-8.1-3-12 states:

- (a) The department may audit any returns filed in respect to the listed taxes, may appraise property if the property's value relates to the administration or enforcement of the listed taxes, may audit gasoline distributors for financial responsibility, and may investigate any matters relating to the listed taxes.
- (b) The department may audit any returns with respect to the listed taxes using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded.

The Department has the authority to use statistical sampling methodology when investigating a taxpayer's business records for tax purposes, including refund claims. After review of the Department's sampling methodology, the Department during the refund evaluation, treated the redeemed transactions as non-adjustments. The Department determined that the sample provided by Taxpayer was an accurate representation of Taxpayer's business, thus, it was reasonable for the Department to rely on a transaction list provided by Taxpayer. It was up to Taxpayer to remove the redeemed transactions. Thus, the Department was reasonable in conducting a sample based on the documentation presented as part of Taxpayer's refund claim.

FINDING

Taxpayer's protest is denied.

SUMMARY

As stated above in Issue I, Taxpayer's protest is sustained regarding its market discount calculation subject to an income tax refund investigation. As stated in Issue II, Taxpayer's protest is denied regarding the inclusion of redeemed transactions in the refund claim sample.

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