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REVENUE ADMINISTRATIVE BULLETIN 2019-3

Approved: February 15, 2019

SALES AND USE TAX BAD DEBT DEDUCTION

(Replaces Revenue Administrative Bulletin 2015-27)

Pursuant to MCL 205.6a, a taxpayer may rely on a Revenue Administrative Bulletin issued by the Department of Treasury after September 30, 2006, and shall not be penalized for that reliance until the bulletin is revoked in writing. However, reliance by the taxpayer is limited to issues addressed in the bulletin for tax periods up to the effective date of an amendment to the law upon which the bulletin is based or for tax periods up to the date of a final order of a court of competent jurisdiction for which all rights of appeal have been exhausted or have expired that overrules or modifies the law upon which the bulletin is based.

RAB 2019-3. This Revenue Administrative Bulletin (RAB) describes the sales and use tax bad debt deduction, for periods before and after September 30, 2009. This RAB has been updated to incorporate the Michigan Supreme Court's decision in *Ally Fin Inc et al v Dep't of Treasury*, 502Mich 484 (2018). This RAB replaces RAB 2015-27.

INTRODUCTION

The bad debt deduction allows a taxpayer to claim a refund for sales or use taxes it remits that become bad debts or to deduct bad debts from its gross proceeds for purposes of computing its sales or use tax liability. A "bad debt" is any portion of a debt arising from a taxable sale at retail that is eligible to be claimed, or would be eligible to be claimed if the taxpayer kept accounts on an accrual basis, as a deduction pursuant to the internal revenue code, IRC 166, excluding certain amounts.[1] A taxpayer must meet certain requirements, discussed in detail below, to qualify for the deduction.

For periods before September 30, 2009, the deduction is only available to retailers.[2] However, 2007 PA 105 expanded the deduction to include third-party lenders for periods on or after September 30, 2009. A third-party lender may claim the deduction if the retailer and lender timely execute and maintain a written election designating which party may claim the deduction. Additionally, the lender must demonstrate that no deduction or refund was previously claimed or allowed. Finally, the taxpayer must demonstrate that the account receivable has been found worthless and is or was written off by the taxpayer that made the sale or the lender designated to claim the deduction.

[1] MCL 205.54i; MCL 205.99a.
[2] *Menard, Inc et al v Dep't of Treasury,* 302 Mich App 467 (2013).

ISSUES

I. What amounts qualify for the bad debt deduction?

II. What requirements must be met in order to claim the deduction?

III. Who may claim the deduction?

CONCLUSIONS

I. **BAD DEBT DEFINED**

"Bad debt" means that portion of a debt relating to a taxable sale at retail, not otherwise deductible or excludable, that has become worthless or uncollectible. The debt must be eligible to be claimed as a deduction under IRC 166 or would be eligible if the taxpayer kept accounts on an accrual basis.[3]

Transactions requiring prepayment of sales tax for fuel under MCL 205.56a are eligible for the bad debt deduction, regardless whether the sale or transfer is a sale at retail.[4]

Bad debt does not include:

1. interest or finance charges;
2. sales or use tax collected on the purchase price of the property;
3. uncollectible amounts on property that remains in the possession of the taxpayer until the full purchase price is paid, e.g., property placed on "layaway;"
4. expenses incurred attempting to collect any account receivable, or any portion of the debt that is recovered;
5. debts or accounts receivable that have been sold, assigned, or transferred to a third party, except to a third-party lender as described in Section III of this RAB; and,
6. the portion of the debt equal to the value of repossessed property (that is, the amount collected); taxpayers may claim the bad debt deduction for the uncollected debt remaining after the sale of the repossessed property.[5]

Example 1.

ABC Inc. is in the business of making retail sales. ABC financed sales for some of its customers and sold the debt to XYZ Inc. Some of the customers fail to pay for the property and bad debt is incurred. ABC may not claim a deduction for the bad debt.

[3] MCL 205.54i(1)(a); MCL 205.99a(6)(a).
[4] MCL 205.56a(5).
[5] *Ally, supra.*

Example 2.

ABC Inc. is in the business of making retail sales of vehicles. ABC sold a vehicle for $31,000 to Customer and financed the sale. Customer made payments that paid off $1,000 in principal before failing to make any further payments. ABC repossessed and sold the vehicle at auction for $20,000. ABC may not claim the bad debt deduction for the amount collected from the sale of the repossessed property at auction. However, ABC may claim the bad debt deduction for the amount of the debt remaining after the repossession and sale (i.e., $10,000).

II. REQUIREMENTS TO CLAIM THE DEDUCTION

The bad debt deduction allows an eligible taxpayer to deduct bad debts from its gross proceeds used to compute its sales and/or use tax liability.[6] To claim the deduction, all of the following requirements must be met:

1. The amount of gross proceeds claimed as bad debt must be written off the taxpayer's books and records as uncollectible at the time the debt becomes worthless.
2. The debt must be deducted on the return for the period the bad debt is written off as uncollectible in the taxpayer's books and records.
3. The debt must be eligible to be deducted for federal income tax purposes.[7]

If, after claiming the deduction, the taxpayer receives payment of all of a bad debt, the taxpayer must remit on its next remittance to the Department the taxes for which it had previously claimed the deduction. If a partial payment is received, the taxpayer must proportionately apply the payment to the taxable price of the property and the tax on the property before applying it to any interest, service, or other charge and remit the appropriate tax to the Department with its next remittance.

Example 3:

Assume the same facts as Example 2. ABC must apply $18,868 of the proceeds from the auctioned vehicle to the price of the property and $1,132 to sales tax which must be remitted to the Department. There would be no remaining proceeds to be applied to any interest, service, or other charges.

A taxpayer must retain records of all of the following:

1. The name of the purchaser/debtor.
2. The date of the sale giving rise to the bad debt.
3. The price of the property and the amount of sales tax charged.

[6] MCL 205.54i(2) and MCL 205.99a(1).
[7] This requirement applies regardless whether the taxpayer is required to file a federal income tax return.

4. The amount of interest, finance or service charges incorporated in the debt or account.
5. The dates and amounts of any payments made on a debt or an account.
6. The portion of the debt or account representing a charge that was not subjected to tax in the original transaction. [8]

Upon request of the Department, the above records must be provided to substantiate the deduction.

Additionally, if the bad debt claimed is the result of the sale of a vehicle, the taxpayer requesting the refund or claiming the deduction must provide a RD-108 Application for Title and Registration validated by the Michigan Secretary of State for each vehicle for which it claims the deduction.[9] However, if a validated RD-108 is unavailable the taxpayer may provide a cleared check in payment of the tax along with other documentation that demonstrates that the payment was directly related to the vehicle sale for which it is claiming the bad debt deduction.

III. ENTITIES THAT MAY CLAIM THE DEDUCTION

A. <u>Retailers and Lenders</u>

For bad debts incurred before September 30, 2009, the deduction may only be taken by the person that remitted the sales or use tax directly to the Department (i.e., the retailer);[10] lenders may not claim the deduction for bad debts incurred prior to that date. Furthermore, the retailer must independently meet all of the statutory requirements to claim a bad debt deduction. In other words, a retailer may not rely on another party, e.g., a third-party lender, to meet the requirements of the deduction. For example, if a retailer sells the account receivable associated with the bad debt to a third-party lender, it may not claim the deduction because it did not write the bad debt off its own books and records.[11]

After September 30, 2009, either a retailer or a lender may claim the deduction if the following conditions are met:

1. the retailer and lender execute and maintain a written election designating which party is entitled to take the deduction;
2. no deduction or refund was previously claimed or allowed on any portion of the account receivable; and,
3. the account receivable has been found worthless and written off by the taxpayer that made the sale or the lender on or after September 30, 2009.[12]

[8] MCL 205.54i(4); MCL 205.99a(2).
[9] *Ally, supra.*
[10] MCL 205.54i(1)(e); MCL 205.99a(6)(e).
[11] *Menard, Inc, supra* .
[12] MCL 205.54i(3); MCL 205.99a(3).

The written election must clearly and unequivocally state which party is entitled to the deduction; the mere assignment of the right to the debt alone does not satisfy the written election requirement. The written election must be executed before the bad debt deduction or refund is claimed.

A "lender" includes any person that holds or has held an account receivable for purchases directly from the taxpayer that reported the tax (i.e., the retailer), any person that holds or has held an account receivable pursuant to a contract with the taxpayer that reported the tax, or the issuer of a private label credit card (PLCC).[13]

A PLCC is a credit or charge card that is branded with the name or logo of a retailer that can only be used for purchases from that retailer.[14] A "lender," for purposes of the deduction, does not include the issuer of a credit or charge card that can be used to make purchases from a person other than the retailer whose name and logo appears on the card.[15]

<u>Example 4.</u>

> ABC Inc., a retailer, and XYZ Inc., a third-party lender, enter a written agreement assigning ABC's accounts receivable to XYZ for sales financed by XYZ. The agreement does not provide a written election specifying the party entitled to claim the Michigan bad debt deduction. Neither ABC nor XYZ may claim the deduction.

<u>Example 5.</u>

> ABC Inc., a retailer, and XYZ Inc., third-party lender, enter a written agreement on January 1, 2015, assigning ABC's accounts receivable to XYZ for sales financed by XYZ. The agreement also provides a written election specifying that XYZ is entitled to claim the Michigan bad debt deduction. XYZ, but not ABC, may claim the deduction on claims made after January 1, 2015.

B. Taxpayers and Certified Service Providers under the Streamlined Sales and Use Tax Agreement

A Certified Service Provider (CSP) that assumes sales and use tax filing responsibilities on behalf of taxpayers under the Streamlined Sales and Use Tax Administration Act, MCL 205.801 to 205.833, may claim a bad debt deduction on behalf of the taxpayer. The CSP must credit or refund the amount of the deduction claimed to the taxpayer. Taxpayers, and CSPs on behalf of taxpayers, that file under the Streamlined Sales and Use Tax Administration Act may allocate a bad debt deduction among Streamlined Sales and Use Tax Agreement member states if the taxpayer's books and records support such an allocation.

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[13] MCL 205.54i(1)(b); MCL 205.99a(6)(b).
[14] MCL 205.54i(1)(d); MCL 205.99a(6)(d).
[15] MCL 205.54i(1)(c); MCL 205.99a(6)(c).