Private Letter Rulings

"Private letter rulings" are written statements issued to a taxpayer by the department, that interpret Wisconsin tax laws based on the taxpayer's specific set of facts. Any taxpayer may rely upon the ruling to the extent the facts are the same as those in the ruling.

The ruling number is interpreted as follows: The "W" is for "Wisconsin"; the first four digits are the year and week the ruling becomes available for publication (80 days after it is issued to the taxpayer); the last three digits are the number in the series of rulings issued that year. The date is the date the ruling was issued.

Certain information that could identify the taxpayer has been deleted. Additional information is available in Wisconsin Publication 111, "How to Get a Private Letter Ruling From the Wisconsin Department of Revenue."

The following private letter ruling is included:

✵ W 0318003 ✵

February 10, 2003

Type Tax: Sales and Use Taxes

Issue: Bad debts

Statutes: Sections 77.51(4)(b)4, (10), and 77.58(3)(a), Wis. Stats. (1999-00)

Wis. Adm. Code: Section Tax 11.30(2)(d)2 (June 1991 Register)

This letter responds to your request for a private letter ruling regarding the Wisconsin sales and use tax treatment of bad debts and the sale of receivables under sec. 77.51(4)(b)4, Wis. Stats. (1999-00), and sec. Tax 11.30(2)(d)2, Wis. Adm. Code (June 1991 Register).

Facts as stated in your request:

Company A is a used car dealer. At present, it is organized as a limited liability company and has elected for federal and Wisconsin income tax purposes to be taxed as a partnership. Company A sells used cars and provides installment financing for the cars to its customers.

Company A currently sells the installment contracts to Company B, a related entity. Company B is also a limited liability company treated as a partnership for income tax purposes. Both limited liability companies are under the common control of two related individuals for income tax purposes.

Company B purchases the auto contracts at a discount and agrees to bear the risk of loss for any bad debts realized on the underlying installment obligations. It claims a bad debt deduction for federal income tax purposes. Company B, on occasion, sells the installment contracts it purchases from Company A to unrelated financial institutions.

Company A claims an income tax deduction for the discount it now realizes on the sale of the contracts. Neither Company A nor Company B claim a bad debt deduction related to the installment contracts sold at a discount in reporting taxable gross receipts for Wisconsin sales tax purposes.

For the 2003 tax year, Company A and Company B will "check the box" to be treated as a corporation for federal and Wisconsin income tax purposes. In addition, effective as of January 1, 2003, the entities will elect S corporation status.

Effective January 1, 2003, Company C will be formed as a subsidiary of Company A. Company C will elect qualified subchapter S subsidiary ("QSSS") status. It will be disregarded for federal and Wisconsin corporate income tax purposes.

Company C will have its own employees and bank accounts. It will pay Company A a management fee to handle certain accounting, payroll, and tax functions.

Under the new structure, Company A will sell auto installment contracts to Company C. However, the contracts will be sold at 100% of their face value and the

risk of loss will remain with Company A. Any defaults on the contracts held by Company C or third parties must be made good by Company A.

Company C will sell the installment contracts purchased from Company A at a discount to either Company B or to outside financial institutions.

Company A will pay the balance of any installment contract that a customer defaults on to Company B or, if appropriate, to a third-party financial institution that has purchased the contract.

Company A will be reimbursed for any installment receivable that has been charged off as a bad debt by the company to the extent Company B recovers all or a portion of the defaulted contract. The recovered amounts will be paid to Company A by Company B.

The proposed restructuring of Company A and Company B will allow the owners to bring specialized expertise and management focus to the retail automotive business and the financial/treasury operations. The creation of Company C will separate the consumer credit operations of Company B from the other corporate financing activities. This will facilitate the sales efforts of Company A by providing faster turnaround on auto financing deals. Company C's credit managers will work closely with Company A's sales personnel to qualify prospective buyers and tailor credit terms to meet their individual needs.

Company B will be able to concentrate more fully on the strategic issues of the business, such as raising capital and providing cash to affiliated businesses. It will work closely with outside creditors and financial institutions rather than Company A's customers. Company B personnel will fulfill treasury functions rather than the retail credit objectives of Company C.

The new organization of Company A and related entities will be similar to other companies in the retail industry that have specialized sales, consumer credit, and treasury/financing functions (e.g., department stores, auto manufacturers). The discreet businesses will have separate performance goals. The managers and employees will be evaluated independently and their compensation structured with specific rewards.

Request:

For installment contracts sold on or after January 1, 2003, by the entities described above, you requested that the department rule on the following issues:

1. Can Company A claim a bad debt deduction under sec. 77.51(4)(b)4, Wis. Stats. (1999-00), and sec. Tax 11.30(2)(d)2, Wis. Adm. Code (June 1991 Register), for installment contracts that will be sold to Company C if Company C sells these contracts at a discount to Company B and the contracts subsequently become worthless in whole or part? Stated another way, does the fact that the installment contracts will be sold by Company C at a discount to Company B preclude Company A from taking a bad debt deduction?

2. Can Company A claim a bad debt deduction under sec. 77.51(4)(b)4, Wis. Stats. (1999-00), and sec. Tax 11.30(2)(d)2, Wis. Adm. Code (June 1991 Register), for installment contracts that will be sold to Company C if Company C sells these contracts at a discount to outside financial institutions and the contracts subsequently become worthless in whole or part? That is, does the fact that the installment contracts will be sold by Company C at a discount to outside financial institutions preclude Company A from taking a bad debt deduction?

Ruling:

1. Company A may claim a bad debt deduction under the factual situation described above for that portion of the contract that becomes worthless. This answer assumes that Company A previously paid sales tax to the State of Wisconsin for the sales represented by the accounts, and the accounts are found worthless and charged off for income or franchise tax purposes. The fact that the installment contracts will be sold by Company C at a discount to Company B does not preclude Company A from taking a bad debt deduction.

   Note: If any such accounts found worthless and charged off are thereafter in whole or in part collected by Company A, Company B, or any other party, the amount so collected must be included in the first return filed by Company A after such collection, and the amount of the tax thereon paid with the return.

2. Company A may claim a bad debt deduction under the factual situation described above for that portion of the contract that becomes worthless. This answer assumes that Company A previously paid sales tax to the State of Wisconsin for the sales represented by the accounts, and the accounts are found worthless and charged off for income or franchise tax purposes. The fact that the installment contracts will

be sold by Company C at a discount to outside financial institutions does not preclude Company A from taking a bad debt deduction.

Note: If any such accounts found worthless and charged off are thereafter in whole or in part collected by Company A, Company B, or any other party, the amount so collected must be included in the first return filed by Company A after such collection, and the amount of the tax thereon paid with the return.

Caution: The unsigned proposed contracts between Company A and Company C and Company C and Company B contain language obligating Company A to repurchase any contract upon default by the vehicle purchaser only with respect to a failure by the vehicle purchaser to make the **first** scheduled payment. These contracts do not correspond with the representation that Company A is liable for any default by the vehicle purchaser, regardless of the identity of the holder. This ruling is premised on the representation made, and not the proposed contracts. If any of the representations made are different from what actually occurs, this ruling may not be relied upon as authority for the positions taken therein.

Analysis:

Section 77.51(4)(b)4, Wis. Stats. (1999-00), provides:

> "In the case of accounts which are found to be worthless and charged off for income or franchise tax purposes, a retailer is relieved from liability for sales tax. A retailer who has previously paid the sales tax on such accounts may take as a deduction from the measure of the tax the amount found to be worthless and this deduction must be taken from the measure of the tax in the period in which said account is found to be worthless or within a reasonable time thereafter."

Section Tax 11.30(2)(a), Wis. Adm. Code (June 1991 Register), provides:

> "*Deduction from measure of tax*. A retailer is relieved from the liability for sales tax by ss. 77.51(4)(b)4. and 77.52(6), Stats., or from liability to collect and report use tax by s. 77.53(4), Stats., insofar as the measure of the tax is represented by accounts found worthless and charged off for income tax purposes or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. However, only a retailer who has previously paid sales or use tax to this state on the accounts may claim the bad debt deduction. The deduction shall be taken from the measure of tax in the period in which the account is found to be worthless. That period is defined as any time within the retailer's fiscal or calendar year in which the account is written off. However, if the taxpayer is out of business when the account becomes worthless, a bad debt deduction may be claimed on the last return filed by that business, or through a refund claim or amended return filed within the statutory time allowed. Notes, which later become worthless, received on the sale of tangible personal property shall be treated in the same manner as other worthless accounts."

Section Tax 11.30(2)(b), Wis. Adm. Code (June 1991 Register), provides:

> "*Recovery of bad debts charged off*. If any accounts found worthless and charged off are thereafter in whole or in part collected by the retailer, the amount so collected shall be included in the first return filed after such collection and the amount of the tax thereon paid with the return."

Section Tax 11.30(2)(d)2, Wis. Adm. Code (June 1991 Register), provides:

> "A retailer who sells its receivables and agrees to bear any bad debt loss on them is entitled to a bad debt deduction to the same extent as if the accounts were not sold. However, a bad debt deduction is not allowable when receivables are sold outright at a discount."

For accounts that are sold by Company A to Company C and that subsequently become worthless, Company A is entitled to a bad debt deduction because Company A will not sell the receivables at a discount, and the risk of loss will remain with Company A. This is provided in sec. Tax 11.30(2)(a) and (d)2, Wis. Adm. Code (June 1991 Register). This answer assumes that Company A previously paid sales tax to the State of Wisconsin for the sales represented by the accounts, and the accounts are found worthless and charged off for income or franchise tax purposes.

Although Company C will be formed as a subsidiary of Company A and will be disregarded for federal and Wisconsin corporate income tax purposes, it is a separate entity from Company A for sales and use tax

purposes other than reporting and collecting sales and use tax.

Various income and franchise tax statutes were amended and created by 1997 Wisconsin Act 27 to adopt federal provisions that allow qualified subchapter S subsidiaries (QSSSs) and certain single-owner entities to be disregarded as separate entities for Wisconsin income or franchise tax purposes.

As part of this same legislation, two sales and use tax provisions were amended as described below:

1. The definition of "person" in sec. 77.51(10), Wis. Stats., was amended to include single-owner entities disregarded as separate entities under ch. 71, Wis. Stats.

2. Section 77.58(3)(a), Wis. Stats., was amended to provide that the owner of a qualified subchapter S subsidiary or single-owner entity disregarded as a separate entity for Wisconsin income or franchise tax purposes must report taxable sales and purchases of the disregarded entity on the owner's sales and use tax return.

No sales and use tax provisions, other than 1 and 2 above, were amended or created to state that a qualified subchapter S subsidiary or single-owner entity that is disregarded as a separate entity for Wisconsin income and franchise tax purposes is also disregarded as a separate entity for Wisconsin for sales and use tax purposes. Therefore, for sales and use tax purposes other than reporting and collecting sales and use tax, Company C is an entity separate from Company A.