ST 20-0008-PLR 12/17/2020 CLAIMS FOR CREDIT

A retailer is relieved from liability for any tax that becomes due and payable if the tax is represented by amounts that are found to be worthless or uncollectible, have been charged off as bad debt on the retailer's books and records in accordance with generally accepted accounting principles, and have been claimed as a deduction pursuant to section 166 of the Internal Revenue Code on the income tax return filed by the retailer. See 86 Ill. Adm. Code 130.1960(d) and 35 ILCS 120/6d. (This is a PLR.)

December 17, 2020

NAME
ADDRESS

Dear Xxxx:

This letter is in response to your letter dated September 11, 2019, in which you requested information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.tax.illinois.gov to review regulations, letter rulings and other types of information relevant to your inquiry.

Review of your request disclosed that all the information described in paragraphs 1 through 8 of Section 1200.110 appears to be contained in your request. This Private Letter Ruling will bind the Department only with respect to COMPANY, for the issue or issues presented in this ruling, and is subject to the provisions of subsection (e) of Section 1200.110 governing expiration of Private Letter Rulings. Issuance of this ruling is conditioned upon the understanding that neither COMPANY, nor a related taxpayer is currently under audit or involved in litigation concerning the issues that are the subject of this ruling request. In your letter you have stated and made inquiry as follows:

> COMPANY is a used motor vehicle dealer in Illinois. COMPANY self-finances sales of motor vehicles to individual customers with less than perfect credit. In a typical transaction, when a customer wishes to buy a vehicle, COMPANY enters into a sale and financing agreement with the customer. In that agreement, the customer agrees to pay the total cost of the vehicle including the Retail Occupation or Use Tax (sometimes called sales or use tax and hereafter collectively referred to as "tax"), any additional fees and interest for a specific number of payments over a specific period of time. COMPANY completes the Illinois ST-556, Sales Tax Transaction Return, calculates the tax due, and remits the amount of tax due to the state with the return.
>
> Because most of COMPANY's customers cannot afford to pay the all of the tax up front, COMPANY prepays the tax for the customer out of COMPANY's own funds. COMPANY adds the prepaid tax amount to the financed total for the customer. COMPANY pays the

customer's tax because Illinois vehicle registration law requires that the purchaser of a motor vehicle in Illinois must have a receipt showing the payment of tax on the purchase of the motor vehicle in order to title or register the vehicle, and presumably to obtain a license plate.[1]

However, COMPANY's customers often default on the finance agreement without making a payment or without making all of the required payments. When this happens, COMPANY has prepaid tax of hundreds if not thousands of dollars of the customer's tax out of COMPANY's own funds, and it has not received full, or in some cases any, reimbursement from the customer.

Beginning with COMPANY's 2019 tax year, for federal income tax purposes, COMPANY reports using the cash basis of accounting. Utilizing a cash basis (or gross receipts method) of accounting is the preferred method adopted for Illinois tax purposes.[2]

Relevant Law and Ruling Request

In order to register titled property (e.g. motor vehicles), the Illinois Secretary of State requires a receipt showing the payment of tax to the Illinois Department of Revenue for the titled property. Illinois requires the motor vehicle dealer to (1) file a transaction return reporting the amount of tax due from the retailer and the amount of tax collected from the purchaser or satisfactory evidence that the sale is exempt from tax and (2) remit with the transaction return the proper amount of tax due.[3] Once the transaction return and proper tax remittance is filed, the Department will issue the receipt in the purchaser's name so that the purchaser may register the vehicle.[4]

In Illinois, the gross receipts, or cash basis accounting method, is the preferred method for reporting receipts from sales for Retail Occupation Tax and retailer collected Use Tax purposes.[5] Under this method, tax is reported and remitted to the Department when it is collected by the retailer. This includes when a retailer receives multiple payments that make up the total sales price. The retailer reports and remits the tax it receives with each partial payment. If it did not receive all of the payments due, the retailer would report only the tax it received from the customer. Thus, a gross receipts method retailer would not need to claim a credit for overpayment of taxes (i.e. a bad debt deduction) because it would remit only the tax it actually receives.

A taxpayer may change its reporting method to gross sales, or accrual basis accounting, after notifying the Illinois Department of Revenue.[6] Under this method, the retailer reports and remits the tax due at the time of the sale based on the total sale price even if the tax or total sales price has not been collected from the customer at the time of sale; rather, it will be collected in installments over time.

---

[1] ILCS 120/3.
[2] ILCS 120/3 including only "receipts" in returns; ILCS 120/1 definition of gross receipts; 86 III. Admin. Code 130.401(a).
[3] ILCS 120/3.
[4] ILCS 120/3.
[5] ILCS 120/3 including only "receipts"" in returns; ILCS 120/1 definition of gross receipts; 86 III. Admin. Code 130.401(a).
[6] 86 III. Admin. Code 150.910(b).

To put a gross sales (accrual basis) retailer on the same footing as a gross receipts (cash basis) retailer, the gross sales retailer would need the ability to claim a credit for overpayment of taxes (i.e., a bad debt deduction) because it would remit tax before it collected the tax from the customer. Illinois grants gross sales method retailers this ability by relieving them from liability for any tax that becomes due and payable if the tax is represented by amounts that are charged off as bad debt.[7] The intent of affording the bad debt deduction to a gross sales retailer is to attempt to put him on equal footing with a gross receipts retailer with regard to the total amount of tax paid on the same transaction.

Ruling Request:
Motor vehicle retailers must prepay the tax due regardless of the accounting method they choose, in order for their customers to obtain the proper title. When a motor vehicle retailer chooses the cash method, but is forced to prepay the tax on behalf of its customer, how does that retailer obtain a refund of the prepaid tax when the customer defaults on the loan?

Option 1:

Even though COMPANY is a gross receipts (i.e., cash basis) retailer in Illinois, it will remit tax on more than the amount of the receipts the customer paid at the time of the transaction because it sells motor vehicles.

Instead of paying the tax as it receives it, COMPANY is required to prepay the total tax due out of COMPANY's own funds on behalf of a customer at the time of the transaction. When the customer fails to make some (or any) of the payments on the customer's finance agreement, COMPANY will have only received part (or none) of the tax it prepaid on behalf of the customer. (Under GAAP, a portion of each payment the customer makes goes to principal, interest, tax, etc.)

COMPANY paid a total amount of tax on behalf of a customer based on receipts it never actually received. Therefore, as a gross receipt (cash basis) retailer, it is entitled to a refund of or credit for the total tax amount it erroneously paid to the Department.

Additionally, Illinois treats gross receipts retailers of motor vehicles like COMPANY differently than it treats ordinary gross receipts retailers – allowing other gross receipts retailers to remit tax as they collect it and never be put in a situation where they are required to prepay a customer's tax out of their own funds. To restore COMPANY to equal footing with other Illinois gross receipts retailers, a refund or credit of an amount of tax it paid out of pocket for receipts it did not collect must be granted.

COMPANY respectfully requests a Private Letter Ruling stating that as a gross receipts retailer, it is entitled to a refund of the amount of tax it prepaid to the Department that is associated with receipts it never actually receives from the customer. COMPANY also respectfully requests that the Private Letter Ruling outlines the procedure for requesting and obtaining the credit or refund, including any documentation requirements to sustain the credit or refund.

[7] ILCS 120/6d; 86 III. Admin. Code 130.1960(3).

Option 2, to the extent Option 1 is denied:

In the alternative, COMPANY can be treated as a gross sales retailer entitled to a credit for or refund of tax prepaid on a sale of a motor vehicle based on uncollectible amounts reported as bad debt under Internal Revenue Code (IRC) § 166.

The Department has recognized that, even without going through a formal process, retailers who report and pay Retailer's Occupation or Use Tax before all gross receipts have been received from purchasers, may be filling on a "gross sales" basis.[8] Because COMPANY prepays tax on behalf of COMPANY's customers for each motor vehicle transaction, COMPANY may be treated as a gross sales retailer in Illinois.

If treated as a gross sales retailer, COMPANY may claim a credit or refund of tax it prepaid on transactions in which it did not receive full payment from the customer – transactions which resulted in a worthless debt owed to COMPANY.

In fact, "a retailer is relieved from liability for any tax that becomes due and payable if the tax is represented by amounts that are found to be worthless or uncollectible, have been charged off as bad debt on the retailer's books and records in accordance with generally accepted accounting principles, and have been claimed as a deduction pursuant to IRC § 166 on the income tax return filed by the retailer."[9]

A worthless debt is allowed as a deduction under Internal Revenue Code §166 only if the income arising from the creation of the receivable was previously included in income.[10] For cash-basis taxpayers, like COMPANY, this typically means that a bad debt deduction is not allowed because usually no income is recorded until payments on the debt are received. However, when making a sale on credit, COMPANY reports gross income equal to the cash and fair market value of the notes received. This is required under the "cash equivalent" doctrine.[11] The Treasury Regulations provide that for taxpayers who include in income the fair market value of accounts receivable when received the amount deductible under IRC §166 is limited to such fair market value.[12]

For federal tax purposes in the year when debts become uncollectible or worthless, COMPANY takes a deduction under IRC §166.[13] This deduction is in the amount of COMPANY's adjusted basis in the debt (provided in IRC §1011).[14] Internal Revenue Code §1011 generally requires the use of cost as the basis under IRC §1012 unless an alternative basis rule under subchapter O, C, K, or P applies. The market discount rules are contained in subchapter P. COMPANY accounts for the basis in the debt using the market discount rules.

Internal Revenue Code §1016 provides that proper adjustment in respect of the property shall be made for expenditures, receipts, losses or other items properly

---

[8] Illinois Dept. of Rev. General Information Letter No. ST 00-0091-GIL, 05/16/2000.
[9] ILCS 120/6d.
[10] Treas. Reg. §1.166-1(e).
[11] *Cowden v. Commissioner*, 289 F2d. 20, 23; *Estate of Scharf v. Commissioner*, 38 T.C. 15, 32; *Barnsley v. Commissioner*, 31 T.C. 1260, 1261.
[12] Treas. Reg. §1.166-1(d)(2)(i)(a).
[13] 26 U.S. Code §1.166-1(a)(1),
[14] 26 U.S. Code §1.166-1(b).

chargeable to the capital account of the property. Internal Revenue Code §1276 requires that a taxpayer that has a market discount bond must report the collected market discount as ordinary income. According to the law[15], when a principal payment is made, a portion of the payment that is made reduces the taxpayer's basis in the note receivable, and a portion is recorded as earned discount income.

To help explain the calculation of the federal bad debt deduction under IRC §166, we have provided the following simplified example to more easily demonstrate the application of the rules outlined in the IRC code sections described above:

> COMPANY sells a vehicle to a customer on credit for $10,000 with $0 down at 0% interest (for simplification purposes). COMPANY calculates that the fair market value of this receivable is $7,000. COMPANY debits accounts receivable for $10,000, credits sales revenue (income) for $7,000, and credits fair market value discount (a contra asset account) for $3,000. COMPANY has $7,000 of federal tax basis in the debt as this is the amount COMPANY reported as income.
>
> When the customer makes a $1,000 principal payment, COMPANY debits cash for $1,000 and credits accounts receivable for $1,000. COMPANY also credits discount income for $300 (30% of $1,000 payment per the original 30% discount on the debt) and debits fair market value discount for $300. COMPANY's basis in the debt decreased by $700 for federal income tax purposes and is now $6,300.
>
> At this point the customer defaults on the debt and COMPANY repossesses the vehicle and sells it for $500 at auction. COMPANY debits cash and credits accounts receivable for $500. COMPANY also debits fair market value discount and credits discount income for $150 (30% of $500 reflecting the original 30% discount on the note). COMPANY's basis in the debt decreases by $350 to $5,950.
>
> COMPANY now makes the determination that the debt is worthless or uncollectible. Taxpayer credits accounts receivable or $8,500 (the amount remaining on the note), debits fair market value discount for $2,550 (the amount remaining of the discount). This leaves COMPANY with a debit to bad debt deduction for $5,950, equal to COMPANY's remaining federal income tax basis in the debt.

As previously stated, under Illinois law, a retailer may claim a refund for any tax represented by amounts that are found to be worthless or uncollectible, have been charged off as bad debt on the retailer's books and records in accordance with accepted accounting principles, and have been claimed as a deduction pursuant to IRC §166 on the income tax return filed by the retailer.[16]

As described above COMPANY meets all three requirements. COMPANY has found amounts to be worthless or uncollectible. COMPANY has charged off such amounts as bad debt on COMPANY's books and records, as described above. COMPANY will claim

[15] 26 U.S. Code §§1276 and 1278(b)(4).
[16] ILCS 120/6d(a)

such amounts as a deduction pursuant to IRC §166 on COMPANY's federal income tax return. Consequently, COMPANY is eligible for a refund of sales tax associated with COMPANY's bad debt deduction calculated pursuant to accepted accounting principles and IRC §166.

Note that Option 2 does not make COMPANY whole for the full amount of tax COMPANY paid on behalf of COMPANY's customer. Using the same example as above and assuming a 6.25% tax rate, under a gross receipts method, COMPANY would pay $93.75 in tax to the Department. (COMPANY would have collected 1,500 in receipts x .0625 = 93.75.) Under a gross sales method and allowing for a bad debt deduction tied to IRC 166, COMPANY would have netted a total tax liability of 253. (COMPANY would have initially paid $625 (10,000*.0625) but would have only received a bad debt deduction of 372 (5,950 x .0625).) The difference is a function of the fair market discount income calculation required for federal income tax purposes as discussed above (2550 x .0625 = 159.3 which is the difference in the two calculations).

Only to the extent that Option 1 is denied, COMPANY respectfully requests a Private Letter Ruling stating that COMPANY is entitled to a refund of tax paid on behalf of customers associated with uncollectable or worthless amounts that it claims as a bad debt deduction pursuant to IRC §166 on COMPANY's federal income tax return.

Thank you for your consideration of this matter. Should you have questions or need additional information, please contact me directly at NUMBER or E-MAIL.

DEPARTMENT'S RESPONSE:

The Retailers' Occupation Tax Act imposes a tax upon persons engaged in this State in the business of selling tangible personal property at retail to purchasers for use or consumption. See 86 Ill. Adm. Code 130.101. Use Tax is imposed on the privilege of using, in this State, any kind of tangible personal property that is purchased anywhere at retail from a retailer. See 86 Ill. Adm. Code 150.101. These taxes comprise what is commonly known as "sales tax" in Illinois.

Public Act 99-217, effective July 31, 2015, codified the bad debt deduction provisions in newly created Section 6d of the Retailers' Occupation Tax Act. (35 ILCS 120/6d) The Department's bad debt deduction rules have been updated to reflect the provisions of Section 6d. These rules provide that, on and after July 31, 2015, a retailer is relieved from liability for any tax that becomes due and payable if the tax is represented by amounts that are found to be worthless or uncollectible, have been charged off as bad debt on the retailer's books and records in accordance with generally accepted accounting principles, and have been claimed as a deduction pursuant to section 166 of the Internal Revenue Code on the income tax return filed by the retailer. A retailer that has previously paid such a tax may take as a deduction the amount charged off by the retailer. If these accounts are thereafter, in whole or in part, collected by the retailer, the amount collected shall be included in the first return filed after the collection, and the tax shall be paid with the return. See 86 Ill. Adm. Code 130.1960(d)(3)(A) and 35 ILCS 120/6d(a).

The rules go on to provide that because retailers of motor vehicles, watercraft, trailers and aircraft do not pay Retailers' Occupation Tax to the Department on retail sales of motor vehicles, watercraft, trailers and aircraft with monthly returns, but remit the tax to the Department on a transaction-by-transaction basis, they are unable to take a deduction on the returns that they file with

the Department, but may file a claim for credit with the Department on any eligible transaction. See 86 Ill. Adm. Code 130.1960(d)(3)(B).

Prior to this point, it was the Department's understanding that a cash-basis taxpayer is not eligible under Internal Revenue Code section 166 to take a deduction for a worthless debt. The Department's bad debt rules include the statement that "Retailers or lenders that file federal returns on a cash basis and cannot claim a deduction pursuant to section 166 of the Internal Revenue Code are not eligible for the bad debt deduction." (86 Ill. Adm. 130.1960(d)(5)(B)) Based, however, on the assertions in your letter that, although you file federal returns on a cash basis, you are, nonetheless, eligible to claim a deduction pursuant to section 166 of the Internal Revenue Code, it is the Department's opinion that you are entitled to file a claim for credit under 86 Ill. Adm. Code 130.1960. It is important to point out, however, that the claim for credit must be limited to only that portion of the bad debt that was allowed and was taken as a deduction on your federal income tax return under section 166 of the Internal Revenue Code. Amounts not allowed to be deducted under that provision are not allowed to be used to claim a credit or refund against the Retailers' Occupation Tax paid on the transaction.

It is important also that you meet the other conditions of the rule. Retailers are required to maintain adequate books, records or other documentation supporting the charge off of the accounts or receivables for which a deduction was taken or a refund was claimed under Sections 6 or 6d of the Retailers' Occupation Tax Act, including, but not limited to, a copy of the federal return on which the deduction was claimed. If a retailer does not charge off an account receivable that is found to be worthless or uncollectible as a bad debt in its books and records and claim a deduction pursuant to section 166 of the Internal Revenue Code on its federal income tax return or amended return, the tax paid on that bad debt or receivable will not be considered a tax paid in error and, thus, the retailer will not be able to file a deduction or claim for credit in accordance with Sections 6 or 6d of the Retailers' Occupation Tax Act. For purposes of the deduction or refund allowable under Section 6d of the Retailers' Occupation Tax Act, the limitations period for claiming the deduction or refund shall be the same as the limitations period set forth in Section 6 of the Retailers' Occupation Tax Act for filing a claim for credit, and shall commence on the date that the accounts or receivables have been claimed as a bad debt deduction pursuant to section 166 of the Internal Revenue Code on the federal income tax return, regardless of the date on which the sale of the tangible personal property actually occurred. 86 Ill. Adm. Code 130.1960(d)(5)

The factual representations upon which this ruling is based are subject to review by the Department during the course of any audit, investigation, or heCOMPANYng and this ruling shall bind the Department only if the factual representations recited in this ruling are correct and complete. This Private Letter Ruling is revoked and will cease to bind the Department 10 years after the date of this letter under the provisions of 2 Ill. Adm. Code 1200.110(e) or earlier if there is a pertinent change in statutory law, case law, rules or in the factual representations recited in this ruling.

I hope this information is helpful. If you have further questions concerning this Private Letter Ruling, you may contact me at (217) 782-2844. If you have further questions related to the Illinois sales tax laws, please visit our website at www.tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336.

Very truly yours,

Richard S. Wolters
Chairman, Private Letter Ruling Committee

RSW:ter