

Bad Debt

Sales Tax Refund Claims in the Auto Industry

Introduction

Bad debt refund claims pose a challenge for auto dealerships and finance companies that finance auto sales based on the records provided for examination, the allocation of payments, the rules regarding repossessed vehicles, and the amounts claimed on sales tax refund requests. To ensure a level playing field, the Idaho State Tax Commission is offering guidance to companies engaged in this activity.

Sales taxes these entities pay on sales that create accounts later found to be worthless from customer default can be refunded to the extent that the bad debt contains uncollectible sales tax. However, the error rate reported on filed refunds is often much greater than what is allowed by Idaho tax law.

Typical Errors Outlined

Typical errors sellers make when calculating the sales tax portion of existing debt include applying loan payments to late fees, increased interest rates, and other penalty charges that occur when customers don't comply with the terms of the sales contract. To properly calculate a sales tax refund, the seller must always allocate loan payments between non-penalty interest based on the rate designated in the sales contract and the principal balance of the payments (See *What the Industry Should Do*, below).

The Tax Commission doesn't allow payments on auto loans to be applied to late fees, increased interest, or other penalties because these charges occurred due to the customer's failure to comply with the terms of the sales contract, and they bear no relationship to the sales tax that was charged and paid to the Commission. Also at issue for auto retailers and finance companies claiming bad debt sales tax refunds are instances where the principal balance of the loan isn't revised by the auto dealership or financier after a vehicle is repossessed.

Review Shows Reporting Problems

The Tax Commission reviewed refunds claimed by auto dealerships on sales and use tax returns (Forms 850). This review revealed that the returns filed by some dealerships included an extraordinarily high rate of adjustments for bad debt issues. Here are some of the findings:

- Some dealerships incorrectly requested a refund for vehicles they repossessed and sold, or repossessed and didn't resell seasonably, or right away, through a public or private sale. Idaho Sales and Use Tax Administrative Rule 35.01.02.063.03.b provides that the repossession and retention of the vehicle satisfies the debt and no bad debt adjustment is allowed.
 - Some repossessed vehicles were transferred to related entities at an unrealistically low basis and later sold to customers at a substantially higher amount. The dealer then claimed a bad debt refund using the low basis from the transfer to the related entity, creating a significantly inflated refund. Cars were repossessed multiple times, with each repossession generating an additional Sales and Use Tax Return Line 7 adjustment for an inflated amount. These situations don't constitute a rescinded sale under Idaho Sales and Use Tax Administrative Rule 35.01.02.045 and
-

circumvent Idaho Sales and Use Tax Administrative Rule 35.01.02.063.03.b, which provides that if the car is repossessed and retained, no bad debt exists and no sales tax refund is allowed.

What the Industry Should Do

The auto sales industry should follow these guidelines to comply with Idaho Sales and Use Tax Law and Administrative Rules 35.01.02.063 (Bad Debts and Repossessions) and 35.01.02.117 (Refund Claims):

- Provide documentation with the refund request that substantiates the refund claim; this includes a list of the individual bad debts (with the required data elements) that total to the refund requested and any other documents that support the basis of the claim. If these elements aren't provided, the dealership or finance company will be given 30 days to provide the requested information. The Tax Commission won't accept a refund request unless this information is provided within the stated timeframe.
- Apply loan payments on a pro-rata basis only to the principal, interest, tax, administrative fees, etc., that are included in the original loan amount in the sales contract and are unrelated to the customer's future behavior in paying off the loan.
- Once payments are missed and the loan defaults, use the following payment allocation calculation: ***(Total Payments Received on Loan) X (Original amount Financed on Loan / Total Payments Expected for Loan Term) = Principal Amount of Received Payments.***
- In calculating a sales tax refund, don't apply loan payments to fees, penalties, increased interest, etc., which occur because a customer didn't comply with the original sales contract.
- Don't request a bad debt refund if the vehicle has been repossessed but not resold.
- If a vehicle has been repossessed and is resold, the sales amount used to reduce the principal balance cannot be reduced merely as a means to inflate the refund amount.

Other Information

This document isn't intended to cover all aspects of bad debt refund claims. For more information, please review Idaho Code section 63-3626 and Idaho Sales and Use Tax Administrative Rules 35.01.02.06 and 35.01.02.117 which refer to refunds and related limitations, bad debts, and repossessions.