

**TENNESSEE DEPARTMENT OF REVENUE  
REVENUE RULING # 11-59**

**WARNING**

**Revenue rulings are not binding on the Department. This presentation of the ruling in a redacted form is information only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Departmental policy.**

**SUBJECT**

The application of the bad debt deduction found under TENN. CODE ANN. § 67-6-507(e) (2011) for Tennessee sales and use tax purposes.

**SCOPE**

Revenue Rulings are statements regarding the substantive application of law and statements of procedure that affect the rights and duties of taxpayers and other members of the public. Revenue Rulings are advisory in nature and are not binding on the Department.

**FACTS**

The Taxpayer is an automobile dealer with operations in Tennessee. As part of its operations, the Taxpayer sells vehicles to customers wherein the purchasers enter into retail installment sales contracts with the Taxpayer. The amount financed by the retail installment sales contract includes 1) the portion of the purchase price not paid by the purchaser at the time of delivery; 2) the Taxpayer's miscellaneous fees and charges; and 3) the full amount of the sales tax due on the sale of the vehicle. The Taxpayer remits Tennessee sales tax with respect to its retail sales in Tennessee.

Following the execution of the installment sales contract, the Taxpayer sells the contract to a third party financing company pursuant to a written agreement (the "Agreement"). The purchase price of the installment sales contract equals the amount financed, less insurance premiums as reflected in the contract, discounted by 30 percent.

The Agreement provides that the financing company may require the Taxpayer to repurchase and take reassignment of the installment sales contract in the event: the Taxpayer breaches any warranties of merchantability or fitness relating to the automobile; the Taxpayer takes possession of the vehicle (whether by repossession or customer return) without the financing company's written consent; the purchaser makes a "holder in due course" demand against the financing company; or the installment sales contract is rescinded by law or by agreement between the Taxpayer and the purchaser. The Taxpayer is also required to repurchase the contract if it fails to provide the financing company with a certificate of title and evidence of the financing company's security interest in the vehicle.

The Agreement does not contain any provision regarding the repurchase price of the installment sales contract. However, the repurchase price of a particular installment sales contract will be the fair market value of the contract at the time of repurchase and reassignment.

Additionally, the Agreement may require the Taxpayer to repurchase the automobile in the event the customer defaults on the installment sales contract and the financing company repossesses or enforces its lien against the vehicle. Pursuant to the Agreement, the repurchase price of the vehicle is the actual cash value of the vehicle under current market conditions, which are determined by the published book value. If the parties cannot agree as to the actual cash value, the financing company has the right to have the vehicle appraised by an independent appraiser.

In practice, when the financing company exercises the recourse provisions of the Agreement, the Taxpayer will either 1) repurchase the installment sales contract and the vehicle, or 2) repurchase only the vehicle.

When the Taxpayer repurchases an installment sales contract from the financing company, the Taxpayer claims a deduction on its federal income tax return with respect to any such accounts that are properly treated as worthless debts, in the amount permitted under I.R.C. § 166. However, the Taxpayer will not claim the federal income tax deduction in the event it repurchases only the vehicle.

## **RULINGS**

1. For purposes of the Tennessee sales and use tax, may the Taxpayer claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) with respect to installment sales contracts that it repurchases under the Agreement?

Ruling: The Taxpayer may claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) for an account with respect to which it reacquires an installment sales contract under the recourse terms of the Agreement.

2. If the response to Question #1 is affirmative, what is the amount that the Taxpayer may claim as a bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) with respect to an installment sales contract that it repurchases under the Agreement?

Ruling: The amount that the Taxpayer may claim as a bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) for an account with respect to which it reacquires an installment sales contract under the recourse terms of the Agreement will equal the amount claimed as a bad debt deduction on the Taxpayer's federal income tax return under I.R.C. § 166 with respect to such account, reduced by the amount of any financing charges or interest, sales or use taxes charged on the purchase price, uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid, expenses incurred in attempting to collect any debt, and the value of any repossessed property.

3. For purposes of the Tennessee sales and use tax, may the Taxpayer claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) when it repurchases only the vehicle under the Agreement?

Ruling: The Taxpayer may not claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) for an account with respect to which it reacquires only the vehicle under the recourse terms of the Agreement.

4. If the response to Question #3 is affirmative, what is the amount that the Taxpayer may claim as a bad debt deduction under TENN. CODE ANN. § 67-6-507(e) (2011) with respect to a vehicle that it repurchases under the Agreement?

Ruling: Not applicable.

## ANALYSIS

TENN. CODE ANN. § 67-6-202(a) (2011) imposes the Tennessee sales tax on the sales price<sup>1</sup> of each article of tangible personal property sold at retail in Tennessee. TENN. CODE ANN. § 67-6-504 (2011) requires the dealer making the sale to file Tennessee sales and use tax returns on a monthly basis, showing the gross sales or purchases arising from all taxable sales or purchases during the preceding calendar month, and remitting the tax due.<sup>2</sup>

However, in the event that a dealer has remitted sales tax with respect to an account that is later deemed worthless, the dealer is entitled to claim a deduction, provided that certain requirements are met. Specifically, TENN. CODE ANN. § 67-6-507(e) (2011) provides that a “deduction from taxable sales shall be allowed for bad debts arising from a sale” on which sales tax was paid. The deduction must be claimed on the return for the period “during which the bad debt is written off as uncollectible in the claimant’s books and records and is eligible to be deducted for federal income tax purposes.” TENN. CODE ANN. § 67-6-507(e)(3). However, if a deduction is taken for a bad debt and the debt is subsequently collected in whole or in part, the tax on the amount collected must be paid and reported on the return filed for the period in which the collection is made. TENN. CODE ANN. § 67-6-507(e)(4).

TENN. CODE ANN. § 67-6-507(e)(2) provides that, for purpose of calculating the deduction, a “bad debt” is “as defined in 26 U.S.C. § 166.” However, the amount calculated pursuant to I.R.C. § 166 “shall be adjusted to exclude: financing charges or interest, sales or use taxes charged on the purchase price, uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid, expenses incurred in attempting to collect any debt, and repossessed property.” *Id.* Additionally, any deduction taken that is attributed to bad debts shall not include interest. TENN. CODE ANN. § 67-6-507(e)(1).

I.R.C. § 166 (West 2011) allows a federal income tax deduction for bad debts but does not contain a definition of the term “bad debt.” Rather, the description of what constitutes a bad debt for federal income tax purposes is found in the accompanying regulations. In particular, Treas. Reg. § 1.166-1(a) (West 2011) states that the deduction “shall be allowed in respect of bad debts

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<sup>1</sup> TENN. CODE ANN. § 67-6-102(81)(A) (2011) defines the term “sales price” in pertinent part as the “total amount of consideration, including cash, credit, property, and services, for which personal property or services are sold, leased, or rented, valued in money, whether received in money or otherwise.”

<sup>2</sup> The sales tax is paid by the consumer, but collected and remitted by the dealer making the sale. *See* TENN. CODE ANN. §§ 67-6-501 and -502 (2011).

owed to the taxpayer.” Treas. Reg. § 1.166-1(c) provides that only a “bona fide debt” qualifies for the deduction. A bona fide debt is “a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.” *Id.*

Additionally, I.R.C. § 166(b) and Treas. Reg. § 1.166-1(d) set forth extensive rules regarding the computation of the amount that is deductible; generally speaking, the basis for determining the amount of the deduction under I.R.C. § 166 is the same as the adjusted basis for determining the loss from the sale or other disposition of property. Treas. Reg. § 1.166-3 (West 2011) generally requires that the party claiming the deduction charge off the debt on its books and records during the taxable year in which the deduction is taken.

Thus, a taxpayer will be entitled to claim the deduction under TENN. CODE ANN. § 67-6-507(e) if the following requirements are satisfied: 1) the account in question is properly considered a bad debt owed to the taxpayer; 2) the bad debt arises from a sale on which the sales tax was paid; 3) the taxpayer is the party that wrote off the debt as uncollectible on its books and records; and 4) the taxpayer is eligible to deduct the debt for federal income tax purposes.

#### 1. Bad debt deduction with repurchase of contract

The Taxpayer may claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires an installment sales contract under the recourse terms of the Agreement.

As discussed above, for the Taxpayer to be entitled to claim the bad debt deduction, the following requirements must be satisfied: 1) the account in question must be properly considered a bad debt owed to the Taxpayer; 2) the bad debt must arise from a sale on which the sales tax was paid; 3) the Taxpayer must be the party that wrote off the debt as uncollectible on its books and records; and 4) the Taxpayer must be eligible to deduct the debt for federal income tax purposes.

The first requirement is satisfied because the amounts that the Taxpayer must pay to reacquire contracts in default under the recourse terms of the Agreement are properly considered bad debts owed to the Taxpayer. The Retailers’ Sales Tax Act and accompanying regulations do not address whether a dealer is entitled to claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) with respect to commercial paper that it has sold with recourse and later reacquired. However, the interpretation and application of I.R.C. § 166 by the federal courts indicates that such accounts are properly treated as bad debt in the hands of the Taxpayer, both for federal income tax and Tennessee sales and use tax purposes.

Interpretations of federal tax law are generally not controlling for purposes of applying Tennessee tax law.<sup>3</sup> However, the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) presents an exception to this rule because TENN. CODE ANN. § 67-6-507(e)(2) provides that a

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<sup>3</sup> The Tennessee Court of Appeals has stated that “rulings of the federal courts in regard to federal tax laws are not binding on Tennessee courts when they are called upon to interpret Tennessee tax laws.” *Little Six Corp. v. Johnson*, 1999 WL 336308 at 3 (Tenn. Ct. App. May 28, 1999); *See also Tidwell v. Berke*, 532 S.W.2d 254, 261 (Tenn. 1975) (finding that the revision of a federal tax law does not precipitate a revised interpretation of a corresponding but unaltered state tax law).

“bad debt” is “as defined in 26 U.S.C. § 166.” Thus, whether an account is properly considered a bad debt for Tennessee sales and use tax purposes depends on whether it is a bad debt for federal income tax purposes. As explained below, for federal income tax purposes, the Taxpayer is entitled to claim the bad debt deduction with respect to accounts that it must reacquire under the recourse provisions of the Agreement. Because such accounts are considered to be bad debts for purposes of I.R.C. § 166, they are also bad debts for purposes of TENN. CODE ANN. § 67-6-507(e).

The United States Tax Court has held that no federal bad debt deduction is available when the account in question is worthless at the time of its acquisition by the party claiming the deduction. *Wilson v. CIR*, 40 T.C. 543, 550-51 (T.C. 1963) (citing *Eckert v. Burnet*, 283 U.S. 140 (1931)). However, a guarantor who acquires a debt pursuant to a contract of guaranty is in “an entirely different position from a taxpayer who voluntarily acquires a debt known by him to be worthless.” *Id.* at 551. In *Putnam v. Commissioner*, 352 U.S. 82 (1956), the United States Supreme Court held that when a guarantor makes a payment in satisfaction of a guaranteed debt, the debt is properly considered a bad debt in the hands of the guarantor for purposes of the deduction under I.R.C. § 166. As explained by the United States Court of Claims, *Putnam* holds that “once a guarantor pays his liability as such, his relationship to the defaulted debtor becomes that of a creditor, so as to provide the statutory framework for a bad debt deduction for his actual loss.” *Maryland Sav. Share Ins. Corp. v. U.S.*, 1980 WL 4700, 6 (Ct. Cl. 1980).

The United States Tax Court has held that an automobile dealer who sells a financing contract to a bank or other financing company with the express promise to reimburse the bank in the event of default for any unpaid amounts due under the contract is considered a guarantor for purposes of the bad debt deduction. *High Plains Agricultural Credit Corp. v. CIR*, 63 T.C. 118, 124 (T.C. 1974). Furthermore, a dealer who sells installment contracts at a discount to a bank with recourse is eligible to claim the deduction with respect to accounts that it must reacquire under the recourse terms of the sales agreement. *Foster Frosty Foods, Inc. v. C.I.R.*, 332 F.2d 230, 233 (10<sup>th</sup> Cir. 1964). Such a dealer is considered a guarantor because the “assignment and discounting of commercial paper with recourse is but a method of obtaining working capital and the tax concept of debt remains existent because of the continuing liability of guaranty.” *Id.* (citing *Putnam*, 352 U.S. 82).

Thus, for Tennessee sales and use tax purposes, an account with respect to which the Taxpayer reacquires an installment sales contract under the recourse terms of the Agreement is properly considered a bad debt owed to the Taxpayer.

The second requirement is satisfied because the bad debt arises from a sale on which the sales tax was paid by the Taxpayer. The Taxpayer has stated that it remits Tennessee sales tax with respect to its retail sales of motor vehicles in Tennessee.

The third and fourth requirements are satisfied because the Taxpayer is the party that wrote off the debt as uncollectible on its books and records and the Taxpayer is eligible to deduct the debt for federal income tax purposes. For the reasons explained above, the Taxpayer is eligible to deduct the debt for federal income tax purposes. Additionally, the Taxpayer has stated that when it repurchases an installment sales contract from the financing company, the Taxpayer actually does claim a deduction on its federal income tax return with respect to any such accounts that are

properly treated as worthless debts, in the amount permitted under I.R.C. § 166. For the Taxpayer to be able to claim the federal deduction, it must charge off the debt on its books and records during the taxable year in which the deduction is taken, as required by Treas. Reg. § 1.166-3.

The conclusion that a dealer is eligible to claim the bad debt deduction after the repurchase of a note is also supported by Tennessee case law. The Tennessee courts have stated that an automobile dealer cannot assign away its right to a bad debt credit or deduction when it sells a financing contract. In *SunTrust Bank, Nashville v. Johnson*, 46 S.W.3d 216 (Tenn. Ct. App. 2000), the Tennessee Court of Appeals held that a bank that purchased a retail installment sales contract from an automobile dealer was not entitled to claim a bad debt credit<sup>4</sup> when the contract became worthless. The court found that, while the automobile dealer had assigned its rights and obligations under the contract to the bank, the dealer was precluded from assigning its right to claim the tax credit related to the contract. *Id.* at 226-27. Thus, the dealer continues to hold the right to claim a potential bad debt credit or deduction even after the dealer assigns its right to collect on an account. *See id.* *See also Hollingsworth, Inc. v. Johnson*, 138 S.W.3d 863 (Tenn. Ct. App. 2003) (applying *SunTrust* to hold that the assignee of the assets of a health club operator was not entitled to claim the bad debt credit). This suggests that the dealer is eligible to claim the deduction upon reacquisition of the account under the recourse terms of a sale agreement.

Accordingly, the Taxpayer may claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires an installment sales contract under the recourse terms of the Agreement.

## 2. Amount of deduction with repurchase of contract

The amount that the Taxpayer may claim as a bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires an installment sales contract under the recourse terms of the Agreement will equal the amount claimed as a bad debt deduction on the Taxpayer's federal income tax return under I.R.C. § 166 with respect to such account, reduced by the amount of any financing charges or interest, sales or use taxes charged on the purchase price, uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid, expenses incurred in attempting to collect any debt, and the value of any repossessed property.

TENN. CODE ANN. § 67-6-507(e)(2) provides that, for purpose of calculating the deduction, a "bad debt" is "as defined in 26 U.S.C. § 166." However, TENN. CODE ANN. § 67-6-507(e)(2) further provides that the amount calculated pursuant to I.R.C. § 166 "shall be adjusted to exclude: financing charges or interest, sales or use taxes charged on the purchase price, uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid, expenses incurred in attempting to collect any debt, and repossessed

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<sup>4</sup> For periods prior to January 1, 2008, a dealer was permitted a *credit* for sales taxes paid with respect to accounts that became worthless debts. For periods beginning on or after January 1, 2008, a dealer is permitted a *deduction* for sales that have become worthless debts.

property.” Additionally, any deduction taken that is attributed to bad debts shall not include interest. TENN. CODE ANN. § 67-6-507(e)(1).

The Taxpayer has indicated that, in practice, it will repurchase the repossessed vehicle whenever it reacquires an installment sales contract under the recourse terms of the Agreement. As noted above, TENN. CODE ANN. § 67-6-507(e)(2) requires that the bad debt deduction be reduced by the value of any repossessed property. Thus, the Taxpayer must exclude such amounts from the deduction when it repurchases a repossessed vehicle from the financing company, if such amounts were not already excluded in the computation of the amount of the federal bad debt deduction under I.R.C. § 166.

### 3. Bad debt deduction with repurchase of vehicle only

The Taxpayer may not claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires only the vehicle under the recourse terms of the Agreement.

For the Taxpayer to be entitled to claim the bad debt deduction, the following requirements must be satisfied: 1) the account in question must be properly considered a bad debt owed to the Taxpayer; 2) the bad debt must arise from a sale on which the sales tax was paid; 3) the Taxpayer must be the party that wrote off the debt as uncollectible on its books and records; and 4) the Taxpayer must be eligible to deduct the debt for federal income tax purposes.

When the Taxpayer does not reacquire the account through the repurchase of the installment sales contract, the debt is not owed to the Taxpayer. Rather, the financing company continues to hold the note and is the party to whom the debt is owed.

Additionally, it is improbable that the Taxpayer is eligible to claim the bad debt deduction under I.R.C. § 166 when it repurchases only the repossessed vehicle. Treas. Reg. § 1.166-1(c) allows the federal deduction only for a bona fide debt, and states that a bona fide debt is “a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.” Under this factual scenario, it is doubtful that the repurchase of the repossessed vehicle gives rise to a bona fide debt. Pursuant to the Agreement, the repurchase price of the vehicle is the actual cash value of the vehicle under current market conditions, which are determined by the published book value. Although the payment to the financing company could potentially be considered a payment by a guarantor, and therefore a bad debt in the hands of the Taxpayer,<sup>5</sup> such payment is made in exchange for repossessed collateral, the value of which equals the amount of the payment. Thus, rather than making a guarantee payment that places it in the position of a creditor with respect to the defaulting customer, the Taxpayer has simply exchanged cash for property of equal value. The Taxpayer’s means of recovering the amount paid is by reselling the vehicle, not by enforcing an obligation against the customer. In other words, the debt is not a bona fide debt. Thus, it is unlikely that the Taxpayer is eligible to claim the bad debt deduction under I.R.C. § 166 when it repurchases only the repossessed vehicle.

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<sup>5</sup> See the discussion under the response to Question #1, above.

Accordingly, the Taxpayer may not claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires only the vehicle under the recourse terms of the Agreement.

4. Amount of deduction with repurchase of vehicle only

Because the Taxpayer may not claim the bad debt deduction under TENN. CODE ANN. § 67-6-507(e) for an account with respect to which it reacquires only the vehicle under the recourse terms of the Agreement, no response to this question is required.

Kristin Husat  
Senior Tax Counsel

APPROVED: Richard H. Roberts  
Commissioner of Revenue

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