Cite as Det. No. 14-0217, 33 WTD 623 (2014)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 14-0217
. . .	)	Registration No. . . .
And	)	
. . .	)	Registration No. . . .

[1] RULE 167; RCW 82.04.4284; RCW 82.08.037: RETAIL SALES TAX – B&O TAX – BAD DEBT DEDUCTION – BONA FIDE DEBTS. Two affiliated companies failed to prove through adequate evidence that certain transactions they entered into with other affiliated companies constituted "bona fide debts" under 26 CFR § 1.166-1(c). As such, those transactions could not qualify as bad debts under 26 U.S.C. § 166 for federal tax purposes, and, consequently, those transactions were also ineligible to form the basis for any bad debt deduction against Washington B&O tax or retail sales tax.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Yonker, A.L.J. – Two affiliated limited liability companies (Taxpayers) engage in construction services. Taxpayers protest the Department of Revenue's (Department) disallowance of bad debt deductions taken against retailing business and occupation (B&O) tax and retail sales tax. Taxpayers argue that they were eligible to claim the bad debt deductions for federal income tax purposes and, therefore, qualified for the deduction on their Washington combined excise tax returns. We disagree and deny Taxpayers' petition accordingly.[1]

ISSUES

1. Under RCW 82.04.4284, are Taxpayers entitled to a retailing business and occupation (B&O) tax deduction for bad debts?

2. Under RCW 82.08.037, are Taxpayers entitled to a retail sales tax deduction for bad debts?

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[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

FINDINGS OF FACT

[Taxpayer A] and [Taxpayer B] (referred to jointly as Taxpayers) are single-member limited liability companies, whose only member is [the Parent Company]. The Parent Company, in turn, is owned by three individuals. Taxpayer A offers construction services to commercial property owners while Taxpayer B offers construction services for residential projects, such as condominiums and townhouses. Because Taxpayers are single-member limited liability companies, the Parent Company reports all of Taxpayers' business activity in its Form 1065 federal income tax return.

Between 2006 and 2009, Taxpayer A performed construction work for eleven affiliated entities (affiliates), which were each owned by the Parent Company, or by other entities that were, in turn, owned by the Parent Company. The work Taxpayer A performed for the affiliates generated a total of $. . . in accounts receivable. Reporting on the accrual basis, Taxpayer A reported that amount of receivables, including retail sales tax, to the Department in the years in which the amounts accrued. Taxpayer A, claiming that the affiliates never paid the amounts accrued, identified the total amount as uncollectible in December 2009. Taxpayer A then claimed a bad debt deduction on its January 2010 combined excise tax return for the full $. . . . Later, Taxpayer A requested a refund for the retail sales tax amount associated with the claimed bad debts. On April 23, 2010, the Department's Taxpayer Account Administration (TAA) issued a refund of $. . . in retail sales tax to Taxpayer A "subject to future verification in the event of an audit."

Similarly, between 2006 and 2009, Taxpayer B performed residential construction work for three affiliates. The work Taxpayer B performed for the affiliates generated a total of $. . . in accounts receivable. Reporting on the accrual basis, Taxpayer B reported that amount of receivables, including retail sales tax, to the Department in the years in which the amounts accrued. Taxpayer B, claiming that the affiliates never paid the amounts owed, identified the total amount as uncollectible in December 2009. Taxpayer B then claimed a bad debt deduction on its January 2010 combined excise tax return for the full $. . . . Later, Taxpayer B requested a refund for the retail sales tax amount associated with the claimed bad debts. On April 23, 2010, TAA [issued] a refund of $. . . in retail sales tax to Taxpayer B "subject to future verification in the event of an audit."

In 2013, the Department's Audit Division conducted a review of Taxpayers' books and records for the period of January 1, 2009 through September 30, 2012 (audit period).[2] During the Audit Division's review, Taxpayers provided limited documentation, including trial balance sheets and applications for payment documents on certain transactions. During that review, the Audit Division found that Taxpayers' records did not support the bad debt deductions they claimed on their respective January 2010 combined excise tax returns, making the following observation:

> It was difficult to determine whether actual bad debts were incurred. Apart from not claiming the bad debts in the original federal returns, taxpayer was not able to provide bank statements, general ledger, sales invoices, and flow of transactions to and from affiliates to substantiate bad debts claimed to [the Department]. . . . Although each entity

[2] While we continue to refer to the audit period throughout this determination as meaning January 1, 2009 through September 30, 2012, we note that Taxpayer B ceased operations on December 31, 2010, and the time period for which the Audit Division reviewed Taxpayer B's records was only January 1, 2009 through June 30, 2010.

> was established as a separate entity [the Parent Company] acts as a central banker for all of its wholly owned entities; this means only one cash account is used to facilitate cash movement from one affiliate to another. Movement of money between affiliates was a challenge to monitor.[3]

Taxpayer did not provide the Audit Division with any documentation demonstrating that the amounts at issue were never paid by the affiliates. The Audit Division also found that the Parent Company had not claimed bad debt deductions in either the 2009 or 2010 federal income tax returns.

The Audit Division disallowed the bad debt deductions Taxpayers claimed on their respective January 2010 combined excise tax returns, finding that there was no evidence that Taxpayers were eligible to claim bad debt deductions in that year. The Audit Division likewise found Taxpayers were not entitled to bad debt deductions for the amounts they designated as uncollectible in 2009.

On March 28, 2013, based on the results of the Audit Division's review, the Department issued a tax assessment against Taxpayer A for a total of $. . . , which included $. . . in retail sales tax, $. . . in retailing B&O tax, an $. . . five percent assessment penalty, and $. . . in interest.

Also on March 28, 2013, based on the results of the Audit Division's review, the Department issued a tax assessment against Taxpayer B for a total of $. . . , which included $. . . in retail sales tax, $. . . in retailing B&O tax, a $. . . five percent assessment penalty, and $. . . interest.

Subsequently, the Audit Division discovered that an error in the amount of the tax assessment issued for Taxpayer B. As a result, on June 2, 2014, the Department issued a post assessment adjustment (PAA) for Taxpayer B, adjusting the total amount of Taxpayer B's tax assessment to $. . . , which included $. . . in retail sales tax, $. . . in retailing B&O tax, a $. . . five percent assessment penalty, $. . . in original interest, and $. . . in extension interest.

Taxpayers appealed the full amount of their tax assessments, arguing that the amounts at issue constituted debts that were worthless.[4] On appeal, Taxpayers provided some additional documentation. Specifically, Taxpayers represented that on April 17, 2013, the Parent Company amended its 2009 federal income tax return, claiming a bad debt deduction of $. . . on behalf of Taxpayer A and claiming a bad debt deduction of $. . . on behalf of Taxpayer B, and increasing gross income by the same amounts. The Parent Company provided the following explanation for its amendment to its 2009 federal income tax return:

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[3] In response, Taxpayers explained the Parent Company's decision to have one single bank account for all of its affiliates, including Taxpayers, as follows:

> To reduce administrative complexity, [the Parent Company] acts as a central banker for all of its wholly owned entities; the amounts owed to each entity are tracked using an intercompany payable account. As [Taxpayers] performed the . . . construction contracts, [they] accrued income that gave rise to receivables. These receivables were maintained in [Taxpayers'] "bank account" with [the Parent Company] and were therefore reflected on [Taxpayers'] books as *negative payables* in the intercompany payable account.

[4] Taxpayers offered arguments and evidence related only to the underlying tax liability on their respective tax assessments. Taxpayers offered no arguments or evidence specifically related to the penalties or interest imposed. As such, we do not independently address penalties or interest in this determination.

> This second amendment correctly classifies bad debt expense which had inadvertently been included in gross revenue. The adjustments were made to [Taxpayer B] and [Taxpayer A] in the amounts of $. . . and $. . . respectively. The overall effect of taxable income as a result of these reclassifications is $0.

Taxpayers explained that because the Parent Company originally adjusted the gross income amounts to take the bad debt amounts into account, when the Parent Company amended its federal income tax returns, it added those amounts of bad debts back into the gross income amounts for 2009 for both Taxpayers and then claimed a corresponding bad debt deduction in the amended federal income tax return. [5]

In addition, Taxpayers provided evidence establishing the following facts on appeal:

- Six of the thirteen affiliates for whom Taxpayers completed work filed for bankruptcy between 2010 and 2012. Those affiliates did not identify the amounts due to Taxpayers as debts in those bankruptcy cases. Taxpayers did not make claims against the affiliates for any of the amounts at issue.
- Five of the thirteen affiliates for whom Taxpayers completed work had property that was subject to either receivership or trustee sales between 2009 and 2012.

Taxpayers did not provide any bank statements or other evidence documenting the flow of cash between Taxpayers and the other affiliates.

ANALYSIS

RCW 82.04.4284 states the following:

> In computing tax there may be deducted from the measure of tax bad debts, as that term is used in 26 U.S.C. Sec. 166, as amended or renumbered as of January 1, 2003, on which tax was previously paid.

RCW 82.08.037(1) allows a similar bad debt deduction for retail sales tax previously paid.[6] WAC 458-20-196 (Rule 196) is the administrative rule implementing the statutes providing for the deduction of bad debts for both retail sales tax and B&O tax. Rule 196(1)(c) states that "Washington credits, refunds, and deductions for bad debts are based on federal standards of worthlessness under section 166 of the Internal Revenue Code." Rule 196(2)(a) states the following regarding the bad debt deduction for retail sales tax:

> Under RCW 82.08.037 . . . , sellers are entitled to a credit or refund for [retail sales tax] previously paid on "bad debts" under section 166 of the Internal Revenue Code . . . .

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[5] We note that the gross income amounts the Parent Company reported on its amended 2009 federal income tax return for Taxpayers is significantly . . . [higher than] the amounts Taxpayers reported on their 2009 combined excise tax returns. For instance, Taxpayer A reported $. . . in gross income on its 2009 combined excise tax returns compared to $. . . reported on the federal income tax return. Likewise, Taxpayer B reported $. . . in gross income on its 2009 combined excise tax returns compared to $. . . reported on the income tax return.

[6] [The Legislature amended RCW 82.08.037 in 2010, but the amendments do not affect the issues addressed in this appeal. *See* Laws of 2010, 1st Spec. Sess., ch. 23, § 1502."]

> Taxpayers may claim the credit or refund for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes.[7]

Similarly, Rule 196(3)(a) states the following regarding the bad debt deduction for B&O tax:

> Under RCW 82.04.4284, taxpayers may deduct from the measure of B&O tax "bad debts" under section 166 of the Internal Revenue Code . . . , on which tax was previously paid. Taxpayers may claim the deduction for the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes.

Thus, Taxpayers' eligibility for claiming bad debt deductions on their Washington combined excise tax returns is dependent on their eligibility to claim a bad debt deduction under Section 166 of the Internal Revenue Code. *See Home Depot USA, Inc. v. Dep't of Revenue*, 151 Wn. App. 909, 920-22, 215 P.3d 222 (2009) (analyzing a Washington taxpayer's ability to claim the bad debt deduction on its Washington combined excise tax return using both state and federal laws, regulations, and court decisions). We, therefore, must determine if Taxpayers were eligible to take such deductions for federal income tax purposes based on relevant federal laws, regulations, and court decisions dealing with Section 166. *See Sauve v. K.C., Inc.*, 19 Wn. App. 659, 665, 577 P.2d 599 (1978) ("When a state borrows federal legislation it also borrows the construction placed upon such legislation by the federal courts").

Additionally, we note that every taxpayer is required to "keep and preserve, for a period of five years, suitable records as may be necessary to determine the amount of tax for which he may be liable . . . ." RCW 82.32.070. *See also* RCW 82.32A.030 (taxpayers must "[k]eep accurate and complete business records"). WAC 458-20-254 (Rule 254) sets forth specific requirements for a taxpayer to maintain and disclose books, records, and other sources of financial information to the Department. Rule 254(3)(b) states in relevant part:

> (b) It is the duty of each taxpayer to prepare and preserve all records in a systematic manner conforming to accepted accounting methods and procedures. Such records are to be kept, preserved, and presented upon request of the department or its authorized representatives which will demonstrate:
>
> . . .
>
> (ii) The **amounts of all deductions**, exemptions, or credits claimed **through supporting records or documentation required by statute or administrative rule, or other supporting records or documentation necessary to substantiate the deduction**, exemption, or credit.

Rule 254(3)(b) (emphasis added).

[7] Although Rule 196(2)(a) speaks in terms of a "credit" or "refund" for retail sales tax, Rule 196(1)(b) states that "[g]enerally, a retail sales tax credit for bad debts is reported as a deduction from the measure of sales tax on the excise tax return." Thus, a taxpayer may claim a bad debt "deduction" for retail sales tax.

1. Bad Debt Deduction for 2010

Both Rule 196(2)(a), regarding retail sales tax, and Rule 196(3)(a), regarding B&O tax, discussed above, state that taxpayers may claim a bad debt deduction "**for the tax reporting period in which the bad debt is written off as uncollectible** in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purpose." (Emphasis added).

Taxpayers concede that they wrote off the amounts at issue as uncollectible in December 2009, but did not claim the bad debt deductions on their respective December 2009 combined excise tax returns. Instead, they claimed the bad debt deductions in their January 2010 combined excise tax returns. There is no evidence that Taxpayers wrote off any debts as uncollectible in 2010, or that they were otherwise eligible to claim bad debt deductions for federal income tax purposes for that tax year. As such, we conclude that the Audit Division correctly disallowed the bad debt deductions Taxpayers claimed on their January 2010 combined excise tax returns because they did not write off any debt as uncollectible in 2010, and, therefore, were ineligible to claim bad debt deductions for that tax period under Rule 196.

2. Bad Debt Deduction for 2009

Taxpayers argued during the Audit Division's review, and on appeal, that despite their error in claiming the bad debt deductions on their respective January 2010 combined excise tax returns, Taxpayers were eligible to claim the bad debt deductions for 2009, when Taxpayers wrote off the debts. Tax benefits such as the bad debt deductions allowed under RCW 82.04.4284 and RCW 82.08.037, and all other deductions, exemptions, and credits, must be strictly construed, though fairly, and in keeping with the ordinary meaning of their language, against the taxpayer. *See, e.g., Budget Rent-a-Car, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 500 P.2d 764 (1972); *Group Heath Coop. v. Tax Comm'n*, 72 Wn.2d 422, 429, 433 P.2d 201 (1967); Det. No. 07-0034E, 26 WTD 212 (2007). "The burden of showing qualification for the tax benefit afforded . . . rests with the taxpayer." *Group Health*, 72 Wn.2d at 429. Thus, Taxpayers must prove they are entitled to the bad debt deductions.

The only issue in dispute here is whether Taxpayers were eligible to claim the bad debt deductions for federal income tax purposes, which is required for claiming the bad debt deduction on Taxpayers' combined excise tax returns in Washington. RCW 82.04.4284; RCW 82.08.037; Rule 196(2)(a) and (3)(a); . . . . The Audit Division disallowed Taxpayers' claimed bad debt deductions because there was no evidence that Taxpayers were eligible to claim the bad debt deductions on their federal income tax return. *See Home Depot USA*, 151 Wn. App. at 22 (holding that a Washington Taxpayer no longer held any "debt" as defined by Section 166 of the Internal Revenue Code, and, therefore, could not claim the bad debt deduction on its Washington combined excise tax return).

In response to the Audit Division's finding, Taxpayers' Parent Company amended its consolidated federal income tax return for 2009, claiming the bad debt deductions at issue on Taxpayers' behalf. Taxpayers argued on appeal that "[b]y filing this return – under penalty of perjury – with the federal government," this act is sufficient to prove they were eligible for the deduction under Section 166. We disagree. Rule 196(2)(a) and (3)(a) clearly state that Taxpayers may claim the deduction "for the tax reporting period in which the bad debt . . . would be **eligible** for a bad debt deduction for federal income tax purposes." (Emphasis added). We decline to equate "claiming" the deduction with being "eligible" for the deduction. Thus, regardless of whether the Parent Company actually claimed bad debt deductions on its federal income tax return, Taxpayers must still prove that they were actually eligible to claim that bad debt deduction under Section 166 based on the relevant federal standards. *See* Rule 196(1)(c).[8]

26 U.S.C. § 166 provides for a bad debt deduction for federal income tax purposes, stating that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year." As such, to qualify for this deduction, a taxpayer must satisfy two essential elements. First, a taxpayer must show the existence of a "bona fide debt." 26 CFR § 1.166-1(c). Second, if there is such a "bona fide debt," a taxpayer must also prove that such debt is "worthless." 26 CFR § 1.166-2.

A. Bona Fide Debt

26 CFR § 1.166-1(c) explains the "bona fide debt" requirement as follows:

> Only a bona fide debt qualifies for purposes of section 166. 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. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.[9]

Federal courts determine whether a purported debt is a "bona fide debt" from the facts and circumstances of each individual case. *Lundgren v. Comm'r*, 376 F.2d 623, 626 (9th Cir. 1967). We note that under federal standards, taxpayers bear the burden of proving "debt." *Hubert Enterprises, Inc v. Comm'r*, 125 T.C. No. 6, 125 T.C. 72, 91 (2005) (citing *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 630 (6th Cir. 1986)).

Additionally, where, as here, the parties to the transactions at issue are related or affiliated entities with common ownership, federal courts scrutinize carefully those transactions before determining that they, in fact, constitute "bona fide debts":

> Transfers between related parties are examined with special scrutiny. A transfer's economic substance prevails over its form, and a finding of economic substance turns on whether the transfer would have followed the same form had it been between the

[8] [. . . .]

[9] Taxpayers argued on appeal that, according to the third sentence of 26 CFR § 1.166-1(c), "'[d]ebts' include the receivables of an accrual method taxpayer to the extent the income giving rise to such receivables has been reported on the taxpayer's federal income tax returns." We do not agree with Taxpayers that 26 CFR § 1.166-1(c) defines "debts" in this manner. Instead, we read the third sentence to simply contemplate that receivables can give rise to an "enforceable obligation," and, in turn, can be a "bona fide debt." However, a close reading of that sentence reveals that, like all taxpayers, those that claim a bad debt deduction based on receivables must be able to demonstrate that such receivables are based on an actual "debt." *See Dell v. Comm'r*, T.C. Memo. 1995-315, 1995 WL 421262 (U.S. Tax Ct.) (stating that the third sentence of 26 CFR § 1.166-1(c) "is concerned only with a *bona fide debt*" and "there is nothing in the regulation to suggest that the same result would follow if there were *no debt at all*" (emphasis in original)).

> transferee and an independent lender. **The more a transfer appears to result from an arm's-length transaction, the more likely the transfer will be considered debt**. The subjective intent of the parties to a transfer that the transfer create debt does not override an objectively indicated intent to the contrary.

Hubert Enterprises, Inc v. Comm'r, 125 T.C. No. 6, 125 T.C. 72 (2005) (internal citations omitted; emphasis added).

As a threshold matter, any analysis of whether a transaction constitutes a "bona fide debt" must include a determination that there is an actual "debt." While it may often be the case that such a determination does not require significant discussion, we conclude that determination to be pivotal here, especially given the heightened scrutiny required in cases involving related entities. Here, we conclude, for a number of reasons, that Taxpayer has not adequately proven the existence of any debts.

First, while the applications for payment offered by Taxpayers as proof of the debts in question indicate the amount Taxpayers charged the affiliates, the applications for payment do not prove that the charges were not subsequently paid. Further, because Taxpayers did not provide their books or bank statements, there is no way to tie the applications for payment to Taxpayers' respective accounts receivables, or to specifically determine that the amounts in the applications for payment were actually included in Taxpayers' receivables they reported to the Department.

Second, in the six bankruptcy cases filed by affiliates who purportedly owed debts to Taxpayers, none of those affiliates identified the amounts at issue as "debts" in their respective bankruptcy proceedings. This suggests that the purported debts were not considered "debts" by the affiliates, or that the affiliates paid the amounts at issue to Taxpayers or some other form of discharge of the debt occurred prior to the commencement of the various bankruptcy actions.

Third, there is no evidence that Taxpayers made actual attempts to collect the amounts identified in the applications for payment, which suggests that Taxpayers may not have expected the affiliates to pay these amounts back. This absence of collection efforts again suggests that the purported debts were not considered "debts" by Taxpayers, or that the affiliates paid the amounts at issue.

Finally, of particular concern in this case is the fact that Taxpayers and their affiliates all shared one bank account. As the Audit Division pointed out, Taxpayers' close relationship with the affiliates made it very "challenging" to determine whether the purported debts were unpaid in the first place. Generally, a taxpayer may effectively prove that it has not received payment on a debt by providing bank statements. However, here, the parties on both sides of the transactions at issue share one bank account. Thus, even if Taxpayers produced bank records, the flow of money between Taxpayers and their affiliates would likely require additional documentary evidence to reconcile. In short, Taxpayers have failed to prove with adequate evidence that the amounts at issue were actual debts and were not paid at some point by the affiliates.[10]

[10] Indeed, Taxpayers explained on appeal that any amounts due to them from the affiliates were recorded in their accounting records of the common bank account, not as receivables, but as "negative payables." Such a treatment of the amounts at issue further suggests that even the bank records, which have not been produced, do not treat these amounts as debts.

On the whole, given the close relationship between Taxpayers and the affiliates, and the lack of documentation to demonstrate that the amounts at issue were actual debts as of December, 2009, and went unpaid, we conclude that Taxpayers failed to prove that those transactions gave rise to "bona fide debts" under Section 166.

B. Worthlessness

On appeal, Taxpayer provided documentation establishing that many of the affiliates at issue commenced bankruptcy actions or lost their assets through foreclosure or receivership in 2009 or sometime thereafter. Because we concluded above that Taxpayers failed to prove that the amounts at issue were "debts," and, therefore, failed to prove the amounts at issue were "bona fide debts," we need not make any determination as to the worthlessness of those amounts.

We conclude that the Audit Division correctly disallowed the bad debt deductions Taxpayers claimed against both retailing B&O tax and retail sales tax on their respective excise tax returns. For Taxpayer A, we affirm the tax assessment as originally issued. For Taxpayer B, we affirm the tax assessment as reflected in the PAA.

DECISION AND DISPOSITION

Taxpayer A's petition is denied.

Taxpayer B's petition is denied.

Dated this 9th day of July, 2014.