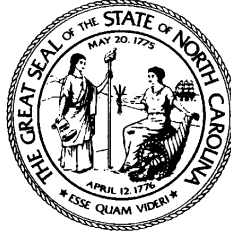

North Carolina Department of Revenue



DIRECTIVE

Subject: Worthless Accounts/Bad Debts
Tax: Sales and Use Tax
Law: G.S. 105-164.13(15)
Issued By: Sales and Use Tax Division
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This Directive explains the deduction from gross retail sales allowable for worthless accounts upon which the sales and use tax has been previously paid that are charged off for income tax purposes. The Directive sets out the current treatment of such worthless accounts and clarifies the timing of when bad debts may be deducted from gross receipts.

Section I. The Law

G. S. 105-164.13(15) provides that:

Accounts of purchasers, representing taxable sales, on which the tax imposed by this Article has been paid, that are found to be worthless and actually charged off for income tax purposes may, at corresponding periods, be deducted from gross sales. In the case of a municipality that sells electricity, the account may be deducted if it meets all the conditions for charge-off that would apply if the municipality were subject to income tax. Any accounts deducted pursuant to this subdivision must be added to gross sales if afterwards collected.

Section II. Worthless Accounts (Bad Debts)

In reporting sales and use taxes on an accrual basis, accounts of purchasers representing taxable sales on which the tax has been paid may be determined to be worthless and will actually be charged off for income tax purposes as "bad debts." The term "bad debts" will bear the same meaning as defined by 26 U.S.C. Sec.166, but shall exclude finance charges or interest, sales and use taxes charged on the sales or purchase price, amounts that cannot be collected on property that remains in the possession of the seller until the purchase price is paid, expenses incurred in attempting to collect a debt, and repossessed property. The amount charged off representing taxable retail sales may, during corresponding periods, be deducted from gross taxable sales provided the vendor maintains records disclosing separately the portion of bad debts representing taxable sales and the portion representing nontaxable sales. The amount of any deduction taken that is attributable to bad debts shall not include accrued interest. 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

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paid and reported on the sales and use tax return filed for the period in which the collection occurs. For purposes of reporting collection of the bad debt subsequent to having charged off and deducted such bad debt, any payments on the debt shall be applied first proportionally to the taxable price of the property or service, and secondly to interest, service charges, and any other charges.

Section III. When Bad Debts are Deductible

In order for a worthless account to be “charged off for income tax purposes,” the account must be written off as uncollectible on the claimant’s books and records. If the charge-off is not made until the income tax return is filed, the bad debt should generally be deducted within one month of the date the income tax return reflecting the bad debt is filed. If the charge-off is made during the income tax year, the deduction of the bad debt should be taken for the period in which the charge-off occurs. A taxpayer is required to make the deduction for sales and use tax purposes within three (3) years of charging off an account for income tax purposes. If a taxpayer fails to deduct a bad debt for sales and use tax purposes within three years of the date the bad debt is deducted for income tax purposes, the deduction from taxable gross receipts is not allowable.

A taxpayer who is not required to file income tax returns may deduct a bad debt on a return filed for the period in which the bad debt is charged off in its books and records as uncollectible and would otherwise be eligible for a bad debt deduction for income tax purposes if the taxpayer were required to file income tax returns. In this instance, the taxpayer is required to make the deduction for sales and use tax purposes within three (3) years of the date the account is recognized and finally expensed as a bad debt in its books and records.

Section IV. Refund Provisions

When the amount of the bad debt deduction exceeds the amount of taxable sales and the tax due is a credit (negative) balance on the sales and use tax return, a refund claim may be filed within the statute of limitations for filing refund claims. The claim must be filed within three years of the date the bad debt becomes eligible for deduction from gross retail sales on the sales and use tax return.

Section V. Certified Service Providers

If filing responsibilities are assumed by a Certified Service Provider (CSP) who files returns and remits sales and use tax on behalf of a seller/taxpayer, the CSP may claim any bad debts that would ordinarily be claimed by the seller/taxpayer in accordance with the above procedures. The CSP must issue a credit or refund for the tax paid on the bad debt to the seller/taxpayer before deducting the bad debt from gross retail sales or filing a refund claim based on a return bearing a credit (negative) balance of tax due.

Questions about this Directive may be directed to the Taxpayer Assistance Division of the North Carolina Department of Revenue, P. O. Box 1168, Raleigh, N. C. 27602 or by telephone toll free to (877) 252-3052.