

New York State Department of Taxation and Finance
Office of Counsel
Advisory Opinion Unit

TSB-A-13(3)S
Sales Tax
January 8, 2013

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S110826B

The Department of Taxation and Finance received a Petition for Advisory Opinion from Petitioner, [REDACTED]. Petitioner inquires as to the sales tax implications of a recovery on a bad debt in regard to a taxable sale. We conclude that where Petitioner enters into a true lease of taxable equipment, the lessee defaults, and Petitioner eventually wins a court judgment against the lessee for a portion of the amount due under the lease, any collection of the judgment would be taxable. We also conclude that Petitioner's subsequent recovery of a part of a bad debt involving a taxable sale would not be subject to sales tax if Petitioner never received any bad debt credit or refund in regard to that bad debt.

Facts

Petitioner is an equipment lease finance company that uses both true leases and financing leases to make its sales. The equipment that is the subject of this petition does not include any property that would be subject to the acceleration provisions in Tax Law section 1111(i). When Petitioner makes an outright sale of equipment (i.e., title transfers to the purchaser at the outset of the contract), but provides financing, it enters into a financing lease with the purchaser. The financing lease functions as a security agreement for purposes of the Uniform Commercial Code. A true lease is a sale in which Petitioner retains title to the property, but allows the lessee to have possession of the property in return for a series of rental payments. Petitioner asks about the taxability of recoveries made on accounts under two different scenarios where the lessee defaults and the account has been written off for purposes of general accounting principles and Federal income tax purposes.

Under Scenario 1, Petitioner enters into a 60-month equipment lease that is a true lease. Petitioner collects sales tax on each monthly payment. The lease provides that, in the case of the lessee's default, Petitioner can require the lessee to pay all accrued and unpaid balance, as well as "all unpaid future balance of this Agreement." Prior to the end of the term of the contract, the lessee defaults. Petitioner obtains possession of the equipment and sells it to an unrelated third-party, charging the applicable sales tax. Application of the sale proceeds to the lessee's account results in a net deficiency balance of \$55,000. Petitioner charges the debt off as bad debt in accordance with generally accepted accounting principles, but does not claim any bad debt deduction for New York sales tax purposes. Petitioner is awarded \$20,000 as a final judgment from litigation in regard to the bad debt. Alternatively, it receives \$10,000 from a third party guarantor in regard to the debt.

Under Scenario 2, Petitioner enters into a 60-month financing lease for equipment. Petitioner charges sales tax on the total cost of the equipment that was financed. The purchaser eventually defaults, Petitioner regains the equipment, and sells it to an unrelated third party, charging the applicable sales tax. Application of the sale proceeds leaves a net deficiency balance of \$25,000 on the financing lease. That balance is charged off to bad debt in accordance with generally accepted accounting principles. No refund request or credit is taken for the uncollected portion of the up-front sales tax that was financed into the contract.

Analysis

The Tax Law imposes sales and use tax on retail sales of tangible personal property and the sale, except for resale, of certain services (*see* Tax Law § 1105[a], [c]). The term “sale,” as used in article 28, includes “[a]ny transfer of title or possession or both, exchange or barter, rental, lease or license to use or consume, conditional or otherwise” (Tax Law § 1101[b][5]). Section 526.7(c) (1) of the Sales and Use Tax Regulations provides that: “[t]he terms rental, lease, license to use refer to all transactions in which there is a transfer of possession of tangible personal property without a transfer of title to the property. Whether a transaction is a ‘sale’ or a ‘rental, lease or license to use’ shall be determined in accordance with the provisions of the agreement.” The Regulations recognize that a contract denominated as a lease of tangible personal property may in fact represent a security agreement (*see* 20 NYCRR § 526.7[c][3]).

Because the sales tax is a transaction tax, liability for the tax occurs at the time of the transaction (*see* 20 NYCRR § 525.2[a][2]). In the case of a lease, the tax is imposed on each rental payment at the time paid, regardless of the date of the agreement (*see Matter of Petrolane N.E. Gas Service v. State Tax Commn.*, 79 AD2d 104 [3d Dept 1981]).

Petitioner inquires about the sales tax consequences of making recoveries on a bad debt account in two different scenarios.

In Scenario 1, Petitioner leases equipment under a true lease, which is for 60 months. Petitioner collects sales tax on each payment. The lessee defaults. Petitioner recovers the property and sells it, leaving a net deficiency balance of \$55,000. The lease provides that, in the case of the lessee’s default, Petitioner can require the lessee to pay all accrued and unpaid balances, as well as “the unpaid future balance of this Agreement.” Subsequently, Petitioner obtains a \$20,000 judgment against the lessee. Any part of the \$20,000 judgment that Petitioner collects is subject to sales and use tax because it represents payment for a liability that resulted under a lease in which Petitioner transferred possession of tangible personal property to the lessee for a consideration (*see* Tax Law §§ 1101[b][5]; 1105[a]; 20 NYCRR § 541.9[c][1][c]; TSB-A-2004[1]S). Similarly, if, as Petitioner alternatively posits, it is paid \$10,000 from a guarantor on the lease as a result of the lessee’s default, that payment would also constitute a taxable receipt, notwithstanding that it comes from a third-party and not the lessee (*see* 20 NYCRR § 526.5[c][when a vendor is tendered a manufacturer’s coupon in partial payment for a taxable purchase, the amount of the manufacturer’s coupon is included in the vendor’s taxable receipts]).

In Scenario 2, Petitioner makes an outright sale of equipment under a financing lease. After it has collected and remitted the appropriate sales tax, the purchaser defaults. Petitioner eventually writes off the account as a bad debt, but does not obtain a bad debt credit or refund from the Department. Petitioner obtains a court judgment as damages for the purchaser's breach of the financing lease. No part of the judgment is subject to sales tax because Petitioner has already collected and remitted the full amount of the sales tax due in relation to the purchase of the equipment under the financing lease. The result would be the same if, alternatively, Petitioner received a \$2,000 payment from a third-party guarantor.

DATED: January 8, 2013

/S/

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NOTE: An Advisory Opinion is issued at the request of a person or entity. It is limited to the facts set forth therein and is binding on the Department only with respect to the person or entity to whom it is issued and only if the person or entity fully and accurately describes all relevant facts. An Advisory Opinion is based on the law, regulations, and Department policies in effect as of the date the Opinion is issued or for the specific time period at issue in the Opinion. The information provided in this document does not cover every situation and is not intended to replace the law or change its meaning.