
State of South Carolina
Department of Revenue
301 Gervais Street, P. O. Box 12265, Columbia, South Carolina 29211
Website Address: <http://www.sctax.org>

SC PRIVATE LETTER RULING #12-3

SUBJECT: Sales Tax on Amounts Recovered through Litigation or Guarantor
Payments
(Sales Tax)

REFERENCES: S.C. Code Ann. Section 12-36-2560 (2000)
S.C. Code Ann. Section 12-36-910(A) (2000)
S.C. Code Ann. Section 12-36-1110 (Supp. 2011)
S.C. Code Ann. Section 12-36-1310(A) (2000)
S.C. Code Ann. Section 12-36-100 (2000)
S.C. Code Ann. Section 12-36-90 (2000 and Supp. 2011)
S.C. Code Ann. Section 12-36-130 (Supp. 2011)

AUTHORITY: S. C. Code Ann. Section 12-4-320 (2000)
S. C. Code Ann. Section 1-23-10(4) (2005)
SC Revenue Procedure #09-3

SCOPE: A Private Letter Ruling is an advisory opinion issued to a specific taxpayer by the Department to apply principles of law to a specific set of facts or a particular tax situation. It is the Department's opinion limited to the specific facts set forth, and is binding on agency personnel only with respect to the person to whom it was issued and only until superseded or modified by a change in statute, regulation, court decision, or another Departmental advisory opinion, providing the representations made in the request reflect an accurate statement of the material facts and the transaction was carried out as proposed.

Questions:

1. Are compensatory damages recovered by MNO, Inc. through litigation for breach of a lease contract, as described in the facts, subject to sales and use tax?
2. Are amounts recovered by MNO, Inc. from a third party guarantor of a lease contract after the lessee defaults, as described in the facts, subject to sales and use tax?

Conclusions:

1. Compensatory damages recovered by MNO, Inc. through litigation for a breach of contract, as described in the facts, are subject to the sales and use tax unless the lease contract is otherwise exempt from the tax.

2. Amounts recovered by MNO, Inc. from a third party guarantor of a lease contract, as described in the facts, are subject to the sales and use tax unless the lease contract is otherwise exempt from the tax.

Facts:

MNO, Inc. submitted the following two fact situations which each pose two sales tax issues:

Situation 1. Parties enter into a 60-month fair market value lease contract which is non-cancellable and irrevocable. The sales tax is paid to the Department based on each monthly lease charge. The lessee defaults on the lease prior to the end of the contract term leaving a deficiency balance of \$55,000 which is charged off as a bad debt in accordance with generally accepted accounting principles. Following the default, one or both of the following occur:

- (A) The lessor brings legal action against the lessee and as a result of litigation receives a final judgment of \$20,000 which is paid by the lessee.
- (B) The lease has been signed by a third party guarantor. That guarantor pays \$10,000 to the lessor.

Situation 2. Parties enter into a 60-month capital/finance lease agreement which is non-cancellable and irrevocable. The sales tax is paid to the Department of Revenue based on each monthly lease charge in accordance with Code Section 12-36-2560.¹ The lessee defaults on the lease prior to the end of the contract term leaving a deficiency balance of \$55,000 which is charged off as a bad debt in accordance with generally accepted accounting principles. Following the default, one or both of the following occur:

- (A) The lessor brings legal action against the lessee and as a result of litigation receives a final judgment of \$20,000 which is paid by the lessee.
- (B) The finance lease agreement has been signed by a third party guarantor and that guarantor pays \$10,000 to the lessor.

Discussion:

Code Section 12-36-910(A) imposes “a sales tax, equal to [six]² of the gross proceeds of sales, ... upon every person engaged ... within this State in the business of selling tangible personal property at retail.”

Code Section 12-36-1310(A) imposes a use tax “on the storage, use, or other consumption in this State of tangible personal property purchased at retail for storage, use, or other consumption in this State, at the rate of [six] percent of the sales price of the property, regardless of whether the retailer is or is not engaged in business in this State.

¹ A retailer can elect to pay sales tax on each payment provided the sale is made on an installment basis which conforms to the provisions of the Uniform Commercial Code in which the retailer takes a security interest. Code Section 12-36-2560.

² Code Section 12-36-1110 increased the general sales and use tax rate by 1% from 5% to 6%.

Code Section 12-36-100 defines a sale, in part, to mean “any transfer, exchange, or barter, conditional or otherwise, of tangible personal property for a consideration including ... a rental, lease, or other form of agreement....”

Situation 1 involves leasing tangible personal property. Situation 2 involves a capital lease in which the tangible personal property is purchased through a financing agreement. Since South Carolina imposes the sales and use tax on both leases of tangible personal property and sales of tangible personal property under financing agreements, for purposes of the questions presented, the answers and legal analysis for Situation 1 and Situation 2 are the same.

The first issue in each situation is whether amount received from the lessee as a payment of a judgment from litigation is subject to sales and use tax. The second issue in each situation is whether amount received from a third party guarantor after the default of the lessee is subject to sales and use tax. The legal authority and analysis for both of these issues is the same.

Under Code Section 12-36-910 the sales tax is computed based on “the gross proceeds of sales.” Code Section 12-36-90 defines the term “gross proceeds of sales,” in part, as:

Gross proceeds of sales, or any similar term, means the value proceeding or accruing from the sale, lease, or rental of tangible personal property.

Under Code Section 12-36-1310, the use tax is computed based on the sales price of tangible personal property. The term “sales price” is defined in Code Section 12-36-130, in part, as:

...the total amount for which tangible personal property is sold, without any deduction for the cost of the property sold, the cost of the materials used, labor or service cost, interest paid, losses, or any other expenses....

In *Meyers Arnold v. South Carolina Tax Commission*, 285 S.C. 303, 328 S.E.2d 920 (1985), the Court of Appeals, in interpreting the definition of “gross proceeds of sales” with respect to lay-away fees paid in conjunction with lay-away sales, held:

Section 12-35-30 [now Section 12-36-90] defines gross proceeds of sales as “the value proceeding or accruing from the sale of tangible personal property ... without any deduction for service costs.” But for the lay away sales, Meyers Arnold would not receive the lay away fees. The fees are obviously charged for the services rendered in making lay away sales. For these reasons, this court holds the lay away fees are part of the gross proceeds of sales and subject to the sales the tax.

Applying the test in *Meyers Arnold* to the current fact situation, but for the lease agreement, the lessor would not have received the judgment as a result of litigation or the third party guarantor payment. As a result, under the *Meyers Arnold* test, compensatory damages received as a result of litigation and payments from a third party guarantor as a result of the failure of the lessee to make lease payments would be part of the gross proceeds that are derived from the lease agreement.

The Department has also addressed issues similar to the one presented in this ruling request. In Private Letter Ruling #88-5 the Department found that lease cancellation fees are subject to the sales tax. In Private Letter Ruling #88-5, the lessee returned equipment to the lessor before the end of the lease term. The lessor had the option to hold the lessee to the terms of the lease, release the lessee from the lease, or release the lessee from the lease upon payment of a cancellation fee. The amount of the cancellation fee was within the discretion of the lessor. Upon payment of the cancellation fee the lease was cancelled and the lessee was relieved of future payments. The issue in this private letter ruling was whether the cancellation fee was subject to sales tax. Citing, in part, *Meyers Arnold*, the private letter ruling concludes that amounts paid by a lessee to obtain cancellation of the lease are gross proceeds of sales and subject to the State's sales and use tax.

Similarly, in Commission Decision S-D-92, the Department found that the face value of a note payable received by a retailer in settlement of amounts due on lease agreements that were broken by the lessee were taxable proceeds of sale subject to the sales tax.

In both fact situations presented in this ruling, the proceeds received from litigation (\$20,000) and from the third party guarantor (\$10,000) are considered part of the gross proceeds of sale or sales price and subject to the sales and use tax, unless the lease contract is otherwise exempt under the tax.³

SOUTH CAROLINA DEPARTMENT OF REVENUE

s/James F. Etter

James F. Etter, Director

June 22, 2012
Columbia, South Carolina

³ This conclusion is also consistent with the bad debt provision in Code Section 12-36-90(2)(h) which provides that gross proceeds of sale does not include:

[T]he sales price, not including sales tax, of property on sales which are actually charged off as bad debts or uncollectible accounts for state income tax purposes. A taxpayer who pays the tax on the unpaid balance of an account which has been found to be worthless and is actually charged off for state income tax purposes may take a deduction for the sales price charged off as a bad debt or uncollectible account on a return filed pursuant to this chapter, except that if an amount charged off is later paid in whole or in part to the taxpayer, the amount paid must be included in the first return filed after the collection and the tax paid. (Emphasis Added).