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IN THE SUPREME COURT
OF THE STATE OF WASHINGTON

Supreme Court No. 96383-5

(Court of Appeals No. 50080-9-II)

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LOWE'S HOME CENTERS, LLC

Petitioner

v.

DEPARTMENT OF REVENUE, STATE OF WASHINGTON

Respondent

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# REPLY TO ANSWER TO PETITION FOR REVIEW OF LOWE'S HOME CENTERS, LLC

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## TABLE OF CONTENTS

**PAGE**

I. INTRODUCTION .......... 1

II. ARGUMENT ON ISSUES RAISED IN ANSWER TO PETITION FOR REVIEW .......... 4

A. Section 320.C of the Streamlined Sales and Use Tax Agreement Does Not Impose a Write-Off Requirement .......... 4

B. The Department Focuses on Distinguishable Cases from Two SSUTA Member States While Ignoring Persuasive Authority from Oklahoma, Another SSUTA Member State .......... 6

C. The 2010 Amendment to the Bad Debt Statute – Enacted After the End of the Assessment Period – Does Not Suggest a Legislative Intent to Adopt a Blanket Prohibition .......... 10

D. The Failed 2017 Amendment Was Intended to Address Situations Where the Third-Party Bank Is Without Recourse Against the Seller and Is Irrelevant to This Petition .......... 13

III. CONCLUSION .......... 15

## TABLE OF AUTHORITIES

**PAGE**

**CASES**

*Citibank (S.D.), N.A. v. Dep't of Taxes*,
202 Vt. 296, 149 A.3d 149 (Vt. 2016) .............................................6, 7

*Doe ex rel. Roe v. Wash. State Patrol*,
185 Wn.2d 363, 374 P.3d 63 (2016) ..................................................13

*Home Depot USA, Inc. v. State Dep't of Revenue*,
151 Wn. App. 909, 215 P.3d 222 (2009) (App. 1-36) ............2, 3, 6, 14

*In re Cascade Fixture Co.*,
8 Wn.2d 263, 111 P.2d 991 (1941) .....................................................11

*In re Hoffman*,
16 F. Supp. 391 (E.D. Pa. 1936) ..........................................................5

*Puget Sound Nat'l Bank v. Dep't of Revenue*,
123 Wn.2d 284, 868 P.2d 127 (1994) (*en banc*) .......................2, 11, 15

*Putnam v. Comm'r*,
352 U.S. 82, 77 S. Ct. 175, 1 L. Ed. 2d 144 (1956) ............................12

*Sears, Roebuck & Co. v. Roberts*,
2016 WL 2866141 (Tenn. Ct. App. May 11, 2016) ..........................6, 7

*Texas Dep't of Housing & Cmty. Affairs v. Inclusive Communities Project, Inc.*,
135 S. Ct. 2507, 192 L. Ed. 2d 514 (2015) .........................................13

**STATUTES**

IRC § 166 ......................................................................................... *passim*

OKLA. STAT. ANN. Title 68 ........................................................ 9

RCW 82.04.4284 ........................................................ 1

RCW 82.04.4284(1) ........................................................ 1

RCW 82.08.037 ........................................................ passim

RCW 82.08.037(1) ........................................................ 1

RCW 82.08.037(7) ........................................................ 10

**REGULATIONS AND RULES**

TREAS. REG. § 1.166-9 ........................................................ 12

TREAS. REG. § 1.166-9(d) ........................................................ 15

WAC 458-20-196 ........................................................ 14

WAC 458-20-196(1)(d) ........................................................ *passim*

WAC § 458-20-196(6) ........................................................ 12, 14

**OTHER AUTHORITIES**

About Us: The Streamed Sales Tax Governing Board, Streamlined Sales Tax Governing Board, Inc. (last visited November 28, 2019), http://www.streamlinedsalestax.org/index.php?page=About-Us ............... 4

65th Leg., Reg. Sess., pt. II (Wash. 2017) ........................................ 15

65th Leg., Reg. Sess., § 2(2)(c) (Wash. 2017) ........................................ 15

## I. INTRODUCTION

Petitioner Lowe's Home Centers, LLC ("Lowe's") submits this reply to issues raised in Respondent's Answer to Petition for Review ("Answer" or "Answer to Pet. for Review"), but not raised in the Petition for Review ("Petition").

As stated in the Petition, the issue presented is whether a seller, like Lowe's, can ever claim Washington sales tax credits and business and occupation (B&O) tax deductions under RCW 82.08.037 and 82.04.4284 (the "Bad Debt Statutes") for taxes it remitted on worthless private label credit card ("PLCC") accounts if the transactions were initially financed by a third party bank. The controlling Bad Debt Statutes are clear and unambiguous: "A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166."[1] The corresponding regulation confirms that "Washington credits, refunds, and deductions for bad debts ***are based on federal standards for worthlessness under section 166 of the Internal Revenue Code***."[2] There are no other statutory or regulatory preconditions to claiming a bad debt tax

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[1] RCW 82.08.037(1) (as amended effective July 1, 2004) (App. 50). *See also* RCW 82.04.4284(1) (as amended effective July 1, 2004) (providing a similar deduction for B&O tax: "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 . . . on which tax was previously paid.") (App. 52).

[2] WAC 458-20-196(1)(d) (effective July 1, 2004) (the "Bad Debt Regulation") (emphasis added) (App. 55-58).

credit in Washington.

In its Answer to the Petition, the Washington Department of Revenue ("Department") continues to take the extreme position that retailers who participate in PLCC arrangements with third party lenders can ***never***, under ***any*** circumstances, qualify for bad debt credits or deductions in Washington. Imposing such a wholesale prohibition is unsupported by law and in direct conflict with the legislative purpose underlying the Bad Debt Statutes which, as the Department has acknowledged, "is to allow sellers to recover taxes they were required to remit to the State but could not collect from the buyer." CP 2673 (Dep't Opp'n at 4). Moreover, there is nothing in the Bad Debt Statutes, the Bad Debt Regulation, this Court's decision in *Puget Sound National Bank v. Department of Revenue*,[3] or the Court of Appeals' decision in *Home Depot USA, Inc. v. State Department of Revenue*[4] to justify banning retailers from claiming tax credits and deductions for bad debt losses they actually suffer on PLCC accounts. Rather, the lesson derived from *Home Depot* is that a seller who actually (1) bears losses on PLCC accounts, (2) deducts the losses as bad debts on line

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[3] 123 Wn.2d 284, 868 P.2d 127 (1994) (*en banc*) (hereinafter "*Puget Sound*"). The Department does not dispute that *Puget Sound* is controlling or that this Court construed RCW 82.08.037 as imposing only three requirements: a retailer must satisfy to claim a credit/deduction for bad debt losses: "(1) the seller must be a person, (2) making sales at retail, and (3) entitled to a refund for sales taxes previously paid on debts which are deductible as worthless for federal income tax purposes." 123 Wn.2d at 287.

[4] 151 Wn. App. 909, 215 P.3d 222 (2009) (hereinafter "*Home Depot*") (App. 1-36).

15 of its federal tax returns, and (3) thereafter is entitled to recoveries made on those accounts, is eligible to take the corresponding sales tax credits and B&O tax deductions in Washington.[5]

In support of its blanket prohibition argument, the Department asserts four new contentions in its Answer that were not raised in the Petition:

(a) The model bad debt rules of the Streamlined Sales and Use Tax Agreement ("SSUTA"), which the Bad Debt Regulation mirrors, provides that a seller must write off as uncollectible the specific bad debt accounts in its books and records in order to claim corresponding sales tax credits and B&O tax deductions (Answer to Pet. for Review at 8-9);

(b) The Court of Appeals' decision in *Home Depot* is consistent with decisions in other SSUTA member states that have addressed supposedly "similar variations" on the *Home Depot* template as the variations appearing in the Lowe's PLCC Agreements (Answer to Pet. for Review at 16);

(c) The 2010 amendment to RCW 82.08.037 shows that the Legislature never intended to authorize a bad debt credit or

[5] *Home Depot*, 151 Wn. App. at 919-20.

deduction for retailers on loans originated by a financial institution (Answer to Pet. for Review at 17-18); and

(d) The Legislature's failure in 2017 to pass proposed legislation to amend RCW 82.08.037 further demonstrates the Legislature never intended to allow retailers to claim bad debt credits or deductions on loans originated by financial institutions (Answer to Pet. for Review at 18-19).

As set out below, each of these new contentions is unsupported and meritless.

## II. ARGUMENT ON ISSUES RAISED IN ANSWER TO PETITION FOR REVIEW

### A. SECTION 320.C OF THE STREAMLINED SALES AND USE TAX AGREEMENT DOES NOT IMPOSE A WRITE-OFF REQUIREMENT

Washington is a member of the SSUTA, the purposes of which are "to simplify and modernize sales and use tax administration in order to substantially reduce the burden of tax compliance" and promote "[u]niformity in the state and local tax bases," "[u]niformity of major tax base definitions," and "[s]implified administration of exemptions."[6] In 2004, the Legislature amended RCW 82.08.037 specifically to conform to

[6] About Us: The Streamed Sales Tax Governing Board, Streamlined Sales Tax Governing Board, Inc. (last visited November 28, 2019), http://www.streamlinedsalestax.org/index.php?page=About-Us.

SSUTA's model bad debt rules set forth in Section 320. *See* CP 2677 (Dep't Br. in Opp'n to Pl.'s Mot. for Summ. J. at 8). The Department's Answer relies on SSUTA, § 320.C, and *In re Hoffman*, 16 F. Supp. 391, 393 (E.D. Pa. 1936), in claiming that "write-off is 'the essence of the bad debt deduction.'" Answer to Pet. for Review at 9.

The Bad Debt Regulation, however, explains that Washington bad debt credits and deductions "are based on ***federal standards for worthlessness under section 166 of the Internal Revenue Code***."[7] Neither IRC § 166 nor the corresponding regulations requires a taxpayer to write off a specific account to be eligible for a bad debt deduction for wholly worthless debts. The language in SSUTA, § 320.C, which is contained in the Bad Debt Regulation, neither creates nor imposes a new, independent requirement a retailer must satisfy. Rather, it simply describes ***when*** the credit or deduction may be taken. *See* Pet. for Review at 16. It is no more than a timing requirement.

*In re Hoffman* therefore provides no support for the Department's contention. The Pennsylvania court disallowed the taxpayer's bad debt deduction not because he did not own the worthless accounts but only because he violated the timing requirement – he deliberately waited to

[7] WAC 458-20-196(1)(d) (effective July 1, 2004) (emphasis added).

charge off the debts until the year after they were deemed worthless.[8] In any event, as discussed in the Petition, the record confirms that Lowe's, in fact, timely wrote off in its books and records the losses it bore related to the PLCC Bad Debts.[9] Since the Bank owned the specific customer accounts, however, Lowe's could not reflect the accounts in its books and records. Nevertheless, uncontroverted expert testimony establishes that the distinction is irrelevant; there is no specific manner in which the bad debt losses must be recorded in order to comply with federal standards. Petition at 8, 16-17 (citing Blasi Dep. 31:14-32:9 (App. 44)).

### B. THE DEPARTMENT FOCUSES ON DISTINGUISHABLE CASES FROM TWO SSUTA MEMBER STATES WHILE IGNORING PERSUASIVE AUTHORITY FROM OKLAHOMA, ANOTHER SSUTA MEMBER STATE

The Department cites two cases decided by courts in SSUTA member states that it claims involved contract terms similar to those in Lowe's PLCC Agreements. Answer to Pet. for Review at 16 (citing *Citibank (S.D.), N.A. v. Dep't of Taxes*, 202 Vt. 296, 149 A.3d 149, 155 (Vt. 2016); *Sears, Roebuck & Co. v. Roberts*, 2016 WL 2866141, at *9 (Tenn. Ct. App. May 11, 2016)). A review of the cases, however, shows that the PLCC agreements at issue in *Citibank* and *Sears, Roebuck* followed the

[8] 16 F. Supp. at 393.

[9] *See* CP 455 (Decl. ¶ 16).

*Home Depot* template: the retailer claiming the sales tax credits (1) contracted away its right to take the loss on defaulted PLCC accounts, (2) bore no risk of loss, and (3) was ineligible to take PLCC bad debt deductions on its federal income tax returns.

For instance, in *Sears, Roebuck*, "Citibank paid Sears in full for all purchases, including sales tax."[10] "Under the parties' arrangement, Citibank did not have 'recourse' against Sears for bad debts resulting from cardholders' failures to pay Citibank. Citibank bore all losses on cardholder accounts."[11] In addition, Citibank, not Sears, "deducted [the defaulted accounts] as a bad debt on its federal income tax returns."[12]

Likewise, in *Citibank*, the bank "pa[id the] retailer the amount charged; that is, the sale amount plus any applicable sales tax,"[13] and the bank "could not collect the unpaid amounts, including the sales tax amounts, from retailer."[14] Further, the bank, and not the retailer, "took bad debt deductions for the [defaulted] accounts on its federal corporate income tax returns during the period, pursuant to 26 U.S.C. § 166."[15]

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[10] 2016 WL 2866141 at *2.
[11] *Id.*
[12] *Id.* at *3.
[13] 202 Vt. at 298.
[14] *Id.*
[15] *Id.* at 298-99.

The Department focuses on these inapposite cases involving very different PLCC agreements, yet omits mention of persuasive authority from Oklahoma (another SSUTA state) involving the exact same PLCC Agreements at issue in this case. Specifically, a similar controversy involving the Lowe's PLCC Agreements was litigated and resolved in Oklahoma before an Administrative Law Judge ("ALJ") associated with the Oklahoma Tax Commission ("OTC"). CP 461 (Aultman Decl. at ¶32). There, the ALJ described the issue to be resolved as "[w]hether Protestant [Lowe's Home Centers, Inc. ('LHC')] properly took sales tax deductions on its Oklahoma sales tax returns during the period of November 12, 2004, through October 31, 2007, for purchases made on private label credit cards ('PLCC') when the PLCC accounts were written off as worthless and deducted on LHC's federal corporate income tax returns." CP 1092 (Aultman Decl. at Ex. J-1 at 3). In ruling in favor of Lowe's, the Oklahoma ALJ recognized the critical distinctions between Lowe's PLCC Agreements and Home Depot's agreements and found that Lowe's, unlike Home Depot, was entitled to take and properly took bad debt deductions for sales taxes it previously remitted to Oklahoma on defaulted PLCC accounts:

> The Protestant's position succinctly stated is "This controversy exists because the [Division] has failed to distinguish the [Protestant's] Agreements from the PLCC agreements that were the subject of the *Home Depot* lawsuits, both in Oklahoma and nationwide." In

support of this position, the Protestant asserts, ". . . [Protestant] – unlike Home Depot – had the following rights and obligations under the PLCC agreements at issue in this case: (1) it remained directly liable as guarantor for paying the bad debts arising out of defaulted PLCC accounts, (2) it actually wrote off the bad debts on its books and records, and (3) it expressly retained the right to deduct, and in fact deducted, the bad debt payments on its U.S. Corporation Income Tax Returns pursuant to Section 166 of the Internal Revenue Code (the 'IRC')".

The comparison of *Home Depot* to this matter illustrates the Protestant's initial point; the Division fails to distinguish this case from *Home Depot*. The Court in *Home Depot* held, "There is no evidence that Home Depot could deduct the Service Fee, or a portion of the Service Fee, as a bad debt pursuant to Section 166 of the Internal Revenue Code. Rather, Home Depot stipulated the Service Fee was deducted on its federal return as a 'credit card discount.' That being so, Home Depot could not satisfy its burden of proving a right to a refund of sales tax under that statute. [OKLA. STAT. ANN. tit. 68. § 1366 (the Oklahoma Bad Debt Statute)] implicitly requires the owner of the bad debt account to be the entity allowed the deduction where it also requires the owner to report subsequent collections of bad debt accounts as income."

. . .

The language of the Bad Debt Statute is plain and unambiguous, so it will not be subject to judicial construction, but will be given the effect its language dictates. The Division's argument appears to stem from its constricted reading of the Bad Debt Statute. ***If the Legislature had intended to limit the Bad Debt Deduction to only vendors who finance their customer's credit purchases (without third parties, such as the Banks) or whose customers write uncollectible "hot checks," it would not have based eligibility for the Bad Debt Deduction on IRC § 166.***

> The Treasury Regulations clearly contemplate circumstances outside the traditional examples.

CP 1115-19 (Aultman Decl. at Ex. J-1 at 26-30) (emphasis added) (internal citations omitted). The OTC subsequently adopted the ALJ's findings and conclusions in their entirety. CP 461, 1128-30 (Aultman Decl. at ¶32, Ex. J-2). The ALJ's reasoning, as adopted by the OTC, is equally applicable here.

### C. THE 2010 AMENDMENT TO THE BAD DEBT STATUTE – ENACTED AFTER THE END OF THE ASSESSMENT PERIOD – DOES NOT SUGGEST A LEGISLATIVE INTENT TO ADOPT A BLANKET PROHIBITION

The Department's Answer asserts the "availability and scope of a tax exemption or deduction is purely a matter of legislative grace." It then refers to a 2010 amendment of RCW 82.08.037(7) to argue that the Legislature intended to preclude all retailers from obtaining Washington tax credits and deductions on credit accounts originated by third party banks. Answer to Pet. for Review at 17. The Department's argument is wrong. The 2010 amendment – enacted after the end of the Assessment Period (April 1, 2001, through December 31, 2009) – does not suggest a legislative intent to adopt a blanket prohibition.

In 2010, the Washington Legislature amended the Bad Debt Statute so that it now provides:

> If the original seller in the transaction that generated the bad

> debt has sold or assigned the debt instrument to a third party with recourse, the original seller may claim a credit or refund under this section only after the debt instrument is reassigned by the third party to the original seller.[16]

This amendment represented a substantive change in law, effective July 1, 2010, that is not applicable to the Assessment Period. *See, e.g., In re Cascade Fixture Co.*, 8 Wn.2d 263, 273, 111 P.2d 991 (1941) ("In view of the statutory rule of construction enunciated, the language of the 1939 amendment cannot be regarded as creating a retroactive paramount lien in favor of the department, since there is nothing in that language which either expressly, or by necessary implication, shows that such an effect was intended.").

Nonetheless, the amendment supersedes only that portion of *Puget Sound* that allowed a bank, as assignee, to fall within the definition of the term "seller" for purposes of claiming sales tax credits for bad debts. It provides that such credits are now limited to the original seller. But the amendment does not indicate, as the Department now argues, that the Legislature intended to prohibit original sellers on credit accounts originated by banks from ever claiming bad debt credits or deductions.

Consistent with the statutory amendment, the Department added a section (6) to the Bad Debt Regulation:

> If a business contracts with a financial company to provide

[16] RCW § 82.08.037(7) (2010).

> a private label credit card program, and ***the financial company becomes the exclusive owner of the credit card accounts and solely bears the risk of all credit losses***, the business that contracted with the financial company is not entitled to any bad debt deduction if a customer fails to pay his or her credit card invoice.[17]

As with the amendment to RCW 82.08.037, the new rule was not effective until after the Assessment Period and is inapplicable here. In any event, the rule contains ***two*** separate requirements for precluding a bad debt deduction: the financial company (i) must be "the exclusive owner of the credit card accounts" ***and*** (ii) must "solely bear[ ] the risk of all credit card losses."[18]

Even under this new rule, ownership of the debt by a third-party lender, by itself, does not prohibit the original seller from claiming the credit. Indeed, under federal standards, the ownership of the account is irrelevant. Under the federal standards (IRC § 166 and TREAS. REG. § 1.166-9) to which the Bad Debt Statutes are tied, a guarantor of a worthless debt, who neither initiated the account nor owned it when it defaulted, is still entitled to claim a bad debt deduction. *See* CP 1235 (Decl. at Ex. A (Jones Dep. at 86:1-25)); *Putnam v. Comm'r*, 352 U.S. 82, 85-86, 77 S. Ct. 175, 176, 1 L. Ed. 2d 144 (1956) (acknowledging the right of guarantors to deduct, as bad debts, payments made to creditors in satisfaction of their

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[17] WAC § 458-20-196(6) (2010) (emphasis added).
[18] *Id.*

guaranties) (CP 1284 (Smith Decl. at Ex. F)). While Lowe's did not own the PLCC accounts when they became worthless, it (unlike Home Depot) ultimately bore the losses when the accounts defaulted, reflected the losses in its books and records, and was entitled to take the federal bad debt deduction on such losses. As a matter of law, Lowe's remained entitled to claim the corresponding Washington sales tax credits and B&O tax deductions.

### D. THE FAILED 2017 AMENDMENT WAS INTENDED TO ADDRESS SITUATIONS WHERE THE THIRD-PARTY BANK IS WITHOUT RECOURSE AGAINST THE SELLER AND IS IRRELEVANT TO THIS PETITION

The dissent rightfully found that "the majority unnecessarily complicates what should be a straightforward analysis"; the Bad Debt Statutes "unambiguously show that [Lowe's] is entitled to retail sales tax credits and [B&O] tax deductions." Likewise, the Department's Answer tries to complicate the straightforward analysis in this case by referring to the Legislature's failed attempt to amend RCW 82.08.037 in 2017. Answer to Pet. for Review at 18 (citing S.B. 5910, 65th Leg., Reg. Sess. (Wash. 2017)). The Department claims the Legislature deliberately declined to act on a bill that would have allowed a bad debt sales tax refund for retailers

that contract with third-party financial institutions. Its reliance on S.B. 5910 is misplaced.

As an initial matter, "a failed amendment means little."[19] More importantly, S.B. 5910 is irrelevant to Lowe's Petition because the bill was intended to amend RCW 82.08.037 to allow retailers to receive bad debt credits where the debts are sold or assigned to third parties and ***the third party is without recourse against the seller.*** In other words, the bill was intended to provide relief to retailers who are parties to PLCC Agreements that follow the *Home Depot* template.[20] The bill is therefore irrelevant to the issue presented here, because the Bank in this case had recourse against Lowe's by operation of the "Bad Debt Guarantee."

As noted above, RCW 82.08.037 and WAC 458-20-196 were amended in 2010 to preclude sellers from obtaining bad debt credits where (1) "a business contracts with a financial company to provide a private label credit card program" and (2) "the financial company becomes the exclusive owner of the credit card accounts and solely bears the risk of all credit

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[19] *Doe ex rel. Roe v. Wash. State Patrol*, 185 Wn.2d 363, 381, 374 P.3d 63 (2016); *Texas Dep't of Housing & Cmty. Affairs v. Inclusive Communities Project, Inc.*, 135 S. Ct. 2507, 2539, 192 L. Ed. 2d 514 (2015) ("[F]ailed amendments tell us 'little' about what a statute means.").

[20] The fact that the Legislature specifically limited its proposed remedy in S.B. 5910 to PLCC Agreements that follow the *Home Depot* template demonstrates the Legislature's understanding that PLCC Agreements like the ones at issue here did not require a statutory change in order to preserve the seller's right to claim bad debt credits and deductions.

losses."[21] S.B. 5910 was intended to modify RCW 82.08.037 so as to allow sellers who are parties to PLCC agreements following the *Home Depot* template to receive bad debt credits. The Department of Revenue Fiscal Note discusses the 2010 version of RCW 82.08.037, and states "the statute restricts the credit to the seller and explicitly excludes debts sold or assigned by the seller to third parties, ***where the third party is without recourse against the seller.***"[22] Section 2 of S.B. 5910 indicates that the amendment to the definition of the term "bad debt" proposed in Section 8 relates to "debts sold or assigned by the seller to third parties, ***where the third party is without recourse against the seller.***"[23] At most, S.B. 5910 shows that the Legislature contemplated expanding bad debt refunds beyond the federal standards for worthlessness under IRC § 166 to cover retailers who did not "act as guarantor, endorser, or indemnitor of an obligation."[24] The proposed bill, whether it passed or not, has no effect on whether Lowe's was entitled to a credit or deduction for taxes it remitted on defaulted PLCC accounts performing on its guaranty.

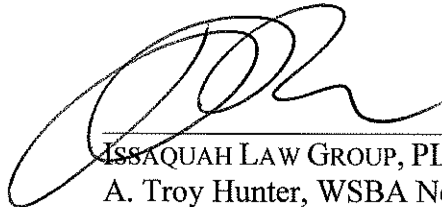
## III. CONCLUSION

For the reasons detailed in the Petition and discussed above, this

[21] WAC § 458-20-196(6) (2010) (emphasis added).
[22] Department of Revenue Fiscal Note for S.B. 5910, 65th Leg., Reg. Sess., Part II (Wash. 2017) (emphasis added).
[23] S.B. 5910, 65th Leg., Reg. Sess., Sec. 2(2)(c) (Wash. 2017) (emphasis added).
[24] TREAS. REG. § 1.166-9(d).

Court should accept review of this Petition because the majority's decision misinterprets the Bad Debt Statutes and regulation and conflicts with *Puget Sound* on an issue of substantial public interest. Further, this Court should also accept review because the proper interpretation of the Bad Debt Statutes is of substantial public interest. No Washington court decision has addressed a PLCC arrangement like the one at issue here, and none has held that a seller who has guaranteed a bad debt and is entitled to a deduction under IRC § 166 is nevertheless barred from taking corresponding Washington credits and deductions for taxes previously remitted on defaulted PLCC accounts.

Respectfully submitted this 29th day of November, 2018.



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**CERTIFICATE OF SERVICE**

THIS IS TO CERTIFY that on the 29th day of November, 2018, I caused to be served a true and correct copy of the foregoing via Legal Messenger and addressed to the following:

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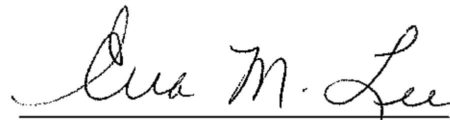

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