No. 96383-5

No. 50080-9-II

IN THE COURT OF APPEALS
OF THE STATE OF WASHINGTON
DIVISION II

LOWE'S HOME CENTERS, LLC

Appellant

v.

DEPARTMENT OF REVENUE, STATE OF WASHINGTON

Respondent

BRIEF OF APPELLANT

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I. INTRODUCTION

This appeal seeks clarification regarding this Court's interpretation of certain Washington tax statutes. At issue is whether Lowe's HIW, Inc. ("HIW")[1] properly claimed sales tax credits and business and occupation ("B&O") tax deductions on its Washington Combined Excise Tax Returns ("Washington Returns") between April 1, 2001 through December 31, 2009 (the "Assessment Period"). These credits and deductions related to bad debt losses arising out of HIW's sales of merchandise to Washington customers who used private label credit card ("PLCC") accounts. During this period, HIW properly deducted these PLCC bad debts on its federal corporate income tax returns pursuant to section 166 of the Internal Revenue Code of 1986, as amended ("IRC"). Under Washington law, that fact entitled HIW to take the corresponding sales tax credits and B&O tax deductions relating to its PLCC bad debt losses.

But Respondent, the Washington Department of Revenue (the "Department"), denied HIW's claims based on its erroneous beliefs that: (1) the PLCC financing arrangements here were identical to those at issue in *Home Depot USA, Inc. v. State Department of Revenue*, 151 Wn. App. 909, 215 P.3d 222 (2009) ("*Home Depot*"); and (2) under Washington law,

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[1] On December 31, 2013, HIW merged into Appellant Lowe's Home Centers, LLC ("Lowe's"). Lowe's is the successor-in-interest of HIW. CP 450 (Aultman Decl. at ¶2).

only the original owner of bad debt accounts, and not a guarantor who ultimately paid off those accounts, can claim the corresponding bad debt credits and deductions. The Department's first belief is demonstrably untrue and its second belief is contrary to Federal and Washington law. Moreover, the Department's position conflicts with that of every other member state of the Streamlined Sales & Use Tax Agreement.

This controversy was presented to the Superior Court of Thurston County (the "Trial Court") on undisputed facts via cross motions for summary judgment. The record confirms (and the Trial Court acknowledged) that the PLCC agreements entered into between Lowe's affiliated companies, including HIW, and third-party financing companies (collectively, the "Banks") in effect during the Assessment Period (the "PLCC Agreements") were materially different from the PLCC agreements that were the subject of the *Home Depot* case. Unlike Home Depot, HIW: (1) remained directly liable as guarantor and bore the economic loss for all bad debts arising from the PLCC accounts (up to a specified cap); (2) wrote off the PLCC bad debt losses in its books and records; and (3) retained the right to deduct, and in fact deducted, the losses on its federal income tax returns pursuant to IRC §166.

In *Home Depot*, this Court affirmed the Department's denial of Home Depot's claim to the bad debt sales tax credits and B&O tax deductions because Home Depot contracted away its right to take the loss on defaulted PLCC accounts and was not eligible to take, and did not take, any PLCC bad debt deductions on its federal income tax returns. Instead, Home Depot surrendered the risk of all credit losses on the accounts, along with the right to take the deduction, to the bank that financed the PLCC transactions. The Department's position, which this Court accepted, was that only the party that ***actually deducted*** the bad debt losses on its federal returns was eligible to take the corresponding sales tax credits and B&O tax deductions. *Home Depot*, 151 Wn. App. at 919-20.

Washington law permits a retailer like HIW to claim a corresponding credit for sales taxes it has previously remitted to the state if its customer, on whose behalf the retailer remitted the taxes, buys goods on credit and later defaults on the account:

> A seller is entitled to a credit or refund of sales taxes previously paid on bad debts, as that term is used [for federal income tax purposes] in 26 U.S.C. Sec. 166.

RCW 82.08.037(1) (as amended effective July 1, 2004). Washington also permits retailers to take a bad debt deduction for B&O tax on the same basis. *See* RCW 82.04.4284(1); WAC 458-20-196(3)(a). The corresponding regulation explains that, with respect to both taxes, "Washington credits, refunds, and deductions for bad debts ***are based on federal standards for worthlessness under section 166 of the Internal***

Revenue Code." WAC 458-20-196(1)(d) & (2) (emphasis added).

Unlike Home Depot, HIW actually bore the PLCC bad debt losses and actually deducted those losses on its federal income tax returns. Under the federal standards set out in IRC § 166 and TREAS. REG. § 1.166-9(d), HIW made payment to the Banks as the guarantor of worthless PLCC accounts, stood in the shoes of the original creditor, and became the sole party eligible to deduct its PLCC bad debts for federal income tax purposes. And since (1) "Washington credits, refunds, and deductions for bad debts are based on federal standards for worthlessness" under IRC § 166; and (2) RCW 82.08.037 and 82.04.4284 impose no additional requirement, separate from the federal standards, that a taxpayer must have originated and owned the account, then HIW was entitled, as a matter of law, to take the corresponding sales tax credits and B&O tax deductions.

On the merits, the Trial Court agreed with this legal position:

> And the court will be candid at the outset of arguments that it appears that Lowe's has a significant number of persuasive arguments in this case as to why this situation is different than the *Home Depot* situation for the reasons articulated in their briefing, particularly the plain text of the statute that appears to link this directly to the federal income tax provisions, which have been audited and have been found to be satisfactory. What the court struggles with, however, is the *Home Depot* decision's language, which appears at the urging of the Department of Revenue in that case to have been originally focused on the issue of whether or not the bad debt could be taken as a deduction from federal income tax returns, but then goes on to use

> very firm language about the debt must be held or owned by the party seeking to take the state deduction or credit or whatever.
>
> * * *
>
> So if I were sitting *de novo* without any authority that was binding me from the Court of Appeals in *Home Depot*, I would feel much more inclined to go Lowe's direction… . Which puts the court in a unique situation of believing that perhaps on appeal, the Court of Appeals is in a position to revisit its prior decision or the Supreme Court could be in a position to reverse that decision, finding those statements to be either incorrect or *dicta*. I struggle myself, being a mere Superior Court judge, to make those determinations.

Verbatim Report of Proceedings ("VRP") at 3:18-4:11; 4:23-5:1; 5:12-19.

Simply put, the Trial Court felt bound by its reading of potential *dicta* in the *Home Depot* decision to ignore Lowe's "persuasive arguments" and set aside its inclination "to go Lowe's direction," and instead ruled in favor of the Department, with the expressed hope that this Court would "revisit its prior decision" in *Home Depot*, or the Washington Supreme Court would "reverse that decision."

Lowe's contends that the Trial Court misread and misapplied the *Home Depot* decision. If so, then this Court should correct the Trial Court's error by reversing the Order. If, however, this Court intended for *Home Depot* to impose a new initiation and ownership requirement on retailers seeking bad debt credits and deductions in Washington, then the Court should now correct that error. This appeal therefore provides this Court, in a case involving undisputed facts, the opportunity to clarify and, if necessary, correct the legal effect of the *Home Depot* decision.

II. ASSIGNMENTS OF ERROR

The Trial Court erred by ruling that, under the undisputed facts, Lowe's was not entitled to claim a sales tax credit and B&O tax deduction on the bad debts it bore on PLCC accounts in Washington during the Assessment Period.

III. ISSUES PERTAINING TO ASSIGNMENTS OF ERROR

1. Whether the Trial Court erred in concluding that, under Washington law, a retailer who has guaranteed worthless customer debts and properly taken a bad debt deduction on its federal corporate income tax returns, is nevertheless ineligible to take a corresponding bad debt sales tax credit and B&O tax deduction if it did not initiate, manage, and own the account when it became worthless.

2. Whether the Trial Court erred in concluding that this Court's decision in *Home Depot* implicitly altered Washington tax law so as to require a taxpayer to initiate, manage, and own an account when it became worthless in order to be eligible to take a corresponding bad debt sales tax credit and B&O tax deduction.

3. Whether the denial of HIW's refund claim for bad debt sales tax credits and B&O tax deductions because it did not own the

accounts when they became worthless violates HIW's constitutional right of equal protection.

4. Whether the denial of HIW's refund claim for bad debt sales tax credits and B&O tax deductions because it did not own the accounts when they became worthless violates HIW's constitutional right of due process.

IV. STATEMENT OF THE CASE

A. Procedural History

On April 6, 2011, the Department's Appeals Division issued a Determination rejecting HIW's claims for PLCC bad debt deductions and assessing Washington sales and B&O taxes, interest, and penalties in the sum of $824,955.91 for the period of April 1, 2001 through December 31, 2005. CP 450, 464-74 (Aultman Decl. at ¶3 & Ex. A). On September 25, 2012, the Appeals Division issued a second Determination to HIW affirming an assessment of sales and B&O taxes, interest, and penalties in the sum of $1,393,551.72 for the period January 1, 2006 through December 31, 2009. CP 450, 475-87 (Aultman Decl. at ¶3 & Ex. B). HIW paid in full all amounts claimed due for both assessments. On February 11, 2016, after exhausting all required administrative remedies, Lowe's, as successor to HIW, filed with the Trial Court a suit for refund of these payments pursuant to RCW 82.32.180, seeking to recover the principal sum of $2,218,507.63, plus interest. CP 450-51 (Aultman Decl. at ¶4).

After completing discovery, the parties filed cross motions for summary judgment. The Trial Court conducted a hearing on February 10, 2017, during which the judge concluded that (1) there was no genuine issue of material fact and (2) his decision was controlled by his reading (which Lowe's contends was erroneous) of certain language in the *Home Depot* decision—which he suggested may have been *dicta*. *See* CP 1154-55 (Notice of Hearing); VRP at 3:15-5:1; 29:20-25. On March 3, 2017, the Trial Court entered an Order on Cross Motions for Summary Judgment in which it denied Lowe's motion and granted summary judgment in favor of the Department (the "Order"). CP 2800-02 (Order). This appeal followed.

B. FACTUAL BACKGROUND

During the Assessment Period, HIW was a Washington corporation and a retailer of home improvement products that operated numerous stores throughout Washington and other states. CP 450-51 (Aultman Decl. at ¶¶2, 6). Prior to the Assessment Period, Lowe's-affiliated companies, including HIW, executed the PLCC Agreements, which provided that the Banks would, in certain circumstances, extend credit to qualified HIW customers to make purchases at HIW stores. HIW entered into this arrangement in the ordinary course of its business as a retailer. CP 451-52, 488-844 (Aultman Decl. at ¶¶7-9 & Exs. C-F).

A customer seeking to buy items from HIW could submit an application with one of the Banks at an HIW store. If the Bank approved the application, then it granted HIW's customer (the "Cardholder") a line of credit which could be used to buy items on credit at an HIW store. Within a day or two, the Bank would forward to HIW payment for the purchases and all corresponding taxes. HIW, as the retailer, would promptly remit Washington sales and B&O tax on the PLCC transactions that took place in the state. CP 453 (Aultman Decl. at ¶10).

After HIW remitted tax on the purchases, some Cardholders failed to pay in full, resulting in bad debt losses ("PLCC Bad Debts"). Although the Banks technically owned and managed the accounts, the PLCC Agreements required HIW to assume responsibility for all PLCC Bad Debts up to a specified cap (the "Cap"), measured as a stated percentage of average net PLCC receivables. In other words, HIW guaranteed that all payments due on PLCC accounts would be made to the Bank, up to the Cap (the "Bad Debt Guarantee"). CP 453 (Aultman Decl. at ¶¶10, 11). HIW was therefore subject to recourse (on a dollar-for-dollar basis) on all PLCC Bad Debt losses incurred throughout the Assessment Period, except for certain amounts that ran over the Cap during 2008 and 2009.[2] CP 455

[2] HIW did not claim bad debt deductions for amounts exceeding the Cap.

(Aultman Decl. at ¶15). The benefits HIW received by entering into the PLCC Agreements, including incentivizing customers to purchase products and reducing tender costs, was reasonable consideration for HIW to assume liability related to the Bad Debt Guarantee. CP 454 (Aultman Decl. at ¶12).

In honoring the Bad Debt Guarantee, HIW paid to the Banks the unpaid balances due on the written-off PLCC accounts, which included any corresponding taxes that HIW had previously remitted to the Department. Consequently, with respect to PLCC Bad Debts on which the Banks had recovered payments from HIW pursuant to the Bad Debt Guarantee, HIW had remitted taxes that it could not recover from its customers. In other words, HIW – and not the Banks – was the party who had advanced and was out of pocket as to sales and B&O taxes paid on the PLCC transactions that eventually became worthless. CP 2668 (Second Aultman Decl. at ¶2). Since HIW was subject to recourse, the PLCC Agreements correspondingly provided it with the right to take a credit/deduction for the resulting losses at the federal and state levels: "[HIW] and not Bank shall have the right to claim any available sales tax deductions related to Net Write-Offs borne by" HIW. CP 454, 523, 613, 696, 782 (Aultman Decl. at ¶13 & Exs. C-F); 1137-38 (Blasi Decl. at ¶12).

The Banks retained and made available to HIW detailed customer and sales information on a state-by-state basis. From this information, HIW was able to net PLCC Bad Debts against any recoveries on a state-by-state basis. CP 454 (Aultman Decl. at ¶13). HIW's books and records reflected all PLCC Bad Debts that had been written off. CP 455 (Aultman Decl. at ¶16).

Throughout the Assessment Period, Lowe's Companies, Inc., HIW's parent, filed consolidated federal corporate income tax returns ("Federal Returns") on behalf of HIW. Pursuant to IRC § 166, HIW deducted the PLCC Bad Debts, along with its other bad debts, as "Bad Debts" on Line 15 of the returns. CP 455-57, 845-98 (Aultman Decl. at ¶¶17-18 & Exs. G-1 through G-9). The Internal Revenue Service ("IRS") regularly audited the Federal Returns, and for tax years 2004 through 2007 it specifically focused on the bad debt deductions claimed on Line 15, including the PLCC arrangement with the Banks. The IRS ultimately accepted and proposed no adjustments to the PLCC Bad Debts claimed by HIW. CP 457-59 (Aultman Decl. at ¶¶19-25).

HIW also claimed corresponding Washington sales tax credits and B&O tax deductions on the principal amounts of the PLCC Bad Debts, after removing all recoveries, expenses, late fees, insurance and finance charges. CP 459 (Aultman Decl. at ¶¶26-27). The Department audited HIW as to all bad debts resulting from customer defaults, including losses resulting from fraudulent charges or charge-backs made on third party credit cards such as Visa, MasterCard and American Express ("Charge-backs"). CP 459-60 (Aultman Decl. at ¶¶26, 31). The Department allowed all credits and deductions claimed by HIW that related to Charge-backs, but disallowed those relating to PLCC Bad Debts. CP 460 (Aultman Decl. at ¶31).

V. <u>ARGUMENT</u>

A. THE TRIAL COURT'S ORDER IS SUBJECT TO *DE NOVO* REVIEW

This Court reviews an order of summary judgment *de novo*, "engaging in the same inquiry as the trial court." *Old City Hall LLC v. Pierce Cty. AIDS Found.*, 181 Wn. App. 1, 8, 329 P.3d 83 (2014); *McIntyre v. State*, 135 Wn. App. 594, 598, 141 P.3d 75 (2006). Where, as here, the only issues to be resolved are questions of law, this Court "'review[s] a trial court's legal conclusions in a tax refund action *de novo*.'" *Nelson Alaska Seafoods, Inc. v. Dep't of Revenue*, 143 Wn. App. 455, 461, 177 P.3d 1161 (2008) (quoting *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 148, 3 P.3d 741 (2000)). *See also* CP 2801 (Order) ("[T]here is no genuine issue of material fact".).

B. HIW WAS ENTITLED TO TAKE PLCC BAD DEBT DEDUCTIONS ON ITS WASHINGTON RETURNS

A proper reading of RCW 82.08.037 and 82.04.4284 (the "Bad

Debt Statutes"), WAC 458-20-196 (the "Bad Debt Regulation"), and the *Home Depot* decision, shows that a taxpayer is not required to have initiated the underlying accounts, managed them while they were active, and then owned them when they became worthless to be entitled to claim Washington sales tax credits and/or B&O tax deductions for the actual losses it suffers as a result of the accounts becoming worthless.

Under the Washington Supreme Court's interpretation of the Bad Debt Statutes in effect during the Assessment Period, there were only three requirements a retailer had to satisfy to claim a bad debt credit or deduction, each of which HIW met. *See Puget Sound Nat'l Bank v. Dep't of Revenue*, 123 Wn.2d 284, 287, 868 P.2d 127 (1994) ("*Puget Sound*"). It is undisputed that HIW met the first two requirements. The controlling requirement was whether HIW could show that it actually remitted tax on the defaulted PLCC accounts for which it provided the guarantee, bore the economic loss, and was entitled to deduct its PLCC losses as bad debts on its federal income tax returns under IRC § 166.

1. The Requirements Under Washington Law for Claiming Bad Debt Credits and Deductions

When interpreting a statute, this Court must carry out the legislative intent as derived from the statute's plain and unambiguous language. *Agrilink Foods, Inc. v. Dep't of Revenue*, 153 Wn.2d 392, 396, 103 P.3d 1226 (2005). This Court must carry out such intent regardless of a contrary interpretation by an administrative agency. *Id.* Here, the Department has acknowledged that "[t]he legislative purpose of the bad debt sales tax statute is to allow sellers to recover sales taxes they were required to remit to the State but could not collect from the buyer." CP 2673 (Dep't Br. in Opp'n to Pl.'s Mot. for Summ. J. at 4). Implementing that purpose mandates allowing HIW the claimed credits and deductions. Since HIW – and not the Banks – was the seller who had advanced on and was out of pocket as to sales and B&O taxes remitted to Washington on the PLCC transactions that eventually became worthless, it fell within the scope and intended purpose of the Bad Debt Statutes. CP 453 (Aultman Decl. at ¶10); 2668 (Second Aultman Decl. at ¶2).

During the Assessment Period, RCW 82.08.037 provided in pertinent part as follows:

> A seller is entitled to a credit or refund for sales taxes previously paid on bad debts, as that term is used [for federal income tax purposes] in 26 U.S.C. Sec. 166.[3]

The corresponding Bad Debt Regulation provides in pertinent part:

> Washington credits, refunds, and deductions for bad debts are based on federal standards for worthlessness under section 166 of the Internal Revenue Code … . Under RCW 82.08.037 and 82.12.037, sellers are entitled to a credit or

[3] RCW 82.08.037(1) (as amended effective July 1, 2004).

> refund for sales and use taxes previously paid on "bad debts" under section 166 of the Internal Revenue Code, as amended or renumbered as of January 1, 2003.[4]

Washington law requires uniform treatment of bad debts losses for purposes of sales tax and B&O tax.[5] Accordingly, RCW 82.04.4284 permits a bad debt deduction for B&O tax on the same basis:

> 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.[6]

For B&O tax purposes, the Bad Debt Regulation provides in relevant part:

> 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, as amended or renumbered as of January 1, 2003, on which tax was previously paid.[7]

Consequently, under the Bad Debt Statutes in effect during the Assessment Period, Washington looked exclusively to federal law and standards relating to bad debt losses under IRC § 166, along with the corresponding U.S. Treasury Regulations, to determine whether a retailer, like HIW, was eligible to claim a sales tax credit or B&O tax deduction for taxes previously paid to the State on bad debts. Except for the timing requirement that the credit be taken in "the tax reporting period in which

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[4] WAC 458-20-196(1)(d) & (2).

[5] WAC 458-20-196(1)(c).

[6] RCW 82.04.4284(1).

[7] WAC 458-20-196(3)(a).

the bad debt is written off as uncollectible" and "would be eligible for a bad debt deduction for federal income tax purposes," WAC 458-20-196(2), neither the Bad Debt Statutes nor the Bad Debt Regulation imposed any additional conditions or restrictions on a seller's right to claim a credit or deduction for tax paid on bad debts.

Puget Sound was the controlling case law throughout the Assessment Period. *See* CP 1161-62 (Dep't Mot. for Summ. J. at 6-7, n.1). In *Puget Sound*, the Washington Supreme Court confirmed that RCW 82.08.037 contained only three requirements: "(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.[8] Significantly, the court did not require that the taxpayer claiming the deduction must have initiated and managed the financing, and then own the account when it became worthless.

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[8] When the Washington Legislature amended RCW 82.08.037, effective July 1, 2004, it did so while expressly preserving the requirements established in *Puget Sound*, including the requirement that a bad debt be deductible under IRC § 166:

> [T]he legislature does not intend by any provision of this act relating to bad debts, and did not intend by any provision of chapter 168, Laws of 2003 relating to bad debts, to affect the holding of the supreme court of the state of Washington in *Puget Sound National Bank v. the Department of Revenue*, 123 Wn. 2nd 284 (1994).

2004 Wash. Legis. Serv. Ch. 153 (S.B. 6515), § 301 (CP 1269 (Smith Decl. at Ex. C)).

In sum, under the applicable Washington law as interpreted by the supreme court, the right to obtain a sales tax credit or B&O tax deduction is governed entirely by whether the bad debt loss is deductible under IRC § 166. Indeed, the Trial Court agreed with HIW that "the plain text of the statute [ ] appears to link [the Washington credits and deductions] directly to the Federal income tax provisions." VRP at 3:18-4:2.

2. HIW Satisfied the *Puget Sound* Requirements

It is undisputed that HIW satisfies the first two requirements of the *Puget Sound* test: (1) It is a "person",[9] and (2) it made taxable retail sales in Washington. *See* CP 1255 (Smith Decl. at Ex. B (Barrett Dep. at 58:13-25; 59:17-22)). As such, this case distills to the third and final requirement – whether HIW's Bad Debt Guarantee payments were "deductible as worthless for federal income tax purposes."

HIW was clearly a "guarantor" of the PLCC accounts, as that term is defined for purposes of IRC § 166, and payments it made to discharge its obligation as guarantor were payments "on debts which are deductible as worthless for federal income tax purposes." CP 1137-38 (Blasi Decl. at ¶12). The Washington Supreme Court in *Puget Sound* confirmed that a person (in that case a bank) who acquired through assignment the

[9] A "person" is defined to include any company and corporation. RCW 82.04.030, 82.08.010(6).

outstanding accounts receivables originated by a seller satisfied the requirements of the Bad Debt Statute, even though he was not the original seller. The court reasoned that, as a result of the assignment, the bank was the party that actually fronted the sales tax and thereby "stepped into the shoes" of the seller for purposes of claiming sales tax credits for accounts that later defaulted. 123 Wn.2d at 292-93. The reasoning applies equally here where HIW, as a result of the Bad Debt Guarantee, is the party that actually fronted the tax. In both cases, the party that retains risks for and actually bears the bad debt losses on defaulted accounts is the one eligible to claim the deduction for federal income tax purposes, thereby satisfying the third requirement under *Puget Sound.*

The Department presented no evidence to dispute that HIW properly calculated and deducted its PLCC bad debt losses on its Federal Returns. CP 1255 (Smith Decl. at Ex. B (Barrett Dep. at 60:17-61:5)). Rather, the Department simply assumed that the PLCC financing arrangements here were identical to those at issue in *Home Depot* and that HIW, like Home Depot, was simply paying a fixed "service fee" to the Banks.

Nonetheless, it is now undisputed that the PLCC Agreements expressly required HIW to guarantee payment of the PLCC accounts to the Banks, up to the Cap. For example, section 4.02 of the Amended and

Restated Consumer Credit Card Program Agreement (the "Consumer Agreement") dated as of March 31, 2001 provides that HIW

> shall be responsible for Net Write-Offs [*i.e.*, bad debt losses] during such year up to a maximum of 7.25% of Average Net Receivables for such year.

CP 1137-38 (Blasi Decl. at ¶12).[10] Because they subjected HIW to recourse for bad debt losses, the PLCC Agreements gave HIW the express, corresponding right to deduct, or take a credit for, any resulting PLCC Bad Debt losses on its Washington Returns. Section 4.05 of the Consumer Agreement provided that HIW "and not [the] Bank shall have the right to claim any available sales tax deductions related to Net Write-Offs borne by Retailers pursuant to Section 4.02." *Id.*

The Department, however, fails to appreciate that these guaranty provisions shifted the risk of loss for PLCC Bad Debts from the Banks to HIW. Robert R. Jones, the Department representative who denied HIW's claims, opined that: "Lowe's does not bear – bear a loss. There is no risk there. There is no loss." CP 1221 (Smith Decl. at Ex. A (Jones Dep. at 32:6-7)). He based this opinion on his mistaken belief "that Lowe's is paying a service fee to the Banks for operating this program." CP 1223 (Smith Decl. at Ex. A (Jones Dep. at 38:12-14)). Later, after being shown

[10] The other PLCC Agreements contain substantially similar language.

the PLCC Agreements, he acknowledged that they provide otherwise, but still refused on principle to accept the legal effect of the Bad Debt Guarantee:

> Q: And this also, in Section 4.05 [of the PLCC Agreement], and again, I think you've circled it with your pencil –
>
> A: Correct.
>
> Q: – deals with the Bank agreeing that the Retailer, not the Bank, has the right to claim any available sales tax deduction relating to the Net Write-Offs borne by the Retailers, and again, it is your conclusion that has no legal effect in the state of Washington?
>
> A: Correct.
>
> * * *
>
> Q: [Section 4.05] says the Retailer has the right to claim any available sales tax deduction related to the Net Write-Offs borne by the Retailers pursuant to Section 4.02. It is the Department's position that no, it doesn't, that the Retailers don't have that right; is that correct?
>
> A: That's correct.

CP 1222, 1223 (Smith Decl. at Ex. A (Jones Dep. at 36:16-24; 38:5-10)).

3. Federal Standards Authorize Bad Debt Deductions for Guarantors

Under the federal standards[11] to which the Bad Debt Statutes are

[11] IRC § 166 and the corresponding Treasury Regulation.

tied, a guarantor of a worthless debt, even though he neither initiated the account nor owned it when it defaulted, is nevertheless entitled to claim a bad debt deduction once he makes good on his guaranty obligation. *See* CP 1235 (Smith Decl. at Ex. A (Jones Dep. at 86:1-25)) (acknowledging that the federal standards "make[ ] very clear that a guarantor of an account that goes bad, if he has to pay on his guarantee, has the right to claim a bad debt deduction."). In particular, IRC § 166(a)(1) states that "[t]here shall be allowed as a deduction any debt which becomes worthless within the taxable year" and the Treasury Regulation explains that "a payment of principal or interest made … by the taxpayer in discharge of part or all of the taxpayer's obligation ***as a guarantor***, endorser, or indemnitor ***is treated as a business debt becoming worthless in the taxable year in which the payment is made***."[12]

By its express terms, the Regulation allows bad debt deductions to be claimed by guarantors, endorsers, and indemnitors – persons who, by definition, neither extended credit to the debtors in the first instance nor owned the accounts when they became worthless. For purposes of the Regulation, a party is a guarantor if he acts "as (or in a manner essentially equivalent to) a guarantor", *see id.* § 1.166-9(a), and the obligation does

[12] TREAS. REG. § 1.166-9(d) (the "Regulation") (emphasis added).

not have to take any particular form or format. Further, contractual privity with the debtor or debt holder is not required. *See* CP 1348-60 (Smith Decl. at Ex. K (Technical Advice Memorandum 200814026)).[13]

Congress and the federal courts have long acknowledged the right of guarantors to deduct, as bad debts, payments made to creditors in satisfaction of their guaranties of an underlying debt. Sixty years ago, the U.S. Supreme Court explained the rationale:

> The familiar rule is that, *instanter* upon the payment by the guarantor of the debt, ***the debtor's obligation to the creditor becomes an obligation to the guarantor, not a new debt***, but, by subrogation, the result of the shift of the original debt from the creditor to the guarantor who steps in the creditor's shoes. Thus, the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt. ***This has been consistently recognized in the administrative and the judicial construction of the Internal Revenue laws which ... have always treated guarantors' losses as bad debt losses.***

Putnam v. Comm'r, 352 U.S. 82, 85-86, 77 S. Ct. 175, 1 L. Ed. 2d 144 (1956) (emphasis added) (CP 1284 (Smith Decl. at Ex. F)).

In a 1954 Senate Report, Congress addressed its modification of the IRC, which extended the bad debt deduction to noncorporate guarantors (corporate guarantors were already entitled to take a deduction):

[13] Even though Technical Advice Memoranda may not be used or cited for precedent, *see* CP 1360 (Smith Decl. at Ex. K, p. 12), they are persuasive and provide guidance regarding the IRS's interpretation of issues.

> Your committee has added a new provision, subsection (f), relating to the tax treatment of guarantors of certain noncorporate obligations. ... This subsection will allow a deduction from gross income for a loss suffered by a noncorporate taxpayer through payment during the taxable year of part or all of his obligation as a guarantor, endorser, or indemnitor of a noncorporate obligation. ... The term "guarantor, endorser, or indemnitor," includes not only those persons having collateral obligations as guarantors or endorsers but also those persons having direct obligations as indemnitors. ***The payment by the taxpayer of such obligation will result in the treatment of such payment as a debt becoming worthless during the taxable year ....***

Sen. Report No. 1622, 83d Cong., 2d Sess. 200 (1954), 1954 USCCAN 4621, at 4835 (emphasis added) (CP 1319 (Smith Decl. at Ex. G)).

Federal courts have uniformly held that guarantors may take bad debt deductions for payments made in satisfaction of their guaranties.[14] The U.S. Court of Appeals for the Ninth Circuit clarified that IRC § 166 "is triggered by the worthlessness of the principal debt, and no independent debt between principal debtor and the third party [guarantors], created by subrogation, is necessary." *Horne*, 523 F.2d at 1365 (CP 1322

[14] *See, e.g., Horne v. Comm'r*, 523 F.2d 1363, 1365 (9th Cir. 1975) ("The loss covered by section 166(d) ... includes not only any loss sustained by the obligee of the debt but also any loss sustained by a third party, whether acting as surety, guarantor, or indemnitor.") (CP 1322 (Smith Decl. at Ex. H)); *Cushman v. United States*, 148 F. Supp. 880, 887 (D. Ariz. 1956) (providing that payment of a guaranty creates the necessary relationship between the guarantor and the primary borrowers for purposes of the guarantor's deduction of any bad debt) (CP 1335 (Smith Decl. at Ex. I)).

(Smith Decl. at Ex. H)).[15]

4. HIW Satisfied the Federal Standards for Taking PLCC Bad Debt Deductions

The Regulation sets forth four conditions for treating payments made in discharge of a guarantor's obligation as a debt "deductible as worthless for federal income tax purposes":

> (1) The agreement [must be] entered in the course of the taxpayer's trade or business or a transaction for profit;
>
> (2) There [must be] an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer);
>
> (3) The agreement [must be] entered into before the obligation became worthless ...; [and]
>
> * * *
>
> [4] [R]easonable consideration [must be] received for entering into the agreement.

TREAS. REG. § 1.166-9(d) & (e). The record demonstrates that HIW satisfied this four-part test so as to be eligible to take the federal bad debt deduction and, consequently, be entitled to corresponding Washington sales tax credits and B&O tax deductions. CP 1135-38 (Blasi Decl. at ¶¶10-12).

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[15] *See also* John C. McCoy, "Bad Debts", 538 Tax Mgmt. (BNA) at A-42, with excerpts from H.R. Rep. 94-658, 94th Cong., 1st Sess. (1975) (stating courts and Congress have rejected the theory that the tax consequences of a guarantor's loss hinged on whether the guarantor had a right of subrogation) (CP 1342 (Smith Decl. at Ex. J)).

First, HIW executed the PLCC Agreements in the course of its business as a national retailer of home improvement products for the purpose of generating additional sales and profits. Next, the PLCC Agreements explicitly required HIW to pay the Banks for worthless PLCC accounts – a legal obligation the Banks could have enforced in court, if necessary. Third, the Agreements became effective before any PLCC accounts existed, much less became worthless. CP 451-53 (Aultman Decl. at ¶¶7-9; 11).

With respect to the final requirement regarding reasonable consideration, the Regulation explains the following:

> [R]easonable consideration is not limited to direct consideration in the form of cash or property. Thus, where a taxpayer can show that the guaranty was given without direct consideration in the form of cash or property, but in accordance with normal business practice or a good faith business purpose, worthless debt treatment is allowed.

TREAS. REG. § 1.166-9(e)(1). The record confirms that HIW entered into the PLCC Agreements for the good faith purpose of promoting and increasing sales of merchandise. CP 452 (Aultman Decl. at ¶9); CP 1137-38 (Blasi Decl. at ¶12). The benefits conferred on HIW from entering into the PLCC Agreements, including reduced tender costs and increased sales, provided ample consideration for HIW to assume the obligations arising out of the Bad Debt Guarantee. CP 454 (Aultman Decl. at ¶12).

The Department does not dispute Mr. Blasi's and Mr. Aultman's testimony establishing that HIW met the requirements of TREAS. REG. § 1.166-9(d) & (e). Its representative, Mr. Jones, allegedly became aware during his October 27, 2016 deposition (purportedly for the first time) that, under the federal standards, a guarantor of an account can claim a bad debt deduction even though he does not own the defaulted account. He even acknowledged that the standards "make[ ] very clear that a guarantor of an account that goes bad, if he has to pay on his guarantee, has the right to claim a bad debt deduction." CP 1235 (Smith Decl. at Ex. A (Jones Dep. at 86:1-25)). As of that date, Mr. Jones had "no opinion at this point as to whether the argument is valid or not." CP 1235 (Smith Decl. at Ex. A (Jones Dep. at 88:14-22; 89:9-15)).

During the parties' briefing in support of their cross motions for summary judgment, the Department submitted no affidavits or other evidence to counter any of HIW's evidence.[16] For purposes of this appeal,

[16] The Department made only the following unsupported conclusions: "The Department disputes Lowe's characterization of its agreements with the Bank as contracts of guaranty. The Department also disputes whether Lowe's actually 'paid' any amount in satisfaction of this purported 'guarantee,' as required under the federal regulation relating to guaranty payments." CP 1167 (Dep't Mot. for Summ. J. at 12). Such bare assertions do not suffice to create a genuine issue of fact. *See Trimble v. Wash. State Univ.,* 140 Wn. 2d 88, 94, 993 P.2d 259 (2000) ("More than bare assertions that a genuine material issue exists are required."); *Meyer v. Univ. of Wash.*, 105 Wn. 2d 847, 855, 719 P.2d 98 (1986) ("[C]onclusory statements unsupported by facts admissible in evidence cannot be considered on a motion for summary judgment."); CP 2801 (Order) (ruling there is no genuine issue as to any material fact).

the record on these issues stands uncontroverted.

5. The IRS Audits Confirmed HIW Properly Took the PLCC Bad Debt Deductions

The IRS itself verified that HIW's PLCC Bad Debts met the federal standards for deductibility. Indeed, the Trial Court expressly acknowledged that HIW's Federal Returns were "audited and have been found to be satisfactory." VRP at 3:18-4:2.

Specifically, HIW's parent timely filed Federal Returns on behalf of HIW for each year within the Assessment Period and consistently reported HIW's Bad Debt Deductions, including those arising from the PLCC accounts, as "Bad Debts" on Line 15 of the returns. CP 455-57 (Aultman Decl. at ¶¶17-18); CP 1138 (Blasi Decl. at ¶13).[17] Throughout the period, the IRS audited the Federal Returns in two-year cycles. For the 2004-05 and 2006-07 cycles, the IRS specifically inquired about and examined the PLCC bad debt deductions, but neither challenged nor proposed any adjustments to the PLCC Bad Debts claimed on Line 15 of the Federal Returns. CP 457-59 (Aultman Decl. at ¶¶19-25). Instead, the IRS concluded that HIW had properly claimed Bad Debt Deductions with respect to the PLCC accounts "as debts which are deductible as worthless

[17] For the 2006 tax year, the Federal Return erroneously reported the PLCC Bad Debts for that year on Line 26 as "Other Deductions." HIW's parent filed an Amended Return for 2006 which corrected that error. CP 455-56 (Aultman Decl. at ¶17).

for federal income tax purposes." CP 1139 (Blasi Decl. at ¶14).

6. Requiring that HIW Own the Accounts When They Become Worthless Is Unauthorized by and Contrary to Law

To justify denying HIW's claim, the Department unilaterally fabricated and imposed its own additional requirement for claiming a bad debt credit or deduction in Washington. It disallowed the claim because "Lowe's did not own the accounts receivable. They didn't own the debt." CP 1216-17 (Smith Decl. at Ex. A (Jones Dep. at 13:19-14:7)). Moreover, on the issue of whether one may claim a bad debt deduction regarding a worthless account, "the Department of Revenue deems that ownership of the account is controlling":

> Q: When can a taxpayer that does not own the defaulting account claim a bad debt deduction?
>
> A: They can't.
>
> Q: Absolutely? They never can? Is that your understanding?
>
> A: Never can. Absolutely. That's correct, that's my understanding.

CP 1217, 1220, 1230 (Smith Decl. at Ex. A (Jones Dep. at 14:8-17; 28:15-20; 66:3-11)).

The Department even goes so far as to insist that Washington is an "outlier" among other states on the bad debt issue because, with respect to

IRC § 166 and Washington law, "we have two different schemes, tax schemes, at play, and one of them relies on the definition contained in the other, but it does not operate the same way with regard to the individual activity, it can be confusing." CP 1258 (Smith Decl. at Ex. B (Barrett Dep. at 72:8-15)).[18] *See also* CP 1258 (Smith Decl. at Ex. B (Barrett Dep. at 71:24-72:6) ("[T]he federal scheme and the State scheme are different with regard to what is allowable as a bad debt.")).

However, the Department's designated 30(b)(6) witness admitted in her deposition that this "ownership requirement" is unwritten and unpublished; it appears nowhere in either the Bad Debt Statutes or the Bad Debt Regulation. Instead, the Department conjured up this arbitrary requirement and imposed it on HIW:

> Q: The additional requirements that you say that Washington imposes over and above what the federal government and the IRC requires on its definition of bad debt are (i) the claimant must own the account, (ii) the claimant must have been the

[18] In fact, Washington cannot be an outlier on this issue. Rather, it is a member of the Streamlined Sales and Use Tax Agreement ("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 "uniformity in the state and local tax bases," "uniformity of major tax base definitions," and "simplified administration of exemptions." http://www.streamlinedsalestax.org/index.php?page=About-Us. The Department admits that the Legislature amended RCW 82.08.037 in 2004 to conform to SSUTA's model bad debt rule. CP 2677 (Dep't Br. in Opp'n to Pl.'s Mot. for Summ. J. at 8). And Washington has responded affirmatively in its Certificate of Compliance with the Governing Board that it "allow[s] bad debts to be deducted on the return for the period during which the bad debts is written off as uncollectible and is ***eligible to be deducted for federal income tax purposes***." CP 2698 (Certificate of Compliance, § 320) (emphasis added).

one who extended the credit in the first place; have I got those right?

A: Starts with a retail sale, okay?

Q: Okay.

A: A retail sale, and the credit transaction originates with the retailer.

Q: Okay.

A: So the bad debt is there, it belongs to the retailer.

* * *

Q: ***And as we've noted, that's not stated in the [Bad Debt Deduction] Statute or the [Bad Debt] Regs, but that's how you've interpreted the statutes?***

A: ***Yes.***

CP 1259 (Smith Decl. at Ex. B (Barrett Dep. at 75:22-76:9; 76:16-19)) (emphasis added). Although Washington law states that credits and deductions for bad debts are to be based on federal standards under IRC § 166, the Department summarized its proposed interpretation of the law as follows:

Q: Let me ask you this: I establish to your satisfaction that I am a guarantor of an account as provided in this provision [Treasury Regulation § 1.166-9], and I have fulfilled my obligation, and I am claiming a bad debt that is allowed under the Federal Statute; is it Washington's position they will not allow that bad debt because I do not own the account?

A: Yes.

CP 1260 (Smith Decl. at Ex. B (Barrett Dep. at 78:22-79:4)).

The Washington Legislature did not give the Department either the discretion or authority to substantively alter the Bad Debt Statutes by imposing an additional "ownership requirement" for claiming a bad debt credit or deduction. To the contrary, the Bad Debt Statutes coupled the availability of a Washington bad debt credit or deduction directly, and exclusively, to the taxpayer's right to deduct the worthless account on its federal income tax return, and the Bad Debt Regulation expressly provides that "Washington credits, refunds, and deductions for bad debts ***are based on federal standards for worthlessness under section 166 of the Internal Revenue Code***." WAC 458-20-196(1)(d) (emphasis added). There are no additional caveats, exceptions, or conditions. Indeed, TREAS. REG. § 1.166-9 specifically identifies guarantors, who do not initiate, manage or own the accounts, as appropriate parties for taking bad debt deductions on the accounts that become worthless.

The Department's own amendment to the Bad Debt Regulation in 2010 – after the end of the Assessment Period – further belies its claim that ownership of the account, in and of itself, is controlling. Specifically, the Department added subsection (6) to the Bad Debt Regulation, which now precludes a retailer from obtaining a bad debt credit or deduction for defaulted PLCC accounts where "a financial company becomes the exclusive owner of the credit card accounts ***and*** solely bears the risk of all credit losses." WAC 458-20-196(6) (emphasis added). The provision contains two interconnected requirements, both of which must be met in order to preclude the credit or deduction. The new subsection actually supports HIW's position since HIW, and not the Banks, bore the risk of loss on the PLCC accounts up to the Cap.[19]

The Department concedes that (1) its only "job is to enforce the laws as enacted by the Legislature"; (2) the Department "itself has no authority to create its own laws or to ignore, alter, or add to the laws enacted by the Legislature"; and (3) it "would be up to the Internal Revenue Service to determine if [a] corporation qualifies for a bad debt deduction on its federal corporate income tax return." CP 1215 (Smith Decl. at Ex. A (Jones Dep. at 9:1-25)); CP 1244 (Smith Decl. at Ex. B (Barrett Dep. at 14:21-25; 15:8-10; 17:5-13)); *see also Fid. Title Co. v. Dep't of Revenue*, 49 Wn. App. 662, 666, 745 P.2d 530 (1987) ("The Department has authority to adopt only procedural rules; it cannot enact or amend the law."); *Coast Pac. Trading, Inc. v. Dep't of Revenue*, 105 Wn.2d 912, 917, 719 P.2d 541 (1986) (stating the Department lacks authority to expand the law as enacted by the legislature). Since the

[19] In addition, the Department allowed all sales tax credits and B&O tax deductions claimed by HIW that related to Charge-backs, notwithstanding that HIW neither extended the credit nor owned those credit card accounts. CP 459-60 (Aultman Decl. at ¶¶26, 31). This undisputed fact also undermines the Department's claim that there is an additional, implicit "ownership" requirement.

Legislature chose not to impose any separate "ownership" requirement in the Bad Debt Statutes, and since HIW unquestionably met the federal standards for claiming the bad debt deductions, the Trial Court should have granted summary judgment in favor of Lowe's.

C. CASE LAW CONFIRMS HIW PROPERLY TOOK THE BAD DEBT CREDITS AND DEDUCTIONS

1. The Trial Court Erred in Reading *Home Depot* as Requiring Taxpayers to Initiate and Own Worthless Accounts to Be Entitled to Bad Debt Credits and Deductions

The Trial Court recognized the key differences between HIW's PLCC Agreements and those at issue in *Home Depot.* Further, it acknowledged that neither the Washington Bad Debt Statutes, the Bad Debt Regulation, nor the Federal standards to which Washington law is linked contain any language that imposes an ownership requirement on the claimant. Rather, the Trial Court "struggled with" language in this Court's *Home Depot* decision, which he read as requiring that "the debt must be held or owned by the party seeking to take the state deduction or credit". VRP at 4:3-22. Based on this erroneous reading, the Trial Court – although wanting to rule in favor of Lowe's – reluctantly entered summary judgment in the Department's favor.

In *Home Depot*, the parties agreed that the contracting bank ("GECC") – not the retailer – was the only party eligible to claim the bad debt deductions under IRC § 166. Home Depot paid a fixed monthly service fee in lieu of bearing the uncertain risk of loss on defaulted PLCC accounts. The PLCC agreements at issue explicitly provided that GECC exclusively "b[ore] the risk of all credit losses on the accounts". 151 Wn. App. at 913. Consequently, GECC was the sole party eligible under IRC § 166 to take the bad debt deductions for defaulted Home Depot PLCC accounts on its federal corporate income tax returns. 151 Wn. App. at 913. And, consistent with the Home Depot agreements, GECC took the deductions on its federal returns.

Home Depot nevertheless argued that it effectively bore the risk of loss for unpaid PLCC accounts through the fixed service fee, because the fee factored in the fact that the banks would likely suffer bad debt losses. *Id.* at 923. But Home Depot was never at risk on any specific PLCC accounts, and it never had to repay amounts to GECC that included taxes relating to the PLCC transactions. In other words, Home Depot was never out of pocket on taxes it remitted to Washington on the PLCC accounts. As a result, instead of deducting the service fee it paid to GECC as bad debts on Line 15 of its federal corporate income tax returns, Home Depot deducted the fee on Line 26 as a "credit card discount." *Id.* at 913-14.

The Department took the position that "Home Depot cannot obtain a sales tax refund under former RCW 82.08.037 because it could not deduct defaulted debt on its private label cards as bad debt under federal income tax laws." 151 Wn. App. at 915. It argued that only the party entitled to deduct the bad debt loss on its federal return can take the corresponding Washington sales tax credit and B&O tax deduction:

> DOR counters that the third requirement [for taking a bad debt credit or deduction as established in *Puget Sound*] applies only to seller-claimants that incur the deductible debt. It notes that the *Puget Sound* court determined that this requirement had been satisfied when it found relevant that the Bank took a worthless debt deduction for income tax purposes.

Id. at 919. This Court agreed:

> [T]he opinion [of the *Puget Sound* court] supports DOR's position. In assessing the bank's eligibility for a refund, the court considered it material that the bank, the refund claimant, although not the retailer, took the debt deduction.

Id. at 920. The Department never made the "ownership of the accounts" argument to this Court in *Home Depot*, and it never suggested that Washington was an "outlier" that had, by implication, different standards from the IRS (and all other SSUTA states) for determining what constitutes a bad debt.

Nevertheless, the Trial Court read *Home Depot* as possibly requiring that the party seeking the credit or deduction must own the account when it becomes worthless. It focused on the following language (which it believed may have been *dicta*):

> Although the tax refund statute at issue does not explicitly

> contain a requirement that bad debts be deductible by the refund claimant, analysis of related federal and state tax law demonstrates that the party seeking the deduction must be the one ***holding*** the bad debt as well as the one to whom repayment on such a debt would be made.

Id. at 922 (emphasis added). While this Court observed in *Home Depot* that the party seeking the deduction must be the one "holding" the bad debt, it did not state the party had to ***own*** the account. There is a difference between ***holding*** a debt and ***owning*** the account.[20] Although HIW did not initially own the PLCC accounts, by operation of its payments made in accordance with the Bad Debt Guarantee, HIW stepped into the shoes of the Banks and held the PLCC Bad Debts when it claimed the deduction under IRC § 166 and corresponding Washington credits and deductions.

When a PLCC Cardholder purchased merchandise from HIW, the initial debtor-creditor relationship was between the Bank and the Cardholder. But once HIW fulfilled its obligation as guarantor of the PLCC Bad Debts, it assumed the Bank's role as the Cardholder's creditor. The record establishes that HIW: (1) was contractually liable, as a guarantor, to pay the Banks on a dollar-for-dollar basis for any bad debt losses (including any related sales taxes) arising from the PLCC accounts up to the Cap; (2) reflected the bad debt losses in its books and records;

[20] Under TREAS. REG. § 1.166-9, ownership of the account is not even relevant.

and (3) expressly retained the right to deduct, and in fact deducted, the bad debt losses on its Federal Returns pursuant to IRC § 166. During the Assessment Period, the Banks recovered from HIW the unpaid balances due on the written-off PLCC accounts, which included any related sales taxes incurred on the sale. Accordingly, by operation of law, HIW became "the one holding the debt" and the "one to whom repayment on such debt would be made". CP 453-57 (Aultman Decl. at ¶¶11, 14-15, 17-18); CP 2668 (Second Aultman Decl. at ¶2).[21] This is the critical distinction between this case and *Home Depot*.

Conversely, in *Home Depot*, the PLCC agreements provided that "the contracting bank bears the risk of all credit losses on the accounts" and "Home Depot ha[d] no interest in the accounts or indebtedness the credit card program created." 151 Wn. App. at 913. GECC not only owned the Home Depot PLCC accounts, it bore the exclusive risk of loss if any of

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[21] The Washington Supreme Court has now embraced this principle for 117 years:

> It is a well-settled principle that a surety or guarantor who pays the debt of his principal will be substituted in the place of the creditor of such principal, as to all securities for the debt held by the creditor, and will be entitled to the same benefit from them as the creditor himself might have had.

Blewett v. Bash, 22 Wash. 536, 543-44, 61 P. 770 (1900). When a guarantor is compelled to pay a claim presented by a creditor, the guarantor assumes the creditor's rights as against the debtor. *See Hartford Fire Ins. Co. v. Columbia State Bank*, 183 Wn. App. 599, 609-10, 334 P.3d 873 (2014) (stating a surety who is forced to pay its principal's debts is entitled to be reimbursed and that the surety's rights as against the debtor exist "even without a contractual promise") (citing *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132, 136-38, 83 S. Ct. 232, 9 L. Ed. 2d 190 (1962)).

the accounts defaulted, including the loss of taxes that GECC had fronted for Home Depot. When a cardholder made a purchase, Home Depot received "payment of the full amount of the sale made on the card plus the sales tax, minus a service fee." *Id.* at 912. Thus, Home Depot was not out of pocket for sales tax remitted to Washington on accounts that became worthless. As a practical matter, Home Depot did not care if the PLCC customers ever paid on their accounts. This Court denied the refund claim, not because Home Depot did not own the PLCC accounts, but because Home Depot did not bear the economic loss and "could not deduct defaulted debt on its private label cards as bad debt under [the] federal income tax laws." *Id.* at 915. And because GECC paid Home Depot the full price of the goods plus all applicable taxes, "Home Depot no longer held any 'debt'—either as defined by state law under former RCW 82.08.050 or federal law under 26 U.S.C. § 166—directly attributable to its sales tax payment to DOR." 151 Wn. App. at 922.

2. To the Extent *Home Depot* Can Be Read to Create and Impose an Ownership Requirement, It Should Be Overruled

When interpreting a statute, this Court's "fundamental objective is to ascertain and carry out the Legislature's intent, and if the statute's meaning is plain on its face, then the court must give effect to that plain meaning." *Crystal Mountain, Inc. v. Dep't of Revenue*, 173 Wn. App. 925, 932, 295 P.3d 1216 (2013); *Flight Options, LLC v. Dep't of Revenue*, 172 Wn.2d 487, 500, 259 P.3d 234 (2011). As noted, the Washington Supreme Court found the Bad Debt Statute was unambiguous and contained only three requirements. It did not require the retailer to own the accounts when they become worthless. Also, even the Department admits that the Washington Bad Debt Statutes contain no ownership requirement. Further, as the Trial Court recognized, Washington law is linked exclusively to the Federal standards, which specifically allow a bad debt deduction for guarantors who neither extended the initial credit nor owned the accounts when they defaulted. Consequently, to the extent that *Home Depot* can be read to create and impose an ownership requirement, it fails to give effect to the plain language of the Bad Debt Statutes and should be overruled.

3. Decisions from Other Jurisdictions Confirm Home Depot Operated Under Materially Different PLCC Agreements and Was Not Entitled to a Bad Debt Deduction Under IRC § 166

The numerous state court and administrative decisions from across the United States that address Home Depot's PLCC agreements are all inapplicable to this case. Each notes that Home Depot was expressly relieved of any potential bad debt liability under its PLCC agreements because it chose the certainty of paying a predetermined monthly service fee over the risk (and different tax benefits) of retaining direct liability for bad debts. As the Arizona Court of Appeals explained: "the retailer's choice is simple: experience the loss and receive the deduction, or avoid the loss and forgo the deduction." *Home Depot USA, Inc. v. Ariz. Dep't of Revenue*, 287 P.3d 97, 102 (Ariz. Ct. App. 2012) (CP 1366 (Smith Decl. at Ex. L)). Because Home Depot chose to avoid the uncertainty of being directly liable for bad debt losses, tribunals have consistently ruled that it correspondingly chose to "forgo the deduction." The decisions were not based on the fact that Home Depot did not own the accounts when they became worthless.

Several of these courts have quoted the pertinent language of Home Depot's PLCC agreements:

> All credit losses on Accounts shall be solely borne at the expense of [the finance companies] and shall not be passed on to [Home Depot].

Home Depot USA, Inc. v. Ind. Dep't of State Revenue, 891 N.E.2d 187, 188 (Ind. Tax Ct. 2008) (alterations supplied) (CP 1372-73 (Smith Decl. at Ex. M)). *See also, e.g., Home Depot USA, Inc. v. Dir., Div. of Taxation*, 25 N.J. Tax 221, 224 (N.J. Super. Ct. App. Div. 2009); *Magee v. Home Depot USA, Inc.*, 95 So. 3d 781, 783-84 (Ala. Ct. Civ. App. 2011) (CP 1381, 1386-87 (Smith Decl. at Exs. N & O)). The Supreme Court of Ohio summarized Home Depot's PLCC program as follows:

> ***Home Depot specifically rejected a recourse arrangement***

> ***with GE that would have allowed the latter to recover bad-debt losses from Home Depot.*** Thus, Home Depot no more bears the economic burden of customer default on a private-label credit card transaction than it does on an ordinary credit card deal ....

Home Depot USA, Inc. v. Levin, 905 N.E.2d 630, 633 (Ohio 2009) (emphasis added) (CP 1404 (Smith Decl. at Ex. P)).

In contrast, HIW's PLCC Agreements did not factor the cost of potential liability into any service fee calculation. Instead, HIW paid for the credit losses, dollar-for-dollar, as they arose (up to the annual Cap set by the Agreements) and directly assumed the risk of uncertainty as to what the aggregate amounts of those losses would be. CP 453-55 (Aultman Decl. at ¶¶11, 14-15). Unlike Home Depot, HIW cared deeply whether the PLCC customers actually paid on their accounts.

The tribunals addressing Home Depot's claims to sales tax refunds have explicitly noted, and rejected, Home Depot's assertion that its service fee allocated financial responsibility to it for the Bad Debt losses borne by the finance companies:

- **Arizona**: "Taxpayer next argues that the service fees it paid reimbursed the Finance Companies for anticipated bad debts." *Ariz. Dep't of Revenue*, 287 P.3d at 101 (CP 1365 (Smith Decl. at Ex. L)).
- **Indiana**: "Home Depot asserts that in paying the service fees to the finance companies, it fully 'reimbursed' them, in advance, for all anticipated losses due to uncollectible credit card accounts." *Ind. Dep't of State Revenue*, 891 N.E.2d at 190

(CP 1374 (Smith Decl., Ex. M)).

- **Kentucky**: "Home Depot also argues that it effectively wrote off the bad debt when it charged off the service fees that it paid to the finance companies as a business expense." *Home Depot USA, Inc. v. Finance & Admin. Cabinet, Dep't of Revenue*, No. K10-R-25, 2012 WL 5213018, at *1 (Ky. Bd. Tax App. Oct. 17, 2012) (CP 1411 (Smith Decl. at Ex. Q)).

- **Michigan**: "[P]laintiff argues, it was affected by the bad debt in that this debt essentially forced plaintiff to pay higher fees in the servicing agreements with the finance companies." *Home Depot USA, Inc. v. Mich.*, No. 301341, 2012 WL 1890219, at *1 n.2 (Mich. Ct. App. 2012) (CP 1422 (Smith Decl. at Ex. R)).

- **New York**: "The credit card service fees charged were variable based on the credit risk associated with each customer." *Home Depot USA, Inc. v. Tax Appeals Tribunal of State of N.Y.*, 68 A.D.3d 1571, 1573 (N.Y. App. Div. 2009) (CP 1438 (Smith Decl. at Ex. T)).

- **Ohio**: "Home Depot contends that … its contract with GE is intended to build the cost of the bad-debt overhead into the service fees." *Home Depot USA, Inc. v. Levin*, 905 N.E.2d at 633.

- **Oklahoma**: "Home Depot claimed that it … prepaid the private label credit card issuers for bad debts by paying service fees." *In re Sales Tax Claim for Refund of the Home Depot*, 198 P.3d 902, 903 (Okla. Ct. Civ. App. 2008) (CP 1443 (Smith Decl. at Ex. U)).

- **Washington**: "Home Depot maintains that in setting the service fees … the parties incorporated the anticipated bad debt expenses into the pricing." *Home Depot*, 151 Wn. App. at 923.

All of these tribunals denied Home Depot's refund claim because it was not entitled to and did not write off the defaulted accounts as worthless under IRC § 166. For example, the Indiana Tax Court explained:

> With respect to the Home Depot credit card accounts that had been defaulted upon and were therefore uncollectible, the finance companies claimed "bad debt" deductions on their federal income tax returns, pursuant to section 166 of the Internal Revenue Code, during the period at issue. On its federal income tax returns, Home Depot deducted the service fees it paid to the finance companies as a business expense pursuant to section 162 of the Internal Revenue Code.
>
> More specifically, the finance companies reported these deductions on line 15 of their federal income tax returns (Forms 1120), entitled "Deductions: Bad debts."
>
> Home Depot reported these deductions on line 26 of its Forms 1120, entitled "Deductions: Other deductions."

Ind. Dep't of State Revenue, 891 N.E.2d at 188-89 & n.2-3. The court then held: "Home Depot would be entitled to the deduction under Indiana Code § 6-2.5-6-9 if it wrote off the uncollectible credit card accounts for federal tax purposes under section 166 of the Internal Revenue Code. Home Depot did not and therefore it is not entitled to the deduction." *Indiana Dep't of State Revenue*, 891 N.E.2d at 191 (internal citations omitted).

4. The Oklahoma Tax Commission's Decision in a Similar Controversy Is Persuasive Authority

A similar controversy involving these same PLCC Agreements was litigated and resolved in Oklahoma (another SSUTA state) before an Administrative Law Judge ("ALJ") associated with the Oklahoma Tax Commission ("OTC"). 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 461, 1092 (Aultman Decl. at ¶32, Ex. J-1 at 3). In ruling in favor of Lowe's, the ALJ made the following findings and conclusions:

> 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."
>
> In stark contrast to *Home Depot*, the Protestant (1) wrote off PLCC Bad Debts in its books and records during the Assessment Period, (2) claimed the Bad Debt Deduction on Line 15 of its Federal Returns for the Assessment Period, and (3) claims its eligibility to the Bad Debt Deduction pursuant to IRC § 166 via Treas. Reg. § 1.166-9(d) as a Guarantor.
>
> * * *
>
> 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). 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.[22]

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[22] This is particularly true because Oklahoma, like Washington, is a member of SSUTA. *See* n.18 *supra*.

D. THE TRIAL COURT'S DENIAL OF HIW'S REFUND CLAIM VIOLATED HIW'S CONSTITUTIONAL RIGHT OF EQUAL PROTECTION

The equal protection clause of the Fourteenth Amendment to the U.S. Constitution provides that no state shall "deny to any person within its jurisdiction equal protection of the laws." Similarly, the Washington Constitution contains a privileges and immunities clause, which provides that "[n]o law shall be passed granting to any citizen, class of citizens, or corporation … privileges or immunities which upon the same terms shall not equally belong to all citizens, or corporations." WASH. CONST. art. I, § 12. These provisions serve to protect a person "from state action which selects him out for discriminatory treatment by subjecting him to taxes not imposed on others of the same class." *Allegheny Pittsburgh Coal Co. v. Cty. Comm'n of Webster Cty., W. Va.*, 488 U.S. 336, 344, 109 S. Ct. 633, 102 L. Ed. 2d 688 (1989) (internal quotation marks and citation omitted). The Washington Supreme Court has explained that, for legislation to comply with these equal protection requirements, it must "apply alike to all persons within the designated class" and "reasonable ground must exist for making a distinction between those who fall within the class and those who do not." *State ex rel. N. Pac. Ry. Co. v. Henneford*, 3 Wn.2d 48, 54, 99 P.2d 616 (1940).

The Department acknowledges that "RCW 82.08.037 is a tax preference for retailers that paid sales taxes they cannot actually collect from the buyer." CP 1170 (Dep't Mot. for Summ. J. at 15). HIW, as guarantor of the PLCC accounts, fell squarely within this class of retailers – it was out of pocket as to the sales and B&O taxes that it had previously remitted to Washington on PLCC accounts that later defaulted. CP 2668 (Second Aultman Decl. at ¶2). HIW does not contend that the Bad Debt Statutes themselves violate its equal protection rights, but rather that the unauthorized and unreasonable imposition of an ownership requirement – one that the Department admits does not exist in the Bad Debt Statues – violated HIW's rights by treating it different from other retailers who have remitted sales taxes they cannot collect from the buyer.

In *Allegheny Pittsburgh Coal Co.*, the West Virginia legislature enacted a statute which provided that all property should be taxed at a rate uniform throughout the state according to its estimated market value. The statute did not distinguish between recently sold property and property which had not been recently sold. Nonetheless, a county tax assessor chose to value recently sold property on the basis of its recent purchase price, but assessed neighboring property which had not been recently sold under another method. 488 U.S. at 338. The U.S. Supreme Court held that the distinction drawn by the assessor, on her own initiative, resulted in disparate treatment of property in the same class, which violated the petitioners' equal protection rights:

> But West Virginia has not drawn such a distinction. Its Constitution and laws provide that all property of the kind held by petitioners shall be taxed at a rate uniform throughout the State according to its estimated market value. … We are not advised of any West Virginia statute or practice which authorizes individual counties of the State to fashion their own substantive assessment policies independently of state statute. *See Salsburg v. Maryland*, 346 U.S. 545, 74 S.Ct. 280, 98 L.Ed. 281 (1954). The Webster County assessor has, apparently on her own initiative, applied the tax laws of West Virginia in the manner heretofore described, with the resulting disparity in assessed value of similar property.

Allegheny Pittsburgh Coal Co., 488 U.S. at 345.

The same principle applies here with respect to the Department which, on its own initiative, chose to impose an arbitrary ownership requirement that is neither authorized by nor consistent with the Bad Debt Statutes.

E. The Trial Court's Denial of HIW's Refund Claim Violates HIW's Constitutional Right of Due Process

Likewise, by imposing arbitrary requirements on HIW that are neither authorized by statute nor promulgated as regulations, the Department has denied HIW its right to a refund of overpaid sales and B&O taxes without due process of law, in violation of Article I, section 3 of the Washington State Constitution ("No personal shall be deprived life, liberty, or property, without due process of law."), as well as the Fifth and Fourteenth Amendments to the U.S. Constitution ("No person shall … be deprived of life, liberty, or property, without due process of law.").

VI. CONCLUSION

During the Assessment Period, Washington's Bad Debt Statutes looked exclusively to federal law and standards under IRC § 166 and the corresponding U.S. Treasury Regulations to determine whether a taxpayer was eligible to claim a corresponding sales tax credit or B&O tax deduction for bad debts. HIW – as guarantor of the PLCC Bad Debts – was entitled to claim and, in fact, took bad debt deductions on its Federal Returns under IRC § 166 and TREAS. REG. § 1.166-9. Consequently, HIW was entitled to claim sales tax credits and B&O tax deductions on its Washington Returns. Washington law neither contains nor supports an additional requirement that HIW must have initiated, managed, and owned the accounts when they became worthless. Accordingly, this Court should reverse the grant of summary judgment in the Department's favor of and remand this case to the Trial Court with instructions to enter judgment in favor of Lowe's on its refund claim in the aggregate principal amount of $2,218,507.63, plus all accrued interest.

DATED this 28th day of June, 2017.

Respectfully submitted,

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CERTIFICATE OF SERVICE

THIS IS TO CERTIFY that on the 28th day of June, 2016, 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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June 28, 2017 - 4:32 PM

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