No. 96383-5

No. 50080-9-II

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

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LOWE'S HOME CENTERS, LLC

Appellant

v.

DEPARTMENT OF REVENUE, STATE OF WASHINGTON

Respondent

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# APPELLANT'S REPLY BRIEF

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## INTRODUCTION

In its Brief of Respondent ("Response"), the Washington Department of Revenue ("Department") continues to insist that this case is indistinguishable from and therefore governed by *Home Depot USA, Inc. v. Department of Revenue*[1] and the numerous similar decisions handed down by courts throughout the country.[2] In each court decision cited by the Department, the subject PLCC agreement between the seller and its third party lender followed the *Home Depot* template: the seller (1) contracted away its right to take the loss on defaulted PLCC accounts; (2) was fully paid for the purchase prices and corresponding tax; (3) bore no risk of loss; and (4) was ineligible to take PLCC bad debt deductions on its federal income tax returns. Citing these cases, the Department broadly concludes that "[f]or this reason, this Court and others have rejected retailer claims of entitlement to a sales tax refund on defaulted private label credit card accounts." (Response at 15.)

But the PLCC Agreements at issue here do not follow the *Home Depot* template. HIW, unlike the sellers in the cited cases, (1) directly

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[1] 151 Wn. App. 909, 215 P.3d 222 (2009), *review denied*, 168 Wn.2d 1008, 226 P.3d 781 (2010) ("*Home Depot*").

[2] *See, e.g., Circuit City Stores, Inc v. Dir. of Revenue,* 438 S.W.3d 397 (Mo. 2014); *Citibank (South Dakota), N.A. v. Dep't of Taxes*, 149 A.3d 149 (Vt. 2016); *Dep't of Revenue v. J.C. Penney Co.*, 96 Wn.2d 38, 633 P.2d 870 (1981); *Home Depot USA, Inc. v. Levin*, 121 Ohio St. 482, 905 N.E.2d 630 (2009).

bore the economic loss for bad debts arising from PLCC accounts; (2) paid sales taxes it could not collect back from the buyers; (3) wrote off the PLCC bad debt losses in its books and records; and (4) deducted the losses as bad debts on its federal income tax returns pursuant to IRC § 166. Moreover, when recoveries were made on PLCC accounts that had previously been written off as worthless, the proceeds went to HIW, not the third party bank. CP 454-55 (Aultman Decl. ¶¶ 13-14). When it made guaranty payments on these accounts, HIW stepped into the Bank's shoes and held the debt when the recoveries were received. HIW then remitted the corresponding additional sales tax to the State.

The controlling Bad Debt Statute is clear and unambiguous: "A seller is entitled to a credit or refund of sales taxes previously paid on bad debts, as that term is used in 26 U.S.C. Sec. 166."[3] The controlling 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***."[4] There are no other statutory or regulatory preconditions to claiming a bad debt tax credit in Washington.

No court decision issued in Washington or elsewhere has addressed the specific arrangement in this case (*i.e.*, a seller who has

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[3] RCW 82.08.037(1) (as amended effective July 1, 2004).
[4] WAC 458-20-196(1)(d) & (2)(emphasis added).

guaranteed a bad debt such that he is entitled to a deduction under § 166 of the Internal Revenue Code, and none has held that a seller under these circumstances is barred from claiming a corresponding credit or deduction for taxes previously remitted on defaulted PLCC accounts.[5] Consequently, the numerous cited decisions based on PLCC agreements following the *Home Depot* template are inapplicable here. This is, in fact, a case of first impression involving an unambiguous statute and undisputed facts.

The Department nevertheless takes the extreme position that sellers who participate in PLCC arrangements with third party lenders can ***never***, under ***any*** circumstances, qualify for bad debt credits or deductions in Washington. It insists that any and all "[v]ariations in the terms and conditions of a seller's agreement with the financial institution providing credit to a seller's customers are immaterial." (Response at 25). And because there are no laws, rules or cases adopting such an extreme position, the Department asks this Court to "clarify" its earlier ruling in *Home Depot* by now declaring on a blanket basis "that a seller cannot qualify for a sales tax refund under RCW 82.08.037 by contractually agreeing to indemnify a third party lender for its bad debt losses." (*Id.*)

Imposing such a wholesale prohibition would be unsupported by

[5] In fact, the Arizona Court of Appeals suggested that where, as here, a seller "experiences the loss", it is entitled to the deduction. *Home Depot USA, Inc. v. Arizona Dep't of Revenue*, 287 P.3d 97, 102 (Ariz. Ct. App. 2012) (CP 1366 (Smith Decl., Ex. L)).

law and would undermine the legislative purpose underlying the Bad Debt Statutes which, as the Department acknowledges, "is to provide a remedy for sellers that paid sales taxes they could not collect from the buyer." (*Id.* at 12). There is nothing in the Bad Debt Statutes, the Regulation, or *Home Depot* to justify banning sellers from claiming tax credits and deductions for bad debt losses they actually suffer on PLCC accounts. Rather, the clear lesson derived from *Home Depot* is that a seller who (1) actually bears losses on PLCC accounts, (2) deducts the losses as bad debts on line 15 of its federal returns, and (3) is thereafter entitled to recoveries made on those accounts, is eligible to take corresponding sales tax credits and B&O tax deductions in Washington.[6]

In addition to its blanket prohibition argument, the Department tries to further complicate this straightforward case by asserting various subsidiary contentions. For example, citing to the portion of the Bad Debt Regulation that describes when a taxpayer may claim a credit or deduction – during "the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes"[7] – the Department claims that HIW, because it did not initiate and own the PLCC accounts,

[6] *Home Depot*, 151 Wn. App. at 919-20.
[7] WAC 458-20-196(2).

"had nothing to write off as uncollectible when a cardholder defaulted." (Response at 15). It also claims that "[b]ecause GE Capital never had a right to a sales tax refund on the uncollectible proceeds of its credit card loan transactions, [HIW] could not have acquired any such right by agreeing to reimburse GE Capital for its bad debt losses." (*Id.* at 25). As set out below, these subsidiary contentions are also meritless.

## ARGUMENT

### I. THE CONTENTION THAT HIW CANNOT CLAIM BAD DEBT CREDITS OR DEDUCTIONS ON PLCC ACCOUNTS IT DID NOT OWN IS UNSUPPORTED BY LAW

The Department's primary contention is that no seller can ever claim a refund of sales or B&O taxes it remitted on worthless PLCC accounts if the transactions were initially financed by a third party bank. But, under the law, the mere fact that a bank owned and managed the PLCC accounts prior to their being written off does not affect whether HIW is entitled to a credit or deduction for taxes it remitted on the accounts after it performs on its guaranty. The contention should be rejected for at least five reasons:

1. The Bad Debt Statutes and the one Washington Supreme Court case interpreting them, *Puget Sound National Bank v. Department of Revenue*[8], confirm that there are only three requirements a seller must satisfy to claim a credit or deduction for bad debt losses, and

[8] 123 Wn.2d 284, 868 P.2d 127 (1994).

HIW met each one.

2. The Department's designated representative acknowledged under oath that neither the Bad Debt Statues nor the Regulation imposes or even suggests an additional "ownership requirement" for claiming tax credits or deductions on bad debts.

3. The Department concedes that the "federal standards" on which the Washington credits and deductions are based specifically allow a bad debt deduction for guarantors – parties who neither extend the credit nor own or manage the defaulting accounts.

4. *Home Depot* only provides that a seller should be "holding" a bad debt when it seeks the deduction. But there is a difference between "holding" a debt and "owning" the account. Nonetheless, the Department asks this Court to (mis)read *Home Depot* as implying a requirement of ownership, one that is not contained in the plain language of the Bad Debt Statutes or Regulation.

5. The 2010 amendments to the Bad Debt Statute and Regulation – enacted after the end of and not applicable to the Assessment Period – do not suggest a legislative intent to adopt a blanket prohibition. The new rule only precludes sellers from obtaining a 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."[9] Here, HIW, and not the Bank, bore the risk of loss on the PLCC accounts.

### A. THE BAD DEBT STATUTES AND REGULATION DO NOT REQUIRE OR SUGGEST THAT SELLERS MUST ORIGINATE AND OWN THE DEFAULTED PLCC ACCOUNTS.

The Department acknowledges that the Washington Supreme Court interpreted RCW 82.08.037 for the first and only time in *Puget Sound* and this decision was controlling law throughout the Assessment Period. (Response at 17). As noted, *Puget Sound* identified only ***three***

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[9] WAC 458-20-196(6) (emphasis added).

requirements a seller had to satisfy to claim a bad debt credit or deduction: "(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"[10] and HIW met all three.

The Department itself concedes that neither the Bad Debt Statutes nor the Regulation states that, to obtain a refund of sales and/or B&O taxes remitted on bad debts, a seller must have extended credit directly to its customers and owned the accounts when they default. *See* CP 1259 (Smith Decl., Ex. B (Barrett Dep., pp. 75:22-76:9, 76:16-19)). Although the Department now suggests that its designated representative's sworn testimony regarding the Department's understanding and implementation of the controlling law is somehow irrelevant here (Response at 10), the testimony is in fact a binding admission regarding a key material fact.[11]

The Department instead argues that the law, although silent on this issue, somehow ***implies*** an "ownership" requirement. It claims that the "write-off is the 'essence of the bad debt deduction'" and, since HIW did not own the PLCC accounts, it could not write them off its books and

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[10] 123 Wn.2d at 287.

[11] *See Raborn v. Hayton*, 34 Wn.2d 105, 108, 208 P.2d 133 (1949) ("[U]ndenied admissions of a party-opponent have substantial weight."). *Avnet, Inc. v. Department of Revenue*, 187 Wn. App. 427, 348 P.3d 1273 (2015), does not help the Department disavow this testimony. There, the court held that "an agency's internal debates concerning possible amendments to a rule" has little bearing on a court's interpretation of such rule. *Id.* at 437 n.6. *Avnet* did not address binding admissions.

records when they defaulted. (Response at 14-15). It falsely premises this claim on the Regulation's language describing when a taxpayer may claim the credit: during "the tax reporting period in which the bad debt is written off as uncollectible in the taxpayer's books and records and would be eligible for a bad debt deduction for federal income tax purposes."[12] The Department speculates that the inclusion of the words "written off" necessarily implies that the seller must own the unpaid accounts and, since HIW did not own the PLCC accounts, it had nothing to "write off" when the accounts became worthless. (Response at 14-15).

But the cited language is merely descriptive, ***not*** prescriptive. It describes ***when*** the credit or deduction may be taken; it neither creates nor implies any additional, extra-statutory requirements a claimant must satisfy.[13] Moreover, the record shows that HIW in fact reflected in its books and records the losses it suffered related to the PLCC Bad Debts. *See* CP 455 (Aultman Decl. ¶ 16). Ronald W. Blasi, an expert in the field of federal corporate income tax law, testified that there is no specific manner in which the bad debt losses must be recorded:

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[12] WAC 458-20-196(2)(a).

[13] Neither IRC § 166 nor the corresponding regulations require a write off for a taxpayer to be eligible for a bad debt deduction for wholly worthless debts. *In re Hoffman*, 16 F. Supp. 391 (E.D. Penn. 1936), is of no use to the Department because it did not concern the Bad Debt Statutes. Further, the Pennsylvania court disallowed the taxpayer's bad debt deduction because he deliberately waited to charge off the debts until the year after they were deemed worthless – confirming that the write off is a timing requirement.

> Q: How is that [bad debt loss] going to be reflected on Lowe's books and records?
>
> * * *
>
> A: There should be some type of accounting entry that indicates Lowe's is fulfilling its obligation as a guarantor. It doesn't have to follow any fixed pattern. There's nothing in the law or in the regulations that requires any fixed pattern to be followed. It just has to be demonstrated that it has had a debt, in this case, a debt that arises as a result of the guarantee, and that debt is bad. And if you could just demonstrate that is some reasonable way, it's going to be accepted for federal income tax purposes.

Blasi Dep. 31:14-32:9 (Appendix A). The Department provided no evidence and made no attempt to challenge Mr. Blasi's expert testimony.

### B. HIW'S GUARANTY PAYMENTS REPRESENT TAXES IT REMITTED BUT COULD NOT RECOVER FROM ITS CUSTOMERS.

The "paramount consideration" for this Court "is that the statute[s] be interpreted consistently with the[ir] underlying policy."[14] Although the Department describes the legislative policy underlying the Bad Debt Statutes as "to provide a remedy for sellers that paid sales taxes they could not collect from the buyer" (Response at 12), it nevertheless asserts that HIW is not entitled to this remedy because it "received cash payment of the entire amount it was entitled to collect from the buyer, including the sales taxes." (*Id.* at 16). This assertion is fallacious.

When the Bank approved a customer's credit application, it

[14] *Auto. Club of Wash. v. Dep't of Revenue*, 27 Wn. App. 781, 786, 621 P.2d 760 (1980).

granted a line of credit that the customer could use to buy items at HIW stores. And within a day or two, the Bank forwarded payment to HIW for the Cardholder's purchases, along with all corresponding taxes. HIW, as the seller, would remit Washington sales and B&O taxes on the PLCC transactions that took place in the state. CP 453 (Aultman Decl. ¶ 10). But HIW remained subject to recourse (on a dollar-for-dollar basis) on PLCC accounts that defaulted during the Assessment Period. In honoring the Bad Debt Guarantee, HIW paid to the Bank the unpaid balances due on written-off PLCC accounts, including any sales taxes that HIW had previously received from the Bank. On these accounts, HIW – and not the Bank – was the "seller that paid sales taxes [it] could not collect from the buyer." CP 2668 (Second Aultman Decl. ¶ 2). As a result, HIW plainly fell within the scope and legislative purpose of the Bad Debt Statutes.

### C. THE FEDERAL STANDARDS EXPRESSLY AUTHORIZE BAD DEBT DEDUCTIONS FOR GUARANTORS WHO DO NOT ORIGINATE OR OWN THE BAD DEBT ACCOUNT.

The Department also acknowledges that, under IRC § 166 and the corresponding Treasury Regulation, a guarantor of a worthless debt is entitled to claim a bad debt deduction once he makes good on his guaranty obligation. *See* CP 1235 (Smith Decl., Ex. A (Jones Dep., p 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.")). Further, the record establishes that, during the Assessment Period, HIW made guaranty payments to the Bank for the PLCC Bad Debts up to the Caps. *See* CP 451-55 (Aultman Decl. ¶¶ 6-14); 1137-38 (Blasi Decl. ¶ 12). In its Response, the Department tacitly concedes these facts.

Instead, the Department now declares – citing no supporting authority – that "following *Puget Sound*, the requisite basis for a sales tax refund is the existence of an unpaid debt obligation *originated by a seller*." (Response at 18). But *Puget Sound* requires no such thing. As the Washington Supreme Court confirmed, the controlling requirement is that the seller be entitled to a federal deduction of "bad debts, as that term is used [for federal income tax purposes] in 26 U.S.C. Sec. 166."[15] The Department now asks this Court to ***alter*** the Bad Debt Statutes by declaring "that a seller cannot qualify for a sales tax refund under RCW 82.08.037 by contractually agreeing to indemnify a third party lender for its bad debt losses." (Response at 25). To make this extra-legislative declaration, the Court would have to ignore Treasury Regulation § 1.166-9, the controlling U.S. Supreme Court and other federal court decisions that interpret it, and the acknowledged legislative policy underlying the Bad

[15] 123 Wn.2d at 287; RCW 82.08.037(1) & 82.04.4284(1).

Debt Statutes.

IRC § 166(a)(1) "allow[s] as a deduction any debt which becomes worthless within the taxable year." Treasury Regulation § 1.166-9(a) 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***." (Emphasis added). These are the governing "federal standards" and they specifically allow a bad debt deduction for guarantors of defaulted credit accounts initiated and owned by third party lenders. By definition, such guarantors do not extend credit to the debtors and do not own the accounts when they became worthless. But they still bear the loss when the accounts default.

The U.S. Supreme Court explained the reasoning as follows:

> 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 into 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.***[16]

Moreover, "no independent debt between principal debtor and the third party [guarantors], created by subrogation, is necessary."[17] Of note, the Response fails to address or even mention these controlling authorities.

Similarly, the record establishes, and the Department does not genuinely dispute, that HIW met the four conditions set out in the federal standards for qualifying as a guarantor: (1) it entered the PLCC agreements in the course of its business; (2) there was an enforceable legal duty for HIW to make the guaranty payments; (3) the agreements were entered into before the PLCC accounts became worthless; and (4) HIW received reasonable consideration for entering into the agreements. Treas. Reg. § 1.166-9(d)&(e). CP 1131-37 (Blasi Decl. ¶¶ 2, 4-7 & 11).

### D. *Home Depot* Does Not Require That A Seller Initiate And Own The Underlying PLCC Accounts.

In claiming that there must be a direct connection between the purported bad debts and the retail sale transactions for which a seller seeks a tax refund, the Department does not rely on either the Bad Debt Statutes or the Regulation. Instead, like the trial judge, it only cites to *Home Depot*. (Response at 20 (insisting that, like Home Depot, HIW did not incur a bad

[16] *Putnam v. Comm'r*, 352 U.S. 82, 85-86, 77 S. Ct. 175, 1 L. Ed. 2d 144, 57-1 U.S. Tax Cas. (CCH) P9200, 50 A.F.T.R. (P-H) 502, 1957-1 C.B. 501 (1956) (CP 1284 (Smith Decl., Ex. F)) (emphasis added).
[17] *Horne v. Comm'r*, 523 F.2d 1363, 1365 (9th Cir. 1975).

debt loss "'***directly attributable to***' a retail sale"; rather, HIW's bad debt losses were attributable to its collateral agreement with GE Capital)). The key language upon which the Department relies is:

> 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.[18]

There is, however, a fundamental difference between ***holding*** a debt and ***owning*** the account. 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 under the Bad Debt Guarantee, it stepped into the Bank's shoes as the Cardholder's creditor. By operation of law, HIW became "the one holding the debt" and, as the evidence established, it was the "one to whom repayment on such debt would be made." *See* CP 454-44 (Aultman Decl. ¶¶ 13-14). In fact, HIW subsequently received recoveries on PLCC accounts that had previously been written off as worthless, and paid sales tax on these amounts. These are the critical and determinative distinctions between this case and all the cases involving the *Home Depot* template.[19]

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[18] *Home Depot*, 151 Wn. App. at 922 (emphasis added).

[19] This Court's conclusion that Home Depot no longer held any debt directly attributable to its sales tax payments to the Department turned on the fact that it received "payment of

The Department nevertheless argues that any bad debts HIW incurred as guarantor were not "'directly attributable to' a retail sale" because the Cardholder was not a party to the guaranty contract. (Response at 29-30). It relies on *Frontier Bank v. Bingo Investment, LLC* for the proposition that "[a] guaranty is a promise to answer for the debt, default, or miscarriage of another person" and "imports the existence of two different obligations, one being that of the principal debtor and the other that of the guarantor."[20] But *Frontier Bank* is clearly distinguishable; it did not involve the bad debt issue before this Court and did not even involve sales tax. Specifically, it did not address (1) what happens when a guarantor makes good on his obligation, or (2) whether the guarantor is entitled to claim a bad debt deduction relating to his resulting loss.

The Bad Debt Statutes tie eligibility to claim a sales tax credit or B&O tax deduction ***exclusively*** to whether the bad debts on which taxes were paid were deductible as worthless under "federal standards" (IRC § 166 and the corresponding Regulations).[21] The federal standards do not require privity of contract between the taxpayer and the debtor. CP 1348-

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(continued...)

the full amount of the sale made on the card plus the sales tax" and was not economically at risk. 151 Wn.2d at 912. In contrast, HIW had to pay back to the Bank the unpaid balance due on defaulted PLCC accounts, which included any sales taxes HIW had previously remitted to the Department. CP 2668 (Second Aultman Decl. ¶ 2).

[20] 191 Wn. App. 43, 53, 361 P.3d 230 (2015) (quotation marks and citations omitted).

[21] RCW 82.08.037, 82.04.4284; WAC 458-20-196(1)(d).

60 (TAM 200814026 (Smith Decl., Ex. K)). In fact, § 1.166-9 identifies guarantors, who neither initiate nor own the receivables, as appropriate parties to take bad debt deductions if the guaranteed accounts become worthless.

Since there are no reported court cases embracing the Department's blanket prohibition premise, the Response cites to a recent Washington Board of Tax Appeals decision that purportedly rejected a similar "'guarantor' theory." (*See* Response at 39-40) (citing *Kohl's Dep't Stores, Inc. v. Dep't of Revenue*[22]). This BTA decision, however, has no bearing on this case.

*First*, there is no evidence in the record that Kohl's PLCC agreement contained a provision similar to the Bad Debt Guarantee contained in HIW's PLCC Agreements. *Second*, in the *Kohl's* case, the Department challenged and the BTA focused on whether there was "an enforceable legal duty upon the taxpayer to make the [guaranty] payment." CP 2708 (BTA No. 13-107, p. 8). Here, it is undisputed that HIW satisfied all of the conditions under Regulation § 1.166-9. *See* CP 1135-38 (Blasi Decl. ¶¶ 10 & 12). *Third*, the BTA's decision is an administrative ruling that is not binding on this Court.[23] *Finally*, the ruling is not even

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[22] Bd. Tax App. Docket No. 13-107 (June 10, 2016).
[23] *See Valley Fruit v. Dep't of Revenue*, 92 Wn. App. 413, 419, 963 P.2d 886 (1998).

final; it is currently under review. (Response at 39 n.15). [24]

### E. **THE 2010 AMENDMENTS TO THE BAD DEBT STATUTE AND REGULATION SUPPORT HIW'S CLAIM FOR A SALES TAX CREDIT.**

In 2010 – ***after*** the end of the Assessment Period – 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.[25]

This amendment represented a substantive change in law, effective July 1, 2010, that is not applicable to the Assessment Period.[26]

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 only the original seller can now claim such credits. But the amendment does not indicate, as the Department suggests, that the Legislature never intended to authorize bad debt credits or deductions for

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[24] The Department also contends that (1) "absent an unpaid debt owed by the buyer to the seller on a retail sale transaction, there can be no entitlement to a sales tax refund" under the Bad Debt Statutes; and (2) "[t]he cardholder's debt obligation to GE Capital remained intact. There was no unpaid debt obligation owed to Lowe's by the buyer." (*Id.* at 13-14 & 16, n.7). These are simply variations of the Department's ownership position and fail for the same reasons. These arguments fail to acknowledge that, once HIW's obligation under the Bad Debt Guarantee was triggered, it and not the Bank received any subsequent recoveries and paid the sales tax on those recoveries to the Department.

[25] RCW 82.08.037(7)(2010).

[26] *See, e.g., In re Cascade Fixture Co.*, 8 Wn.2d 263, 273, 111 P.2d 991 (1941).

sellers on credit accounts originated by banks. (Response at 27).

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 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.[27]

Like the 2010 amendment to the Bad Debt Statute, the new rule was not effective until after the Assessment Period and is inapplicable here. In any event, it contains ***two*** separate requirements for precluding a seller from claiming a bad debt deduction: the lender financing the transactions (i) must be "the exclusive owner of the credit card accounts" ***and*** (ii) must "solely bear[ ] the risk of all credit card losses."

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 if he still bears the risk of loss. Indeed, under federal standards, the ownership of the account is irrelevant. While HIW did not own the PLCC accounts when they became worthless, it (unlike Home Depot) 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

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[27] WAC 458-20-196(6) (emphasis added).

losses. Consequently, as a matter of law, HIW remained entitled to claim the corresponding Washington sales tax credits and B&O tax deductions.

## II. THE DEPARTMENT FAILS TO REFUTE THAT THE OKLAHOMA TAX COMMISSION'S DECISION IS PERSUASIVE AUTHORITY

Unlike the *Home Depot* template cases cited by the Department, the Oklahoma decision involved the very same PLCC Agreements that are at issue here. The Oklahoma ALJ recognized the critical distinctions between HIW's PLCC Agreements and Home Depot's agreements and ruled that HIW, 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. CP 461, 1089-1103 (Aultman Decl., ¶ 32, Ex. J-1 & J-2). Moreover, the ALJ concluded that the exact amount of sales tax at issue, exclusive of penalties and interest, was $804,332.84. CP 1098 (Aultman Decl., Ex. J-1 at ¶ 9). The Department, contends that this decision should be ignored because the Oklahoma taxing authority, unlike the Department, agreed to stipulate that HIW wrote off the PLCC Bad Debts on its books and records and deducted the bad debts on its federal tax returns. (Response at 36-37). But these same facts have been established by evidence in this case: HIW wrote off the PLCC bad debt losses in its books and records and deducted the losses as bad debts on line 15 of its federal returns. CP 455-57 & 845-98 (Aultman

Decl. ¶¶ 16-18 & Exs. G-1 through G-9). The fact that the Oklahoma taxing authority stipulated to these facts is of no consequence.

The Department also claims, without citing to the decision itself, that the ALJ had deemed it immaterial that the bad debt deductions HIW took were not directly attributable to the retail sales. (Response at 38). This claim misrepresents the ALJ's decision and, in any event, is irrelevant. Here, HIW established with evidence that its deductions were directly attributable to retail sales by virtue of the Bad Debt Guarantee.

## III. THE DEPARTMENT'S ARGUMENT THAT HIW CANNOT CLAIM A RETAILING B&O TAX DEDUCTION IS BASELESS

Separately, the Department argues that HIW is not entitled to a retailing B&O tax deduction. First, it details the difference between the B&O tax rate applicable to retail sales and the rate applicable to financial services. Then it accuses HIW of mixing and matching its deductible expenses for B&O tax purposes. (*Id.* at 44-45). Specifically, it claims that HIW is claiming retailing B&O tax deductions for bad debts that, according to the Department, reduced HIW's alleged "unreported financing income." (*Id.* at 45-47).

This new claim is a canard. Recall that the Department's central premise in this appeal is HIW did ***not*** own or manage the PLCC accounts; therefore, HIW could ***not*** have been in the business of extending credit to

PLCC Cardholders and servicing their accounts. Yet, at the same time, the Department argues that HIW is improperly seeking retailing B&O tax deductions on its alleged financial services income. It relies on three cases[28] for the general proposition that "the activity of financing and servicing credit accounts is a separate and distinct taxable activity for B&O tax purposes from the activity of making retail sales." (Response at 46). But the Department's argument is self-contradictory. If HIW did not service the PLCC accounts, then it could not receive income for financing and servicing those accounts. Moreover, the cases the Department cites simply do not apply. Each involved a finance company that earned income solely from initiating and servicing installment purchases and credit accounts, and the controversies focused solely on whether the finance companies had nexus with the State for B&O tax purposes.

In *J.C. Penney Company*, the seller financed its own PLCC program. Customers submitted credit applications to Penney's regional credit office in Portland, Oregon and if the application was approved, the Portland office extended credit to the customer.[29] The controversy was whether Washington could tax income from finance charges generated on

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[28] *Nordstrom Credit, Inc. v. Dep't of Revenue*, 120 Wn.2d 935, 845 P.2d 1331 (1993); *Dep't of Revenue v. J.C. Penney Co., Inc.*, 96 Wn.2d 38, 633 P.2d 870 (1981); and *Rena-Ware Distributors, Inc. v. State*, 77 Wn.2d 514, 463 P.2d 622 (1970).
[29] 96 Wn.2d at 40.

credit sales at stores located in the State.[30] Similarly, *Rena-Ware Distributors, Inc.* earned income from servicing installment accounts. It charged service fees – fixed amounts added to the purchase price of merchandise for the privilege of purchasing it in installments over a period of time – on deferred payment accounts.[31] Finally, the taxpayer in *Nordstrom Credit Inc.* was a separate corporation created to finance Nordstrom's accounts receivable and the issue was whether it conducted business outside of the State through an agent and thus was entitled to apportion its income, which included finance and late payment fees, for purposes of calculating the B&O tax.[32] None of these cases involved mixing and matching income and deductions from a retail business.

This case, however, concerns B&O deductions claimed by HIW solely in connection with its retailing activity. Each PLCC Bad Debt loss deducted by HIW directly corresponded to a specific Cardholder who failed to pay for his/her HIW purchases. CP 459 (Aultman Decl. ¶ 27). Moreover, the credits and deductions claimed by HIW were exclusive of all recovery expenses, late fees, insurance charges, penalties, interest, and finance charges. (*Id.*). Since this case does not involve deductions for finance or service charges, the Department's reliance on *Nordstrom Credit,*

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[30] *Id.* at 42.
[31] 77 Wn.2d at 515-16.
[32] 120 Wn.2d at 940.

*J.C. Penney Company*, and *Rena-Ware Distributors* is misplaced.

## IV. THE AMOUNT OF THE SALES TAX REFUND DUE TO HIW IS NOT GENUINELY IN DISPUTE

The Department also claims that HIW cannot prove the exact amount of the sales tax refund to which it is entitled. Specifically, it contends that HIW cannot segregate out "the amounts it paid in exchange for 'benefits' such as 'reduced tender costs' and 'increased sales' from amounts attributable to uncollectible sales proceeds." (Response at 41-42).

The record shows that the amounts HIW deducted on its Washington Returns were exclusive of all non-deductible costs of doing business. CP 459 (Aultman Decl. ¶ 27). Mr. Aultman testified that the claimed amounts are "pure principal [*i.e.*, the original selling price and sales tax] less recoveries" and that "[e]ach PLCC Bad Debt loss deducted by HIW on a Washington Return directly corresponded to a specific Cardholder who failed to pay for his/her HIW purchases." Aultman Dep. at 91 (Appendix B); CP 459 (Aultman Decl. ¶ 27). The Department presented no evidence to contradict this testimony.

The cases cited by the Department are inapposite. *Automobile Club of Washington* involved a taxpayer who "made no attempt to segregate [membership dues that were deductible]" from general administrative and other expenses. Due to that failure the Department was allowed to presume that the entire amount of expenses was taxable.[33] Here, however, HIW's accounting is unchallenged: there is no issue regarding whether it separated the bad debts for which it claimed sales tax credits from non-deductible costs of doing business.

## V. EQUAL PROTECTION AND DUE PROCESS

Finally, the Department acknowledges that *Allegheny Pittsburgh Coal Co. v. County Commission of Webster County, West Virginia*[34] provides that disparate treatment, neither authorized by statute nor promulgated as regulations, violates equal protection. But it claims to have not violated HIW's equal protection rights because "as this Court recognized in *Home Depot*, RCW 82.08.037 impliedly requires that the person claiming a sales tax refund is the person that ***holds and owns*** the unpaid debt obligation on a retail sale." (Response at 48) (emphasis added). *Home Depot*, however, does not contain or support such an ownership requirement. Instead, the Department has chosen to unilaterally impose an unauthorized ownership precondition on sellers that use private label credit cards, thereby violating HIW's equal protection as well as its due process rights.[35]

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[33] 27 Wn. App. at 786-87.

[34] 488 U.S. 336, 345, 109 S. Ct. 633, 102 L. Ed. 2d 688 (1989).

[35] The Response asserts that HIW's due process argument should be disregarded. (Response at 48 n.17). HIW raised the same argument below, and the Department did

## CONCLUSION

HIW – as guarantor of the PLCC Bad Debts – was entitled to claim a bad debt deduction on its federal returns under IRC § 166 and Treasury Regulation § 1.166-9. As a matter of law, it was therefore entitled to claim the corresponding credits and deductions on its Washington Returns. There is no legal requirement that, to claim the credit or deduction, it must have initiated and owned the PLCC accounts when they were active.

DATED this 27th day of September 2017.

Respectfully submitted,

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(continued…)

not assert waiver at the time and does not claim that it will be prejudiced by this Court's decision on the issue. The Court has "considerable discretion" in determining whether to consider a party's arguments. *State ex rel. Wash. State Pub. Disclosure Comm'n v. Permanent Offense*, 136 Wn. App. 277, 282, 150 P.3d 568 (2006).

# APPENDIX A

SUPERIOR COURT OF WASHINGTON
FOR THURSTON COUNTY

| | | |
|---|---|---|
| LOWE'S HOME CENTERS, LLC, | ) | |
| | ) | |
| Plaintiff, | ) | |
| | ) | |
| vs. | ) | NO. 15-2-02994-34 |
| | ) | |
| DEPARTMENT OF REVENUE, STATE OF WASHINGTON, | ) | |
| | ) | |
| Defendant. | ) | |

DEPOSITION OF

RONALD W. BLASI

November 30, 2016

9:00 a.m.

1420 Peachtree Street, N.E.
Suite 800
Atlanta, Georgia 30309

Piper L. Quinn, CCR B-2198

APPEARANCES OF COUNSEL

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Troy Hunter, Esq., by phone

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(Original Exhibit D-1 has been attached to the original transcript.)

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obligations on its own books?

MR. SMITH: Object to form.

THE DEPONENT: You see, we have to be careful. Remember what happens. You have a creditor. The creditor has a debt that goes bad. The guarantee then is trigged. Another debt is then created.

So we're talking about two different debts, in theory. You see? So the bank charges off, in the first instance, the receivable from the customer. Lowe's then becomes the creditor to the extent of the guarantee.

Q. (By Ms. Fitzpatrick) How is that going to be reflected on Lowe's books and records?

A. I don't know how -- are you asking me how Lowe's has reflected that?

Q. Yes. When this occurs, you said that by operation of law, that Lowe's becomes the creditor. What would be an appropriate entry on their own books and records to reflect the existence of this new obligation?

A. There should be some type of accounting entry that indicates Lowe's is fulfilling its obligation as a guarantor. It doesn't have to follow any fixed pattern. There's nothing in the law or in the regulations that requires any fixed pattern to be followed. It just has to be demonstrated that it has had a debt, in this case, a debt that arises as a result of the guarantee, and that debt is bad.

And if you could just demonstrate that in some reasonable way, it's going to be accepted for federal income-tax purposes.

Q. Would you agree that the new debt obligation that arises between Lowe's and the debtor -- actually, withdraw that question.

In your experience -- is it your understanding that GE Capital, now Synchrony Financial, is one of the largest private label credit card issuers in the United States?

A. I guess so. I don't really --

Q. Well, I see you have written articles about sales of credit card receivables among banks. So you're basically familiar --

A. It's certainly a very big company that does this work. That's right.

Q. Gosh, I just lost my train of thought. Sorry.

A. Do you want to take a break?

# APPENDIX B

SUPERIOR COURT OF WASHINGTON
FOR THURSTON COUNTY

| | | |
|---|---|---|
| LOWE'S HOME CENTERS, LLC, | ) | |
| | ) | |
| Plaintiff, | ) | |
| | ) | |
| vs. | ) | NO. 15-2-02994-34 |
| | ) | |
| DEPARTMENT OF REVENUE, STATE OF WASHINGTON, | ) | |
| | ) | |
| Defendant. | ) | |

DEPOSITION OF

JOHN NORRIS AULTMAN

November 29, 2016

10:50 a.m.

1420 Peachtree Street, N.E.
Suite 800
Atlanta, Georgia 30309

Piper L. Quinn, CCR B-2198

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William Lowe

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(Original exhibits have been attached to the original transcript.)

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level.

Q. So let's assume, when you trace back my transactions, it will show, over the course of 18 months, I paid $75 in late fees and $22 in debt cancellation, insurance, and interest, et cetera, and $3 of the principal. Let's assume that's the case.

So when you trace it back, you'd find -- well, my understanding is, under your methodology, GE would have reported to you on your monthly report at the moment of default I owe $97 principal. That's the amount of the bad debt expense for you; is that correct?

A. So I guess where I'm getting confused is are we talking about the sales-tax returns in terms of the principal amount of bad debt, or are we talking about --

Q. Okay. I'm talking about -- the GE reports, on a monthly basis, give you a bad debt amount, which you've said today will be stripped of accrued financing and interest. So it's going to represent, theoretically, the pure principal portion that remains unpaid; is that correct?

A. Pure principal less recoveries.

Q. Less recoveries, okay. But just the



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## CERTIFICATE OF SERVICE

On this 27th day of September 2017, I filed with the Court of Appeals – Division II the foregoing document, and caused to be served a true and correct copy of the same via Legal Messenger and addressed to the following:

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Olympia, WA 98504-0123

Kathleen A. Hunter
Kathleen A. Hunter
Paralegal

# ISSAQUAH LAW GROUP, PLLC

## September 27, 2017 - 11:47 AM

## Transmittal Information

| | |
|---|---|
| **Filed with Court:** | Court of Appeals Division II |
| **Appellate Court Case Number:** | 50080-9 |
| **Appellate Court Case Title:** | Lowe's Home Centers, LLC, Appellant v. Dept. of Revenue, State of WA, Respondent |
| **Superior Court Case Number:** | 15-2-02994-8 |

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