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Washington State: Home improvement retailer entitled to bad debt deduction (court decision)

The Washington State Supreme Court reversed a state appellate court decision to hold that a home improvement retailer was entitled to a sales tax and Business & Occupation (B&O) tax bad debt deduction.

The case is: *Lowe's Home Centers, LLC v. Dep't of Revenue*, 96383-5 (Wash. January 16, 2020). Read the Supreme Court's [decision](#) [PDF 1.8 MB]

KPMG observation

The high court's decision for the taxpayer in this case is viewed by tax professionals as being significant because retailers regularly lose similar cases when they are litigated.

Background

The taxpayer contracted with certain banks to offer private label credit cards to its customers. After a customer made a purchase using the card, the banks would send payment and the related sales taxes to the taxpayer that, in turn, remitted the taxes to the Department of Revenue.

Certain cardholders inevitably defaulted on their loans. The taxpayer mitigated this risk to the banks by acting as a guarantor and agreeing to reimburse the banks for defaults up to a certain percentage of net receivables per year. Further, the contracts between the taxpayer and the banks stated that the taxpayer alone could claim bad debt relief on defaulted accounts.

On its federal income tax returns, the taxpayer claimed bad debt deductions based on the amount of the payments it made to the banks for the guarantee payments. For state tax (B&O and sales tax) purposes, the taxpayer claimed the same amount as a bad debt deduction. After the Department of Revenue denied the deductions and both the trial court and the state appellate court agreed and held for the Department, the taxpayer appealed to the state's highest court.

Supreme Court case

Before the high court, the key issue was whether the taxpayer was entitled to a refund of sales and B&O taxes based on the bad debt deductions. In two prior decisions—*Puget Sound National Bank* and *Home Depot*—the Washington courts had addressed similar issues and reached different conclusions. In *Puget Sound*, the court held that no statute or public policy prohibited the assignment of a sales tax refund, and that an assignee of installment contracts acceded to the rights and obligations of the contract and was entitled to a bad debt deduction related to defaulted payments on the contracts. In *Home Depot*, however, a retailer that sold all interest in credit card accounts to a financier surrendered its right to deduct losses and claim a refund for the defaulted debt.

Under Washington State law, sellers may claim a deduction for sales taxes previously paid on bad debts if they meet four requirements—the taxpayer must (1) be a seller (2) making sales at retail and (3) entitled to a refund for sales taxes previously paid on bad debt (4) that are federally deductible.

The Department and the taxpayer in this case disagreed as to whether the taxpayer satisfied requirement number three and disagreed over the meaning of the fourth requirement. The Department's position regarding criterion three was that the taxpayer's profit-share reductions (the amounts that the taxpayer paid to the banks) were not "bad debts" under state law because they were not directly attributable to retail sales for "sales taxes previously paid" and "written off as uncollectible" but were amounts paid under contract to cover the banks' losses. The taxpayer, on the other hand, contended that state bad debt relief was based exclusively on federal bad debt relief, and because the taxpayer received a federal deduction, it also qualified for a state deduction.

At the outset of its analysis, the Washington State high court noted that under federal tax law, a payment made in discharge of an obligation as a guarantor of debt is treated as a business debt becoming worthless in the tax year in which the payment is made. In other words, the taxpayer would be entitled to a federal bad debt deduction (and in fact claimed such a deduction on its payments as a guarantor).

The bulk of the analysis was devoted to whether the taxpayer was, in fact, entitled to a "refund for sales tax previously paid" on bad debts that "were written off as deductible" for federal purposes as a result of its guarantor payments. The Department, relying on the appellate court decision in *Home Depot*, argued that the taxpayer recovered the unpaid sales tax because it was fully paid by the banks when they remitted proceeds of the sales to the taxpayer. At that point, the Department argued, the buyer ceased to owe the taxpayer anything, and the taxpayer no longer held any debt "directly attributable" to B&O or sales tax payments. The bad debt guarantee made by the taxpayer to the banks occurred after the taxpayer was paid the sales tax, and any payments made by the taxpayer to the banks were to cover account losses by the banks.

The high court disagreed with this position of the Department, noting that the "directly attributable" language did not appear in the statute or regulation concerning bad debt deductions, and that regardless, there was no doubt that the taxpayer had remitted sales tax to the Department as a retailer, and that the taxpayer was also the guarantor of the unpaid sales tax associated with the customer defaults. The court likened the taxpayer to the bank in the *Puget Sound* case in which the bank acted as the assignee of the retailer and was therefore eligible for the bad deduction on accounts that were defaulted.

That the bad debt at issue was created in two steps rather than one (i.e., in the original sale, followed by the guarantee arrangement) is of no moment—the policy underpinning the bad debt deduction is to 'provide relief to vendors' left holding uncollectible sales tax.

Therefore, the high court reversed the decision of the state appellate court and held that the taxpayer was entitled to a bad debt deduction for both sales tax and B&O tax because the taxpayer was the seller burdened with bad debt from its customers' defaults.

KPMG observation

Tax professionals believe that this decision creates a blueprint that other retailers may want to consider in structuring their private label credit card contracts because use of the guarantor arrangement preserved the bad debt relief in Washington State. Further, retailers that have these types of provisions in their contracts may be entitled to bad debt deductions in other jurisdictions.

For more information, contact a KPMG State and Local Tax professional:

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