Washington's Ever-Expanding Definition of Tax Nexus

by Michelle DeLappe

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This edition of Skookum Tax News discusses recent developments in Washington's expanding definition of tax nexus, including transactional, affiliate, and economic nexus. The most recent change is legislation imposing sales and use tax obligations on parties involved in online retail. DeLappe offers strategies for taxpayers to address the challenges and questions that lie ahead.

The article is intended to be general and not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to specific circumstances.

Loath to be left behind in states' "kill *Quill*" efforts and anxious to capture tax from transactions involving out-of-state companies, Washington has been aggressively pushing the boundaries of tax nexus. Evolving standards for transactional nexus, affiliate nexus, and economic nexus are the centerpieces of the state's strategy. In the last year, court decisions have established new guidance on transactional nexus. Department of Revenue rulings have better defined the requirements for affiliate nexus. Most recently, in adopting a two-year operating budget barely in time to avert a government shutdown, state lawmakers radically expanded economic nexus. The new law sweeps retail sales into the state's tax jurisdiction by imposing duties that go beyond even Colorado's controversial law for sales and use tax responsibilities.

Increased Transactional Nexus Burden

Late last year, the Washington Supreme Court weighed in on transactional nexus, which relates to the principle of dissociation.[1] Taxpayers with in-state physical presence have long relied on this concept to separate specific transactions as not taxable unless the transactions relate to the taxpayer's in-state presence. *Norton*, a 1951 U.S. Supreme Court decision, provides the key support for the concept.[2] In Washington, taxpayers also relied on a 1951 state supreme court decision following *Norton* and on a DOR regulation recognizing the concept.[3]

Based on this support, Avnet Inc., an Arizona-based manufacturer with an office in Washington, believed two types of transactions were not subject to the state's business and occupation (B&O) tax. The first consisted of orders customers placed through Avnet offices outside Washington that Avnet delivered to customer facilities or third parties in Washington (national sales). The second consisted of drop-shipment orders placed by customers outside Washington, through a sales office outside the state, but shipped to the customer's customer in Washington. Avnet argued that national sales and drop-shipments qualified for dissociation. The court of appeals ruled that case law since 1951 had eroded the principle of dissociation to the point of implicitly

[1] *Avnet Inc. v. Department of Revenue*, 187 Wn.2d 44, 364 P.3d 120 (2016).

[2] *Norton Co. v. Department of Revenue of Illinois*, 340 U.S. 534, 537 (1951).

[3] *B.F. Goodrich Co. v. State*, 38 Wn.2d 663, 231 P.2d 325 (1951); and WAC 458-20-193 (before the Department of Revenue modified this rule in 2015).

overruling it. It further concluded that the DOR regulation was not binding.

On further appeal, the state supreme court disagreed that the U.S. Supreme Court had ever implicitly overruled *Norton*. The court's lead opinion explained that *Norton* "unquestionably remains good law as pertains to the principle that the taxpayer has the burden to show that the bundle of its instate corporate activities are 'dissociated from the local business and interstate in nature.'" But it held that Avnet failed to meet that burden, noting that Avnet's Washington office had provided market intelligence to its corporate office. It concluded that doing so tainted all of Avnet's sales into Washington with Washington nexus, even orders placed at offices outside the state and drop-shipments that its customers sent to third parties in Washington. A strongly worded dissent supported by three of the nine justices argued that the DOR should have followed its regulation and interpreted any ambiguity in that rule in the taxpayer's favor. Avnet did not seek further review.

Another out-of-state company, Irwin Naturals, met a similar fate in challenging both sales and B&O taxes based on a lack of transactional nexus. This year the state supreme court and U.S. Supreme Court denied the taxpayer's request to review the case.[4] The taxpayer, a California company selling nutritional supplements, made retail sales independently of its wholesales in the state. Based on numerous circumstances, it believed the retail sales lacked substantial nexus with Washington. The court held that dissociation never applies to sales tax: Once a taxpayer has tax nexus, it must collect and remit sales tax on all its sales to the state. Several factors established substantial physical presence, such as visits by company employees to the state to present items and attend trade shows. For the B&O tax, the fact that both the retail and wholesale activities involved nutritional products under the same brand led the court to conclude that Irwin's state presence for wholesaling supported its market for the retail products. As such, the court also refused to dissociate the sales for B&O tax purposes.

These decisions may signal the demise of transactional nexus for practical purposes, even though *Norton* remains good law in theory. If merely sharing market intelligence is enough to create nexus for all of a company's transactions, it seems few could ever qualify for dissociation. After *Avnet*, the taxpayer's burden in proving transactions are unrelated to in-state activities appears so onerous as to reduce the concept's application to a vanishing point. Any future challenge based on this concept will need to have very strong evidence of a complete lack of connection between the transactions and the taxpayer's in-state activities. And given the DOR's position that transactional nexus never exists, any future challenger should expect to take the battle to the highest court that will hear it. One can only hope that the U.S. Supreme Court could someday be persuaded to articulate more clearly what the taxpayer must prove to qualify for dissociation.

Avoiding Affiliate Nexus

Washington has also vigorously sought to tax out-of-state affiliates of in-state taxpayers. One DOR ruling published this year shows the department's efforts to establish a case against affiliates and points to possible strategies to avoid affiliate nexus.[5] The ruling is a taxpayer win resulting from an appeal of an audit assessment of sales tax and B&O tax.

The audit division claimed that the taxpayer's online retailing entity had nexus in Washington because of an affiliated entity. The latter had nexus based on an in-state independent representative that made wholesales to third parties operating physical stores in the state. The two entities shared the same brand and products. Product packaging was the same and referenced the online retailer's website, which had a store locator. And most importantly, the auditor claimed there was overlap in the system for handling returns and refunds: The auditor bought an item through the online retailer, then exchanged it at a physical store for a less expensive item and a partial refund. But this key

[4] *Irwin Naturals v. Department of Revenue*, 195 Wn. App. 788 (2016) (unpublished), *rev. denied*, 187 Wn.2d 1017 (2017), *cert denied*, No. 17-91 (2017).

[5] 36 WTD 330 (2017). *See also* 28 WTD 9 (2009).

incident occurred after the audit period; by then, the two entities had merged and started paying tax on all Washington sales. Without evidence that returns of online purchases to the physical stores were possible during the audit period, the DOR concluded that affiliate nexus did not exist. In so concluding, the ruling indicates that brand and product overlap and cross-references on packaging or websites do not suffice for establishing affiliate nexus.

This and other cases show a tendency to find affiliate nexus where the entities share the same systems for product returns, refunds, gift cards, or customer rewards. It is not unusual, in our experience, for auditors and even DOR tax review officers to test for potential overlap through independent investigation, as was the case in this ruling. But knowing what they are looking for presents planning opportunities for taxpayers who want to avoid affiliate nexus and related disputes. This precedential decision (published rulings have precedential weight)[6] shows that some arguments the DOR has often used against affiliates, such as cross-references in packaging and online, are not enough to establish affiliate nexus.

Radical New Economic Nexus Stance

Gov. Jay Inslee (D) signed H.B. 2163 into law on July 7, thereby expanding Washington's existing economic nexus provisions. The legislation made two significant changes relating to out-of-state retailers. First, it sweeps retailing activities into existing economic nexus provisions for B&O taxes, effective July 1. Second, it extends sales and use tax reporting or collection duties to remote sellers, marketplace facilitators, and referrers meeting specific criteria, with most duties effective January 1, 2018. (Sales and use tax economic nexus will not apply to sales of some digital products through a marketplace until January 1, 2020, however.) The DOR expects a
$1 billion state revenue increase over the next four years based on those new provisions.[7]

Washington has had economic nexus provisions for B&O taxes since 2010. The thresholds for establishing substantial nexus are $250,000 in receipts from Washington or $50,000 in property or payroll in the state, or at least 25 percent of total property, payroll, or total receipts in Washington during the year. Initially, these standards applied only to apportionable income such as income from royalties and services,[8] but effective September 1, 2015, lawmakers expanded economic nexus for wholesaling B&O tax. The 2015 changes also created a click-through nexus presumption in which some retailing B&O tax and sales tax could be imposed on out-of-state retailers who had agreements with Washington residents involving a commission or consideration for the referral and a $10,000 annual Washington sales minimum. If an out-of-state business missed any of those past developments, Washington has a voluntary disclosure program to avoid some noncompliance consequences — but only if the business contacts the DOR before the DOR contacts it.

As of July 1 retailing B&O tax also applies to any out-of-state business with more than $267,000 in receipts from Washington, $53,000 in property or payroll in the state, or at least 25 percent of its total property, payroll, or total receipts in the state during the year. (All dollar thresholds for economic nexus have crept up with the consumer pricing index.)

Washington's new direction is a radical expansion of sales and use tax nexus for remote sales. Like the Colorado law upheld last year by the Tenth Circuit Court of Appeals in *Direct Marketing Association v. Brohl*,[9] Washington's new law presents a dilemma: One must elect to either comply with notice and reporting requirements or collect and remit sales tax. And it goes further than any other new state law by extending these duties to marketplace facilitators and referrers, imposing them based on a very low $10,000 annual sales threshold, and imputing a marketplace facilitator's sales and use tax nexus to marketplace sales by remote sellers who

[6] Wash. Rev. Code section 82.32.410.

[7] Tom Banse, "Online Sales Tax that Undergirds Washington Budget Likely to Be Challenged," NW News Network (July 5, 2017).

[8] Wash. Rev. Code section 82.04.067; and Wash. Rev. Code section 82.04.460.

[9] 814 F.3d 1129 (10th Cir. 2016), *cert. denied*, 137 S.Ct. 591 (2016).

would not otherwise meet the annual sales threshold.[10] Marketplace facilitators, a defined term in the new law, basically refers to retail platform operators through website, catalog, or other medium — for example, Amazon Marketplace and eBay.

The first consideration is whether the marketplace facilitator or remote seller has met the $10,000 annual sales threshold. If not, no duties apply under the new law. The law deems the marketplace facilitator an agent for the marketplace sellers, so all Washington sales in the marketplace count toward the threshold. For the remote seller, all its sales sourced to Washington apply toward the threshold. For the referrer, a different threshold applies: $267,000 in annual income from referral services and retail sales sourced to Washington. For all three, the thresholds trigger economic nexus whether met during the current or preceding year.

If the threshold has been met, the next consideration is the election. Any marketplace facilitator or remote seller not registered with the DOR and collecting and remitting sales tax is conclusively presumed to be complying with the notice and reporting requirements. An election is binding, and limitations restrict how often it can be changed.

Notice requires providing the consumer with a conspicuous notice on the website or catalog and providing notice to each consumer again at the time of sale. Reporting means sending a report to both consumers and the DOR by February 28 each year. Steep cumulative penalties apply for noncompliance. For failure to provide notice, a penalty of $20,000 per year applies. For each failure to provide an annual report to consumers, the penalty is graduated based on Washington sales. And for each instance of failing to report to the department, a $20,000 minimum penalty applies ($25 per consumer). There are limited grounds for penalty waivers.

If a remote seller elects to collect and remit tax or if it already has substantial physical nexus in Washington, that seller will take a sales tax deduction for any sales tax remitted by the marketplace facilitators. If the marketplace facilitator has elected to collect and remit, it should remit directly to the DOR, as the facilitator will be directly liable for the tax. The department is also adjusting its tax returns to recognize the fact that marketplace facilitators and remote sellers may be remitting sales tax but not B&O tax on retailing given that facilitators do not owe retailing B&O tax if the facilitator is not the seller, and the remote seller is subject to different dollar thresholds for nexus for the two types of tax.

As the DOR scrambles to put a system in place by January 1, 2018, there are many questions to resolve. For questions on what sales are subject to sales tax, the state's taxability matrix on the Streamlined Sales Tax Governing Board's website should be consulted. Regarding whether a sale should be sourced to Washington, the state complies with the Streamlined Sales and Use Tax Agreement. The DOR is holding stakeholder meetings to address questions and concerns about the new law's implementation. The agency does not expect to have a regulation offering more detail on the law by 2018, but it will publish questions and answers and other guidance on its website.[11] The department welcomes questions sent to DORMarketplacefairness@dor.wa.gov, without the need to include any taxpayer identifying information. To obtain binding advice, a ruling request must include the taxpayer's identifying information; a letter ruling on one taxpayer's facts will not be deemed binding on any other taxpayer.

Among the concerns raised, confidentiality is one area in which the DOR will need to provide specific reassurance. Annual reports should of course be treated as confidential taxpayer information. Another concern is how referrers can meet their duties when they are not involved in the actual sale and often lack sufficient information (such as where the sale is sourced), even if the sale is a direct result of the referral. A provision in the law barring class actions in state court against marketplace facilitators or referrers for overpayment of sales tax has also prompted concerns as to whether it provides any real protection.

[10] Engrossed H.B. 2163 sections 202(2), 203(1)(a).

[11] Washington State DOR, "Marketplace Fairness — Leveling the Playing Field" (2017), http://dor.wa.gov/MarketplaceFairness.

Also, how the department audits and enforces the law presents new questions. What evidence must be kept to prove notice was provided? How can the state enforce that law equally against domestic sellers and those outside U.S. legal jurisdiction?

Aside from how implementation will work, a lawsuit challenging the law's legality under the U.S. Constitution and the Internet Tax Freedom Act may also be on the horizon. NetChoice has been the most vocal so far as a likely challenger.[12] As of this writing, no lawsuit has materialized, but many expect one or more will soon.

Conclusion

Washington has been sweeping more taxpayers into its nets by fighting against dissociation, pursuing affiliate nexus, and expanding economic nexus. Has the state's latest step finally gone too far? The new law's complexities certainly show that even with tax compliance technology, there is no easy way to impose sales tax nexus on all out-of-state retailers. And even if challenged in court, the wheels of justice move slowly; retailers, marketplace facilitators, and referrers need to act before any judicial opinion or even a guiding regulation is issued. Even if South Dakota were to obtain review and prevail before the U.S. Supreme Court with its economic nexus law for sales tax (S.B. 106) — two very big "ifs" — that would not likely shed much light on whether Washington's much more far-reaching law is legal.

Those keen to avoid hefty penalties would do well to analyze the new law, ascertain the systems they will need to put in place, and get ready to start complying with this new paradigm. Given the uncertainty in how the new law will be implemented, this is the ideal time to submit questions and letter rulings to the DOR. Those questions should both provide guidance to taxpayers and help guide the department in its implementation. ■

[12] Paul Jones, "Litigation Likely for Law Pushing Marketplaces to Collect Sales Taxes," *State Tax Notes*, July 17, 2017, p. 254.