

Cite as Det. No. 14-0342, 34 WTD 250 (2015)

BEFORE THE APPEALS DIVISION
 DEPARTMENT OF REVENUE
 STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 14-0342
)	
...)	Registration No. . . .
)	
)	
)	

[1] RCW 82.04.067: B&O TAX – SUBSTANTIAL NEXUS – ECONOMIC NEXUS. A Taxpayer that has more than \$250,000.00 in total service-taxable receipts in Washington has substantial nexus with Washington.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Weaver, A.L.J. – An out-of-state web hosting company requests that the Department cancel an assessment of service and other activities business and occupation (B&O) tax, interest, and penalties, because it argues that it does not have substantial nexus. We deny Taxpayer’s petition.¹

ISSUES

1. Whether, under the Commerce Clause of Article I, § 8, clause 3 of the U.S. Constitution, and RCW 82.04.067, Taxpayer has substantial nexus such that the Department may assess tax against Taxpayer when it had over \$250,000 in receipts from Washington in 2010, 2011, and in 2012.
2. Whether, under the Due Process Clause of Amendment XIV of the U.S. Constitution, Taxpayer has nexus such that the Department may assess tax against Taxpayer when it has no physical presence in Washington.

FINDINGS OF FACT

[Taxpayer] provides web-hosting services to consumers. Taxpayer has facilities located [out of state]. Prior to December 27, 2012, Taxpayer was not registered to do business in Washington.

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Earlier in 2012, the Compliance Division of the Department of Revenue (Department) contacted Taxpayer because Taxpayer was not registered to do business in Washington. On October 24, 2012, the Compliance Division mailed an inquiry letter and the Washington Business Activities Questionnaire (WBAQ) to Taxpayer. On November 23, 2012, Taxpayer provided a completed WBAQ, signed by its general counsel. The WBAQ states that Taxpayer:

- Provides services to Washington customers;
- Had \$920,000.00 in sales to Washington for the years 2005 through 2011;
- Makes sales to consumers; and
- Delivers products or services over the Internet.

On December 27, 2012, Taxpayer filed a Business License Application in Washington. In e-mail correspondence with the Compliance Division, Taxpayer confirmed that its Washington income exceeded \$250,000.00 in 2010, 2011, and in 2012.

On September 30, 2013, the Department issued Assessment No. . . . totaling \$. . . . That amount included \$. . . in service and other activities B&O tax, a delinquency penalty of \$. . . , \$. . . in interest, a 5% assessment penalty of \$. . . , and a 5% unregistered business penalty of \$. . . . In its Agent's Detail of Differences and Instructions to Taxpayer, the Compliance Division states that "Taxpayer has not established physical nexus presence in Washington State" and, for that reason, the Compliance Division did not assert retail sales tax or retailing B&O tax on Taxpayer's retail-taxable activities. The Department only assessed tax on Taxpayer's income from its service-taxable web-hosting activities.

Taxpayer appeals the assessment.

ANALYSIS

Washington imposes a business and occupation ("B&O") tax "for the act or privilege of engaging in business" in this state. RCW 82.04.220. The tax rate varies based on the type of business activity the taxpayer engages in, and the statute provides numerous classifications of activities. Taxpayers engaging in . . . businesses in this state not otherwise classified in Chapter 82.04 RCW are subject to the service and other activities B&O tax, measured by the "gross income of the business." RCW 82.04.290(2). Taxpayer does not dispute that its business activity is not otherwise classified in Chapter 82.04 RCW, and, therefore, does not dispute that its business activity, if taxable in Washington, is properly taxable under the service and other activities B&O tax classification. Income taxable under the service and other activities B&O tax classification is apportionable income, as it is income generated from engaging in apportionable activities. *See* RCW 82.04.460(4).

The B&O tax is "extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State." *Analytical Methods, Inc. v. Dep't of Revenue*, 84 Wn. App. 236, 241, 928 P.2d 1123 (1996) (quoting *Palmer v. Dep't of Revenue*, 82 Wn. App. 367, 371, 917 P.2d 1120 (1996)). "Business" is defined broadly to include "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140.

Notwithstanding the broad definition of "business" in RCW 82.04.140 that essentially includes

all business activities that benefit a taxpayer, a state cannot tax transactions that do not have sufficient connection or “nexus” with that state. *See, e.g., Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L.Ed.2d 326 (1977); *Tyler Pipe Industries, Inc. v. Dep’t. of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 97 L.Ed.2d 199 (1987); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); Det. No. 05-0376, 26 WTD 40 (2007). This nexus requirement flows from limits on a state’s jurisdiction to tax found in both the Due Process Clause and the Commerce Clause of the United States Constitution. *Quill*, 504 U.S. at 305; Det. No. 01-188, 21 WTD 289 (2002); *Lamtec Corp. v. Dep’t of Revenue*, 170 Wn.2d 838, 246 P.3d 788 (2011) (“A tax on an out-of-state corporation must satisfy by the requirements of the due process clause of the Fourteenth Amendment and the commerce clause.”). Further, the requirements of the Due Process Clause and the Commerce Clause “pose distinct limits on the taxing powers of the States” and these “two constitutional requirements differ fundamentally, in several ways.” *Quill*, 504 U.S. at 305.

1. Substantial Nexus Requirement Under the Commerce Clause

The United States Supreme Court has identified certain requirements under the Commerce Clause in order for a state to impose tax on an out-of-state business. In *Complete Auto*, the Court held that the Commerce Clause requires that the tax: (1) be applied to an activity with “substantial nexus” with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the state. *Complete Auto*, 430 U.S. at 279.

Here, the only element under the *Complete Auto* test that Taxpayer challenged is the first element, “substantial nexus.” Taxpayer argued on appeal that it lacked “substantial nexus” in Washington because it did not have any physical presence in Washington. Taxpayer argued that it does not have substantial nexus with Washington, because its activities are performed entirely outside of Washington.

Taxpayer argues that, while many state courts have concluded that physical presence is not required to establish substantial nexus for state *net income tax* purposes,² the Washington B&O tax is distinguishable, because it is an activity-based gross receipts tax. Taxpayer specifically cites *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1938), for the proposition that the Washington B&O tax is subject to different constitutional analysis than a net income tax, arguing that the U.S. Supreme Court concluded that Washington’s B&O tax was unconstitutional to the extent “measured by gross receipts derived from activities . . . which extend beyond the territorial limits of the taxing state.” *Gwin, White & Prince*, 305 U.S. at 439. We note, however, that the Washington Supreme Court has interpreted the holding in *Gwin, White & Prince*, to stand for the proposition that the tax at issue was invalid because it was applied to the entire volume of interstate commerce rather than being “apportioned to the activities within the state.” *Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 46, 156 P.3d 185 191 (2007) (distinguishing *Gwin, White & Prince*, 305 U.S. 434). Taxpayer also cites *Oklahoma Tax Comm’n v. Jefferson*

² Taxpayer cites the following authorities for this proposition: *KFC Corp. v. Iowa Dep’t of Revenue*, 792 N.W.2d 308 (Iowa 2010); *Capital One Bank v. Comm’r of Revenue*, 899 N.E.2d 76 (Mass. 2009); *Geoffrey, Inc. v. S.C. Tax Comm’n*, 437 S.E.2d 139 (S.C. 1993); *Tax Comm’r v. MBNA Am. Bank, N.A.*, 640 S.E.2d 226 (W.Va. 2006). *Contra J.C. Penney Nat’l Bank v. Johnson*, 19 S.W.3d 831 (Tenn. Ct. App. 1999); *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000); *Galland Henning Nopak, Inc. v. Combs*, 317 S.W.3d 841 (Tex. Ct. App. 2010).

Lines, Inc., 514 U.S. 175 (1995), claiming that it affirms the holding in *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250 (1938), that “the sales of services to be performed wholly in one state are taxable by that State.” See *Oklahoma Tax Comm’n*, 514 U.S. at 188 (citing *Western Live Stock*, 303 U.S. 250). Taxpayer cites these authorities to support its argument that Washington has no claim to tax any portion of the receipts from Taxpayer’s services, because Taxpayer performed its services outside of Washington.

Washington’s definition of “substantial nexus” is in RCW 82.04.067, which codified that term in 2010. Under RCW 82.04.067, a person engaging in a service activity is deemed to have substantial nexus with Washington if the person is:

- (a) An individual and is a resident or domiciliary of this state;
- (b) A business entity and is organized or commercially domiciled in this state; or
- (c) A nonresident individual or a business entity that is organized or commercially domiciled outside this state, and in any tax year the person has:
 - (i) More than fifty thousand dollars of property in this state;
 - (ii) More than fifty thousand dollars of payroll in this state;
 - (iii) More than two hundred fifty thousand dollars of receipts from this state;³ or
 - (iv) At least twenty-five percent of the person’s total property, total payroll, or total receipts in this state.

RCW 82.04.067(1). RCW 82.04.067(6) further makes clear that the physical presence requirement applies only for purposes of taxes imposed on activities not included in the definition of apportionable activities in RCW 82.04.460 (such as retailing). Thus, under Washington law, so long as Taxpayer had more than \$250,000.00 in 2010, 2011, and 2012 of “receipts from this state” from an apportionable activity, we must find that Taxpayer has substantial nexus, regardless of whether it has physical presence in Washington.⁴ The Washington Supreme Court describes the nexus requirement thusly:

The United States Supreme Court has made clear that an established sales force is *sufficient* to satisfy the nexus requirement. It has not held that an established sales force (or a physical presence) is a *requirement* to establish the requisite nexus.

³ RCW 82.04.067(5)(a) requires the Department to review “the cumulative percentage change in the consumer price index” each December, and adjust the nexus threshold amounts to reflect the change in the consumer price index. For the years in question in this case, however, the threshold remained at \$250,000. See WAC 458-20-19405(2)(a).

⁴ Taxpayer cites certain Washington Tax Decisions in its briefing as standing for the proposition that physical presence may be required for nexus in Washington. *E.g.*, Det. No. 96-147, 16 WTD 117 (1996); Det. No. 01-188, 21 WTD 289 (2001). We note that these WTDs predate the statutory enactment of RCW 82.04.067 and the *Lamtec* decision. In light of the newly enacted nexus statute and the recent Washington Supreme Court guidance, the cited WTDs are of no utility in this matter.

Lamtec, 170 Wn.2d at 845, 246 P.3d at 792 (citing *Quill*, U.S. at 315; *Nat'l Geographic Soc. v. Cal. Bd. of Equalization*, 430 U.S. 551 (1977)).

In this case, Taxpayer concedes that it had more than \$250,000.00 in total receipts from web-hosting services for Washington customers in 2010, 2011, and 2012. There is no dispute in this case that the income at issue in this case is generated by Taxpayer's web-hosting services, an activity subject to service and other activities B&O tax under RCW 82.04.290(2), which is an apportionable activity under RCW 82.04.460. These amounts clearly meet the receipts threshold of \$250,000.00. RCW 82.04.067(1)(c)(iii). As such, Taxpayer had substantial nexus in 2010, 2011, and 2012.

We hold that Taxpayer meets the statutory nexus threshold in RCW 82.04.067(1)(c)(iii). For these reasons, we hold that the Department's application of the economic nexus statute to assess service and other B&O tax on Taxpayer's apportionable activities did not violate the Commerce Clause. Moreover, even if the statutory definition of "substantial nexus" as codified in RCW 82.04.067 were facially unconstitutional, we do not have authority to rule on that issue. *Bare v. Gorton*, 84 Wn.2d 380, 383, 576 P.2d 379 (1974) ("An administrative body does not have the authority to determine the constitutionality of the law it administers; only the courts have that power."); *see also* Det. No. 98-083, 17 WTD 271 (1998).

2. Requirements for Taxation Under the Due Process Clause

The Due Process Clause requires two things in order for a state to tax an out-of-state business. First, there must be "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill*, 504 U.S. at 306 (citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-45, 74 S.Ct. 535 (1954)). Second, "the income attributed to the state for tax purposes "must be rationally related to 'values connected with the taxing State.'" *Quill*, 504 U.S. at 306 (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273, 98 S.Ct. 2340 (1978)). RCW 82.04.066 addresses the first requirement by defining the term "engaging within this state," when used in connection with any apportionable activity defined by RCW 82.04.460, as meaning that a person generates gross income from sources within this state, "regardless of whether the person is physically present in this state." RCW 82.04.066 (emphasis added). RCW 82.04.462 addresses the second requirement by attributing apportionable income to Washington through the use of a receipts factor formula where a taxpayer's apportionable Washington income is divided by the taxpayer's worldwide apportionable gross income. *See* RCW 82.04.462(3)(a).

With respect to the first requirement, The *Quill* Court relied heavily on judicial jurisdiction cases to determine if a taxpayer had "minimum contacts" with the taxing state such that taxing that taxpayer did not offend "traditional notions of fair play and substantial justice." *Quill*, 504 U.S. at 307 (citing *Int'l Shoe Co. v. Washington*, 326 U.S. 310, 316, 66 S.Ct. 154 (1945)). The *Quill* Court stated the following:

Applying these principles, we have held that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State.

Quill, 504 U.S. at 307. The Court went on to quote its previous decision in *Burger King Corp. v. Rudzewicz*, 471 U.S. 462, 105 S.Ct. 2174 (1985):

Jurisdiction in these circumstances may not be avoided merely because the defendant did not *physically* enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are "purposefully directed" toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

Burger King Corp., 471 U.S. at 476 (emphasis in original). The *Quill* Court's reasoning makes clear that any efforts that are "purposefully directed" toward residents of the taxing state will satisfy the first requirement of the due process test even if there is "an absence of physical contacts" in that state. *See also* Det. No. 93-120, 14 WTD 7 (1994).

Here, Taxpayer argues that it the receipts that Washington is attempting to tax are not "rationally related to values connected with the taxing State." We disagree. Taxpayer receives gross income from customers within Washington in return for Taxpayer hosting the Washington customers' websites. We conclude that because Taxpayer's income from web-hosting services provided to Washington customers exceeds the statutory thresholds in RCW 82.04.067, it is clear that Taxpayer purposefully availed itself of the benefits of the economic market in Washington. Therefore, we conclude that Taxpayer has adequate minimum contacts with residents of Washington sufficient to satisfy the first requirement of the due process test.

With respect to the second requirement, wide latitude is given to a state's selection of a method for attributing value of the enterprise. *Moorman Mfg. Co.*, 437 U.S. at 274. Such a selection "will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted'" or has 'led to a grossly distorted result.'" *Id.* (citations omitted). *See also Exxon Corp. v. Dep't of Revenue*, 447 U.S. 207, 227 (1980) (holding that a state's taxing formula satisfies the second requirement of the Due Process Clause if it is not inherently arbitrary and does not tax a portion of the taxpayer's income out of all appropriate proportion to the business transacted in that state). According to the United States Supreme Court in *Moorman*, where a state has shown that some minimal connection exists, income attributed to the taxing state need only be "rationally related" to values connected with the state. *Moorman*, 437 U.S. at 272-73.

Here, Taxpayer argues that because the physical activities related to its web-hosting services are performed entirely outside Washington, the tax on those activities is not "rationally related to values connected with the taxing state." Again, we disagree. Taxpayer has not offered "clear and cogent evidence" that the taxation of income earned on services provided to customers in Washington is arbitrary, is not in proportion to, or is not "rationally related" to the business Taxpayer transacted that was attributed to Washington. Therefore, we conclude that, as applied,

the Department's tax assessment does not violate the Due Process Clause of the U.S. Constitution.⁵

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 30th day of October 2014.

⁵ Again, as stated above, even if the economic nexus provisions of RCW 82.04.067 are facially unconstitutional, we do not have the authority to determine the constitutionality of the statute. *Bare*, 84 Wn.2d at 383, 576 P.2d 379.