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Ending the Nexus Guessing Game for Taxpayers: Lamtec Corp. v. Washington Department of Revenue

By
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The Tax Foundation today filed a brief with the U.S. Supreme Court, asking them to take the case of *Lamtec Corp. v. Department of Revenue of the State of Washington*. The case involves the State of Washington's effort to impose tax on economic activity occurring in other states.

Our brief argues that this activity is properly taxed by other states, and that Washington's action threatens to impose unconstitutional burdens on interstate commerce. We ask the Supreme Court to reaffirm its "physical presence rule" for state taxation, which limits state taxing power to entities with property or employees within the state. Such a ruling would provide relief from increasingly burdensome uncertainty and inconsistency in interstate taxation.

States Have Resisted 1992 Supreme Court Ruling Upholding "Physical Presence Rule"

In *Quill Corp. v. North Dakota* (1992), the U.S. Supreme Court reaffirmed a physical presence standard in the context of sales and use taxes.[1] The Court cited the fact that the statute in question encompassed vendors who merely advertised in the state, and that replicating it nationwide would subject them to collection duties and compliance costs associated with tracking thousands of different tax rates, exemption lists, and administrative requirements.

The Court noted the value of a bright-line standard in *Quill*. "Undue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation."[2] This bright-line standard has achieved this objective; litigation about the content of the physical presence standard in corporate, individual, and sales tax contexts has been limited.

Many states have nonetheless sought to impose business activity taxes on remote entities under the general

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[1] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

[2] *Id.* at 315.

heading of economic nexus without regard to lack of physical presence. While a rule premised on the physical presence of employees or business property can be demarcated with predictability, this is not the case with economic nexus. Scholars disagree sharply on what the term even means, with many definitions involving case-by-case, defendant-specific, multi-factor inquiries that leave businesses generally incapable of foreseeing whether a particular activity will create nexus in a given state.[3]

The complexities imposed by states' steadily expanding their nexus standards beyond the bright-line physical presence rule can be illustrated with a review of current nexus standards. Each year, tax publisher BNA produces the *Survey of State Tax Departments*, a compilation of questionnaire results on nexus-creating activities submitted to state taxing authorities. For each scenario, the state responds as to whether a particular activity creates nexus. For example:

- Merely having a phone number listed in a telephone book is treated as sufficient nexus-creating activity in nine states.
- Having a website hosted on another entity's server in the state creates nexus in 13 states.
- Sending employees to attend a seminar but engaging in no sales activity creates nexus in one state and the District of Columbia.
- While shipping products in non-returnable containers is protected by Public L. 86-272, shipping products into a state in returnable containers creates nexus in 26 states.

While this thick volume remains the best comprehensive guidance for interstate business, it is littered with footnotes, exceptions, and "depends" notations, reinforcing the lack of clarity the states have imposed on those engaged in interstate commerce. For example, ten states (primarily those with aggressive nexus rules) requested that BNA note that they (the states) do not consider any of their answers to be binding guidance if the particular situation were actually to arise.

With the increasing level of economic integration we have today, the economic costs of nexus uncertainty burden and impede the economy much more than even before. As some states follow the physical presence rule and others follow some iteration of economic nexus (roughly half the states taking each approach at present for business activity taxes), compliance costs for business engaged in interstate commerce will increase. Businesses that expand their sales into states following economic nexus will have to file tax returns and understand the local tax base, applicable tax rates, available tax incentives, and differing apportionment formulas. Many taxpayers will have to guess about what approach a state will follow for their situation, leaving them taking a chance on whether or not to file taxes.

Washington Tax Nexus Rules Create a Guessing Game for Taxpayers

The Washington legislation at issue epitomizes both the trend and the complexity of rules that are engendered by "economic nexus." In 2010, Washington adopted a new standard for "engaging [in business] within this state." Under this definition, a person is engaged in business in Washington when the "person generates gross income of the business *from sources within this state*, such as customers or intangible property located in this state, regardless of whether the person is physically present in this state."[4]

The apportionment formula applicable to a multistate taxpayer with putative "substantial nexus" adopts a cascading set of principles that ask the taxpayer, first, to determine (and keep records on) where the customer

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[3] *See* Joseph Henchman, *Why the Quill Physical Presence Rule Shouldn't Go the Way of Personal Jurisdiction*, 46 STATE TAX NOTES 387, 393 (2007), http://www.taxfoundation.org/research/show/22785.html.
[4] Wash. Rev. Code § 82.04.066 (2010) (emphasis added).

"received the benefit of the taxpayer's service," or where the customer "used the taxpayer's intangible property."[5] If the taxpayer believes this occurred in more than one state in the customer's operations, the taxpayer is asked to determine where the benefit was "primarily received" or the intangible property was "primarily used."[6] In an integrated national economy, these tests superimpose a challenging subjective analysis on a high-volume accounting process. The taxpayer has the burden of showing these tests are not reasonably answerable, of course, before it may move on to the other five possible allocation rules under the statute.

Additionally, the Respondent Department of Revenue has adopted emergency rules that, for example, allocate to Washington receipts paid by a business customer for a service – if it is not related to real or tangible personal property – if the service "relates to the [customer's] business activities in this state."[7] Under the emergency rule, an out-of-state entity with no property or employees in Washington can be found to have putative "substantial nexus" with Washington if the services it performs for a client are deemed to be "relate[d] to [the client's] business activities in" Washington and if the fees from this client and/or similar clients exceed $250,000 in a tax year.

The Washington example shows how economic nexus exacerbates the uncertainties and compounds the burdensome recordkeeping that attend doing business with customers in other states.

Exporting Tax Burdens Is the Ultimate Objective of Economic Nexus

The U.S. Supreme Court has recognized that not every state law that may affect economic decision-making across state lines violates the Commerce Clause, because permitting states to enact a lower tax rate, for instance, fosters a competitive business climate consistent with the federalism and liberty that the Commerce Clause protects.[8] More problematic policies have also been upheld by the courts, including targeted tax credits and single-sales factor apportionment formulas.

While such policies on their own are constitutionally permissible, and while state motivations normally do not drive a judicial result, the imposition of economic nexus can be a tool for explicitly shifting the burdens of government from the voters and businesses that benefit directly from its services to unrepresented, remote taxpayers. As technologies permit commercial transactions between remote parties ever more easily, bright-line nexus standards are even more important to prevent economic disruption.[9]

The State of Washington is again a perfect example. The Department of Revenue summarized the prospective

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[5] Wash. Rev. Code § 82.04.462(3)(b)(i) (2010).

[6] Wash. Rev. Code § 82.04.462(3)(b)(ii) (2010).

[7] Wash. Admin. Code § 458-20-19402(5)(a)(i)(C)(II) (emergency rule effective Jan. 28, 2011 through September 24, 2011), http://dor.wa.gov/Docs/Rules/ draft/20-19402-19403cr3efrmdraft2011-4.pdf.

[8] *See, e.g.*, *Western & Southern Life Ins. Co. v. State Bd. Of Equalization of California*, 451 U.S. 648, 671 (1981) ("This Court has recognized the legitimacy of state efforts to maintain the profit level of a domestic industry, and of efforts to protect and enhance the reputation of a domestic industry so that it might compete more effectively in the interstate market.") (internal citations omitted). *See also West Lynn Creamery, Inc. v. Healy*, 512 U.S. 186, 211 (1994) (Scalia, J., dissenting) ("I would therefore allow a State to subsidize its domestic industry so long as it does so from nondiscriminatory taxes that go into the State's general revenue fund."); *Camps Newfound/Owatonna, Inc. v. Town of Harrison, Me.*, 520 U.S. 564, 621 (1997) (Thomas, J., dissenting).

[9] *See, e.g.* Daniel Shaviro, 90 MICH. L. REV. 895, 902 (1992) ("Today's far greater set of economic interrelationships among the states, founded above all on drastic reductions in the costs of travel and communication, suggest a far greater elasticity of response to locational tax disparities. Thus, the efficiency consequences of locational disparities probably have grown immensely."); *id.* ("Today's more integrated national economy presents far greater opportunities than existed in 1787 for states in effect to reach across their borders and tax nonconsenting nonbeneficiaries.").

impact of Washington's 2010 legislation as requiring tax payments from "out-of-state businesses [that] currently do <u>millions of dollars</u> in business with the state but pay <u>zero tax</u> because they lack physical nexus" (emphasis original).[10] At the same time, they write, "[m]any Washington-based businesses will see <u>reduced taxes</u>" (emphasis original).[11]

A physical presence standard for business activity taxes would halt these growing state efforts to export tax burdens. A physical presence standard would also have the benefit of focusing states on raising their tax revenue from those who work and live in the jurisdiction.

Physical Presence Is in Line with the "Benefit Principle" and International Practice

The physical presence rule articulated in *Quill* comports roughly with what economists call the "benefit principle": the idea that the taxes one pays should be a rough proxy for the government services that one consumes.[12] State spending overwhelmingly, if not completely, is meant to benefit the people who live and work in the jurisdiction. Education, health care, roads, police protection: the primary beneficiaries are state residents. The "benefit principle" means that residents should be paying taxes where they work and live, and jurisdictions should not tax those who don't work and live there. The proper taxation rule to achieve this is physical presence.

Physical presence has its analogy in the international context:

> An almost universal consensus has been achieved regarding the use of the [Permanent Establishment physical presence] standard to determine income tax jurisdiction. This has created much needed uniformity, predictability, and certainty for multinational corporations and other taxpayers. Moreover, the consensus around the standard helps to mitigate double taxation and prevent tax jurisdictional disputes, which is especially important in a global economy. Finally, the rule prevents the administrative burden for multinational corporations and other taxpayers of having to file net basis income tax returns in every jurisdiction where they have customers or other sources of business income.[13]

Mr. Mundaca, most recently Deputy Assistant Treasury Secretary in the Obama Administration, further noted that "assertions of expansive tax jurisdictions by the U.S. states" threaten boycotting or retaliation from foreign corporations and foreign governments and could lead to the unraveling of the international physical presence standard.[14]

When the states assert, through economic nexus, the power to tax remote persons based solely on the source of payment, they are asserting a sovereign power that, in the international business context, the United States has largely renounced. Professor Isenbergh contrasts this position with that found more frequently in the undercapitalized developing world: "Some tax systems (usually in countries that are heavy importers of capital) engage in no dissection of the economic origins of income, but simply ask from whose pocket it was paid. In their view the source of the income is the source of the payment."[15]

The Commerce Clause was crafted during a time of economic transformation, with the desire to remove

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[10] Washington State Department of Revenue, "Economic Nexus Summary" (Jan. 19, 2010) at 2-3.
[11] *Id.*
[12] *See, e.g.*, HARVEY S. ROSEN, PUBLIC FINANCE 467 (7th ed. 2005).
[13] *How Much Should Borders Matter?: Tax Jurisdiction in the New Economy: Hearing on H.R. 1956 Before the S. Committee on Finance*, 109th Cong. 24 (2006) (statement of Michael F. Mundaca, Principal, Ernst & Young).
[14] *See id.*
[15] *See* JOSEPH ISENBERGH, INTERNATIONAL TAXATION at 29 (2d ed. 2005)

obstacles to economic growth overriding states' desire to tax interstate commerce.[16] This economic tension between the states and Congress's lack of power to regularize it led directly to calls for a new Constitution that would include a clear federal power to regulate interstate commerce. The pressures that drove states in the 1780s are similar to the pressures today: need for revenue caused by an increase in demand for state services or lackluster economic growth, and a desire to export tax burdens to nonresidents.

Lamtec offers an opportunity to stabilize the case law and guide taxpayers' business arrangements by adopting a simple and sensible rule. Namely, a taxpayer with a continuous presence in a state is presumptively taxable on all commercial relations with that state, and has the burden of rebutting the presumption, while conversely a taxpayer that is present only intermittently is presumptively not taxable in the state, and the state has the burden of showing a causal relationship between the intermittent activities and the in-state customer relations.

The case is *Lamtec Corp. v. Department of Revenue of the State of Washington*, No. 10-1289.

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About the Tax Foundation

The Tax Foundation is a 501(c)(3) non-partisan, non-profit research institution founded in 1937 to educate taxpayers on tax policy. Based in Washington, D.C., the Foundation's economic and policy analysis is guided by the principles of sound tax policy: simplicity, neutrality, transparency, and stability.

[16] *See* Brannon P. Denning, *Confederation-Era Discrimination Against Interstate Commerce and the Legitimacy of the Dormant Commerce Clause*, 94 KY. L. J. 37, 40 (2005) ("The mid-1780s brought on a severe depression, during which states scrambled to raise revenue. Imposts and duties on commerce became popular, with nearly every state enacting some sort of impost or duty regime.").