Economic Nexus In Washington State: Defining Substantial Nexus

Armikka R Bryant
ECONOMIC NEXUS IN WASHINGTON STATE: DEFINING SUBSTANTIAL NEXUS

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I. INTRODUCTION

This Article explores the evolving framework of nexus and examines the constitutional constraints imposed on states’ tax jurisdiction and how states overcome those limitations. In 2010, the Washington State Legislature declared that out-of-state businesses with no physical presence in Washington were earning significant income from Washington residents by providing services or collecting royalties on the use of intangible property in the state.1 The Legislature also determined that, although these out-of-state businesses did not have a physical presence in the state and were not paying their fair share of Washington State taxes, they were nonetheless receiving the following significant benefits provided by the state:

- Laws providing protection of business interests or regulating consumer credit;
- Access to courts and judicial process to enforce business rights, including debt collection and intellectual property rights;
- An orderly and regulated marketplace; and

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• Police and fire protection and a transportation system benefiting in-state agents and other representatives of out-of-state businesses.2

The Legislature therefore decided to extend Washington’s business and occupation (‘‘B&O’’) tax, a gross receipts tax, to out-of-state businesses without a physical presence in the state in an attempt to raise tax revenues to pay for the above-mentioned services.3 Beginning on June 1, 2010 Washington’s B&O tax became applicable to out-of-state businesses without a physical presence in the state if the business has more than:

• $250,000 of gross receipts in the state;
• $50,000 of payroll in the state;
• $50,000 of or property in the state; or
• 25% of total gross receipts, payroll, or property in the state.4

In short, the Legislature determined that an economic presence in the state was all that was necessary to impose its gross receipts tax on a business; if a business has payroll (i.e. employees) and property in the state, they are naturally physically present, and the $50,000 limits are merely de minimis thresholds.

II. NEXUS FOUNDING PRINCIPLES

Nexus is the minimum level of business activity or connection with a state that subjects the business to the taxing jurisdiction of the state.5 Nexus is generally created when a taxpayer engages in business activities in a taxing jurisdiction, either directly or through a representative.6 In general, a taxpayer does not need to have a permanent place of business within a state to create nexus in Washington

2. Id. at § 101.
3. See id.
4. WASH. REV. CODE ANN. § 82.04.067(1)(c) (West 2011).
5. See, e.g., WASH. REV. CODE ANN § 35.102.050 (West 2011) (“A city may not impose a business and occupation tax on a person unless that person has nexus with the city. For the purposes of this section, the term ‘nexus’ means business activities conducted by a person sufficient to subject that person to the taxing jurisdiction of a city under the standards established for interstate commerce under the commerce clause of the United States Constitution.”).
6. See id.
for specific tax classifications. The modern nexus analysis begins and ends with determining if a business has nexus under both the Commerce Clause and the Due Process Clause. If a state or local tax jurisdiction determines that a business satisfies both clauses, it is able to constitutionally impose a tax or a tax collection responsibility on the business.

The Commerce Clause of the U.S. Constitution gives Congress the power to regulate interstate commerce; this power includes determining how and what states may tax when interstate commerce is affected. Even when Congress has chosen not to regulate a part of interstate commerce, the Supreme Court has interpreted the Commerce Clause to prohibit certain state taxes on interstate commerce. Under the Commerce Clause, a business must have “substantial nexus” with a state to permit taxation. However, neither the Supreme Court nor Congress has defined exactly what establishes a “substantial nexus.” Some commentators have noted that “substantial nexus” is simply nexus plus some other contact with the state. Under the Due Process Clause, nexus focuses on whether the tax has a rational relationship to the opportunities, benefits, or protections conferred or afforded by the State to the activity undertaken by the taxpayer. If a tax satisfies the Commerce Clause, it has been generally accepted that it also satisfies the Due Process nexus requirements; therefore most disputes regarding a state’s nexus to tax actually arise under the Commerce Clause, not the Due Process Clause.

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7. See Wash. Rev. Code Ann. § 82.04.067(6) (stating that physical presence in the state “need only be demonstrably more than a slightest presence”).
9. Id.
10. See U.S. Const. art. I, § 8, cl. 3.
11. In general, a state tax is valid under the Commerce Clause if it satisfies the four-part test of Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977):
   (1) The tax does not discriminate against interstate commerce;
   (2) The tax is fairly apportioned among states;
   (3) There is substantial nexus; and
   (4) The tax fairly relates to the benefits provided by the state.
12. Id. at 279.
15. This is true for cases involving sales and use tax. Taxpayers would dispute the following, but for business activity taxes such as income taxes and gross receipts taxes, it
A. The Due Process Clause Nexus Analysis

The Due Process Clause of the United States Constitution states that no state shall “deprive any person of life, liberty, or property, without due process of law . . .”\(^\text{16}\) In terms of state taxation of a non-resident taxpayer, the Due Process Clause has two requirements: minimum connection and rational relationship.\(^\text{17}\) The Due Process Clause requires “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.”\(^\text{18}\) Minimum connection is not a particularly high standard because all that is required is a showing that the taxpayer has purposefully availed itself of the benefits of the state’s economic market.\(^\text{19}\) The Supreme Court spent the greater part of its International Shoe Co. v. Washington opinion struggling to craft a universally applicable test to determine whether Washington’s contention of in personam jurisdiction was consistent with due process.\(^\text{20}\) The Court examined whether the necessity of physical presence in the forum state had been compromised by personal service and summons and held that:

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\text{[S]ome of the decisions holding the corporation amenable to suit have been supported by resort to the legal fiction that it has given its consent to service and suit, consent being implied from its presence in the state through the acts of its authorized agents. But more realistically it may be said that those authorized acts were of such a nature as to justify the fiction.}^{21}\]

Accordingly, a corporation’s presence or consent to service and suit in the state is all that is required for the defendant to have minimum contacts with the forum state, “such that the maintenance of the suit does

\(^\text{16}\) U.S. CONST. amend. XIV, §1.
\(^\text{19}\) See generally Asahi Metal Ind. Co. v. Superior Court, 480 U.S. 102 (1987).
\(^\text{20}\) 326 U.S. 310, 316 (1945) (describing the relevant inquiry in determining nexus for due process purposes as whether the taxpayer has the minimum contacts with a jurisdiction “such that the maintenance of [a] suit does not offend ‘traditional notions of fair play and substantial justice’”).
\(^\text{21}\) Id. at 318 (internal citations omitted).
not offend ‘traditional notions of fair play and substantial justice.’”\textsuperscript{22}

In \textit{Travelers Health Ass’n v. Virginia}, the Court held that parties who reach beyond one state and create continuing relationships and obligations with citizens of another state become subject to regulation and sanctions in the other state for the consequences of their actions.\textsuperscript{23} In describing the burden that states find themselves under, the Court described the state as “[h]elpless when the out-of-state company operates beyond the borders, establishes no office in the state, and has no agents, salesmen, or solicitors to obtain business for it within the state.”\textsuperscript{24} Again, the Court found that the Due Process Clause does not preclude a state from regulating a non-resident who has “certain minimum contacts with it.”\textsuperscript{25}

The Due Process Clause also requires that a “rational relationship” exist between the subject matter over which jurisdiction is sought and the state.\textsuperscript{26} In other words, in the context of tax imposition, the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state.\textsuperscript{27} This principle is illustrated in a series of non-tax cases. For example, in \textit{Kulcko v. Superior Court}, the appellant did not dispute the adequacy of notice he received, but instead contended that “his connection with the State of California [wa]s too attenuated, under the standards implicit in the Due Process Clause of the Constitution, to justify imposing upon him the burden and inconvenience of defense in California.”\textsuperscript{28} The Court agreed and held that where a party does not purposefully derive benefits from interstate activities, it would be unfair to require him to conduct a defense in the state.\textsuperscript{29}

Similarly, in \textit{Burger King Corp. v. Rudzewicz}, the Court held that “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.”\textsuperscript{30} This

\textsuperscript{22} \textit{Id.} at 316.
\textsuperscript{23} 339 U.S. 643, 647 (1950).
\textsuperscript{24} \textit{Id.} at 653–54.
\textsuperscript{25} \textit{Id.} at 648.
\textsuperscript{27} \textit{Id.}
\textsuperscript{28} 436 U.S. 84, 91 (1978).
\textsuperscript{29} \textit{See id.} at 96.
reasoning was again followed just a few years later in *Asahi Metal Industry Co. v. Superior Court*, where the Court found the requisite minimum contacts to be sufficient to invoke the court’s jurisdiction where the party’s activities were the result of purposeful action directed towards the state.\(^{31}\)

### B. The Commerce Clause Nexus Analysis

Because the Due Process Clause sets the bar fairly low by requiring only a minimum connection to the state, and for the states’ action to be only rationally related to that connection, most businesses challenge the nexus requirement by attacking the more stringent Commerce Clause standard. Article I, Section 8 of the United States Constitution states that “Congress shall have the power . . . to regulate commerce . . . among the several States . . . “\(^{32}\) Even where Congress is silent, the Commerce Clause has a “dormant” or “negative” impact on state laws that discriminate against or interfere with interstate commerce.\(^{33}\) Nexus under the modern “Dormant” Commerce Clause is a deceptively straightforward test that is set out in *Complete Auto Transit Inc. v. Brady*.\(^{34}\) For nexus to satisfy the Commerce Clause and be upheld as constitutional, a tax must:

- Be imposed on a business that has substantial nexus with the taxing state;
- Be fairly apportioned;
- Not discriminate against interstate commerce; and
- Be fairly related to the benefits and protections provided by

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32. U.S. CONST. art. I, § 8, cl. 3.
34. 430 U.S. 274, 274 (1977). In this case, the Court examined the “Spector rule,” see Spector Motor Serv. v. O’Connor, 340 U.S. 602 (1951), which had provided a blanket prohibition against the state taxation of the privilege of engaging in interstate commerce. *Brady*, 430 U.S. at 609. In overturning the rationale of *Spector*, the Court articulated a new rule that a state tax on the “privilege of doing business” in a state is not per se unconstitutional under the Commerce Clause if the activity taxed has (1) sufficient nexus with the state to justify a tax; (2) the tax is fairly related to the benefits provided by the state to the taxpayer; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly apportioned to local activities. *Id.* at 274. The taxpayer in *Brady* argued that it was exempt from state taxation because it was engaged in interstate commerce. *Id.* at 277. It was never argued that the state lacked sufficient nexus to impose a tax (or, for that matter, that the tax discriminated against interstate commerce, was unfairly apportioned, or was unrelated to services provided by the taxing state). *Id.* at 277–78.
the state.\textsuperscript{35}

The purpose of the “substantial nexus” prong of \textit{Complete Auto} is to “limit the reach of state taxing authority so as to ensure that state taxation does not unduly burden interstate commerce.”\textsuperscript{36} According to the Court in \textit{Quill Corp. v. North Dakota}, in contrast to the purpose of the Due Process Clause minimum connection requirement, “the Commerce Clause and its nexus requirement are informed not so much by concerns about fairness for the individual defendant as by structural concerns about the effects of state regulation on the national economy.”\textsuperscript{37}

In \textit{National Bellas Hess}, the Court had held that an out-of-state vendor, whose only contacts with the taxing state were by mail or common carrier, lacked nexus with the state.\textsuperscript{38} The \textit{Quill} Court acknowledged that “contemporary Commerce Clause jurisprudence might not dictate the same result were the [issues in \textit{Bellas Hess}] to arise for the first time today . . . .”\textsuperscript{39} It consequently held, however, that with respect to retail sales tax and use tax collection, a taxpayer must have a physical presence in the state before the state could impose a collection responsibility on the taxpayer.\textsuperscript{40} It has been argued that the Court chose to support the continuing value of a bright-line physical presence test because of the principles of \textit{stare decisis} and the substantial reliance of the entire mail order industry on the \textit{Bellas Hess} holding.\textsuperscript{41}

\section*{III. The Nexus Defining Cases}

The Supreme Court established the current constitutional framework for assessing nexus issues in the \textit{Quill} case without distinguishing the U.S. Constitution’s Commerce Clause and Due Process Clause nexus requirements for tax purposes, and without definitively stating to what taxes physical presence applies. However,

\begin{itemize}
  \item \textsuperscript{35} \textit{Id.} at 274.
  \item \textsuperscript{36} \textit{Quill Corp. v. North Dakota}, 504 U.S. 298, 313 (1992).
  \item \textsuperscript{37} \textit{Id.} at 325 (citation omitted).
  \item \textsuperscript{38} \textit{See generally Nat’l Bellas Hess, Inc. v. Dep’t of Revenue}, 386 U.S. 753 (1967).
  \item \textsuperscript{39} \textit{Quill}, 504 U.S. at 311.
  \item \textsuperscript{40} \textit{See Quill}, 504 U.S. at 317–18. The Court seemed to limit the holding that a business must have a physical presence in a state for the state to require the business to collect and remit retail sales tax and use tax, but this is not one-hundred percent clear.
  \item \textsuperscript{41} \textit{See, e.g.}, John A. Swain, \textit{Cybertaxation and the Commerce Clause: Entity Isolation or Affiliate Nexus?}, 75 S. CAL. L. REV. 419, 432 (2002).
\end{itemize}
the Court expressed foundational constitutional nexus principles in several important earlier decisions.

In Wisconsin v. J.C. Penney Co., the Court defined the nexus analysis as “whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state” and stated that “the simple but controlling question is whether the state has given anything for which it can ask return.” In International Shoe Co. v. Fontenot, the Louisiana Supreme Court upheld Louisiana’s imposition of a net income tax based on the in-state solicitation of orders by salespersons that carried samples and were provided company-owned automobiles. The U.S. Supreme Court’s denial of certiorari, in conjunction with earlier United States Supreme Court cases, indicated the Court’s view that the Commerce Clause was not violated by the imposition of a net income tax under such circumstances.

In Miller Bros. v. Maryland, the Court ruled that the State of Maryland could not impose a tax collection obligation on a Delaware corporation because the Delaware business, through its general advertising and occasional delivery of goods sold at an out-of-state store, had not established the due process requirement of “some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax.” Miller sold directly to customers at its store in Delaware. It did not accept mail or telephone orders and made no solicitation of customers other than by newspaper, radio, and occasional direct mail advertising. Residents of nearby Maryland came to the store and made purchases, which they took away or which were delivered to them in Maryland by common carrier or by Miller’s own truck. Maryland imposed an excise tax on its residents on “the use, storage, or consumption” of such articles in that state, and it required every vendor to collect and remit the tax from its Maryland customers, regardless of how the goods were delivered.

In Northwestern States Portland Cement Co. v. Minnesota, the taxpayer carried out “a regular and systematic course of solicitation” in the taxing state, and the Court held that merely being present in the state

42. 311 U.S. 435, 444 (1940).
45. Id. at 341.
46. Id.
47. Id.
was an adequate justification to merit Minnesota’s imposition of income tax.\textsuperscript{49} Portland Cement precipitated the enactment of Public Law 86-272, which restricts the applicability of state net income tax in various circumstances.\textsuperscript{50} In \textit{National Geographic Society v. California Board of Equalization}, California issued a use tax assessment against National Geographic that was measured by its mail order sales to California residents.\textsuperscript{51} Although National Geographic performed no activities related to its mail order business in California, the state assessed it with a tax liability because California residents ordered items by mail directly from National Geographic.\textsuperscript{52} The Court upheld the tax and determined that National Geographic had a significant presence in the state through its advertising sales offices and enjoyed the benefits of the state.\textsuperscript{53}

In \textit{Quill}, North Dakota imposed a use tax collection obligation on the Quill Corporation, a Delaware mail order business with offices and warehouses in three states, none of which was in North Dakota.\textsuperscript{54} Quill Corporation’s ownership of tangible property in North Dakota was insignificant or nonexistent and consisted primarily of sending catalogs to North Dakota residents.\textsuperscript{55} North Dakota assessed use tax under a statute imposing a collection obligation on retailers who maintained a “place of business” in North Dakota.\textsuperscript{56} Maintaining a “place of business” under North Dakota law included the regular or systematic

\begin{footnotesize}
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\item 358 U.S. 450, 454, 464 (1959).
\item Pub. L. No. 86-272, 73 Stat. 555 (1959) (codified at 15 U.S.C. §§ 381–391(2006)). This federal statute applies to sellers of tangible personal property and protects them from net income taxes if the seller limits its in-state activities to solicitation. \textit{Id.} It provides that a State may not impose a net income tax on any person if that person’s only business activities within such State involve the “solicitation of orders are sent outside the State for approval . . . and, if approved, are filled . . . outside the State.” 15 U.S.C. § 381(a)(1). The Act, effective September 14, 1959, was passed in response to a series of United States Supreme Court cases that culminated in a denial of \textit{certiorari} in \textit{Int’l Shoe Co. v. Fontenot}, 107 So.2d 640 (La. 1958), \textit{cert. denied}, 359 U.S. 984 (1959). As enacted, the law prohibits states from imposing a net income tax on a business whose sole activity within a state is the solicitation of orders for goods to be delivered from outside the state. As stated by the United States Supreme Court in \textit{Wisconsin Department of Revenue v. William Wrigley, Jr.}, Co., 505 U.S. 214, 222 (1992), the Act sets “a ‘minimum standard’ for [the] imposition of a state net-income tax based on solicitation of interstate sales.” The reach of the Act, however, is limited to a “tax imposed on, or measured by, net income.” 15 U.S.C. § 383. The \textit{Wrigley} case, in contrast, involved a net income based franchise tax. See generally \textit{Wrigley}, 505 U.S. 214.
\item See 430 U.S. 551, 551–52 (1977).
\item \textit{Id.} at 552–53.
\item \textit{Id.} at 556.
\item \textit{Id.} at 302.
\item \textit{Id.}
\end{enumerate}
\end{footnotesize}
solicitation of a consumer market in the state, further defined by regulation to mean three or more advertisements within a twelve-month period. The Quill Court followed the bright-line rationale set forth in Bellas Hess, which not only requires a physical presence in the taxing state, but also creates a safe harbor for vendors “whose only connection with customers in the [taxing] state is by common carrier or the United States mail.” Therefore, under Bellas Hess and Quill, mail order vendors with no other physical presence in a state are free from state-imposed duties to collect retail sales tax and use tax. According to Professor John Swain, “Quill did not raise the Commerce Clause nexus bar.” Instead, Quill lowered the Due Process nexus bar to the same “purposeful availment” standard that had been previously established by the Court’s personal jurisdiction decisions.

Several valuable lessons flow from Quill, which was decided in 1992. Since that time, a number of states have successfully argued that Quill’s holding is limited to retail sales tax and use tax collection, and that physical presence is not required to impose other types of taxes on an out-of-state business; most of these cases, however, involved income taxes. Therefore, the question remains of whether a gross receipts tax such as Washington’s B&O tax would be subject to the Quill physical presence test.

The first case to tackle Quill’s unanswered issues was Geoffrey, Inc. v. South Carolina Tax Commission (“Geoffrey I”). South Carolina assessed Geoffrey Inc., an out-of-state Delaware corporation with no physical presence in South Carolina, for corporate income tax. Due process nexus was met because Geoffrey purposefully directed its economic activities toward the state and because of the “presence of Geoffrey’s intangible property in the State.” In Kmart Properties, Inc.

57. Id. at 302–03.
60. Id. at 346.
63. Id. at 17.
64. Id. at 20–21.
v. Taxation and Revenue Department, Kmart Properties, Incorporated ("KPI"), a wholly owned subsidiary of Kmart Corporation, was assessed in New Mexico for income tax and gross receipts tax.65 The court dismissed the notion that Quill demanded a physical presence within the state and held that a nexus analysis begins with Complete Auto, not Quill.66 Similarly, in A&F Trademark v. Tolson A&F Trademark had no employees or physical property in North Carolina, but generated significant royalty income in the state from licensing trademarks to Abercrombie & Fitch, Inc., Lane Bryant, Inc., and Victoria’s Secret in the state.67 North Carolina assessed A&F Trademark for state income and franchise taxes.68 The North Carolina Supreme Court ruled that physical presence does not apply to every state tax.69 Courts of other states have held the same.70

To be sure, the movement among states is clearly toward economic nexus establishing a constitutionally valid method of imposing income tax liability on remote entities.71 Proof of this was the watershed West Virginia case of Tax Commissioner v. MBNA America Bank, N.A.72 The sole issue before the West Virginia Supreme Court was whether MBNA, who had no physical presence in the state, could be subjected to the state’s franchise tax and income tax under the Commerce Clause.73 Instead of conducting a physical presence analysis, however, the court developed what it coined as “a significant economic presence test” because it was “a better indicator of whether substantial nexus exists for Commerce Clause purposes.”74 The court applied the “significant

65. 131 P.3d at 31.
66. Id. at 36.
68. Id.
69. Id. at 195.
73. Id. at 228–29.
74. Id. at 234.
economic presence test” and examined the following factors:

- The degree to which an entity exploited a local market;
- The quality and quantity of the entity’s economic presence in the taxing jurisdiction; and
- The frequency, quantity, and systematic nature of the entity’s economic contacts with the jurisdiction.\(^75\)

Needless to say, MBNA was held taxable in West Virginia and appealed to the U.S. Supreme Court, which denied certiorari.\(^76\) This denial of certiorari was a signal to the states that if they provided identifiable benefits to a taxpayer, the taxpayer was liable for taxation under both the Commerce Clause and the Due Process Clause.

IV. ECONOMIC NEXUS

Because Quill likely held that physical presence was only required with respect to retail sales tax and use tax, debate ensued as to whether a business must have a physical presence within a state for the state to impose other types of taxes such as income, gross receipts, and franchise taxes, or if an economic presence was sufficient to impose the latter types of taxes. In general, the term “economic nexus” refers to the situation where an entity does business in a state and derives revenue from those activities without having a physical presence within the state. The concept was first employed by states to curb abusive state tax planning devices such as passive investment companies (“PICs”).\(^77\)

The typical arguments in favor of economic nexus, using the Quill decision as a starting point, are as follows: First, the Supreme Court

\(^{75}\) Id.
\(^{77}\) “A passive investment company is a tax planning device whereby a corporation sets up a holding company and transfers all of the corporation’s valuable intangible property to the holding company in a tax-free transaction.” Julie Roman Lackner, Note, The Evolution and Future of Substantial Nexus in State Taxation of Corporate Income, 48 B.C. L. REV. 1387, 1401 (2007). The holding company is incorporated in a state that does not tax income derived from intangibles, typically Delaware or Nevada. Id. “The PIC then licenses the intangible property back to the corporation in exchange for royalty payments.” Id. This creates a deduction for the corporation (reducing its pre- apportionment net income), while at the same time generating income for the PIC that is not taxed by the state where the PIC was organized. Often times, the corporation will also borrow funds from the PIC, thereby creating interest expense to the corporation and interest income to the PIC.
reluctantly affirmed the *National Bellas Hess* physical presence standard in *Quill*. Second, the *Quill* Court acknowledged that it might not decide the case the same way if the issue was to arise for the first time under contemporary Commerce Clause analysis. Third, the Court articulated no reliance interests built up over time outside the direct marketing industry. Last, there is less of a compliance burden with respect to state income and franchise taxes than there is with retail sales tax and use tax, i.e., with respect to retail sales tax and use tax, the state is reliant on the taxpayer to remit monthly collections, but with income taxes and franchise taxes, the taxpayer must prepare and file an annual tax return.

The counter arguments against using the *Quill* decision to affirm economic nexus are: First, the U.S. Supreme Court has never upheld a state tax on Commerce Clause grounds where physical presence was lacking. Second, there is no constitutional justification for employing a different nexus standard for retail sales tax and use tax collection than for income tax, gross receipts tax, etc. Third, a direct tax on an out-of-state business with no physical activity in the taxing state is disproportionate to the benefits and protections afforded by the state. Last, the compliance burden on businesses is significant, even with respect to direct business activity taxes. Justice Frankfurter’s dissent in *Northwestern States Portland Cement Co. v. Minnesota* elegantly articulates this “compliance burden” argument:

> [T]here are thousands of relatively small or moderate size corporations doing exclusively interstate business spread over several States. To subject these corporations to a separate income tax in each of these States means that they will have to keep books, make returns, store records, and engage legal counsel, all to meet the diverse and variegated tax laws of [the] States, with their different times for filing returns, different tax structures, different modes for determining “net income,” and different, often conflicting, formulas of apportionment. This will involve large increases in bookkeeping, accounting, and legal paraphernalia to meet these new demands. The cost of such a far-flung scheme for complying with the taxing requirements of the different States may well exceed the burden of the taxes themselves, especially in the case of small companies doing a small volume of business in several States.78

It is doubtful that this dispute will be resolved anytime soon. To that end, numerous states have decided to forego explicit guidance from the Supreme Court or Congress and have decided to impose “direct”

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78. 358 U.S. 450, 474 (1959) (Frankfurter, J., dissenting).
taxes on out-of-state business with no physical presence within their borders. Like Washington State, these states have determined that economic nexus is established, and that the tax is imposed and measured, by a business’ activities attributed to or apportioned to the state.

V. WASHINGTON’S B&O TAX AND PHYSICAL PRESENCE

A tax’s legality can hinge on its classification. In 1895, the U.S. Supreme Court classified the federal income tax as a “direct” tax. The income tax was imposed on rentals, dividends, and interest and was “direct” because it was imposed on the underlying property that produced the income, rather than “indirect” because it was not imposed on the income itself. This outcome condemned the tax as unconstitutional because it was not apportioned among the states according to population as required by Article I, Section 9, Clause 4 of the U.S. Constitution. In 1913, the 16th Amendment gave Congress the power “to lay and collect taxes on incomes, from whatever source derived, without regard to apportionment among the several States . . . ” But, in Eisner v. Macomber, the U.S. Supreme Court held Congress’ attempt to impose income tax on stock dividends unconstitutional because it was a tax on “property” that was not apportioned among the states by population. The Court determined that the tax was imposed on the underlying property rather than on the income earned from property. In short, “income” is gain derived from capital, labor, or both, including profit gained through conversion or sale of capital. Traditional notions of income also take into account the net appreciation (gains) and depreciation (losses) of assets held during the tax period. As Professor Hasen explains, “[t]he occurrence or not of

79. For an excellent analysis on the relationship between tax classifications and nexus, see generally Walter Hellerstein & John A. Swain, Classifying State and Local Taxes: Current Controversies, 54 ST. TAX NOTES 35 (2009), upon which this paragraph is largely based.
81. Id.
82. Id.
83. U.S. CONST. amend. XVI.
85. Id.
86. Id. at 193.
transactions is irrelevant to the amount of the taxpayer’s income or loss and, therefore, to the amount of income tax liability the taxpayer has during the tax period. For example, whether or not Sara sells Blackacre to Mitch on December 31st, her tax liability for the year ending on that date is the same because the increase or decline in the value of Blackacre is definitive of whether she has taxable income or loss.

Currently, there are no decisions from the courts of Washington State that have thoroughly analyzed whether the Washington B&O tax (arguably an operational/direct tax) is in the same classification as the retail sales tax and use tax (arguably a transactional/indirect tax) at issue in Quill. The Washington Court of Appeals briefly touched on the issue in General Motors Corp. v. City of Seattle when it held that Seattle’s B&O tax, which is based on the state B&O tax, “is neither a sales or use tax, nor is it a franchise tax.” Then, a second division of the Washington Court of Appeals dealt with the issue even more succinctly when it held that, “therefore, the Quill language does not support [the taxpayer’s] proposition that a physical presence is required to establish substantial nexus in the context of B&O taxes.” Professors Hellerstein and Swain believe that the Court of Appeals’ use of the word “therefore” indicates that the court interprets the B&O tax to be distinct from a retail sales tax and use tax.

As Philip Tatarowicz points out:

88. Id.
89. Id. at 898.
93. Hellerstein & Swain, supra note 79. The authors state:
   Earlier in its opinion, however, the Lamtec court provided more analytical content to this distinction, albeit in the context of the state law issue of whether the place of “sale” was relevant to the application of the B&O tax:

   Sales tax is inherently different from B&O tax. In Ford Motor, the Washington Supreme Court emphasized this inherent difference:
   Looking at the place of sale is proper in the sales tax context because the incident of tax in that situation is the individual transaction. Such is not the case where a B&O tax is involved because . . . the B&O tax is imposed upon activities associated with the privilege of doing business in the taxing jurisdiction.

   Id. at n.25 (quoting Lamtec, 215 P.3d at 972).
Historically, in analyzing cases under the commerce clause, the courts have distinguished between two types of taxes: operational [direct] and transactional [indirect] taxes. Operational taxes are those imposed on taxpayers engaged in operations, such as manufacturing and wholesaling in the state. A classic example of an operational tax is an income tax. Transactional taxes are those imposed on discrete transactions, such as retail sales, occurring within the state [and require that the seller collect and remit the tax to the state].

An example of a transactional tax is a retail sales tax, although some indirect taxes are sometimes called a “fee.” Of this distinction, Nathaniel Trelease and Andrew Swain write:

The distinction between a gross-receipts tax and a [retail] sales tax is that the latter is essentially a transactional tax on the consumer of goods and services, separately stated and collected from the purchaser by the vendor [and remitted to the state], while a gross-receipts tax is a tax on the 'vendor's business activity.'

Tatarowicz notes, "[i]t appears that the courts may converge [their] analysis of operational and transactional taxes under the commerce clause, as a result of which operational tax doctrines may come to be applied to transactional taxes." He also writes:

The trend towards convergence can best be seen in gross receipts tax cases because these taxes are on the borderline between operational and transactional taxes. Gross receipts taxes are usually imposed on the recipient of gross income on an annual or some other periodic basis. Gross receipts taxes, therefore, are similar to retail sales taxes in that they tax receipts from the sale of goods.

....

Unlike [retail] sales taxes, however, gross receipts taxes are imposed on the seller rather than the customer. Gross receipts taxes may also include receipts from activities other than sales of goods and, therefore, to some extent resemble income taxes. A gross receipts tax is imposed whether or not the

95. Id.
97. Tatarowicz, supra note 94, at 112.
business is profitable. Although gross receipts taxes are neither clearly operational taxes nor clearly transactional taxes, the courts have historically distinguished gross receipts taxes from net income taxes and treated them more like transactional taxes.

Nevertheless, the courts have begun to apply some traditionally operational tax doctrines to gross receipts taxes. The four-prong Complete Auto Transit test, which includes a prong for fair apportionment, was developed in the context of a gross receipts tax. In addition, the mere risk of “multiple burdens” has been sufficient to invalidate an unapportioned gross receipts tax. Moreover, in Armco Inc. v. Hardesty and Tyler Pipe Industries v. Washington State Department of Revenue, consolidated with National Can Corp. v. Washington State Department of Revenue, the Court applied an internal consistency doctrine analysis to strike down gross receipts taxing schemes. Thus, it is now unclear whether, and to what extent, the courts will continue to make distinctions between operational and transactional taxes.  

Washington State’s B&O tax is undoubtedly imposed on the gross proceeds of the act or privilege of engaging in business; these characteristics make it seem as though the B&O tax is an operational tax. Nonetheless, the Washington Supreme Court previously held that “[t]he character of a tax is determined by its incidents, not by its name.” Many decades later in Chicago Bridge & Iron Co. v. Department of Revenue, the Court characterized the B&O tax when it stated, “[W]e find Washington’s B&O tax on the privilege of doing business in Washington constitutionally valid under state and federal due process clauses and under the federal commerce clause.” To be sure, this holding clearly laid to rest that the B&O tax is an operational tax. Just a decade after Chicago, however, the Court in Nordstrom Credit, Inc. v. Department of Revenue referred to the B&O tax as a transactional tax when it stated, without clarification, that “Washington taxes transactions.” But Nordstrom did not overrule Chicago in its re-characterization of the B&O tax because most courts would likely agree

that the tax is first and foremost an excise tax.\textsuperscript{103}

Title 82 of the Revised Code of Washington, titled “Excise Taxes,” covers Washington’s B&O, sales, use, and other taxes.\textsuperscript{104} In 2006, the Washington State Court of Appeals held that “[a]n excise tax is a tax that the State of Washington imposes on a taxpayer for exercising a certain right or privilege.”\textsuperscript{105}

Even if the B&O tax is deemed a transactional tax, that does not convert the tax into a retail sales tax that is \textit{collected} by the seller and remitted to the state that was subject to physical presence under Quill. To some extent, Seattle’s King County Superior Court already settled this matter when it analyzed the city’s B&O tax, which is very similar to the state B&O tax. As stated earlier, the court in General Motors held that “[t]he tax at issue here is neither a sales or use tax nor is it a franchise tax. It is a business and occupation tax for the privilege of engaging in business within the City of Seattle.”\textsuperscript{106} The court then declined to extend Quill’s physical presence requirement to the B&O tax.\textsuperscript{107} The Court of Appeals’ analysis is arguably dicta and, therefore, did not conclusively answer the question presented, which is why the Washington Legislature likely did not rely on the court’s analysis in its “Intent” section of the statute when extending the B&O tax to out-of-state businesses. It is certainly significant, however, that the Court of Appeals considered and rejected General Motors’ assertion that the Quill physical presence test applies outside the retail sales tax and use tax context.\textsuperscript{108}

For the purpose of requiring a business to collect retail sales or use taxes only, the U.S. Supreme Court in Quill did not hold that physical presence is required on all taxes that happen to be “transactional” in

\begin{itemize}
\item \textsuperscript{103} See WASH. REV. CODE ANN. § 82.04.220 (West 2011).
\item \textsuperscript{104} Id. §§ 82.04.0001–82.04.900.
\item \textsuperscript{105} Tesoro Refining and Marketing Co. v. Dep’t. of Revenue, 144 P.3d 368, 371 (Wash. Ct. App. 2006).
\item \textsuperscript{106} Gen. Motors Corp. v. Seattle, 25 P.3d 1022, 1029 (Wash. Ct. App. 2001). Although the court’s decision discussed economic nexus, it described activities that were likely examples of physical presence. It is possible that the court was merely rejecting the idea that maintaining an officer or having resident employees is required for physical presence nexus. Therefore, the actual holding of this case is uncertain, despite the fact that it expressly stated that it declined to extend the Quill physical presence requirement to a municipality’s B&O tax.
\item \textsuperscript{107} Id.
\item \textsuperscript{108} Id.
\end{itemize}
Those opposed to taxing agencies limiting Quill’s physical presence requirement to only retail sales tax and use tax will no doubt argue that physical presence for all manner, classification, and characterization of taxes is the law of the land until the U.S. Supreme Court or Congress say otherwise. To be sure, the Washington State Department of Revenue, as well as all other taxing agencies, are required to follow the Quill physical presence standard for nexus when imposing retail sales and use tax collection responsibilities. This is because it is clear that Quill’s physical presence standard applies to retail sales tax and use tax, but the case does not extend to any and all taxes—to find otherwise is a gross over-simplification of Quill.

The Washington State Department of Revenue historically followed the Quill physical presence test to determine whether nexus exists to impose B&O taxes, although it was not required to do so except when applying the test to retail sales and use tax collection obligations that usually accompany the State’s retailing B&O tax classification. Washington applied the physical presence standard when it was assumed that it was the constitutional standard for all taxes, and did not modify the requirement in light of changing constitutional developments. Out-of-state taxpayers may argue that physical presence continues to be constitutionally compelled, although the State Legislature and the Department of Revenue no longer believe this to be the case. While the Nordstrom court characterized the state B&O tax as a tax on transactions, the General Motors court explicitly stated that the city of Seattle’s B&O tax is not a retail sales tax, which was the subject of controversy in the Quill case. Therefore, even if the B&O is a transactional tax, it is not the type of tax that was at issue in Quill. In the two decades since the Quill decision in 1992, a number of states have successfully argued that the Quill holding is limited to retail sales tax and use tax collection and that physical presence is not required for other

110. See WASH. REV. CODE ANN. § 82.04.250 (West 2011).
111. See WASH. ADMIN. CODE ANN § 458-20-193(7) (West 2011).
types of taxes. Most of these state cases involved income taxes.

VI. DEFINING SUBSTANTIAL NEXUS

Since Quill, the courts of twelve states have ruled that economic presence, not physical presence, is the constitutional standard for taxes other than retail sales tax and use tax.116 This includes income tax and Washington’s B&O tax, which is imposed on the act or privilege of engaging in business activities in Washington—not physical presence.117 Of those twelve cases, seven were subsequently appealed to the U.S. Supreme Court, which made good on its prediction in Quill and uniformly denied certiorari.118 Five other states have agreed that


At least sixteen other states follow an economic presence analysis at a minimum for intangibles, although apparently not pursuant to court decision. These states include: Arkansas, Colorado, Georgia, Florida, Hawaii, Iowa, Maine, Maryland, Massachusetts, Minnesota, Mississippi, New Hampshire, Ohio, Oregon, Rhode Island and Wisconsin. See Craig J. Langstraat & Emily S. Lemmon, Economic Nexus: Legislative Presumption or Legitimate Proposition?, 14 AKRON TAX J. 1, 16 nn. 55–56 (1999); Kelley W. Strain, Geoffrey the Giraffe Arrives in Louisiana: Why Geoffrey Should Not Pay State Income Tax, 6 LOY. L. & TECH. ANN. 1, 29 n. 183 (2006); Matt Tomalis, Some Fatal Flaws of S. 1726, H.R. 5267, and All BAT Nexus Bills, 47 ST. TAX NOTES 691 (2008).

117. See WASH. REV. CODE ANN. § 82.04.220 (West 2011); Gen. Motors Corp., 25 P.3d at 1029. Although the court’s decision discussed economic nexus, it described activities that we would say were examples of physical presence. It is possible that the court was merely rejecting the idea that maintaining an officer or having resident employees is required for physical presence nexus. Therefore the actual holding of this case is uncertain despite the fact that it expressly stated that it declined to extend the Quill physical presence requirement to a municipality’s B&O tax.

economic presence, not physical presence, is the nexus standard for income tax, but these cases did not reach the United States Supreme Court for a decision on certiorari.\textsuperscript{119} Four states, on the other hand, initially ruled that physical presence is required for income tax,\textsuperscript{120} although the Missouri Supreme Court decided the issue on state statutory grounds, not constitutional grounds.\textsuperscript{121} However, the reasoning of the Tennessee Appellate Court was subsequently rejected by two other cases\textsuperscript{122} and the Michigan case was later overturned statutorily by the Michigan Business Tax.\textsuperscript{123}

Attorneys who litigate cases on behalf of states that are members of the Multistate Tax Commission ("MTC") are concerned that the denial of certiorari in the MBNA case may signal the beginning of a shift to economic nexus among several additional states.\textsuperscript{124} In the event a

\begin{itemize}
  \item The degree to which an entity exploited a local market;
\end{itemize}
number of states apply this test at the same time, without also voluntarily adopting some prudential limitations, the movement might create some impetus in Congress to pass a bill that would limit nexus for income tax or business activity tax purposes. If Congress did so, it would be even more severe than what Public Law 86-272 did for income tax states.\textsuperscript{125} To avoid that possibility, attorneys are urging states considering adopting the economic presence test to voluntarily adopt some minimum nexus standards. Doing so would rebut the argument made by proponents of Business Activity Tax Simplification Act of 2008 ("BATSA")\textsuperscript{126} that state nexus standards are so vague that a taxpayer cannot really know whether its activities in a state will create nexus there.\textsuperscript{127} Those in favor of states adopting minimum standards speculate that a minor and unintentional or casual sale might be enough to create nexus if there is no physical presence requirement.\textsuperscript{128} To counter these fears, Representative John Conyers, Jr. (D–MI) circulated the Main Street Fairness Act bill featuring the MTC Factor Presence Nexus Standards,\textsuperscript{129} with the intent of showing that states really can adopt clear nexus standards.

The bill may be a dangerous development in and of itself. It puts the decision on how to limit the reach of economic presence in the hands of Congress, instead of in the hands of the states where it belongs. The recent experience with the Internet Tax Freedom Act ("ITFA")\textsuperscript{130} shows how difficult it is for the states to protect their sovereign taxing powers from being negotiated away by federal legislators who feel more

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- The quality and quantity of the entity’s economic presence in the taxing jurisdiction; and
- The frequency, quantity, and systematic nature of the entity’s economic contacts with the jurisdiction.

\textit{Id.} at 234; See also Andrew W. Swain & John D. Snethen, \textit{Paying Their Fair Share: The Hidden Lesson of Complete Auto and Quill}, 46 ST. TAX NOTES 749 (2007), for a detailed discussion of the MBNA case.

\textsuperscript{125} See supra note 50 and accompanying text.


\textsuperscript{128} \textit{Id.}

\textsuperscript{129} Main Street Fairness Act, H.R. 2701, 112th Cong. (2011). Senator Richard Durbin (D–IL) also introduced a companion bill in the Senate that same year. See Main Street Fairness Act, S. 1452, 112th Cong. (2011).

in institutional pressure to compromise than to protect states’ taxing powers.\textsuperscript{131} Towards the end of the ITFA negotiations, when faced with the prospect of a permanent moratorium, even the states’ supporters felt compelled to agree to a seven-year moratorium.\textsuperscript{132} If states fail to use the time and opportunity afforded by the current Democratic control of Congress, in which the BATSA pressure is reduced, to adopt such minimum standards themselves, the Conyers bill itself could be the vehicle by which the states’ ability to define their own nexus standards will ultimately be negotiated away.

Before passing Second Engrossed Substitute Senate Bill 6134,\textsuperscript{133} Washington State did not tax businesses operating in the state unless they had a physical presence in the state, such as personal or real property, or had either employees or non-employee representatives enter the state for business reasons. Washington State took heed, however, of the several states that had successfully argued that nexus may be established by intentionally entering a state’s marketplace to engage in business without physically entering the state. In addition, the MTC proposed model regulations that established minimum nexus standards with economic criteria such as $500,000 or more annual sales.\textsuperscript{134} States considering adopting an economic nexus standard were urged to consider also adopting the \textit{Factor Presence Nexus Standards for Business Activity Taxes}, which were approved by the MTC on October 17, 2002.\textsuperscript{135} These standards essentially declare that the following activities in the state will satisfy Complete Auto’s substantial nexus test:

\begin{itemize}
\item \textsuperscript{131} The ITFA exempts Internet access from state taxation through 2014. \textit{Id.} § 1101. The ITFA was enacted in 1998 when the Internet was still nascent and in need of government protection. Since that time, the Internet has grown into a highly profitable component of the communications industry that no longer needs government protection. ITFA limits the ability of states and local governments to level the playing field between competitors in this area of technological convergence, exempts a significant portion of the communications industry from taxation, and permits many providers to avoid taxation without justification.
\item \textsuperscript{133} \textit{Second E.S.S.B. 6143, 61st Leg., 1st Spec. Sess. (Wash. 2010).}
\item \textsuperscript{134} \textit{MULTISTATE TAX COMM’N, FACTOR PRESENCE NEXUS STANDARD FOR BUSINESS ACTIVITY TAXES (approved Oct. 17, 2002), reprinted in POLICY STATEMENT 02-02: ENSURING THE EQUITY, INTEGRITY AND VIABILITY OF STATE INCOME TAX SYSTEMS app. (amended Oct. 17, 2002), available at http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/About_MTC/Policy_S_and_R/2002/Policy02-02_Amended10-17-02(1).pdf.}
\item \textsuperscript{135} \textit{Id.}
\end{itemize}
• Residing in or having corporate domicile;
• A dollar amount of $50,000 of property;
• A dollar amount of $50,000 of payroll;
• A dollar amount of $500,000 of sales; or
• Having 25% of a company’s total employees, property or sales in the state.136

These items are further defined in the uniformity proposal.137

Modifications to the proposal may be appropriate in the future. For example, non-income tax states need not be limited to considering the presence of employees, but they may place a dollar value on having representatives in the states. Further, any of the monetary standards could be increased or reduced. Taking its cue from the MTC, in 2005 Ohio adopted economic presence and the MTC minimum nexus standards when it adopted its Commercial Activity Tax.138 Similarly, West Virginia adopted a statute litigated in the MBNA case, specifically stating that “[a] financial organization that has its commercial domicile in another state is presumed to be regularly engaging in business in [West Virginia] if . . .” it meets the minimum nexus standards.139 In 2007, Oregon introduced a bill in the legislature to adopt the MTC minimum nexus standards, but it was withdrawn by the Governor as part of a deal to get other tax legislation of higher priority to the Governor.140 Representatives from the Oregon Department of Revenue revealed that the banking industry argued that adopting minimum nexus standards was a back door method of adopting economic nexus. The Oregon Department of Revenue’s view was that economic nexus was already the standard in Oregon and the bill limited such nexus. Oregon has since, however, adopted an administrative rule which defines “substantial nexus,” in part, as existing “where a taxpayer regularly takes advantage of Oregon’s economy to produce income for the taxpayer and may be established through the significant economic presence of a taxpayer in

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136. Id.
139. See W. VA. CODE § 11-24-7b(d) (2011).
140. S.B. 177, 74th Leg., Reg. Sess. (Or. 2007).
the state." The rule has yet to be challenged on constitutional grounds.

From a tax administrator’s perspective, Oregon’s rule is not a radical departure because the majority of states that have litigated economic presence have interpreted their states’ general “doing business” imposition statutes as authorizing an economic presence standard. No separate legislation was sought for this purpose. Massachusetts, for example, imposes corporate income tax on foreign corporations when the corporation does business in Massachusetts or owns or uses any part of its capital, plant, or any other property in the state. Massachusetts’ Tax Commission construes this provision to the fullest extent permitted by the Constitution and the laws of the United States. Consequently, in 1996, Massachusetts issued Directive 96-2 interpreting this statute to apply to an out-of-state company’s use of intangible property such as a trademark that generates income in the state. This interpretation was limited by the requirement that the use of intangible property must be purposeful and more than de minimus. The statute cited is similar to Washington’s B&O tax.

In total, thirty-one states apply an economic nexus analysis to at least some of their business activity taxes. Organizations such as the Federation of Tax Administrators and the Multistate Tax Commission

143. MASS. GEN. LAWS ch. 63, § 39 (2011) (providing for excise tax on “every business corporation, organized under the laws of the commonwealth . . . or qualified to do business or actually doing business within the commonwealth . . . .”).
144. 830 MASS. CODE REGS. 63.32B.2 (West 2011).
146. Id.
147. See infra Appendix. These thirty-one states include: Arkansas; California; Colorado; Connecticut; Delaware; Florida; Georgia; Hawaii; Illinois; Indiana; Iowa; Louisiana; Maine; Maryland; Massachusetts; Michigan; Minnesota; Mississippi; New Hampshire; New Jersey; New Mexico; North Carolina; Ohio; Oklahoma; Oregon; Rhode Island; South Carolina; Tennessee; West Virginia; Washington; Wisconsin.
believe that the Supreme Court has now clearly signaled that it will not interfere with states that impose business activity taxes without physical presence. Over eighty-five percent of the thirty-one states that apply economic nexus use either single factor sales or other multiple sales factors to apportion income amongst the states, the second prong of the *Complete Auto* test.\(^{148}\)

VII. WASHINGTON STATE’S MINIMUM NEXUS_THRESHOLDS

For the purpose of requiring a business to collect retail sales or use taxes, the U.S. Supreme Court in *Quill* held that the business has to have a physical presence in the state.\(^{149}\) Physical presence is the act of having employees, representative third parties, or property present in the taxing jurisdiction for a business-related purpose.\(^{150}\) As a general rule, it is widely accepted that states are required to follow the *Quill* physical presence standard for nexus when imposing retail sales and use tax collection responsibilities.\(^{151}\) Prior to June 1, 2010, the Washington State Department of Revenue followed the *Quill* physical presence test to determine whether nexus exists to impose not only its retail sales tax and use tax, but also all classifications of its B&O taxes.\(^{152}\) It is assumed that Washington applied the physical presence standard to its B&O tax because it believed that this was the applicable constitutional standard and only modified the requirement in light of changing constitutional developments.

In the spring of 2010, the Washington State legislature passed Second Engrossed Substitute Senate Bill 6143, applying an economic presence test rather than a physical presence test to its apportionable B&O taxes.\(^{153}\) In doing so, the Legislature determined that many businesses without a physical presence earn significant income from Washington customers and receive significant benefits from doing business in Washington.\(^{154}\) Therefore, an economic nexus rather than a

\(^{148}\) Complete Auto Transit v. Brady, 430 U.S. 274, 274 (1977); see *supra* note 35 and accompanying text.


\(^{150}\) See generally id.

\(^{151}\) See *supra* note 70 and accompanying text.


\(^{154}\) Id.
physical presence standard was needed for these companies to pay their fair share of taxes. This nexus standard applies only to the apportionable tax classifications, i.e., “service and other activities,” “royalties,” and about twenty other discrete apportionable tax classifications; it does not apply to businesses engaged in manufacturing, retailing, wholesaling, or extracting. The legislation also imposes a new single sales factor apportionment rule to apportionable income. The “service and other activities” classification applies to businesses that provide services to customers, such as consulting, advertising, legal, financial, or accounting services. It also includes any business activity that is not described under other B&O tax classifications.

The “royalties” classification applies to businesses that receive income from the granting of intangible rights (such as copyrights, licenses, patents or franchise fees). Under prior law, royalties or amounts received for the use of an asset such as a copyright, patent, trademark or trade name were subject to the service and other B&O tax classification. This tax classification was imposed only when the taxpayer was domiciled in Washington. Businesses domiciled elsewhere that were authorized to use the intangible property in Washington did not pay any taxes in Washington on the gross income from that use. That distinction led some Washington taxpayers to transfer their intangible assets to wholly-owned subsidiaries whose sole place of business is outside of Washington. Sometimes these subsidiaries are “domiciled” in states, such as Nevada, that do not tax income from the use of intangibles. Now, out-of-state owners of assets that are used in Washington will be subject to tax. Also, Washington domiciled owners that license the use of their intangible assets to out-of-state customers will pay less in state taxes.

After the passage of the legislation, businesses are now deemed to be engaging in business in Washington when they generate gross income from sources within Washington, such as customers or intangible property located in Washington, regardless of whether the person is domiciled.

156. Id.
158. Id.
159. See § 82.04.2907.
161. Id.
physically present in the state. More specifically, a person “engaging in business”\(^\text{163}\) is deemed to have substantial nexus with Washington if the person is:

(1) An individual and is a resident or domiciliary of Washington;
(2) A business entity that is organized or commercially domiciled in Washington; or
(3) A nonresident individual or business entity that is organized or commercially domiciled outside the Washington, and in any tax year has:
   (a) More than $50,000 of payroll or property in Washington;
   (b) More than $250,000 of receipts from Washington; or
   (c) At least 25% of its total property, total payroll, or total receipts in Washington.\(^\text{164}\)

The fiscal impact for the state of Washington due to the change to economic nexus was estimated to be $84.3 million dollars for 2011 and $173.2 million for 2012.\(^\text{165}\) Many out-of-state businesses currently do millions of dollars in business in the state, but pay no tax because they lack physical nexus. The Revised Code of Washington requires businesses to pay tax to Washington on the same basis as their in-state competitors.\(^\text{166}\) Specifically, the fact that “substantial nexus” (the Constitutional standard) under Complete Auto Transit\(^\text{167}\) can be established by economic presence has been recognized by numerous state court decisions, including the Washington State Court of Appeals case General Motors Corp. v. City of Seattle.\(^\text{168}\)

Presently, it is not clear where the United States Supreme Court or Congress will draw the line between Due Process Clause minimum connection and Commerce Clause substantial nexus with respect to business activity taxes. The weight of authority supports the proposition

\(^{163}\) See WASH. REV. CODE ANN. § 82.04.150 (West 2011) (defining “engaging in business”).

\(^{164}\) WASH. REV. CODE ANN. § 82.04.067 (West 2011).


\(^{166}\) See WASH. REV. CODE ANN. § 82.04.067 (West 2011).

\(^{167}\) See supra note 33.

\(^{168}\) 25 P.3d 1022, 1030 (Wash. Ct. App. 2001). Although the court’s decision discussed economic nexus, it described activities that were arguably examples of physical presence. It is possible that the court was merely rejecting the idea that maintaining an officer or having resident employees is required for physical presence nexus. Therefore, the actual holding of this case is uncertain despite the fact that it expressly stated that it declined to extend the Quill physical presence requirement to a municipality’s B&O tax.
that physical presence is not required outside the retail sales tax and use tax arena, and the Supreme Court continues to refuse to grant certiorari in economic nexus cases presented to it for review. This trend leads one to conclude that for business activity taxes, the Due Process and Commerce Clauses are not held to the same physical presence standard found in Quill for the retail sales tax and use tax. Nevertheless, the legislatures and courts of a majority of the states across the country have taken it upon themselves to determine that businesses are receiving taxable benefits from their state.
## Appendix. Survey of State Positions on Economic Nexus

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<sup>*</sup> With respect to income earned from financial institutions only.

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170. See supra note 116 and accompanying text.

171. This survey of states is based on the author’s personal knowledge and experience and was compiled by reading numerous state and federal cases, attending The Multistate Tax Commission’s Nexus School, and using resources such as Professor Annette Nellen’s compilation of state nexus guidelines. See Annette Nellen, Economic Nexus, http://www.cob.sjsu.edu/nellen_a/taxreform/economic_nexus.htm (last visited Feb. 11, 2012).


173. Adopted by departmental regulation.

174. The Court of Appeals in Washington has stated in dicta that physical presence is not required to establish nexus for business & occupation tax purposes.