When Practicality Takes a Vacation

by Garry G. Fujita

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In this inaugural edition of his column Puget Sound SALT, Fujita uses several examples that illustrate Washington's trend to determine a taxpayer's tax status by another party's activities. Through these examples, starting with 1983 legislation and ending with the 2016 ballot Initiative 732, he explains why it is bad tax policy to go beyond the taxpayer's activities, books, and records to establish that taxpayer's proper reporting requirements.

Imagine that you operate an office supply store. The state has decided to have a tax holiday the two weeks before school starts, temporarily exempting school supplies from the sales and use tax. The state is trying to do its part to make education a little more affordable, and you are excited and expect sales to increase. The state has been very helpful, providing the sellers with a comprehensive list of supplies that qualify for the sales tax exemption. According to the instructions, you must see proof that the purchaser is, or that the purchase is for, a student, for example by checking a student ID. During the tax holiday, you exempt sales of school supplies to buyers who provide adequate proof.

A few years later, the state audits your books and notices that you had great sales during the tax holiday. The auditor congratulates you on the large number of exempt sales and then casually asks if you can prove that school supplies were *actually used by students for school purposes* and not for some other purposes. You mumble something like, "How would I know?" The auditor then gives you the bad news, explaining that the claimed exempt sales are not exempt from sales tax because you can't prove that the supplies were actually used for school purposes. "You see, it is not only your specific transaction that we consider," the auditor shares. The auditor goes on to explain that whether the transactions are exempt depends on the subsequent activities of the buyer. According to the auditor, *you* bear the burden to prove the exempt use. So the auditor assesses the uncollected sales tax on the tax holiday sales. Ouch.

That store owner's tax status did not depend on anything he did; rather, it depended on what the *purchaser* did. That strikes me as bad tax administration and policy. Unfortunately, that approach has crept its way into how Washington applies some of its taxes.

Example 1 — The DSR Exemption: Can You Prove What the Buyer Did With Your Products?

Let's begin by looking at Washington's direct seller's representative (DSR) exemption, enacted in 1983.[1] Although memories differ as to why this exemption exists, many recall that the exemption was a response to the U.S. Supreme Court's trend to relax the limitations on the states' ability to impose business taxes on out-of-state businesses. In 1959 Congress responded by enacting P.L. 86-272, establishing the "mere solicitations" limitation that applies to income taxes. But that law provided no protection in Washington. Washington's gross receipts tax[2] is an excise tax, not an income tax. Many businesses were concerned about whether Washington would seek to tax wholesale sales to the seller's representatives.

My memory is that the convention centers and trade associations feared that out-of-state vendors would reject Washington as a venue for trade shows, because their wholesale sales would be subject to the business and occupation (B&O) tax if they attended just one trade show in a single year.[3] Others remember that the Legislature wanted to limit the exemption to businesses that conducted door-to-door sales, for example, Fuller Brush Co. or Tupperware.[4]

The DSR statute appeared simple on its face. It exempted an out-of-state wholesaler from the wholesale B&O tax for some sales through a DSR. The DSR is typically one who

[1]RCW 82.04.423.

[2]Washington identifies its gross receipts tax as the B&O tax.

[3]Det. No. 90-148, 9 WTD 268-17 (1990).

[4]The department's "door-to-door" position was curious. In an administrative case permitting the exemption, according to the administrative law judge, "the taxpayer produces and sells automotive products such as aluminum wheels, sport grips, running boards and seat belts." Det. No. 88-29, 5 WTD 73 (1988). It is doubtful that there are any door-to-door sales teams that sell aluminum wheels and running boards at retail to the local neighborhood residents.

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calls on and sells to other wholesalers, retailers, and consumers. However, the statute had a condition: The goods could not be sold from a permanent retail establishment. Taxpayers contended that the "permanent retail establishment" limitation described sales by the DSR in such a way that the direct seller could not be selling from a permanent retail establishment.

For many years, the department took the same position. However, the state reconsidered that position and litigated the statute, arguing that the goods could never be sold from *any* permanent retail establishment, including sales by subsequent resellers. In response, the taxpayer argued that such an interpretation was unworkable since it had no idea what future subsequent sellers would do with the product. The interpretation meant that the seller would need to track the product through each subsequent sale until the item was fully consumed in order to determine whether the product was ever sold from a permanent retail establishment.

The court concluded that the state was correct and suggested during oral argument that the out-of-state seller could contract to limit how subsequent resellers could redistribute the goods. In its opinion, the court accepted the state's argument that the statute was intended to apply only to the door-to-door sales.[5]

However, the court's analysis did not resolve the fundamental issue, because the out-of-state seller would still need to trace the products until final consumption. For example, what if the DSR sold Tupperware in the buyer's home and then the buyer decided that the product was ineffective, later donating it to Goodwill, where it was sold from a permanent retail establishment. The exemption still would not apply even though it was sold "door to door" in the buyer's home. The out-of-state wholesaler would be able to preserve the exemption only if the seller could follow the sale of goods to the final consumption (discarded into the trash) to assure that the goods were never resold from a permanent retail establishment.

Based on that statute, this taxpayer's tax status does not depend on anything it does; it depends on what the subsequent buyers do.[6]

[5]"Stroh [Brewery Co.] argues that the [Department of Revenue's] . . . interpretation is impractical. If a seller must ensure that its products never reach consumers through a permanent retail establishment, the seller *would* have to track each product unit. But the statutory language shows that the legislature never intended the exemption to apply to a seller like Stroh." *Stroh Brewery Co. v. State, Dep't of Revenue*, 15 P.3d 692, 695 (Wash. Ct. App. 2001). That was a curious conclusion because of past DOR published interpretations and legislative history supporting Stroh's interpretation.

[6]The court got a second chance to review this statute and came to the same conclusion that the taxpayer in *Stroh* had asserted in its case, applying the "from a permanent retail establishment" limitation to the direct seller's representative and distinguishing *Stroh* for other reasons. *Dot Foods Inc. v. Washington Dep't of Revenue*, 215 P.3d 185 (Wash. 2009).

Example 2 — The Brokered Natural Gas Credit: Can You Prove Your Vendor Paid Its Tax on Your Purchase?

Another example is the 1989 use tax on brokered natural gas.[7] When the government regulated natural gas, purchasers bought the gas and the delivery service bundled in one charge. Washington applied the public utility tax to the bundled price. When natural gas underwent deregulation, Washington properly feared that the state would lose tax revenue, because with deregulation the buyer could unbundle the natural gas from the delivery service. Buying the natural gas from a broker — for example, one located in Wyoming or Utah and therefore lacking Washington nexus — meant that the public utility tax measure would only be on the value of the delivery service performed by the in-state utility. The price of the natural gas would escape Washington taxation.

Washington solved that problem by ignoring an important taxable incidence: An excise tax on a business's *selling* activity is different from a tax on a buyer's *consumption* activity. Theoretically, in the sales and use tax regime, if the consumer pays a sales tax in one state, that same consumer is entitled to take credit against use tax that is payable in the second state. The tax burdens are on one taxpayer. The state ignored that distinction and imposed a use tax on the consumption of natural gas to compensate for a business tax that the broker did not pay to Washington.

To parallel the sales and use tax style of taxation and to avoid the claim of double taxation, the statute permits the buyer to take a credit equal to the operating tax that that seller has paid to another state to offset the consumer use tax on natural gas. A Washington gas buyer can claim the credit against the use tax on natural gas but only if it knows how much business tax the natural gas seller paid on the natural gas that it sold to the Washington buyer.[8] Because the seller's tax is a business operating tax and not a buyer's tax on the purchase of the natural gas, there's no invoice that identifies how much business tax the seller paid on the sale. Further, what seller will voluntarily share that type of confidential tax information with a buyer?

Thus, that taxpayer's tax status does not depend on anything it does. Rather, it depends on what her seller has or has not done and whether the seller will share that confidential information.

Example 3 — The International Investment Advisers B&O Tax Rate: Can You Prove in What Securities Your Customers Invest Their Funds if You Are Not Your Client's Only Investment Adviser?

In 1995 Washington enacted legislation to encourage international investment advisers to locate in the state,

[7]RCW 82.12.022.

[8]The qualifying business tax must be substantially similar to Washington public utility tax; an income tax would not qualify.

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giving them a lower B&O tax rate. An international investment adviser could use the lower rate by showing that at least 10 percent of the customer's portfolio was invested outside the United States.[9] Most taxpayers attempted to claim the lower rate by demonstrating that their clients' individual portfolios — which the adviser personally handled — held 10 percent or more in foreign investments. The department rejected that interpretation. Instead, it said the advisers must prove that the client's total investment portfolio had at least 10 percent invested in foreign countries.[10]

There are problems with that interpretation.

First, that position is disconnected to the goal of encouraging international investment advisers to locate in Washington. The department's interpretation means that a domestic investment adviser who provided no international investment services could get the lower rate if his client invested at least 10 percent of its total investment portfolio in foreign countries. Why should an adviser that provides no foreign investment advice get the lower rate?

Second, only clients know what their total portfolios look like, and obtaining that information could be nearly impossible. Clients with large portfolios might use more than one investment adviser to assure investment diversity. A client might not be forthcoming about any investments except those that the taxpayer manages. The taxpayer would not know whether it is entitled to the lower rate without monitoring the client's total investment portfolio.

Again, that taxpayer's tax status is not dependent on anything it does; it depends on what its client does.

Example 4 — The Economic Nexus and the Single-Sales-Factor Apportionment: Can You Prove Where Your Customer Benefits From the Services That You Provide?

In 2010 Washington adopted economic nexus and the single-sales-factor apportionment for service, financial, and royalty income. Effective September 1, 2015, economic nexus now applies to vendors under the wholesale classification. Under the new law, gross receipts for service businesses are allocated to Washington, "where the customer received the benefit of the taxpayer's service."[11]

The business community objected to the bill, arguing that a seller will not necessarily know where a customer benefits from a service. The concept is too subjective; the standard would require the taxpayer to perform due diligence on its customers to determine where the customer would benefit from the services. On its surface, the concept is deceptively simple. For example, when an architect specifically designs a building for downtown Seattle or an engineer specifically designs a floating bridge that will cross Lake Washington, the benefit is clearly in Washington.

The problem, the opponents countered, is that it is not always so clear. For example, assume in 2011 that:

- a Texas developer retained a Georgia architect to design five floor plans for a tract housing development in Oregon;
- the Georgia architect met with the Texas developer in Texas to discuss the requirements;
- the Georgia architect designed the five floor plans from its office in Georgia;
- the Georgia architect eventually delivered the blueprints via the Internet to the Texas developer; and
- the Texas developer built the five floor plans in an Oregon project.

According to the regulations, the Georgia architect would source the design fees to Oregon, where the Texas client improved real property.[12] According to the rule, Oregon is where the client benefited from the service because the real property is in Oregon.

Then in 2012 let's assume that the Texas developer found the floor plans to be so popular that unbeknownst to the Georgia architect, the Texas developer also built a project in Washington, where the architect's five floor plan designs were also used.

Does that Georgia architect now owe Washington B&O tax in 2012 even though the architect had no idea that the designs were used in Washington? According to the regulation, the Georgia architect now has that liability.[13]

Does the law require that the architect do annual surveys of his clients until the statute of limitations runs? It would appear the answer is yes.

If other states adopted economic nexus, would the architect have to do that survey in those other states as well? Again, the answer appears to be yes.

The Georgia architect's tax status does not depend on anything it does; it depends solely on what its client does with the design services.

Example 5 — Initiative Measure 732: Can You Prove the Origin of Your Electron?

Leaving the merits of the global warming debate to the scientists, Washington may soon incorporate a carbon tax into its arsenal. In late January, the Washington secretary of state certified that Initiative Measure 732 (I-732) had obtained the necessary signatures to be placed on the ballot in November.

If the people approve I-732, there will be substantial cuts to the sales tax and manufacturing B&O tax, as well as increased funding for a remittance program to help low-income citizens. The voters, in voting to reduce taxes and support the remittance program, will approve a carbon tax

[9]RCW 82.04.293(1)(b).
[10]Excise Tax Advisory 3182.2014, at 4.
[11]RCW 82.04.462(b)(i).
[12]WAC 458-20-19402(303)(a).
[13]*Id.*

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on fossil fuels. The tax would be phased in, but at its last phase, the tax would be $100 per metric ton of carbon.

I-732 targets carbon polluters — specifically businesses that use oil or coal to generate energy. Oil refiners and distributors will bear that carbon tax, but the economic effect of the tax will be paid by the consumer. If the upstream producers or distributors have not paid the tax, only then must the consumer pay it directly to the state.

The purchase of electricity presents a different approach, and the compliance burden often falls on the consumer. I-732 permits a credit against the Washington carbon tax to the extent that the taxpayers claiming it can "provide the department documentation that the tax has been paid to another state."[14] Typically, large power consumers buy their power from a broker that in turn buys a quantity of power on the open market. A broker might buy power from generators in Arizona, California, Idaho, Oregon, and Washington that generate electricity from coal, oil, solar, water, and wind sources. Purchase and sale of commodities like power are likely done daily, maybe even hourly.

When the buyer withdraws the power from the grid and consumes it, it is entitled to take a credit for carbon tax a generator paid to another state. However, the buyer will have no proof where the consumed electrons came from, let alone the exact amounts that came from different generators in Arizona, California, Idaho, Oregon, and Washington. Assuming that the coal and oil generators paid a carbon tax, just how many of the carbon-generated electrons were consumed in Washington? Electrons cannot be traced out of the grid, and no one can explain whether one electron came from a generator in Idaho or from California. How can a taxpayer claim that credit? The credit is illusory. There is no feasible way for the buyer to know or prove the credit.

Therefore, in this case, the power consumer's tax status does not depend on anything it does. It solely depends on what its power generators did.

Is That the Right Approach?

Should state tax laws expect taxpayers to know what others may do later in order to determine their tax liabilities? That is the wrong approach and a dangerous path. It puts taxpayers in the unfortunate predicament of guessing whether they owe taxes because they do not know what taxes or exemptions will apply without examining what their sellers have done or what customers are doing. In most cases, taxpayers will likely pay the additional tax because of the difficulty of proving that they owe less tax. That is irrational, unreasonable, and unfair to say the least.

Example 1, which regarded the DSR exemption, illustrated the imposition of a tax or exemptions based on the activities of others with whom the taxpayer may not have privy of contract and does not control. The Washington Supreme Court revisited that exemption, finding differently from the opinion in *Stroh Brewery Co. v. State, Department of Revenue*.[15] The court quoted from and agreed with an amicus brief that questioned the constitutionality of that kind of tax policy. The court wrote:

> Melaleuca, Inc., in its amicus brief, presents an argument that reinforces Dot's reading of the statute's language:
>
> "[A] proper interpretation of all of the words in the statute makes it understandable that the Legislature only imposed restrictions on sales activities to the extent that the direct sales company could have some control over them. This is not only logical; it is undoubtedly required by the Due Process Clauses of both the United States and the Washington Constitutions. U.S. Const., Amend. XIV, section 1; Wash. Const., Art. I, section 3. A state cannot impose taxes on someone based upon the actions of another person, who is not the seller's agent, and whose actions are beyond the tax payer's control."[16]

The Washington Supreme Court has the right idea, and perhaps that trend will finally end with more cases like *Dot Foods*.[17] ☆

[14]I-732, section 5(5).

[15]15 P.3d 692, 695 (2001).

[16]*Dot Foods Inc. v. Washington Dep't of Revenue*, 215 P.3d 185, 190 (Wash. 2009), quoting *Amicus Curiae Br. of Melaleuca Inc.*, at 11. We agree with this analysis.

[17]The Legislature eventually rewrote the statute in 2010 after *Dot Foods*, so that the exemption no longer depends on what others do with the goods.

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