Washington Research Council

Policy Brief

March 17, 2017 PB 17-05

Washington's Steady Move to an Economic Nexus Standard for Taxes

Briefly

- "Nexus" means a connection, and it is a determinant of jurisdiction in tax law.
- Federal law is unclear as to whether a state may tax businesses without a physical presence in the state.
- Washington has used an economic nexus test for certain businesses in recent years (based on their market in the state).
- Several nexus changes have been proposed this legislative session.
- The constitutionality of the nexus changes has not been determined.

Simply, "nexus" means a connection. In tax law, nexus establishes jurisdiction. States are constrained by the U.S. Constitution as to which out-of-state businesses they may tax. Washington has recently been moving from a physical presence test to an "economic nexus" test (based on a company's market in the state) to determine when out-of-state businesses owe Washington taxes. Additionally, many policymakers would like to be able to require remote sellers to collect taxes on retail sales made over the Internet—something that is currently proscribed by constitutional interpretation.

Federal Law and State Actions

States are generally constrained by the Due Process and Commerce clauses of the U.S. Constitution to tax only those people with a connection to the state. It is generally considered that the courts have prescribed different nexus tests depending on the type of tax, but this area of the law is unsettled.

First, the U.S. Supreme Court held in 1959 that

> *Net income from the exclusively interstate operations of a foreign corporation may be subjected to state taxation, provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same.* (Northwestern Cement Co. v. Minn.)

Later that year, in response to the decision, Congress enacted Public Law 86-272—still in force today—under which states may not impose net income tax "on the income derived within such State by any person from interstate commerce" if the person's only business activities in the state are the solicitation of orders for tangible personal property that are then filled from outside the state. Because this law speaks only to income taxes, it does not apply to Washington. Washington Administrative Code 458-20-193 explicitly states that Public Law 86-272 does not apply to Washington's business and occupation tax.

Second, the U.S. Supreme Court held in 1992 that a business must have a physical presence in a state in order for that state to impose a duty to collect sales and use taxes for the state (Quill Corp. v. North Dakota). The Court noted that different nexus tests apply for purposes of the Due Process and Commerce clauses: The Due Process Clause requires a

"minimum contacts" test, while the Commerce Clause requires a physical presence ("substantial nexus") test.

Additionally, the Court wrote that, as Congress has the "power to regulate commerce among the States," it is "free to decide whether, when, and to what extent the States may burden interstate mail order concerns with a duty to collect use taxes" (Quill Corp. v. North Dakota). (Although this case only spoke to sales and use taxes, the Court did not explicitly say that its reasoning applied *only* to those taxes. Some state courts have held that Quill's physical presence standard applies only to sales and use taxes, while other state courts have held that it also applies to other taxes (Neff et al. 2011).)

Since the Quill decision, 24 states (including Washington) have adopted the Streamlined Sales and Use Tax Agreement, which aims to simplify sales and use tax administration "in order to substantially reduce the burden of tax compliance" (SSTGB 2017). Also, bills have been introduced in Congress that would authorize states that are party to the Streamlined Sales and Use Tax Agreement to require businesses to collect and remit sales and use taxes on remote sales (e.g., the Marketplace Fairness Act). No such bill has been enacted yet. In 2011, the Washington state Senate and House passed SSJM 8009. The joint memorial petitioned the President and Congress to pass federal legislation allowing states to require remote sellers to collect sales and use taxes.

Meanwhile, in 2015, Supreme Court Justice Anthony Kennedy wrote (in a concurring opinion),

> *There is a powerful case to be made that a retailer doing extensive business within a State has a sufficiently 'substantial nexus' to justify imposing some minor tax-collection duty, even if that business is done through mail or the Internet.* (Direct Marketing Association v. Brohl 2015)

Given the changes in the retail economy since 1992 (when the Internet was in its infancy), Justice Kennedy suggested that the Quill decision should be reexamined.

Some states have since enacted legislation that require sales tax reporting (but not collection) by remote sellers, including Colorado, Louisiana, Oklahoma, and Vermont (Weyman and Maddison 2016). In 2016, Colorado's law was upheld by the Tenth Circuit Court of Appeals, which determined that Quill is "limited to tax collection" (Direct Marketing Association v. Brohl 2016). The U.S. Supreme Court denied a petition for a writ of certiorari (meaning it declined to review the case).

Additionally, over the past few years Alabama and South Dakota have enacted economic nexus tests requiring remote sellers to collect sales tax, in the hopes of providing Justice Kennedy with an opportunity to reexamine Quill (Duncan et al. 2016). Litigation has begun in both states, and the South Dakota Sixth Judicial Court found the South Dakota law unconstitutional on March 6 (McLoughlin 2017).

Since 2010, Washington has adopted an economic nexus test for B&O tax purposes for certain out-of-state businesses.

Recent Nexus Changes in Washington

Prior to 2010, Washington only taxed businesses with a physical presence in the state. Since 2010, Washington has adopted an economic nexus test for business and occupation (B&O) tax purposes for certain out-of-state businesses.

In 2017, for service, royalty and wholesaling businesses without a physical presence in Washington, substantial nexus is present if the business has more than $267,000 of receipts in Washington, more than $53,000 of payroll or property in Washington, or at least 25 percent of its total payroll, property or receipts are in Washington (DOR 2017a). These thresholds are adjusted by inflation. Other businesses have a substantial nexus with Washington if they have a physical presence here, "which need only be demonstrably more than a slightest presence" (RCW 82.04.067).

This economic test was first applied to out-of-state businesses that provide services or collect royalties in Washington when 2ESSB 6143 was enacted in 2010. That legislation also changed the apportionment formula used to determine what shares of multistate businesses' revenues are subject to the B&O tax. The nexus and apportionment changes in 2ESSB 6143 were expected to increase revenues by $84.7 million in 2009–11 and $395.0 million in 2011–13 (WRC 2010).

In 2015, the economic nexus test for B&O tax purposes was extended to wholesalers (ESSB 6138). This was expected to increase revenues by $28.7 million in 2015–17 and $53.3 million in 2017–19 (SCS 2015).

The 2015 bill also established "click-through" nexus, meaning that if a remote seller has an agreement with a Washington resident under which the resident refers customers to the seller (through a web link, for example), and gross receipts from sales made to the referred customers are more than $10,000, then the remote seller is presumed to have a substantial nexus with Washington and must collect retail sales taxes and pay retailing B&O tax (ESSB 6138). Adopting click-through nexus was expected to increase revenues by $28.3 million in 2015–17 and $35.3 million in 2017–19 (SCS 2015).

Proposed Changes This Session

This legislative session several proposals have been made related to economic nexus and remote sellers.

First, Gov. Inslee's 2017–19 operating budget proposal would make several revenue changes, some of which are included in SB 5112 (neither it nor its identical companion, HB 1549, have been acted on). The bill would extend economic nexus for purposes of the B&O tax to retailers. (The retailing B&O tax "applies to all transactions subject to retail sales tax" (DOR 2017b).) According to the Department of Revenue, this would increase revenues by $12.1 million in 2017–19 and $22.5 million in 2019–21. Also, according to the Economic and Revenue Forecast Council, the governor's proposal "assumes that by Fiscal Year 2020, Congress will approve national remote sales tax legislation that is estimated by the Department of Revenue to bring in about $360 million in the 2019–21 biennium" (ERFC 2017). The Council chose not to include this estimate in the official budget outlook due to its uncertainty.

Second, the Education Funding Task Force was tasked with making recommendations to the Legislature on implementing the program of basic education. Although the members of the task force could not agree on formal recommendations earlier this year, the Democratic members' proposal suggested that the state should consider enacting four-tier nexus as a way to help fund additional state spending to comply with the McCleary decision (EFTF 2017). No further details were provided by the task force, but the four tiers were included in HB 2224, a bill that was introduced (but not passed) in 2015.

The four tiers are:

- Economic nexus (B&O and retail sales tax nexus for retail sales attributable to Washington),
- Remote sellers' representative nexus (retail sales tax nexus for remote sellers whose representatives have physical presence in Washington),
- Marketplace facilitator nexus (retail sales tax nexus for remote sellers making sales through an online marketplace facilitator with physical presence in Washington—e.g., Amazon), and
- Credit card or payment facilitator nexus (retail sales tax nexus for remote sellers who have agreements with credit card companies or payment facilitators with physical presence in Washington).

Third, Senators Hobbs, Mullet, Takko and Palumbo have introduced SB 5855 and SB 5856. (They are identical, except SB 5856 would dedicate the increased reve-

nues to housing and public assistance programs. Neither has been acted on.) SB 5855 would enact the four nexus tiers noted above. Additionally, sellers who are not required to collect sales and use taxes would have to provide a notice to buyers stating that the buyer may be required to remit sales and use taxes to the Department of Revenue directly. Such sellers would also have to report annually to the Department of Revenue the dollar amount of purchases made by each buyer. (This provision is similar to the Colorado law mentioned above.)

According to the fiscal note, SB 5855 would increase general fund–state (GFS) retail sales tax revenues by $166.4 million in 2017–19, $310.3 million in 2019–21, and $352.3 million in 2021–23. It would also increase GFS B&O tax revenues by $12.1 million in 2017–19, $22.5 million in 2019–21, and $25.6 million in 2021–23.

SB 5855 states that it is "testing the boundaries" of the physical presence nexus rule to induce the U.S. Supreme Court to reevaluate Quill or Congress to enact legislation allowing states to require that remote sellers collect sales taxes.

The nexus changes Washington has made have not been fully evaluated by our courts.

Will Washington Courts Uphold Economic Nexus?

The nexus changes Washington has made have not been fully evaluated by our courts, but similar changes have been upheld in other states.

The Department of Revenue wrote in 2010,

> *At least thirty states currently apply some form of economic nexus, and case law trends have shown a strong move toward judicial approval of economic nexus standards for the imposition of taxes on business income. It is important to note that the constitutionality of economic nexus is not definitively settled. Some tax practitioners argue that physical presence is required by the U.S. Constitution for all state taxes, but the vast majority of state case law upholds economic nexus for business activity taxes. The federal courts have not ruled directly on the issue, but the U.S. Supreme Court has refused on at least six occasions to review state court rulings sustaining economic nexus.* (DOR 2010)

At least two out-of-state companies have appealed Department of Revenue determinations that they owe B&O tax based on the economic nexus standards (DOR 2015 and 2016). The department's Appeals Division found for the state in both cases, but noted that it doesn't have the authority to determine the constitutionality of the law. It's unclear if the cases are being appealed further, but attorneys Arthur Rosen and Eric Carstens write, ". . . the economic nexus threshold enacted in 2010 has not been thoroughly vetted by the courts in Washington" (Rosen and Carstens 2016).

Like Washington, Ohio has a gross receipts tax. Ohio enacted an economic nexus standard in 2005. In 2016, Ohio's Supreme Court found it to be constitutional (Crutchfield Corp. v. Testa). Until the U.S. Supreme Court reviews that standard and Washington courts review our state's standard, it is unclear whether the economic nexus standards Washington has already enacted are constitutional.

Comment

The adoption of economic nexus standards and laws requiring remote sellers to collect sales taxes are attempts to make more economic activity taxable by the states. The law is unsettled, but the proliferation of different state laws may push the U.S. Supreme Court to weigh in sooner rather than later.

If all of these changes are upheld (particularly those on remote sellers collecting sales tax), revenues in Washington could increase by several hundred million dollars a biennium. But it's not clear that they will be upheld, or when. Given these uncertainties, Washington budget writers should not rely on the potential new revenues.

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