No. 45108-5-II

DIVISION II, COURT OF APPEALS
OF THE STATE OF WASHINGTON

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellant/Cross-Respondent

v.

AVNET, INC.,

Respondent/Cross-Appellant

ON APPEAL FROM THURSTON COUNTY SUPERIOR COURT
(Hon. Christine Schaller)

REPLY BRIEF IN SUPPORT OF AVNET'S CROSS-APPEAL

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I. INTRODUCTION

On the issue of dissociation, the parties agree that the U.S. Constitution requires both nexus with the taxpayer and nexus with the transaction. The parties also agree that dissociation occurs when a seller with taxpayer nexus establishes that some of its sales do not have transactional nexus.

The parties disagree on the requirements of transactional nexus. DOR argues that nexus with the transaction is established by the shipping destination. If that were true, *Norton* and *Goodrich* would have been decided differently. Both held that sales shipped to destinations in the taxing state were dissociated. Thus, DOR is forced to argue that *Norton* is no longer controlling and to ignore *Goodrich* altogether. As the trial court correctly held, dissociation is current law, and these cases are controlling.

However, this Court does not need to reach the constitutional issue because Rule 193 expressly provides that sales are "disassociated" when the seller establishes that its in-state activities are "not significantly associated in any way with the sales" at issue. In this case, the undisputed record establishes that Avnet's National Sales and Third Party Drop Ship Sales were not significantly associated in any way with Avnet's Washington activities; they are dissociated under both the Constitution and Rule 193.

II. ARGUMENT

A. The sales at issue are dissociated because they are not associated with Avnet's in-state activities.

1. Nexus with the transaction is not created by shipping destination; if it were, *Norton* and *Goodrich* would have been decided differently.

DOR concedes that the Constitution requires both nexus with the taxpayer and nexus with the transaction. DOR Resp/Reply Br. at 2 (the constitution requires that "a state must have a connection – or nexus – with the taxpayer *and* with the transaction or activity it seeks to tax") (emphasis DOR). DOR also acknowledges that dissociation occurs when a seller with taxpayer nexus demonstrates that some of its sales do not have transactional nexus. DOR Resp/Reply Br. at 31 (dissociation is the "absence" of nexus with the transaction).

These concessions force DOR to argue that transactional nexus occurs whenever goods are shipped to a destination in the taxing state. DOR Resp/Reply Br. at 1 (in-state shipping destination "satisfies the constitutionally required nexus with *the transaction*") (emphasis DOR) and 3 ("'transactional nexus' always exists with" the destination state), *citing McGoldrick v. Berwind-White Coal Mining Co.* 309 U.S. 33, 43-44 (1940). According to DOR, *Berwind-White* "affirm[ed] the right of destination state to tax an interstate sale". DOR Resp/Reply Br. at 3. Thus, DOR argues that dissociation "can only be established" by showing

that goods were shipped to a "destination outside the state." DOR Resp/Reply Br. at 30.

There are two fatal flaws with DOR's argument. First, if true, *Norton Co. v. Dep't of Revenue*, 340 U.S. 534 (1951), and *B.F. Goodrich Co. v. State*, 38 Wn.2d 663, 231 P.2d 325 (1951), both would have been decided differently. The U.S. Supreme Court in *Norton* and the Washington Supreme Court in *Goodrich* each held that sales shipped to destinations in the taxing state are dissociated—and therefore not taxable—when the seller's in-state activities are not significantly associated with those sales. *Norton*, 340 U.S. at 537-39; *Goodrich*,38 Wn.2d at 673-74

Second, DOR mischaracterizes *Berwind-White's* holding, which established a rule specific to sales taxes—a rule that both *Norton* and *Goodrich* held does ***not*** apply to gross receipts taxes like Washington's B&O tax. Contrary to DOR's contention, *Berwind-White* did not "affirm[] the right of destination state to tax an interstate sale." Rather, it held that the state where title passed under the delivery terms of the parties' contract is the only state that can impose a ***sales tax***. 309 U.S. at 58. This holding was confirmed in a subsequent case that struck down the assessment of sales tax by the ***destination*** state because the parties' sales contract provided that "title passe[d] upon delivery to the carrier" at origin rather

than at destination. *McLeod v. J.E. Dilworth Co.*, 322 U.S. 327, 328 (1944).[1] These principles are inapplicable to Washington's B&O tax. If the delivery terms under the parties' contract were relevant to gross receipts taxes, none of Avnet's Washington destination sales would be subject to B&O tax; Avnet's terms and conditions of sale, as in *McLeod*, provide that "title and risk of loss pass to Customer upon delivery of the Products to the carrier." (CP 230); *McLeod*, 322 U.S. at 328.

The Court in *Norton* pointed out the error in DOR's current position, expressly distinguishing both *McGoldrick* and *McLeod* on the ground that *sales taxes* are imposed "on the buyer" and, therefore, "cases involving them are not controlling here." *Norton*, 340 U.S. at 380.[2]

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[1] In *McLeod*, the Supreme Court expressly distinguished *Berwind-White*, noting that it "presented a situation different from this case [that] is on the other side of the line which marks off the limits of state power." 322 U.S. at 329. As the Court explained: "In *Berwind-White* the Pennsylvania seller completed his sales in New York [at destination]; in this case the Tennessee seller was through selling" at origin. 322 U.S. at 330. This constitutional limitation on sales taxes is why states now also impose use taxes, in order to obtain the same tax revenue when a sales tax is constitutionally prohibited. *Id.* at 331.

[2] The Court reaffirmed the constitutional distinction between sales taxes and gross receipts taxes in *Oklahoma Tax Commission v. Jefferson Lines, Inc.* 514 U.S. 175, 190 (1995) ("the two diverge crucially in the identity of the taxpayers"). Sales taxes are imposed on the buyer while a gross receipts tax is imposed on the seller. After expressly distinguishing sales taxes from gross receipts taxes in *Jefferson Lines*, the U.S. Supreme Court held that gross receipts taxes are "simply a variety of tax on income". 514 U.S. at 190. Thus, DOR's suggestion that *Allied-Signal, Inc. v. Div. of Taxation*, 504 U.S. 768, 778 (1992) is "inapposite because it involves a net-income tax," DOR Resp/Reply Br. at 25, is directly refuted by *Jefferson Lines*. As DOR acknowledges, the significance of (continued)

In applying *Norton* to Washington's wholesaling B&O tax, the Washington Supreme Court expressly acknowledged *Norton's* distinction of sales tax cases like *McGoldrick* and *McLeod*, noting that "the Illinois tax [in *Norton*] like the [B&O] tax with which we are here concerned, was a tax laid upon the vendor." *Goodrich*, 38 Wn.2d at 674. Thus, in both *Norton* and *Goodrich,* the Court approved the imposition of gross receipts tax on destination sales that were supported by the seller's in-state activities, but struck down as dissociated (i.e., lacking transactional nexus) those destination sales "involving orders sent by the purchasers directly to an office out of the state, and filled by shipment directly to the purchaser, without any intervention by the local office." *Id.*

As in *Norton* and *Goodrich*, the National Sales and Third Party Drop Ship sales involve orders placed directly to an out-of-state office for products that were shipped to an in-state destination directly from an out-of-state warehouse, without any intervention of the local office. CP 10-11 and 196-200. The National Sales and Third Party Drop Ship Sales customers were not solicited in Washington. *Id.* Orders from such customers were not received, reviewed, accepted, or approved in

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Allied-Signal is its reaffirmation of the principle applied in *Norton* and *Goodrich* that "a state's taxing authority does not extend to transactions that are not significantly associated with a taxpayer's instate business activities." DOR Resp/Reply Br. at 25.

Washington. *Id.* Avnet's Washington office did not investigate or approve credit for any National Sales or Third Party Drop Ship Sales customer. *Id.* And although DOR emphasizes that the local office in *Norton* provided limited engineering advice to customers of some dissociated sales in that case, DOR Resp/Reply at 8, the record is explicit and undisputed that Avnet's Washington office did ***not*** provide any engineering or technical advice to any National Sales or Third Party Drop Ship Sales customers. *Id.* In fact, the National Sales are identical to the Washington-destination sales held dissociated in *Goodrich*—sales to J.C. Penney "pursuant to a contract between the home office of the J.C. Penney Company at New York City" and the "home office of appellant's Hood Rubber Division" in Massachusetts, with the "consummation of which the local office has no connections." 38 Wn.2d at 676. As in *Norton* and *Goodrich*, Avnet's National Sales and Third Party Sales are dissociated because Avnet's Washington office was not associated in any way with the sales.

2. *Norton* and *Goodrich* are controlling; they prohibit the taxation of destination sales that are not significantly associated with the seller's in-state activities.

As noted above, DOR's current position is directly contrary to both *Norton* and *Goodrich*, forcing DOR to argue that *Norton* is no longer controlling law and to ignore *Goodrich* altogether. As the trial court

recognized when rejecting DOR's argument: "Clearly, disassociation is current law. The case from the Supreme Court from 1951 is still good law." 6/7/13 Tr. at 31. The Court need not reach the constitutional issue because Avnet prevails under Rule 193,[3] but if the Court addresses the constitutional issue, the Court should confirm that *Norton* and *Goodrich* remain good law.

Repeating its argument from the trial court (CP 357-363) and its opening brief (DOR Br. at 36-45), DOR again argues that *Norton* is no longer "controlling authority." DOR Resp. Br. at 5-13. Avnet addressed DOR's arguments that subsequent cases somehow rendered *Norton* obsolete in Avnet's Opening Brief (at 23-27). It is sufficient here to note that, as DOR concedes (DOR Resp/Reply Br. at 1, 3), controlling case law requires nexus with the transaction in addition to taxpayer nexus. Moreover, the transactional nexus standard applied in *Norton*, *Goodrich*, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), *Tyler Pipe Indus., Inc. v. Dep't of Revenue*, 483 U.S. 232 (1987), and *Allied-Signal* is the same—the seller's in-state activities must be significantly associated

[3] *See State v. Hall*, 95 Wn.2d 536, 539, 627 P.2d 101 (1981) ("A reviewing court should not pass on constitutional issues unless absolutely necessary to the determination of the case.").

with the seller's ability to create and maintain a market for the sales at issue.

More importantly, DOR does not dispute that only the U.S. Supreme Court can overrule its own opinions, and until it "specifically" does so, its decisions remain binding on Washington courts. *State v. Smith*, 150 Wn.2d 135, 141-42, 75 P.3d 934 (2003). The U.S. Supreme Court has never overruled *Norton*.

Presumably in response to Avnet's observation that research has uncovered no case that has ever concluded *Norton* was overruled, DOR misleadingly implies such a conclusion by characterizing *Dep't of Revenue v. Sears, Roebuck and Co.*, 660 P.2d 1188, 1190-91 n. 4 (Alaska 1983) as "rejecting taxpayer's argument that . . . the court must either follow *Norton* or disregard it." DOR Resp/Reply Br. at 5. However, the *Sears* court expressly held that "we find no basis to conclude that [*Norton*] has been overruled, and we regard it as ***binding precedent*** on this court". 660 P.2d at 1191, n.4 (emphasis added).

In its further effort to avoid *Norton*'s on-point dissociation ruling, DOR erroneously claims that "Avnet has not cited any appellate decision that has followed *Norton* in finding some portion of a seller's transactions 'dissociated' from its instate activities." DOR Resp/Reply Br. at 17. This claim is flatly wrong. As discussed in Avnet's Opening Brief (at 22-23),

that is exactly what *Goodrich* did—follow *Norton* in finding that a portion of a seller's transactions were dissociated from its instate activities.[4] As noted above, the sales held to be dissociated in *Goodrich* were National Sales, in which all of the seller's activities with its national customer take place out of state, and the goods are shipped to the customer's various locations throughout the country as directed by the purchaser.

Just as the U.S. Supreme Court has not overruled *Norton*, the Washington Supreme Court has not overruled *Goodrich*. Thus, *Goodrich* remains binding on all other Washington Courts. *State v. Gore* 101 Wn.2d 481, 487, 681 P.2d 227 (1984) ("once this court has decided an issue [the decision] is binding on all lower courts until it is overruled by this court.").

3. DOR's arguments are contrary to both the plain language and its longstanding application of Rule 193.

Contrary to the Department's argument, DOR Resp/Reply Br. at 30, Rule 193 does ***not*** equate dissociation with out-of-state destination. Rather, consistent with *Norton* and *Goodrich*, Rule 193 expressly provides that dissociation occurs when a taxpayer establishes that its "instate activities are not significantly associated in any way with the sales ***into***

[4] DOR's Resp/Reply Br. pointedly ignores *Goodrich* almost entirely, referencing the case only once in passing in the middle of a lengthy footnote. DOR Resp/Reply Br. at 7, n. 4.

this state." WAC 458-20-193(7)(c) ("Rule 193") (emphasis added). Thus DOR, like the courts, has long applied Rule 193 to dissociate sales shipped to Washington destinations when the seller's local activities are not significantly associated with those destination sales. Det. No. 86-295, 2 WTD 11. (1986); Det. No. 88-144, 5 WTD 137 (1988); Det. No. 93-155, 13 WTD 297 (1993). Notwithstanding its "doubt" as to the "continuing validity of *Norton*," the Department continues to acknowledge is published determinations that "Rule 193(7)(c) continues to allow dissociation where the taxpayer can meet its terms . . . 'establishing that the instate activities are not significantly associated in any way with the sales into this state.'" Det. No. 00-098, 22 WTD 151 at 153-54.

In Det. No. 86-295, 2 WTD 11 (1986) the Department held that Washington-destination sales were dissociated (and therefore not taxable) where the sales "were not solicited or facilitated by the taxpayer's Washington-based sales personnel, [which] had no contact with this buyer." 2 WTD at 14. In so ruling, the Department explained that it "interprets the *Norton* case as requiring the taxpayer to . . . establish that its local activity is not a decisive factor in establishing or maintaining its market for the sales in question." *Id.* at 16. The taxpayer met its burden of so establishing by presenting "testi[mony] that its Washington sales

personnel have no contact with the buyer with respect to sales [at issue], and there is no evidence to the contrary on record."

As noted in Avent's Opening Brief (at 18) and ignored by DOR, DOR's current litigating position is of recent origin, having been developed decades after its enactment of Rule 193, the binding case law that DOR now erroneously claims is inconsistent with Rule 193, and DOR's own administrative determinations. Not surprisingly, the Washington Board of Tax Appeals has also held that Rule 193(7)(c) accurately reflects the dissociation standard applied in *Norton* and *Goodrich*, and the Board has applied Rule 193 consistent with those cases to strike down an assessment of wholesaling B&O tax on dissociated sales. *Guy Brown Management LLC v. Dep't of Revenue*, BTA Docket No. 69422 at 12 (January 11, 2010). In *Guy Brown*, the BTA held:

> The basis for WAC 458-20-193(7)(c) is found in *Norton*. The Washington Supreme Court followed *Norton* in *B.F. Goodrich*. Thus this Board looks to *B.F. Goodrich* to interpret the Department's dissociation rule.

Guy Brown at 12. Guy Brown made sales of ink toner to Office Max stores facilitated by the activities of travelling representatives, including a representative who called on Office Max stores in Washington. Guy Brown also made sales of ink toner and other office supplies directly to Fortune 1000 companies. Guy Brown established that the sales

representative who called on Office Max in Washington was not significantly associated in any way with Guy Brown's Washington destination sales to Fortune 1000 companies. Thus, the BTA held that Guy Brown's Washington destination sales to Fortune 1000 companies were dissociated from its sales to Office Max and, therefore, not subject to B&O tax.

B. The evidence is undisputed that Avnet's Washington activities were not associated in any way with the Third Party Drop Ship and National Sales.

There is a reason why DOR asks this Court to ignore both the plain meaning of Rule 193(7)(c) and controlling Supreme Court precedent; DOR cannot defend the trial court's ruling on the facts. Although the trial court recognized that dissociation remains "current law" under both *Norton* and Rule 193, it nevertheless concluded, without explanation, that Avnet did not meet its burden. 6/7/13 Tr. at 32. That was error.

As in *Norton*, *Goodrich*, Det. No. 86-295, and *Guy Brown*, the undisputed evidence in the record establishes that Avnet's National Sales and Third Party Drop Ship Sales are "not significantly associated in any way" with its Washington activities. As discussed above, Avnet's Washington employees played no role in those sales whatsoever: Avnet's customers were located outside Washington; the customers placed orders with Avnet at offices located outside Washington; and the products were

shipped by Avnet distribution sites located outside Washington. All engineering and technical advice to those customers was also performed outside Washington. CP 194-201; CP 9-12.[5]

In short, the National Sales and Third Party Drop Ship Sales were dissociated. Not only does Rule 193 apply by its plain terms here, but this case is indistinguishable from *Norton* and *Goodrich*.

III. CONCLUSION

For the reasons discussed above, Avnet's National Sales and Third Party Drop Shipped sales were dissociated from Avnet's Washington activities. Accordingly, Avnet requests that the Court: (1) affirm the trial court's order refunding B&O taxes and interest assessed on Third Party Drop Ship Sales[6]; and (2) reverse the trial court's order dismissing Avnet's refund claim for National Sales, instructing the trial court to enter judgment awarding a refund of tax and interest assessed on the National Sales.

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[5] Avnet does not dispute that it has taxpayer nexus in Washington by virtue of its instate activities. And where its sales in Washington are associated with those instate activities in any way, *i.e.*, where there is a transactional nexus, Avnet duly reports and pays B&O tax. Thus, during the audit period, Avnet paid $565,295 in B&O taxes for its Washington sales. CP 195.

[6] Dissociation is an alternative basis to affirm the trial court's ruling with respect to Third Party Drop Ship Sales. As discussed in Avnet's Opening Brief, the trial court correctly concluded that those sales are not "received by the purchaser" in Washington under the plain language of WAC 458-20-193.

RESPECTFULLY SUBMITTED this 1st day of July, 2014.

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CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury of the laws of the State of Washington, that on July 1, 2014, I caused to be served a copy of the foregoing **Reply Brief of Avnet in Support of its Cross-Appeal** on the following persons in the manner indicated below at the following addresses:

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