NO. 46939-1-II

COURT OF APPEALS
FOR THE STATE OF WASHINGTON
DIVISION II

IRWIN NATURALS,

Appellant,

v.

STATE OF WASHINGTON DEPARTMENT OF REVENUE,

Respondent.

ON APPEAL FROM THURSTON COUNTY SUPERIOR COURT
(Hon. Gary R. Tabor)

APPELLANT'S OPENING BRIEF

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I. ASSIGNMENTS OF ERROR

I. The lower court erred in holding that Irwin Naturals (the "Company") was unable to dissociate its retail sales from its wholesale sales of nutritional products in Washington for business and occupation ("B&O") tax purposes under WAC 458-20-193 (Rule 193).

II. The lower court erred in holding that the Company was unable to dissociate its retail sales from its wholesale sales of nutritional products in Washington for B&O tax purposes based on the holding in *Norton Co. v. Dep't of Revenue of Illinois*, 340 U.S. 534 (1951).

III. The lower court erred in holding that the Company's retail sales of nutritional products to Washington residents had transactional nexus with the State for purposes of the Washington Retail Sales Tax ("RST").

II. STATEMENT OF ISSUES

I. Rule 193 provides that a taxpayer may dissociates sales for B&O tax purposes when the "instate activities are not significantly associated in any way with the sales into the state." Is the Company able to dissociate its retail sales under Rule 193 where the uncontroverted evidence is that the retail and wholesale channels of the Company operated independent of one another during the period at issue?

II. Under the United States Supreme Court's holding in *Norton*, a taxpayer can dissociate sales where instate activities "were not decisive factors in establishing and holding [the] market" for unrelated sales. Is the Company able to dissociate its retail sales under *Norton* where the uncontroverted evidence is that the retail and wholesale channels of the Company operated independent of one another during the period at issue?

III. The concept of transactional nexus requires that a taxpayer's transactions or activities have a nexus – or connection – with a state before it can be required to follow the tax laws of a state. Is the concept of transactional nexus applicable in the context of retail sales and use taxes following the decision of the United State Supreme Court in *National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977), such that retail sales of the Company during the period are outside the scope of the RST?

III. SUMMARY INTRODUCTION

The Company, a corporation with its a principal place of business in Los Angeles, California, is in the business of developing, marketing and selling nutritional products. The Company's sale of nutritional products takes place through two distinct channels – wholesale sales (the "Wholesale Channel") and retail sales (the "Retail Channel"). During the period 2002 through 2009 (the "Period"), the Company made wholesale sales of nutritional products to retailers and distributors in Washington. The Company did not begin making retail sales of nutritional products to

Washington residents until 2004.

The operations of the Retail Channel and the Wholesale Channel were independent of one another. Any and all activities relating to the business of the Wholesale Channel was handled in-house by the Company. By contrast, the business of the Retail Channel was outsourced by the Company to third parties.

The solicitation of sales by the Wholesale Channel in Washington was accomplished through independent sales representatives and Company employees making in-person visits in the State. Sales of products by the Retail Channel in Washington were made telephonically or over the internet. The Retail Channel had no payroll or property in Washington during the Period.

While the Wholesale Channel sold directly to Washington retailers and distributors, the target market for the Retail Channel was individuals residing in Washington. With one exception, the products sold through the Wholesale Channel did not overlap those sold through the Retail Channel. Moreover, the product packaging, again, with one exception, was dissimilar between the Wholesale Channel and the Retail Channel. In addition to differences in packaging and product mix, the pricing of products sold through the Wholesale Channel were materially lower than price of products sold through the Retail Channel.

In light of these facts, the presence of the Company's products on the shelves of Washington retailers in no way helped to promote or expand the Company's market for products sold by telephone or over the internet through the Retail Channel.

The Department has long-permitted taxpayers to dissociate revenue streams for purposes of B&O taxes under Rule 193. In order to claim dissociation pursuant to Rule 193, the taxpayer must show that the "instate activities are not significantly associated in any way with the sales into the state." The Company maintains that the uncontroverted facts of this case make clear that it is permitted to dissociate revenues since the instate activities relating to the Wholesale Channel are not in any way associated with the retail sales made by through the Retail Channel. However, even if there should be disagreement on the application of Rule 193, the Company relies on the decision of the United States Supreme Court in *Norton* to support dissociation as it relates to the imposition of B&O taxes.

The unambiguous holding in *Norton* is that dissociation must be permitted under the U.S. Constitution where the taxpayer can demonstrate that instate activities "were not decisive factors in establishing and holding [the] market" for unrelated sales. *Norton*, 340 U.S. at 538. The dissociation test articulated by the Court in *Norton* is less stringent than that contained in Rule 193 and also supports the Company's claim for dissociation of revenues related to the Retail Channel during the Period. The Company's instate activities relating to its Wholesale Channel during the Period were most certainly not "decisive factors" in "establishing" or "holding" the market for the Company's sales through its Retail Channel. Therefore, and irrespective of the result reached under Rule 193, the Company is permitted to dissociate its sales made through the Retail Channel for B&O tax purposes pursuant to the holding in *Norton*.

Rule 193, by its express terms, speaks solely to dissociation for purposes of the B&O tax. However, the United States Supreme Court has decided several recent cases post-*Norton* making clear that, as a matter of U.S. constitutional law, dissociation must also be available to a taxpayer in the context of a state's indirect taxes such as the RST. Under these decisions, dissociation is permitted where the state lacks transactional nexus over the activities or transactions the state seeks to tax. The undisputed facts of this case are that any and all business activities of the Retail Channel took place outside Washington. The Department is unable to subject the Company's retail sales to the RST because all activities generating such sales take place outside the State.

As a result, Washington lacked the requisite transactional nexus to impose the RST in this case, and the Company's request for dissociation must be granted.

IV. <u>STATEMENT OF THE CASE</u>

Irwin Naturals brought this refund action in Thurston County Superior Court challenging the B&O and Retail Sales Tax Assessment issued by the Washington Department of Revenue (the "Department") for the period 2002 through 2009 (the "Period").

During the Period, Irwin Naturals made wholesale sales to retailers and distributors in Washington. CP 19. Employees of Irwin Naturals visited Washington during the Period to solicit wholesale sales. CP 20, 22. Irwin Naturals also engaged independent contractors to solicit wholesale sales on its behalf during the Period. CP 21-22.

Beginning in 2004, Irwin Naturals began making retail sales of healthcare products to Washington residents. CP 21. Irwin Naturals had no employees or independent contractors physically present in Washington to solicit retail sales. CP 21. Irwin Naturals owned no property in Washington related to its solicitation of retail sales in the State. CP 21.

The parties filed cross motions for summary judgment. The Department argued that dissociation was unavailable for B&O tax purposes and *National Geographic* precluded the concept of "transactional nexus" from being applied in the context of the Retail Sales Tax. Irwin Naturals argued that both Rule 193 and *Norton* supported dissociation of retail sales from its wholesale sales for B&O tax purposes and that the holding of *National Geographic* does not control the use of "transactional nexus" in the context of the Retail Sales Tax. The lower court granted summary judgment to the Department denying summary judgment to

Irwin Naturals. Irwin Naturals timely filed its notice of appeal.

V. STANDARD OF REVIEW

A trial court's order granting summary judgment is reviewed de novo. *In re the Estate of Bracken*, 175 Wn.2d 549, 562, 290 P.3d 99 (2012). Summary judgment is appropriate where, viewing the evidence in the light most favorable to the nonmoving party, there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. *Loeffelholz v. Univ. of Wash.*, 175 Wn.2d 264, 285 P.3d 854 (2012). In this case, the parties do not dispute the material facts. Accordingly, the issue in this case is whether the trial court correctly determined that the Company was not entitled to a refunds of B&O tax and RST, a question of law that is reviewed de novo. *Bracken*, 175 Wn.2d at 562.

VI. ARGUMENT

At the heart of this case is the tax concept of "dissociation." Dissociation refers to a taxpayer's ability to bifurcate its activities in a taxing state – one taxable and one not. In this case, the uncontroverted facts permit the Company to bifurcate the activities of its Wholesale Channel in Washington from those of its Retail Channel for B&O ***and*** RST purposes.

The tax laws of Washington expressly permit a taxpayer under certain defined circumstances to claim dissociation for purposes of the imposition of the B&O tax. *See* WAC 458-20-193 ("Rule 193").

Applying a different analysis, the United States Supreme Court made clear in *Norton* that the concept of "dissociation" is firmly embedded in the U.S. Constitution. For these reasons, the use of dissociation by taxpayers to avoid B&O taxes is not in doubt.

The tax laws of Washington are clear that a taxpayer is not permitted to claim dissociation in the context of the RST. Washington's position on the use of dissociation for purposes of the RST is premised on the holding in the *National Geographic*. However, over the last several decades, the United States Supreme Court has issued several decisions making clear that dissociation[1] applies to ***all*** tax types. Although the Court has not expressly overruled its holding in *National Geographic*, the logical extension of its recent decisions has marginalized its impact. The current view of the Court is the Company can successfully claim that the activities of its Wholesale Channel can be dissociated from the transactions and activities of its Retail Channel for purposes of the RST.

[1] In the context of these decisions of the United States Supreme Court the concept is referred to as "transactional nexus." Transactional nexus refers to the presence of a connection – or nexus – between the transaction or activity and the taxing state. If a transactional or activity does not have transactional nexus with a state, the taxpayer will have succeeded in dissociating the disputed transactions or activities. As a result, the concepts of transactional nexus and dissociation are inseparable.

A. The Company is permitted to dissociate sales made through the Retail Channel for B&O purposes under either Rule 193 or the Court's holding in *Norton*.

1. The Company is not liable for B&O taxes on sales completed by the Retail Channel because they are dissociated from the instate activities of the Company's Wholesale Channel under Rule 193.

Rule 193 is clear on its face that the Company is permitted to show that the instate activities relating to its Retail Channel are dissociated from those involving the Wholesale Channel. As applicable to the Period, Rule 193 reads in pertinent part as follows:

> (7) **Inbound sales.** ... There must be both the receipt of goods in Washington by the purchaser and the seller must have nexus for B&O tax to apply to a particular sale. The B&O tax will not apply if one of these elements is missing. ...
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> *************
>
> (c) If a seller carries on significant activity in this state and conducts no other business in the state except the business of making sales, this person has the distinct burden of establishing that ***the instate activities are not significantly associated in any way with the sales into the state.***

WAC 458-20-193 (emphasis added). The language used by the Department in Rule 193 is clear and must be followed without the need to employ the rules of statutory construction. *Overlake Hosp. Ass'n v. Dep't of Health*, 170 Wn.2d 43, 52 (2010) ("if the meaning of a rule is plain and unambiguous on its face, then we are to give effect to that plain meaning"). The Department must not be permitted to argue against their own rule and claim that no such right to dissociation exists. *See Skamania Cty. v. Woodall*, 104 Wn. App. 525, 539, 16 P.3d 701 (2001) (making clear that administrative agencies must be bound by their own rules). As it relates to the facts of this case, Rule 193 leaves no doubt that the retail sales made through the Retail Channel are dissociated from the instate activities of the Wholesale Channel for B&O tax purposes.

Despite the clear right to dissociation under Rule 193, the Department's rules do not explain the specific circumstances under which a taxpayer can successfully demonstrate that its "instate activities are not significantly associated in any way" with other nexus-creating activities. However, administrative rulings issued by the Department do provide insight into this critical analysis.

In Determination No. 04-0208, 24 WTD 217 (Aug. 31, 2004),[2] the Department addressed whether a taxpayer was entitled to dissociate certain retail sales of products in Washington from certain other taxable instate activities for B&O tax purposes. In the ruling, the taxpayer argued that it was permitted to dissociate online retail sales of certain branded products from in-person retail sales of the same branded products in Washington. After a thorough discussion of the interpretive evolution of

[2] Determination No. 04-0208 is the most recent ruling from the Department addressing a request for dissociation under Rule 193.

Rule 193 by the Department, the ruling concludes by stating:

> Therefore, to be eligible for dissociation, a sale must not be in any way associated with any of the taxpayer's instate activities that establish or maintain a market for its products.

Based on the facts of the ruling, the taxpayer faced insurmountable obstacles in its efforts to seek dissociation under Rule 193. Both the online and in-person sales were at retail and involved the ***same*** branded products. The Department concluded in the ruling that the online sales of products undeniably benefited from the brand recognition of the very same products sold by the taxpayer in Washington. In other words, the in-person sales of branded products helped maintain a market for the taxpayer's online retail sales. For these reasons, the Department denied the taxpayer's claim to dissociation under Rule 193.

When contrasted with the facts of Determination No. 04-0208, the undisputed facts of this case present a much clearer case for dissociation under Rule 193. As a threshold matter, unlike the taxpayer in the ruling, the Company had two different channels relating to the sale of products in Washington – a Wholesale Channel and a Retail Channel. In the ruling, both sets of transactions involved retail sales to the same target market. By contrast, the Company makes wholesale sales and retail sales to different target markets. CP 45, 52. Moreover, and unlike the taxpayer in the ruling, with one exception, there was no overlap of nutritional products sold by the Company through each of the Wholesale Channel and the Retail Channel.

Within the Company, the operations of the Retail Channel were wholly independent from the operations of the Wholesale Channel. CP 46. The business relating to the Wholesale Channel was handled entirely in-house. *Id.* All Wholesale Channel functions relating to sales, processing, payment, collection and delivery were handled by Company employees. *Id.* The separateness of the Retail Channel manifested itself through the use of third parties. *Id.* The Company retained unaffiliated vendors to handle the sales, processing, payment, collection and delivery activities of the Retail Channel. *Id.*

Customer inquiries with respect to nutritional products sold through the Retail Channel were handled differently from those relating the Wholesale Channel. CP 47. If a retail customer of the Company called regarding a product offered through the Retail Channel, the person answering the phone on behalf of the Company would solicit sales of Company products offered through the Retail Channel. *Id.* However, when a purchaser of products from the Wholesale Channel called regarding a product, the Company would refer the caller back to the Company's wholesale customers for additional product purchases. *Id.* Customer calls relating to the Wholesale Channel were handled in this way to avoid competing directly with the Company's wholesale customers. CP 46.

Additional evidence of independence is demonstrated by the fact that Company employees and independent sales representatives soliciting sales for the Wholesale Channel did ***not*** solicit sales of products offered through the Retail Channel. CP 46.

The strongest fact supporting the Company's claim to dissociation under Rule 193 relates to the fact that, other than the "Dual Action Cleanse" product, there was no overlap in branded products offered through the Retail Channel and the Wholesale Channel and products sold by the Retail Channel involved different branding and packaging schemes than the products sold by the Wholesale Channel. CP 46. These uncontroverted facts make clear that, other than the "Dual Action Cleanse" product, the Company's nutritional products on retailer's shelves in Washington simply could not have influenced sales of nutritional products through the Retail Channel.

Where branding, packaging and product mix do not overlap, an individual is unable to make the connection that the nutritional product on the shelf at a Washington retailer is in any way related to nutritional products sold under different brands and packaging by telephone or internet order.

The Company's offering of the "Dual Action Cleanse" product in no way impacts the Company's argument for dissociation under Rule 193. The marketing and sale of "Dual Action Cleanse" by the Company was its first effort to promote an "As Seen on TV" product. CP 48. The business plan for "Dual Action Cleanse" was to offer the product only at retail. *See id.* Once retail sales of the product peaked, the Company would then offer "Dual Action Cleanse" for sale to wholesale customers. CP 47. The goal of this business strategy was to maximize the revenue of the sale of "Dual Action Cleanse" over its product life. *See id.*

Consistent with the overall business strategy for "Dual Action Cleanse," the pricing of the product through the Wholesale Channel was ***less expensive*** than if a customer purchased "Dual Action Cleanse" through the Retail Channel. CP 49. Evidence relating to the pricing of the "Dual Action Cleanse" product supports the claim that it could be purchased more cheaply through the Wholesale Channel. CP 49, 53-55. The average purchase price of sales of "Dual Action Cleanse" made to Washington residents through the Retail Channel for the period 2004-2009 was $55.52. *Id.* By comparison, the average price that the Company sold "Dual Action Cleanse" through the Wholesale Channel to retailers in Washington was **$27.32**. *Id.*[3]

The differences in pricing relating to the sale of the "Dual Action

[3] While impossible to record every possible selling price charged by the Company's Washington wholesale customers, according to the Department's evidence on audit in this case, the average retail cost of "Dual Action Cleanse" by such customers was $20.86. CP 49, 53. Based on the Company's detailed pricing report, it appears that the Department's pricing evidence is the result of a small sample size.

Cleanse" product is critical to the Company's claim to dissociation under Rule 193. It is nonsensical to think that a Washington resident would walk into a Sam's Club in Seattle, pick up a bottle of "Dual Action Cleanse" for sale at $20.86 and decide to instead purchase the product from the Company directly for the higher price of $55.52. The Department has acknowledged this pricing logic between the retail and wholesale sales of the same product in Determination No. 08-0128, 28 WTD 9 (May 14, 2008).[4]

Rule 193 provides that a taxpayer is permitted to dissociate transactions and activities where they "are not significantly associated in any way with the sales into the state." The Department has not explained by rule what it means for one set of activities or transactions to be "significantly associated" with another. However, Determination No. 04-0208 fills this void by explaining that to be "significantly associated" one set of activities or transactions must "establish or maintain a market" for the other. In light of this interpretation of Rule 193, this appeal presents an easy case for dissociation.

The Company's Wholesale Channel and Retail Channel were operated independently in all respects. Further, other than "Dual Action

[4] This ruling dealt with the taxpayer's claim that actions of an affiliate selling the same product at retail in Washington did not cause it to have B&O tax nexus with the State. The concept of dissociation was not at issue in the ruling.

Cleanse," there was no crossover of nutritional products or branding between items offered by the Wholesale Channel and the Retail Channel. Although "Dual Action Cleanse" ***was*** offered through both the Wholesale Channel and the Retail Channel, the price differential prevented the sales of products through the Wholesale Channel from "establishing or maintaining a market" for products sold through the Retail Channel. For these reasons, the Company is entitled to dissociate sales of nutritional products through the Retail Channel from sales of products made through the Wholesale Channel. The assessment of B&O taxes by the Department for the Period must be abated under Rule 193.

2. The Company is not liable for B&O taxes on sales completed by the Retail Channel because they are dissociated from the instate activities of the Company's Wholesale Channel under the rule of law in the *Norton* decision.

Rule 193 is not the sole basis for dissociation for B&O tax purposes. The holding of the United States Supreme Court in *Norton* ***also*** supports the Company's claim that it is entitled to dissociate sales made through the Retail Channel. The constitutional test outlined in *Norton* is less restrictive than that in Rule 193 and requires an abatement of the B&O tax assessment in this case.

In *Norton*, the taxpayer was an out-of-state producer and retailer of abrasive machines. The taxpayer made retail sales of its machines through a branch office in Chicago, Illinois and by mail order from its offices in

Massachusetts. *Norton*, 340 U.S. at 535. The critical issue in the case was whether the taxpayer was liable for the Illinois gross receipts tax on both the over-the-counter sales made in Chicago and the mail order sales processed in Massachusetts. The taxpayer argued under the Commerce Clause of the U.S. Constitution that only its instate retail sales should be subject to tax. In other words, the taxpayer contended that it was entitled to dissociate its mail order sales from its over-the-counter sales made in Chicago, Illinois. The Department countered that the instate retail operation maintained a market for the out-of-state mail order sales and therefore the taxpayer was not entitled to dissociate such sales.

The *Norton* Court made clear that dissociation was permitted under the Commerce Clause of the U.S. Constitution, but it held that in order to successfully claim dissociation, a taxpayer would need to show that its instate activities were not "decisive factors in establishing and holding" the market for the out-of-state sales. *Norton*, 340 U.S. at 538. In the case, the taxpayer made retail sales of the same abrasive machinery through each channel.[5] In addition, the Chicago sales office of the taxpayer assisted the Massachusetts offices in facilitating mail order sales. On these facts, the Court ruled against the taxpayer concluding that the taxpayer's instate

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[5] The facts and holding in Norton mirror the facts and holding in Determination No. 04-0208. In each case, the taxpayer sold identically-branded products through two retail channels. On these facts, it is not hard to see why the taxpayers were denied the ability to dissociate sales.

retail sales of machines were "decisive factors in establishing and holding" a market for the company's out-of-state retail sales of the same machines through mail order. *Id.*

The Washington Supreme Court followed the holding in *Norton* in *B.F. Goodrich v. State*, 38 Wn.2d 663, 231 P.2d 325 (1951). The facts in *Goodrich* were nearly identical to those at issue in *Norton*. In *Goodrich*, the company had multiple locations in Washington making retail sales, but it also accepted and filled retail sale orders from offices outside Washington. The Department sought to tax all retail sales made by the company whether or not accepted and filled in Washington. Applying the test laid out in *Norton*, the court held that the Commerce Clause prevented Washington from taxing all retail sales because taxpayer's out-of-state sales were dissociated from the instate sales. A critical fact in the case was that, unlike in *Norton*, the local offices did not facilitate sales accepted and filled outside Washington. *Id.*, 38 Wn.2d at 672, 674. The constitutional test outlined in *Norton* – followed in *Goodrich* – remains good law in Washington.

The Commerce Clause jurisprudence of the United States Supreme Court has evolved since *Norton*, however, this evolution has merely affirmed the constitutional basis supporting the use of dissociation. At the time of *Norton*, there existed a litmus test for violations of the Commerce Clause. If a tax law was worded in such a way to impose burdens on interstate commerce, it was struck down. *See e.g., McLeod v. J. E. Dilworth Co.*, 322 U.S. 327 (1944). The Court in *Norton* made reference to this litmus test stating that the taxpayer could have "approached the Illinois market through solicitors only and it would have been entitled to the immunity of interstate commerce[.]" *Norton*, 340 U.S. at 538.

This formalistic approach to the interpretation of the Commerce Clause ended with the Court's decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). In *Complete Auto*, the Court acknowledged the arbitrariness of the Court's Commerce Clause jurisprudence to that point and articulated a more flexible four-pronged analysis for evaluating challenges brought to state tax laws.

Under the new test, a state tax law survives scrutiny under the Commerce Clause where the tax (1) is applied to an activity with a substantial nexus with the state, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the taxing state. The first prong, requiring a "substantial nexus" between the out-of-state corporation's activities and the taxing state, reflects the concept of "dissociation" first expressed in *Norton*. In sum, while the formalistic test for evaluating Commerce Clause violations changed between *Norton* and *Complete Auto*, the concept of "dissociation" survived.

Complete Auto's mandate that there be a substantial nexus between the activities of the out-of-state corporation and the taxing state permeates the Court's Commerce Clause jurisprudence. In *Quill Corp. v. North Dakota*, 540 U.S. 298 (1992), the Court issued a landmark decision making clear that there is a distinct difference between challenges brought under the Due Process Clause and those under the Commerce Clause. With respect to the Commerce Clause, the Court made clear that the appropriate test is that articulated in *Complete Auto*. *Id.* at 311. In so doing, the Court in *Quill* affirmed that dissociation remains a powerful tool when challenging an assessment under the Commerce Clause.

Norton, *Complete Auto* and *Quill* collectively reflect an uninterrupted line of decisions making clear that the state must have sufficient nexus with the instate transactions or activity of the out-of-state corporation in order to impose tax. Where such nexus does not exist, the taxpayer can dissociate such transactions or activities. The doctrine of dissociation as first articulated in *Norton* continues to guide the U.S. Supreme Court in its resolution of state tax cases to this day.

As explained in *Norton*, an out-of-state corporation can dissociate certain transactions from taxable instate activities if the taxable instate activities are not "decisive factors" in promoting or maintaining a market in the state for the otherwise non-taxable transactions. *Norton*, 340 U.S. at 538. The constitutional test in *Norton* is less restrictive than that found in Rule 193.

In light of the undisputed facts of this case, there can be no serious question that the transactions and activities of the Wholesale Channel were not "decisive factors" in "establishing and holding" a market for the transactions and activities of the Retail Channel in Washington for the period 2004-2009. Other than the "Dual Action Cleanse" product, there was no overlap of products offered by the Retail Channel and the Wholesale Channel. CP 47. Further, the Retail Channel used different branding and packaging than the Wholesale Channel. CP 47. If a retail purchaser of a product made through the Wholesale Channel called the Company about the availability of additional products, such calls would direct the purchaser back to the Company's wholesale customer. CP 47. Finally, the independent sales representatives and employees of the Company related to the Wholesale Channel were not involved in soliciting sales for the Retail Channel. CP 47. Unlike the facts in *Norton*, the business operations of the Retail Channel and the Wholesale Channel were completely independent of each other during the Period.

The "Dual Action Cleanse" product was the only Company product offered through ***both*** the Retail Channel and the Wholesale Channel, but the pricing strategy was dictated by the "As Seen on TV" model. CP 48. "Dual Action Cleanse" was offered through the Retail Channel in Washington beginning in 2004, but not offered through the Wholesale Channel in Washington until 2006. CP 47. The pricing of the product was set to encourage sales through the Wholesale Channel – ***not*** the Retail Channel. CP 47.

Under the Court's decision in *Norton*, the Company is entitled to dissociate the sales made through the Retail Channel for B&O tax purposes. It is clear that the instate activity relating to the Wholesale Channel were not "decisive factors" in promoting or maintaining a market for sales through the Retail Channel. For these reasons, the Company is permitted to dissociate the retail sales made to Washington residents from the wholesale sales made to Washington retailers for B&O tax purposes.[6]

B. The Company is permitted to dissociate sales made through the Retail Channel for RST purposes under the Commerce Clause of the U.S. Constitution.

Rule 193 is clear that it does not apply in the context of the RST. In other words, the Company is unable to rely on Rule 193 to claim dissociation with respect to sales made through the Retail Channel for RST purposes. The very same United States Supreme Court decisions supporting the use of dissociation for B&O tax purposes likewise support the Company's claim to dissociation for the RST.

The only distinction between the Commerce Clause analysis

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[6] If this Court should hold that the Company is not entitled to dissociate its retail sales based on the sales of Dual Action Cleanse through both the Wholesale Channel and the Retail Channel, the Company should only be liable for B&O taxes for the period 2006-2009. It was only during the period 2006-2009 that Dual Action Cleanse was offered to Washington customers through both sales channels.

relating to the B&O tax and that involving the RST is the impact of the Court's 1977 decision in *National Geographic*. In *National Geographic*, the Court held that the taxpayer was not permitted to dissociate its mail order sales for sales and use tax purposes. The Company maintains that several cases of the Court – starting with *Complete Auto* – have diminished, if not tacitly overruled, the holding in *National Geographic*.

In *National Geographic*, the taxpayer conducted its operations through two offices in California. *National Geographic*, 430 U.S. at 552. The employees of these two offices were tasked with soliciting advertising copy for the taxpayer's magazine. *Id.* In addition to these instate offices, the taxpayer conducted a mail order business from its offices in the District of Columbia. *Id.* The mail order business was concerned with the retail sale of globes, maps and related items to California residents. *See id.* There was no dispute between the parties that the instate solicitation and sale of advertising by the taxpayer's offices was not subject to the California sales and use tax. The issue for the Court was whether under the Due Process Clause and the Commerce Clause of the U.S. Constitution the taxpayer's mail order business conducted outside California could be liable for sales and use taxes based on the instate presence of the two offices selling advertising.

The taxpayer maintained that its mail order sales of tangible personal property were separate and distinct from the activities of the instate offices. *National Geographic*, 430 U.S. at 560. As a result, the taxpayer argued, each line of business must be analyzed independently. *See id.* Since the mail order business lacked any physical connection with California, the taxpayer maintained it should be able to dissociate those sales for sales and use tax purposes under both the Due Process Clause and the Commerce Clause. The Court, relying on *dicta* in the *Norton* decision, dismissed these arguments holding that the concept of transactional nexus was not a relevant concern for sales and use tax purposes. *Id.* at 561.

The holding of the Court in *National Geographic* is subject to attack on several fronts. As an initial matter, the Court cited *dicta* in *Norton* for what it believed to be a *per se* rule regarding the availability of dissociation for sales and use tax purposes. The key passage in *Norton* reads as follows:

> Where a corporation chooses to stay home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filling and delivery back to the buyer, it is obvious that the state of the buyer has no local grip on the seller. Unless some local incident occurs sufficient to bring the transaction within its taxing power, the vendor is not taxable. *McLeod v. J. E. Dilworth Co.*, 322 U.S. 327. ***Of course, a state imposing a sales or use tax can more easily meet this burden, because the impact of those taxes is on the buyer or user. Cases involving them are not controlling here, for this tax falls on the vendor.***

Norton, 340 U.S. at 537 (emphasis added).

There can be no question that the above-cited passage reflects *dicta* from the Court. How and when the concept of dissociation may apply in the context of sales and use taxes was wholly irrelevant to the specific issue in dispute in *Norton* – *i.e.*, whether dissociation could be used for purposes of the Illinois ***franchise tax***. For this reason alone the rule of law in *National Geographic* is subject to question.

As can be seen from the plain language of the quoted paragraph above, the Court in *Norton* fell far short of articulating a *per se* rule relating to the use of dissociation to avoid sales and use taxes. The statement that "a state imposing a sales or use tax *can more easily* meet this burden" lacks any and all hallmarks of a *per se* rule. The use of the phrase "more easily" moots the claim that *Norton* provided a *per se* rule. If the *Norton* Court had intended to provide a *per se* rule it would have said "can meet this burden." However, the Court's use of "more easily" logically indicates that there are circumstances where a taxpayer ***can*** show dissociation for purposes of challenging a state's assessment of sales and use taxes.

In addition to its erroneous reliance on *dicta* in *Norton*, the Court's holding in *National Geographic* is also called into question in light of its constitutional underpinnings. Although the taxpayer challenged the imposition of sales and use taxes under both the Due Process Clause and the Commerce Clause, the Court in *National Geographic* decided the case solely on ***due process*** considerations. The Court explained its holding as follows:

> [T]he relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on in the State, but simply whether the facts demonstrate "some definite link, some minimum connection between (the State and) the person ... it seeks to tax."

National Geographic at 561 (quoting *Miller Bros.*, 347 U.S. at 344-345). Such references to a "definite link" or "minimum connection" undeniably speak to the touchstones of the Due Process Clause. The Court's holding in *National Geographic* is devoid of any specific discussion relating to Commerce Clause principles. The Court's failure in this regard is not terribly surprising. At the time *National Geographic* was decided the Court did very little to distinguish between its analysis under the Due Process Clause and the Commerce Clause. However, in its landmark decision in *Quill*, the Court made clear the constitutional underpinnings of the Due Process Clause and the Commerce Clause command two distinct inquiries.

In *Quill*, the Court readily acknowledged that its prior decisions had been inexact when dealing with claims brought under both the Due Process Clause and the Commerce Clause. *Quill*, 504 U.S. at 305 ("although we have not always been precise in distinguishing between the two, the Due Process Clause and the Commerce Clause are analytically distinct"). Correcting for this past ambiguity, the *Quill* Court engaged in a lengthy discussion of the differing limits and purposes of the Due Process Clause and the Commerce Clause. *See id.* at 305 ("[t]he two constitutional requirements differ fundamentally, in several ways"). The attendant differences between the Due Process Clause and the Commerce Clause, the Court continued, require separate constitutional tests. *See id.*

The Court stated that the Due Process Clause is fundamentally concerned with the concept of "fairness." *See Quill*, 504 U.S. at 307. Specifically, the Due Process Clause is intended to evaluate whether "a [taxpayer's] contacts with the forum [make] it reasonable, in the context of our federal system of government, to require it to defend the suit in that state." *Id.* According to the Court in *Quill*, in order for a state tax to pass muster under the Due Process Clause, the taxpayer must have "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill*, 504 U.S. at 306 (citing *Miller Bros.*, 347 U.S. at 344-345).[7] Where such a "link" or "connection" does exist, the imposition of tax does not offend the Due Process Clause.

The purpose of the Commerce Clause, the *Quill* Court continued, is to evaluate impediments to the free flow of commerce between the

[7] This quote from *Miller Brothers* forms the sole basis for the Court's holding in *National Geographic*. As explained in *Quill*, however, this language relates exclusively to Due Process Clause considerations. This is yet further evidence that the *National Geographic* Court failed to consider the taxpayer's challenge under the Court's current view of the Commerce Clause.

states. *Quill*, 504 U.S. at 309. The Court noted that its Commerce Clause jurisprudence had evolved from a formalistic approach to a more flexible analysis of the impact of state tax laws on interstate commerce. *See id.* at 309-312. The Court concluded its discussion by confirming that all state tax laws challenged under the Commerce Clause must be evaluated under the four-prong test in *Complete Auto*. *Id.* at 313 (stating that the constitutional analysis in *Complete Auto* best addresses the purpose of the Commerce Clause).

As stated by the Court in *Quill*, a state tax survives a Commerce Clause challenge when it: "(1) is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State." *Id.* at 311 (quoting *Complete Auto*, 430 U.S. at 279). This four-prong Commerce Clause analysis makes no appearance – directly or indirectly – in *National Geographic*.

The takeaway from the *Quill* decision is that the holding in *National Geographic* was at-best incomplete. The test applied by the Court in *National Geographic* to evaluate whether dissociation could be used for sales and use taxes dealt solely with concerns specific to the Due Process Clause. We know this to be true based on the *Quill* Court's explanation of the unique underpinnings of both the Due Process Clause and the Commerce Clause. Moreover, the case relied on by the Court in

National Geographic for its holding – *Miller Brothers* – was the centerpiece of the *Quill* Court's Due Process Clause discussion.

Stated simply, the Court in *National Geographic* failed to properly address whether the concept of dissociation was consistent with the Commerce Clause. Because the first prong of the *Complete Auto* test requires that the tax "be applied to an activity with a substantial nexus with the taxing state," we know with certainty that "dissociation" is a concept consistent with the Commerce Clause.

In this case, the Company can dissociate sales made through the Retail Channel from the instate activities of the Wholesale Channel for purposes of the RST. The holding in *National Geographic* is of no assistance to this Court on this point of law. *Complete Auto* and *Quill* make clear through the requirement of "substantial nexus" that dissociation remains a part of any analysis under the Commerce Clause. Stated simply, *National Geographic* cannot be reconciled with the Court's later decisions under the Commerce Clause.

The identical facts that supported the Company's claim for dissociation for B&O tax purposes likewise support dissociation under the RST. The Retail Channel was set up to operate independently of the Wholesale Channel. CP 46. While all business operations of the Retail Channel were outsourced to third parties, all business operations relating to the Wholesale Channel were handled in-house at the Company. CP 46.

Unlike the Wholesale Channel, the Retail Channel had no payroll or property attributable to any physical presence in Washington. CP 45. Telephone inquiries from customers were handled in such a way to make certain that the Company's Retail Channel did not compete with the retail customers of the Wholesale Channel. CP 47.

Other than the "Dual Action Cleanse" product offered through both channels beginning in 2006, there was no overlap of products sold between the Retail Channel and the Wholesale Channel. CP 47. Products sold through the Retail Channel had different branding and packaging than those sold through the Wholesale Channel. CP 47.

Moreover, the Company's pricing strategy regarding Dual Action Cleanse made the cost of purchasing the nutritional product through the Wholesale Channel substantially cheaper than if the customer had purchased directly from the Company's Retail Channel. CP 49, 53-55. As a result, it is irrational to think that the sales of the "Dual Action Cleanse" product through the Wholesale Channel in any way helped promote or maintain the market for sales through the Retail Channel.

For these reasons, the Company is entitled to dissociate sales made through the Retail Channel from the instate activities of the Wholesale Channel for RST purposes. The RST assessment for the Period must be abated.

VII. CONCLUSION

The concept of dissociation is firmly entrenched in Washington law and in the U.S. Constitution. In this case, for B&O tax purposes, the Company has met the test imposed by Rule 193 to dissociate sales made through the Retail Channel. The Court's holding in *Norton* also makes clear that dissociation is part of the required Commerce Clause analysis. The undisputed facts of this case relating to the operations of the Wholesale Channel and the Retail Channel support dissociation of the retail sales for purposes of the B&O tax under either Rule 193 ***or*** *Norton.*

Relating to the assessment of the RST, the Company has demonstrated that, despite the holding in *National Geographic*, dissociation remains a viable tool under the Commerce Clause. The Court's rulings in *Complete Auto* and *Quill* support the Company's argument on this point of law. The facts of this appeal present a clear case for dissociation of the Company's retails sales for RST purposes.

For these reasons, the Company is not liable for B&O taxes or the RST with respect to all retail sales made by the Retail Channel during the Period. The holding of the lower court must be reversed.

RESPECTFULLY SUBMITTED this 11th day of March, 2015.

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DECLARATION OF SERVICE

The undersigned declares under penalty of perjury, under the laws of the State of Washington, that the following is true and correct:

That on March 11, 2015, I caused the foregoing document to be served on the persons identified below via e-mail and U.S. First Class Mail, postage prepaid:

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