44195-1

No. 869723

SUPREME COURT
OF THE STATE OF WASHINGTON

SPACE AGE FUELS, INC.,

Appellant,

v.

STATE OF WASHINGTON,

Respondent.

REPLY BRIEF OF APPELLANT

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A. INTRODUCTION

As Space Age noted in its opening brief, this case offers the Court an opportunity to further clarify what constitutes substantial nexus under the Commerce Clause in an era when such clarification is essential for businesses. This is particularly important in light of the "market exploitation" definition of substantial nexus advocated by the State in its response brief. This argument has been rejected by the United States Supreme Court, and for good reason. It improperly reduces the distinct Commerce Clause substantial nexus standard into the "minimum contacts" Due Process Clause analysis, effectively subjecting any business whose products touch Washington to taxation in Washington. Moreover, it provides no articulable standard that would allow an out-of-state business to determine when it is subject to taxation in Washington. The Court should decline the State's invitation to adopt the "market exploitation" analysis, and instead continue to apply well-established existing United States Supreme Court precedent.

Under that precedent, an out-of-state vendor whose only connection with the taxing state is that its products are delivered by common carrier of the United States mail does not have the required

substantial nexus. Moreover, "the crucial factor governing nexus is whether the activities performed in [the taxing] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales." *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1997), quoting *Tyler Pipe Industries, Inc. v. State Department of Revenue*, 105 Wn. 2d 318, 323, 715 P.2d 123, 126 (1986). If the taxpayer's in-state activities are not "significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales," the required substantial nexus does not exist, regardless of the frequency or dollar amount of sales made to in-state residents.

Contrary to the State's argument, this Court is not free to ignore the "crucial factor" analysis of *Tyler Pipe* and replace it with the ill-defined and potentially unlimited "market exploitation" test. The *Tyler Pipe* analysis applies to all cases where the out-of-state taxpayer challenges the state's tax on Commerce Clause grounds. Under that analysis, Space Age does not have the required substantial nexus with Washington, and the trial court erred in holding that Space Age's deliveries

of fuel to Washington wholesale customers, standing alone, created substantial nexus.

B. ARGUMENT

(1) United States Supreme Court Precedent Establishes the Framework for Evaluating the Issue of Substantial Nexus

Under the *Complete Auto* test established by the United States Supreme Court in 1977, the courts will sustain a state tax against a Commerce Clause challenge if, *inter alia*, "the tax is applied to an activity with substantial nexus with the taxing State." *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977).

Ten years later the Court explained in *Tyler Pipe* what is necessary for substantial nexus to exist under the Commerce Clause: "the crucial factor governing nexus is whether the activities performed in [the taxing] state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales." *Tyler Pipe*, 483 U.S. at 250, quoting *Tyler Pipe,* 105 Wn. 2d at 323, 715 P.2d at 126.

Five years after that the Court decided *Quill Corp. v. North Dakota*, 504 U.S. 928, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992). *Quill* involved the question of whether North Dakota could require an out-of-

which businesses in interstate commerce can reasonably predict whether they subject themselves to taxation in Washington.

The fact that *Quill* involved sales and use taxes is no basis for concluding that its holding is not equally applicable to other kinds of taxes. From a constitutional law perspective, there is no principled reason why physical presence should be required for sales and use taxes, but not for other kinds of taxes. In *Rylander v. Bandag Licensing Corp.*, 18 S.W.3d 296 (Tex. Ct. App. 2000), the court held that *Quill* applied to the state's effort to impose a franchise tax. The court rejected the argument that *Quill* was limited to sales and use taxes, reasoning that

> [w]hile the decisions in *Quill Corp.* and *Bellas Hess* involved sales and use taxes, we see no principled distinction when the basic issue remains whether the state can tax the corporation at all under the Commerce Clause. As construed in *Quill Corp.* and *Bellas Hess*, when the corporation conducts its activity solely through interstate commerce and lacks any physical presence in the state, no sufficient nexus exists to permit the state to assess tax.

Id. at 300.

Likewise, in *J.C. Penney National Bank v. Johnson*, 19 S.W.3d 831(Tenn. Ct. App. 1999), the court held that *Quill* applied to the state's efforts to impose franchise and excise taxes. The court rejected the state's argument that *Bellas Hess* and *Quill* were limited to sales and use taxes:

> [w]hile it is true that the *Bellas Hess* and *Quill* decisions focused on use taxes, we find no basis for concluding that the analysis should be different in the present case. * * * [W]e are not in a position to speculate as to how the Supreme Court might decide future cases. We are only able to rely on past decisions. Any constitutional distinctions between the franchise and excise taxes presented here and the use taxes contemplated in *Bellas Hess* and *Quill* are not within the purview of this court to discern. As such, we feel that the outcome of this case is governed by *Bellas Hess* and *Quill*, as those decisions interpret the first prong of the *Complete Auto* test.

Id. at 300.[5]

In the absence of any United States Supreme Court sanctioned reason for applying *Quill* to one type of tax, but not another, it must be presumed that the same constitutional principles apply to all types of taxes. It would be poor policy indeed to have different constitutional standards of nexus for a myriad of different types of taxes. After all, the Commerce Clause addresses "structural concerns about the effects of state regulation on the national economy," *Quill*, 504 U.S. at 312, and there is no reason to

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[5] Space Age acknowledges that some courts hold to the contrary. Among other things, the problem with the reasoning of those other courts is that they essentially rely on Due Process analysis, and fail to recognize that something more is required when a tax is challenged on Commerce Clause grounds. Those courts come perilously close to collapsing Due Process Clause nexus and Commerce Clause nexus into a very minimal connection that would subject any business whose products touch Washington to taxation. Again, *Quill* held that such standards must remain distinct.

suppose that those structural concerns are any less present when evaluating types of taxes other than sales and use taxes.

Under *Quill's* physical presence rule, the State could not constitutionally impose the B&O tax on Space Age if its fuel was delivered to Washington customers by common carrier. In light of the reasons for the Commerce Clause, there is no reason to think that the result would be any different simply because Space Age itself delivered the fuel in its own trucks. If the Court draws this distinction, it will be creating a tax incentive for out-of-state businesses to deliver goods by common carrier. Regardless of whether the fuel was delivered by common carrier or in Space Age's own trucks, Space Age lacks the requisite physical presence in Washington required by *Bellas Hess* and *Quill*.

(4) This Court Should Reject the State's Attempt to Replace the "Crucial Factor" Analysis Mandated by *Tyler Pipe* with an Ill-Defined and Potentially Unlimited "Market Exploitation" Test

In the event that the Court declines to revisit that part of *Lamtec* where it declined to decide the issue of whether physical presence is required, it should continue to adhere to the analytical framework used in *Lamtec*. Only halfway through its response brief does the State begrudgingly acknowledge the "crucial factor" analysis of *Tyler Pipe*.

Resp. Br. at 18-19. The State seeks, however, to limit that analysis to cases "analyzing whether an out-of-state business that engages in in-state solicitation or similar sales supporting activities has sufficient connections with this state to meet the jurisdictional requirements of the dormant Commerce Clause." *Id.* at 19. The State further contends that this court should not "use[ ] the standard applied in *Tyler Pipe*, and later in *Lamtec* * * * as a one-size fits-all 'litmus test.'" *Id.* at 19.

The State's argument that the Court should not apply *Tyler Pipe* is directly opposite to the position it advanced to this Court in *Lamtec*. In a brief filed with this court a little over two years ago the State said that

> [o]ver twenty years ago, this Court established the modern test for determining whether an out-of-state seller of goods has sufficient nexus with a state to allow taxation of the seller without running afoul of the dormant Commerce Clause of the United States Constitution. In *Tyler Pipe Indus. Inc. v. Dep't of Revenue*, 105 Wn.2d 318, 715 P.2d 123 (1986), this Court held that a seller has sufficient nexus with Washington to be subject to taxation if its in-state activities are significantly associated with establishing and maintaining a market in the state. *Id.* at 323. The United States Supreme Court adopted the standard announced by this Court, and subsequent case law reinforces that this standard remains the law for determining which out-of-state sellers are subject to Washington's business and occupation (B&O) tax on wholesale sales. *Tyler Pipe Indus., Inc. v. Wash. Dep't of Revenue*, 483 U.S. 232, 251, 107 S. Ct. 2810, 87 L. Ed. 2d 199 (1987); *General Motors Corp. v. City of Seattle*, 107 Wn. App. 2d 42, 49, 25 P.3d 1022 (applying *Tyler Pipe* standard to uphold city B&O tax),

review denied, 145 Wn. 2d 1014 (2001), *cert. denied*, 535 U.S. 1056 (2002).

Respondent Department of Revenue's Supplemental Brief, 2010 WL 3027922, at *1 (May 7, 2010) (emphasis added). The State went on to assert that Lamtec improperly asked the court to "abandon its prior holding." *Id.*

Now, a little more than two years later, the State asks the Court to abandon the *Tyler Pipe* analysis by contending that it should not be universally applied (because application of that analysis here would render the tax unconstitutional, *see infra*). The State's argument would effectively subject any business that touches Washington to Washington taxation, a result beneficial to the State, but contrary to constitutional law.

In one limited sense, the State is correct. As Space Age argued in its opening brief, in-state activities that are "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state" are activities that occur at the initial and ongoing solicitation stages of the customer relationship and are designed to generate an original or subsequent sale. That is because a company "establish[es] and maintain[s] a market" by making initial and subsequent sales of its products or services. Absent sales, there is no market. Under the *Tyler Pipe* "crucial

factor" analysis, absent these types of in-state activities, there is no substantial nexus.[6]

The State is incorrect, however, when it asserts that the *Tyler Pipe* analysis is not the analysis generally applicable to all cases where the taxpayer challenges the existence of substantial nexus on Commerce Clause grounds, and that substantial nexus can exist in the absence of in-state activities that are "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state." Nothing in *Tyler Pipe* suggests that substantial nexus exists in the absence of in-state activities that are "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state." And nothing in *Tyler Pipe* suggests that a different analysis applies if application of the *Tyler Pipe* analysis results in the state being unable to constitutionally impose the tax in question.

The State's reliance on *D.H. Holmes Company, Ltd. v. McNamara*, 486 U.S. 24, 108 S. Ct. 1619, 100 L. Ed. 2d 21 (1988), Resp. Br. at 11, is misplaced because that case does not indicate that the *Tyler Pipe* analysis is not the generally applicable Commerce Clause analysis. In *D.H.*

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[6] *See generally* pages 20-25 of Space Age's opening brief.

Holmes, the Court, not surprisingly, held that there was "nexus aplenty" to allow Louisiana to impose a use tax on catalogs printed out-of-state and sent to Louisiana residents where the taxpayer, who had 13 retail stores in Louisiana, "admit[ted] that it initiated the distribution to improve its sales and name recognition among Louisiana residents." *Id.* at 32. The Court noted that the distribution "was directly aimed at expanding and enhancing [the taxpayer's] Louisiana business." *Id.* at 33. This is simply another way of saying that the in-state activities of the taxpayer were "significantly associated with the taxpayer's ability to establish and maintain a market in [Louisiana] for sales."[7]

In addition, deliberately or not, the State is vague on the analysis that it thinks should be used in lieu of the *Tyler Pipe* analysis. Based on its repeated and breathless recitations of how much fuel Space Age sold to Washington customers and how many miles Space Age trucks drove in

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[7] The State's reliance on *Oklahoma Tax Commission v. Jefferson Lines, Inc.*, 514 U.S. 175, 115 S. Ct. 1331, 131 L. Ed. 261 (1995), Resp Br. at 11, is also misplaced because it likewise does not suggest that *Tyler Pipe's* analysis does not generally apply. In that case, which involved a sales tax on an interstate bus ticket, the taxpayer did not argue that there was a lack of nexus to the in-state portion of the bus service, but rather that it was lacking as to the out-of-state portion. *Id.* at 184. That argument, held the Court, went to the second prong of the *Complete Auto* test, not the first one. *Id.*

Washington to deliver that fuel, the State's argument ultimately appears to be that because Space Age sold a lot of fuel to Washington customers, and delivered the fuel in its own trucks, substantial nexus must necessarily exist because Space Age is "exploiting" the Washington market.

The Court should reject the State's attempt to broaden the scope of "substantial nexus" as set forth in *Tyler Pipe*. As an initial matter, the State's own regulation mirrors the *Tyler Pipe* analysis. WAC 458-20-193(2)(f) defines "nexus" as "the activity carried on by the seller in Washington which is significantly associated with the seller's ability to establish or maintain a market for its products in Washington." The State should not be allowed to so cavalierly abandon its own interpretive regulation, upon which businesses relied, and back away from its stated definition of nexus simply because application of that rule would render application of the tax to Space Age in this case unconstitutional.

Moreover, the United States Supreme Court has never held that the sort of "market exploitation" test being advanced by the State is sufficient to pass muster under the Commerce Clause.[8] United States Supreme Court precedent establishes that it is the type of in-state activities that is

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[8] In fact, as noted above, the Court rejected that view in both *Bellas Hess* and *Quill*.

significant, not the size of the non-resident taxpayer's economic presence in the taxing state.[9] *Tyler Pipe* makes two things clear. First, the relevant activities for nexus purposes, are the in-state activities on behalf of the taxpayer: "the crucial factor governing nexus is whether the activities performed in [the taxing state] on behalf of the taxpayer . . . ." *Tyler Pipe*, 483 U.S. at 250 (emphasis added). Second, the relevant inquiry is whether those in-state activities "are significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales." *Id.* If the in-state activities themselves are not "significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales," there is no substantial nexus, regardless of the frequency or dollar volume of products that the taxpayer may ultimately sell into the taxing state.

The State's argument also fails to acknowledge the difference between Due Process Clause analysis and Commerce Clause analysis. As noted above, *Quill* makes clear that there is a distinction in the analysis under the two clauses. The State's "exploiting the market" argument,

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[9] In *Quill*, the fact that the taxpayer sold over $1 million in goods to over 3,000 customers in North Dakota was insufficient to create the required substantial nexus under the Commerce Clause.

however, reduces the analysis to a pure Due Process Clause analysis. In *Quill* the Court upheld North Dakota's tax against a Due Process Clause challenge because the taxpayer "purposefully directed its activities at North Dakota residents [and] the magnitude of those contacts is more than sufficient for due process purposes." *Quill*, 504 U.S. at 308. This was not, however, enough to sustain the tax against a Commerce Clause challenge, despite the significant volume of sales to North Dakota customers. Something more is required for substantial nexus to exist for Commerce Clause purposes; significant sales to in-state customers simply is not enough. The State's "economic exploitation" argument fails to recognize the Due Process Clause-Commerce Clause distinction set forth in *Quill*.

Finally, the State's argument fails to set forth any sort of workable principle or guidance by which the presence or absence of substantial nexus may be determined. If "market exploitation" is the "test," what type of activity amounts to "exploiting the market"? How much "exploitation" is enough to create substantial nexus? If a business sends its products to Washington by United States mail, common carrier, or electronic transmission, without having a physical presence in Washington, is that an "exploitation" of the Washington market? Is hiring outside counsel in

Seattle to review a contract "exploiting" the Washington market? What about visiting a client at Sea-Tac during a layover? How can taxpayers determine in advance when the State will claim that their activities are subject to the B&O tax? If the Court does not adopt an articulable standard an out-of-state business cannot structure its business model, prepare its financial statements, or know how much money to reserve for potential taxes, interest, and penalties. The State's proposed "market exploitation" test would subject taxpayers and the courts to inevitable and substantial uncertainty and litigation, two outcomes the Court should seek to avoid.

While the State accuses Space Age of turning back the clock to pre-*Complete Auto* days, Resp. Br. at 21, Space Age is doing no such thing. Space Age is simply asking the Court to apply the "substantial nexus" prong of the *Complete Auto* test, as subsequently interpreted by *Tyler Pipe*. As the State acknowledged in its brief in *Lamtec*, the *Tyler Pipe* standard "remains the law for determining which out-of-state sellers are subject to Washington's business and occupation * * * tax on wholesale sales." Respondent Department of Revenue's Supplemental

Brief, 2010 WL 3027922, at *1. The State is not free to disregard it just because the State now claims that it is outdated.[10]

(5) Space Age's In-State Activities, the Deliveries, are not Significantly Associated with Space Age's Ability to Establish and Maintain a Market for Sales in Washington

Space Age's only activities in Washington are the deliveries of the fungible fuel that Washington customers have already decided to buy based on Space Age's ability to sell at the lowest price.[11] The activity of delivery is not "significantly associated with [Space Age's] ability to

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[10] As the Supreme Court has stated: "If a precedent of this Court has direct application in a case, yet appears to rest on reasons rejected in some other line of decisions, [lower courts] should follow the case which directly controls, leaving to this Court the prerogative of overruling its own decisions." *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 484 (1989). The Court has repeatedly applied this rule of constitutional law to state tax cases. *See, e.g., American Trucking Ass'ns, Inc. v. Smith*, 496 U.S. 167, 180 (1990); *Quill*, 504 U.S. at 320 (Scalia, J., concurring, quoting *Rodriguez de Quijas* and concluding that: "It is strangely incompatible with this to demand that private parties anticipate our overrulings.... [R]eliance upon a square, unabandoned holding of the Supreme Court is always justifiable reliance").

[11] Although the State contends that the "sale" is not completed until the fuel is delivered in Washington, Resp. Br. at 3, 6, 18, that would also be true of deliveries by United States mail or common carrier. The Court need not involve itself with that issue, however, because it is not relevant to the instant case. The important fact here is that the sale was not based on any in-state activities by Space Age, but rather that the customer had already decided to purchase the fuel, before it was delivered, based on the low price.

establish and maintain a market in this state for sales" because the deliveries have nothing to do with the customers' decision to purchase fuel from Space Age originally or in the future. Space Age's customers purchase fungible fuel based on one factor only: price.

Rebutting an argument that Space Age did not make, the State argues that substantial nexus does not require the in-state solicitation of sales. Resp. Br. at 16. What Space Age did argue is that for in-state activities to be "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state" those activities must occur at the initial or ongoing solicitation stages of the customer relationship and be designed to generate an original or subsequent sale. App. Br., at 21. Space Age's argument rests on the unremarkable principle that in order to establish or maintain a market a company must make initial and ongoing sales. If the activity in question is not designed to generate sales, by solicitation or otherwise, it simply is not "significantly associated with the taxpayer's ability to establish and maintain a market in [the taxing] state."

Neither *Standard Pressed Steel v. Washington Department of Revenue*, 419 U.S. 560, 95 S. Ct. 706, 42 L. Ed. 2d 719 (1975), nor *Dell*

Catalog Sales, L.P. v. Taxation and Revenue Department of New Mexico, 145 N.M. 419, 199 P.3d 863 (N.M. Ct. App. 2008), *cert. denied*, ___ U.S. ___, 129 S. Ct. 1616 (2009), is to the contrary. As the State notes, in *Standard Pressed Steel* the taxpayer's local employee's "primary duty was to consult with Boeing regarding its anticipated needs and requirements." *Id.* at 561. As Space Age pointed out in its opening brief, the purpose of such consultation, of course, was so that the taxpayer could make future sales to Boeing; the Court explained that the local employee "made possible the realization and continuance of valuable contractual relations between [the taxpayer] and Boeing." *Id.* (emphasis added). Likewise, in *Dell Catalog Sales* the availability of the post-sale warranty repair services offered by the taxpayer's vendor in New Mexico was an important factor in allowing the taxpayer to make sales of computers in the first instance. *Dell Catalog Sales*, 145 N.M. at 429, 199 P.3d at 873. In contrast, delivery of the fuel by Space Age in the present case contributed nothing to Space Age's ability to make the sales in question, since the customers' purchasing decisions were based solely on price.

The State's reliance on out-of-state cases for its "delivery alone is sufficient to create substantial nexus" argument, Resp. Br. at 21-24, was

anticipated, and should be rejected for the reasons set forth in Space Age's opening brief. App. Br. at 27-30. As explained therein, some of the cases involved Due Process challenges to the tax at issue, and in all of the cases there was some activity by the taxpayer in the taxing state beyond delivery. *Id.* And most important, the state courts did not apply the *Tyler Pipe* analysis because they did not inquire if the deliveries were "significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales." *Tyler Pipe*, 483 U.S. at 250.

Analyzing the line of United States Supreme Court cases, from *Standard Pressed Steel* through *Quill* indicates that the Supreme Court will find that substantial nexus exists in cases like *Standard Pressed Steel* and *Tyler Pipe*, where the taxpayer's in-state activities were designed to generate original or subsequent sales, but not in cases like *Bellas Hess* and *Quill*, where the in-state activity was simply delivery of a product. After all, some form of delivery occurs in every interstate transaction in goods, and if delivery alone were enough to create substantial nexus, surely the Supreme Court would have said so long ago.[12]

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[12] The State also suggests that substantial nexus exists because Space Age obtained motor fuel and fuel supply licenses from the State. Resp. Br. at 20. Obtaining a license to conduct business in a state is not, however, an event that creates [footnote continued on next page]

C. CONCLUSION

The United States Supreme Court has never held that delivery alone by an out-of-state company amounts to the "substantial nexus" that is required before a State may impose a tax on that company without violating the Commerce Clause. Indeed, that Court's precedent holds that an out-of-state vendor whose only connection with the taxing state is that its products are delivered by common carrier of the United States mail does not have the required substantial nexus that would allow the State to impose a sales or use tax without violating the Commerce Clause. There is no reason to suppose that delivery of the same products by the vendor in its own trucks, or the fact that the tax at issue is a B&O tax, leads to any different result. Since Space Age's only contacts with Washington are the deliveries of fuel, it lacks the requisite substantial nexus to allow the State to impose its B&O tax.

Under the *Tyler Pipe* analysis, which focuses on the "crucial factor" of whether the in-state activities are "significantly associated with the taxpayer's ability to establish and maintain a market in this state for sales," Space Age lacks the requisite substantial nexus. This is because

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substantial nexus. *Rylander*, 18 S.W.3d at 298-300.

Space Age's only in-state activities are the deliveries of fuel that the customer has already determined to purchase based on price alone. The deliveries are not activities designed to generate original or subsequent sales of fuel in Washington, but simply the inevitable step in any interstate sales transaction.

DATED this 12th day of September, 2012.

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DECLARATION OF SERVICE

On said day below I mailed and deposited in the U.S. Mail a true and accurate copy of the Motion for Extension of Time in Supreme Court Cause No. 86972-3 to the following parties:

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I declare under penalty of perjury under the laws of the State of Washington and the United States that the foregoing is true and correct.

Dated September 12, 2012, at Portland, Oregon.

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Clerk – Attached please find the Reply Brief of Appellant for filing in the captioned case. Thank you.

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