NO. 45108-5

COURT OF APPEALS, DIVISION II
OF THE STATE OF WASHINGTON

STATE OF WASHINGTON, DEPARTMENT OF REVENUE,

Appellant/Cross-Respondent,

v.

AVNET, INC.,

Respondent/Cross-Appellant.

BRIEF OF APPELLANT/CROSS-RESPONDENT

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I. INTRODUCTION

This case concerns the application of Washington's business and occupation (B&O) tax to the wholesale sale of goods made by "drop shipment." In a drop shipment, a wholesale seller sells goods to a wholesale buyer, who orders the goods to be shipped directly to the wholesale buyer's own customer. In other words, the supplier/distributor makes a wholesale sale to its customer, who then resells the goods to its own customer. A drop shipment thus involves two sale transactions but only one physical delivery of goods. The issue in this case is whether that single physical delivery determines where both of the sale transactions occurred for B&O tax purposes.

Washington, like nearly every other state, assigns an interstate sale to the place where physical possession of the goods transfers to the buyer, i.e. the shipping destination. In a drop shipment transaction, however, the wholesale buyer *never* takes physical possession of the goods sold. Nevertheless, a sale indisputably occurs.

Avnet, Inc. makes wholesale sales of goods that are shipped into Washington by common carrier. A substantial portion of Avnet's sales are drop-shipments to the Washington customer of an out-of-state purchaser. Avnet argued, and the trial court agreed, that the wholesaling B&O tax does not apply to its drop-shipment transactions because the goods were

not received in this state "by the purchaser" within the meaning of WAC 458-20-193 (Rule 193), an administrative rule that explains how the B&O tax applies to interstate sales of goods.

The trial court's interpretation of the Department of Revenue's rule leads to absurd results and should be reversed. Rule 193 identifies where in the chain of commerce an interstate sale occurs and it treats "inbound" and "outbound" sales the same. This ensures the B&O tax is fairly apportioned and non-discriminatory as required by the Commerce Clause. Properly applied, Rule 193 assigns each interstate sale to a single state--no more and no less. Under the trial court's reading of the Rule, however, wholesale sales made by drop shipment are removed entirely from the universe of potentially taxable transactions.

In view of the legislative intent to impose the B&O tax on "virtually all business activity" in this state, the only reasonable interpretation of Rule 193 is that both of the sale transactions in a drop shipment arrangement occur upon when the goods are received at the shipping destination. If the goods are shipped to a Washington destination, the sale is deemed to occur in Washington.

Not only have these sales occurred in Washington for purposes of the B&O tax, but Avnet has sufficient constitutional "nexus" with Washington to be taxed. Avnet's in-state activities that support its market

dwarf the minimum "nexus" required to be subject to taxation, and Avnet is not entitled to "dissociate" its drop shipment sales from its in-state nexus-creating activities. Accordingly, this Court should reverse the trial court and grant summary judgment to the Department.

II. ASSIGNMENTS OF ERROR

1. The trial court erred by ruling that the receipt of goods at the shipping destination by the purchaser's designee does not constitute receipt "by the purchaser" for B&O tax purposes.

2. The trial court erred by failing to hold as a matter of law that Avnet cannot "dissociate" any of its Washington-destination sales from its concededly taxable sales.

3. The trial court erred by denying the Department's motion for summary judgment as to Avnet's "third party drop shipment sales."

III. ISSUES

1. Does a wholesale sale transaction occur in Washington for B&O tax purposes when the goods sold are shipped into the state by common carrier and received by the purchaser's designee?

2. Can a centralized, functionally integrated multistate business like Avnet that has nexus with Washington "dissociate" a portion of its Washington sales from its instate business activities by establishing that none of its local personnel participated in a specific sales transaction?

IV. STATEMENT OF THE CASE

Avnet is one of the world's largest distributors of electronic components, computer products, and embedded technology. CP 424. Avnet markets and sells goods produced by more than 300 electronic component manufacturers and software developers to more than 100,000 customers worldwide. CP 500. It operates out of 250 locations, with 35 offices in the United States, including an office in Redmond, Washington.

A. Avnet's Revenues From Washington Destination Sales.

From 2003 through 2005, Avnet earned more than $200 million in revenues from its sales of goods shipped into Washington by common carrier from an out-of-state warehouse (Washington destination sales). On the state excise tax returns it filed with the Department, Avnet failed to include approximately $80 million of its gross receipts from those Washington destination sales. CP 111.

Avnet identified two categories of Washington destination sales that it claimed were not subject to B&O tax: (1) sales of goods shipped to the Washington office of a multistate business, for which Avnet alleged there was no involvement by the local sales office (which it labeled "National Sales"), and (2) sales of goods shipped to the Washington customer of an out-of-state purchaser (which it labeled "Third Party Drop-Shipments"). CP 5-6.

In a "National Sale," Avnet makes a wholesale sale to a customer that has branch offices in multiple states, including Washington. The product is delivered to the customer in Washington, but the goods are billed to the customer's out-of-state office. For example, Intel Corporation purchased products for delivery to its office in Dupont, Washington, but directed Avnet to send the bill to Intel's Oregon headquarters. CP 228.

In a "Third Party Drop Shipment," an out-of-state customer orders a product from Avnet and directs Avnet to deliver the product to a Washington destination. For example, Solutions-II, Inc., located in Littleton, Colorado, purchased products for delivery to the Deaconess Medical Center in Spokane, Washington. CP 257.

B. Avnet's Business Model.

Avnet is organized into different operating groups, which are subdivided into divisions that serve specific product lines and geographic areas. CP 500. Avnet's sales and marketing divisions generally focus on a specific customer segment, particular product lines provided by a specific group of suppliers, or on a specific geography. CP 501.

Each division "relies heavily on the support services that are provided centrally within each operating group and centralized support at the corporate level." CP 500. In a report to investors, Avnet explained

that the traditional linear supply chain "is evolving into a broad more complex structure – a value web characterized by an interconnected marketplace where the boundaries between buyers and sellers blur, and where model configurations change with the rapidity of the latest technological advance. Avnet is at the center of this value web." CP 446.

Avnet's "legacy business" is the sale of goods to the "traditional buyer, who may choose to do business by telephone, online or both." CP 453. Approximately 45% of Avnet's sales are ordered online. CP 425. Avnet also works with customers and suppliers to achieve the integration of its suppliers' components into the products manufactured by other suppliers. This is known as a "design win." CP 507, 510, 512. Achieving and monitoring design wins is an important component of Avnet's growth strategy. Avnet employs field engineers who work closely with customers to monitor product performance and design improvements that anticipate the future needs of the customer. Avnet feeds this information back to its suppliers so they can incorporate design improvements into their products to ensure a continuing market for the goods.

C. Avnet's Business Activities In Washington.

During the tax period at issue (2002 through 2005), Avnet had from 44 to 52 employees stationed at its branch office in Redmond, Washington. CP 59-64. Avnet's employees in Washington included

sixteen to eighteen Account Managers who were responsible for identifying the product and service needs of customers within their geographic area, developing sales strategies, and coordinating their efforts with other departments to maximize sales and profits. CP 474. Each Account Manager managed a portfolio of customer accounts that was expected to generate $4 million in annual sales revenue. *Id.* (see "Primary Duties and Responsibilities," 8th bullet point).

Avnet also employed seven or eight sales and marketing representatives in Washington. CP 476. These employees were responsible for soliciting new customer accounts and selling to existing customers, primarily through telephone communications. *Id.* They provided customers with current product information, negotiated prices, evaluated problem accounts, and interacted with manufacturers' representatives. *Id.* Avnet expected each sales representative to generate more than $2 million in annual sales revenue from sales to 15 or more existing and new customers. *Id.* (see "Distinguishing Characteristics").

A number of managers also worked at Avnet's Washington office, including the Regional Director, a District Manager, Business Development Manager, Sales Manager, Marketing Manager, Product Manager, and Manager of Emerging Accounts. CP 62, 64.

Avnet's District Manager in Washington managed the local branch's sales activities for new and existing accounts. CP 478. The District Manager coordinated the office's sales activities and reported on accounts, competitors, and suppliers to product management. *Id.* The District Manager also exchanged "market intelligence" with corporate headquarters and communicated relevant information to the local office staff. *Id.*

Avnet's Business Development Manager in Washington managed Avnet's accounts with both suppliers and customers. CP 480. This included meeting with both Avnet's sales team and the suppliers' sales teams to create greater demand for products and services. *Id.* The Business Development Manager made technology recommendations to Avnet's customers and also worked with design engineers to qualify products for adoption by customers. *Id.*

Avnet's Sales and Marketing Manager in Washington oversaw the sales and marketing activities at the Washington office and exchanged "market intelligence" with the corporate headquarters, including "market share, registration, head count analysis, and related data for market intelligence for district." CP 483.

Avnet's Sales Director in Washington developed relationships with existing and prospective suppliers and manufacturers, prepared sales

forecasts, developed sales strategies, supervised the sales and marketing representatives, established and cultivated positive relationships with customers, manufacturers and suppliers, assigned account responsibilities, consulted with other divisions to ensure sales made through the Washington office conformed to Avnet's current pricing, delivery and inventory policies, monitored sales performance and reported results to management. CP 485.

Avnet's Product Manager in Washington managed a group of assigned suppliers within the region and kept Avnet's sales force abreast of industry sales trends. CP 487. The Product Manager monitored and reported upon the daily order activity for the goods provided the suppliers. *Id.* The Product Manager also was involved in organizing trainings and meetings with the suppliers in order to add market/customer value. *Id.*

In addition to marketing and selling existing products, Avnet provided design services to help its suppliers make new and improved products. CP 451-53. Avnet employed field systems engineers in Washington to work directly with customers to better understand their needs and to help meet those needs by proposing design improvements. The duties of Avnet's Account Managers in Washington included working with Avnet's Field Application Engineers to help identify opportunities for "design wins." CP 510-12.

Avnet employed from three to five Field Application Engineers and four or five Technology Consultants in Washington. CP 59-64. The Engineers worked directly with local customers to answer their questions, demonstrate products, install computers and software, instruct customers in the use of equipment, and resolve customer problems with the assistance of local suppliers or technical support centers. CP 490.

Avnet also employed a Senior Systems Engineer in Washington from 2002 through 2005. CP 492-94. The Senior Systems Engineer's duty was to provide product, technical, and engineering support to Avnet's customers and sales staff. CP 492. In addition, the Senior Systems Engineer was involved with research, design, and development of new electronic components, including building prototypes and documenting their technical specifications. *Id.*

Avnet's marketing materials and website identify its Redmond, Washington office as one of its branch locations and lists the telephone number, physical address, and links to a map showing the office's location. CP 427-30, 472.

D. Procedural History.

Following an audit of Avnet's books and records, the Department assessed it wholesaling B&O tax for its unreported Washington destination sales. CP 5. The Department's Appeals Division affirmed the

assessment. CP 7. Avnet paid the contested assessment and then filed a tax refund action in Thurston County Superior Court. CP 7.

In its complaint, Avnet alleged that Washington's B&O tax does not apply to the contested sales transactions for two reasons. CP 6. First, Avnet argued the assessments violated the Commerce Clause because the state lacked adequate "nexus" with the contested sales. *Id.* Second, Avnet alleged the sales did not occur in Washington under the Department's rule on interstate sales because they were not "received by the purchaser" in this state. *Id.*

On cross-motions for summary judgment, the trial court agreed with Avnet's interpretation of the Department's rule and granted summary judgment to Avnet as to its "third party drop shipments." CP 700; Verbatim Report of Proceedings (VRP) at 30-31. The trial court did not address Avnet's constitutional "nexus" claim as applied to the contested drop-shipment transactions. However, the trial rejected Avnet's constitutional "nexus" claim as to its "National Sales" and granted summary judgment to the Department on that issue. CP 700. Both parties appealed.

V. SUMMARY OF THE ARGUMENT

The Department properly assessed tax on Avnet for its sales of products shipped to Washington. Contrary to Avnet's proposed

interpretation, the Department's application of its rule to tax these sales maintains the consistency of the taxing scheme and does not lead to absurd results. Moreover, the Commerce Clause does not prevent Washington taxation of these sales. Avnet has an enormous, physical presence in Washington, and it is not entitled to disregard this presence by attempting to "dissociate" its sales from its market-creating activities. Accordingly, this Court should reverse the trial court and grant summary judgment to the Department.

VI. ARGUMENT

A. This Court Applies The De Novo Standard Of Review To The Trial Court's Summary Judgment Order, Giving Substantial Weight To The Department's Interpretation Of The Law It Administers.

This Court reviews a trial court's summary judgment order de novo. *Lamtec Corp. v. Dep't of Revenue*, 170 Wn.2d 838, 843, 246 P.3d 788 (2011). In a tax refund lawsuit, the taxpayer has the burden of showing that the tax is improper. *Id.*; RCW 82.32.180. In other words, "taxes are presumed to be just and legal, and the burden rests upon one assailing the tax to show its invalidity." *Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 41, 156 P.3d 185 (2007) (internal quotations and citation omitted).

The Legislature directed the Department to adopt "rules and regulations, not inconsistent therewith, necessary to enforce" the state's tax laws. RCW 82.32.300. As with statutes, the language of the Department's rules "should not be read in isolation but rather within the context of the regulatory and statutory scheme as a whole." *Department of Revenue v. Nord Nw. Corp.*, 164 Wn. App. 215, 225, 264 P.3d 259 (2011). Moreover, courts avoid interpreting a tax regulation in a way that leads to an absurd result. *North Cent. Wash. Respiratory Care Servs., Inc. v. Dep't of Revenue*, 165 Wn. App. 616, 637, 268 P.3d 972 (2011).

B. The Legislature Intended That, Absent An Applicable Statutory Exception, The B&O Tax Be Applied To All Selling Activities Within The State To The Fullest Extent Constitutionally Permissible.

Washington imposes a B&O tax on every person "for the act or privilege of engaging in business activities." RCW 82.04.220. "Engaging in business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140; *Ford Motor*, 160 Wn.2d at 42 (discussing local B&O taxes). The B&O tax applies to different categories of activities, including "making sales" within the state. RCW 82.04.250 (tax on retailers); RCW 82.04.270 (tax on wholesalers). A "sale" means "any transfer of the ownership of, title to, or possession of property for a

valuable consideration[.]" RCW 82.04.040(1). The measure of the wholesaling B&O tax is the "gross proceeds of sales." RCW 82.04.070.

In view of these broad provisions, the Supreme Court repeatedly has emphasized that when the Legislature enacted the B&O tax, it intended "to tax all business activities not expressly excluded." *Coast Pac. Trading, Inc. v. Dep't of Revenue,* 105 Wn.2d 912, 917, 719 P.2d 541 (1986). The Department's administrative regulations must be interpreted and applied consistently with that legislative intent. *Id.*

RCW 82.04.4286 is a catchall provision that excludes from taxation "amounts derived from business which the state is prohibited from taxing under the Constitution of this state or the Constitution or laws of the United States." RCW 82.04.4286. The Legislature's express acknowledgement of the constitutional constraints imposed on the state's taxing power shows legislative intent that, absent an applicable specific statutory exception, the B&O tax is to be applied to the fullest extent constitutionally permissible. *Coast Pac. Trading,* 105 Wn.2d at 917.

C. For B&O Tax Purposes, A Sale Occurs Where The Buyer Takes Physical Possession Of The Goods Sold.

Avnet did not dispute that it made wholesale sales of electronic components and computer parts that were shipped into Washington to the place designated by the buyer. However, Avnet claimed the sales did not

occur in Washington because the buyer did not, itself, take physical possession of the goods in this state.

Although RCW 82.04.040 defines what a "sale" is, it does not address *where* a sale occurs for state tax purposes. Each interstate sale has a connection to at least two states, the state where the goods originate and the state where they are physically delivered.[1] Washington, like most other states, deems a sale to have occurred in the destination state.[2] The Department promulgated an administrative rule to address the issue. WAC 458-20-103 (Rule 103) states, in part:

> For the purpose of determining tax liability of persons selling tangible personal property, a sale takes place in this state when *the goods sold are delivered to the buyer in this state*, irrespective of whether title to the goods passes to the buyer at a point within or without this state.

(Emphasis added.)

Rule 193 explains that for the B&O tax to apply to an interstate sale of goods, there must be both receipt of the goods by the purchaser in this state and the seller must have nexus. Rule 193 provides, in part:

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[1] Other possibilities include the state where the sales office is located, the contract of sale was negotiated, where the purchaser resides, and where title was transferred, among others. *See Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 279, 98 S. Ct. 2340, 57 L. Ed. 2d 197 (1978) (states may have different rules regarding where a "sale" takes place for tax purposes). The important point is that a single standard apply to both inbound and outbound sales. *Cf. Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 97 S. Ct. 599, 50 L. Ed. 2d 514 (1977) (a tax that imposes a greater liability on out-of-state sales than on in-state sales runs afoul of the Commerce Clause).

[2] Forty-five states and the District of Columbia attribute sales receipts to the destination state. Jerome R. Hellerstein & Walter Hellerstein, State Taxation, ¶ 9.18[1] (3d ed. 2002) ("Receipts or Sales Factor").

> (3) **Outbound sales**. Washington state does not assess its taxes on sales of goods which originate in Washington if receipt of the goods occurs outside Washington . . . Where the seller *delivers the goods to the purchaser who receives them at a point outside Washington*, neither retailing nor wholesaling business tax is applicable.
>
> (7) **Inbound sales.** Washington does not assert B&O tax on sales of goods which originate outside this state unless *the goods are received by the purchaser in this state* and the seller has nexus. There must be both the receipt of the goods in Washington by the purchaser and the seller must have nexus for the B&O tax to apply to a particular sale. The B&O tax will not apply if one of these elements is missing.

(Emphasis added.)

The dispute in this case is whether the receipt of goods in Washington by the purchaser's designee is receipt "by the purchaser" for purposes of determining the place of sale. In a drop shipment transaction, the wholesale buyer *never* takes physical possession of the goods sold. Nevertheless, a wholesale sale indisputably occurs and it is consummated by the physical delivery of the goods to the shipping destination designated by the wholesale buyer. The only reasonable interpretation of Rule 193 is that the transfer of possession in Washington to the person designated by the person is receipt "by the purchaser" in this state.

It was necessary for the Department to adopt a place of sale rule because multiple events may trigger a sale and each may occur in a different state. *Cf. St. Regis Paper Co. v. State*, 63 Wn.2d 564, 568-69,

388 P.2d 520 (1964) (manufacturer made a "sale" within the state upon execution of contract of sale, notwithstanding that title, ownership *or* possession passed outside the state). For example, legal "ownership" may transfer to the buyer upon execution of the contract in one state, "title" to the goods may pass in a different state, and physical "possession" in yet another.

Rule 193 identifies where in the chain of commerce a sale will be deemed to have occurred for tax purposes and it applies the same standard to inbound and outbound sales to ensure it is logically impossible for the sale to occur in multiple jurisdictions. The provisions for outbound and inbound sales must be read together. These provisions parallel one another by locating an interstate sale at the place where the goods are physically delivered to the buyer.

As with any tax formula, Washington's place of sale rule results in foregoing tax revenues on some transactions that were mostly carried out within the state (e.g. outbound sales where the seller and purchaser both reside in Washington but the goods are received outside the state), while claiming the full taxable value of some transactions mostly carried out in another state (inbound sales where the seller and purchaser reside outside Washington but the goods are delivered to the buyer within the state by a seller with nexus). So long as a tax applies consistently to inbound and

outbound sales, a sale transaction is "properly measurable by the gross charge for the purchaser, regardless of any activity outside the taxing jurisdiction that might have preceded the sale or might occur in the future." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 186, 115 S. Ct. 1331, 131 L. Ed. 2d 261 (1995). Washington's consistent treatment of inbound and outbound sales ensures the constitutionality of its tax scheme, notwithstanding such imprecision. *Chicago Bridge & Iron Co. v. Dep't of Revenue,* 98 Wn.2d 814, 824-25, 659 P.2d 463 (1983) (*citing Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 279, 98 S. Ct. 2340, 57 L. Ed. 2d 197 (1978)), *appeal dismissed for want of substantial federal question*, 104 S. Ct. 542, 78 L. Ed. 718 (1983).[3]

One important justification for the "destination rule" is that attributing the sale to the destination state, where the goods likely will be used or consumed, better reflects the substance of the transaction than some factor readily susceptible to manipulation, such as the place an order is made, accepted, or fulfilled, the billing address, or some other element of the transaction that can be performed virtually anywhere in an age of electronic commerce. *Cf. Chicago Bridge*, 98 Wn.2d at 825 (the incidence of the B&O tax should not turn on matters of "[c]orporate convenience,"

[3] A dismissal for want of a substantial federal question operates as an affirmance and is binding authority on lower courts, unlike a denial of a petition for certiorari. *Hicks v. Miranda*, 422 U.S. 332, 344-45, 95 S. Ct. 2281, 45 L. Ed. 2d 223 (1975); *State v. Wanrow*, 91 Wn.2d 301, 309-10, 588 P.2d 1320 (1978).

such as where a contract of sale is negotiated or executed). Moreover, the market state has a fair claim to the transaction because it provides an environment that supports the demand for the seller's products. *See* Jerome R. Hellerstein & Walter Hellerstein, State Taxation, ¶ 8.06[3] (3d ed. 2002).

Properly applied, Rule 193 identifies each and every interstate sale of goods that are shipped into or out of Washington as either an "outbound sale" or an "inbound sale" based on the shipping destination. The trial court's interpretation of the rule creates a third category of "nowhere sales." The only reasonable interpretation of Rule 193 is that "receipt of the goods in Washington by the purchaser" includes receipt of the goods by the person designated by the purchaser. This interpretation of the Rule is supported by case law, the common law of sales, common sense, and is consistent with the legislative intent to apply the B&O tax in a manner that avoids both multiple taxation and nowhere taxation.

1. Rule 193 should be interpreted consistently with the common law principle that receipt by the purchaser's designee is receipt by the purchaser.

Rule 193 does not specifically address how the wholesaling B&O tax applies to drop shipments.[4] Under the common law of sales, however,

[4] However, the rule provides an example of how the retail sales tax and retailing B&O tax apply to an out-of-state retailer that uses a third-party supplier in Washington to deliver goods to a Washington customer. WAC 458-20-193(11)(h). The rule explains

receipt by the purchaser's designee is receipt by the purchaser for purposes of consummating a sale transaction. *See, e.g., Williamsburgh Stopper Co. v. Bickart*, 104 Conn. 674, 134 A.233 (1926) (delivery to the buyer's customers in accordance with his instructions is delivery to the buyer). During the summary judgment proceeding, Avnet argued the Department's reliance on commercial common law principles was contrary to both case law and the Department's own published guidance stating that the Uniform Commercial Code (UCC) is "not controlling" for B&O tax purposes. CP 669. Avnet's argument was inaccurate.

What courts and the Department have said is that the common law of sales and related UCC provisions are inapplicable to the extent they are *inconsistent* with the state's tax laws. *Cf. Lamtec Corp. v. Dep't of Revenue,* 151 Wn. App. 451, 460-61, 215 P.3d 968 (2009) (holding that Rule 193 controls over contrary UCC provisions regarding passage of title in determining the tax consequences of an interstate sale). Nothing prohibits the Department from drawing upon the common law in order to fill a gap when interpreting and applying the state's tax laws. *Cf. Nord*

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that the Washington supplier may accept a resale certificate from the out-of-state seller. This is consistent with the fact that the third-party supplier makes a wholesale sale to the out-of-state retailer when it delivers the goods, not a retail sale to the consumer. The rule also explains that the out-of-state seller is not subject to tax unless it has nexus in Washington. The rule conforms Washington's administration of the sales tax with the approach taken by the majority of the states. *See, generally*, Jerome R. Hellerstein & Walter Hellerstein, State Taxation, ¶ 18.04 (3d ed. 2002) ("Three Party Transactions: Drop Shipments and Similar Arrangements") (discussing thorny issues in the administration of the sales tax that arise in the drop shipment context).

Nw. Corp., 164 Wn. App. at 228-29 (interpreting tax regulation consistently with common law governing real property transactions).

In this case, neither the statutes nor the rules specifically address how the B&O tax applies to the wholesale sale made when a supplier delivers goods directly to the customer of the wholesale buyer.[5] The Department's place of sale rules presume that physical possession will transfer to the buyer at some point in the chain of commerce and that every sale may be classified accordingly as either "outbound" or "inbound." To conclude that *no* sale occurred is not consistent with the governing statutes, which preclude gaps in the application of the B&O tax to the extent not authorized by statute or required by the constitution. Thus, it is appropriate to fill the gap left by the Department's rule by applying both the common law and common sense in deciding whether receipt by the person designated by the wholesale buyer is receipt by the buyer for purposes of determining the place of sale.

Common law authorities fully support this interpretation. "[I]t is a well-established rule that delivery to a person appointed by the buyer to

[5] In published determinations, however, the Department has stated that absent an applicable statutory exemption, drop shipment transactions are subject to taxation under the same principles applicable to ordinary sales. That is, the Department looks to the contractual obligations of the parties to identify who sold what to whom. Det. No. 08-0111, 27 WTD 221 (2008) (online pharmacy made retail sales when it directed third-party supplier to ship goods directly to its online customers); Det. No. 95-134E, 15 WTD 149 (1996) (litter tax applies equally to a wholesale sale made by drop shipment as to a direct sale transaction, even though the seller does not, itself, take physical possession of the goods sold).

receive the goods or to any third person at the buyer's request or with his consent is sufficient delivery to the buyer." *Middleton v. Evans*, 86 Utah 396, 45 P.2d 570, 573 (1935); *Weiner v. Am. Credit-Indemnity Co. of New York*, 245 Mich. 418, 222 N.W. 699, 701 (1929) ("It is not unusual in business for orders to direct delivery to be made to a party other than the one giving the order, and a delivery so made is in legal effect a delivery to the party ordering the shipment.").[6]

During the summary judgment proceeding, Avnet dismissed these authorities as irrelevant because they address whether ownership passed to the buyer for purposes of resolving contract disputes and tort claims, not tax disputes. But contract disputes and tort claims involving the sale of goods often turn on whether, when, or where a sale occurred for purposes of determining the respective rights and obligations of the parties. There is no reason that common law principles do not apply to tax disputes to the extent consistent with the governing tax laws.

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[6] See also *Williamsburgh Stopper Co. v. Bickart*, 104 Conn. 674, 134 A.233 (1926) (delivery to the buyer's customers in accordance with his instructions is delivery to the buyer); *Francis v. Merkley*, 59 Cal. App. 196, 210 P.437, 438 (1922) (delivery to purchaser's designee deemed delivery to purchaser for purpose of consummating contract of sale); *Fergus Cnty. Hardware Co. v. Crowley*, 57 Mont. 340, 188 P. 374 (1920) ("It is too well-settled to open the question that delivery of goods to one designated by the buyer to receive them is delivery to the buyer himself."); *Roy v. Griffin*, 26 Wash. 106, 66 P. 120 (1901) (delivery to shipper designated by purchaser constituted delivery to purchaser for purposes of consummating a sale of lumber); *Pierson v. Werhan*, 14 Hung. 626 (N.Y. Sup. 1878) ("When property is bought by one, and by his direction is delivered to another, the former is nevertheless liable as much as if it had been delivered to himself."); *Wing v. Clark*, 24 Me. 366 (1844) ("The cases are numerous, which show that, a delivery of an article sold to a person appointed by the vendee to receive it is delivery to the vendee.").

Avnet may argue that the provisions of Rule 193 regarding common carriers show that the common law rule of receipt by a buyer's designee does not apply. But the common carrier provisions are explicitly limited to common carriers, and are designed to address the special considerations governing typical common carrier contracts. Rule 193 specifies that receipt by a common carrier at either the shipping point or the destination point does not constitute "receipt" by the purchaser. WAC 458-20-193(3)(b), (7)(a). Washington, like most jurisdictions, disregards the intermediate transfers of possession that occur between the shipping point and the shipping destination when goods are transported in interstate commerce by common carrier.[7] *See* WAC 458-20-193(3)(b) (outbound sales are exempt from tax, even though the seller transfers possession in this state to a common carrier acting on behalf of the purchaser); WAC 458-20-193(7)(b) (inbound sales are taxable notwithstanding the seller

[7] When goods are delivered by common carrier, the contract of sale typically specifies that title to the goods (and, thus, risk of loss in transit) passes to the buyer either when the seller transfers physical possession to the common carrier or upon delivery at the shipping destination. *See* RCW 62A.2-319 (F.O.B. and F.A.S. terms). The terms of a shipping contract do not change the substance of an interstate sale. When a common carrier takes possession of goods at the shipping point, the common carrier itself assumes the risk of loss of the goods in transit. *Pressed Steel Car Co. v. Lyons*, 7 Ill.2d 95, 100, 129 N.E.2d 765 (1955) (explaining rationale for ignoring F.O.B. terms in determining place of sale). "F.O.B." terms merely determine which party—the seller or the buyer—is responsible for pursuing freight claims against the shipper for missing or damaged goods. *Cf. Roy v. Griffin*, 26 Wash. 106, 109, 66 P. 120 (1901) (dismissing buyer's action against seller for damages occurring in transit where goods were delivered by common carrier F.O.B. shipping point).

transfers physical possession to a common carrier outside the state, unless the carrier was the buyer's "agent"); *Lamtec*, 151 Wn. App. at 460 (shipping terms do not determine B&O tax consequences of an interstate sale). With that exception, the common law principle that receipt by the purchaser's designee constitutes receipt by the purchaser is entirely consistent with the state's tax laws.

The reason that Rule 193 specifies a sale occurs in Washington upon receipt "by the purchaser" is merely to clarify that receipt by a common carrier or other third party during the course of transit does not determine the place of sale. To interpret that language as excluding from taxation transactions in which the goods were actually received at a Washington shipping destination would improperly create an exemption not authorized by statute. "The Department is without authority to amend the statute by regulation. It cannot properly carve out an exemption...when the state makes no such exemption." *Coast Pac. Trading,* 105 Wn.2d at 917 (taxpayer could not rely on a Department rule that granted tax immunity broader than that required under the Import-Export Clause) (internal citations omitted).

2. Case law supports the Department's interpretation.

Treating receipt by the buyer's designee as receipt by the buyer for purposes of the B&O tax is consistent with prior Washington cases that

look to substance over form rather than the contractual technicalities of the transfer and possession for purposes of taxing sales. Thus, in addressing a similar set of facts, the Supreme Court rejected a taxpayer's claim that no sale occurred when it used a third-party supplier to deliver goods on its behalf. *Time Oil Co. v. State*, 79 Wn.2d 143, 483 P.2d 628 (1971).

Time Oil sold petroleum products at wholesale. *Id.* at 144. It entered into agreements with other oil companies whereby it would supply petroleum products at certain locations in exchange for an equal quantity of product at a different location. These arrangements allowed the companies to reduce their costs by making fuel available nearer their customers. Although no money was exchanged, it was undisputed the intercompany exchanges of petroleum products constituted wholesale sales between the oil companies. *Id.* at 145.

On occasion, Time Oil directed a corporate affiliate, U.S. Oil, to deliver fuel directly to an exchanger company on its behalf. *Time Oil*, 79 Wn.2d at 145. U.S. Oil billed Time Oil for the products delivered and Time Oil debited the exchanger company's account for the amount it received at U.S. Oil's Tacoma refinery.

Time Oil argued "the tripartite transactions" were not "sales" as defined by RCW 82.04.040 because Time Oil did not, itself, transfer title, ownership or possession of the petroleum products. *Time Oil*, 79 Wn.2d

at 145. Rather, title and possession passed directly to the exchange partner at the Tacoma refinery of its affiliate. The Supreme Court rejected the argument, stating:

> Time's argument is ingenious and in some other fields of legal liability revolving around the manner, time, and place of passage of possession and actual title to the petroleum products involved the argument might well prevail. However, here we are not concerned with the technicalities of the transference of title and possession.

Time Oil, 79 Wn.2d at 146.

The Court rejected the notion that *Time Oil* could avoid B&O tax "through the convenient conduit" of a third-party supplier, stating "To hold otherwise would be to exalt form over substance, and would import an exemption into the tax statutes where none now exists." *Id.* at 147.

The Supreme Court did not explain why it viewed the "substance" of the transaction as a sale when it dismissed Time Oil's reliance on "the technicalities of the transference of title and possession." 79 Wn.2d at 146. However, the Court apparently inferred that Time Oil made a sale because the buyer owed Time Oil, not the third-party supplier, "valuable consideration" in exchange for the transferred fuel. *Id.* at 145 ("Following such delivery, U.S. Oil would invoice Time for the products supplied. Time, in turn, would pay U.S. Oil and debit the recipient exchange company with the quantity of petroleum product so delivered.").

A sale transaction necessarily involves two parties: a seller who agrees to accept and a buyer who agrees to pay "valuable consideration" in exchange for the transfer of ownership or possession of property. *Inland Empire Dairy Ass'n v. Dep't of Revenue*, 14 Wn. App. 592, 594, 544 P.2d 52 (1975). Although Time Oil did not, itself, transfer ownership or possession of the fuel to its customer, the Court attributed the actions of the third-party supplier to Time Oil because Time Oil was the person entitled to "valuable consideration" from the buyer in exchange for the goods received.

Similar reasoning applies here. Avnet concedes that it made wholesale sales when it shipped goods into Washington on behalf of its out-of-state customers. The wholesale buyer owed Avnet "valuable consideration" in exchange for Avnet's physical delivery of the goods to the shipping destination. Just as the seller's act of using a third-party supplier did not negate the existence of a taxable sale in *Time Oil*, the buyer's act of designating a third party to receive the goods at the shipping destination does not negate the wholesale sale made by Avnet.

It is important to note that Avnet's method of delivering goods by drop-shipment is not merely an incidental aspect of its business activities. Avnet promotes drop-shipping as a central value-added feature of its distribution network:

> Today, the supply chain necessitates additional shipping and handling, increasing freight costs and transit time for material to reach your end customer. Customers must invest dollars to inventory units and process shipments from their facility, invoicing the end customer at the point of shipment from the customer's warehouse and decreasing the cash-to-cash cycle.
>
> A direct ship model facilitates material flowing from the supplier to Avnet for integration and then shipment directly to the customers' end customer. Links in the supply chain are removed, decreasing the lead time for the finished product and eliminating unnecessary shipping, handling and freight costs. In addition, customers have the financial advantage of increasing the cash-to-cash cycle by turning the inventory as product ships directly from Avnet.

CP 437.

Avnet's customers rely on Avnet to move goods quickly, efficiently, and at less expense than they might otherwise incur. Avnet's direct shipment of goods to its customer's customer in Washington is a substantial component of the value it offers to its out-of-state buyers. Avnet generally does not manufacture the goods it sells and, with some exceptions, it does not sell its own branded goods. Its success as a wholesaler depends, in significant part, "in establishing cost-effective channels to market." In an annual report, Avnet explained:

> At a very fundamental level, Avnet's strategy has always been to occupy as much space on the supply chain as possible by creating services that connect suppliers to customers, integrating the physical flow of the products Avnet sells to customers around the world.

CP 446.

Avnet's method of delivering goods by drop shipment, which it promotes to customers as "direct shipments" that will speed the time-to-market and reduce overhead costs, is an important part of the value it provides to its customers. Thus it is entirely appropriate to deem Avnet's drop-shipment sales to have occurred in Washington upon receipt at the shipping destination designated by the buyer.

As in *Time Oil*, this Court should reject Avnet's reliance on the technicalities of the transference of title and possession and hold that the sale occurred in Washington when the goods were physically delivered to the person designated by the wholesale buyer.

3. Avnet's interpretation of the rule leads to absurd results.

Unless the phrase, receipt "by the purchaser" means receipt by the purchaser *or the purchaser's designee*, taxpayers may avoid the B&O tax simply by having the goods shipped to a third party. Under Avnet's interpretation of Rule 193, the B&O tax would not apply even if both the seller and the buyer were in Washington and the shipping destination happened to be the purchaser's next door neighbor, because in that scenario—and using Avnet's interpretation of the Rule's requirements—the goods would not be received "by the buyer" in Washington. The applicability of the B&O tax cannot turn on such an insubstantial factor as

whether the purchaser designates a third party to take possession of the goods at the shipping destination. This is especially true when the insubstantial factor is entirely within the control of the parties to the transaction, and thus could lead to substantial tax avoidance. *Cf. Washington Imaging Servs., LLC v. Dep't of Revenue*, 171 Wn.2d 548, 556, 252 P.3d 885 (2011) (independent contractor could not avoid its B&O tax obligation by purporting to disclaim an ownership interest in the amounts owed for services rendered); *Ford Motor*, 160 Wn.2d at 43-44 (out-of-state seller could not avoid B&O tax by contractually transferring title at the point of shipment); *Chicago Bridge*, 98 Wn.2d at 824 (construction contractor could not avoid B&O tax by bifurcating the design and manufacturing components of contracts for constructions services from the installation of the products in Washington); *Wasem's, Inc. v. State*, 63 Wn.2d 67, 70, 385 P.2d 530 (1963) (retailer could not avoid state excise taxes by having a nonresident purchaser sign a bill of lading agreeing to deliver goods to himself at a point outside the state).

D. Washington Has Taxing Jurisdiction To Impose Its Wholesaling B&O Tax On All Of Avnet's Washington Destination Sales.

Because the trial court granted summary judgment to Avnet on the ground that its drop-shipments into Washington were not "received by the purchaser in this state" within the meaning of Rule 193, it did not address

Avnet's alternative argument that the Commerce Clause prohibited the state from taxing those transactions. However, the trial court rejected Avnet's identical constitutional claim as to its "National Sales." The trial court correctly ruled that Avnet "certainly" has nexus with Washington and that it could not establish that its instate activities were "not associated in any way" with those transactions. VRP at 31-32. Under modern commerce clause analysis, Avnet's market-creating activities in the state support the state's taxing jurisdiction over all of Avnet's Washington destination sales, not just those that were handled by its local office.

There is no material difference between Avnet's "National Sales" and the drop shipment transactions that are at issue in this appeal. Avnet can no more isolate its drop shipment transactions from its instate business activities than it could its National Sales. Thus, the Department was entitled to summary judgment on this issue.

1. Avnet has constitutional nexus with Washington.

The Commerce Clause imposes constraints on a state's power to tax out-of-state businesses. In a series of cases, the United States Supreme Court developed a four-part test for assessing the constitutionality of a state tax. A state tax is valid if it is: 1) applied to an activity with a substantial nexus with the taxing state; 2) fairly apportioned; 3) nondiscriminatory with respect to interstate commerce; and 4) fairly

related to the services provided by the state. *Lamtec*, 170 Wn.2d at 844, *citing Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977). This case involves only the first requirement—substantial nexus.[8]

In *Tyler Pipe*, the United States Supreme Court agreed with the Washington Supreme Court's determination that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *Tyler Pipe Indus., Inc. v. Dep't of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987), *quoting Tyler Pipe Indus., Inc. v. Dep't of Revenue,* 105 Wn.2d 318, 323, 715 P.2d 123 (1986).

Avnet concedes it has nexus with respect to the majority of its Washington destination sales. Avnet claims, however, that it may

[8] Washington courts previously have addressed the second and third prongs of the four-part test with respect to the Washington B&O tax on retail or wholesale sales, upholding the tax as non-discriminatory and inherently apportioned. *E.g., W.R. Grace & Co. v. Dep't of Revenue*, 137 Wn.2d 580, 596-97, 973 P.2d 1011, *cert. denied*, 528 U.S. 950 (1999). The fourth prong of *Complete Auto*—whether the state tax is fairly related to services provided by the state—has been addressed by the Supreme Court in *Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 156 P.3d 185 (2007). In *Ford Motor Co.*, the Court explained that "[t]his fourth requirement does not address the rate or amount of the tax" and does not require a comparison of "the actual value of services provided . . . with the income taxed." *Id.* at 53. Instead, the fourth prong is easy to meet and requires only that "the tax measure, as well as the tax incident, be tied to the earnings which the State . . . has made possible." *Id.* (internal quotations and citations omitted).

"dissociate" the category of drop-shipment sales from its nexus-creating business activities within the state.

Avnet's effort to isolate its drop-shipment transactions from its other Washington destination sales is based on an overly narrow view both of the incidence of the B&O tax and of the nature and extent of Avnet's instate activities that establish nexus. Nexus focuses on a seller's *market-creating* activities within the state, not merely on the activities related to any specific transaction. *Tyler Pipe*, 483 U.S. at 250. Avnet's physical presence in Washington far surpasses the nexus threshold. *Cf. Lamtec,* 170 Wn.2d at 845-46 (periodic visits by sales representatives may establish nexus over all inbound sales).

The scope of market-creating activities of a seller is much broader than the activities involved in making any particular sale. *See*, *e.g.*, *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560, 95 S. Ct. 706, 42 L. Ed. 2d 719 (1975) (providing technical advice); *Tyler Pipe*, 483 U.S. at 250 (gathering information about the local market); *Lamtec* 170 Wn.2d 838 (providing product information to customers); *Ford Motor*, 160 Wn.2d at 42, 44 (advertising; marketing warranties for products sold; resolving customer complaints); *Chicago Bridge*, 98 Wn.2d at 828 ("passive" presence of instate personnel available to assist, if necessary); *General Motors Corp. v. State*, 60 Wn.2d 862, 376 P.2d 843 (1962), *aff'd*

377 U.S. 436, 84 S. Ct. 1564, 12 L. Ed. 2d 430 (1964) (maintaining relationships with local dealers); *General Motors Corp.. v. City of Seattle*, 107 Wn. App. 42, 25 P.3d 1022 (2001) (advertising in local market, warranty sales to retail buyers, and monthly visits by sales representatives provided nexus for wholesale sales to local dealers where orders were made online or with out-of-state office and goods were shipped by common carrier from another state).

Here, there is no question that Avnet is involved in extensive and continuous business activities within the state. Avnet's Redmond office is staffed with forty-four employees dedicated to a variety of marketing, sales, engineering, and managerial activities. CP 59-64, 474-95. Its employees engage in continuous solicitation and servicing of customer accounts, market research, and providing technical advice, all of which obviously support Avnet's ability to establish and maintain the instate market for its goods.

Avnet's field engineers work with customers to develop new and improved products in order to maintain and create future demand for the products Avnet sells. The information they gather from Washington consumers leads to improvements at the supply end which help sustain and grow demand for the sales of Avnet's products worldwide. Avnet's managers exchange "market intelligence" with the corporate headquarters.

The activities of Avnet's Washington employees support the market for all of Avnet's Washington destination sales, regardless of which office handles a particular sale.

During the summary judgment proceeding, Avnet repeatedly asserted it was "undisputed" that Avnet "conducted ***no*** activities in Washington" with respect to the contested sale transactions. CP 182, 513, 662. This assertion is inaccurate for at least two reasons. First, it assumes the only relevant "activities" are those involved in handling a specific sale transaction, such as accepting an order or billing a customer. Avnet ignores the broad range of market-creating activities it conducts in Washington, which are linked to all its Washington destination sales under the nexus standard adopted in *Tyler Pipe*.

Second, Avnet ignores the fact that every sale transaction at issue was consummated by the physical delivery of the goods in Washington pursuant to the contract of sale. This "partial performance" of the contract of sale in Washington provides the constitutionally required "rational relationship" between the taxable activity (engaging in "making sales at wholesale" within the state) and the measure of the tax (gross proceeds of all Washington destination sales). *Jefferson Lines,* 514 U.S. at 189 ("sales with at least partial performance in the taxing State justify that State's taxation of the transaction's entire gross receipts in the hands of the

seller"). Following *Complete Auto Transit* and its progeny, the constitutionality of a tax measured by the full value of a transaction that, like Avnet's drop shipment sales, occur only partially within a state, is assessed by the internal and external consistency of the tax, i.e. whether it treats inbound and outbound sales equally. *Jefferson Lines*, 514 U.S. at 185. It is undisputed that the wholesaling B&O tax is both internally consistent and fairly apportioned.[9]

2. Avnet relies on inapplicable Supreme Court authorities and ignores controlling Commerce Clause case law.

In support of its dissociation claim, Avnet may rely on *Norton Co. v. Dep't of Revenue*, 340 U.S. 534, 537, 71 S. Ct. 377, 95 L. Ed. 517 (1951) and *B.F. Goodrich Co. v. State*, 38 Wn.2d 663, 671-72, 231 P.2d 325 (1951). During the summary judgment proceeding, Avnet characterized these decisions as "controlling authority." Avnet's Mot. Summ. J. at 10. They are not. The controlling authorities are *Complete Auto Transit*, 420 U.S. 274, and *Tyler Pipe*, 483 U.S. 232. Following those and several other United States Supreme Court and Washington

[9] In *Tyler Pipe*, the Court struck down an earlier version of the B&O tax because it lacked "internal consistency." *Am. Nat. Can Corp. v. Dep't of Revenue*, 114 Wn.2d 236, 242-43, 787 P.2d 545 (1990). Specifically, the earlier statute shielded instate businesses but not out-of-state businesses from a risk of multiple taxation when they engaged in both manufacturing and selling activities. *Id.* The Legislature corrected the problem by enacting a multiple activities tax credit for out-of-state businesses, thus restoring consistency to the taxation of instate and out-of-state businesses. *Id.* at 243-44; *See generally*, *W.R. Grace & Co. v. Dep't of Revenue*, 137 Wn.2d 580, 973 P.2d 1011 (1999) (discussing the *Tyler Pipe* saga and its aftermath).

court cases subsequent to *Norton* and *B.F. Goodrich*, it is apparent that a company engaged in selling activities within the state may not "dissociate" a portion of its inbound sales merely because the local office had no direct involvement in the transaction.

Norton involved a Massachusetts company that made sales to customers in Illinois. Norton had "a branch office and warehouse in Chicago from which it [made] local sales at retail." *Norton*, 340 U.S. at 535. The company also made mail order sales to Illinois customers. Some of the mail order sales were channeled through the Chicago office. However, some mail order sales involved orders sent directly to Norton's home office in Massachusetts and were then shipped directly to the customer. *Norton*, 340 U.S. at 536.

The issue before the Supreme Court was whether Illinois could constitutionally tax Norton on all the gross income it derived from sales (including mail-order sales) to Illinois customers. *Norton*, 340 U.S. at 535-36. Norton argued that only the "over the counter" sales made from the Chicago office were subject to the Illinois tax. *Id.* at 535. The United States Supreme Court disagreed, holding that Illinois was permitted to tax those sales that were connected in some fashion to Norton's in-state activities -- including mail order sales "channeled" through Norton's Chicago office. *Norton*, 340 U.S. at 537. The *Norton* Court went on to

hold that Norton could "avoid taxation on some Illinois sales only by showing that particular transactions are dissociated from the local business and [are] interstate in nature." *Id.* The burden was on Norton to prove that certain of its sales were unconnected to any of its in-state activities. *Id.* A majority of the Court concluded, without analysis, that *Norton* satisfied its burden with respect to mail order sales that were handled exclusively by the seller's out-of-state office because they were "clearly interstate in nature." *Id.* at 539.

In *B.F. Goodrich*, the Washington Supreme Court drew a similar conclusion in addressing similar facts, finding itself constrained by the *Norton* decision. The Washington Supreme Court expressed its frustration with the *Norton* decision, noting the Commerce Clause decisions of the United States Supreme Court had "not always been doctrinally consistent." *B.F. Goodrich*, 38 Wn.2d at 669.

Following *Complete Auto Transit* and *Tyler Pipe*, the instate activities that establish nexus are not limited to direct selling activities linked to any particular sale transaction. *Cf. Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 40, 43, 156 P.3d 185 (2007) (affirming imposition of local selling B&O taxes despite absence of any direct selling activities within the cities). Rather, the question is whether the taxpayer's instate activities are significantly associated with establishing and maintaining *a*

market in the state, not whether they are significantly associated with any particular *sale*. *Cf. Tyler Pipe,* 483 U.S. at 250; *Standard Pressed Steel,* 419 U.S. 563. The scope of market-making activities that establish nexus under the *Tyler Pipe* standard is far broader than what the six-justice majority in *Norton* deemed necessary to confer taxing jurisdiction over sales of goods shipped into a state by an out-of-state seller.

The three dissenting justices in *Norton* would have held that the taxpayer's decision to avail itself of the privilege of conducting business within the state was sufficient to permit Illinois to impose its gross receipts tax on all of its sales to Illinois residents. 340 U.S. at 541-42. They reasoned that the taxpayer's selling activities within the state grew the market for its products and thus necessarily were related to the sales in which customers ordered directly from the out-of-state office. As the Washington Supreme Court observed in *B.F. Goodrich*, the Court previously had held as much with respect to mail-order sales made by the out-of-state mail-order division of a national retailer that had retail outlets within the state. *B.F. Goodrich*, 38 Wn.2d at 673-74, *citing Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 61 S. Ct. 586, 85 L. Ed. 888 (1941). Although Sears operated its mail-order business independently from the retail stores, the Court considered the presence of the instate retail outlets necessarily associated with the demand for goods ordered through the

national catalogue. The Court reasoned the state "may rightly assume" that mail-order sales "are not unrelated to" a seller's instate selling activities. 312 U.S. at 365.

The United States Supreme Court subsequently explained that the disagreement in the Court in *Norton* "concerned *the burden of showing a nexus* between the local office and interstate sales—whether a nexus could be assumed and whether the taxpayer had carried the burden of establishing its immunity." *Standard Pressed Steel*, 419 U.S. at 562-63 (emphasis added). A majority of the justices in *Norton* believed that a sale transaction in which an out-of-state office receives an order and ships the goods directly to the buyer, without any assistance from the local office, is "so clearly interstate in character" that the state cannot tax it. *Norton*, 340 U.S. at 539. The minority, in contrast, consistently with the *Sears Roebuck* line of cases, viewed the market-creating activities of the local office as inextricably linked to the direct sale transaction, and thus a sufficient justification to support the state's taxing power over all inbound sales. *Id.* at 541-42.

In *Standard Pressed Steel* and later decisions, the United States Supreme Court firmly embraced the minority position in *Norton*.[10] *See*

[10] Under current Commerce Clause nexus analysis, it can be difficult, if not impossible, for a company with the vast, instate activities that Avnet has with Washington to dissociate any of its sales into the state. Indeed, some commentators have

Quill Corp. v. North Dakota, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 2d 91 (1992); *Department of Revenue v. Assoc. of Wash. Stevedoring Cos.*, 435 U.S. 734, 98 S. Ct. 1388, 55 L. Ed. 2d 682 (1978); *Tyler Pipe,* 483 U.S. 232; *Complete Auto Transit*, 430 U.S. 274; *Standard Pressed Steel*, 419 U.S. 560. Under the rule established by these later cases, the "crucial factor governing nexus is whether the taxpayer's instate activities are significantly associated with its ability to establish and maintain a market in the state." *Lamtec*, 170 Wn.2d at 850-51, *quoting Tyler Pipe*, 483 U.S. at 250-51, *quoting Tyler Pipe*, 105 Wn.2d at 323. "Nexus" does not require a direct connection between the taxpayer's instate activities and any particular transaction. Thus, in *Lamtec*, the Washington Supreme Court recently found that two or three visits per year by the representatives of an out-of-state seller established nexus for all Washington sales, even though Lamtec received and fulfilled the orders in New Jersey, without

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determined that *Norton* is likely no longer valid, e.g., Walter Hellerstein, *State Taxation of Interstate Business and the Supreme Court, 1974 Term:* Standard Pressed Steel *and* Colonial Pipeline, 62 Va. L. Rev. 149, 155 (1976) (stating that "the Court seems to have liberated the states completely from the restraints of *Norton*."). This is because the United States Supreme Court has repudiated the doctrines used by the *Norton* Court in reaching its conclusions. For example, the *Norton* Court applied a doctrine that "interstate" business could not be taxed, which was subsequently repudiated by the United States Supreme Court and is no longer a part of modern Commerce Clause analysis. *Complete Auto Transit*, 430 U.S. at 288-89. Similarly, the Court has repudiated the *Norton* Court's reasoning that a taxpayer could avoid taxation by employing "solicitors" instead of having a local office. *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S. Ct. 619, 4 L. Ed. 2d 660 (1960).

direct involvement by any office or salesperson in Washington. 170 Wn.2d at 841, 851.

Similarly, in *Standard Pressed Steel*, the presence of a single in-state technical consultant who monitored the needs of the taxpayer's primary (but not only) instate customer (Boeing) provided nexus for all sales into Washington even though the orders were received and filled from out-of-state. *Standard Pressed Steel,* 419 U.S. at 561 (affirming imposition of Washington's wholesaling B&O tax on sales of nuts and bolts shipped to Washington from out-of-state seller). In *General Motors*, the court looked to "the bundle of corporate activity" carried out by an out-of-state manufacturer in developing a market in Washington and deemed its "maze of local connections" sufficient to ground the state's taxing jurisdiction over the sales of parts that were ordered and shipped directly from an out-of-state office. *General Motors,* 377 U.S. 436 (affirming imposition of Washington's wholesaling B&O tax on interstate sales of auto parts). *See also National Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 97 S. Ct. 1386, 51 L. Ed. 2d 631 (1977) (in-state office involved in selling advertising services provided nexus over all

mail-order sales to California residents even though in-state personnel had no direct involvement with the out-of-state mail-order division).[11]

The *Tyler Pipe* decision also shows that Avnet's contention is not correct. *Tyler Pipe* involved an out-of-state business that sold pipe and drainage products in Washington. *Tyler Pipe*, 483 U.S. at 249. It had no office, property, or employees in Washington. *Id.* Its sole presence in the state consisted of an independent contractor who was supervised by an out-of-state manager. *Id.* The independent contractor visited customers, solicited orders, and gathered data about the market. *Id.* The Court concluded the presence of the independent contractor created nexus for the taxpayer's Washington sales. *Id.* at 251.

In *Tyler Pipe*, two-thirds of the Washington destination sales were handled by in-state representatives; the rest involved transactions in which the customer placed an order directly with the out-of-state business. *Tyler Pipe*, 105 Wn.2d at 321. Like Avnet, Tyler Pipe argued that the sales

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[11] *National Geographic* addresses the obligation of an out-of-state seller to collect sales tax on mail-order sales to California residents. *National Geographic Soc'y v. Cal. Bd. of Equalization*, 430 U.S. 551, 97 S. Ct. 1386, 51 L. Ed. 2d 631 (1977). In dicta, the Court suggested the outcome might have been different if the case involved a "direct" tax imposed on the seller. *Id.* at 560. However, this dicta is inconsistent with subsequent authorities, which focus on the practical impact of taxes rather than formalistic distinctions between "direct" and "indirect" burdens. *See Quill*, 504 U.S. at 309-10 (discussing competing theories underlying prior Commerce Clause decisions). And in *Tyler Pipe*, the United States Supreme Court cited to *National Geographic* in approving the Washington Supreme Court's nexus analysis. 483 U.S. at 250. Since the Court's decision in *Complete Auto Transit*, the Court has never applied the distinction between "direct" and "indirect" taxes to invalidate a tax and has not applied a disassociation analysis at all.

transactions handled exclusively by its out-of-state office should not be subject to tax even if those channeled through its local representatives were taxable. The Washington Supreme Court rejected the taxpayer's argument. *Id.* at 326-27.

The Court concluded that the absence of any particular instate selling activity did not negate the nexus created by the totality of Tyler Pipe's instate activities, including the presence of instate representatives who provided important market intelligence to the corporate headquarters and who were "available to assist, if necessary," in addressing any concerns. 105 Wn.2d at 321-22. In affirming the decision, the United States Supreme Court agreed that the totality of Tyler Pipe's instate activities gave Washington jurisdiction to impose the wholesaling B&O tax on its sales into Washington. *Tyler Pipe*, 483 U.S. at 250.

Even the mere "passive presence" of an instate office is a nexus-creating activity if the local personnel are available to assist, if needed, in responding to customer inquiries or complaints. *Chicago Bridge*, 98 Wn.2d at 828 (rejecting taxpayer's attempt to dissociate design contracts that were negotiated and executed outside the state from construction contracts concededly subject to B&O tax, even though local personnel had no direct involvement with the design contracts).

Avnet lists its Redmond branch office on its website and on printed marketing materials, with contact information. CP 427-30, 472. The Redmond branch office employs a number of sales representatives engaged primarily in telephone communications with existing and prospective customers. CP 59-64. As in *Tyler Pipe* and *Chicago Bridge*, Avnet's local personnel are, at least, "available to assist, if necessary" with any issues relating to any of Avnet's Washington destination sales.

Avnet's field application engineers work with customers in Washington to evaluate product quality, identify design improvements, anticipate future needs, recommend improvements for existing products, and feed that information back to the central organization, which analyzes the data and uses it to help its suppliers make product improvements that will foster the continued market demand for the products Avnet supplies. CP 490. The instate activities of Avnet's marketing, sales, and engineering personnel are functionally integrated with Avnet's worldwide network of suppliers, engineers, marketing and sales personnel, facilities, supply chain management, and customers.

Under the nexus standard embraced by the Court in *Tyler Pipe,* an integrated, multinational business like Avnet may not dissociate any of its Washington destination sales from the instate activities of its established marketing, sales, and customer service force within the state. The absence

of specific activities related to particular sale transactions does not negate the substantial nexus created by Avnet's extensive and continuous business development activities within the state.

3. Rule 193 does not support Avnet's dissociation claim.

Avnet may claim that the Department's own rule on interstate sales recognizes *Norton* and *B.F. Goodrich* as controlling authorities. CP 190, 519. That is incorrect.

The Department has amended Rule 193 many times since 1935 to reflect the current understanding of the constitutional limitations on the state's taxing power over out-of-state businesses.[12] Following *Norton* and *B.F. Goodrich*, the Department revised the rule to reflect the key holdings of those 1951 decisions. Former Rule 193 (1960). CP 645-49. However, in 1974 the Department further revised the rule to reflect the "functional approach" embraced by the United States Supreme Court in a number of subsequent decisions, including *Standard Pressed Steel* and *General Motors*, both of which specifically addressed Washington's B&O tax.

[12] Certain aspects of the rule have remained relatively constant, including the standard for determining the place of an interstate sale as the shipping destination of the goods sold, without regard to passage of title or shipping terms. But the provisions stating the nature and extent of local business activities that will trigger Washington's taxing jurisdiction over inbound sales made by an out-of-state seller have changed significantly to reflect developments in the dormant commerce clause case law. The previous versions of the rule that are most relevant to that issue are in the record at CP 631-58.

Tyler Pipe, 105 Wn.2d at 323. As the Washington Supreme Court recently observed, in *Tyler Pipe*:

> [The Court] approved the Department's stated requisite minimal connection of "nexus" in former WAC 458-20-193B (1970),[13] "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."

Lamtec, 170 Wn.2d at 849-50 (*quoting Tyler Pipe*). The nexus standard approved by the Court in *Tyler Piper* superseded a narrower one that required performance of "a local service essential to the completion of the sale to the purchaser in Washington." Former WAC 458-20-193B (1970). CP 641-42.

At the same time the Department adopted the language quoted approvingly in *Tyler Pipe*, which broadens the focus from a particular sale to the seller's market-creating activities, the Department eliminated rule language exempting from taxation inbound sales where the order was made directly by a Washington customer to the out-of-state office of the seller, which exclusively handled the transaction. *Compare* former WAC 458-20-193B (1970) *with* former WAC 458-20-193B (1974). CP 637, 641. Consistent with that change, the Department explained that the seller's burden to "dissociate" such transactions could not be met by

[13] The Washington Supreme Court incorrectly cited to the 1970 version of Rule 193B. The text quoted by the Court first appeared in the 1974 version of the rule.

showing the absence of a link between the local office and "the transaction." *Id.* Rather, the seller must establish the activities of the local office in "the state" were not significantly associated in any way with the inbound sales. *Id.* These changes were part and parcel of the nexus standard approved by both the Washington and United States Supreme Courts in *Tyler Pipe*.

In 1991, the Department deleted language stating that sales transactions could be dissociated where "there has been no participation whatsoever in this state" by the seller's instate representatives. Former WAC 458-20-193 (1991). CP 633.

Following the 1974 and 1991 revisions to Rule 193, to "dissociate" any of its inbound sales, a seller must establish that its activities within the state "are not significantly associated in any way with the sales in this state." In other words, dissociation is the absence of substantial nexus.[14]

[14] In 2005, the Department proposed to further revise Rule 193 to eliminate any reference to dissociation. The Department had published determinations that explain how exceedingly difficult it is to establish a dissociation claim in light of the *Tyler Pipe* nexus standard. *See* Det. No. 04-0208, 24 WTD 217 (2005) (increased brand recognition generated by instate activities precluded seller from dissociating any inbound sales); Det. No. 00-098, 22 WTD 151 (2003) (availability of warranty service precluded seller from dissociating inbound sales). CP 377-89. Nevertheless, taxpayers have continued to rely on *Norton* and *B.F. Goodrich* in support of dissociation claims. CP 574. In response to vigorous opposition by taxpayer representatives, the Department dropped the proposed rule change. Ignoring the rule revisions of 1974 and 1991, as well as the subsequent published determinations that apply the *Tyler Pipe* nexus standard to dissociation claims, Avnet heavily relied on the Department's 2005 decision not to revise the rule as evidence the Department, itself, continues to view *Norton* and *B.F. Goodrich* as "controlling authority." CP 190, 519-21.

As confirmed by *Tyler Pipe*, and more recently by *Lamtec*, the nexus standard set forth in Rule 193 does not impermissibly disregard *Norton* or *B.F. Goodrich*. Rather, it properly reflects the modern understanding of the boundaries of the state's power to tax interstate sales transactions as set forth by subsequent decisions of the United States Supreme Court.

Avnet's contention that it may "dissociate" a segment of its Washington destination sales is based on a long-discarded view of the constitutional constraints imposed on the state's taxing power. The *absence* of a particular instate activity related to a specific sale transaction does not negate the nexus-creating effect of the instate *presence* of the wide range of market-creating business activities carried out by Avnet's employees and representatives. Avnet's nexus-creating activities in the state allowed Washington to tax all of its Washington destination sales.

VII. CONCLUSION

This Court should hold that a sale occurs in Washington for B&O tax purposes when the goods sold are shipped into this state by common carrier and received at the shipping destination by the purchaser or the purchaser's designee. If the seller has nexus with the state, Washington's B&O tax applies to the transaction. Because both of these requirements are met with respect to Avnet's drop shipments into the state, the trial

court erred by denying the Department's motion to deny Avnet's tax refund claim on summary judgment. This Court should reverse the trial court's summary judgment order and direct the trial court to grant summary judgment for the Department.

RESPECTFULLY SUBMITTED this 3rd day of December, 2013.

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

DATED this 3rd day of December, 2013, at Tumwater, WA.

Julie Johnson, Legal Assistant

WASHINGTON STATE ATTORNEY GENERAL

December 03, 2013 - 11:30 AM

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