NO. 46939-1-II

COURT OF APPEALS
FOR THE STATE OF WASHINGTON
DIVISION II

IRWIN NATURALS,

Appellant,

v.

STATE OF WASHINGTON DEPARTMENT OF REVENUE,

Respondent.

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

APPELLANT'S REPLY BRIEF

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ARGUMENT

For the tax years in dispute, Irwin Naturals (the "Company") seeks to dissociate retail sales made to Washington customers from wholesale sales made to retailers located in the state for purposes of the Retail Sales Tax ("RST") and the B&O tax. The Company's retail operations (the "Retail Channel") operated wholly independent from its wholesale business (the "Wholesale Channel"). The nature of the independence was such that, other than the crossover of one nutritional product, a Washington customer would have no idea that the Company sold products at both retail and wholesale.

The Company readily concedes that it has B&O tax nexus with Washington for purposes of its wholesale activities in the state.[1] However, the uncontroverted facts of this case are that the Retail Channel had no employees, representatives, and owned to property in the Washington during the relevant periods. Further, other than one commonly-branded product, there was no way to determine that Company products sold at wholesale had any relationship to the dissimilarly-branded nutritional products sold through the Retail Channel.

In the brief filed by the Respondent ("Resp. Brf."), the Department of Revenue (the "Department") claims that the Company is not entitled to dissociate its out-of-state retail activities from its in-state wholesale

[1] The Company's wholesale activities in the state do not give rise to RST liability.

activities for RST and B&O tax purposes. The Department claims that the Company is liable for RST based solely on the holding in *Nat'l Geographic Soc'y v. California Bd. of Equalization*, 430 U.S. 551, 97 S. Ct. 1386, 51 L. Ed. 2d 631 (1977). Regarding the Company's liability for the B&O tax on sales through the Retail Channel, the Department argues that the holding in *Avnet, Inc. v. Dep't of Revenue*, No. 45108-5-II, slip op. (Wn. App. April 28, 2015) controls. The Department's reliance on precedent is misplaced on both counts.

With respect to the Company's liability for RST, the Department wrongly clings to the holding in *Nat'l Geographic*. According to the Department, *Nat'l Geographic* is the beginning and end of the discussion regarding the outstanding assessment of RST. However, the Department fundamentally misunderstands the constitutional underpinnings of *Nat'l Geographic*. That case was decided at a time when the relevant tests under the Due Process Clause and the Commerce Clause were all but indistinguishable. Evidence of this claim is found in the express holding of the case. The language used by the Court in *Nat'l Geographic* to address the taxpayer's dual challenges under the Due Process Clause and the Commerce Clause was tethered to the due process principle of "minimum contacts." Under contemporary Commerce Clause jurisprudence, the crux of the analysis – as it is in this appeal – relates to the concept of ***substantial nexus***. In the years following its decision in

Nat'l Geographic, the United States Supreme Court has made clear that "minimum contacts" under the Due Process Clause and "substantial nexus" under the Commerce Clause are two distinct analyses. In sum, because *Nat'l Geographic* does not reflect the Court's modern view of the Commerce Clause, the holding of the case is not a bar to the Company's claim of dissociation for purposes of the RST.

The Company is also permitted to dissociate for purposes of the B&O tax. This court's decision in *Avnet, Inc. v. Dep't of Revenue*, No. 45108-5-II, slip op. (Wn. App. April 28, 2015) is factually distinguishable from this case. In *Avnet*, this Court confirmed the use of dissociation, but held that the instate activities assisted the taxpayer in maintaining a market in Washington for sales therefore denying the taxpayer's claim to dissociation. Although the Company disagrees with this Court's discussion in *Avnet* of the holding in *Norton Co. v. Illinois Dep't of Revenue*, 340 U.S. 534, 71 S. Ct. 377, 95 L. Ed. 517 (1951), the facts of this case are distinguishable from those in *Avnet* and form a clear basis for dissociation.

I. The Underlying Facts of This Case are Unique and Provide a Clear Case for Dissociation

There are numerous cases that directly or indirectly address the concept of dissociation. The Department cites to several of these cases in its brief. Yet, without exception, the authority relied on by the

Department relates to a common set of facts. Specifically, in each case, the taxpayer's in-state and out-of-state business activities relate to the same functional business, branding, market and category of sales. The same cannot be said with respect to the facts at issue in this appeal. The Company's in-state activities related solely to the Wholesale Channel. Other than one commonly-branded item, the Wholesale Channel sold a different list of nutritional products, to a different market, under different branding and through a different process. The activity sought to be taxed in this case – *i.e.*, the sales made through the Retail Channel – lacks the requisite connection to the Wholesale Channel and therefore dissociation is permitted for RST and B&O tax purposes.

A. The Dissociation Cases Cited by the Department are Inapposite to the Facts at Issue in this Appeal

The case most critical to the Department is *Tyler Pipe Indus., Inc. v. Dep't of Revenue*, 483 U.S. 232, 107 S. Ct. 2810, 97 L. Ed. 2d 199 (1987). In that case, the taxpayer sold various types of industrial products at wholesale to Washington customers. *See id.* at 249. Although the products were manufactured outside the state, the taxpayer also retained an independent sales representatives to call on Washington customers and solicit orders for wholesale purchases. *Id.* The in-state activities of the taxpayer in *Tyler Pipe* were part of the same wholesale business operation conducted outside the state.

In *Standard Pressed Steel, Co. v. Dep't of Revenue*, 419 U.S. 560, 95 S. Ct. 706, 42 L. Ed. 719 (1975), the taxpayer argued that Washington was constitutionally precluded from imposing B&O tax relating to the activities of one of its employees in the state. The taxpayer manufactured and made wholesale sales of industrial and aerospace fasteners. *Id.* at 708. An employee of the taxpayer lived in Seattle and met with Boeing to discuss the fastener needs of the company. *Id.* The employee did not take orders for fasteners. *Id.* As in *Tyler Pipe*, the in-state activities were part of the same wholesale business operation conducted across the country.

The case of *General Motors Corp. v. Washington*, 377 U.S. 436, 84 S. Ct. 1564, 12 L. Ed. 430 (1964) presents a substantially similar fact pattern. The taxpayer manufactured and sold motor vehicles under several brands. *Id.* at 442. All sales of vehicles were wholesale sales through branded dealerships throughout the United States. *See id.* The taxpayer employed district managers[2] who lived in Washington to call on and work with dealers with the goal of increasing sales of the taxpayer's vehicles. *Id.* at 443. The in-state activities of the district managers assisted in increasing the taxpayer's wholesale sale of vehicles in Washington.

Lamtec Corp. v. Dep't of Revenue, 151 Wn. App. 451, 215 P.3d 968 (2009), *aff'd*, 170 Wn.2d 838, 246 P.3d 788 (2011), presents a similar

[2] Each brand of vehicle sold by the taxpayer had a designated district manager residing in Washington. *See id.*

set of facts to those at issue in *Standard Pressed Steel*. The taxpayer manufactured and made wholesale sales of insulation and vapor barriers from outside Washington. *Id.* at 840. Two or three times a year, the taxpayer sent employees into Washington to visit major customers. *Id.* at 841. During these visits, these employees answered questions from Washington customers and provided information about other products sold by the taxpayer at wholesale. *See id.* The taxpayer argued that it lacked substantial nexus with Washington under the Commerce Clause. *Id.* at 842. In this case, as in *Standard Pressed Steel*, the in-state activities of the employees were part of the same wholesale operation conducted by the taxpayer nationwide.

The case of *Chicago Bridge & Iron Co. v. Dep't of Revenue*, 98 Wn.2d 814, 659 P.2d 463 (1983), has a substantially identical set of facts. The taxpayer designed, engineered, manufactured and installed various industrial elements. *Id.* at 816. During the years at issue in the case, the taxpayer entered into 149 contracts with Washington customers to manufacture and install various industrial items. *Id.* at 817. The taxpayer had a sales office in Seattle that assisted with 133 of the contracts. *Id.* Because the in-state sales office was not involved in the negotiation and formalization of the remaining 16 contracts, the taxpayer argued it was not required to remit B&O tax on those projects. *See id.* These 16 contracts were no different than the 133 contracts on which the taxpayer paid B&O

tax – other than the situs of the formalized agreement between the parties. There was no operational distinction between the two categories of contracts in the case.

The Department also relies on *Dep't of Revenue v. J.C. Penney Co., Inc.*, 96 Wn.2d 38, 633 P.2d 870 (1981). In *J.C. Penney*, the taxpayer operated over 50 retail stores in Washington during the period in dispute. *Id.* at 39. J.C. Penney offered credit cards to its customers through local retail stores and through catalogs. *Id.* at 40. The employees at retail locations – including those in Washington – assisted with the operation of the J.C. Penney credit card program by, *inter alia*, accepting credit card payments and assisting customers applying for credit. *Id.* at 44. Moreover, all of the credit sales at issue were consummated in Washington retail stores. *Id.* The Department sought to apply the B&O tax to the credit card service charges. *Id.* at 41. J.C. Penney argued that the in-state activity was insufficient to permit the imposition of B&O tax. *Id.* In this case, as in *Tyler Pipe*, *Standard Press Steel*, *General Motors*, *Lamtec* and *Chicago Bridge & Iron*, the in-state activities were part of the overall business operation of the taxpayer.

Finally, the Department places great weight on this Court's recent decision in *Avnet v. Dep't of Revenue*, No. 45108-5-II, slip. op. (Wn. App. April 28, 2015) (attached as Appendix A). At issue in *Avnet* was whether the taxpayer could dissociate a subset of wholesale sales for B&O tax

purposes. Avnet was a distributor of various technological products. *Avnet*, slip. op. at 2. The taxpayer had an office in Redmond, Washington with more than 40 employees. *Id.* These employees were responsible for servicing customers in Washington and eastern Idaho and were also engaged in market and product development. *Id.* Again, the in-state activities were part of the same nationwide wholesale business conducted by Avnet.

B. The Undisputed Facts of This Case Juxtapose Business Activities Involving Two Distinct Markets, Business Operations and Categories of Sales

Unlike in the cases cited immediately above, the Company operated two different functional businesses – a retail (or direct response) business and a wholesale business. The target market for the Wholesale Channel was Washington retailers while the Retail Channel directed its activities at Washington residents. **[CP 45, 52]**. The operations of the Retail Channel were wholly independent from the operations of the Wholesale Channel. **[CP 46]**.

The business relating to the Wholesale Channel was handled entirely by Company employees at Company locations. **[*Id*]**. Company employees handled all operations relating to sales, processing, payment, collection and delivery for the Wholesale Channel. **[*Id*]**. Company employees and independent sales representatives soliciting sales for the Wholesale Channel did ***not*** solicit sales of products offered through the

Retail Channel. **[*Id*]**. Customer calls relating to the Wholesale Channel were handled in a way to avoid competing directly with the Company's wholesale customers. **[*Id*]**. When a purchaser of products from the Wholesale Channel called regarding a product, the Company would refer the caller back to the Company's wholesale customers for additional product purchases. **[CP 47]**.

The separateness of the Retail Channel manifested itself through the use of third party service providers. **[CP 47]**. During the years at issue, the Company retained unaffiliated vendors to handle the sales, processing, payment, collection and delivery activities of the Retail Channel. **[*Id*]**. Customer inquiries with respect to products sold through the Retail Channel were handled differently from those relating the Wholesale Channel. **[*Id*]**. If a retail customer of the Company called regarding a product offered through the Retail Channel, the person answering the phone on behalf of the Company would solicit sales of Company products offered through the Retail Channel. **[*Id*]**.

The strongest fact supporting the Company's claim to dissociation relates to the fact that, other than the "Dual Action Cleanse" product, there was no overlap in branded products offered through the Retail Channel and the Wholesale Channel. **[CP 46]**. Further, nutritional products sold by the Retail Channel involved different branding and packaging schemes than the products sold by the Wholesale Channel. **[Id]**.

Under these facts there is no logical connection between the in-state wholesale operations and the retail business conducted wholly outside Washington. A Washington citizen purchasing a product off the shelf in a Seattle CVS would have no way of knowing that the Company also sells completely different nutritional products under different branding and packaging.

The sole exception to the above discussion of the independence of the two competing lines of business relates to the sale of the "Dual Action Cleanse" product. The business plan for "Dual Action Cleanse" was to offer the nutritional product only at retail. **[CP 48]**. Once retail sales of the product peaked, the Company would then offer "Dual Action Cleanse" for sale to wholesale customers. **[CP 47]**. The goal of this business strategy was to maximize the revenue of the sale of "Dual Action Cleanse" over its product life. ***[See id]***. As the retail sales for "Dual Action Cleanse" began to fall, the wholesale sales would increase thereby maximizing total sales revenue for the product.

In order to properly implement the business strategy for "Dual Action Cleanse," the retail pricing of the product needed to be significantly higher than the price offered to wholesale customers of the Company. As a result, the Company set the wholesale price of the product much lower than the price offered through the Retail Channel. **[CP 49]**. Uncontroverted evidence relating to the pricing of the "Dual Action

Cleanse" product during the relevant periods supports the claim that it could be purchased significantly more cheaply through the Wholesale Channel. **[CP 49, 53-55]**. The average purchase price of sales of "Dual Action Cleanse" made to Washington residents through the Retail Channel for the period 2004-2009 was **$55.52**. ***[Id]***. By comparison, the average price that the Company sold "Dual Action Cleanse" through the Wholesale Channel to retailers in Washington was **$27.32**. ***[Id]***.[3]

In each of the cases relating to transactional nexus or dissociation, the inquiry relates to whether the ***in-state*** activities helped establish or maintain a market for the business activities conducted ***outside*** the state. The marketing and sale of "Dual Action Cleanse" worked in the ***opposite direction***. The Retail Channel began selling "Dual Action Cleanse" in 2004. As noted by the Department, the Retail Channel heavily advertised "Dual Action Cleanse" to Washington retail customers. Beginning in 2006 when "Dual Action Cleanse" became available in the Wholesale Channel, the Company used an "As Seen On TV" marketing strategy to transition sales volume to the Wholesale Channel. With respect to "Dual Action Cleanse," it was the business activity of the Retail Channel ***outside***

[3] The Department has acknowledged this pricing logic between the retail and wholesale sales of the same product in Determination No. 08-0128, 28 WTD 9 (May 14, 2008). This ruling dealt with the taxpayer's claim that actions of an affiliate selling the same product at retail in Washington did not cause it to have B&O tax nexus with the State. The concept of dissociation was not at issue in the ruling.

Washington that assisted the sales growth of the Wholesale Channel ***inside*** the State. The end result of the Company's business strategy for "Dual Action Cleanse" was to increase in-state wholesale sales subject to B&O tax. There is no logical way, and the Department makes no effort to argue to the contrary, that the Wholesale Channel's in-state activities relating to "Dual Action Cleanse" helped maintain the Company's retail market in Washington for sales of the nutritional product.

In sum, the facts of this case are undeniably distinguishable from those in *Tyler Pipe*, *Standard Press Steel*, *General Motors*, *Lamtec, Chicago Bridge & Iron* and *Avnet*. The unique nature of the undisputed facts of this case clearly support the Company's claim to dissociate the out-of-state activities of the Retail Channel from the in-state activities of the Wholesale Channel.

II. The Holding in *Nat'l Geographic* is Not an Obstacle to the Company's Claim for Dissociation Regarding Liability for RST

The Department's sole defense to the Company's claim to dissociation for purposes of the RST is *Nat'l Geographic*. In support of its position, the Department argues that this case mirrors the dispute in *Nat'l Geographic* and therefore that the same result should follow. Resp. Brf. at 19. However, the nature of the Court's Commerce Clause scrutiny has markedly changed since *Nat'l Geographic*. Under contemporary Commerce Clause jurisprudence the holding in *Nat'l Geographic*

resembles an anachronistic landmark in the Court's doctrinal evolution.

In its brief, the Department boldly claims that the taxpayer in *Nat'l Geographic* argued and briefed the identical Commerce Clause argument raised by the Company in this appeal. Resp. Brf. at 19 citing **[CP 230-239]**. However, that cannot possibly be the case. At the time that the taxpayer briefed its case in *Natl'l Geographic* the Court's precedent prevented a state from directly taxing interstate commerce. *See e.g.*, *Spector Motor Service v. O'Connor*, 340 U.S. 602, 71 S. Ct. 508, 95 L. Ed. 573 (1951). As readily admitted by the Department, it was not until its decision in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S. Ct. 1076, 51 L. Ed. 2d 326 (1977), that the Court distanced itself from its prior holdings and put forth a four-pronged test for evaluating violations under the Commerce Clause and requiring business to pay their "fair share" for operating business in interstate commerce. Under *Complete Auto*, a state tax will be sustained against a Commerce Clause challenge if the tax (1) is applied to an activity with a substantial nexus with the taxing State, (2) is fairly apportioned, (3) does not discriminate against interstate commerce, and (4) is fairly related to the services provided by the State. *Id.* at 279. The key to the Company's claim to dissociation in this case is whether the activities of the Retail Channel have the required "substantial nexus" with Washington during the periods at issue.

Complete Auto was decided just months before the Court's decision

in *Natl' Geographic*. Counsel to National Geographic could not have briefed and argued a Commerce Clause argument based on "substantial nexus"[4] when the concept was not a relevant consideration under the Commerce Clause prior to the Court's holding in *Complete Auto*. Absent the use of a "time machine," the Commerce Clause argument presented to and considered by the Court could not have involved a rationale that had yet to be articulated. The ***actual*** Commerce Clause arguments raised by counsel to National Geographic confirm the Company's position on this point. **[CP 221-241]**.

The Court in *Nat'l Geographic* cited *Complete Auto* solely for the proposition that state taxes will generally be sustained under the Commerce Clause where they are "fairly related to the services to the services provided the out-of-state seller by the taxing state." *Nat'l Geographic*, 430 U.S. at 558. This reference to "fairly related" is primarily a concern of the Due Process Clause,[5] but is also touched on in the ***fourth*** prong of the *Complete Auto* four-part Commerce Clause test. *See Complete Auto*, 430 U.S.at 279. The Department's contention that the Court in *Nat'l Geographic* was focused on whether the taxpayer had "substantial nexus" with California is belied by the express language used

[4] Both parties agree that only the "substantial nexus" prong of Complete Auto is in dispute in this appeal.

[5] *See Quill*, 504 U.S. at 306 (stating that the Due Process requires that there be a rational relationship between the tax imposed and the "value" provided by the taxing state).

by the Court in its decision.

The Department also argues that the Court in *Nat'l Geographic* rejected an identical Commerce Clause argument as is presented in this appeal. Resp. Brf. at 20. The Department is technically correct on this point. It is true that in *Nat'l Geographic*, as in this case, the taxpayer argued that under the Commerce Clause certain out-of-state activities lacked the requisite relationship with the state for purposes of sales and use taxes. However, the required ***analysis*** under the Commerce Clause is ***different*** in this case. The Court's view and interpretation of the Commerce Clause at the time of *Nat'l Geographic* has evolved substantially and is now defined by the holding in *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S. Ct. 1904, 119 L. Ed. 91 (1992).

Complete Auto represented a distinct break in precedent from preventing direct taxation of interstate commerce to a more liberal analysis under the Commerce Clause. However, despite the holding in *Complete Auto*, there remained uncertainty regarding the analytical distinctions between challenges brought under the Due Process Clause and the Commerce Clause. In *Quill* the Court reviewed its prior precedent and noted that it had been ambiguous regarding the nature of the applicable constitutional test for challenges brought under either the Due Process Clause or the Commerce Clause. *Quill*, 504 U.S. at 305 ("although we have not always been precise in distinguishing between the two, the Due

Process Clause and the Commerce Clause are analytically distinct"). In sum, while *Complete Auto* was an important decision from a Commerce Clause perspective, it was the Court's decision in *Quill* that set the contemporary foundation for the evaluating future constitutional challenges.

The Court's discussion of the Due Process Clause in *Quill* is telling as it explains the rationale supporting the Court's prior ruling in *Nat'l Geographic*. In *Quill*, the Court outlined a two-part test to scrutinize state taxes under the Due Process Clause. First, the Court stated that the Due Process Clause "requires some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax." *Quill*, 504 U.S. at 306 citing *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-345, 74 S. Ct. 535, 98 L. Ed. 744 (1954). Where such "minimum contacts" exist, the state tax will be upheld under the Due Process Clause where the "income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing state.'" *Id.* citing *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273, 98 S. Ct. 2340, 57 L. Ed. 2d 197 (1978).

In *Nat'l Geographic*, the Court stated that the relevant constitutional test to determine whether an out-of-state seller can be required to collect and remit sales and use tax:

"is not whether the duty to collect the use

> tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate 'some definite link, some minimum connection, between the State and the person ... it seems to tax."

Nat'l Geographic, 430 U.S. at 561 citing *Miller Brothers Co. v. Maryland*, 347 U.S. at 344-345. This is the exact language and citation to *Miller Brothers* used by the Court in *Quill* to outline the applicable analysis under the Due Process Clause.

In reaching its holding, the Court in *Nat'l Geographic* also concluded that the state taxes assessed against the taxpayer were "fairly related" to the services provided by the State of California to the taxpayer. *Nat'l Geographic*, 430 U.S. at 558 citing *Complete Auto*, 430 U.S. at 279. This reference to "fairly related" is likely a reference by the Court to the fourth prong of the four-part Commerce Clause analysis under *Complete Auto*. *Complete Auto*, 430 U.S. at 279 (a state tax will be sustained under the Commerce Clause where it "is fairly related to the services provided by the State"). Whether the Company is correct on this reference is not relevant to this case. What is clear is that the Court in *Nat'l Geographic* made no effort to consider whether the California sales and use tax was "applied to an activity with a substantial nexus" with the state.

All challenges brought under the Court's contemporary Commerce Clause jurisprudence must be analyzed through the lens of the four-pronged test in *Complete Auto*. *Quill*, 504 U.S. at 311. Critical to this

case is whether the activities of the Retail Channel had substantial nexus with Washington during the relevant period. *Nat'l Geographic* does not speak to the critical issue of substantial nexus and is therefore not a bar to the Company's claim for dissociation for RST purposes.

III. Department Rules and Controlling Precedent of the United States Supreme Court Support the Company's Claim for Dissociation for B&O Tax Purposes

A. This Court's Holding in *Avnet* Does Not Prevent the Company's Claim for Dissociation Under Rule 193(7)(c)

The Department relies on this Court's recent decision in *Avnet* for its position that the Company is unable to seek the protections of Rule 193 for purposes of dissociating the activities of its Retail Channel. As applicable to the Period, Rule 193 reads in pertinent part as follows:

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

(emphasis added). The language used by the Department in Rule 193 is clear and must be followed. The Company contends that the Department must be bound by the language of its own rule. *See Skamania Cty. v. Woodall*, 104 Wn. App. 525, 539, 16 P.3d 701 (2001) (making clear that administrative agencies must be bound by their own rules).

In *Avnet*, this Court rejected the taxpayer's argument that it was entitled to dissociate a subset of wholesale sales under Rule 193. The Court's view was that Rule 193 was an interpretive rule and is therefore not permitted to expand on the governing statute. *Avnet*, slip. op. at 12. According to the Court, the relevant B&O statute intended to tax interstate commerce to the extent permitted by the U.S. Constitution. *Id.* However, the support cited by the court for its holding, *Coast Pacific Trading, Inc. v. Dep't of Revenue*, 105 Wn.2d 912, 719 P.2d 541 (1986) and *Space Age Fuels, Inc. v. State*, 178 Wn. App. 756, 315 P.3d 604 (2013), *review denied*, 180 Wn.2d 1010 (2014), are of no help in evaluating the significance of Rule 193(7)(c) in this case.

At issue in *Coast Pacific Trading* was a B&O tax exemption relating to export sales of timber. *Coast Pac. Trading*, 105 Wn.2d at 541-542. That exemption was found in Rule 193C. *Id.* The taxpayer argued that its facts fell within Rule 193C and that the Department should not be permitted to disregard its published authority. This Court rejected the taxpayers arguments. Addressing the specific claim for an import

exemption, this Court cited RCW 82.04.4286 which provides specific guidance to interpreting the authoritative scope of Rule 193C. *Id.* at 544. RCW 82.04.4286 provides that the deduction for export sales applies only to tax amounts "which the state is prohibited from taxing under the Constitution ... of the United States." This authority is of no assistance to this Court in evaluating the importance of Rule 193(7)(c).

This Court also referred to *Space Age Fuels* as a recent case supporting its holding regarding Rule 193(7)(c) in *Avnet*. Yet, this case also fails to make the desired connection. In *Space Age Fuels*, the taxpayer argued that certain of its sales of fuel lacked the required nexus with Washington for B&O Tax purposes. The taxpayer cited an example in a Department rule which it believed agreed with its constitutional argument. *Id.* a 764. The Court in *Space Age Fuels* declined to follow the import of Rule 193(11)(a) for reasons wholly unrelated to this Court's position in *Avnet*. *Id.* at 764-765. The Court stated that (1) it is not bound by the rule, (2) it gives no deference to a rule unless the statute is ambiguous, and (3) the language of Rule 193(11)(a) was contrary to the taxpayer's position. *Id.*

Neither Coast Pacific Trading nor Space Age Fuels support the holding in Avnet that Rule 193(7)(c) must be disregarded because it expands on a governing statute.

Rule 193 states that dissociation is permitted for B&O Tax

purposes where the relevant transactions and activities where they "are not significantly associated in any way with the sales into the state." The Department has not explained by rule what it means for one set of activities or transactions to be "significantly associated." However, in Determination 04-0208 the Department interpreted its own rule and explained that to be "significantly associated" one set of activities or transactions must "establish or maintain a market" for the other. In light of this interpretation of Rule 193, this appeal presents an easy case for dissociation.

The Company's Retail Channel and Wholesale Channel were operated independently in all respects. Critical to the analysis under Rule 193(7)(c), the Retail Channel and the Wholesale Channel served completely separate markets for sales. Further, other than "Dual Action Cleanse," there was no crossover of nutritional products or branding between items offered by the Wholesale Channel and the Retail Channel. Although "Dual Action Cleanse" ***was*** offered through both the Wholesale Channel and the Retail Channel, the price differential prevented the sales of products through the Wholesale Channel from "establishing or maintaining a market" for products sold through the Retail Channel. Under Rule 193(7)(c), the in-state activities of the Wholesale Channel I no way "established or maintained a market" for the Retail Channel. For these reasons, the assessment of B&O Tax by the Department must be

abated under Rule 193.

B. The Concept of Substantial Nexus as Explained in *Complete Auto* and *Quill* Confirms the Company's Ability to Dissociate the Activities of the Retail Channel for Purposes of the B&O Tax

Critical to this Court's holding in *Avnet* was its conclusion that the decision in *Norton Co. v. Illinois Dep't of Revenue*, 340 U.S. 534, 71 S. Ct. 377, 95 L. Ed. 517 (1951), had been "eroded" by subsequent precedent from the United States Supreme Court. Yet, a careful review of cases such as *Complete Auto* and *Quill* confirm that the central holding of *Norton* relating to dissociation lives on.

This Court discounted the significance of *Norton* based in part on its belief that it relied on prior precedent of the United States Supreme Court preventing the direct taxation of interstate commerce. *Avnet,* slip. op. at 15. The Company does not dispute this Court's observation on this point. However, a close review of the *Norton* reflects the fact that the holding resulted from a two-step process. As a threshold matter, the Court stated the general rule under the Commerce Clause that a state was not permitted to directly tax interstate commerce. *Norton*, 340 U.S. at 537. The method by which the Court implemented this general rule was through the concept of dissociation. *See id.* at 537-538. In other words, the taxpayer needed to prove dissociation in order to claim the exemption for sales made strictly through interstate commerce. The fact that the

states are ***now*** permitted to directly tax interstate commerce does not take away from the fact that *Norton* confirmed the viability of dissociation. Under *Norton*, a taxpayer proves dissociation by showing that in-state activities "were not decisive factors in establishing and holding [the] market" for activities conducted outside the state. *Id.* at 538.

The holding in *Norton* lives on in the Court's Commerce Clause jurisprudence of the court. The two most notable decisions are *Complete Auto* and *Quill*. In each of these cases, the Court noted that a state tax will be upheld only when it is "applied to an activity with a substantial nexus" with the taxing state. *Complete Auto*, 430 U.S. at 279; *Quill*, 504 U.S. at 311. The use of the term "activity" necessarily means that substantial nexus is evaluated on an activity-by-activity basis. As a result, where, as in this case, the taxpayer is conducting multiple activities in a state, the taxpayer proves that an activity lacks substantial nexus through a claim of dissociation. The holding in *Norton* forms the basis for such a claim. *Complete Auto* and *Quill* represent mere logical extensions of the core holding in *Norton*.

Regarding the applicable test for dissociation, the Court stated in *Norton* that the taxpayer must demonstrate that the in-state activities were not "decisive factors" in "establishing" or "holding" the market for the out-of-state activities. The Court has not overruled this aspect of *Norton*. Cases involving one type of business activity make it difficult for a

taxpayer to successfully claim dissociation. For example, when evaluating the taxpayer's retailing activities in *Norton* the Court stated "[t]his corporation has so mingled taxable business with that which it contends is not taxable that it requires administrative and judicial judgment to separate the two." *Norton*, 340 U.S. at 538. Yet, the uncontroverted facts of ***this*** dispute present two distinct business activities, conducted wholly independently and addressing two different markets.

Under *Norton*, the facts of this appeal present a clear case for dissociation. Even with respect to the sole cross-over product – "Dual Action Cleanse" – it cannot be said that the in-state activities of the Wholesale Channel were "decisive" in assisting the Retail Channel to "establish" or "hold" a market for retail sales in Washington.

III. The Company is Entitled to Dissociate the Activities of its Retail Channel for RST and B&O Tax Purposes Under the Express Holding in *Avnet*

A. The Holdings in *General Motors* and *Tyler Pipe* Outline the Proper Analysis for Dissociation for RST Purposes

In the event that the Department prevails with its argument that the *Norton* "decisive factor" test is not relevant to an indirect tax such as the RST, the Company is still entitled to dissociation under this Court's analysis in *Avnet*. In *Norton*, the Court alluded to the fact that dissociation is more difficult in the context of an indirect tax such as sales and use taxes. *Norton*, 340 U.S. at 537. Addressing only the constitutionality of

direct taxes, the Court in *Norton* did not expressly outline its views on what the proper dissociation analysis was for indirect taxes.

In *Avnet*, this Court looked to *General Motors* and *Tyler Pipe* to determine whether dissociation was appropriate for B&O Tax purposes. Under these cases, this Court concluded that dissociation is shown where the taxpayer can demonstrate that its in-state activities are not "significantly associated with the taxpayer's ability to establish and maintain a market in [the] state for the sales." *Avnet*, slip. op. at 16-17 quoting *Tyler Pipe*, 483 U.S. at 250. This test as employed in *General Motors*, *Tyler Pipe* and *Avnet* is a difficult hurdle to overcome for multistate businesses engaged in one business activity. However, in this appeal the Company was engaged in two wholly different business activities through two independent manufacturing, distribution and sales channels. Most important, the branding of products in the Retail Channel and the Wholesale Channel - with the exception of "Dual Action Cleanse" – did not overlap. As a result, there was no way that the in-state activities of the Wholesale Channel could have assisted the Company in maintaining its market for sales through the Retail Channel.

The sale of "Dual Action Cleanse" through both the Retail Channel and the Wholesale Channel does not impact the Company's claim for dissociation. First, "Dual Action Cleanse" began as a product solely of the Retail Channel. For the first two years of its lifecycle it was not offered

through the Wholesale Channel. Pursuant to the Company's marketing strategy for the product, it began selling "Dual Action Cleanse" in the Wholesale Channel only when it anticipated a steady drop in retail sales. Offering the product more cheaply at wholesale through an "As Seen On TV" marketing approach was intended to boost sales of the Wholesale Channel at the expense of the drop in sales in the Retail Channel. For these reasons, the in-state activities of the Wholesale Channel relating to "Dual Action Cleanse" were not "significantly associated with the [Company's] ability to establish and maintain a market in [Washington] for the sales" of the product through the Retail Channel.

For these reasons, the Company is entitled to dissociate the out-of-state activities of the Retail Channel for purposes of the RST.

B. The Company is Permitted to Dissociate the Activities of its Retail Channel for B&O Tax Purposes Under Test Articulated in *Avnet*

Even if this Court should hold that the test for dissociation in Norton is no longer valid, the Company remains entitled to dissociation under this Court's holding in *Avnet*. In *Avnet*, this Court employed the approach in *General Motors* and *Tyler Pipe* to conclude whether a subset of the taxpayer's wholesale sales had substantial nexus – could not be dissociated – for B&O Tax purposes. As discussed *supra*, the same facts which support the Company's claim for dissociation for RST purposes supports its claim to dissociation in the context of the B&O Tax.

For B&O Tax purposes, the Company is engaged in two classifications of business activities – retailing and wholesaling. These business activities were conducted entirely separate from one another. While the Company handled the activities of the Wholesale Channel through its own employees and certain independent sales representatives physically located in Washington, the activities of the Retail Channel were outsourced to independent third parties. Further, there was no overlap in branded products – except for "Dual Action Cleanse." However, as repeatedly explained herein, the marketing and sales strategy of "Dual Action Cleanse" actually worked to establish and maintain a market for the activities of the Wholesale Channel ***in Washington***. The activities of the Wholesale Channel could not have assisted the out-of-state activities of the Retail Channel in maintaining its Washington retail market.

The in-state activities of the Wholesale Channel were not "significantly associated" with the ability of the Retail Channel to maintain its retail market for sales for B&O Tax purposes

CONCLUSION

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

RESPECTFULLY SUBMITTED this 8th day of June, 2015.

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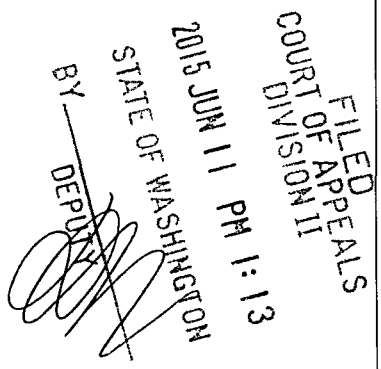
CERTIFICATE OF SERVICE

I, Miriam Green, certify under penalty of perjury under the laws of the State of Washington that, on June 8, 2015, I caused to be served on the persons listed below in the manner shown:

- APPELLANT'S REPLY BRIEF



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