FILED
SUPREME COURT
STATE OF WASHINGTON
7/16/2020 11:51 AM
BY SUSAN L. CARLSON
CLERK

No. 98470-1

IN THE SUPREME COURT
STATE OF WASHINGTON

KMS FINANCIAL SERVICES, INC.,

Respondent

v.

CITY OF SEATTLE,

Petitioner

ANSWER TO PETITION FOR REVIEW

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I. INTRODUCTION

The Commerce Clause requires taxes to be "fairly apportioned" so that tax is imposed only on income reasonably attributed to the taxpayer's in-state activities. Washington law imposes the same limitation on city taxes. Seattle uses a two-factor apportionment method for B&O tax on service income earned both within and outside the city. One of those factors, the "payroll factor," compares the compensation the taxpayer pays in Seattle to the compensation it pays everywhere else. At bottom, the more a taxpayer pays for work performed outside the city, the lower its apportionment factor—which means a lower B&O tax.

KMS Financial Services, Inc. ("KMS") is headquartered in Seattle, but generates most of its income through sales of securities by registered representatives working outside the city. Even though they are treated as employees under federal securities law, Seattle ignored KMS's registered representatives when apportioning KMS's income on the grounds that they are independent contractors, and not "employees" as defined by its tax code. The city refused to include their compensation in calculating KMS's payroll factor—which roughly tripled KMS's B&O tax liability.

The Court of Appeals properly concluded that Seattle's B&O tax was unconstitutional as applied to KMS because the principle of fair apportionment forbids Seattle from ignoring the work of KMS's registered

representatives simply because they are considered "independent contractors." Whether KMS sells securities through employees or independent contractors is without constitutional significance. For purposes of fair apportionment, the only constitutionally significant fact is that most of KMS's income-generating activity occurs outside the city.

There are no grounds for review. The Court of Appeals' decision reflects a straightforward application of settled constitutional law, and presents no issue of substantial public interest. The court did not strike down Seattle's B&O tax, nor did it hold that fair apportionment requires inclusion of all independent contractors in the "payroll factor." The court was careful to find Seattle's tax unconstitutional only "as applied" because of the unique role KMS's registered representatives play in generating the firm's income and their status as de facto employees under federal law.

By the same token, the Court of Appeals' decision does not conflict with federal or state case law. On the contrary, the court found Seattle's attempt to ignore the income-generating activities of KMS's registered representatives unconstitutional for largely the same reasons it did when it invalidated an earlier iteration of Seattle's B&O tax in *KMS Fin. Servs. v. City of Seattle*, 135 Wn. App. 489, 146 P.3d 1195 (2006) (KMS I). This Court denied review in *KMS I. Id.*, 161 Wn.2d 1011, 166 P.3d 1217 (2007). It should do the same thing here.

II. COUNTERSTATEMENT OF THE ISSUE

Did the Court of Appeals properly hold, consistent with federal and Washington precedent, that Seattle's B&O tax, as applied to KMS, violated the Commerce Clause and analogous state law because it did not "fairly apportion" KMS's revenue to reflect the income-generating activities of KMS's registered representatives outside the city. **Yes.**

III. COUNTERSTATEMENT OF THE CASE

A. KMS Is A Seattle-Based Broker-Dealer That Generates Revenue Primarily Through The Sale Of Securities By Registered Representatives Working Outside The City.

The parties stipulated to the undisputed, material facts. CP 9-42. KMS is a Washington corporation, headquartered in Seattle, that engages in the securities, insurance and investment advisory business. *Id.* (¶ 3). KMS is a broker-dealer under the Securities Exchange Act of 1934 ("1934 Act"), and registered with the Securities and Exchange Commission ("SEC"), the Financial Industry Regulatory Authority ("FINRA," the successor to the National Association of Securities Dealers or "NASD") and state securities regulators in all 50 states. *Id.* (¶ 4).

Under the federal securities laws, a broker-dealer acts primarily through "registered representatives," and anyone who assists others in the trading of securities must be a registered representative of a broker-dealer. *Id.* (¶¶ 5, 6). Registered representatives are individuals, often referred to as

stockbrokers or account executives, who provide a variety of investment related services, including (among other things) opening and servicing client accounts, giving investment advice and arranging for the purchase and sale of securities on the broker-dealer's account. *Id.* (¶ 5).

Federal law requires a broker-dealer to supervise its registered representatives, oversee their licensing status, and ensure they comply with industry rules, as well as the standards of conduct and procedures set out in its policy manual. *Id.* (¶ 8). Broker-dealers are typically structured so that their registered representatives are either all employees (Form W-2) or independent contractors (Form 1099) for federal income tax purposes. *Id.* (¶ 9). Under the 1934 Act and FINRA regulations, however, a broker-dealer's responsibilities vis-à-vis its registered representatives are the same regardless of how they are classified. *Id.* (¶ 10).

Indeed, both the SEC and FINRA consider a broker-dealer's registered representatives to be "employees" because they are, by law, subject to the broker-dealer's control—even if they are classified as independent contractors. An SEC circular states:

> It has been long-standing policy of the Commission that independent contractors whose selling activities were controlled by their broker-dealer employers could be characterized as employees for purposes of the Act. … Thus, it is clear that the independent contractor salesperson may be deemed an employee and associated person under the Act if the requisite control relationship exists.

CP 21-24. Similarly, a NASD Notice informed its broker-dealer members and their registered representatives as follows:

> Irrespective of an individual's location or compensation arrangements, **all associated persons are considered to be employees of the firm with which they are registered for purpose of compliance with NASD rules governing the conduct of registered persons and the supervisory responsibilities of the member.**

CP 16-19 (emphasis in original). These rules remain in effect. CP 16-19.

KMS generates its revenue through the work of approximately 350 registered representatives operating throughout the United States. CP 9-42 (¶¶ 3, 14). KMS classifies its registered representatives as independent contractors. *Id.* (¶ 13); CP 26-30 (contract). During the relevant period, KMS employed approximately 50 W-2 employees, most of whom worked in its Seattle headquarters. CP 9-42 (¶¶ 3, 16). These W-2 employees handle various back office administrative functions, but do not provide or generate investment advice, give securities advice, or solicit the sale of securities or other insurance products. *Id.* (¶¶ 16, 17).

During the audit years, KMS paid its W-2 employees between approximately $2.6 million and $4 million annually, almost all of which (around 95%) went to Seattle-based staff. For that same period, KMS paid its registered representatives between approximately $70 million and $79 million, the vast majority of which (around 85%) went to representatives

working outside of Seattle. CP 32. As discussed below, even though registered representatives working outside the city are responsible for the bulk of KMS's revenue, Seattle excluded their compensation from the "payroll factor" used in determining KMS's B&O tax liability.

B. The Court Of Appeals Invalided Seattle's B&O Tax Under A Prior Tax Code Because It Failed To Consider The Income-Generating Activities Of KMS's Registered Representatives.

This is not the first time Seattle has tried to exclude the income-generating activities of KMS's registered representatives when purporting to apportion KMS's revenue. The Court of Appeals rejected the city's prior effort as unconstitutional. *See KMS Fin. Servs. v. City of Seattle*, 135 Wn. App. 489, 146 P.3d 1195 (2006) (KMS I). Seattle replaced the local ordinance at issue in *KMS I*, but the Court of Appeals properly recognized that the city's application of the current two-factor formula resulted in the very same constitutional infirmity identified in *KMS I*. Notably, this Court denied review in *KMS I*. *Id.*, 161 Wn.2d 1011, 166 P.3d 1217 (2007).

In *KMS I*, the Court of Appeals held that, "when considering the constitutionality of a gross receipts tax, it is the *activities* that *generate* those gross receipts that are determinative in an apportionment analysis." 135 Wn. App. at 506-07, 509 (internal quotations and citation omitted). As applied to KMS, Seattle's tax was unconstitutional because "[a]lthough KMS may not maintain 'offices' outside Seattle, it is undisputed that some

of its registered representatives generate sales outside Washington state," and not "all securities transactions which generate commissions occur inside the City of Seattle." *Id.* at 509. All the same remains true.

C. Seattle Enacts A Two-Factor Apportionment Formula, But Refuses To Include The Compensation Paid By KMS To Its Registered Representatives In the "Payroll Factor."

Beginning in 2008, Seattle replaced the apportionment formula considered in *KMS I* and adopted the two-factor apportionment formula set forth in RCW 35.102; *see* SMC 5.45.081(F). For income derived from services, this formula requires the taxpayer to calculate an "income factor" and "payroll factor," both of which are reflected as a fraction. Those fractions are added together and divided by two. The resulting number is then multiplied by the taxpayer's total taxable income, without regard to source, to derive the amount of income that can be allocated to the taxpayer's Seattle activities for B&O tax assessment. *Id.*

The dispute in this case centers exclusively on the calculation of KMS's "payroll factor." CP 12 (¶ 23). The portion of Seattle's tax code addressing the payroll factor states in relevant part:

> The payroll factor is a fraction, the numerator of which is the total amount paid for compensation in the city during the tax period . . . and the denominator of which is the total compensation paid everywhere during the tax period.

SMC 5.45.081(F)(1). "Compensation" is defined as "wages, salaries, *commissions*, and any other form of remuneration paid to individuals for

personal services that are or would be included in the individual's gross income under the federal Internal Revenue Code. *Id.*, (H) (emphasis added). "Individual" is defined as one "who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer." *Id.*

Seattle recognized that strict application of this two-factor formula may not lead to fair or constitutional apportionment in all cases. So, the code provides that if the formula does "not fairly represent the extent of the taxpayer's business activity in the city," Seattle must apply alternative methodologies to achieve an "equitable allocation." SMC 5.45.081(F)(3). And, in all events, the code admonishes Seattle that "apportionment of revenue under this section shall be made in accordance with and in full compliance with the provisions of the Interstate Commerce Clause of the United States Constitution where applicable." *Id.*, (I).

D. KMS Challenges Seattle's B&O Tax Assessment; The Court of Appeals Invalidates Seattle's Tax As Applied To KMS.

For the period at issue, KMS included the compensation it paid to its registered representatives when calculating the "payroll factor." CP 12-13 (¶¶ 25, 29). Because most of the compensation KMS pays comes in the form of commissions paid to registered representatives, and most of its registered representatives work outside the city, the resulting payroll factor

ranged between 14% and 20%. *Id.* (¶ 26); CP 32. After averaging this payroll factor with the service income factor, and multiplying that figure by KMS's total revenue, KMS calculated, reported and paid $187,998.34 in Seattle B&O tax with its regularly filed returns. CP 13 (¶ 34).

After an audit, Seattle assessed KMS an additional $505,523.22 in B&O tax, interest and penalties. CP 13-14 (¶ 35). The sole basis for the assessment was Seattle's calculation of the payroll factor. *Id.* (¶ 28). The city took the position that the compensation KMS paid its registered representatives must be excluded because, as "independent contractors," they did not qualify as "employees" within the meaning of Seattle's tax code. *Id.* (¶¶ 29, 30); CP 34-42. Exclusion of compensation paid to KMS's registered representatives increased the payroll factor to nearly 100%—roughly tripling the amount of B&O tax due. *Id.* (¶¶ 31, 32); CP 32.

KMS paid the assessment and filed this refund action. CP 1-3. The Court of Appeals found Seattle's B&O tax unconstitutional as applied to KMS because the city "ignore[d] where KMS's registered agents work and generate income in calculating the payroll factor." Op. at 12-13. As a remedy, the court ordered Seattle to treat KMS's registered representatives as employees for purposes of calculating the payroll factor. The court concluded that this remedy was not only required by the tax code's alternative apportionment provision, but was consistent with the "plain

language" of the payroll factor itself—because, under federal securities law, KMS's registered representatives have the status of "employees." Op. at 14-16. The court denied Seattle's motion for reconsideration.

IV. ARGUMENTS AGAINST REVIEW

A. Seattle Did Not Fairly Apportion KMS's Income.

1. Seattle Improperly Ignored The Income-Generating Activities Of KMS's Registered Representatives.

Seattle cannot demonstrate grounds for review in the first instance because the Court of Appeals' decision was entirely correct. The court recognized that "[b]ecause KMS's registered representatives operated in Seattle, in other Washington state locations, and in locations outside Washington state, the City's tax must meet both state and federal constitutional requirements." Op. at 8 (quoting *KMS I*, 135 Wn. App. at 503). To satisfy those requirements, Seattle's B&O tax must be "fairly apportioned" to reflect the location of the income-generating activities of KMS's registered representatives. Op. at 11-12. "[T]he point of fair apportionment is to ensure that a city only taxes income attributable and proportional to a taxpayer's income-generating activity in the city." *Id.*

Seattle didn't do that. By excluding registered representatives from the payroll factor, Seattle attributed most of KMS's income to the work of a few dozen administrative employees working the city even though it was

undisputed that most of KMS's revenue was generated by hundreds of registered representatives working outside the city. Op. at 12-13. As the Court of Appeals aptly noted, "It does not matter whether income is generated by independent contractors or employees working outside the city. Either way, they are not working in the city; the city has no claim to a 'fair share' of the income they generate." *Id.* (underline in original).

Seattle offers no authority to show that fair apportionment differs when a taxpayer's income is generated by independent contractors.[1] The fact that a taxpayer does business through independent contractors, rather than employees, is "without constitutional significance." *Scripto v. Carson*, 362 U.S. 207, 211-12 (1960). Seattle points out that *Scripto* addressed nexus, not apportionment, but cannot explain why that makes a difference. Pet. at 15. It doesn't. If Seattle can tax income generated by a taxpayer's independent contractors working both in and outside the city—and it does, *see* SMC 5.30.030(B)(3)—then where those independent contractors work must be reflected in how that income is apportioned.

[1] The only case Seattle cites (*see* Pet. at 15, n. 9) was decided solely on statutory grounds; it did not consider fair apportionment under federal or state constitutional principles. But, even on statutory grounds, courts have found alternative apportionment necessary if inclusion of independent contractors in the payroll factor results in unfairness. *See Miami Corp. v. Ill. Dep't of Revenue*, 571 N.E.2d 800 (Ill. App. 1991); *Lancaster Colony Corp. v. Limbach*, 524 N.E.2d 1389 (Ohio 1988).

2. The "Income Factor" Does Not Reflect The Location Of KMS's Income-Generating Activities.

Conspicuously, Seattle does not argue that the Court of Appeals' constitutional analysis was flawed. Rather, it attacks the court's reliance on *KMS I* because the city's "apportionment methodology has changed significantly." Pet. at 12-13. The Court of Appeals rejected this false distinction. "While the law has changed, the City's argument here suffers the same defect it did in *KMS I*. The City again ignores where KMS's registered agents work and generate income in calculating the payroll factor. . . . In essence, the City attributes most of KMS's income to the work of approximately 50 employees based in the city when it is undisputed that the bulk of KMS's income comes from the work of the 300-plus registered representatives based outside the city." Op. at 13.

In so holding, the Court of Appeals recognized that the "income factor" of Seattle's two-factor apportionment formula did not salvage the tax's constitutionality. Seattle argues that the court "improperly conflates the formula's payroll and income factors," because it is the income factor that "fully reflects . . . where KMS earned its income." Pet. at 14. Wrong. As required, KMS (and the city) calculated the income factor exclusively based on "customer location." CP 12; SMC 5.45.081(F)(2)(a). And, of course, the location of KMS's customers is not the same as the location of

KMS's registered representatives. Seattle offered no evidence that KMS's customers always live where its registered representatives work. They don't. Customers living in Seattle can and do buy securities from registered representative working outside the city, and vice versa.

The income factor focuses on "customer location" because it is intended to reflect the contribution of the ***market*** for a taxpayer's service (*i.e.*, where the benefit of the service is received), not the contribution of the ***labor*** needed to create that market (*i.e.*, where income-generating activity occurs). *See* Pechacek & Nakamura, *The Payroll Factor: Whose Factor Is It Anyway?* 2010 St. & Loc. Tax Law 155, 155-56 (2009); Hellerstein & Hellerstein, *State Taxation*, ¶¶ 9.17 & 9.18 (3d ed. 2001 & Supp. 2014). Only the payroll factor reflects the location of the taxpayer's income-generating activities, and it does so by comparing compensation it pays for work performed inside and outside the city.

Even if Seattle could show that the income factor reflected some of KMS's income-generating activities, it still is not enough. One factor of a multi-factor apportionment formula "may be so distortive that the other [factors] do not mitigate its effect on the formula as a whole." *In re Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 1989 WL 95886, *3 (Cal. St. Bd. Eq. June 2, 1989). To identify unconstitutional distortion, courts compare "the percentage differences between the application of different

methodologies." Hellerstein, *supra*, at ¶ 8.15[5]. The U.S. Supreme Court has found differences around 200% or more to be "out of all appropriate proportions to the business transacted" in the state. *Hans Rees' Sons, Inc. v. N.C.*, 283 U.S. 123, 135 (1931) (250%); *Norfolk & Western Railway v. Missouri State Tax Comm'n*, 390 U.S. 317, 326-29 (1968) (166%).

Here, Seattle's erroneous application of the payroll factor plainly surpassed this unconstitutional threshold. KMS's income factor ranged between 13.11% and 15.29%. CP 32. When KMS properly included compensation paid to registered representatives in the payroll factor, the overall apportionment ratio was consistent, ranging between 15.17% and 16.78%. *Id.* But when the city excluded that compensation from the payroll factor, KMS's apportionment ratio increased by more than 300%. *Id*. The simple fact that the city's exclusion of registered representative compensation from the payroll factor tripled KMS's B&O tax liability refutes Seattle's claim that the income factor adequately reflects the location of KMS's income-generating activities.

3. There Is No Difference Between Federal And State Law.

Finally, this Court can easily reject Seattle's suggestion that the Court of Appeals erred in applying Commerce Clause analysis to the intra-state component of KMS's fair apportionment challenge because the "tests are not identical." Pet. at 15-16. To begin with, Seattle did not raise any

purported distinction between federal and state law during administrative review, at the trial court, or with the Court of Appeals—or even mention it in passing. It is axiomatic that the city cannot raise the issue for the first time in a petition for review to this Court. *See Crystal Ridge Homeowners Assoc. v. City of Bothell*, 182 Wn.2d 665, 678, 343 P.3d 746 (2015).

The argument is a red-herring anyway. Seattle cannot cite any authority to show that the interstate and intrastate apportionment tests are different—because they are not. (As discussed below, no separate test was articulated in *Dravo*.) Rather, "[o]ur Supreme Court, in molding limits upon the exercise of a municipal corporation's power to impose a business and occupation tax on local business activities, has analogized from decisions of the United States Supreme Court in cases involving state taxation of interstate commerce." *KMS I*, 135 Wn. App. at 510 (quoting *Tacoma v. Fiberchem, Inc.*, 44 Wn. App. 538, 543, 722 P.2d 1357 (1986)). The same fair apportionment standards applied to interstate transactions under the Commerce Clause apply equally to intrastate transactions that occur within Washington but outside Seattle city limits. *Id.* at 512.

B. There Are No Issues Of Substantial Public Interest.

Seattle offers two reasons why it believes this case presents issues of public importance, neither of which have merit. The city first falsely characterizes the scope of the Court of Appeals' decision, arguing it "calls

into question the application of ordinances across the State." Pet. at 16. But the decision does not question the validity of the two-factor formula used by Seattle and other cities under RCW 35.102.130. The holding is expressly limited to KMS. "Because the tax is not fairly apportioned, it is unconstitutional as applied to KMS." Op. at 13. There is no question that the formula is constitutional as applied to most taxpayers and, indeed, it would have been constitutional as applied to KMS if, as the Court of Appeals held, Seattle had properly construed its "plain language" to allow KMS to treat its registered representatives as employees. *Id.* at 15-16.

Equally overblown is Seattle's claim that the decision will require cities to "conduct a nuanced legal and factual analysis of whether each taxpayer uses employees or independent contractors." Pet. at 17. The Court of Appeals did not hold that compensation paid by any taxpayer to any independent contractor must be included in the payroll factor. Here, too, the decision was limited to KMS and, like *KMS I*, turned on the specific nature of KMS's business—"the City attributes most of KMS's income to the work of approximately 50 employees based in the city," who generate no income, when "the bulk of KMS's income comes from the work of the 300-plus registered representatives based outside the city." Op. at 13. Seattle fails to show that other taxpayers are similarly situated, or that the decision will impact the tax treatment of any such taxpayer.

Seattle's second reason posits that the Court of Appeals' decision will encourage taxpayers to flout the two-factor apportionment formula. Pet. at 18. The city's premise is factually and legally wrong. This is not a case where a taxpayer secretly used an alternative methodology, waiting to request permission to use that methodology when audited. From the start, KMS treated its registered representatives as employees when calculating the payroll factor, and it was transparent in doing so. There was no reason for KMS to request alternative apportionment when—as the Court of Appeals concluded—it was properly applying the two-factor formula all along. Indeed, the court ordered the city to use alternative apportionment as a judicial remedy, not because KMS requested it during audit. So the decision in no way can be read to countenance taxpayer subterfuge.

If anything, the decision correctly rejects Seattle's suggestion that cities should be able to assess an unconstitutional tax if the taxpayer does not "petition" for alternative apportionment before paying its taxes. The city's tax code states that "apportionment of revenue . . . shall be made in accordance with and in full compliance with the provisions of the Interstate Commerce Clause of the United States Constitution." SMC 5.45.081(I). As the Court of Appeals correctly recognized, alternative apportionment requires cities to comply with this constitutional imperative if the two-factor formula does not—and, that is so even if the taxpayer

does not request alternative apportionment in advance. The Ordinance permits the City to use alternative methods upon a taxpayer's "petition" ***or*** if "the tax administrators … jointly require." SMC 5.45.081(F)(3).

At bottom, Seattle cannot explain why the merits of the Court of Appeals' decision—with its sound constitutional analysis and holding limited to a single taxpayer—raises an issue of public importance. Nor can it show that the decision creates any ambiguity in the way cities administer the two-factor formula. The import of the decision is clear and correct; if the formula produces an unconstitutional outcome, cities must use an alternative methodology—or they will be ordered to do so by a court.

C. There Is No Conflict With Federal Or State Authority.

Seattle does not argue that the Court of Appeals' decision conflicts with federal Commerce Clause authority. It doesn't. Nor does the city identify any conflict between the decision and any prior opinion from this Court or the Court of Appeals—on either federal or state law grounds. Indeed, the decision is entirely consistent with (and, in fact, followed) the Court of Appeals' decisions in *KMS I*, *supra*, and *Avanade, Inc. v. City of Seattle*, 151 Wn. App. 290, 211 P.3d 476 (2009). As noted, this Court denied review in *KMS I*, 161 Wn.2d 1011, 166 P.3d 1217 (2007).

Seattle argues that conflict exists because the decision does not apply a "separate" state law test articulated in *Dravo Corp. v. City of*

Tacoma, 80 Wn.2d 590, 496 P.2d 504 (1972). Pet. at 20. Not only did the city fail to make this argument below, it is bogus. In *Dravo*, Tacoma taxed a contract executed in the city, but performed outside the city. The issue was nexus. And the only test articulated was the traditional due process standard for nexus—that is, "whether there is a definite link or minimum connection between the city and the transaction it seeks to tax." 80 Wn.2d at 599. Because "the locus of the activity taxed (I.e. [*sic*], the making of the contract) occurred within the city," the Court found "sufficient nexus upon which the city could base its B&O tax." *Id.* at 600-601.

The *Dravo* court did not reach the issue of fair apportionment, much less articulate a "separate test governed under state law." Pet. at 20. The Court recognized that intrastate transactions must be apportioned when "the incidence of the tax takes place both within and without the city," but found that no apportionment was required because the "taxable activity was the making of the contract," and that activity "took place entirely within the city limits." *Id.* at 603. Unlike *Dravo*, no one disputes that KMS's income must be apportioned because it was generated both in and outside Seattle. As discussed above, the test for fair apportionment of intrastate transactions under state law is the same as that for interstate transactions under federal law. Op. at 10-11; *KMS I*, 135 Wn. App. at 510. For this reason too, there is no conflict with Washington (or federal) law.

V. CONCLUSION

The petition for review should be denied.

RESPECTFULLY SUBMITTED this 16th day of July, 2020.

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CERTIFICATE OF SERVICE

I certify under penalty of perjury under the laws of the state of Washington that on this date I have caused a true and correct copy of the foregoing pleading to be served on the following person as indicated:

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July 16, 2020 - 11:51 AM

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Appellate Court Case Number:	98470-1
Appellate Court Case Title:	City of Seattle v. KMS Financial Services, Inc.

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