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Tax Policy

Criss-crossing the country, Crowell & Moring's state tax team meets regularly with state tax commissioners and their counsel to bring Bloomberg BNA's readers candid and timely observations from the country's top state tax decision-makers. Well into this 50-state journey, Walt Nagel, Don Griswold, and Jeremy Abrams spoke this month with Carol Nelson, Director of the Washington Department of Revenue, and Gil Brewer, Senior Assistant Director of Tax Policy at the Washington Department of Revenue. In this column, Nelson and Brewer discuss the tax appeals process, cloud computing, and B & O tax nexus, among other topics.

Crowell's Conversations: An Interview With Carol Nelson and Gil Brewer, Washington Department of Revenue



CAROL NELSON AND GIL BREWER, INTERVIEWED BY
WALT NAGEL, DON GRISWOLD, AND JEREMY ABRAMS

Backgrounds and Careers

CROWELL: We're excited to sit down and chat with both of you this morning. Carol, tell us a little about your background and your transition to Director.

NELSON: My background comes strictly from the private sector. I was in the banking and financial services industry for over 30 years. Most recently, I was the President and CEO of a community bank here in Washington. We ended up selling our community bank to a

California-based bank, and I was fortunate to take a little time off. Then I got the call from the Governor's office about heading up the Department of Revenue. There is a definite connection between banking and tax. So after a very interesting and fun career in banking I am now in the public sector. It's been an interesting 13 months.

One of the biggest surprises about coming to government is that it has really shattered some of the stereotypes that some people have around state workers. I was delighted to find an agency that is very well regarded. It is filled with talented people who are really mission driven. They truly do believe in serving the citizens of our state, and are trying to make a difference.

And so it is exciting for me to be part of that mission as well, and I'm very pleased with what I am finding. Now that being said, of course, there are lots of opportunities to get better, and we've really been embracing lean management practices to improve things and eliminate waste in terms of wasted time, energy, and resources, and to establish high service standards.

CROWELL: That's great. Carol's been with the Department for 13 months. Gil, you've been with the Department almost 13 years. What is your role in the Department?

BREWER: I am the head of four different divisions in the Department. That's the Appeals Division, Interpretations and Technical Advice, Legislation and Policy, and Research and Fiscal Analysis. And together that forms the core of what we refer to as the Policy Divisions within the Department.

Tax Appeals Process

CROWELL: Speaking of appeals, proposed legislation this year would have modified the tax appeals process in Washington by eliminating the "pay to play" requirement under the current Board of Tax Appeals ("BTA") rules and/or replacing the BTA with an independent tax tribunal. (S.B. 6175 and S.B. 6176.) What is the Department's view on the appellate process?

NELSON: The proposals reinforced that there is a need for a conversation around reforming the tax appeals process. And that's something that we can continue to look at. There is quite a backlog at the BTA right now. That's what triggers some of the frustration with trying to get things moved through the system. Again, we had some concerns with the bills. We testified and shared those concerns. But they did not make it through the short session.

"The [legislative] proposals reinforced that there is a need for a conversation around reforming the tax appeals process."

BREWER: We recognize that there is certainly a lot of interest among taxpayers and practitioners in trying to make changes to the appeals process. Things like "pay to play" don't affect us one way or another from a policy point of view. What we do, though, is advise the legislature that when they make that change, it's going to have a fiscal impact. Because right now whenever anyone goes to court, the State gets that money when they file. So [if "pay to play" is abolished], there will be a transition period where the State is going to lose revenue. Again, that's not a policy issue for us, but it's something we want to make sure the legislators take into consideration. But now that neither bill passed, I expect we'll get into additional discussions with stakeholders and see if we can get enough significant support for any one proposal, and get something through the legislature.

Revenue Department Priorities

CROWELL: What would you like to accomplish during your tenure as Revenue Director?

NELSON: We've established four priority areas for the agency. The first is customer-focused service; taking a hard look at the service levels that we're delivering throughout the entire agency to our taxpayers and to Washingtonians. The second is efficient and effective program administration and revenue collections. Of course, as a revenue agency, we are responsible for collecting dollars, and we have a cash commitment that we need to make sure we're meeting, which we are. But also taking a look at how we can be more efficient and effective, and so that's where these lean management practices that I mentioned are coming into play. The third is fair and consistent tax policy administration. As we take a look, for example, at the two bills that we introduced,¹ they really were designed to help ensure that we are more fair and consistent in our application of tax policy. The fourth is legislative and executive branch support. We are probably responsible for providing over 50 percent of the fiscal notes attached to bills each session. We also support the Governor's office in terms of legislation that they are supporting and introducing. It's very important to us that we are fulfilling that side of our responsibilities as well. So we took a look at all the activities in the agency, and we put them into those four buckets to identify how we are going to move the agency forward. And that seems to be resonating with our employees and I think it makes our work a little bit easier to understand and clearer to our constituents.

CROWELL: Are there any examples you'd like to highlight?

NELSON: Earlier this year we launched Live Chat where taxpayers can go onto our website and receive assistance. That's been very well received so we are really pleased about that. We also introduced an online amended tax return this year. And it's kind of funny because yesterday I was out doing a little deeper dive into our tax administration area and sat with one of our agents and looked at some of these amended tax returns. We have a standard that we're going to clear those in 10 days. And this has been so popular that we are actually having a hard time keeping up with our standard. But we pulled one of the amended tax returns and cleared it while we were sitting there. That's another example of using technology to become more efficient. For tax, that's kind of exciting.

Cloud Computing

CROWELL: Many states are pushing the envelope on cloud computing rather than going to the legislature to enact more modern statutes that capture the reality of cloud computing. How does Washington treat cloud computing services?

BREWER: Washington actually did come up with a statute that addresses digital products including services like cloud computing which, of course, covers a large array of different types of activities. What we found in the course of our study and working with stakeholders on the legislation is this digital stuff isn't

¹ S.B. 6405, enacted March 27, 2014 (provides greater consistency in how non-profit tax-exempt property may be used for non-exempt purposes without jeopardizing the property's tax-exempt status); H.B. 2539/S.B. 6472 (would have simplified amusement and recreation taxes by subjecting specified activities to retail sales tax and retail B & O tax, among other provisions).

like your mother's old tangible personal property. It's not like old professional services. This is a new thing and it requires a new mindset. And that's why it required a new statute, a new way of looking at it. So we did that. We adopted the statute.² So when it comes to activities in the digital realm, again it's going to depend somewhat on what you are doing and that will drive how it's taxed. A lot of these digital services under the new statute are defined as retail sales. And in that case, we would be applying the physical presence standard. Hence, if a company is providing a cloud computing service classified as a retail sale, and they do not have physical presence here, there would be no tax liability in Washington.

“[T]his digital stuff isn't like your mother's old tangible personal property . . . it requires a new mindset.”

B & O Tax Quirks

CROWELL: Let's pivot to the Business and Occupation (“B & O”) tax. Historically it's been the kind of tax that makes a lot of sense if you're more of a consumer state than a producer state. But Washington has come a long way in terms of being a hotbed of new ideas and companies. Is there a thought to replacing it with a more traditional income tax?

NELSON: There has always been talk about tax reform. For years, different people have taken stabs at coming up with alternative programs. But we have a tax system that's pretty well entrenched in the state. The B & O tax generates about 18 percent of the state's revenue, second only to the sales tax. So for it to change would really take some catalytic event and I don't know what that would be.

BREWER: If it's going to happen, it almost absolutely is going to be through a referendum or subject to a referendum, and at least until now there's been absolutely no will to do that. There are folks still looking at possibilities of an income tax with some type of additional reforms that would reduce taxes elsewhere or put in some constitutional cap on rates because people are always afraid of rate creep once it gets in. There are also people looking at alternative taxes like a margins tax, similar to what Texas has or what Nevada is considering. And there are people who are talking about simply reforming the B & O tax. But to Carol's point, it's going to be tough to trigger enough consensus to make any kind of change.

CROWELL: What would you say about the B & O tax to an out-of-state company that's looking to do business in Washington?

BREWER: Whether or not Washington is going to be attractive compared to another state is really going to be dependent upon what you are doing. If you're a high-

² Wash. Rev. Code §§82.04.190 to 82.32 (nonconsecutive), as amended by 2009 H.B. 2075, effective July 26, 2009; Wash. Rev. Code §§82.04.050 to .32.533 (nonconsecutive), as amended by 2010 H.B. 2620, effective July 10, 2010.

tech company and you're selling electronic services and most of your customers are around the world, Washington is a fabulous place to be located because you will be classified as service, which has the highest rate (1.5 percent of gross revenue), but then you look at our apportionment and we're single sales factor. So if you're located in Washington and most of your sales are outside the state, this is a pretty darn attractive place to be. Of course, the absence of a personal income tax is also attractive to some people for purely personal reasons.

When it comes to nexus, there are a couple odd quirks for a company to do business in Washington. One that often trips up out-of-state companies is that P.L. 86-272 does not apply in Washington. So mere solicitation can create nexus in Washington for B & O purposes and often out-of-state firms assume incorrectly that they can rely on federal preemption under that statute. Second, some folks tend to think of the B & O tax like a sales tax and we don't think of it that way. B & O tax is not necessarily bound by *Quill*.³ However, when the legislature adopted the economic nexus standard for apportionable activities in 2010,⁴ it did statutorily impose a physical presence nexus requirement for the remaining B & O classifications. So as of 2010, we do have the same standards for B & O retailing, wholesaling activity that you would under *Quill*. It's all a physical presence standard. But for service activities, we apply the pure economic nexus standard I mentioned earlier.

“[M]ere solicitation can create nexus in Washington for B & O purposes and often out-of-state firms assume incorrectly that they can rely on federal preemption . . .”

CROWELL: Tell us about some of the recent nexus cases that have been handed down.

BREWER: The two that come to mind are *Sage V Foods* and *Space Age Fuels*.⁵ *Sage V* was a tough case. This was an out-of-state company, they didn't have strong physical ties to the state, but they did have rail cars that they rented for their product. It's rice flour that makes French fries crispy, which for me is a big deal, I'm a big French fry guy. So, they have to rent these

³ *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (physical presence was necessary for state to require taxpayer to collect use tax).

⁴ Wash. Rev. Code §82.04.067, as added by 2010 S.B. 6143, effective June 1, 2010.

⁵ *Space Age Fuels Inc. v. Washington*, 315 P.3d 604 (Wash. Ct. App. 2013) (taxpayer had substantial nexus with Washington, and the state's assessment of B & O tax did not violate the dormant commerce clause because the taxpayer's regular deliveries to Washington customers established its physical presence in the state), *appeal docketed*, No. 89849-9, (Wash. Jan. 31, 2014) (set for consideration on April 29, 2014); *Washington Dept. of Rev. v. Sage V Foods LLC*, No. 12-2-01893-3 (Wash. Sup. Ct. Aug. 20, 2013) (an out-of-state taxpayer that leased railcars to make deliveries to Washington did not have substantial nexus when the taxpayer's activities were insufficient to establish or maintain an in-state market).

special rail cars to keep the flour in the condition they need it so that it can be used in the manner to treat the fries. We made the argument that their leased property—those rail cars—even though they were being hauled by a common carrier, that it was still the out-of-state taxpayer's property and that that should suffice to create a physical presence. Both the BTA and the Superior Court disagreed with us, and at that point we simply said okay. We recognize this is a borderline case, and we just thought we'd be better off focusing our resources elsewhere.

Space Age Fuels is a more traditional nexus case where you had an out-of-state fuel company that, using their own trucks, came into Washington to make those deliveries on a very regular basis and the court came out with a well-reasoned decision that is a very good guide to nexus in Washington. Now I believe they've petitioned for review by the Supreme Court in Washington, so it's possible that we haven't yet heard the last word from the courts.

Agency Focus and Continuity

CROWELL: Is there continuity in the Department from administration to administration, or is there more of a break when there is a change in administrations and a new director comes in?

NELSON: From my perspective what I have observed is that it sort of goes in spurts. There's been a lot of turnover in the last few years and I think that can be disruptive. I don't think that from a policy standpoint there were major shifts in the direction of the agency during that time period. But I think it just creates an uncertainty in the minds of employees that makes it a little bit difficult to operate, maybe slows down the process. But it's not like we've turned and gone around in a completely different direction.

BREWER: We're not a political department. We try to apply the laws as written. We do our best to understand the original intent and accomplish those goals, and that mission goes on pretty much regardless of who's sitting in the corner office.

CROWELL: Was tax a major part of Governor Inslee's agenda when he took office in 2013?

NELSON: Not specifically. The Governor's focus is on economic vitality, creation of jobs, and improving the economic climate here in our state and we are all for that. That is reflected in the tax incentives provided to Boeing and the aerospace industry, a very important presence here in our state. I think that our legislature reacted swiftly to try to encourage the growth of their business here in Washington, and we feel good about that. I live in Snohomish County, which is where Boeing has its wide-body jet manufacturing facility. And so it's been a huge, huge player in the community that I lived in for years. It's very obvious to the community because everyone that you know has some member of Boeing in their family.

CROWELL: Is there anything else you'd like to say to tell the readers of Bloomberg BNA's Weekly State Tax Report?

NELSON: Again, our focus as an agency has been pretty clearly stated in terms of the priorities that we set out for the Department of Revenue. I think that our team is doing a terrific job in terms of implementing and moving forward streamlining, increasing efficiencies, and being a much more effective agency in state government. And we really pride ourselves here at Revenue as being one of the best agencies in our state, so we are pleased with the progress that we are making. But of course, we always want to keep doing better.

CROWELL: Well you're doing a fabulous job. Thanks for joining us today.