Cite as Det. No. 14-0345, 34 WTD 294 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 14-0345
. . .	)	Registration No. . . .

[1] RCW 82.04.067: B&O TAX – SUBSTANTIAL NEXUS – RECEIPTS THRESHOLD. Substantial nexus is established for a taxpayer when that taxpayer has receipts in Washington beyond the threshold amounts as established in RCW 82.04.067.

[2] Due Process Clause of Amendment XIV of the U.S. Constitution: B&O TAX – NEXUS – DUE PROCESS REQUIREMENTS. Where a taxpayer makes minimum contacts with Washington and the method of attributing income to Washington is rationally related to the value of the taxpayer's business, the requirements of the Due Process Clause are met, and the taxpayer may be subject to taxation in Washington.

[3] RULE 19401; RULE 19402; RULE 19404; RCW 82.04.067(1)(c)(iii): B&O TAX – SUBSTANTIAL NEXUS – RECEIPTS FROM THIS STATE. To determine what constitutes "receipts from this state" for determining substantial nexus, the states apportionment rules govern. For loan servicing fees, the fees are attributed to Washington under Rule 19404 if the borrower on the loan being serviced is located in Washington.

[4] RULE 101; RCW 82.32.030: TAX REGISTRATION – INVOLUNTARY. The Department may involuntarily register a taxpayer when the Department find that taxpayer to be subject to taxation in Washington and that taxpayer has not voluntarily registered itself.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Yonker, A.L.J. – An out-of-state student loan servicer (Taxpayer) appeals a tax assessment, contending that because it has no physical presence and does not solicit business to establish a market in Washington, it has no nexus with Washington. Taxpayer further contends that the income it received from loan lenders for "servicing" loans cannot constitute "receipts" from Washington. We conclude Taxpayer has adequate nexus with Washington under the Commerce

Clause and the Due Process Clause of the U.S. Constitution, and that a portion of Taxpayer's income from lenders may constitute receipts attributable to Washington, thereby subjecting Taxpayer to taxation in Washington. Taxpayer's petition is denied.[1]

ISSUES

1. Pursuant to the Commerce Clause of Article I, § 8, clause 3 of the U.S. Constitution, and RCW 82.04.067, does Taxpayer have substantial nexus such that the Department may assess tax against Taxpayer where it had over $250,000 in receipts from Washington in 2012 and over $267,000 in receipts from Washington in 2013?

2. Pursuant to the Due Process Clause of Amendment XIV of the U.S. Constitution, does Taxpayer have nexus such that the Department may assess tax against Taxpayer where it has no physical presence in Washington?

3. Pursuant to RCW 82.04.067(1)(c)(iii), and WACs 458-20-19401, 458-20-19402, 458-20-19404, do Taxpayer's receipts from various lenders for "servicing" loans of borrowers located in Washington constitute "receipts from this state"?

4. Pursuant to RCW 82.32.030 and WAC 458-20-101, did the Department err when it involuntarily registered Taxpayer as a business in Washington after the Department determined that Taxpayer had nexus with Washington?

FINDINGS OF FACT

[Taxpayer] is [an out of state] limited liability company . . . Taxpayer's primary business activity is servicing student loans.[2] Taxpayer contracts with various lenders to "service" portfolios of unpaid loans. Lenders assign Taxpayer various portfolios of loan accounts and Taxpayer represents that it has no control over the location of the borrowers on those loan accounts. In general, Taxpayer's loan "servicing" activity includes sending account statements to borrowers, collecting borrower payments, maintaining a website and call center to assist borrowers from Taxpayer's central location . . . . Taxpayer also performs collection efforts on delinquent borrower accounts remotely from its central location by calling borrowers with delinquent accounts and by sending delinquent letters to borrowers. For these services, Taxpayer receives its compensation directly from the contracted lenders. Taxpayer represented to the Audit Division that for certain lenders, Taxpayer receives its compensation based on the number of accounts Taxpayer serviced. For other lenders, the basis of compensation is the amount of loan payments paid by borrowers on accounts serviced by Taxpayer.[3]

During the relevant time period, Taxpayer serviced two categories of student loans. First, Taxpayer serviced approximately 200,000 loan accounts under the Federal Family Education Loan Program (commercial loans), the lenders of which were various commercial banks.

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] Taxpayer also provides "higher education services," or HES, which offers various financial aid services to certain post-secondary schools located in other states. This service is not at issue in this appeal.
[3] Taxpayer did not provide any documentation to determine which specific lenders paid based on either of these compensation methods.

Second, Taxpayer serviced approximately 840,000 loan accounts for the U.S. Department of Education under the federal Direct Loan program (federal loans).

In 2013, it came to the Department's attention that Taxpayer's business activity might be taxable in Washington. On March 25, 2013, the Department's Audit Division sent Taxpayer a Washington Business Activities Questionnaire, which Taxpayer completed and returned to the Department on May 29, 2013. In Taxpayer's completed questionnaire, it stated that it had no revenue, payroll, or property in Washington between January 1, 2009 and March 31, 2013. The Audit Division subsequently conducted a review of Taxpayer's books and records for the period of January 1, 2012 through November 30, 2013, and found that Taxpayer had a total of $. . . in receipts attributable to Washington in 2012 and $. . . in receipts attributable to Washington in 2013.

Specifically, the Audit Division determined Taxpayer's amount of receipts from commercial loans attributable to Washington for 2012 and 2013 through the following steps:

1. Based on Taxpayer's documentation, the Audit Division determined the total income from commercial loans in 2012 and 2013, and also the total number of borrowers of commercial loans during those years.
2. The Audit Division determined the relative number of borrowers that were in Washington during 2012 and 2013, and also determined the relative amount of debt owed by borrowers in Washington during those years.
3. The Audit Division took an average of the two relative numbers found in the previous step, and used that average as the percentage of total receipts attributable to Washington.

The Audit Division used an average of these two relative numbers because Taxpayer did not provide records to determine how each individual lender calculated the compensation it paid to Taxpayer during the audit period.

For the federal loans Taxpayer serviced during the audit period, the Audit Division determined the relative number of borrowers that were in Washington during 2012 and 2013, and used only that relative number as the percentage of total receipts attributed to Washington as that was the basis for compensation for all of the federal loans Taxpayer serviced.

On February 21, 2014, as a result of the Audit Division's review, the Department issued a tax assessment for $. . . , which included $. . . in service and other activities B&O tax, a $. . . delinquent penalty, a $. . . five percent assessment penalty, a $. . . unregistered business penalty, and $. . . in interest. Taxpayer timely appealed the full amount of the tax assessment.

ANALYSIS

Washington imposes a business and occupation ("B&O") tax "for the act or privilege of engaging in business" in this state. RCW 82.04.220. The tax rate varies based on the type of business activity the taxpayer engages in and the statute provides numerous classifications of activities. Taxpayers engaging in service businesses in this state not otherwise classified in Chapter 82.04 RCW are subject to the service and other activities B&O tax, measured by the "gross income of the business." RCW 82.04.290(2). Taxpayer does not dispute that its business activity is not otherwise classified in Chapter 82.04 RCW, and, therefore, does not dispute that

its business activity, if taxable in Washington, is properly taxable under the service and other activities B&O tax classification.

The B&O tax is "extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State." *Analytical Methods, Inc. v. Dep't of Revenue*, 84 Wn. App. 236, 241, 928 P.2d 1123 (1996) (quoting *Palmer v. Dep't of Revenue*, 82 Wn. App. 367, 371, 917 P.2d 1120 (1996)). "Business" is defined broadly to include "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.

Notwithstanding the broad definition of "business" in RCW 82.04.140 that essentially includes all business activities that benefit a taxpayer, a state cannot tax transactions that do not have sufficient connection or "nexus" with that state. *See, e.g.*, *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S. Ct. 1076, 51 L.Ed.2d 326 (1977); *Tyler Pipe Industries, Inc. v. Dep't. of Revenue*, 483 U.S. 232, 250, 107 S. Ct. 2810, 97 L.Ed.2d 199 (1987); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); Det. No. 05-0376, 26 WTD 40 (2007). This nexus requirement flows from limits on a state's jurisdiction to tax found in both the Due Process Clause and the Commerce Clause of the United States Constitution. *Quill,* 504 U.S. at 305; Det. No. 01-188, 21 WTD 289 (2002); *Lamtec Corp. v. Dep't of Revenue*, 170 Wn.2d 838, 246 P.3d 788 (2011) ("A tax on an out-of-state corporation must satisfy by the requirements of the due process clause of the Fourteenth Amendment and the commerce clause."). Further the requirements of the Due Process Clause and the Commerce Clause "pose distinct limits on the taxing powers of the States" and these "two constitutional requirements differ fundamentally, in several ways." *Quill,* 504 U.S. at 305.

1. Substantial Nexus Requirement Under the Commerce Clause

The United States Supreme Court has identified certain requirements under the Commerce Clause in order for a state to impose tax on an out-of-state business. In *Complete Auto,* the Court held that the Commerce Clause requires that the tax: (1) be applied to an activity with "substantial nexus" with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the state. *Complete Auto,* 430 U.S. at 279.

Here, the only element under the *Complete Auto* test that Taxpayer challenged is the first element, "substantial nexus." Taxpayer argued on appeal that it lacked "substantial nexus" in Washington because it did not have any physical presence in Washington. Taxpayer argued that physical presence in the taxing state is a constitutional requirement under *Quill*. Taxpayer further argued that it did not perform any activities in Washington during the audit period that were "significantly associated with the taxpayer's ability to establish and maintain a market in this state" for its business activity. *See Tyler Pipe Industries v. Dep't of Revenue,* 105 Wn.2d 318, 323, 715 P.2d 123 (1986).

Our state's definition of "substantial nexus" is in RCW 82.04.067, which codified that term in 2010. Under RCW 82.04.067(1), a person engaging in a service activity is deemed to have substantial nexus with Washington if the person is:

(a) An individual and is a resident or domiciliary of this state;

(b) A business entity and is organized or commercially domiciled in this state; or

(c) A nonresident individual or a business entity that is organized or commercially domiciled outside this state, and in any tax year the person has:

(i) More than fifty thousand dollars of property in this state;

(ii) More than fifty thousand dollars of payroll in this state;

(iii) More than two hundred fifty thousand dollars of receipts from this state;[4] or

(iv) At least twenty-five percent of the person's total property, total payroll, or total receipts in this state.

RCW 82.04.067(6) further makes clear that for service activity, there is no physical presence requirement as there is for other types of activity. Thus, under Washington law, so long as Taxpayer had more than $250,000 in 2012 and $267,000 in 2013 of "receipts from this state" from service activity, we must find that Taxpayer has substantial nexus, regardless of whether it has physical presence in Washington.

Here, the Audit Division found that Taxpayer had $. . . in service receipts attributed to Washington for 2012 and $. . . in service receipts attributed to Washington in 2013. *See infra* Part 3 (discussing the Audit Division's process of determining Taxpayer's receipts that were attributed to Washington). These amounts clearly meet the receipts threshold of $250,000 for 2012 and $267,000 for 2013 pursuant RCW 82.04.067(1)(c)(iii). As such, Taxpayer had substantial nexus in 2012 and 2013.

To the extent that Taxpayer argued at hearing that the statutory definition of "substantial nexus," as codified in RCW 82.04.067, is unconstitutional, we do not have authority to rule on that issue. *Bare v. Gorton*, 84 Wn.2d 380, 383, 576 P.2d 379 (1974) ("An administrative body does not have the authority to determine the constitutionality of the law it administers; only the courts have that power."); *see also* Det. No. 98-083, 17 WTD 271 (1998). Accordingly, such an argument is not properly reviewable by us, and we make no ruling on Taxpayer's argument made at hearing regarding the constitutionality of RCW 82.04.067.

2. Requirements for Taxation Under the Due Process Clause

The Due Process Clause requires two things in order for a state to tax an out-of-state business. First, there must be "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, 344-45, 74 S.Ct. 535 (1954)). Second, "the income attributed to the state for tax purposes "must be rationally related to 'values connected with the taxing State.'"

[4] RCW 82.04.067(5)(a) requires the Department to review "the cumulative percentage change in the consumer price index" each December, and adjust the nexus threshold amounts to reflect the change in the consumer price index. As a result of this statutory requirement, the Department adjusted this threshold upward to $267,000 for the 2013 calendar year. WAC 458-20-19405(2)(a). For 2012, however, the threshold remained at $250,000.

Quill, 504 U.S. at 306 (quoting *Moorman Mfg. Co. v. Bair,* 437 U.S. 267, 273, 98 S.Ct. 2340 (1978)).

With respect to the first requirement, The *Quill* Court relied heavily on judicial jurisdiction cases to determine if a taxpayer had "minimum contacts" with the taxing state such that taxing that taxpayer did not offend "traditional notions of fair play and substantial justice." *Quill,* 504 U.S. at 307 (citing *Int'l Shoe Co. v. Washington,* 326 U.S. 310, 316, 66 S.Ct. 154 (1945)). The *Quill* Court stated the following:

> Applying these principles, we have held that if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State.

Quill, 504 U.S. at 307. The Court went on to quote its previous decision in *Burger King Corp. v. Rudzewicz,* 471 U.S. 462, 476, 105 S.Ct. 2174 (1985):

> Jurisdiction in these circumstances may not be avoided merely because the defendant did not *physically* enter the forum State. Although territorial presence frequently will enhance a potential defendant's affiliation with a State and reinforce the reasonable foreseeability of suit there, it is an inescapable fact of modern commercial life that a substantial amount of business is transacted solely by mail and wire communications across state lines, thus obviating the need for physical presence within a State in which business is conducted. So long as a commercial actor's efforts are "purposefully directed" toward residents of another State, we have consistently rejected the notion that an absence of physical contacts can defeat personal jurisdiction there.

(Emphasis in original). The *Quill* Court's reasoning makes clear that any efforts that are "purposefully directed" toward residents of the taxing state will satisfy the first requirement of the due process test even if there is "an absence of physical contacts" in that state. *See also* Det. No. 93-120, 14 WTD 7 (1994).

Here, Taxpayer argues that it "has not directed [its] activities toward residents of Washington in order to 'purposefully avail itself of the benefits of an economic market'" in Washington. We disagree. Taxpayer sends statements and other correspondence to borrowers in Washington, it receives calls from such borrowers by telephone, and it engages in collection efforts with delinquent borrowers located in Washington by mail and by telephone. These efforts are "purposefully directed" toward residents in Washington even if Taxpayer did not physically enter Washington. We conclude that it makes no difference that Taxpayer is not "soliciting" business directly from Washington residents or that Taxpayer may not have control over which loan accounts lenders assign to Taxpayer for servicing. We conclude that Taxpayer has adequate minimum contacts with residents of Washington to satisfy the first requirement of the due process test.

With respect to the second requirement, wide latitude is given to a state's selection of a method for attributing value of the enterprise. *Moorman Mfg. Co.*, 437 U.S. at 274. Such a selection "will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted'" or has 'led to a grossly distorted result.'" *Id.* (citations omitted). *See also Exxon*

Corp. v. Dep't of Revenue, 447 U.S. 207, 227 (1980) (holding that a state's taxing formula satisfies the second requirement of the Due Process Clause if it is not inherently arbitrary and does not tax a portion of the taxpayer's income out of all appropriate proportion to the business transacted in that state). According to the United States Supreme Court in *Moorman*, where a state has shown that some minimal connection exists, income attributed to the taxing state need only be "rationally related" to values connected with the state. *Moorman*, 437 U.S. at 272-73.

Here, Taxpayer argued that because it did not solicit business directly from residents of Washington and does not receive revenue directly from Washington borrowers, the tax imposed is not "fairly related" to its activity attributed to Washington. Again, we disagree. The Audit Division attributed a portion of Taxpayer's income to Washington based on the average of two numbers: (1) the percentage of total borrowers in Washington during the audit period and (2) the percentage of total amount of unpaid debt owed by borrowers in Washington. We conclude that such a formula is "rationally related" to Taxpayer's business activity attributed to Washington.

Taxpayer has not offered by "clear and cogent evidence" that the formula used is "out of all appropriate proportion to" the business Taxpayer transacted that was attributed to Washington. Therefore, we conclude that the Department's tax assessment does not violate the Due Process Clause of the U.S. Constitution.

3. "Receipts from this state" under RCW 82.04.067(1)(c)(iii)

RCW 82.04.067(1)(c)(iii) states that substantial nexus, discussed above, is met when a taxpayer in any tax year has "[m]ore than two hundred fifty thousand dollars of **receipts from this state**." (Emphasis added). Taxpayer argued on appeal that its income from lenders during the audit period did not qualify as "receipts from this state" under RCW 82.04.067(1)(c)(iii) because the lenders were not located in Washington, and Taxpayer received no income directly from Washington borrowers. Taxpayer's argument follows that if its income from lenders cannot be considered "receipts from this state," then Taxpayer did not meet the receipts threshold for establishing substantial nexus under RCW 82.04.067(1) for 2012 and 2013.

The Legislature directed that "receipts from this state" be determined by reference to the numerator of the receipts factor under the Department's apportionment rules. RCW 82.04.067(4). WAC 458-20-19401(6) clarifies that the receipts threshold contained in RCW 82.04.067(1)(c)(iii) "is met if a taxpayer receives more than [$250,000 for 2012 and $267,000 for 2013] from apportionable activities that is **attributed to** Washington." (Emphasis added). WAC 458-20-19401(6)(b) states that receipts are generally attributed to Washington pursuant to WAC 458-20-19402 (Rule 19402). Rule 19402(305)(c), in turn, specifically provides that activities including "servicing loans" must be attributed "in the same manner a financial institution attributes income under WAC 458-20-19404."

WAC 458-20-19404 (Rule 19404) addresses how to determine the income attributed to a state for financial institutions, and for nonfinancial institutions such as Taxpayer, who service loans. Rule 19404(4)(i)(ii) states that "loan servicing fees for servicing either the secured or the unsecured loans **of another**" is attributed to Washington "if the borrower is located in this state."

(Emphasis added).[5] Thus, all loan servicing income Taxpayer received from the lenders related to borrowers located in Washington during the audit period are attributed to Washington.

Here, the Audit Division attributed to Washington only the loan servicing income related to borrowers located in Washington. Specifically, the Audit Division used an average of the relative number of borrowers in Washington and relative amount of debt owed by borrowers in Washington to determine the amount of income attributable to Washington. The Audit Division used an average of those two numbers because Taxpayer stated during the audit process that it received income from servicing the various lenders based either (1) on the number of loan accounts services or (2) on the total amount collected. However, Taxpayer did not provide documentation of the payment method of each individual lender.

If a taxpayer fails to maintain and provide adequate records, the Department is authorized to "proceed, in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax." RCW 82.32.100(1). We conclude that the Audit Division was authorized to estimate Taxpayer's income attributed to Washington in the absence of complete records, and, based on the available information, used a proper method for attributing Taxpayer's loan servicing income to Washington during the audit period.

We ultimately conclude that the amounts of gross income the Audit Division attributed to Washington for 2012 and 2013 constitute "receipts in this state" for the purposes of RCW 82.04.067. As discussed above, those amounts are above the $250,000 receipts threshold for 2012 and $267,000 receipts threshold for 2013. Accordingly, we affirm the Audit Division's tax assessment.

4. Involuntary Registration in Washington

RCW 82.32.030(1) requires that "if any person engages in any business or performs any act upon which a tax is imposed," that person must "apply for and obtain from the department a registration certificate." *See also* WAC 458-20-101(2). Additionally, WAC 458-20-101(5) further clarifies that out-of-state businesses "who have established sufficient nexus in Washington to be subject to" Washington's B&O tax "must obtain a tax registration endorsement" with the Department.

As we concluded above, Taxpayer had sufficient nexus in Washington to be subject to B&O tax in Washington. As such, Taxpayer was required to become registered with the Department. Thus, the Audit Division's involuntary registration of Taxpayer after Taxpayer chose not to voluntarily register was authorized under RCW 82.32.030(1) and WAC 458-20-101.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 3rd day of November, 2014.

[5] While Rule 19404(4)(i) does not speak in terms of "attributing," the rule generally treats the method for determining the numerator of the receipts factor for apportionment purposes as also being the method for attributing income to a state. *See* Rule 19404(2)(a).