Cite as Det. No. 15-0031, 35 WTD 311 (2016)

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. 15-0031
. . .	)	Registration No. . . .

[1] RULE 193; RCW 82.04.067; B&O TAX – SUBSTANTIAL NEXUS – PHYSICAL PRESENCE. Taxable nexus is created by the presence of two taxpayer representatives, one that made periodic visits to Washington and the other that resided in Washington, for the purpose of maintaining business relationships with various customers. Those activities are significantly associated with establishing or maintaining a market for the sales of the taxpayer's products in Washington.

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 manufacturer and seller of bedding products protests the assessment of business and occupation (B&O) tax and retail sales tax on sales of its products in Washington, contending it did not have sufficient nexus with Washington . . . . We deny Taxpayer's petition . . . .[1]

ISSUES

1. Does Taxpayer have nexus in Washington under WAC 458-20-193 when it had "limited" physical presence of two representatives in Washington? . . .

. . .

FINDINGS OF FACT

[Taxpayer] is an [out of state] corporation in the business of manufacturing . . . bedding products. Taxpayer's manufacturing facilities are located [out of state]. Taxpayer has no manufacturing facility or other office in Washington.

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

Procedural History

On January 16, 2013, the Department's Compliance Division sent Taxpayer a Washington Business Activities Questionnaire to complete so that the Compliance Division could determine what, if any, business activity Taxpayer had in Washington. On April 29, 2013, Taxpayer submitted its completed questionnaire, in which Taxpayer stated the following regarding the 2011 tax year:

- It made sales, provided services, or had customers in Washington.
- It made sales or provided services via the internet.
- It had gross sales in Washington of $ . . . .
- It had no payroll or property in Washington.
- It had "[p]eriodic sales visits to [its] customers located in Washington."
- Its sales visits were conducted by a resident independent representative and a nonresident employee that made five annual visits of one to two days.
- Its products were delivered to Washington customers via "[t]hird-party carriers."

Based on Taxpayer's responses on the completed questionnaire, the Compliance Division determined that Taxpayer was subject to taxation in Washington and requested that Taxpayer provide sales records to the Department or the Department would proceed with issuing a tax assessment based on estimated sales figures. Taxpayer did not provide actual sales records, and on December 13, 2013, the Department issued two estimated tax assessments against Taxpayer.

The first estimated tax assessment, which covered the time period of January 1, 2006 through December 31, 2009, was for a total of $ . . . . This total included $ . . . in retail sales tax, $ . . . in retailing business and occupation (B&O) tax, $ . . . in wholesaling B&O tax, a $ . . . delinquent penalty, a $ . . . five percent assessment penalty, a $ . . . unregistered business penalty, and $ . . . in interest.

The second estimated tax assessment, which covered the time period of January 1, 2010 through December 31, 2013, was for a total of $ . . . . This total included $ . . . in retail sales tax, $ . . . in retailing B&O tax, $ . . . in wholesaling B&O tax, a $ . . . delinquent penalty, a $ . . . five percent assessment penalty, a $ . . . unregistered business penalty, and $ . . . in interest. Taxpayer appealed the full amount of the two tax assessments.[2]

1. Categories of Taxpayer's Sales

During the review period, Taxpayer made three categories of sales. By far, the largest category of sales was for "private label" products sold at wholesale to a number of large retailers. Taxpayer manufactured and sold "private label" products at wholesale to [Retailer 1], [Retailer 2], [Retailer 3], [Retailer 4], and [Retailer 5].[3] These large retailers contracted with Taxpayer to

[2] While Taxpayer appealed the full amount of the two tax assessment, it only provided arguments regarding the imposition of B&O tax and retail sales tax. As such, we limit our determination to those issues only.

[3] Taxpayer reported that it began its private label relationship with each of these retailers in the following years: [Retailer 1] prior to 2006; [Retailer 2] in 2007; [Retailer 3] in 2006; [Retailer 4] in 2007 or 2008; and [Retailer 5] in 2005.

manufacture bedding products under their respective "private label" brands. For instance, [Retailer 1] contracted with Taxpayer to manufacture bedding products under [Retailer 1's] " . . . " private label. Taxpayer sold the " . . . " products it manufactured exclusively to [Retailer 1], and had no license or other right to sell such products to any other customer. The other "private label" retailers had substantially similar arrangements with Taxpayer.

The second category of sales was for "licensed" products sold at wholesale to various retailers. During the review period, Taxpayer entered into licensing agreements with two Washington companies, [Retailer 6] and [Retailer 7], in which Taxpayer received the right to manufacture products under the licensed "name brands" of those two companies.[4] Taxpayer then sold such licensed products to some of its retailers, including [Retailer 2] and [Retailer 8].[5]

Regarding its licensing agreement with [Retailer 6], Taxpayer obtained a nonexclusive right to manufacture, and an exclusive right to sell, certain [Retailer 6] products within the United States, Canada, Mexico, and Puerto Rico.[6] [Retailer 1] and [Retailer 2] are both specifically mentioned in Exhibit C of the agreement, and are identified as retailers that place "loads" on wholesale costs, meaning they pay an additional amount to Taxpayer above the standard wholesale price that Taxpayer then repays to them as "advertising support" or "slotting fees." [Retailer 1] and [Retailer 3] are also specifically mentioned in Exhibit E of the agreement as internet retailers to which Taxpayer may sell the licensed products.

Regarding its licensing agreement with [Retailer 7], Taxpayer obtained an exclusive right to manufacture and sell certain [Retailer 7] products to certain retailers within the United States, Canada, Mexico, and South Korea.[7] [Retailer 1] and [Retailer 2] are both specifically mentioned in Exhibit J of the agreement as retailers to which Taxpayer is authorized to sell at wholesale the licensed products.

The third, and smallest, category of sales was retail sales of licensed products on Taxpayer's internet website directly to end consumers, some of which, Taxpayer acknowledges, may have been sold to Washington residents.

1. Taxpayer's Activities in Washington

During the review period, Taxpayer engaged two individuals to make contact with Taxpayer's Washington-based customers. The first individual [(Employee 1)], . . . , was a [out of state] based employee who made two to four visits each year during the audit period to meet with Taxpayer's Washington customers.[8] The purpose of these visits was "to promote goodwill with Washington customers and maintain [Taxpayer's] ongoing business relationships."

[4] Taxpayer reported that it first entered into a licensing agreement with [Retailer 7] in February 2008, and with [Retailer 6] in October 2009.
[5] Taxpayer specifically denied selling licensed products to [Retailer 1] and [Retailer 3].
[6] Paragraph 2.2(c) of the licensing agreement with [Retailer 6] makes clear that [Retailer 6] reserved the right to sell the same licensed products itself within the same territory.
[7] Paragraph 2.2 of the licensing agreement with [Retailer 7] makes clear that [Retailer 7] reserved the right to sell the same licensed products itself within the same territory.
[8] . . . Taxpayer's original questionnaire indicated there were up to five two-day visits annually.

[Employee 1] visited [Retailer 5] and [Retailer 4] in Washington "on behalf of" Taxpayer. Taxpayer stated that during such visits, [Employee 1] "can and [did] occasionally accept sales from these clients." In addition, [Employee 1] visited [Retailer 7] and [Retailer 6] for the purpose of cultivating the licensing relationships Taxpayer developed with those companies during the review period.

At least for some of the review period, [Employee 1] was the Vice President of Sales & Business Development for Taxpayer, which gave him the responsibility of managing Taxpayer's relationship with [Retailer 8], and also overseeing Taxpayer's bulk sale of down material to apparel and outerwear companies, including Washington-based companies [Retailer 9], , and [Retailer 6].[9]

The second individual [(Employee 2)], . . ., was an independent contractor who resided in Washington that Taxpayer engaged from 2007 to 2012. Taxpayer engaged [Employee 2] "principally because of his pre-existing relationship with [Retailer 8]." Throughout the review period, [Employee 2] only visited [Retailer 8] on behalf of Taxpayer, and received commission on the sales Taxpayer made to [Retailer 8] during the time he was engaged by Taxpayer. . . .

. . .

ANALYSIS

Washington imposes a B&O tax on "every person that has a substantial nexus" with Washington "for the act or privilege of engaging in business" in this state. RCW 82.04.220(1). The B&O tax measure and rate are determined by the type or nature of the business activity in which a person is engaged. Chapter 82.04 RCW. The measure of the B&O tax is the application of rates against the "value of products, gross proceeds of sales, or gross income of the business, as the case may be." RCW 82.04.220(1). In addition, retail sales tax is imposed under RCW 82.08.020 on sales of tangible personal property to consumers, and if a seller fails to collect such retail sales tax, under RCW 82.08.050(3), that seller is "personally liable to the state for the amount of the tax" that should have been collected.

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. Taxpayer does not dispute that it engaged in retailing, wholesaling, and manufacturing business activity during the review period, but maintains that these business activities occurred outside of Washington. The Compliance Division found that while Taxpayer may manufacture its products outside of Washington, some of Taxpayer's products are ultimately received by customers in Washington.

[9] The record is unclear as to whether [Employee 1] visited [Retailer 8] or the apparel and outerwear companies in Washington for the purpose of making bulk sales of down material during the review period.

WAC 458-20-193 (Rule 193) explains the B&O tax and retail sales tax liability associated with interstate sales of tangible personal property received in Washington. Rule 193(7) provides the following instruction on imposing Washington's B&O tax on "inbound" sales of tangible personal property:

> Washington does not assert B&O tax on sales of goods which originate outside this state unless the goods are received by the purchaser in this state and the seller has nexus. There must be both the receipt of the goods in Washington by the purchaser and the seller must have nexus for the B&O tax to apply to a particular sale. The B&O tax will not apply if one of these elements is missing.

Rule 193(8) states that retail sales tax must be collected "in every case" where retailing B&O tax is due pursuant to Rule 193(7). Thus, Rule 193 makes clear that for a particular seller of goods to be liable for retailing B&O tax and retail sales tax in Washington, (1) the seller must have nexus in Washington, and (2) the purchaser must receive the goods in Washington.

1. Nexus in Washington

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; *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."); Det. No. 01-188, 21 WTD 289 (2002). Here, Taxpayer has only raised the issue of lack of nexus 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 challenges is the first element, "substantial nexus."

Rule 193 defines nexus in the context of inbound sales from out of state as "the activity carried on by the seller in Washington which is significantly associated with the seller's ability to establish or maintain a market for its products in Washington." Rule 193(2)(f). This definition for substantial nexus was cited with approval by the United States Supreme Court in *Tyler Pipe*, 483 U.S. at 250. On June 1, 2010, the Washington legislature enacted RCW 82.04.067(6), which provides a statutory definition for "substantial nexus" that mirrors the definition of that term in

both Rule 193(2)(f) and *Tyler Pipe* for persons like Taxpayer that are engaged in retailing, wholesaling, and manufacturing business activity:

> [A] person is deemed to have substantial nexus with this state if the person has **physical presence in this state, which need only be demonstrably more than a slightest presence**. For purpose of this subsection, a person is physically present in this state if the person has property or employees in this state. A person is also physically present in this state if the person, either directly or through an agent or other representative**, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in this state.**

(Emphasis added). *See Tyler Pipe*, 483 U.S. at 250; *see also* Det. No. 08-0117, 27 WTD 239, 241 (2008) ("[I]t is the purpose motivating the in-state visits that is key to the nexus inquiry, not the number or duration of the visits."). . . . [Once] nexus is established for a particular taxpayer, that nexus generally extends to all of that taxpayer's sales that are received in Washington, unless some specific exception applies. With these considerations in mind, we now turn to our examination of Taxpayer's Washington activities to determine which of those activities are "significantly associated" with Taxpayer's "ability to establish or maintain a market for its products" in Washington, and, thus, created substantial nexus.

First, Taxpayer conceded on appeal that it had "limited" physical presence in Washington through its employee, [Employee 1], who visited both [Retailer 4 and 5] "on behalf of" Taxpayer during the review period two to four times each year. Taxpayer's business activity with both [Retailer 4 and 5]during the review period included both the manufacturing of private label products for both companies, and selling at wholesale such manufactured products to those companies. Taxpayer conceded that during such visits, [Employee 1] "[could] and [did] occasionally accept sales from these clients." It stands to reason that [Employee 1's] visits "on behalf of" Taxpayer, in which he "occasionally" accepted sales from those customers, were in furtherance of Taxpayer's business activities with those companies.

While Taxpayer termed these visits to Washington as "limited," we note that physical presence "need only be demonstrably more than a slightest presence" to create substantial nexus. RCW 82.04.067(6); *see National Geographic Society v. California Bd. of Equalization*, 430 U.S. 551, 556, 97 S.Ct. 1386 (1977); *Quill*, 505 U.S. at 315, n.8. Further, we have consistently held that infrequent in-state visits by employees of an out-of-state business can establish nexus. *See* Det. No. 08-0117, 27 WTD 239 (2008) (holding that two one-day sales visits by employees to Washington over a four year period created nexus); Det. No. 97-061, 18 WTD 211 (1999) (holding that two annual visits by employees to Washington lasting no more than two days each created nexus).[10] Thus, the two to four annual visits to Washington by [Employee 1]during the audit period are sufficient to establish nexus. This is consistent with Rule 193(7)(c)(iii), which

[10] Taxpayer directs our attention to a Board of Tax Appeals decision, *Sage V Foods, Inc. v. Dep't of Revenue*, Docket No. 11-704 (2012), where the Board found that a single visit to Washington in a seven year period was not adequate to create substantial nexus with Washington. Board decisions are not precedential here, but even if they were, we do not see how *Sage V Foods* furthers Taxpayer's argument given that Taxpayer concedes that one of its representatives visited Washington up to four times annually and that another representative resided in Washington during the review period. Thus, Taxpayer's physical presence is clearly not as "limited" as was the case in *Sage V Foods.*

states that nexus-creating activities include situations where "[t]he order for the goods is solicited in this state by an agent or other representative of the seller."

Second, [Employee 1] visited both [Retailer 6 and 7] in Washington during the review period to obtain and maintain licensing agreements with those companies so that Taxpayer could manufacture products using those name brands and then, in turn, sell those products to retailers for resale. But for Taxpayer's Washington activity of procuring these two licensing agreements, it would not have had those licensed products to sell to such Washington retailers as [Retailer 8]. Clearly, by having such licensing agreements with well-known companies, Taxpayer placed itself in a better position to establish a market for its licensed products among Washington retailers like[Retailer 8]. Thus, entering into such agreements was significantly associated with Taxpayer's ability to maintain a market for its licensed products with Washington retailers.

Third, [Employee 1] and an independent contract, [Employee 2], both participated in business activities in Washington with [Retailer 8]. [Employee 1], who made between two and four visits annually to various customers in Washington during the audit period, stated that one of his responsibilities during that time was management of Taxpayer's relationship with [Retailer 8].[11] Also, [Employee 2] was engaged by Taxpayer specifically "to provide a conduit through which [Taxpayer] could make sales" to [Retailer 8] since [Employee 2] had a pre-existing relationship with [Retailer 8]. Indeed, between 2007 and 2012, [Employee 2] "was credited, and paid commissions, for sales" made to [Retailer 8] by Taxpayer.[12] As such, we conclude that [Employee 2] "solicited" orders for goods from [Retailer 8] in Washington during the review period.

While Taxpayer pointed out [Employee 2's] status as an independent contractor, such status does not preclude a finding that nexus existed between Taxpayer and Washington during the audit period based on [Employee 2's] physical presence. It is well settled that nexus may be established not only by a seller's own employees, but also by the actions of an independent contractor. Rule 193(7)(c)(v); *Tyler Pipe,* 483 U.S. at 250-51; *Scripto, Inc. v. Carson,* 362 U.S. 207, 211-12 (1960). Thus, we conclude that this activity is also significantly associated with Taxpayer's ability to establish or maintain a market for its licensed products with [Retailer 8]. *See* Rule 193(7)(c)(iii) (stating that soliciting orders in Washington creates nexus).

On appeal, Taxpayer made much of the fact that its activities in Washington were not aimed at establishing or maintaining a market for its products among end consumers in Washington. Taxpayer pointed out that it did not advertise to end consumers in Washington, and that Taxpayer has no brand recognition in Washington because its products are all sold under either a private label name or a licensed name brand. We find no legal support for limiting the market to end consumers and observe that, in general, wholesalers like Taxpayer do not generally sell directly to end consumers. As such, the market in this case includes the retailers to which

[11] Taxpayer did not specifically identify [Retailer 8] as one of the Washington-based customers that [Employee 1] visited during the review period.

[12] We do not have specific details of the efforts in which [Employee 2] engaged to receive these commissions. While Taxpayer has characterized [Employee 2's] role in the sales as "substantively insignificant," we cannot overlook the fact conceded to by Taxpayer that regardless of how "insignificant" those efforts may have been, Taxpayer still saw fit to continue to pay [Employee 2] commission on the sales to [Retailer 8], and continued to engage him in this capacity for five years.

Taxpayer "markets" its products for purchase and eventual resale in their retail stores in addition to end consumers.

We ultimately conclude that all three of Taxpayer's Washington activities as described above created nexus in this state because each activity was significantly associated with Taxpayer's ability to establish or maintain a market for its products primarily among the Washington retailers that purchased both licensed products and private label products for resale.

. . .

DECISION AND DISPOSITION

[The taxpayer's petition is denied on the nexus issue.]

Dated this 12th day of February, 2015.