Cite as Det. No. 94-060E, 14 WTD 220 (1995).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Refund of	)	D E T E R M I N A T I O N
	)	No. 94-060E
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

RCW 82.04.290: SERVICE B&O TAX -- CLASSIFICATION -- BIFURCATION -- PRIMARY ACTIVITY -- EXCLUSIVE LICENSE TO SELL. A specified sum received by a taxpayer primarily for granting exclusive license to sell is taxed under the service and other business classification when the taxpayer also provided an unspecified quantity of the product "free of charge" for the sole purpose of obtaining governmental approvals. The Department will not bifurcate the payment between the service and manufacturing classification.

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.

NATURE OF ACTION:

A Washington developer and producer of critical reagents protests a business and occupation (B&O) tax assessment reclassifying income from the manufacturing classification to the service classification.[1]

FACTS:

Pree, A.L.J. -- The taxpayer researches, develops, manufactures, and sells a variety of medical products including critical

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

reagents used to diagnose health problems. It is a corporation headquartered in Washington with no place of business outside the state.

In its petition, the taxpayer protested the assessment of B&O tax at the service and other activities rate on income received from a foreign drug corporation. It received a credit for the tax it paid when it reported that income and paid B&O tax under the manufacturing classification. No objections are raised regarding the other schedules in the assessment.

Under the contract governing the payment, the taxpayer agreed to grant a foreign drug company a license to assemble, market, promote, sell and distribute a critical reagent in a foreign country. The critical reagent was used to diagnose a particular health problem and to monitor the progress of particular treatments. The taxpayer retained ownership rights in the technology, that is, the patent rights and "know-how" relating to the development, production, and use of the critical reagent.

In the first phase of the contract, the taxpayer agreed to provide "free of charge" the critical agent in frozen liquid concentrate with diagnostic kits upon request. The foreign company could only use the product provided during this phase of the contract in scientific studies and clinical trials to obtain the necessary governmental approvals for marketing the reagent in the foreign country. The product provided during this phase could not be resold. The quantity was not specified in the contract.

The second phase began once the foreign government granted the necessary approvals. The contract provided a price formula under which the foreign corporation would purchase the critical reagent and the kits manufactured by the taxpayer in Washington. The foreign corporation would resell the reagent under its exclusive license at profit.

During the audit period the taxpayer only received payments under the first phase of the contract. Specifically, the contract called for an "Up-front License Fee":

> $. . . (one-half) due within 30 days of execution of the agreement;
>
> $. . . (one-quarter) due within 30 days of the first clinical trial; and
>
> $. . . (one quarter) due within six months of the first clinical trial.

Only the first payment was received during the audit period. The taxpayer reported these receipts under the manufacturing classification for the business and occupation tax. The Audit Division reclassified the income under the service and other activities classification.

The taxpayer contends that under the first phase of the contract, its customer purchased the critical reagent. The sale of a product the taxpayer reasons should be taxed at the lower manufacturing or wholesaling rate. If a portion of the contract is for a license to sell the product, the taxpayer contends that the value of the product provided in the first phase should be deducted from the service and other activities measure and taxed as manufacturing. According to the taxpayer, the "free of charge" reference meant or should have been written as "no additional charge".

According to the taxpayer's calculations, if the estimated quantity of product provided under the first phase of the contract is valued under the formula for pricing it in the second phase of the contract, the amount supplied "free of charge" could be determined. The taxpayer proposes taxing this amount under the manufacturing classification with the balance taxable as service, i.e., tax the value of product shipped during audit period under manufacturing with the balance of the payment taxable under service.

The Audit Division concluded that the first payment was taxable under the service and activities classification and could not be exempted as a casual or isolated sale. The Audit Division and the taxpayer agree that later payments for the product priced according to a formula under the second phase of the agreement are taxable under the manufacturing/wholesaling classifications.

ISSUE:

Was the payment during the first phase of the contract a license to sell, taxable under the service and other business and occupation tax classification, or could a portion of it be attributed to the lower manufacturing classification?

DISCUSSION:

Generally, activities involving the manufacture and sale of goods are taxed under the manufacturing and/or wholesaling business and occupation tax rate, while sales of license fees are taxed under the service and other business classification. See RCW 82.04.240 and RCW 82.04.290. Where a taxpayer agrees to perform an activity taxable primarily under a particular classification and only incidentally engages in other activities in furtherance of that activity, the taxpayer will be taxed according to its

primary activity. See, Final Det. No. 89-433A, 11 WTD 313 (1992) and Det. No 92-183ER, 13 WTD 93 (1993).

The contract identified the payment as an up-front license fee stating that the fee was not subject to offset for any reason. Payment dates were based upon the date the contract was signed and when clinical trials began with no reference to delivery of the product. We believe that if the sale of the product had been the object of this phase of the agreement, it is likely payment would coincide with product delivery dates. Also if the product sale was of primary concern, it is likely there would be offset of the up-front fee for product not delivered. In fact the agreement did not specify the amount of product to be supplied under this phase.

The grant of rights or consideration section of the agreement focused on the exclusive license, future generations of the product, new territory, and know-how. An unspecified[2] quantity of the product was provided solely for governmental approval, "free of charge". Payments under the first phase of the agreement did not vary with the quantity of product provided as we would expect with product purchases.

The taxpayer agreed to cooperate in obtaining the necessary governmental approvals. That approval benefitted both the taxpayer as well as the licensee. Providing the product was incidental to these activities.

In discussing "material breach" or "failure to perform", the agreement specified failure to remit payments, failure to meet due diligence obligations,[3] failure to notify the other party of any known significant third-party infringement, or failure to comply with any reporting requirement. Delivery of the product during this phase was not mentioned in respect to breach of the contract.
If the agreement was terminated, the required payment at issue was not adjusted for the amount of product provided during this phase, nor did it provide that the product be returned. This indicates that the parties were not primarily concerned with payment for the product during this phase of the contract.

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[2] Even if the quantity could have been determined, we question whether the product could have been valued under the formulary pricing mechanism in the agreement. Since there was no existing market for the product, a cost basis of valuation may have been appropriate. See WAC 458-20-112 (Rule 112).

[3] Only the licensee's due diligence obligations were specified.

After reviewing the contract with all the information available, we find that during the first phase of the contract, the taxpayer primarily agreed to provide an exclusive license to sell its product. The product provided under this phase of the contract was only incidental to the license since it was only used to obtain governmental approval. It had no economic value to the purchaser other than to fulfill its responsibility to get governmental approval. The product delivered under this phase of the contract could not be resold. The first payment was taxable under the service classification.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

DATED this 31st day of March, 1994.