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

In the Matter of the Petition For Correction of Assessment	)	D E T E R M I N A T I O N
	)	No. 86-303
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] RULE 193B AND RCW 82.04.4286: B & O AND RETAIL SALES TAX -- INTERSTATE COMMERCE -- VALIDITY OF TAX. A state tax on interstate commerce is valid if it meets the four requirements set forth in Complete Auto Transit, Inc. v. Brady.

[2] RULE 193B: B & O AND RETAIL SALES TAX -- INTERSTATE COMMERCE -- DUE PROCESS -- NEXUS -- FACTORS DETERMINING. The crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

[3] RULE 193B: B & O AND RETAIL SALES TAX -- INTERSTATE COMMERCE -- DUE PROCESS -- DIVISIONAL NEXUS -- AFFILIATED CORPORATION AS TAXPAYER'S REPRESENTATIVE -- DISSOCIATION. There is a sufficient nexus between a state and the interstate commercial activity it taxes, for purposes of the commerce and due process clauses, if the in-state activities performed on the business' behalf are significantly related to the business' ability to establish and maintain an in-state market for its sales. The in-state activities do not have to be performed by the business' own employees, but can be performed by employees of an affiliated corporation. To avoid taxation, the foreign corporation must sustain the burden of showing the sales at issue are disassociated from the in-state activities.

[4] RULE 193B: B & O AND RETAIL SALES TAX -- INTERSTATE COMMERCE -- DUE PROCESS -- NEXUS -- WASHINGTON FRANCHISEE AS LOCAL OUTLET. A corporation that approaches a market through local outlets is distinguishable from a corporation approaching a market through solicitors only or one whose only connection with the customers

in the state is by common carrier or mail. Services provided by a local franchisee can be decisive in establishing and holding a market for the franchise products.

[5] RULE 193B: B & O AND RETAIL SALES TAX -- INTERSTATE COMMERCE -- NEXUS -- FRANCHISE PRODUCT -- FRANCHISOR'S ACTIVITIES CREATING MARKET. A franchisor corporation creates a market for franchise products by establishing franchises, providing training programs, management advice, marketing surveys, newspaper and network advertising. A franchisee and franchisor have a community interest in selling trademarked goods and services.

[6] RCW 82.32.100: PENALTIES -- UNREGISTERED TAXPAYER. RCW 82.32.100 provides that the Department shall add late payment penalties if a person fails to make any return required by the Revenue Act.

[7] RULE 228 AND RCW 82.32.105: PENALTIES OR INTEREST -- WAIVER -- CIRCUMSTANCES BEYOND CONTROL OF TAXPAYER -- WHAT CONSTITUTES. Lack of knowledge of a tax obligation does not render failure to pay taxes "beyond the control" of the taxpayer within the meaning of RCW 82.32.105 and WAC 458-20-228 which allow the Department of Revenue to waive or cancel interest and penalties under limited situations.

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 a Determination.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: July 2, 1986

NATURE OF ACTION:

The taxpayer protests the assessment of Retailing business tax and retail sales tax on sales to Washington franchisees of an affiliate company. The taxpayer contests the assessment on grounds the state of Washington has no jurisdiction to tax those revenues.

FACTS AND ISSUES:

Frankel, A. L. J. -- The taxpayer is a [out-of-state] corporation engaged in the business of selling health food products at wholesale. It is a subsidiary of . . . . The taxpayer's records were audited for the period January 1, l981 through June 30, 1984. The examination disclosed taxes, interest, and penalties due . . . As the taxpayer was unregistered in Washington, the Department registered the company and issued Tax Assessment No. . . . on December 10, 1985, for the total amount found due.

. . . the parent corporation, (hereinafter the parent) underwent a corporate reorganization in January of 1983. Prior to the reorganization, [the parent] developed franchises in various states, including Washington. Subsidiary corporations, . . . various states, including Washington, operated the company-owned . . . [businesses].

In 1983, [the parent] merged all of the state companies except the taxpayer into [franchisor company]. [The parent] became a holding company and [franchisor company] the franchise operator. The taxpayer's activities have been the same before and after the reorganization. The taxpayer was formed to sell [product] to the . . . [company businesses] on the West Coast. During the audit period, the [taxpayer] consisted of a [an out-of-state] warehouse and office. . . with four employees. Billings were made by the home office of the parent in . . . .

At issue in this appeal is the assessment of retail sales tax and retailing and wholesaling business and occupation tax on the proceeds from the taxpayer's sales to Washington franchise operators. The auditor determined the sale of [product] was subject to the Wholesaling-Other tax (Schedule II) and the sale of supplies and promotional items subject to Retailing B & O and Retail Sales Tax. The auditor relied on WAC 458-20-193B, a copy of which was provided to the taxpayer.

The taxpayer protests the assessment, contending no nexus with this state exists because it has no business facilities or employees in Washington. Orders are submitted by mail from the franchisees in Washington to [franchisor company] in [its home state] and then telexed to the taxpayer in [its home state]. The orders are filled by the taxpayer's employees from the stock in its . . . warehouse and shipped by common carrier to the purchasers in Washington.

The taxpayer argues that neither its parent or affiliate undertakes any activities in Washington in connection with the sales. It stated that the only local activity engaged in by the affiliated operating company in relation to the franchisees was a less-than-annual visit to ensure that the franchisees were operating properly. The taxpayer contends that no part of the visits concerned marketing of its products and that any marketing assistance was provided from [out-of-state] by phone or mail.

The auditor recognized that the taxpayer itself had no employees or activity in Washington. Tax was assessed based on the activities of the parent and affiliated companies when setting up the franchises and the ongoing consulting activities of the affiliated company.

If the Department finds nexus exists, the taxpayer requests a waiver of the penalty because of its good faith understanding that its revenues were not taxable in Washington.

ISSUES:

1) Whether the imposition of the B&O tax, measured by the gross receipts of all retail and wholesale sales to Washington franchisees, violates the due process clauses of the federal and state constitutions or the commerce clause of the federal constitution.

2) If the tax is upheld, whether the penalties should be waived because of the taxpayer's good faith belief that it was not required to be registered and pay B&O tax in Washington.

DISCUSSION:

[1] Washington's B&O tax is levied on every person for the act or privilege of engaging in business activities. RCW 82.04.220. A deduction is permitted for amounts derived from business which the Constitution or laws of the United States prohibit a state from taxing. RCW 82.04.4286.

In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), the Court overruled prior decisions which held that a tax on the privilege of engaging in an activity in the state may not be applied to an activity that is part of interstate commerce. The court noted that such a rule has no relationship to economic realities. 430 U.W. at 279. "It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business." Id. quoting Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938).

To be valid, the state tax on interstate commerce must meet four requirements: (1) there must be a sufficient nexus between the interstate activities and the taxing state; (2) the tax must be fairly apportioned; (3) the tax must not discriminate against interstate commerce; and (4) the tax must be fairly related to the services provided by the state. Complete Auto Transit at 279. Accordingly, if the tax at issue meets those requirements, it is not invalid even if the shipments are considered a part of interstate commerce.

[2] The taxpayer does not contend that the tax at issue is not fairly apportioned, that it discriminates against interstate commerce, or that it

is not fairly related to the services provided by the state. The taxpayer contends the tax is invalid because Washington does not have adequate jurisdictional "nexus" with the sales at issue to impose a tax on the interstate activities. Accordingly, the taxpayer contends the tax violates both the Commerce Clause and the Due Process Clause of the Fourteenth Amendment. The Due Process Clause requires a "'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425, 436-37 (1980).

WAC 458-20-193B (Rule 193B) is the administrative rule which defines the Constitutional limits upon this state's ability to impose its excise tax upon sales of goods originating in other states to persons in Washington. The crucial factor in establishing the requisite minimal connection or "nexus" is whether the taxpayer's instate services enable it to make the sales:

> Sales to persons in this state are taxable when the property is shipped from points outside this state to the buyer in this state and the seller carries on or has carried on in this state any local activity which is significantly associated with the seller's ability to establish or maintain a market in this state for the sales. . . . The characterization or nature of the activity performed in this state is immaterial so long as it is significantly associated in any way with the seller's ability to establish or maintain a market for its products in this state.

The fact that a tax is contingent upon events that take place outside a state does not destroy the nexus between the tax and the transactions within the state being taxed. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444-45 (1940). Nor does nexus require that a majority of a taxpayer's business activity lie in the taxing state. Standard Pressed Steel co. v. Dep't of Revenue, 419 U.S. 560 (1975) (one lone employee who engaged in no direct sales activity created the necessary relationship).

[3] Although the taxpayer itself may not be engaged in any local activity which enables it to make the sales at issue, we do not agree that the taxpayer's parent or affiliate has not done so on its behalf. Washington courts have upheld this state's B&O tax against claims of divisional nexus. See, e.g. General Motors Corp. v. State, 60 Wn.2d 862 (1962), affirmed 377 U.S. 436 (1963).

General Motors argued that the sales by its parts division which were filled from a warehouse in Oregon should not be subject to Washington's B&O tax. The Supreme Court disagreed, however, finding the corporation's activity "was so enmeshed in local connections" as to subject all of its sales within the state to the B&O tax. 377 U.S. at 447. As in the present case, the orders were sent to an out-of-state office by mail or telephone. The orders were shipped from the factory by common carrier and payment received outside the state.

The absence of a local office was not the controlling factor. The essential inquiry was directed to the "amount and effect of the activities involved and not the form of the operations. 60 Wn.2d at 874. The Washington Court noted General Motors' extensive promotional and service efforts Id. at 875. These activities included advertising on television, billboards, newspapers and magazines, as well as the activities by the field organization representatives who advised the independent dealers on almost every aspect of their operations. The Court noted that where extensive business activity occurs within a state, taxation can only be avoided upon a showing that the activities are dissociated from the sales in question. The Court found General Motors failed to meet that burden, even though, as here, the mechanical aspects of the sales occurred outside the state. The Court noted that "the substance of each transaction occurs in Washington where the customer is located and where the demand for the manufactured product exists, in very large degree, as a result of General Motors promotional activities." Id. at 875-76.

Following General Motors, the Washington Supreme Court has taken a hard line on the divisional nexus issue, also upholding the tax in the presence of substantial activity on the part of a sister corporation acknowledged to be taxable in the state. Chicago Bridge & Iron Co. v. Department of Revenue, 98 Wn.2d 814 (1983). The United States Supreme Court has also noted that the form of business organization may have nothing to do with the underlying unity or diversity of he business enterprise. Mobil Oil Corp. v. Commissioner of Taxes, supra. For Due Process purposes, the Court in Mobil Oil found no difference in the underlying economic realities of a unitary business operated as legally separate entities from those operated as separate divisions of legally as well as functionally integrated enterprises. 445 U.S. at 440-41.[1]

[1]Mobil Oil addressed the imposition of Vermont's corporate income tax based on an apportionment formula, upon "foreign source" dividend income received by the corporation from its subsidiaries and affiliates doing business abroad. The Court found the tax did not violate the Due Process Clause. Mobil failed to establish that its subsidiaries and affiliates engaged in business activities unrelated to its sales of petroleum products in Vermont. The Court rejected the argument that a division between a parent and subsidiary should be treated as a break in the scope of a unitary business, noting that the form of business

In Clairol, Inc. v. Kingsley, 109 N.J. Super. 22, 262 A.2d 213 (1970), the Court appeared to attribute the activities of a subsidiary corporation to the parent. One author noted the rationale might be justified on the theory that the services were rendered by the subsidiary to Clairol's customers as agent for Clairol. J. HELLERSTEIN, STATE TAXATION 246 n. 126 (1983).

Certainly the evidence supports finding that [the franchisor company or parent] served as the taxpayer's agent in processing the [product] orders at issue. The purchase invoices and order forms are printed with [the franchise's] name and logo and the order forms state they are to be sent to the [parent company], Although these activities took place out of state, we believe the evidence supports our finding the parent's or affiliate's instate activities established the market for the Washington sales.

This is not a case where the taxpayer's only contact with this state is via the United States mail or common carrier, as was the situation in National Bellas Hess v. Department of Revenue, 386 U.S. 753 (1967). In that case, the Illinois Court had found National was required to collect Illinois' use tax upon sales to Illinois consumers. The Supreme Court reversed. National's relationship with Illinois, however, is distinguishable from the taxpayer's relationship with this state:

> "[National] does not maintain in Illinois any office, distribution house, sales house, warehouse or any other place of business; it does not have in Illinois any agent, salesman, canvasser, solicitor or other type of representative to sell or take orders, to deliver merchandise, to accept payments, or to service merchandise it sells; it does not own any tangible property, real or personal, in Illinois; it has no telephone listing in Illinois and it has not advertised its merchandise for sale in newspapers, on billboards, or by radio or television in Illinois."

386 U.S. at 754, quoting the State Supreme Court. 34 Ill. 2d at 166-167.[2]

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organization may have nothing to do with the underlying unity or diversity of a business enterprise. Although the present case involves Washington's B&O tax rather than an income tax, we believe the Court's "unitary business" analysis also supports our decision that activity by an affiliate, as well as a division of a corporation, can establish the requisite nexus.

[2]National acknowledged its obligation to collect a use tax on sales to customers in states in which it had retail outlets. 386 U.S. at 757, n. 10.

As in National Bellas Hess, the Court in Norton Co. v. Department of Revenue, 340 U.S. 534 (1951) also distinguished the situation where a company had only minimal contact with the taxing state "[w]here a corporation chooses to stay at home in all respects except to send abroad advertising or drummers to solicit orders which are sent directly to the home office for acceptance, filing, and delivery back to the buyer, it is obvious that the state of the buyer has no local grip on the seller." 340 U.S. at 537.

In this case, however, the taxpayer's affiliate has entered into franchise agreements with Washington franchisees and has company-owned weight loss centers in Washington. As the affiliated company has entered this state to do local business by state permission and has submitted itself to the taxing power of the State, it can avoid taxation on the sales at issue only by showing they are disassociated from the local business and interstate in nature. Id.

We would agree that if sales were made by the taxpayer to Washington customers who were not part of the franchise system, such sales would not be taxable if no instate activity by the taxpayer or its affiliates promoted them. See, e.g., B.F. Goodrich Co. v. State, 38 Wn.2d 663 (1951) (the Court applied the principles laid down in Norton and did not uphold the tax on sales made by a division of B. F. Goodrich to Washington outlets of J.C. Penney Company).

[4] Norton Company could not establish that the services rendered by its Illinois office were not decisive in establishing and holding a market for the goods sold to Illinois customers. The Court discussed the advantages of approaching a market through a local outlet to process orders, noting that without a local outlet, customers may view the seller as "remote and inaccessible." In such a case, customers cannot reach the seller with process of local courts for breach of contract, or for service if the goods are defective or in need of replacement. Id. at 539. The court upheld the Illinois Retailers' Occupation tax on the sales to the Illinois customers except on orders sent directly by the customer to Norton Company's head office and shipped directly to the customer.

In this case, the "local outlets" are the Washington franchisees. The fact that they are operated independently is not controlling. The sales at issue in General Motors Corp.v. State, supra, were made to dealers which had individual proprietorships, partnerships, or corporations having no corporate relationship to General Motors. The Court found that General Motors was engaged in business in Washington and that its promotional and service activities had a direct effect upon the sales and operations of the independent retail dealers. 60 Wn.2d at 868.

[5] The affiliated corporation, [franchisor], registered with the Department in 1983 and has been paying B&O tax on its franchise fees and retail sales to Washington [company businesses] since that time. On its Certificate of Registration, it listed eight branch locations in Washington and stated sales are solicited in Washington in its name by resident employees. It also stated it maintained inventories at all eight branches located in Washington and that it is a franchisor, with franchisee locations with the State. Question 5 asked, "Do you render service within the state of Washington to customers, clients or franchisees?" The answer was yes-- "Sale of . . . to be sold by franchise centers."

The additional evidence relied on by the auditor also supports a finding that the affiliated company's instate services were significantly associated with the taxpayer's ability to establish or maintain a market in this state for the sales. The franchise agreement provided the franchisor company would provide, inter alia, assistance in obtaining a suitable location for operating the franchise centers, training programs, operational manuals and diet charts, consultation and advice by a company's representative as to the operation and management of the Centers, marketing surveys, etc. (. . . .) As with many franchise agreements, the franchisee was required to purchase . . . products from an approved supplier. Of course, the taxpayer is an approved supplier. The taxpayer has submitted no evidence of any activity on its part to create the market for its sales to the Washington franchisees. The evidence indicates that newspaper advertising and network television are important parts of the [franchise] advertising program. (. . .)

Washington's Franchise Investment Protection Act recognizes that a franchisee and franchisor have a community interest in selling the trademarked goods and services. See RCW 19.100.010(4). The extensive advertising of the [franchise] program promotes the interests of the entire franchise system, including the taxpayer. See, e.g., Ungar v. Dunkin' Donuts of America, Inc., 68 F.R.D. 65 (D.C.Pa 1975) (relevant advertising is inextricable from the trademark, franchise system and logo as it is the major vehicle for promoting them). The requirement of uniformity of product and control "causes the public to turn to the franchise stores for the product." Susser v. Carvel Corp., 206 F. Supp. 636, 640 (1962). See also Perma Life Mufflers, Inc. v. International Parts Corp., 376 F.2d 692, 694 (1967).[3]

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[3] At least one jurisdiction has held that an out-of-state corporation was "engaging in business" in the state simply because its franchisees were located in the state. Baskin-Robbins Ice Cream Co. v. Revenue Div., 93 N.M. 301, 599 P.2d 1098 (1979); American Dairy Queen Corp. v. Revenue Div., 93 N.M. 743, 605 P.2d 251 (1979) (a franchisor which enters into agreements

As with any exemption, the taxpayer bears the burden of establishing that the sales at issue are dissociated under Norton. The taxpayer has failed to meet this burden. It has shown no independent source for promoting the sales or established that its affiliate's and/or parent's instate activities did not help establish and maintain its market for the sales to the Washington franchisees.

In conclusion, we find that adequate jurisdictional nexus exists to uphold the tax on the wholesale and retail sales to the Washington franchisees. Case law supports our decision that the parent or affiliate can be considered the taxpayer's agent or other representative for due process purposes. The evidence supports a conclusion that the instate activities by the parent and/or affiliate company are significantly associated with the taxpayer's ability to establish or maintain a market for its products sold to and through the Washington franchisees. Accordingly, we find the sales at issue similar to those on which the tax was upheld in General Motors v. State and Norton Company v. Department of Revenue, supra. The tax is not invalid because the taxpayer itself has no formal sales office or no agent or representative formally characterized as a "salesman" in Washington. Rule 193B(5).

[6] As an adminstrative agency, the Department has limited authority to waive penalties and interest. RCW 82.32.100 provides that when a taxpayer fails to make any return as required, the Department shall proceed to obtain facts and information on which to base its estimate of the tax. As soon as the Department procures the facts and information upon which to base the assessment, "it shall proceed to determine and assess against such person the tax and penalties due, . . . To the assessment the department shall add, the penalties provided in RCW 82.32.090." (Emphasis added.)

RCW 82.32.090 provides that if any tax due is not received by the Department of Revenue by the due date, there shall be assessed a penalty. The penalty for returns which are not received within 60 days after the due date is 20 percent of the amount of the tax. RCW 82.32.050 provides that if a tax or penalty has been paid less than properly due, the Department shall assess the additional amount due and shall add interest at the rate

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for use of its trade name and trademark is engaged in business in New Mexico even though franchisor had no employees or offices in New Mexico). In those cases, the New Mexico court upheld the state's B & O tax on the royalty payments or franchise fees. The taxpayer has been paying B & O tax on the income from franchise fees and has not contended it is not "doing business" in Washington to make such income subject to Washington's tax.

of nine percent per annum from the last day of the year in which the deficiency is incurred until the date of payment.

[7] The only authority to cancel penalties or interest is found in RCW 82.32.105. That statute allows the Department to waive or cancel interest or penalties if the failure of a taxpayer to pay any tax on the due date was the result of circumstances beyond the control of the taxpayer. That statute also requires the Department to prescribe rules for the waiver or cancellation of interest and penalties.

The administrative rule which implements the above law is found in the Washington Administrative Code 458-20-228 (Rule 228). Rule 228 lists the situations which are clearly stated as the only circumstances under which a cancellation of penalties and/or interest will be considered by the Department. None of the situations described in Rule 228 apply in the present case. Lack of knowledge or a good faith belief that one is not subject to Washington's B & O tax is not identified by statute or rule as a basis for abating interest or penalties.

DECISION AND DISPOSITION

The taxpayer's petition for correction of Tax Assessment No. . . . is denied.

DATED this 21st day of November 1986.