Cite as Det. No. 01-074, 20 WTD 531 (2001)

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. 01-074
. . .	)	Registration No. . . .
	)	Notices of Balance Due . . .
	)	Docket No. . . .

[1] RULE 193: B&O TAX -- SUBSTANTIAL NEXUS – OTHER REPRESENTATIVE – INDEPENDENT DISTRIBUTOR SALESFORCE – RECRUITMENT AND TRAINING OF. Where an out-of-state manufacturer paid commissions to its Washington independent distributors based on the sales made by new distributors recruited and trained by each Washington distributor, nexus was sustained. The Washington distributor's activities of recruiting, training and motivating new independent distributors was found to be significant services performed on behalf of the out-of-state manufacturer in establishing and maintaining a market within the state.

[2] RCW 82.04.070: WHOLESALING B&O TAX – GROSS PROCEEDS OF SALE -- MEASURE. Where an out-of-state manufacturer sold products to its independent distributors in Washington for resale to customers, the out-of-state manufacturer was required to pay Wholesaling B&O tax measured by its gross proceeds of sale to its distributors.

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:

An out-of-state manufacturer of products sold through multi-level marketing protests the assessment of wholesaling business and occupation (B&O) taxes on sales made to its Washington distributors.[1]

FACTS:

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

Okimoto, A.L.J. -- [Taxpayer] is an out-of-state manufacturer of [products]. Its marketing program is based on a multi-level distribution network. Taxpayer's file was examined for the period Q3/99,[2] and the Taxpayer Account Administration Division (TAA) of the Department of Revenue (Department) issued a notice of assessment on January 12, 2000 in the amount of $. . . . Taxpayer protested that assessment to the Department's Appeals Division (Appeals) on February 10, 2000. Taxpayer's petition was remanded to the Department's Taxpayer Information and Education Section (TI&E) for consideration and evaluation, and on March 8, 2000 TI&E ruled that Taxpayer was fully subject to B&O taxes.[3] Taxpayer again protested to Appeals, and its case is currently before this Division.

Taxpayer explains its business organization and operation in its petition as follows:

> [Taxpayer], [an out-of-state] corporation, engages in the sale of . . . products using direct marketing, direct sales and independent distributors. The sales to the independent distributors are made for resale. In some cases, mall kiosks or carts that are fully owned and operated by independent distributors are used to sell [Taxpayer] products. . . Presumably, these independent distributors are subject to the B&O tax based upon their sales of [Taxpayer] products. [Taxpayer] has no offices within the State of Washington, maintains no inventory or warehouse, and owns no property in the State of Washington. [Taxpayer] maintains neither an office nor any other physical locations within the State of Washington, and employs no salespeople, agents, or other employees in the State of Washington. Any direct marketing sales are made through a toll free 800 number, the internet or mail order and all such direct sales are shipped by common carrier.
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> Independent distributors are not representatives of [Taxpayer]. Independent distributors do not solicit orders for [Taxpayer] and hold no [Taxpayer] products on consignment; rather, they purchase products directly from [Taxpayer] for resale to Washington consumers. [Taxpayer] products are delivered via common carrier to the independent distributors for resale to consumers in the State of Washington. In the State of Washington, [Taxpayer] does not control the independent distributors' sales prices nor does it provide any management services to the independent distributors. [Taxpayer] prohibits independent distributors from representing themselves to the public as agents of [Taxpayer]. [Taxpayer] allows the use of its name by independent distributors in advertising activities with prior approval from [Taxpayer] on a case-by-case basis.
>
> As previously stated, in some cases, [Taxpayer] has permitted independent distributors to use its name for advertising purposes at kiosks in malls that are located in

[2] TAA has also issued Balance Due Notices/Assessments for periods Q2/98, Q3/98, Q4/98, Q1/99, Q2/99, Q4/99, Q1/00, Q2/00 & Q3/00 involving the same issues.

[3] TI&E also ruled that Taxpayer was not entitled to the tax exemption for direct sellers under RCW 82.04.423 and WAC 458-20-246 (Rule 246) because some of Taxpayer's products were sold through kiosks at the local shopping malls. TI&E considered these to be permanent retail establishments, thus disqualifying Taxpayer for the exemption. Taxpayer did not appeal this issue, however.

> the State of Washington and that are fully-owned and operated by such independent distributors. In such cases, [Taxpayer] has required the independent distributors to clearly indicate that the kiosks are not the property of [Taxpayer] by requiring [Taxpayer]'s name to be immediately followed by "Independent Distributor" or similar language. All sales literature and promotional materials provide that the product is being sold by an independent dealer and not by [Taxpayer].

TAXPAYER'S ARGUMENTS AND CONTENTIONS:

First, Taxpayer argues that it does not have sufficient substantial nexus for the state of Washington to tax Taxpayer's sales to its independent distributors. Taxpayer relies on *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), *Pledger v. Troll Book Clubs, Inc.*, 316 Ark. 195 (1994), and *Scholastic Book Clubs, Inc. v. Michigan Department of Revenue*, 223 Mich. App. 576 (1997), in support of its position.

Second, even if the Department should determine that Taxpayer has substantial nexus with Washington, Taxpayer states that the B&O tax assessment for Q3/99 was computed incorrectly. Taxpayer explained that in 1998, Taxpayer voluntarily entered into an agreement with the Department to report retail sales tax on behalf of its multi-level marketing independent contractor salesforce.[4] Under the terms of this agreement, Taxpayer agreed to report and remit retail sales tax on behalf of its independent contractor salesforce based on the suggested retail selling price of products sold to its independent distributor salesforce. Under the terms of the agreement, the independent distributors' B&O taxes were the sole responsibility of the independent distributors, however. Taxpayer states that on its Q3/99 tax return, it reported gross sales of $. . . on the retailing and retail sales tax lines. Taxpayer then took a deduction on the retail sales tax line of $. . . and reported net retail sales taxable of $. . . . Taxpayer computed and paid retail sales tax on the net amount. Taxpayer paid no B&O taxes on the tax return.

Taxpayer states that under the agreement it does not owe any retailing B&O taxes, since that is the sole responsibility of its independent contractor salesforce, both legally and under the agreement. Although Taxpayer does not concede that it owes wholesaling B&O taxes on product sales made by Taxpayer to its independent contractor salesforce, it nevertheless argues that if it did, the wholesaling B&O taxes should be computed based on Taxpayer's actual wholesale selling price. Taxpayer states that this would be approximately 50 percent of the suggested retail selling price of its products and not the gross amounts reported on its Q3/99 tax return.

[4] Independent Contractor Salesforce is the term used in the sales tax collection agreement. *[Taxpayer] Inc. – Washington State Tax Reporting Agreement* – Reg. No. . . ., p. 1. (Exhibit B of the petition.)

ISSUES:

1. Does Taxpayer have substantial nexus with Washington?

2. If Taxpayer does have substantial nexus with Washington, on what value should Taxpayer's wholesaling B&O tax be computed?

DISCUSSION:

[1] NEXUS:

In order for Washington to impose its B&O tax on sales made from a point outside the state to customers located within Washington, the Department has held that there must be both nexus with the out-of-state seller and receipt within Washington. Det. No. 86-161A, 2 WTD 397 (1987), WAC 458-20-193 (Rule 193). Furthermore, recent court cases have held that these taxes may not be constitutionally imposed on interstate commerce unless a taxpayer has substantial nexus with the taxing state. *Quill Corp. v. North Dakota,* 504 U.S. 298 (1992). In Taxpayer's case, it does not dispute that sales of its products are received by customers within the state, but it instead contends that it does not have "substantial nexus" with Washington.

Rule 193(2)(f) defines "nexus" 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(7) describes the types of nexus-creating activities, when performed by a seller or its representative, that "establish or maintain a market for its products in this state." These include activities where:

> (iii) The order for the goods is solicited in this state by an agent or other representative of the seller.
>
> . . .
>
> (v) The out-of-state seller, either directly or by an agent or other representative, performs significant services in relation to establishment or maintenance of sales into the state, even though the seller may not have formal sales offices in Washington or the agent or representative may not be formally characterized as a "salesperson".

The laws and regulations of the state of Washington do not require a seller's representative to reside in Washington for the B&O tax to apply. Soliciting orders by an agent or other representative or any significant activity, which establishes or maintains a market within this state is sufficient. In addition, the representative's activity does not have to be the most important factor, but it is sufficient that the services are significant in establishing and maintaining the seller's market in Washington. *Tyler Pipe Indus., Inc. v. Department of Rev.,* 483 U.S. 232 (1987).

Under this reasoning, the Department has held infrequent visits to Washington customers by nonresident employees constituted sufficient nexus to allow the taxation of sales even though the employees were not salespersons. Det. No. 88-368, 6 WTD 417 (1988). Where employees provided advice to customers regarding the safe handling of a product, such activity was also found to be important in maintaining sales into the state. Det. No. 91-213, 11 WTD 239 (1991); *see also, Standard Pressed Steel Co. v. Department of Rev.* 419 U.S. 560 (1975) (Where nexus was established through the presence of a resident employee engineer who was not involved in sales, but only consulted with the customer regarding the customer's product needs). This activity did not directly establish sales, but only helped to maintain the market.

Taxpayer relies heavily on the fact that it did not send employees into the state and only acted with or through independent distributors. Taxpayer further stresses that the written contract between Taxpayer and the distributors clearly disclaims an agency relationship and specifically provides that the distributors are independent distributors. We note, however, that in Washington "Determination of an agency relationship is not controlled by the manner in which the parties contractually describe their relationship." *Rho Co. v. Department of Rev*., 113 Wn. 2d 561, 570 [782 P.2d 986] (1989). How the parties label their relationship is only one factor. Other factors must be considered, including the manifest conduct of the parties, to determine whether there has been the necessary consent and control to establish an agency relationship. We further note that for purposes of establishing nexus, courts have held that the distinction between an agent and an independent contractor is insignificant. *See, Tyler Pipe Indus., Inc. v. Department of Rev*., 483 U.S. 232 (1987) (Holding that a showing of sufficient nexus cannot be defeated by the argument that the seller's representative was properly characterized as an independent contractor instead of as an agent.)*; Scripto, Inc. v. Carson*, 362 U.S. 207 (1960) (Holding that nexus was established by a seller's in-state solicitation performed through independent contractors). Rule 193 also specifically allows the creation of nexus through the actions of "other representatives" and is not limited to actions only by agents. Therefore, to determine whether nexus is created, we must look to actions by all representatives of the seller, including independent distributors and determine whether the activities and services of these representatives are significant in relation to the seller's ability to establish or maintain a market for its products in this state. Rule 193(7)(v).

In this case, TI&E supplied a sample copy of Taxpayer's Distributor Application and Agreement with its independent distributors. It states in part:

> 4. DISTRIBUTOR shall sell and promote [TAXPAYER]'s goods and services strictly in accordance with this Agreement, which comprises the terms and conditions set out herein, the terms and conditions of the current version of [TAXPAYER]'s Policies and Procedures, the Sales Compensation Plan, the Business Entity Application Form . . . and [TAXPAYER]'s Advertising and Internet Guidelines . . . .
>
> 14. DISTRIBUTOR has the duty to supervise and train and Distributors that he/she may sponsor as described in the Policies and Procedures. DISTRIBUTOR will explain [TAXPAYER]'s programs honestly and completely when presenting them to others.

> DISTRIBUTOR understands and will make clear in any presentation the following; [TAXPAYER] does not guarantee earnings for Distributors; Distributors will not earn money solely for sponsoring other Distributors; [TAXPAYER] does not require Distributors to purchase a specific amount of product; [TAXPAYER] requires Distributors to sell its products; and [TAXPAYER] does not offer Distributors exclusive territories for building their independent businesses.

The *[Taxpayer] Policies and Procedures Manual* that supplements the Distributor Application and Agreement between Taxpayer and its distributors further emphasizes the distributors' training obligation. It states under the section dealing with "Responsibilities of Distributors":

> 5.2 – Continuing Training Obligations
>
> Any Distributor who sponsors another Distributor into [Taxpayer] must perform a bona fide assistance and training function to ensure that his or her downline is properly operating his or her [Taxpayer] business. Distributors must have ongoing contact and communication with the Distributors in their Downline Organizations. Upline Distributors are also responsible to motivate and train new Distributors in [Taxpayer] product knowledge, effective sales techniques, the [Taxpayer] Sales Compensation Plan, and compliance with Company Policies and Procedures.

The above contractual provisions make it apparent that the downline commissions that each independent distributor receives are, in fact, additional compensation to the independent distributor. Taxpayer pays these commissions to encourage its independent distributors to recruit, train and motivate their downline distributors. Such services, even though primarily performed by the independent distributor for its own benefit; i.e., to earn commissions, also significantly helps Taxpayer to establish and maintain a market for its products in Washington. Certainly, the more effectively an independent distributor recruits, trains and motivates its downline distributors, the more product sales Taxpayer will make to those downline distributors. Furthermore, to the extent that independent distributors are required to train and motivate recruited downline distributors, those independent distributors are acting as an "other representative" of Taxpayer within the meaning of Rule 193. Accordingly, we find that independent distributors perform significant services for Taxpayer in establishing and maintaining its market in the state, thereby establishing the required nexus.

We have also examined the United States Supreme Court case cited by Taxpayer and find it to be distinguishable. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), involved an out-of-state mail-order company. The state of North Dakota filed an action to require Quill to collect a use tax on merchandise sold and delivered to customers in that state. Quill performed no sales solicitation nor did it have any physical presence in North Dakota. The United States Supreme Court differentiated between the "minimum contacts" required to establish "nexus" for purpose of the Due Process Clause and the "substantial nexus" required by the Commerce Clause. The Court found that Quill had sufficient "minimum contacts" with North Dakota for Due Process Clause purposes. However, in holding that Quill did not have the "substantial nexus" required by the Commerce Clause, the Court clarified its holding of an earlier case by stating:

> In contrast, the bright-line rule of *Bellas Hess* furthers the ends of the dormant Commerce Clause. Undue burdens on interstate commerce may be avoided not only by a case-by-case evaluation of the actual burdens imposed by particular regulations or taxes, but also, in some situations, by the demarcation of a discrete realm of commercial activity that is free from interstate taxation. *Bellas Hess* followed the latter approach and created a safe harbor for vendors "whose only connection with customers in the (taxing) State is by common carrier or the United States mail." Under *Bellas Hess*, such vendors are free from state-imposed duties to collect sales and use taxes.

Quill, 504 U.S. at 315 (emphasis ours).

The *Quill* case did not significantly undermine the Court's prior cases on nexus or the Department's published position on this issue. Instead, it only clarified the Court's existing caselaw and reaffirmed the Court's bright-line test for Commerce Clause nexus enunciated in *National Bellas Hess, Inc. v. Department of Rev. of Illinois*, 386 U.S. 753 (1967). We believe that *Quill* stands for the limited proposition that those vendors, whose only connection with customers in the taxing state are by common carrier or the United States mail, do not satisfy the "substantial nexus" Commerce Clause nexus test and are not required to collect sales and use taxes. Taxpayer simply does not fall within this narrow "safe harbor." Taxpayer's contacts with Washington go beyond the simple use of common carriers or the United States mail. Taxpayer has had an ongoing and regular physical presence within Washington for several years through its independent distributor salesforce. The independent distributor salesforce is permanently and physically present in Washington and continues to recruit, train, motivate and supervise new independent distributors on an ongoing basis. We believe the independent distributor salesforce acts as a representative of the taxpayer in providing these services to new independent distributors. Based on these facts, we cannot find that Taxpayer's Washington activities fall within the narrow "safe harbor" created by *Bellas Hess*, and reaffirmed in *Quill*.

We have also examined the cases cited by Taxpayer from other jurisdictions and find them to be unpersuasive. Although *Pledger v. Troll Book Clubs, Inc*., 316 Ark. 195, [871 S.W.2d 389] (1994), and *Scholastic Book Clubs, Inc. v. Michigan Department of Revenue*, 223 Mich. App. 576, [567 N.W. 2d 692] (1997), may support Taxpayer's position, cases in other jurisdictions have also come to the opposite conclusion. *See In re Scholastic Book Clubs, Inc*., 260 Kan. 528, [920 P.2d 947] (1996) (Holding that substantial nexus was created with an out-of-state bookseller, when local teachers passed out order forms with the bookseller's name on them and compiled orders, collected money, and distributed books for the bookseller.); *Scholastic Book Clubs, Inc. v. State Board of Equalization*, [255 Cal.Rptr.77], 207 Cal. App. 3d 734 (1989) (Holding that nexus was created on nearly identical facts to those in the *Pledger* case.) Accordingly, Taxpayer's petition is denied on this issue.

[2] COMPUTATION OF TAX:

RCW 82.04.270 imposes a B&O tax:

> (1) Upon every person . . . engaging within this state in the business of making sales at wholesale: as to such persons the amount of tax with respect to such business shall be equal to the gross proceeds of sales of such business multiplied by the rate of 0.484 percent.

RCW 82.04.070 defines "Gross proceeds of sales" as:

> . . . the value proceeding or accruing from the sale of tangible personal property and/or for services rendered . . . .

In Taxpayer's case, it sells tangible personal property to its independent distributors in Washington for resale to their customers. It is that transaction upon which Taxpayer owes its wholesaling B&O tax, and the tax on that transaction must be computed based on the gross proceeds of sale. Although Taxpayer may report retail sales tax on behalf of its independent contractor salesforce pursuant to an agreement with the Department based on the suggested retail selling price of its products,[5] that agreement does not affect the measure of Taxpayer's wholesaling B&O tax liability. Taxpayer's petition is remanded to TAA for recomputation of Taxpayer's wholesaling B&O tax liability based on its gross proceeds of sales.

DECISION AND DISPOSITION:

Taxpayer's petition is denied in part and remanded in part.

Dated this 5th day of June, 2001.

[5] The Agreement provided that Taxpayer was not responsible for reporting B&O taxes on behalf of its independent distributor salesforce. *Washington State Tax Reporting Agreement* – Reg. No. . . ., p. 1. (Exhibit B of the petition.)