Cite as Det. No. 02-0213, 23 WTD 32 (2004)

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. 02-0213[1]
. . .	)	Registration No. . . .
	)	FY . . . /Audit No. . . .
	)	Docket No. . . .

[1] RCW 82.04.290: B&O TAX -- SALES PRIZES -- PROMOTIONAL SUPPLIES VS. REMUNERATION. Incentive prizes a company awards to its sales force are taxable remuneration to the sales agents, and are not excludable under the promotional supplies and materials exception in RCW 82.04.290. The fact that the property is identified in the public mind with the company does not require that the prizes be treated as excludable promotional supplies and materials under RCW 82.04.290.

[2] RULE 194; RCW 82.04.460: B&O TAX -- APPORTIONMENT -- An independent contractor who engages in motivational and training activities for a single company in various states during the year is entitled to apportion her income from providing those services, even when the amount of her compensation is based on factors unrelated to the length or size of specific events or her activities at specific events.

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 self-employed sales representative and national sales director for a [products] company, who receives prizes, . . . , for her success as a seller and team builder, and receives incentive income for performing training, motivational, and other services, in the form of commissions on the firm's wholesale sales to other members of the taxpayer's nationwide sales group, appeals the assessment of B&O tax on the value of the prizes, and asserts the Department wrongly rejected

[1] The reconsideration determination, Det. No. 02-0213R, is published at 23 WTD 50 (2004).

her method for apportioning her commission income. The taxpayer asserts other errors in the manner and method of assessing tax.[2]

FACTS:

Prusia, A.L.J. – The taxpayer, . . . , is a self-employed sales representative (or . . .) for [Company] Inc. (. . .) and is also a [Company] national director. The taxpayer works out of an office in her home in Washington state.

[Company] is an international [products] firm based outside Washington. Its products are sold directly to consumers through an independent contractor sales force. All [Company] sales representatives (. . .) purchase the goods they sell directly from [Company], at wholesale, and resell them to consumers at retail.

[Company's] sales force is not organized geographically, but rather into sales groups . . . consisting of a founder and her . . . recruits plus their recruits, etc. [Company] motivates its [representatives] to build a sales team by offering the opportunity to earn prizes and appointment as a sales director for successful team building. Appointment as a sales director entitles the individual to additional compensation -- [Company] pays a sales director a commission on [Company's] wholesale sales to other [representatives] in the director's sales group. As a director's recruits, in turn, recruit additional [representatives], the director's sales group grows, and the director may be appointed a senior sales director or even a national sales director, entitling her to higher commissions on [Company]'s wholesale sales to other [representatives] in her sales group. . . . .

A national director has responsibilities with respect to her own sales group, and with respect to the [Company] sales force nationally. A national director contractually agrees to engage in ongoing orientation, assistance, counseling, motivational efforts, sales promotion, and inspirational efforts for other directors and [representatives] in her national sales group, and to make personal appearances, speak, lecture, and train at major [Company] events. The national director guidelines and job description state that initial and continued appointment is dependent, in part, upon consistent attendance at national and regional company events, and participation in such events as a speaker or teacher. Attendees at major events come from sales groups all over the region or nation, and national directors are required to provide leadership and training for all participants.

The taxpayer has been a retail seller of [Company] products since 1976. Her sales group consists of approximately 2,500 independent [representatives], scattered all over the nation. About 300 are in Washington. [Company] has rewarded the taxpayer for her outstanding sales and team-building efforts by appointing her a national sales director, . . . awarding her . . . prizes. Her cash commissions on [Company's] wholesale sales to members of her sales group averaged about $ . . . per year during the period 1996-2000.

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

The taxpayer entered into a national sales director agreement with [Company] in July 1991. Her contractual responsibilities and actual activities fit the above general description. Her incentive compensation is based on [Company's] wholesale sales to members of her sales group around the nation. The taxpayer engages in training, counseling, motivational, and promotional activities for her sales group from her home, and at training seminars, leadership and career conferences, and national conferences, where attendees are from many different sales groups.

Prior to 2000, [Company], rather than its sales representatives, remitted retailing business and occupation (B&O) tax and retail sales tax on sales of [Company] [products] in Washington, under an agreement with the Department. [Company] "collected" retail sales tax at the time a [representative] made a wholesale purchase, i.e. in advance of the actual retail sale, by requiring the [representative] to pay the tax at the time of the wholesale purchase, using the suggested retail selling price as the measure of the tax. [Company] also collected an amount to cover the retailing B&O tax at the time of the wholesale sale.

In December 1999, [Company] wrote the taxpayer and other [representatives] and directors in Washington, informing them that beginning January 2000, [Company] representatives would have to individually register with the Department, would be responsible for reporting and paying all B&O tax directly to the Department, and also would be responsible for reporting and paying all retail sales tax and litter tax directly to the Department if their income exceeded defined thresholds. The taxpayer registered with the Department.

In October 2000, the Department's Tax Account Administration Division (TAA) contacted the taxpayer, informing her she must submit information regarding commissions, awards, and prizes received in the period 1996-1998. TAA also informed the taxpayer she must report commission income for 2000 under the service and other B&O classification, and retailing B&O tax, retail sales tax, and litter tax on all her retail sales in 2000. TAA requested a schedule of the taxpayer's Washington State sales and gross revenue during the 1996-1998 period.

The taxpayer questioned why she needed to submit information for 1996-1998. It had been her understanding that [Company] had taken care of all taxes due on the taxpayer's [Company] activities. The taxpayer subsequently learned from TAA that [Company] had assumed responsibility only for retailing B&O tax, retail sales tax, and litter tax. [Company] had not reported or paid any B&O tax that [representatives] and directors might owe on commissions and prizes.

In a series of communications, the taxpayer and TAA argued about appropriate audit methodologies, and about the taxpayer's liability for taxes. The taxpayer contended the Department was barred from assessing taxes for years prior to 2000, for reasons she continues to assert on appeal, discussed below. The taxpayer and TAA disagreed on how the taxpayer's commission income should be apportioned between Washington and other states. The taxpayer proposed she be allowed to apportion her commission income using an accounting methodology she had developed, which apportioned the income based upon the duration of, and number of

attendees at, the [Company] events she attended.[3] TAA rejected the taxpayer's accounting methodology, on the basis the taxpayer's commission income bore no direct relationship to her out-of-state activities, and could not be accurately apportioned based on those activities. TAA told the taxpayer she must provide copies of specified accounting records in order to qualify for apportionment based on costs, and twice provided her with an example of how to compute the out-of-state portion of her gross income using cost apportionment. The taxpayer did not provide the requested records or follow the example TAA provided, and instead submitted her own cost apportionment calculations to TAA, using her own cost methodology.

Based upon information available to it, including information it received from [Company] for 1999 and 2000, TAA issued the above-numbered assessment against the taxpayer, for the period 1996-2000 ("audit period"), on March 29, 2001. Under Schedule 2 of the assessment, TAA assessed Service and Other Activities Business and Occupation (B&O) tax on commissions the taxpayer was paid by [Company], and prizes the taxpayer received from [Company], during the 1996-2000 period. . . . . The tax was assessed on gross income totaling $ . . . for the audit period. The amount of Service and Other B&O tax assessed is $ . . . . The assessment did not apportion the taxpayer's commission or prize income at all, on the basis the taxpayer had not provided necessary records to apportion the income using a cost apportionment methodology. Under Schedule 3 of the assessment, TAA assessed additional retailing B&O tax of $ . . . on the sale of [products] in the year 2000. Under Schedule 4, TAA assessed additional retail sales tax of $ . . . on the sale of [products] in 2000. Under Schedule 5, TAA assessed additional litter tax in the amount of $ . . . on sales in 2000.[4] The assessment assessed interest on the past-due taxes totaling $ . . . to March 29, 2001.

The taxpayer petitioned for correction of the assessment. The statement of issues below provides an outline of the taxpayer's contentions on appeal.

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[3] The taxpayer labels her proposed accounting methodology "separate accounting," and describes it as follows (this description is from a June 23, 2001 letter to the Appeals Division):

> [F]or separate accounting [Taxpayer] uses a simple calculation of her S&O [Service and Other] business activity using Income Activity Units (IAUs) to apportion her S&O income between her in-state business events and her out-of-state business events. For each individual S&O event [Taxpayer] participates in, whether in-state or out-of-state, she multiplies the duration of the event by the number of event attendees. At the end of the year she totals both the in-state and the out-of-state IAUs. The ratio of the annual in-state IAU total to the annual out-of-state IAU total establishes the annual ratio of her in-state to out-of-state S&O activities and therefore apportions her annual S&O revenue.

[4] The "Examiner's Detail of Differences and Instructions to Taxpayer" (audit report), which TAA issued with the assessment, states the retail sales tax is the subject of Schedules 4 (state sales tax) and 5 (local sales tax), but the accompanying schedules handle both state and local sales tax under Schedule 4. The audit report states the litter tax is the subject of Schedule 6, but the accompanying schedules handle litter tax under Schedule 5.

ISSUES

1. If the Department had an agreement with [Company] through 1999 regarding reporting and payment of taxes owed by the [Company] sales force, is that agreement conclusive on the question whether the taxpayer was required to report and pay taxes prior to 2000? Does RCW 82.56.010 (Art. IV)(18) or RCW 82.32.360 make the agreement conclusive, precluding the Department from assessing back taxes against the taxpayer for 1996-1999?

2. Should the . . . prizes, be excluded from taxable income?

3. Was the taxpayer's commission income and other director compensation apportionable?

4. Should the Department allow the taxpayer's method of apportioning her commission income and other director compensation, based on the number of attendees at, and the duration of, events?

5. If cost apportionment is used to apportion the director compensation, should the Department allow the taxpayer to use the cost of doing business calculations she submitted to TAA, rather than requiring her to provide her records to TAA and use the method TAA specified?

6. Should the taxpayer's year 2000 return be accepted as filed, and the assessment's retail schedules and litter tax schedules disallowed because they are based on fictitious numbers?

7. Should the entire assessment be set aside and dismissed, on the basis it does not comply with the body of Washington State tax law regarding the preparation of assessments, and does not meet the standards of professionalism Washington taxpayers are entitled to receive?

8. Should the Department waive interest assessed for 1996-1999, on one or more of the following bases:

    a. The submitting of returns for those years was out of the taxpayer's control;
    b. The Department violated the direct seller's statute, RCW 82.04.423, by splitting the taxpayer's taxes into two components, with [Company] liable for one component while other component liability was to fall on [representatives] at some future time;
    c. The assessment is incorrect and incomplete as written, is superficial and cursory, disregarded taxpayer input, and thus could have been conducted five years ago.

DISCUSSION:

Washington imposes a B&O tax "for the act or privilege of engaging in business" in the State of Washington. RCW 82.04.220. The measure of the B&O tax is the application of rates against "value of products, gross proceeds of sales, or gross income of the business, as the case may be." RCW 82.04.220. The B&O tax measure and rate are determined by the type or nature of the business activity in which a person is engaged. RCW 82.04.290.

The B&O tax of persons engaging in the business of making sales at retail is levied on the gross proceeds of their sales. RCW 82.04.250. Retail sales tax also applies to sales of tangible personal property to consumers in the state of Washington, unless there is a specific exemption. RCW 82.08.020 and 82.04.050. The retail sales tax is to be paid by the buyer, and collected by the seller. RCW 82.08.050. Any sale of tangible personal property in the state is treated as a retail sale, unless the sale is to a person who presents a resale certificate and purchases for specified purposes. RCW 82.04.050.

Ordinary commission income, although based on sales activity, is taxed under the B&O category "other business or service activities," aka "Service and Other," at the rate specified in RCW 82.04.290, rather than under the retailing or wholesaling category. *See Det. 89-286*, 8 WTD 7 (1989). Compensation for most personal services also is taxed under that category. The amount of the B&O tax is equal to the gross income of the business multiplied by a specified rate. Gross income of the business for B&O tax purposes is defined in RCW 82.04.080 as:

> the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, **commissions**, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

(Emphasis added)

RCW 82.19.010 levies a litter tax upon manufacturers, wholesalers, and retailers of certain products that are sold in Washington or shipped into Washington. The measure of the tax is the gross proceeds of sales of the products listed in WAC 458-20-243 (Rule 243). Toiletries are specifically listed in the rule.

Under the above general statutes and rules, the taxpayer, as an independent retailer, would be liable for retailing B&O tax on her retail sales, would be required to collect and remit retail sales tax on her retail sales, and would be liable for litter tax on her retail sales. She would be liable for "Service and Other" B&O tax on any sales commission income or service activity income she receives from [Company].

"Direct seller" situation

A "direct seller" is an out-of-state seller who uses sales representatives ("direct seller's representatives") to sell consumer products directly to the consumer in the home or otherwise than in a permanent retail establishment. Qualifying direct sellers are exempt from B&O tax.[5] Generally, the direct seller status does not affect the tax obligations of the direct seller's sales representatives. A direct seller's representative is subject to the tax obligations described above. That is, a direct seller's representative ordinarily is liable for retailing B&O tax, retail sales tax, and litter tax when the representative sells at retail, and for Service and Other B&O tax on any commissions and other compensation earned.[6]

However, retailing-related tax obligations of direct seller's representatives may be altered by agreement between the Department and the direct seller. Historically, the Department has entered into agreements with some direct sellers that allow the direct seller to remit the retailing B&O tax and retail sales tax owed on retail sales made by their sales representatives. This avoids the direct seller having to obtain resale certificates when it sells the products to its sales force, and relieves the direct seller's representatives from having to register with the Department and report retailing B&O tax and retail sales tax. The practice does not affect the obligation of direct seller's representatives to pay Service and Other B&O tax on any commissions or other compensation earned. In a revision of Rule 246 adopted at the end of 1999, the Department set out this practice at Rule 246(5)(a).[7]

We now address the taxpayer's objections to the assessment.

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[5] See RCW 82.04.423 and WAC 458-20-246 (Rule 246). Ten statutory elements must be met to qualify as a "direct seller." Direct sellers themselves are exempt from wholesaling or retailing B&O tax under the statute and rule, but are subject to other Washington tax obligations. Thus, if a direct seller sells at retail through a representative, it is responsible for retail sales tax. It is not so responsible if it sells at wholesale to its representatives and receives resale certificates from them.

[6] The version of Rule 246 in effect during the years 1996 through 1999 stated, in pertinent part:

> The business and occupation tax likewise applies to the gross income of a "direct seller's representative" who buys "consumer products" for resale and does in fact resell the products. The measure of the business and occupation tax is the gross proceeds of sales.
>
> SERVICE. The law provides no similar business and occupation tax exemption with regard to the compensation paid to the "direct seller's representative." Thus, the representative will remain subject to the business and occupation tax on all commissions or other compensation earned.

[7] That provision states:

> Subject to the agreement of the representatives, the direct seller may elect to remit the B&O taxes of the representatives and collect and remit retail sales tax as agent for the representatives through an agreement with the department. The direct seller's representative should obtain a tax registration endorsement with the department unless otherwise exempt under RCW 82.32.045. (See also WAC 458-20-101 on tax registration.)

If the Department had an agreement with [Company] through 1999 regarding reporting and payment of taxes owed by the [Company] sales force, is that agreement conclusive on the question whether the taxpayer was required to report and pay taxes prior to 2000? Does RCW 82.56.010 (Art. IV)(18) or RCW 82.32.360 make the agreement conclusive, precluding the Department from assessing back taxes for 1996-1999?

The taxpayer contends the Department's agreement with [Company] for years prior to 2000 bars the Department from assessing the taxpayer for unpaid taxes for the years 1996 through 1999. The taxpayer argues the agreement was a secret agreement that put the taxpayer into an active nonreporting status classification, and the agreement is now binding on the Department as to persons in the taxpayer's position. The taxpayer cites RCW 82.56.010 (Art. IV)(18) and RCW 82.32.360 as support for her argument.

The Department is not at liberty to share with the taxpayer agreements the Department has entered into with [Company]. See RCW 82.32.330.[8] Given the Department's historic practice, now set out in Rule 246, the agreement between the Department and [Company] for periods prior to 2000 would only have addressed retailing B&O tax and retail sales tax due on the retail sales made by [Company] [representatives]. It would not have addressed any liability of [Company] [representatives] or directors for service B&O tax on prizes or commissions. If [Company] advised the taxpayer, or led the taxpayer to believe, that [Company] had assumed responsibility for paying all taxes owed by the taxpayer, the taxpayer's complaint should be directed at [Company] rather than at the Department.

The taxpayer's reliance on Article IV of RCW 82.56.010, the Multistate Tax Compact, is misplaced. Article IV concerns net income tax, not B&O tax.

Should the value attributable to . . . prizes be excluded?

The taxpayer contends the value attributed to the use of [Company prizes] should be excluded from taxable income. . . . She argues [Company] awards [prizes] for its own advertising and promotional purposes. . . . . They are displayed at a variety of events. [Company] also uses them as an incentive to promote sales activity by sales representatives. The taxpayer argues RCW 82.04.290 provides that such items are not to be considered a part of a sales agent's remuneration.

. . .

RCW 82.04.290 states, in pertinent part:

[8] The Department has provided the taxpayer with copies of letters [Company] sent to its [representatives] in 1999 informing them [Company] had entered into an agreement with the Department, and informing them of the general ramifications in the agreement. A January 3, 2001 letter from the Public Records Officer explains that the Department is not at liberty to disclose any other information.

> The value of advertising, demonstration, and promotional supplies and materials furnished to an agent by his principal or supplier to be used for informational, educational and promotional purposes shall not be considered a part of the agent's remuneration or commission and shall not be subject to taxation under this section.

The taxpayer cites no authority for her contention that incentive prizes she is awarded by [Company] should be treated as "advertising, demonstration, and promotional supplies and materials furnished to an agent by his principle or supplier to be used for informational, educational and promotional purposes," and therefore excluded from the measure of her B&O tax by RCW 82.04.290. Although there is no existing case law interpreting this statute, we believe the exception in RCW 82.04.290 is only intended to distinguish materials and supplies that a principal or supplier uses to market its products, by furnishing them to a sales agent, from property given or awarded an agent that is in the nature of remuneration. This follows from an analysis of the measure of service B&O tax. "Gross income of the business," which is the measure of Service B&O tax, means "compensation for the rendition of services." The word "compensation" means "payment for value received or service rendered: REMUNERATION." Webster's Third New International Dictionary (unabridged), 463 (1993). Informational, educational, and promotional materials and supplies a principal or supplier gives an agent for the purposes specified in RCW 82.04.290 generally are not in the nature of remuneration for services, although they may incidentally benefit the agent by helping the agent increase the volume of its business activity.

[1] [Company] does not award the use [some] prizes, to its sales force for the purpose of marketing its products to the public, although [the prizes] undoubtedly have an incidental advertising value. Rather, [Company] awards these prizes as a way of motivating members of its sales force and for compensating successful sales and team-building efforts. The . . . prizes are incentives, no different in substance than cash bonuses for outstanding performance. We conclude [Company's] awarding of the . . . prizes, does not fall within the advertising, demonstration, and promotional supplies and materials exception in RCW 82.04.290. The value of their use must be included in the taxpayer's gross income for B&O tax purposes.[9]

Should the Department allow the taxpayer to apportion her national director income?

Washington taxpayers who engage in business both within and outside the state may be entitled to apportion their income among the states in which they engage in business, for B&O tax purposes. *Barclay's Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994). *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939), held that Washington may not impose an unapportioned gross receipts tax on services performed both within and without the state by a taxpayer.

[9] This determination is limited to the taxpayer's B&O tax obligation. We do not reach the issue whether the taxpayer may also have a use tax obligation on her use of the [prizes].

Shortly after the *Gwin, White* decision, the Washington Legislature adopted RCW 82.04.460(1), which provides:

> Any person rendering services taxable under RCW 82.04.290 and maintaining places of business both within and without this state which contribute to the rendition of such services shall, for the purpose of computing tax liability under RCW 82.04.290, apportion to this state that portion of his gross income which is derived from services rendered within this state.

A Department rule, WAC 458-20-194 (Rule 194), also addresses apportionment of service-taxable income. It repeats the RCW 82.04.460 provisions, and further provides:

> When the business involves a transaction taxable under the classification service and other business activities, the tax does not apply upon any part of the gross income received for services incidentally rendered to persons in this state by a person who does not maintain a place of business in this state and who is not domiciled herein. However, the tax applies upon the income received for services incidentally rendered to persons outside this state by a person domiciled herein who does not maintain a place of business within the jurisdiction of domicile of the person to whom the service is rendered.
>
> For example, persons domiciled herein, but having no place of business outside this state, are taxable upon the following types of income:
>
> (1) An insurance agency upon commissions received for insurance placed without the state . . . .

While RCW 82.04.460 and Rule 194 may require apportionment only when a taxpayer maintains a physical office outside this state, the Department has concluded that other limitations on Washington's power to tax revenues from a multi-state activity, found in the federal constitution, require apportionment of gross receipts derived from business activities "which are substantially performed" both within and outside the state. *Det. No. 87-186*, 3 WTD 195 (1987).[10] The current state of the law with respect to when a taxpayer may apportion is explained as follows, in 1 J. Hellerstein & W. Hellerstein, State Taxation 8-27 (2d ed. 1993), in the context of income tax:

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[10] *Det. No. 87-186* did not re-interpret RCW 82.04.460, but rather concluded that RCW 82.04.460 is not the sole source of limitation on Washington's power to tax a taxpayer's service revenues. *Det. No. 87-186* concluded that limitations found in the federal Due Process Clause and Commerce Clause require apportionment of gross receipts derived from business activities "which are substantially performed" both within and outside the state. It reasoned that attributing all the income to this state when the taxpayer engages in substantial service activities outside the state would run afoul of the Due Process Clause requirement that the income attributed to the state for tax purposes must be rationally related to values connected with the taxing state. It also would run afoul of the Commerce Clause requirements set out in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1997). RCW 82.04.4286, which allows a B&O deduction for amounts derived from business the state is constitutionally prohibited from taxing, is the statutory authority for apportionment not specifically covered by RCW 82.04.460.

> [The view that a corporation may apportion its income only if it maintains a regular place of business in another state] clearly is no longer the law, for many activities short of maintaining a place of business in the state will suffice to support a state's jurisdiction to tax a foreign corporation on its net income. Accordingly, no state today can constitutionally deny a taxpayer the right to a division of the tax base, merely because the taxpayer has not established an office outside the state, if the taxpayer is carrying on other activities outside the state (e.g., providing services or owning property) that will subject it to income tax in those other states.

The same principle would apply to a gross receipt tax such as Washington's B&O tax.

As an alternative to the place of business requirement, Department decisions have sometimes framed entitlement to apportion service-taxable income in terms of whether the taxpayer's out-of-state activities are "sufficient to create nexus" with other state(s).[11] Such focus can be misleading. While it is true that the Constitution requires that there be a nexus or connection between the taxing state and the activity sought to be taxed, performing any service activity in a state that generates income will create nexus with the state. *See Memphis Gas Co. v. Stone*, 335 U.S. 80 (1948); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 661 (1948); *Department of Rev. v. J.C. Penney Co.*, 96 Wn.2d 38, 633 P.2d 870 (1981).[12] Further that there is nexus with more than one state does not necessarily mean apportionment is required. When there is nexus with more than one state, the central apportionment issue is fairness--whether the federal constitutional requirement of "fair apportionment" prohibits the state from taxing 100% of the revenues, and, if so, whether the apportionment method used allocates to the state a share of the multi-jurisdictional income that is fairly proportionate to the business transacted in the state.[13]

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[11] *See, e.g., Det. No. 98-196*, 19 WTD 19 (2000) ("As noted, the Department is required to apportion income only if the taxpayer has commerce clause nexus with Washington and another state"); *Det. No. 93-276*, 13 WTD 392 (1994) ("Rule 194 denies apportionment where the services rendered outside the state of Washington are incidental, or insufficient to support a claim of nexus by the other jurisdiction").

[12] Entering a state only to purchase the services of a third party, on the other hand, does not create nexus. *Det. No. 92-262E*, 12 WTD 431 (1992).

[13] Framing the issue in terms of whether there are sufficient activities in the state to create nexus has tended to inappropriately import a test from the sale of goods context into the service context. Several Department decisions have suggested that for service activities to be sufficient to create nexus, and therefore to require apportionment, their purpose must be to enter into the marketplace of, or establish a market in, the jurisdiction. *See, e.g., Det. No. 92-262E, supra*; *Det. No. 96-147*, 16 WTD 117 (1996) ("Substantial nexus has three elements. . . . Third, the activity's purpose is to establish or maintain a position in Washington's marketplace.") That "element" comes from WAC 458-20-193 (Rule 193)'s list of activities that create sufficient nexus for the B&O tax to apply to revenue from the sale of goods. Rule 193 does not apply to service revenues. *Det. No. 01-188*, 21 WTD 289 (2002). The nexus requirement presents unique difficulties in the sale of goods context, because the taxable activity can occur without the taxpayer being present in the state at all. When the seller has a limited presence, there is an issue as to whether the purpose or use of the presence is related to the selling activity. In the service context, on the other hand, if the taxpayer is present performing some aspect of its service, or if a representative of the taxpayer is present in the state and acting in a representative capacity, there is no issue as to the purpose of its presence. Importing the Rule 193 example into the service context is not only unnecessary, it may derail consideration of the apportionment issue by being read as creating a requirement that the taxpayer have the purpose of creating an ongoing market for

In limited circumstances, the Supreme Court has upheld a state's taxation of 100% of service revenues even when there is an interstate element. In *Central Greyhound Lines, supra,* 334 U.S. at 660, the Court suggested that a state may be able to "tax transactions physically outside its borders but so trifling in quantity to the [state's] commerce, of which they form a part, as to be constitutionally insignificant." Older decisions upheld taxation of 100% of the revenues from an activity where the taxpayer was merely performing distinct incidental interstate services that contributed to the value of an otherwise local activity. *See, e.g., Dept. of Treasury of Indiana v. Ingram-Richardson Mfg. Co.*, 313 U.S. 252 (1941) (the process of enameling items was a purely local activity, and the taxpayer's interstate pickup and delivery of the items to be enameled were considered only incidental to that intrastate business). More recent decisions have approved unapportioned taxes on interstate commerce when the state tax scheme otherwise protects interstate commerce from multiple taxation, and apportionment would produce genuine administrative burdens or technological barriers. *See, e.g., D. H. Holmes Co. v. McNamara*, 486 U.S. 24 (1988); *Goldberg v. Sweet*, 488 U.S. 252 (1989). Thus, even when a taxpayer's activities create nexus with more than one state, there are circumstances where "fair apportionment" does not require apportioning out any of the revenue.

[2] Based upon the taxpayer's description of the nature of her activities and what services she was required to perform for [Company] as a condition of her continuing appointment as a national director, we find the taxpayer's commission income was derived from business activities which she performed both within and outside the state. We find her out-of-state activities were neither trifling in quantity nor incidental interstate services. Taxpayer's national director commission income was tied in part to her role in generating sales by her own nationwide sales group, and in part to her services to [Company] in training and motivating the national [Company] sales force. The taxpayer performed those activities principally in Washington, but performed her sales group activities as well as her services for the [Company] organization in part at regional and national training/motivational events outside the state.[14] Her participation in out-of-state events was required not for her own education or development, but rather for [Company's] benefit. She was engaging in business activities at the out-of-state events. RCW 82.04.140 defines "business" as "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer." While [Company] did not pay the taxpayer for participating in any specific event, the taxpayer's continued receipt of national director compensation depended upon "starring" at major out-of-state [Company] events.

We conclude the national director income must be apportioned provided the taxpayer submits the documentation necessary to do so.

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its services in the state. It could lead to the argument that the taxpayer is not present to create or maintain an ongoing market, therefore the activities are not sufficient to create nexus, and therefore apportionment is not required. That is simply wrong. If a taxpayer performs revenue-generating service activity in a state, the activity creates nexus. What is "fair apportionment" then becomes the issue.

[14] Her situation is distinguishable from that of a multi-level marketing participant whose entitlement to commissions on out-of-state sales by down-stream distributors is based on services he or she performs entirely in Washington. *See Det. No. 99-220*, 19 WTD 355 (2000).

Should the Department allow the taxpayer's method of apportioning her commission income and other director compensation, based on the number of attendees at, and the duration of, events?

Once it is determined that a taxpayer's income is subject to division among the states in which the taxpayer conducts business, the proper method of apportionment must be determined. Commonly used methods to divide or apportion the income in many states are separate accounting, allocation, or apportionment by use of a formula. 1 J. Hellerstein & W. Hellerstein, State Taxation 8-6 (2d ed. 1993). Where apportionment of "Service and Other" income is required, Washington has adopted two of these methods. RCW 82.04.460 provides:

> Where such apportionment cannot be accurately made by separate accounting methods, the taxpayer shall apportion to this state that proportion of his total income which the cost of doing business within the state bears to the total cost of doing business both within and without the state.

The statutorily preferred method of apportionment is separate accounting, an apportionment method sometimes referred to as geographic or transactional accounting. In the income tax context, "[s]eparate accounting is a technique of carving out of the taxpayer's overall business the activities taking place, the property employed, and the income derived from sources within a single state and by accounting analysis ascertaining the profits attributable to that portion of the business." *Hellerstein, supra,* at 8-41. Similarly, in the gross receipts tax context, separate accounting is a technique of carving out of the taxpayer's overall business the activities taking place within a single state and by accounting analysis ascertaining the revenue attributable to those activities. In *Det. No. 98-022*, 17 WTD 336 (1998), the Department found that a separate accounting method which billed the customer for specific services based upon the location of the office where the services generating the income (billable services) were performed accurately apportioned revenue. As TI&E explained to the taxpayer in this case prior to the issuance of the assessment, accruing billable hours outside the state, or being paid a fee to give a presentation outside the state, constitutes specific income derived directly from specific out-of-state activities, and such income can be apportioned under separate accounting methods.[15]

Separate accounting cannot be used to apportion the taxpayer's income, because her national director commission income is not directly tied to specific activities or states. The method the taxpayer devised, which she labels "separate accounting," does not accurately separate income derived from out-of-state activities from income derived from Washington activities. The criteria she uses -- the location of specific [Company] events, the number of persons attending the events, and the number of hours in each event -- had neither a direct nor an indirect relationship to the amount of compensation she was entitled to. She was not paid by the event, or on the basis of the number of attendees at an event, or the duration of an event. She was paid for her national director activities as a whole. The taxpayer's methodology also fails to take into

[15] February 16, 2001 letter from TI&E to the taxpayer.

consideration her on-going (non-event) planning, team-building, training, and motivational activities conducted from her home in Washington.

We conclude that the taxpayer's separate accounting method does not accurately apportion the taxpayer's director commission income. Thus, under RCW 82.04.460, the taxpayer must use cost apportionment to apportion her director commission income.

If cost apportionment is used to apportion the taxpayer's audit period director compensation, is the Department required to accept the taxpayer's cost of doing business calculations?

In support of using her own cost apportionment calculations rather than the methodology TAA specified, the taxpayer argues, in an attachment to her petition, that her cost of doing business reports consist of a more complete, squarely on point, and transparent format than the method provided her by TAA.

The Department is not required to accept whatever cost apportionment calculations a taxpayer submits. First, we point out that RCW 82.32.070 requires taxpayers to open for examination by the Department, all their books, records, and invoices. The statute provides: "Any person who fails to comply with the requirements of this section shall be forever barred from questioning, in any court action or proceeding, the correctness of any assessment of taxes made by the department of revenue [for the period]." A taxpayer who refuses to provide records the Department requests, and insists the Department accept the taxpayer's tax calculations, will run afoul of RCW 82.32.070.

We will not further consider the taxpayer's cost apportionment arguments, for two reasons. First, the taxpayer submitted her cost apportionment figures late, and without supporting documentation, and for that reason TAA did not have an opportunity to review the calculations with her. Now that we have clarified that cost apportionment must be used in this case, it is appropriate to remand the file to TAA to give the taxpayer and TAA an opportunity to discuss appropriate cost apportionment numbers. As stated in the previous paragraph, the taxpayer must comply with the RCW 82.32.070 documentation requirements, or TAA will be unable to allow apportionment of her audit period director compensation. Further, the Department has published a clarification of the proper method for implementing cost apportionment, *Det. No. 01-006*, 20 WTD 124 (2001), which the taxpayer and TAA should consider.

We remand the cost apportionment issue to TAA to give the taxpayer an opportunity to provide all the records TAA requests, so that her income may be apportioned under accepted cost apportionment principles. We emphasize that apportionment is not a science. The taxpayer will have to work with TAA to reach a reasonable allocation consistent with current Department interpretation.

. . .

Should the taxpayer's year 2000 return be accepted as filed, and the assessment's retail schedules and litter tax schedules disallowed because they are based on speculative numbers?

As stated in the facts above, for years prior to 2000, [Company] "collected" retail sales tax at the time a [representative] made a wholesale purchase, based on the suggested retail price, and remitted the tax to the Department. As a result, the sales amounts reported and the tax paid did not necessarily correspond with the actual retail sales figures. A [representative] could sell products at less than the suggested retail price.

The taxpayer protests the assessment's use of sales figures provided by [Company] for calculating taxes due on retail sales in 2000, and contends the Department must accept the figures on the return the taxpayer filed for 2000.[16]

We agree that actual sales figures should be used, rather than wholesale sales/suggested retail price figures provided by [Company], for the year 2000. However, we do not agree that the Department must accept the figures the taxpayer placed on her return. The figures upon which these taxes are based should come from the taxpayer's records, if the taxpayer provides them to the Department. We will remand this issue to TAA to give the taxpayer an opportunity to provide complete sales records for 2000. Articles not sold to consumers, but provided as samples, are subject to use tax under RCW 82.12.010(5), measured by the wholesale purchase price.

Should the entire assessment be set aside and dismissed, on the basis it does not comply with the body of Washington state tax law regarding the preparation of assessments, and does not meet the standards of professionalism Washington taxpayers are entitled to receive?

The taxpayer contends the entire assessment should be set aside and dismissed, because TAA insisted she use a cost apportionment methodology, failed to help her create a suitable separate accounting method, disregarded the information she provided to support her separate accounting method, disregarded her cost apportionment calculations, used fictitious retail sales figures for 2000 instead of accepting the figures on her return, assessed interest for periods during which the Department had wrested from the taxpayer control over filing returns, failed to give her a requested supervisor's conference, and the assessment generally was incomplete, superficial and cursory.

We have addressed pieces of this contention above, and address the interest issues below. The audit involved several difficult issues. As is common in a complex audit investigation, there was

[16] The petition argues: "[Company] as a wholesale distributor has no possible way to know how or even *if* its wholesale product sales will ultimately result in retail sales. [Company] has no possible way to know when the independent direct seller's representative's retail sales will occur, nor the retail price discounts that will be applied by the independent direct seller's representative, nor the amount of retail products that will be returned to the independent direct seller's representative, nor what products the independent direct seller's representative will use for promotional purposes, nor what unsold products will become obsolete on the independent direct seller's representative's shelves, just for example."

considerable discussion, back and forth, on contentious issues. There were numerous exchanges of correspondence. The audit report recognizes that additional adjustments may be necessary, if the taxpayer provides additional records. We find no merit in the taxpayer's complaints about the audit process.

Should the Department waive interest assessed for 1996-1999, on any of the bases set out in Issue Statement 2 above?

a) The taxpayer contends the Department should waive interest for 1996-1999 in accordance with RCW 82.32.105. She argues the decision whether to report and pay was removed from her control by the agreement between the Department and [Company].

The Department may waive interest in only two circumstances. One is when the failure to timely pay the tax was the direct result of written instructions given the taxpayer by the Department. RCW 82.32.105(3)(a); 82.32A.020(2); WAC 458-20-228(10). The second is when there is an extension of the due date for payment of an assessment or deficiency that is not at the request of the taxpayer and is for the sole convenience of the Department. RCW 82.32.105(3)(b). Neither circumstance is present in this case.

The taxpayer has not shown that the Department instructed her not to file or report her commission and prize income prior to 2000. The Department may have failed to realize that [Company] directors received income other than from their own sales, and failed to inquire about other income, but that failure would not provide a basis for waiving interest. *Kitsap-Mason Dairymen v. Tax Commission*, 77 Wn.2d 812, 818, 467 P.2d 312 (1970). As the taxpayer herself notes, the Washington tax system is based largely on voluntary compliance.[17] RCW 82.32A.030(2) places upon the taxpayer the responsibility to "[k]now their tax reporting obligations, and when they are uncertain about their obligations, seek instructions from the department of revenue."

We also should point out that interest is not considered a type of penalty. Rather, it is a charge for the use of money. When a taxpayer fails to timely remit taxes due, the State of Washington loses the use of the tax money, while the taxpayer has use of the funds or avoids borrowing money to pay taxes. Statutory interest merely serves to compensate the state for the loss of the use of those funds. RCW 82.32.100(2).

b) The taxpayer argues the Department should waive interest for 1996-1999 because the Department violated the direct seller's statute, RCW 82.04.423, by splitting the taxpayer's taxes into two components, with [Company] liable for one component while other component liability was to fall on [representatives] at some future time.

Even if true, this would not be a basis for waiving interest. *See* the discussion above. Moreover, there is no merit in this argument. RCW 82.04.423 does not prohibit the Department from

[17] RCW 82.32A.005 states: "The legislature further finds that the Washington tax system is based largely on voluntary compliance and that taxpayers have a responsibility to inform themselves about applicable tax laws."

allowing the direct seller to relieve its representatives of responsibility for only some of the taxes the representatives might owe on their business activity.

c) The taxpayer argues that interest should be waived for 1996-1999 because the assessment is incorrect and incomplete as written, is superficial and cursory, disregarded taxpayer input, and thus could have been conducted five years ago.

We have considered the taxpayer's contention that the audit process was incomplete, superficial, cursory, and improperly failed to accept the taxpayer's input. We find no merit in that contention. Therefore, those allegations cannot serve as a basis for waiving interest. Even if we found some merit in the complaints, the alleged deficiencies in the audit process would not be a basis for waiving interest. *See* RCW 82.32.105(3).

Summary

We summarize our conclusions on the issues raised by the taxpayer's petition for correction of assessment as follows:

a) On the issue whether the agreement between [Company] and the Department for years prior to 2000 precludes the Department from assessing back taxes against her for the years 1996 through 1999, we conclude the Department is not precluded from assessing service B&O tax against the taxpayer on her commission income, . . . , and her prizes, for those years.
b) On the issue whether the value attributable to the use of . . . prizes, should be excluded from taxable income, we conclude the value of the use of . . . prizes, should be included.
c) On the issue whether the taxpayer's commission income and other director compensation during the audit period was apportionable, we conclude it was apportionable.
d) On the issue whether the Department should allow the taxpayer's method of apportioning commission income and other director compensation for the audit period, we conclude the taxpayer's method does not accurately apportion the income, apportionment of the income cannot be accurately made by separate accounting, and the taxpayer must apportion the director compensation using a cost apportionment methodology as specified in RCW 82.04.460.
e) On the issue whether, if cost apportionment is used to apportion the taxpayer's director compensation during the audit period, the Department should allow the calculations the taxpayer submitted to TAA, we conclude the Department is not required to accept the taxpayer's submissions. If the taxpayer provides the necessary records, TAA should apportion the taxpayer's commission income for past periods based upon her costs as shown by her records.
f) On the issue whether the Department must accept the taxpayer's figures for retail sales set out in her tax return for 2000, we conclude the Department is not required to accept those figures. Retailing B&O tax, retail sales tax, use tax, and litter tax for 2000 should be based upon an examination of the taxpayer's actual sales records for 2000, if the taxpayer produces those records.
g) On the issue whether the entire assessment should be set aside as superficial and contrary to the body of Washington tax law regarding the preparation of assessments, we find no merit in the taxpayer's contentions, and deny the requested relief.

h) On the issue whether the Department should waive interest for 1996-1999, we conclude there is no basis for waiving interest for those years.

The assessment should be remanded to TAA for possible adjustment as follows:

a) The taxpayer should be given an opportunity to provide such income and expense records as TAA may require to apportion the taxpayer's commissions and other director compensation using cost apportionment. She also must provide information sufficient for TAA to determine whether her prize income is compensation for her national director activities, and therefore potentially apportionable for the audit period, or compensation for her individual retail sales activity in Washington, and therefore not apportionable.
b) The taxpayer should be given an opportunity to provide actual sales records of her retail sales of [Company] [products] during 2000. Use tax is due if items were provided as samples.

DECISION AND DISPOSITION:

The taxpayer's petition is denied in part and remanded in part to the Taxpayer Accounts Administration Division (TAA) for possible adjustment to Schedules 2, 3, 4, and 5[18] of the assessment based on records the taxpayer must provide by March 3, 2003.

Dated this 31st day of December 2002

[18] Again, we note that Schedule 5 (litter tax) is erroneously referred to as schedule 6 in the audit report.