Cite as Det. No. 96-092, 16 WTD 89 (1996)

BEFORE THE INTERPRETATION AND 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. 96-092
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

RULE 106; RCW 82.04.040: SERVICE B&O TAX -- CASUAL AND ISOLATED SALES -- PROPRIETARY INFORMATION -- TRADE SECRETS -- KNOW-HOW -- LICENSE -- ROYALTIES. A product manufacturer that develops a process, the use of which is licensed to others, must pay service B&O tax on its royalty receipts from the licensee.

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 food processing company protests service business and occupation (B&O) tax assessed on its license and royalty receipts for the use of its proprietary information in a specific territory.[1]

FACTS:

Pree, A.L.J. -- The taxpayer is a Washington Corporation engaged in the business of manufacturing and marketing soups, sauces, and other products. It has acquired a substantial amount of technical data, trade secrets and proprietary information in connection with recipes, formulas, and procedures. The taxpayer refers to these as "know-how."

The Audit Division of the Department of Revenue (Department) audited the taxpayer for the period January 1, 1991 through December 31, 1994. As a result of the audit, the Audit Division issued an assessment.

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

The taxpayer protested service and other activities B&O tax assessed on receipts derived from an agreement to sell know-how as well as the interest pertaining to that tax. The taxpayer also requests a refund of B&O tax paid on subsequent payments under the agreement as well as a ruling pertaining to future payments.

The taxpayer estimates that 90% of its receipts come from the wholesale sale of food products. The taxpayer is headquartered in Washington where its manufacturing and research activities occur. The disputed portion of this assessment pertains to the taxpayer's receipts for the use of its know-how.

The taxpayer's know-how consists of a unique cook-chill process and methodology extends product shelf-lives. Each step in the process requires precise standards, procedures, and product knowledge constituting the subject of the "Manufacturing License and Technical Assistance Agreement" (agreement) entered into between the taxpayer and a food company.

Under the agreement, the taxpayer provides the food company with the know-how described above, and some initial consulting regarding that know-how. The agreement specifies that the food company is licensed to use the know-how to manufacture and sell products in a specific territory (territory) outside of the state of Washington. The ownership of the know-how remains with the taxpayer, but the food company retains the right to use it for an unlimited period of time, except in the case of default.

The taxpayer's know-how is not patented. Only the agreement restricts disclosure of these secrets. While government regulators may inspect the facility and food, according to the taxpayer, its process is not regulated.

Under the agreement, the food company must maintain the confidential nature of the know-how. It may not sublicense any rights under the agreement. The taxpayer may not manufacture, produce, or license others to produce, sell or market its products in the territory for a period of five years. The food company may not manufacture or sell products developed from the know-how outside of the territory.

In consideration for the assignment of rights and the transfer of know-how, the food company paid the taxpayer in 1993 and agreed to make future payments for five years based upon certain specified percentages of net sales and product costs. After five years, the agreement allows the food company to continue to use the know-how at no cost, subject to certain restrictions. The agreement restricts the taxpayer from licensing others to use the know-how in the territory for a five year term only.

The agreement referred to the payment as an initial license fee and referred to future payments as continuing royalty payments. The future payments are contingent only on the food company's activities, not the taxpayer's activities. The taxpayer reported the royalty payments on its excise tax returns and requests that the tax it paid on those receipts be refunded.

The taxpayer contends that the agreement constituted a sale of rights, and that it never engaged in the business of selling that type of property. The taxpayer asserts that the agreement represents a casual or isolated sale to which B&O tax was not applicable.

The Audit Division contends the agreement was a license with continuing royalty payments rather than a sale. It included the 1993 payments in the assessment and denied the taxpayer's refund request regarding the tax on the continuing royalty payments.

The taxpayer contends that this is a casual or isolated sale occurring outside of its normal course of business. As a casual or isolated sale, the transaction would be exempt from the B&O tax. The taxpayer had reported the continuing royalty payments as income subject to the B&O tax. The taxpayer requests that these B&O tax payments be refunded.

ISSUE:

Were the license and royalty receipts from the use of know-how in a specific territory exempt because they resulted from casual or isolated sales?

DISCUSSION:

Service and other activities B&O tax is imposed upon the gross income of persons engaged in business in Washington. RCW 82.04.290. B&O tax is not imposed upon casual or isolated sales. WAC 458-20-106 (Rule 106). RCW 82.04.040 defines, "casual or isolated sale" as:

. . . a sale made by a person who is not engaged in the business of selling the type of property involved.

Rule 106 elaborates:

Any sales which are routine and continuous must be considered to be an integral part of the business operation and are not casual or isolated sales.

. . .

Furthermore, persons who hold themselves out to the public as making sales at retail or wholesale are deemed to be engaged in the business of selling, and sales made by them of the type of property which they hold themselves out as selling, are not casual or isolated sales even though such sales are not made frequently. In addition the sale at retail by a manufacturer or wholesaler of an article of merchandise manufactured or wholesaled by him is not a casual or isolated sale, even though he may make but one such retail sale.

We consider receipts from license agreements to use property, a continuous sale by a person engaged in selling that type of property, and not a casual or isolated sale. For instance, a lease is not a single transaction, but a series of transactions. See Gandy v. State, 57 Wn. 2d 690, 695, 395 P.2d 302 (1961). The sale of the property itself, however, may be a casual and isolated sale.

The sale of the patents are generally considered to be casual and isolated while the sale of the rights to use them are considered to be royalties consisting of regular payments in the ordinary course of business. ETB 383. Regarding the taxability of patent royalties, the Department distinguishes between sales of the patents in which the transferee may reassign the patent rights to others, and merely providing a license to use the patents. ETB 324.

Thus, in the case of patents, we have distinguished between an assignment (or sale) and licensing the patent:

The fundamental distinction between an assignment of a patent and a license arrangement under a patent relates to the rights and liabilities of an assignee or licensee to sue or be sued for infringement of the patent. An assignee of a patent has the right to maintain suit for infringement and to be sued regarding the validity of the patent. A licensee only gains immunity from suit for infringement. TWM Mfg. Co. v. Dura Corp., 189 USPQ 518 (1975).

Moreover, the implication in the agreement that the transferee has the right to assign and license the patents transferred to other is another indication of a sale. Hooker Chemicals and Plastics Corp. v. United States, 199 USPQ 549 (1978).

Det. No. 85-97A, 7 WTD 383, 386-387 (1989). Whether or not the transferee had the right to sue for infringement as well as the right to transfer the rights indicates whether the transferror sold the rights or merely licensed their use.

While in this case the taxpayer's know-how is not patented, a similar analysis to the taxability of patents should be applied. Both patents and the know-how[2] pertain to the proprietary interest in information, an intangible right. The taxpayer's activity in developing the know-how is similar to the activity of developing a patent, as is its arrangement with the food company to use the know-how similar to agreement for the use of patented processes. Therefore, the know-how receipts should be taxed in a manner similar to patent royalties.

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[2] The know-how probably constitutes a "trade secret," which is defined in RCW 19-108.010(4) as "information, including a formula, pattern, compilation, program, device, method, technique, or process that:
(a) Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and
(b) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."

The taxpayer retains ownership of the know-how. The taxpayer retains the right to sue for any violation resulting from disclosure of the know-how. Unlike the purchaser of a patent, the food company may not sue for disclosure of the know-how. The food company's interest is similar to that of a licensee.

The contract appears to be a fairly sophisticated five-year arrangement for an ongoing business relationship between the taxpayer and the food company. The food company is given a very specific territory where it may sell products using the taxpayer's know-how. The food company pays the taxpayer an initial license fee, then a continuing royalty based upon its sales of products covered by the agreement. The food company certifies its sales of those products to the taxpayer. After five years, the parties (the taxpayer and the food company) may compete directly anywhere. While the food company may use the know-how, it may not reveal it to others. Finally, the taxpayer reserved the right to sell the know-how or license others to use it in the future.

Under these circumstances, we find that the taxpayer was engaged in the business of selling its know-how. The royalty payments at issue were for a license to use the know-how rather than a sale of the know-how. The transaction was not a casual or isolated sale, but a series of regular, recurring royalty payments subject to B&O tax under the service and other activities classification.

DECISION AND DISPOSITION:

The petition is denied.

DATED this 13th day of June, 1996.