Cite as Det. No. 98-196, 19 WTD 19 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Future Reporting Instructions	)	D E T E R M I N A T I O N
	)	No. 98-196
. . .	)	Registration No. . . .
	)	FY . . ./Audit No. . . .

RULE 194; RULE 224; RCW 82.04.460: SERVICE B&O TAX – NEXUS APPORTIONMENT – SECURITIES DEALER. A Washington-based securities dealer is entitled to apportion its gross receipts between Washington and the numerous other states in which it markets securities through independent sales representatives that own and operate their own offices. The securities dealer has taxable nexus with those other states by entering their marketplaces to sell its services and products to customers in those states. Such out-of-state activities are more than incidental.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

NATURE OF ACTION:

A Washington corporation (the taxpayer) protests future reporting instructions that it must report as gross income for business and occupation (B&O) tax purposes 100% of commissions from sales made by out-of-state independent representatives to out-of-state customers.[1]

FACTS:

De Luca, A.L.J. -- The taxpayer is in the securities business. It is a member of the National Association of Securities Dealers (NASD) and must comply with the rules and regulations of the Securities and Exchange Commission (SEC). The taxpayer has a seat on a large stock exchange

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

located in another state. The taxpayer's principal office is in the state of Washington. However, the taxpayer's business activities are not confined to Washington. The taxpayer is registered to do business in all fifty states. It actually does business in seventeen states in addition to Washington. It files tax returns in each of those eighteen states. The taxpayer declares that it also leases offices in two states in addition to Washington. Since March 1996, the taxpayer claims it has employees in one of those offices and in its Washington office.[2]

The taxpayer has entered into several non-exclusive contracts with independent sales representatives in the seventeen other states. These individuals are able to represent brokers/dealers other than the taxpayer. The representatives are not broker/dealers themselves and cannot sell securities in their own names. They may sell other products such as insurance and annuities, which are not related to the taxpayer's business. The independent sales representatives are licensed and registered to do business in their respective states. With the possible exception of one office, these representatives work in offices that they (or someone other than the taxpayer) provide. The representatives manage their own offices as they see fit, and they follow securities industry rules. They employ the employees working in their offices.

The out-of-state representatives procure their own customers. Typically, when a customer places an order to execute a trade, the representative writes an order ticket provided by the taxpayer. The ticket includes the client's name, address, and account number. The sales representative then either calls or faxes the taxpayer's trading desk with instructions to execute the trade. The taxpayer then executes the trade over the counter or on the exchange. The taxpayer mails the confirmation /invoice to the customer, who remits payment to the taxpayer. From that payment, the taxpayer pays a commission to the out-of-state representative.

Industry rules require the taxpayer to oversee the representatives both within and without Washington to ensure their compliance with securities laws. Accordingly, the taxpayer's administrative personnel periodically visit the out-of-state offices in all seventeen states to make certain the customers of those offices are being served in a manner consistent with both the taxpayer's standards and industry standards. Additionally, the taxpayer's name must be used by the representatives in all business transactions involving the taxpayer, including advertising, business cards, office signs, etc.

The Audit Division (Audit) of the Department of Revenue (the Department) reviewed the taxpayer's books and records for the period January 1, 1992 through December 31, 1995 and assessed use tax and related interest. Document No. FY . . . . The taxpayer does not contest the monetary assessment. However, the taxpayer does protest the future reporting instructions Audit provided in its report. That report stated Audit made no adjustments in the audit due to prior instructions given in the last two excise tax audits it performed on this taxpayer. However, the subject audit report was released on March 7, 1997. It instructed the taxpayer that effective

[2] We note that the Department of Revenue's audit report states that the taxpayer did not have any offices or employees stationed outside Washington during the audit period, which ended December 31, 1995.

retroactively to January 1, 1996 the taxpayer was to report 100% of its commission income under the service B&O tax classification, but would be allowed a deduction for amounts paid to an "established security house" per WAC 458-20-162 (Rule 162). Audit relied on WAC 458-20-194 (Rule 194) and two determinations in support of its future reporting instructions, Det. No. 92-117, 12 WTD 147 and Det. No. 92-195, 12 WTD 383 (1992). Audit quoted the portion of Rule 194 that declares… "the [B&O] 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 the place of domicile of the person to whom the service is rendered." Audit added that in order to apportion income, the taxpayer must show it "…is conducting activities outside Washington state resulting in the generation of income." Consistent with the prior audit instructions, the taxpayer had been deducting the commissions it paid to the out-of-state representatives.

TAXPAYER'S EXCEPTIONS:

The taxpayer argues it is entitled to apportion the commission income because, constitutionally, no state has the power to levy a tax upon activities that occur outside its territorial limits. Dravo Corp. v. Tacoma, 80 Wn.2d 590, 496 P.2d 504 (1972). The taxpayer insists that merely because the out-of-state representatives lease the offices that bear the taxpayer's name, rather than the taxpayer leasing the offices, does not give Washington the right to tax income earned outside this state. Det. No. 88-476, 7 WTD 91 (1988); Det. No. 87-186, 3 WTD 195 (1987); and Det. No. 94-031, 14 WTD 194 (1994). The taxpayer contends the Department is in error if it attempts to grant or deny apportionment on the basis whether the taxpayer uses employees or independent agents in its market-creating activities outside Washington. Tyler Pipe Industries, Inc. v. Department of Rev., 105 Wn.2d 318, 326-27, rev'd on other grounds, 432 U.S. 232 (1987). The taxpayer notes the U.S. Supreme Court has stated it is "a fine distinction [that] is without constitutional significance" whether the market-creating activity is carried on by employees or by independent agents of the out-of-state vendor. Tyler Pipe, 483 U.S. at 250. See also Scripto, Inc. v. Carson, 362 U.S. 207 (1960). Finally, the taxpayer cites Det. No. 92-262E, 12 WTD 431 (1992) for the holding that where a taxpayer's activities in another state are sufficient to establish taxing nexus with the other jurisdiction, Washington must allow apportionment.[3]

The taxpayer believes Audit's reliance on Det. Nos., 92-117 and 92-195, supra, is misplaced. The taxpayer remarks it is factually unclear whether the customers in those cases were dealing with out-of-state offices operating directly under the names and goodwill of Washington brokers/dealers. It is also unclear if the Washington brokers/agents in those cases were as actively involved outside this state in generating income as the present taxpayer is. The taxpayer adds that Det. No. 92-117 contains no discussion of constitutional restraints on taxing receipts from out-of-state activities. Moreover, Det. No. 92-195 does not discuss any of the authorities cited above. Indeed, the taxpayer notes some of the Department authority it cites that recognizes

[3] The taxpayer concedes Rule 162's provision allowing deductions for certain commissions paid is not applicable because the commissions are not paid to "established security houses."

the right to apportionment, e.g. Det. No. 92-262E, is more recent than either Det. No. 92-117 or Det. No. 92-195.

In short, the taxpayer asserts it should be permitted to apportion its gross receipts so that income from sales generated by the offices of its out-of-state representatives doing business under its name may be apportioned to those states. Alternatively, the taxpayer requests it be permitted to report its gross receipts from sales both within and without this state so long as it is allowed to deduct the commissions paid to its out-of-state representatives for services rendered outside Washington.

ISSUES:

1. Does the taxpayer have taxing nexus with the seventeen other states where it is registered to do business and represented by registered independent sales agents?

2. If the taxpayer has taxing nexus with those states, must Washington allow the taxpayer to apportion its gross receipts between Washington and the applicable states?

DISCUSSION:

The Supreme Court in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) announced the test to determine the validity of state taxation of interstate business under the Commerce Clause of the U.S. Constitution. The Washington Supreme Court summarized the Commerce Clause test in Complete Auto by declaring:

> Under this test, state taxation of interstate business must (1) tax only interstate activities having a sufficient connection to the taxing state (nexus requirement); (2) be fairly apportioned to taxpayer's activities in the state (apportionment requirement); (3) not discriminate against interstate commerce (nondiscrimination requirement); and (4) be fairly related to the services provided by the state.

American National Can v. Dept. of Rev., 114 Wn.2d 236, 241, 787 P.2d 545 (1990).

The present taxpayer is correct by arguing that the actions of non-employee agents/representatives can create substantial (i.e., taxing) nexus in a state for an out-of-state vendor. Scripto, supra, and Tyler Pipe, supra. The fact that the taxpayer did not have employees permanently, or even temporarily, stationed in the out-of-state offices of the independent representatives does not prevent those states from establishing taxing nexus with the taxpayer, and is not necessarily determinative in answering the question whether apportionment is applicable.

We explained nexus requirements in Det. No. 92-262E where we held that third party services create taxing nexus if they are performed for the purpose of entering the marketplace of that location. In Det. No. 92-262E, we found third party services were not engaged for that purpose because…

> The taxpayers' use of the independent [contractors] is decidedly different. The location of the independent [contractors] is totally irrelevant to the taxpayers. They are not chosen for the state where they reside or for the purpose of the taxpayers themselves entering into the marketplace of that state. They are chosen for their expertise in providing . . . advice. The taxpayers do not maintain the independent [contractors] in the various states. Rather, the taxpayers are just one of several clients for each independent [contractor].

We also distinguished the taxpayers' activities in Det. No. 92-262E from Scripto and Tyler Pipe, supra, by stating:

> However, these cases [Tyler Pipe and Scripto] are clearly distinguishable from the taxpayers' situation. In both cases [Tyler Pipe and Scripto] the tax paying businesses used the independent contractors to enter the marketplace of the taxing jurisdiction, i.e., to do business in that state's marketplace. In the case of [Det. No. 92-262E], the independent [contractors] are neither promoting the taxpayer's business nor seeking business for them. Rather, these independent [contractors], scattered around the United States, are selling their own services at wholesale to the taxpayers.

Like Tyler Pipe and Scripto, the sole reason the present taxpayer entered into contracts with the out-of-state representatives was to enter the marketplace of their respective states. Based on the facts and law described above, we find the taxpayer has substantial nexus with those seventeen other states.

The B&O tax is imposed on all business activities in the state of Washington. RCW 82.04.220. Business activities that occur outside the state are not subject to the B&O tax. Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1937). Thus, taxpayers who engage in business both within and without the state are entitled to apportion their income. Det. No. 92-262E, supra. If the business activity is subject to service B&O tax under RCW 82.04.290, then apportionment is specified in RCW 82.04.460, which states:

> (1) 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. 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.

(Emphasis added.)

In quoting a provision of Rule 194 (which implements RCW 82.04.460), Audit denied the taxpayer apportionment due to its belief the taxpayer renders only incidental services to persons outside Washington, where the taxpayer itself does not maintain an office. However, we have stated on several occasions that the maintenance of an office outside the state is not a prerequisite for apportionment, provided the services were more than incidental. Det. No. 87-186, supra; Det. No. 89-553, 9 WTD 39 (1989); and Det. No. 94-031, 14 WTD 194 (1994).

As noted, the Department is required to apportion income only if the taxpayer has commerce clause nexus with Washington and another state. We discussed apportionment in Det. No. 92-262E, supra, as follows:

> The second prong of Complete Auto is fair apportionment. This is required to prevent undue burdens on interstate commerce and to prevent the taxation of extraterritorial values. We concur that apportionment is required when a tax paying business conducts revenue producing activities both within and outside the state. See: RCW 82.04.460 quoted above and Rule 194. However, apportionment is only required when the other state has the constitutional ability under Complete Auto to tax the business' activities. There is no requirement to apportion when the other state is unable to constitutionally tax the gross receipts business. The concept of apportionment is designed to assure that, on a theoretical basis, an interstate business is taxed on no more than 100% of its receipts. Container Corp of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). This does not mean that every state must provide an identical apportionment methodology, Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978), rather it means that the apportionment methodology must be internally and externally consistent. Container Corp. of America, supra. By internal consistency the Courts have meant that the apportionment method must be such that if all states use the identical taxing scheme, no more than 100% of the gross receipts from the same income producing activity would be taxed.
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> The Washington apportionment formula must account for all costs of doing business. If the Washington business conducts no activities outside the state, then there is no need to apportion. However, if the Washington business is directly and actively engaged in business both within and outside the state, then the issue becomes where should the costs are attributed.

As noted, it is clear from the facts the present taxpayer's activities in the other seventeen states create taxing nexus with them and is more than incidental. In short, the taxpayer is actively engaged in business in those states by entering their marketplaces to sell its services to customers in those states. Indeed, the taxpayer is registered and actually pays taxes in those states due to its business activities there. Without doubt, if the roles were reversed and the present taxpayer was an out-of-state business contracting with an in-state financial business to advertise and sell the taxpayer's services to Washington customers from Washington offices bearing the taxpayer's name, we would find taxing nexus with Washington exists. For example, we have found taxing nexus in Washington for taxpayers who had fewer and less substantial connections with this state than the present taxpayer has with the seventeen other states. See Det. No. 96-144, 16 WTD 201 (1996) where we held that an out-of-state business had substantial nexus with Washington based on its attendance at trade shows and by providing in-state training of vendors. See also Det. No. 88-368, 6 WTD 417 (1988), where visits to Washington customers by employees of an out-of-state taxpayer, who provided advice on the safe handling of a product, constituted substantial nexus.

Therefore, the taxpayer is entitled to apportion its gross income because it is engaged in more than incidental business activities both within and without Washington. However, we do not believe this necessarily means the taxpayer is entitled to simply deduct the commission payments from its gross income. Rather, RCW 82.04.460 provides for separate accounting, if it can be accurately done, or, in the alternative, the cost accounting method where the taxpayer must identify its in-state costs and compare those to all costs for the purpose of cost apportionment.

DECISION AND DISPOSITION:

The taxpayer's petition is granted.

Dated this 25th day of November, 1998.