Cite as Det. No. 99-220, 19 WTD 355 (2000)

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. 99-220
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RCW 82.04.080: B&O TAX -- MULTI-LEVEL MARKETING NETWORK -- COMMISSIONS ON SALES BY DOWN-STREAM DISTRIBUTORS -- GROSS INCOME. A representative of a multi-level marketing company who receives commissions on sales by down-stream distributors, is taxable on the commission income of distributors in the same chain under him, when he recruits, trains, and motivates distributors with the expectation that they in turn will recruit, train, and motivate additional levels of distributors downstream. The commissions on sales by down-stream distributors are gross income of the taxpayer's business.

[2] RULE 194; RCW 82.04.460: B&O TAX -- MULTI-LEVEL MARKETING NETWORK; COMMISSIONS ON OUT-OF-STATE SALES BY DOWN-STREAM DISTRIBUTORS -- APPORTIONMENT. A taxpayer who is engaged in business only in Washington, who derives commission income from out-of-state sales by down-stream distributors in a multi-level marketing network by virtue of his recruitment, training, and motivational activities performed entirely in Washington, may not apportion the commission income between Washington and other states where sales occur.

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:

Taxpayer protests Taxpayer Account Administration's assessment of Service and Other Activities Business and Occupation tax on his commission income earned as an independent representative of a multi-level marketing company.[1]

FACTS:

Prusia, A.L.J. and Danyo, Manager, Policy & Operations -- As part of its tax discovery program, Taxpayer Account Administration (TAA) of the Department of Revenue (Department) examines certain taxpayers' federal 1099 forms and matches them against the taxpayers' state excise tax returns. In 1996, TAA discovered $. . . in commission income earned by this taxpayer, which had not been included in the taxpayer's state excise tax returns.[2] On October 23, 1996, TAA issued tax assessment No. FY. . . against the taxpayer in the total amount of $. . ., consisting of $…B&O tax and $. . . interest. The taxpayer protests the assessment. It remains unpaid.

The taxpayer, a Washington resident, is an independent representative for a multi-level marketing company, . . . ["MC"]. The taxpayer engages in direct sales of [MC] products to end users, and receives a profit on the products he sells. He also recruits additional representatives to sell [MC] products (the taxpayer refers to these as "first downstream representatives"). Each first downstream representative receives a profit on each retail sale of the [MC] products, and the taxpayer receives a commission (which the taxpayer calls an "override commission") on the sales by the first downstream representatives. The first downstream representatives in turn have the right to recruit additional downstream representatives to sell [MC] products, and each additional downstream representative has the right to recruit additional representatives even further down the stream. The taxpayer refers to all of these additional recruits as "additional downstream representatives." Each prior downstream representative and the taxpayer, as the original recruiter, will receive an override commission on sales of [MC] products by the additional downstream representatives.[3]

The taxpayer is entitled to receive an override commission from an additional downstream representative even though he did not recruit that additional downstream representative, may never have met the individual, has no responsibility for training or supervising the additional downstream representative, and does not train or supervise the individual. He receives an override commission on the sales of all downstream representatives who are in a direct

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.
[2] The taxpayer had reported excise tax on his gross receipts from retail sales.
[3] [MC]'s multi-level structure was recently described by [a court in another state]. . . , as follows:

> [MC] is a [state] corporation, which casts itself as a network or multi-level marketing company. People are encouraged to buy distributorship positions in [MC], sell products, and recruit others in a down-line chain who in turn sell products and recruit more people. These independent distributors sell products that they themselves purchase directly from [MC] and keep any revenue they generate. They can also receive compensation in the form of bonuses and rebates based on the amount of product they buy and sell. Finally, distributors can enhance their income by recruiting others as distributors. The level of enhancement depends on the level they purchase in the company; the higher the position, the larger the investment and the higher percentage return on the work of persons in the down-line.

recruitment chain downstream from him. The taxpayer receives override commissions from more than 30,000 downstream representatives.

According to the taxpayer's petition, he directly supervises 15 to 20 of the downstream representatives, who principally are those he personally recruited. All are located in Washington. Less than 5% of his total override commissions come from downsteam representatives he supervises. The petition states the taxpayer performs no supervision of other downstream representatives, is not associated with recruiting them, and does not otherwise participate in the sales made by them. Some downstream representatives that the taxpayer does not directly supervise are located in Washington. Most are located out of state, and their sales occur entirely out of state. The taxpayer estimates more than 90% of his override commissions originate from sales outside the state. However, the taxpayer's activities occur only in Washington.

Taxpayer offers three arguments in opposition to TAA's assessment of Service and Other Activities B&O tax on his commission income. First, he contends that similar independent representatives of other multi-level marketers, such as …and…, are not being taxed on their commission income. Therefore, he argues, even his commissions on sales by representatives he supervises should not be taxed.

Second, he contends that the override commissions on non-supervised downstream representatives, both those in Washington and those located out of state, are dissociated from the activities leading to the sales, and therefore are not subject to B&O tax. The taxpayer cites Norton v. Illinois Department of Revenue, 340 U.S. 534 (1951), WAC 458-20-193B (Rule 193B), Det. No. 91-192, 11 WTD 383 (1992), Det. No. 87-69, 2 WTD 347 (1987), and Det. No. 88-144, 5 WTD 137 (1988), in support of his contention. The petition argues:

> In this case, [the taxpayer] has no connection of any kind with the sales made by the additional downstream representatives who are not supervised by him and who were not recruited by him. There is no association between the sales and supervisory activities of [the taxpayer] and the sales made by these unsupervised additional downstream representatives. The burden of proving this dissociation is on [the taxpayer]. Because this is an unusual situation, the cases and rulings do not provide guidance as to the nature of the proof, which should be provided by [the taxpayer]. This appeal should establish the nature of that proof and this portion of the appeal[4] should be remanded to the audit division with instructions for [the taxpayer] to provide the defined proof within a reasonable period of time. If he provides the proof in the form required, then this portion of the assessment should be abated.

[4] Here, the taxpayer refers only to override commissions on non-supervised downstream representatives located in Washington. His third contention, below, addresses Washington's power to tax override commissions on downstream representatives located out of state.

Third, the taxpayer contends that there is no nexus in Washington that would constitutionally allow Washington to tax the override commissions from sales made by downstream representatives out of state. The petition argues:

> As a matter of law, a Washington resident is not subject to [B&O] tax on income from sources outside the state of Washington when the Washington resident performed no services in the State of Washington which were a part of that sale. RCW 82.04.4286; WAC 458-20-193. It is important to understand that the products sold by the additional downstream representatives were not products owned or manufactured by [the taxpayer]. These products were never in the possession or control of [the taxpayer]. The additional downstream representative either had the product in his or her possession in the state where the sale took place or the representative took the order of the product from the customer or obtained the product directly from [MC]. The product sold was not manufactured in Washington, was not stored in Washington, was not transported into or out of Washington. The additional downstream representative was not a resident of Washington, was not present in Washington at any time when the sale occurred or the product delivered. Finally, [the taxpayer] had absolutely nothing to do with the sale or with the supervision or recruitment of the additional downstream representative who made the sale.

ISSUES:

1. Is the taxpayer's suspicion that the Department may not be taxing all multilevel marketers on their commission income grounds for overturning this assessment?

2. Is the taxpayer's commission income from the activities of downstream representatives whom he does not supervise income of his trade or business, or is the income so dissociated from the taxpayer's activities that they are not taxable?

3. Is there nexus in Washington that would allow Washington to tax the override commissions from sales that occur out of state?

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. "Business" is defined as including all activities "engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140. "[E]ngaging in business" means commencing, conducting, or continuing in business. RCW 82.04.150. 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 term "gross income of the business" is defined by RCW 82.04.080 as follows:

> "Gross income of the business" means 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.

The term "value proceeding or accruing" is defined in RCW 82.04.090 as follows:

> "Value proceeding or accruing" means the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued. . . .

Washington is able to tax gross receipts from those activities which occur wholly within its borders. Department of Rev. v. Association of Washington Stevedoring Co., 435 U.S. 734 (1978). The corollary is that Washington may not tax gross receipts from activities that occur outside its borders. Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1938). Taxpayers who engage in business both within and outside the state are entitled to apportion their income. Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977); Dravo Corp. v. Tacoma, 80 Wn.2d 500 (1972); Chicago Bridge & Iron Co. v. Department of Rev., 98 Wn.2d 814 (1983); American National Can v. Dept. of Revenue, 114 Wn.2d 236, 787 P.2d 545 (1990); Det. No. 87-186, 3 WTD 195 (1987); Det. No. 92-262E, 12 WTD 431 (1992).

RCW 82.04.460 addresses apportionment of service income of persons who maintain places of business both within and without this state. It 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.

WAC 458-20-194 (Rule 194) restates the requirements of RCW 82.04.460, and states the general rule for persons domiciled in this state who render services in another state but do not maintain a place of business in that state. It states, with regard to the latter:

> When the business involves a transaction taxable under the classification service and other business activities, . . . the tax applies upon the income received for services incidentally rendered 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. . . .

In Det. No. 87-186, 3 WTD 195 (1987), we held that whether or not the taxpayer meets the precise terms of RCW 82.04.460 and Rule 194, "the U.S. Constitution and thus RCW 82.04.4286 require apportionment of gross receipts derived from business activities which are substantially performed both within and without the state."

We will now address the taxpayer's three contentions.

1) Selective Enforcement

The taxpayer argues it is improper for the Department to find the taxpayer subject to service B&O tax, because taxpayer has been told by independent representatives of similar multi-level marketing companies that they are not required to report and pay B&O tax on this type of override commission income.

First and foremost, resolution of this would require that we discuss the taxability of other taxpayers' activities by the Department of Revenue. Our state's legislature has chosen to protect the privacy of every taxpayer in this state by enacting RCW 82.32.330, with its strong language. That statute provides:

> Returns and tax information shall be confidential and privileged, and except as authorized by this section, neither the department of revenue nor any officer, employee, or representative thereof nor any other person may disclose any return or tax information.

Additionally, a correct assessment would not be overturned on grounds of selective enforcement. The business and occupation tax is self-assessing in nature. The responsibility for registering with the Department and properly reporting taxes rests on persons in business, not on the state. In Frame Factory v. Dept. of Ecology, 21 Wn.App. 50, 583 P.2d 660 (1978), the Washington Court of Appeals rejected a claim that the defendant had engaged in "selective enforcement" against the plaintiff. The court noted that

> The Frame Factory does not allege that it was selected for "prosecution" on the basis of some prohibited grounds such as race, religion or other arbitrary classification. But it asserts there is no justifiable reason why it was selected for enforcement.

The court upheld the enforcement of the regulation against the Frame Factory. Here the taxpayer does not allege he was selected for assessment for any prohibited reason, and we do not believe this was the case.

Numerous Department determinations have held that the fact another taxpayer may not be properly reporting its taxes is not sufficient grounds for overturning a valid assessment. See e.g. Det. No. 93-16, 13 WTD 170 (1993); Det. No. 92-4, 11 WTD 551 (1992).

2) Association between the activities of the taxpayer and the commission income from sales by downstream representatives whom the taxpayer does not supervise.

The dissociation principle the taxpayer cites does not fit his factual situation. It relates to the ability of an out-of-state taxpayer that has nexus with Washington because of certain activities in the state, to show that specific sales into Washington are unrelated to the nexus-creating activities. See Rule 193 and the example therein, and the cases cited by the taxpayer. The taxpayer's dissociation argument really relates to the definition of "gross income of the business." His argument is that he is not liable for B&O tax on revenues that do not proceed or accrue by reason of the transaction of the business he is engaged in.

[1] We disagree with the taxpayer's contention that if he does not supervise a downstream representative, the activities of that representative necessarily are not associated with the taxpayer's own business activities. The taxpayer does not merely recruit the first downstream representatives. He supervises and trains them. Because they, in turn, supervise and train the downstream representatives they recruit, the taxpayer's activities are associated with the activities of all representatives in the same chain. The taxpayer recruits and motivates sales representatives with the expectation that they in turn will recruit and train others, and with the knowledge that his income is dependent upon their success in recruiting and motivating others. Income he derives by virtue of his activities that are intended to increase the productivity of the distributors at all levels is gross income of his business.

The U. S. Tax Court addressed a similar argument in two decisions in which taxpayers in multilevel marketing networks claimed such commission income did not constitute net earnings from self-employment.[5] The court held in both instances that the payments from the activities of down-line representatives with whom the taxpayer had little, if any, personal contact, were gross receipts from the taxpayer's trade or business, and therefore subject to federal self-employment tax.[6] In Abraham v. Commissioner, footnote 4, the court reasoned:

> Realizing that his income was dependent on the sales activities of his distributors, petitioner devoted substantial time and energy to training and developing these individuals. He provided them with motivation and encouragement, he imparted on them his skills, knowledge and experience with the products, and he counseled them on selecting successful recruits. Petitioner developed promotional pamphlets, conducted lectures at his home for his distributors and encouraged his distributors to bring their recruits to these lectures. All of these activities were conducted in an attempt to increase the productivity of the distributors at all levels. It makes no difference that petitioner had little, if any personal contact with the distributors at the second, third, and fourth levels. He devoted his time with the expectation that well-trained first level distributors would

[5] Abraham v. Commissioner, Docket No. 18759-87, U.S. Tax Court, T.C. Memo 1988-412, 1988 Tax Ct. Memo LEXIS 444 (1988); Jones v. Commissioner, Docket No. 116-97, U.S. Tax Court, T.C. Memo 1998-354, 1998 Tax Ct. Memo LEXIS 358 (1998).

[6] Section 1401 of the Internal Revenue Code imposes a tax on the gross income derived by an individual from any trade or business less any allowable deductions attributable to the trade or business.

> develop successful second level distributors, who in turn were likely to recruit productive third level distributors. Successful distributors at the various levels meant petitioner could expect income from their sales.

The court's reasoning and conclusion are equally applicable here. We find the payments the taxpayer received from [MC] for sales made by the down-stream distributors are gross income of the taxpayer's business. Such commission income is subject to the B&O tax.

3) Nexus and apportionment issues

[2] We find that the taxpayer is not engaged in business anywhere other than Washington. He has no place of business outside Washington. While most of his income is derived from sales that occur in other states, his services that entitle him to a commission on those sales are performed entirely in Washington. Accordingly, apportionment of his income is not required.

DECISION AND DISPOSITION:

The taxpayer's petition is denied.

Dated this 30th day of June 1999.