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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. 08-0128
. . .	)	
	)	Registration No. . . .
	)	Document No. . . .
	)	Docket No. . . .
	)	

RULE 193: B & O AND RETAIL SALES TAX -- SUBSTANTIAL NEXUS -- AFFILIATED CORPORATION AS TAXPAYER'S REPRESENTATIVE. Before the activities of an affiliated entity with taxing nexus in Washington can establish nexus for an out-of-state affiliate, the affiliate with nexus must directly represent and support sales of the out-of-state affiliate.

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.

Kreger, A.L.J. – A foreign corporation engaged in the business of selling consumer goods over the internet and telephone that it markets through direct response advertising (television infomercials) protests the assessment of business and occupation (B&O) tax, interest, and penalties asserting that does not have substantial nexus with Washington. We conclude that the activities of an affiliated corporation with taxing nexus in Washington are not significantly associated with maintaining a market for the Taxpayer's products in Washington. Absent some additional direct promotional or marketing relationship, there is insufficient evidence to establish nexus for the Taxpayer. Accordingly we grant the Taxpayer' petition and reverse the assessment.

ISSUE

Under WAC 458-20-193, is substantial nexus in Washington established for an out-of-state company, which promotes sales on-line and over the phone through the use of television infomercials, when an affiliate with nexus in Washington makes wholesale sales of the same goods in Washington?

FINDINGS OF FACT

[Taxpayer] is [an out-of-state] corporation engaged in the business of selling consumer goods over the telephone and internet. The Taxpayer markets and solicits the sales of these products through the production and broadcast of television infomercials. The Taxpayer is a subsidiary corporation of [a second out-of-state] corporation.

The Department of Revenue's (Department) Tax Discovery Section of the Compliance Division initiated an investigation of the Taxpayer's parent company after observing products promoted by the Taxpayer's infomercials for sale at Washington retail stores. In December of 2006 an inquiry letter was sent to the Taxpayer's parent company's, [out-of-state] business location. The parent company completed and returned a business questionnaire. As a result of this contact the Taxpayer and [a third related distribution corporation located outside of Washington (the distribution corporation)], engaged in making wholesale sales in the United States, were involuntarily registered. Assessments were issued to both entities. [The distribution corporation] sends independent sales representatives into Washington to promote the sale of products and has conceded taxing nexus. The Taxpayer conversely, contested the assessment in its entirety asserting that it lacked sufficient nexus with Washington to support imposition of taxes. The Taxpayer timely appealed the contested assessment.

<u>Business Activities & Corporate Relationships:</u>

[The second out-of-state, affiliated corporation] focuses on the development and selection of products while its subsidiaries are responsible for the sale and promotion of the selected products. There are five international subsidiaries that manage product distribution [both outside of and within the United States]. In addition to these subsidiary entities, [the second out-of-state, affiliated corporation] also has relationships with third party independent distributors who distribute products around the world to additional markets not covered by its subsidiary entities. [The second out-of-state, affiliated corporation] performs management, legal, and accounting services for its subsidiaries in addition to serving as the central point of selection for products and securing marketing rights for selected products. [The second out-of-state, affiliated corporation] also commonly arranges for the manufacture of the products, frequently using a manufacturing broker [located outside the U.S.]. [The second out-of-state, affiliated corporation] maintains offices in [two states in addition to its primary location] and does not have an office or other direct business presence in Washington.

Once [the second out-of-state, affiliated corporation] has selected, licensed, and arranged for the manufacturing of a product, [it] assigns product rights to its subsidiaries for sale in their respective markets. The subsidiaries then purchase the products directly from the manufacturer and arrange delivery to their customers. Pertinent to this appeal are the activities of two of [the second out-of-state, affiliated corporation's] US subsidiaries, the Taxpayer and [the distribution corporation].

The Taxpayer arranges for the production and broadcast of television infomercials to market and sells its products. The Taxpayer was spun off from [the second out-of-state, affiliated corporation] as a separate corporation . . . at the same time [the distribution corporation] was formed. The business reorganization was initiated in response to inquires from retail outlets about wholesale sales. . . . [The Taxpayer, the second out-of-state, affiliated corporation, and the distribution corporation] have separate employees and separate presidents. Neither is there any commingling of funds or product. Each affiliate establishes and maintains its own accounts and each affiliate is responsible for the development and implementation of its own business and accounting procedures.

The Taxpayer markets between . . . and . . . products at any one time, with the majority of its sales at any one time generally being produced by [a few] particularly successful products. [The distribution corporation] in contrast, works with a far more limited range of products . . . that it wholesales to established retail outlets. . . . Generally, [the distribution corporation] will distribute the products that have had been the biggest sellers for the Taxpayer. While there is communication and discussion between the Taxpayer and [the distribution corporation] the Taxpayer does not direct or control which products are sold by [the distribution corporation] or when and to whom those products are distributed. Each subsidiary has authority and control over their product selection and promotion decisions. As a practical matter [the distribution corporation 's] wholesale sales to retailers follow the Taxpayer's initiating sales and developing brand name recognition though its infomercials. Ideally [the distribution corporation] will commence its sales activity as the Taxpayer's infomercial sales are starting to wane, however the availability of the same product at local retail outlets does take some market share away from the Taxpayer. [The distribution corporation] employs independent sales representatives to visit and promote sales to retailers, but otherwise does not market or advertise it products. Rather the brand name recognition generated by the Taxpayer's infomercials also creates a market for the retail sales of the products [that the distribution corporation] selects to distribute at wholesale.

While the Taxpayer and [the distribution corporation] are wholly owned affiliates they do have distinct and independent officers and staff. The Taxpayer is the larger entity in both business volume and full-time employees. The Taxpayer [has employees for marketing and media analysis] in conjunction with the standard corporate officers and accounting and logistics staff. [The distribution corporation] in contrast does not maintain such marketing and media positions. A full-time employee listing for the parent and affiliates shows [approximately twice the number of employees for] Taxpayer [than for either the parent or distribution company]. [Other sales statistics reflect] both the larger variety of products sold by Taxpayer and the greater market reach of the infomercial distribution.

The Taxpayer and [the distribution corporation] purchase their products independently and arrange for their delivery to a third party fulfillment company . . . which manages the actual delivery of the product to customers. The Taxpayer's products are packaged in plain packaging. . . . In contrast, the retail packaging for the wholesale products distributed by [the distribution corporation] is more decorative [and] is generally a glossy color box with a picture of the product, promotional text lauding the products features, [and printing that indicates it is advertised on TV].

The Taxpayer arranges for the production of the infomercial for a product, outsourcing actual production to a third party video production company, and then broadcasts that infomercial through national and some local television broadcasts. The majority of the Taxpayer's sales for any specific product . . . are telephone sales initiated while the infomercial is being broadcast or shortly thereafter.

The Taxpayer hires an independent call center located outside of Washington to take order information . . . and then transmits the order and payment information to . . . the third party fulfillment center. [The fulfillment center then] processes [and] outsources the payment processing . . . . The business relationship with [the fulfillment center] predates the Taxpayer's formation as a separate subsidiary, but the Taxpayer has renewed the prior [second out-of-state, affiliated corporation's] contracts since its formation. [The fulfillment center] also manages warranty and replacement parts orders for both the Taxpayer and for [the distribution company], but each entity is separately charged and billed for any warranty or replacement parts that are shipped to its respective customers.

The Taxpayer's internet sales are made through a web site that is run by an affiliate [of the second out-of-state, affiliated corporation]. The Taxpayer pays a service fee for web site maintenance and design services. The web site is hosted and maintained outside of Washington. Like the telephone sales, internet sales are also transmitted to [the fulfillment center] for processing . . . . While the internet address broadcast on the infomercials is generally that of the product band name . . ., that address serves as a portal redirecting potential customers to [the second out-of-state, affiliated corporation's] web site. . . .

The Taxpayer's products are shipped with collateral material, such as product brochures and instructions, and may on occasion also include ancillary promotional materials for other products. Occasionally, the Taxpayer will also mail marketing and promotional materials on new products to customers who have previously purchased products from them.

In contrast, the retail packaging materials included in the [products distributed by the distribution corporation] do not include ancillary marketing materials for other products. The retail packaging lists [the second out-of-state, affiliated corporation] as the product distributor and lists an address for the company and the [the second out-of-state, corporation's] web site. . . . [The second out-of-state, affiliated corporation] does not collect product registrations or maintain customers list for future marketing the way the Taxpayer does.

ANALYSIS

The B&O tax is imposed on every person for the act or privilege of engaging in business activities in Washington. RCW 82.04.220. RCW 82.04.030 defines "person" to include corporations, limited liability companies, associations, and any group individuals acting as a unit, whether nonprofit, or otherwise. "Engaging in business" in Washington means "commencing, conducting, or continuing in business." RCW 82.04.150. "Business" is defined as including all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or another person. RCW 82.04.140.

The tax is measured by applying particular rates against the value of products, gross proceeds of sale, or gross income of the business as the case may be. RCW 82.04.220. The tax on retailers is measured by applying the rate of 0.471 percent times their gross proceeds of sales. RCW 82.04.250.

Nexus requirements flow from limits on a state's jurisdiction to tax found in the Due Process and Commerce Clause provisions of the United States Constitution. Generally, a state cannot tax transactions and activities that do not have sufficient connection or "nexus" to the taxing state, and cannot impose taxes that would create undue impediments to the operation of the national economy. These limitations have been recognized and articulated in numerous court decisions. *See, e.g., Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 51 L.Ed.2d 326 (1977)(Nexus is a prerequisite before a state may impose a tax on a nonresident); *Tyler Pipe Industries, Inc. v. Washington Dep't. of Revenue*, 483 U.S. 232, 250, 107 S.Ct. 2810, 97 L.Ed.2d 199 (1987)(Generally, any state in which a taxpayer directly and actively engages in business and from such activity derives part of its gross receipts, has nexus to tax the revenue from the activity.) Washington may not assert B&O tax on revenue from sales of goods which originate outside this state unless the purchaser receives the goods in this state and the seller has nexus. WAC 458-20-193(7)(Rule 193).

In Washington, any activity performed by an employee, agent, or other representative on behalf of a seller that is significantly associated with establishing or maintaining a market within this state, is sufficient to establish nexus. WAC 458-20-193(7); *Standard Pressed Steel Co. v. Department of Rev*., 419 U.S. 560, 95 S.Ct. 706 (1975); *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551, 97 S.Ct. 1386 (1977); *Det. No. 04-0148*, 6 WTD 417 (1988).[1] For example, the Department has held infrequent visits to Washington customers by nonresident employees constituted sufficient nexus to allow the taxation of sales, even though the employees were not salespersons. *Det. No. 88-368*, 6 WTD 417 (1988). Where employees provided advice to customers regarding the safe handling of a product, such activity was also found to be important in maintaining sales into the state. *Det. No. 91-213*, 11 WTD 239 (1991). S*ee also Standard Pressed Steel*, *supra*, where nexus was established through the presence of a resident employee engineer who was not involved in sales, but only consulted with the customer regarding the customer's product needs. In *Det. No. 88-249*, 6 WTD 109 (1988), a single contact or transaction was enough to establish nexus.

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[1] As the US Supreme Court emphasized in *National Geographic:*

> [T]the relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate "some definite link, some minimum connection, between the State and the person . . . it seeks to tax. "

430 U.S. at 561. (Internal quotations omitted.)

WAC 458-20-193 (Rule 193) sets out administrative guidance regarding B&O tax application to interstate sales. The rule defines “nexus” as “the activity carried on by the seller in Washington which is significantly associated with the seller's ability to establish or maintain a market for its products in Washington.” Regarding the nexus requirement, the rule describes specific activities, alone or in conjunction, that are sufficient to support a nexus finding and, consequently, a determination that the taxpayer has established or maintained a market for its products in the state. One such activity is found in paragraph 7(c)(v), which reads:

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

Services or activities by an agent or representative that establish or maintain a market for the taxpayer’s goods can establish nexus for an out-of-state company. Therefore, the activities of an affiliated company with nexus that support the market for an out-of-state affiliate can establish taxing nexus for the out-of-state affiliate. In *Borders Online, LLC v. State Board of Equalization*, 129 Cal.App.4th 1179, 29 Cal. Rptr. 3d 176 (2005), (*Borders Online*) the California Court of Appeals held that the activities of related brick and mortar stores, which operated through a separate but affiliated entity, established nexus for Borders Online which did not have direct activities in California. The California court concluded the advertising and solicitation activities by it’s the affiliated company, the separately owned brick and mortar stores, which accepted returns and exchanges of merchandise purchased on-line and promoted the web site acted as the online entities representative and established nexus. *Id at* 190. The Court stated:

> The cross-selling synergy was also maintained by the use of similar logos, by the link to Borders' website from Online's website, and by the sharing of some market and financial data between the two entities. Online generated more than $1.5 million in sales in California in 18 months. These facts amply support the conclusion that Online had a representative with a physical presence in the State and the representative's activities were “ ‘significantly associated with [Online's] ability to establish and maintain a market in [the] state for the sales.’”

Id at 190-191 (internal citations omitted.)

Similar to *Borders Online*, the activities that are asserted to establish nexus for the Taxpayer, are not the Taxpayer’s direct conduct in Washington but rather the actions of an affiliated corporation with conceded nexus. Tax Discovery emphasizes that [the distribution corporation], which has taxing nexus with Washington, sells and markets the same brand name products as the Taxpayer, and that both [the distribution corporation’s] and the Taxpayer’s products display the [the second out-of-state, affiliated corporation’s] web address. Tax Discovery also raises the collective and coordinated efforts of the parent company and its affiliates to promote and sell the same products and specifically asserts that the activities of the affiliate with nexus serve to establish and maintain a market for the Taxpayer’s goods. The Taxpayer conversely contends that the activities of its affiliate [distribution corporation], are not significantly associated with maintaining a market for its products in Washington, indeed that the reverse is actually true. The Taxpayer also distinguishes the specific reliance on disassociation principles and concepts presented in support of taxation as inapplicable, emphasizing that the question of disassociating sales arises after taxing nexus has been established and that in this case that essential hurdle has not been cleared.

In determining of whether in-state activities create nexus looks to the entire collection of a taxpayer's different activities, the totality of which creates substantial nexus. *GMC v. City of Seattle*, 107 Wn. App. 42, 25 P.3d 1022 (2001)[2]; *See also General Motors Corp. v Washington,* 377 U.S. 436 (1964)(*General Motors*)(Holding that it is the bundle of corporate activity that determines whether a taxpayer has nexus with a state.)(*rev'd on other grounds, Tyler Pipe Industries, Inc. v. Department of Rev*., 483 U.S. 232, 250(1987)); WAC 458-20-193. Thus, establishing taxing nexus requires consideration of the entire bundle of a taxpayer's in-state activities.

Rule 193 provides that if a seller carries on significant activity sufficient to create nexus with this state, then the seller has the distinct burden of establishing that its in-state activities are not significantly associated in any way with the sales made into this state. Nexus for one sale is nexus for all sales unless some sales are specifically divorced from the activity which created the nexus. *Det. No. 94-209*, 15 WTD 96 (1994)(*citing Det. No. 87-69*, 2 WTD 347 (1987). The Taxpayer asserts that what is lacking here is the pivotal first step of establishing nexus for one sale. Taxpayer contends that the analysis and factors emphasized by Tax Discovery in support of the assessment focus and draw on disassociation analysis and principles, which are only applicable once nexus has been established. So specific factors that may be sufficient to preclude the disassociation of sales, where substantial nexus has been established, may be insufficient to independently establish taxing nexus.

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[2] In *GMC,* the Washington Court of Appeals recognized that it is the collective activities of a taxpayer within the state that may be used to support a finding of substantial nexus for B&O tax purposes. The court in *GMC* stated:

> In this case, both GM and Chrysler direct national advertising to the City of Seattle. They send sales, service, and parts managers to their dealers in Seattle on a monthly basis to discuss market conditions, new products, retail customer satisfaction levels, and the like. These representatives speak with dissatisfied customers and discuss problems that may be occurring with certain makes of automobiles. The representatives also train the dealers in sales and management techniques. Finally, the Seattle dealers actively market the automakers' warranties that accompany the sale of an automobile and make service repairs at the dealerships in Seattle on behalf of the automakers. These warranties serve an important marketing function because customers are unlikely to purchase a new vehicle without a warranty.
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> . . .
>
> We are satisfied that in this case**, the collective activities** of each automaker are strategically designed to maximize their sales within the City and that the absence of these activities would significantly affect their ability to maintain a share of the Seattle market. Without these activities, their name recognition, goodwill, ability to obtain market data, customer feedback, and trends unique to Seattle, and their ability to compete with other automakers would be adversely impacted. We hold that substantial nexus exists to justify the City's imposition of its business and occupation tax upon the automakers. (Bolding added.)

GMC v. City of Seattle, 107 Wn. App. at *13 -17*

We note that affiliation or common ownership of corporations is independently insufficient to link the activities and tax liabilities of one entity to the other. "The tax liability of a corporation must be considered without regard to its relationship to a parent or subsidiary company or to the existence of common officers, employees, facilities, or stock ownership." *Det. No. 96- 046*, 16 WTD 074 (1996) (citing Rule 203 and quoting *American Sign & Indicator v. State*, 93 Wn.2d 427, 429, 610 P.2d 353 (1980) and *Rena-Ware Distribs., Inc. v. State*, 77 Wn.2d 514, 463 P.2d 622 (1970).)

Thus, before the activities of an affiliated entity with taxing nexus can establish nexus, the in-state affiliate must directly represent and support sales of the out-of-state affiliate. Rule 193; *Borders Online* supra. In *Det. No. 87-342*, 4 WTD 229 (1987), an out-of-state wholesaler of diet products was found to have taxing nexus based on the in-state activities of franchise affiliates, which had conceded taxing nexus. In that case the entities and products shared a common brand name and the activities of the in-state entities were instrumental in marketing and promoting the sales of the out-of-state entity. The out-of state entity was also involved in establishing, supporting, and advising the in-state franchisees. The out-of-state entity did no marketing or advertising of its own but rather relied on the activities of the affiliated franchisees to create and maintain a market for its products. In this case, the situation is the opposite of that in *Det. No. 87-342*, as it is the out-of-state affiliate, the Taxpayer, promoting and marketing products and their marketing efforts that arguably establish and support the sales of the affiliate with nexus to retail outlets. The business activities of the Taxpayer and [the distribution corporation] are also significantly more distinct than those of the out-of-state affiliate and in-state franchisees at issue in *Det. No. 87-342*. [The distribution corporation] directs its own sales decisions and determines which retail outlets its representatives will visit. The Taxpayer does not advise or direct the business activities of [the distribution corporation].

The products sold by [the distribution corporation] do share the same brand name as the Taxpayer's products. The retail packaging also carries the parent company's name and web address, which is the same web address that the Taxpayer's customers are directed to for online sales, [and have printing indicating that it has been advertised on TV]. However, this brand name similarity and the connections between the in-state sales entity and out-of-state affiliate are also significantly different from type of brand name connection and promotion involved in cases like *General Motors* or *Borders Online,* discussed above. In *General Motors* the brand name of the vehicles and manufactures broad advertising and promotion activities were significant, however those activities occurred in conjunction with visits from the manufacturer's representatives to the Seattle dealerships. *Borders Online* involved commonly branded local retail outlets that were directly promoting and supporting sales of an internet affiliate. The brand name identity and marketing overlap at issue here is not of comparable quality or degree.

In this case, the local retail outlets are independent, third party, stores. It is conceivable that the presence of a particular brand name product [on the shelf of a retail store that has indication that it has been advertised on TV], may contribute to a customer subsequently watching an infomercial and making a purchase. It is also possible that a customer of the retail store could pick up the package, note [the second out-of-state, affiliated corporation's] web address and later decide to visit that address and make a purchase. Similarly, seeing the retail package may prompt a customer to later run an internet search for the product name or company name. However, this is at best an indirect form of marketing and promotion. Conversely, it is equally credible that ability to purchase these products at retail actually decreases the Taxpayer's sales. The retail product is generally priced at or slightly below the infomercial price, is immediately available, and the customer does not incur shipping or handling charges or delay in receiving the product. In light of the Taxpayer's considerable direct promotion of its sales and the actual detrimental impact of retail availability of these products, we conclude that the activity of [the distribution corporation's] sales representative in Washington to facilitate wholesale sales are not sufficient to characterize this activity as being "significantly associated with establishing or maintaining a market" for the Taxpayer's products in Washington. The presence and activities of the [distribution corporation's] sales representatives in Washington do not support the Taxpayer's sales in a manner comparable to representation afforded by a commonly branded local retail outlet.

The representative sales documentation for [the distribution corporation] and Taxpayer illustrates that while the same products are being sold the nature of the individual sales transactions are different. The [distribution corporation's] sales documents establish routine wholesale sales to a retailer. The detail provided tracks transaction type, shipping terms, and payment detail. In contrast the Taxpayer's sales records are both more general and more specific. The initial transaction records are more general and show lumped payment transactions detailing credit card deposits and declined transactions. However, the specific order detail then shows more information about the customer and the specific order including payment plan options and additional items added to that order. The [distribution corporation's] records do not contain this level of variation or detail for each individual sale. The [distribution corporation's] records contain more detail on shipping terms and processes where the Taxpayer's records contain more detail on the mode of payment, and the individual customer's specific order.

The Taxpayer also correctly emphasizes that consideration of brand name recognition and marketing overlap in the context of whether specific sales can be disassociated is a different inquiry than whether those contacts create nexus. In *Det. No. 04-0148*, 24 WTD 317 (2004), different divisions of a company negotiated sales through distinct sales representatives. We noted that national advertising and brand name marketing were part of the collective in-state activities that maintain a market for the taxpayer's products at product. So it was insufficient to merely segregating the activities of specific sales representatives by establishing that a particular sale was negotiated out-of-state. In that case, taxing nexus of the entity was conceded and the focus of the inquiry was on the sales and promotion activities of different divisions. In contrast here, taxing nexus is contested and we are addressing the activities of distinct corporate entities. Similarly, in *Det. No. 94-209*, 15 WTD 96 (1996), we concluded that the activities of independent sales representatives in Washington established nexus, and therefore the burden shifted to the taxpayer to disassociate the telephone sales at issue. We held that the taxpayer had not met this burden for its brand name products because it could not establish an independent source for customer relationships separate and apart from its in-state activities.

An inquiry into disassociation of specific sales in the context where nexus is established is different from an inquiry of whether nexus has been established. Furthermore, Taxpayers bear the burden of disassociating sales. Accordingly, activity supporting and marketing a brand name product that is sufficient to prevent disassociation is not independently sufficient to establish taxing nexus. In this case neither the parent company, . . . nor the Taxpayer engaged in any direct activities in Washington.

We conclude that despite the brand name overlap, the activities of the affiliate with conceded taxing nexus, [the distribution corporation], are not significantly associated with establishing or maintaining a market for the Taxpayer's products in a representative capacity. The activities of [the distribution corporation] are insufficient to create nexus for the Taxpayer.

DECISION AND DISPOSITION

The Taxpayer's petition is granted.

Dated this 14th day of May 2008