

Cite as Det. No. 12-0334, 36 WTD 148 (2017)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 12-0334
)	
...)	Registration No. . . .
)	

[1] RCW 82.04.040; WAC 458-20-106: BUSINESS AND OCCUPATION TAX – CASUAL OR ISOLATED SALES. A manufacturer did not make casual or isolated sales of patents that it granted a license to use or assigned to third parties.

[2] RCW 82.04.080(1); WAC 458-20-111: BUSINESS AND OCCUPATION TAX – EXCLUSION FOR ADVANCES AND REIMBURSEMENTS. A taxpayer is subject to B&O tax on income it earns for allowing its affiliates to use the taxpayer’s employees. Such amounts are not excluded from gross income under Rule 111 because the taxpayer did not act as agent for its affiliates.

[3] RCW 82.08.02565; WAC 458-20-13601: RETAIL SALES TAX - MANUFACTURING AND EQUIPMENT EXEMPTION – MANUFACTURING OPERATION. A taxpayer that makes improvements to its facility in anticipation of blending fuel, but who does not actually engage in the blending of fuel, it not eligible for the M&E exemption on the improvements because it did not engage in a manufacturing operation.

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.

Pree, A.L.J. – A Washington manufacturer disputes business and occupation (B&O) tax assessed on receipts from patent licenses, payroll receipts for employees who worked for affiliates, and use/deferred sales tax assessed on building improvements for a building that was used to transfer fuel to rail cars and later used to blend fuel. Because receipts from the patents were not casual or isolated, they were subject to B&O tax. Through its employees, the manufacturer provided services to the affiliates and was subject to tax on the affiliates’ payment for those services. The building improvements do not qualify for the manufacturing and equipment (M&E) exemption. Petition denied, but remanded to reclassify licensing income.¹

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

ISSUES

1. Were the manufacturer's receipts from the patents exempt from B&O tax as casual or isolated sales under RCW 82.04.040(2); and if not exempt, under which classification were they taxable?
2. Under WAC 458-20-111 (Rule 111), were payroll receipts from affiliates for the manufacturer's employees excludable from the manufacturer's measure of B&O tax?
3. Under WAC 458-20-13601 (Rule 13601) and RCW 82.08.02565, were the manufacturer's improvements to the building exempt from retail sales tax if the building did not initially qualify for the M&E exemption?

FINDINGS OF FACT

[Taxpayer] manufactures fire retardant products in Washington. It also transfers diesel fuel to rail cars. The taxpayer has several affiliates for which the taxpayer's employees provide services. The taxpayer had two patents on its products, which it transferred or assigned to others for consideration. The taxpayer did not pay B&O tax on its receipts from the patents or on the services performed by its employees.

The Department of Revenue (Department) reviewed the taxpayer's records for the period from January 1, 2006, through December 31, 2009. On November 16, 2011, the Department's Audit Division assessed \$. . . in B&O tax under the service and other activities classification on the taxpayer's receipts for the patents and on the taxpayer's payroll receipts from its affiliates. In addition, the Audit Division assessed \$. . . use tax and/or deferred sales tax on improvements to its diesel terminal. The taxpayer appealed. The taxpayer has three issues with the assessment, which we will identify as: (1) Patent Receipts, (2) Payroll, and (3) Terminal Improvements.

Patent Receipts: The taxpayer contends that its patent receipts were from casual and isolated sales and, therefore, not subject to B&O tax. The taxpayer notes that while it has been in the manufacturing business over thirty years, it had only the two patents. According to the taxpayer, it decided to sell the patents after it changed its manufacturing process. As such, the taxpayer argues the patent sales were incidental to its manufacturing activity and, therefore, casual and isolated sales, not subject to B&O tax.

The Audit Division contends that the taxpayer's patent development was a regular, recurrent, and continuing activity. The taxpayer maintained a research and development department during the audit period. It applied for its first patent in 1980 and received the patent in 1982. It applied for its second patent in 1995 and received the patent in 2002. The Audit Division concluded that the taxpayer's development, use, and subsequent sales of patents were the result of a regular and continuing business.

A review of the records indicates that the transactions involving the patents were not simple sales. The first transaction involved [Patent 1], a [patent for a] fire retardant chemical used to treat wood roofing. The taxpayer granted [Company X], an exclusive license to use [the product covered by

Patent 1] for five years. [Company X] could not transfer or sublicense use of [the covered product] without the taxpayer's consent. The agreement was silent regarding the right to sue or be sued The taxpayer retained the right to use [or sell the product covered by the patent]. The taxpayer agreed to sell [the product covered by Patent 1 to Company X] during the term of the license agreement. In addition to an "Up Front License Fee," [Company X] agreed to pay the taxpayer a royalty of \$. . . per square of wood roofing . . . treated with [the patented product]. In litigation with [Company X], the taxpayer acknowledged that the contract was structured as a license, instead of an outright purchase. . . . The taxpayer also entered license agreements with [Company X] for subsequent periods. *Id.*

During the audit period, on September 1, 2007, the taxpayer assigned to an affiliate, "all of its rights title and interest in and to the [p]atent throughout the world . . ." for [Patent 2], a pressure impregnation method, which the taxpayer explained was used to harden wood. On November 30, 2008, the affiliate assigned all of its patents back to the taxpayer. The 2008 assignment agreement did not exclude [Patent 2], nor was it limited to [Patent 2]. Therefore, the taxpayer not only assigned patents to others for consideration, it reacquired the patents, and possibly acquired other patents for its use, or possibly subsequent assignment, resale, or other transfer by the taxpayer.

Payroll: Regarding the receipts from its affiliates for employees, the taxpayer contends that those were excludable reimbursements for its payroll advances. The taxpayer argues the affiliates employed the employees. Yet, the taxpayer was the employer of record. The taxpayer also registered the employees in its name with the Washington Department of Employment Security.

The taxpayer provided various services for its affiliates including accounting, banking, research and development, and management. . . . The Audit Division assessed B&O tax on receivable accounts for the affiliates' payroll.

Terminal Improvements: In 2009, the taxpayer remodeled a building on its manufacturing site into a terminal to load diesel fuel from trucks into rail cars. While the taxpayer did not own the fuel, it received a fee for transferring the fuel, upon which the taxpayer paid B&O tax. Eighteen months after the terminal became operational, the taxpayer began mixing chemicals into the fuel in the facility. The taxpayer contends that its payment for improvements to the facility should be exempt from sales and/or use tax as manufacturing [M&E].

The Audit Division toured the diesel terminal on April 19, 2010. At that time, the taxpayer explained that the terminal was used only to transfer the diesel fuel from trucks to the trains. After the Audit Division provided the taxpayer a preliminary audit schedule assessing deferred sales and/or use tax, the taxpayer said the building was exempt as M&E because it was used to blend additives into the fuel. A second tour on December 14, 2010, revealed that the taxpayer had changed the facility since the first tour so it could mix chemicals into the fuel. The taxpayer did not have the ability to mix chemicals into the fuel until eighteen months after the building was converted into a fueling terminal (after the audit period).

ANALYSIS

Patents: Our first issue involves B&O tax assessed on the taxpayer's receipts from patents. The B&O tax is imposed on the privilege of engaging in business activities and is measured by an application of the tax rate against the gross proceeds of the business. RCW 82.04.220 and RCW 82.04.080. The statutory scheme contemplates taxing a wide range of revenues. In general, all revenues are subject to B&O tax, unless a statutory deduction or exemption applies. The B&O tax does not apply to casual or isolated sales defined in RCW 82.04.040(2) as "a sale made by a person who is not engaged in the business of selling the type of property involved."

WAC 458-20-106 (Rule 106) [interprets] the statutory exemption, and states in pertinent part:

A casual or isolated sale is defined . . . as a sale made by a person who is not engaged in the business of selling the type of property involved. Any sales, which are routine and continuous, must be considered to be an integral part of the business operations and are not casual or isolated sales.

The one-time sale of a single item [may be] casual or isolated; however, licensing the right to use that same item is generally not considered casual or isolated. A license is continuous by its terms. Excise Tax Advisory (ETA) 3142.2009 recognizes B&O tax does not apply to casual and isolated sales of patents:

When the owner of a copyright, patent, license, franchise, trademark, tradename, or similar intangible (not including mineral rights) makes an outright sale of the copyright, patent, license, franchise, trademark, tradename, or similar intangible, the income is subject to the business and occupation (B&O) tax under the service and other activities classification. However, if the sale is a casual or isolated sale, then no B&O tax will apply. See WAC 458-20-106.

When the owner of a patent, copyright, or other intangible (not including mineral rights) grants a license to use the copyright, patent, license, franchise, trademark, tradename, or similar intangible, the income is subject to the B&O tax under the royalties classification. See RCW 82.04.2907.

To determine whether the transaction was a sale or mere license to use, the Department must determine if the purported licensee has a right of assignment (sale) or if the licensor retains residual patent ownership rights along with the right to assign them (license). ETA 3142.2009. We have previously distinguished patents from licenses as follows:

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[s] 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).

. . . We conclude that under ETA 3142.2009, the taxpayer's income from the . . . license was subject to B&O tax. In [separate] litigation . . . , the taxpayer acknowledged that the contract was structured as a license, instead of an outright purchase. [Taxpayers are bound by the structure of transactions that they create. See *Nord Northwest Corp. v. Dep't of Revenue*, 164 Wn. App. 215, 230 (2011).]

[We conclude that the transaction was in substance a license arrangement, not an outright sale. In this case, Company X did not acquire full rights to Patent 1. Company X could not freely transfer, sell, or license Patent 1 to other parties. Company X's rights terminated in five years (or less in the case of material breach) with any rights, including proprietary information, returning to the taxpayer. The taxpayer and Company X entered two license agreements for subsequent periods, which could continue in perpetuity. Because there was no "sale," there was no "casual and isolated sale."

Our conclusion would not change even if we concluded the transaction was a sale. The Washington Supreme Court has described that the casual and isolated sale statute as a "tiny niche" for those not engaged in the business of selling the type of property involved. *Budget Rent-A-Car of Washington-Oregon, Inc. v. Dep't of Revenue*, 81 Wn.2d 171, 175 (1972). Though taxpayer may have only engaged in one or two patent transactions, they involved expensive transfers of very significant rights, and involved products that were significant components of taxpayer's business.]

The taxpayer appeared to assign more of its rights in [Patent 2] to its affiliate. In the September 1, 2007 [Patent 2] agreement, the taxpayer assigned, ". . . all of its rights, title and interest in and to the Patent throughout the world . . ." The assignment included the right to sue. However, the taxpayer reacquired those rights and possibly the rights to more patents within fifteen months of the assignment. The taxpayer not only developed and sold patents; it licensed the rights to use them. Further, it acquired patents. These assignments were not isolated. The assignments were related because the taxpayer reacquired the same patents that it claims it sold. We conclude that the assignment of [Patent 2] and the license of [Patent 1] were not casual or isolated sales and that the income from the sales, transfers, or other assignments of the taxpayer's interests in both patents were subject to B&O tax.

The taxpayer has not raised the issue of the classification of the receipts derived from the taxpayer licensing of [Patent 1] and the [Patent 2] assignment. The Audit Division assessed B&O tax from both these patents under the service and other activities classification. Under ETA 3142.2009, when the owner of a patent grants a license to use the patent, the income is subject to the B&O tax under the royalties' classification. Receipts from outright sale are taxable under the service and other activities B&O classification. *Id.*

The Audit Division properly classified the [Patent 2] income under the service and other activities classification because the taxpayer assigned all rights to [Patent 2], including the right to sue. However, the license to use [Patent 1] did not include granting the right to sue and it specifically limited [Company X's] right to assign its rights. A license is a personal right, which may not be shared or transferred to others in the absence of an express provision in the license sanctioning sublicensing. [PATENT LAW FUNDAMENTALS § 19:5 (2d ed. 2002)]; *see also* Det. No. 85-97A, 7 WTD 383, 386-387 (1989). The taxpayer granted [Company X] a five-year license to use [Patent 1]. It did not sell the patent to [Company X]. The taxpayer and [Company X] structured the contract as a license rather than a sale of the patent. We conclude that the income from [the Patent 1] license was subject to the B&O tax under the royalties classification.

Payroll: RCW 82.04.220 imposes the [B&O] tax with the following language:

(1) There is levied and collected from every person that has a substantial nexus with this state a tax for the act or privilege of engaging in business activities. The tax is measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

“Gross income of the business” means the value proceeding or accruing by reason of the transaction of the business engaged in. RCW 82.04.080(1). Rule 111 recognizes that certain advances and reimbursements are not gross income of the business and may be excluded from the measure of tax. However, Rule 111 states the exclusion for advances and reimbursements applies only when the customer or client alone is liable for payment of the costs and when the taxpayer making the payment has no liability either primarily or secondarily other than as agent of the customer or client. [See *Washington Imaging Services, LLC v. Dep’t of Revenue*, 171 Wn.2d 548, 560, 252 P.3d 885 (2011) (quoting Rule 111)]. In *City of Tacoma v. The William Rogers Company, Inc.*, 148 Wn.2d 169, 60 P. 3d 79 (2002), the Washington Supreme Court decided whether money paid to a temporary staffing company by its clients, which amounts were passed on as wages to temporary workers, could be excluded from the measure of the staffing company’s income. In order to exclude these payments from the measure of tax, the court ruled that two conditions must be met. A taxpayer must first establish that it received the funds as the agent of the customer or client. If this first condition is satisfied, the taxpayer must also establish that its use of the funds to pay a third party is solely as an agent of the customer or client. *Id.* at 177.

“Agency is the relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.” *Walter v. Everett Sch. Dist.* No. 24, 195 Wash. 45, 48, 79 P.2d 689 (1938) (quoting Restatement of Agency sec. 1) (1933); *see also* *Matsumura v. Eilert*, 74 Wn. 2d 362, 368, 444 P.2d 806 (1968) (citing Restatement (Second) of Agency sec. 1 (1958)); [*Washington Imaging*, 171 Wn.2d at 562 (citing Restatement (Third) of Agency § 1.01 (2006))]. We have no evidence that the affiliates controlled the taxpayer, or that the taxpayer acted as their agent. . . . There is also no evidence of control by the purported principal over the purported agent. Control, according to the above-quoted definition, is a key element of an agency relationship. Without it, the definition is not satisfied and there is no agency relationship.

. . . We find that the . . . taxpayer was not an agent of its affiliates. Therefore, the taxpayer may not exclude the wage and benefit amounts it receives from the measure of its B&O tax under Rule 111.

Terminal Improvements: RCW 82.08.02565 exempts retail sales tax and RCW 82.12.02565 exempts use tax on M&E. The M&E exemption applies to “sales to a manufacturer or processor for hire of machinery and equipment used directly in a manufacturing operation.” RCW 82.08.02565(1). We construe the exemption “strictly . . . in favor of application of the tax and against claiming the exemption,” and the taxpayer bears the burden of proving entitlement to the M&E exemption. Det. No. 05-0193, 25 WTD 143 (2006) (*citing Budget Rent-A-Car, Inc. Dep’t of Revenue*, 81 Wn.2d 171, 174-5, 500 P.2d 764 (1972); *All-State Constr. Co. v. Gordon*, 70 Wn.2d 657, 425 P.2d 16 (1967); *Yakima Fruit Growers Ass’n v. Henneford*, 187 Wn. 252, 258, 60 P.2d 62 (1936)).

“Machinery and equipment” includes “industrial fixtures, devices, and support facilities, and tangible personal property that becomes an ingredient or component thereof, including repair parts and replacement parts.” RCW 82.08.02565(2)(a). The definition excludes buildings and building fixtures not integral to the manufacturing activity. RCW 82.08.02565(2)(b)(iii), (iv).

. . .

[During the tax period, the taxpayer had made improvements to its facility in anticipation of blending fuel, but did not actually engage in the blending of fuel. Because the manufacturing operation did not occur during the tax period, the M&E exemption does not apply.] We conclude that the Audit Division properly assessed use and/or deferred sales tax on the terminal improvements.

DECISION AND DISPOSITION

We are remanding the case to Audit Division to adjust the assessment by taxing the income from [Patent 1] under the royalties B&O tax classification (rather than under the service and other activities B&O tax classification). Otherwise, we deny the taxpayer’s petition.

Dated this 21st day of November 2012.