Cite as Det. No. 16-0409, 36 WTD 556 (2017)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 16-0409
. . .	)	Registration No. . . .

[1] RCW 82.32.070; WAC 458-20-254: TAXPAYER'S DUTY TO PRESERVE RECORDS – EXEMPTIONS. Any taxpayer who claims an exemption must keep and preserve records that will demonstrate the amount of all deductions and exemptions claimed. Without documentation, the Department cannot determine whether the taxpayer is entitled to the exemption.

[2] RCW 82.04.067; RCW 82.04.460; RCW 82.04.462; WAC 458-20-19401; WAC 458-20-19402: APPORTIONABLE INCOME – RECEIPTS FACTOR – THROW-OUT INCOME. Apportionable income received from activities that are at least partially performed in Washington can be excluded, or "thrown out," from the receipts factor if the income is attributed to a state in which the taxpayer is not taxable. A taxpayer is taxable in a state in which it would be deemed to have substantial nexus with that state under Washington's economic thresholds, regardless of whether that state imposes such a tax. A taxpayer may not combine apportionable income from multiple states in order to meet the economic thresholds for substantial nexus for purposes of determining throw-out income.

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.

Poley, T.R.O. [successor to Mark Pree, T.R.O.] – A Washington publishing company that provides services within and outside Washington disputes retail sales tax assessed on receipts for products purchased by customers outside of Washington. The company also protests the Department's calculation of "throw-out" income when apportioning its income for Business & Occupation (B&O) tax purposes. The petition is granted in part, denied in part, and remanded for adjustment.[1]

ISSUES

1. Under WAC 458-20-193, did a publishing company establish that its tangible products were delivered outside of Washington and thus not subject to Washington retail sales tax?

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

2. Did a Washington publishing company have substantial nexus in other states under RCW 82.04.067 and WAC 458-20-19401, affecting the calculation of its receipts factor pursuant to RCW 82.04.460, RCW 82.04.462, and WAC 458-20-19402?

FINDINGS OF FACT

. . . (Taxpayer) is a corporation headquartered in Washington. Taxpayer consulted with businesses worldwide to assess their personnel needs and offer training to their employees. Taxpayer sold books, as well as behavioral and personality tests, to businesses it consulted with. Taxpayer often traveled to its customers' business locations to provide these services.

The Department's Audit Division (Audit) examined Taxpayer's books and records for the period January 2011 through December 2014 (the Audit Period). During the Audit Period, Taxpayer reported income to the Department under both the retailing and the service and other activities B&O tax classifications. Taxpayer claimed an interstate and foreign sales deduction of over 87 percent of its retail sales income and over 79 percent of its service income on these returns. Audit disallowed the deduction for any retail sales where the invoice did not show a shipping or customer address. Taxpayer did not file an annual apportionment reconciliation of income for any year included in the Audit Period.

In order to determine Taxpayer's tax liability, Audit calculated Taxpayer's "receipts factor."[2] Audit ascertained Taxpayer's receipts attributable to Washington by subtracting all receipts that could be sourced to a location other than Washington. Some receipts that could not be sourced to a specific location were attributed to Washington. Taxpayer did not have more than $250,000 of receipts, more than $50,000 of property or payroll, or at least 25% of its total property, [receipts,] or total payroll, in any jurisdiction other than Washington or Oregon.

Then, Audit determined Taxpayer's throw-out income. Audit found that each out-of-state activity was, in part, performed in Washington. Audit also found that Taxpayer had Oregon payroll receipts greater than $53,000 in 2013 and 2014, indicating that Taxpayer was taxable in Oregon during those years.[3] Audit concluded that all of Taxpayer's out-of-state apportionable income, other than Oregon income from 2013 and 2014, was throw-out income.

Next, Audit divided Taxpayer's Washington attributable receipts by its world-wide receipts less throw-out income to obtain Taxpayer's receipts factor. Finally, Audit multiplied Taxpayer's receipts factor by its total apportionable income to determine the amount of Taxpayer's income subject to B&O tax in Washington.

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[2] The receipts factor is a fraction that applies to apportionable income for each calendar year. WAC 458-20-19402(401). The receipts factor is calculated by dividing Washington attributed apportionable receipts by world-wide apportionable receipts after throw-out income has been subtracted from the world-wide apportionable receipts. WAC 458-20-19402(402).

[3] The substantial nexus thresholds for payroll were $50,000 for June 1, 2010, through December 31, 2012, and $53,000 for January 1, 2013, through December 31, 2014.

On November 3, 2015, the Department issued a tax assessment against Taxpayer for $ . . . , which included $ . . . in retail sales tax, $ . . . in B&O tax, $ . . . in interest, $ . . . in delinquent payment penalty, and $ . . . in assessment penalty.

After Taxpayer requested administrative review of the assessment, Audit discovered it had inadvertently overlooked some of Taxpayer's records. Audit found that Taxpayer's Oregon payroll exceeded the nexus threshold for all four years examined in the Audit Period, not just during 2013 and 2014 as Audit had previously found. Audit now agrees that none of Taxpayer's income sourced to Oregon is throw-out income for the entire Audit Period and will allow Taxpayer to deduct receipts attributed to Oregon for 2011 and 2012. We grant Taxpayer's petition with respect to this issue and remand it to Audit for adjustment to the assessment.

At the hearing, Taxpayer protested retail sales tax and retailing B&O tax assessed on sales of books and personality tests that Taxpayer claimed were shipped to out-of-state locations. However, Taxpayer did not provide any additional records to support this contention.[4]

Taxpayer also argued that income sourced to locations outside of Washington was incorrectly designated throw-out income in calculating the receipts factor of the apportionment formula. Taxpayer asserts it is taxable in all locations where it solicited sales, and therefore income from those locations is not throw-out income. Taxpayer acknowledges that it did not pay taxes to any other jurisdictions outside of Washington. However, Taxpayer maintains that it is not required to actually pay tax to an outside jurisdiction in order to be found taxable in that jurisdiction.

Additionally, Taxpayer claims that even if it was not taxable in other jurisdictions, Taxpayer's apportionable income from jurisdictions outside of Washington, when combined, met the substantial nexus threshold for apportionable receipts. To the extent Washington's statutes do not allow apportionment in this manner, Taxpayer claims that such statutes violate the Commerce Clause of the U.S. Constitution . . . .

ANALYSIS

1. Delivery of tangible products outside of Washington

Washington imposes retail sales tax on each sale of tangible personal property in this state unless an exemption applies. RCW 82.08.020; RCW 82.04.050. It is the seller's responsibility to collect retail sales tax from the buyer, and if the seller fails to do so, the seller is personally liable for the amount of tax. RCW 82.08.050.

RCW 82.32.070 requires every person liable for payment of excise taxes to keep and preserve suitable records in order to determine the amount of any tax for which the taxpayer may be liable. This includes records that will demonstrate the amount of gross receipts and sales from all sources, the amount of all deductions, exemptions, credits, and refunds claimed, and the payment of retail sales tax or use tax. WAC 458-20-254(3)(b). A taxpayer must also keep its federal and state tax

[4] While Taxpayer sold both tangible personal property and consulting services to customers, Taxpayer has not alleged, and thus we do not address, whether a sale of these products would constitute a bundled transaction under RCW 82.08.190.

returns and all documents and data used in the preparation of such returns. WAC 458-20-254(3)(c).

Here, some of Taxpayer's sales invoices for books and personality tests did not list a shipping address or other customer address. While Taxpayer claims that these sales were to out-of-state customers, Taxpayer did not provide any records in support of its contention.[5] Without documentation that Taxpayer delivered its products to locations outside of Washington, Audit properly assessed retail sales tax on those sales. Taxpayer's petition is denied with respect to this issue.

2. <u>Calculation of throw-out income</u>

Any business earning apportionable income that is both taxable in Washington and "taxable in another state" must apportion its income. RCW 82.04.460(1). Apportionable income includes income earned from engaging in services that are not retail or wholesale sales. RCW 82.04.460(4)(a)(vi); RCW 82.04.290(2)(b). Income is apportioned to Washington by multiplying a business's apportionable income by a receipts factor each tax year. RCW 82.04.462(1); WAC 458-20-19402(401). The numerator of the receipts factor is the business's gross annual income attributable to Washington State, and the denominator is the business's gross annual income received worldwide from that activity less throw-out income. RCW 82.04.462(3)(a); WAC 458-20-19402(402).

Throw-out income is described in RCW 82.04.462(3)(c), which states that apportionable income must be excluded from the denominator of the receipts factor if at least some of the activity is performed in Washington, and the income is attributable to a state in which the taxpayer is "not taxable." *See also* WAC 458-20-19402(403). The phrase "not taxable" means that the taxpayer "is not subject to a business activities tax by that state, except that a taxpayer is taxable in a state in which it would be deemed to have a substantial nexus with that state under the standards in RCW 82.04.067(1) regardless of whether that state imposes such a tax." *Id*.

Under RCW 82.04.067(1),[6] a business is deemed to have substantial nexus with this state if the person is:

> (a) An individual and is a resident or domiciliary of this state;
>
> (b) A business entity and is organized or commercially domiciled in this state; or
>
> (c) A nonresident individual or a business entity that is organized or commercially domiciled outside this state, and in the immediately preceding tax year the person had:
>
> > (i) More than fifty thousand dollars of property in this state;

[5] If suitable records had been provided, Audit would have used those records to properly source Taxpayer's sales in accordance with RCW 82.32.730.

[6] Beginning January 1, 2013, the substantial nexus thresholds in RCW 82.04.067(1)(c)(i)-(iii) increased to $53,000 for property and payroll and to $267,000 for receipts.

(ii) More than fifty thousand dollars of payroll in this state;

(iii) More than two hundred fifty thousand dollars of receipts from this state; or

(iv) At least twenty-five percent of the person's total property, total payroll, or total receipts in this state.

Under these authorities, businesses located in Washington are only entitled to apportion their income when they are "taxable in another state" during that year. [RCW 82.04.460(1).] To be "taxable in another state" means they are either subject to a business activities tax in another state, have substantial nexus in another state using Washington's economic thresholds, or are formed under the laws or domiciled in another state. [WAC 458-20-19401(3).] WAC 458-20-19402(106)(h)(i).

In this case, Taxpayer is domiciled in Washington and incorporated under the laws of Washington. As discussed above, Taxpayer meets the economic threshold for payroll in the state of Oregon for each year in the Audit Period. However, Taxpayer did not meet the economic thresholds for any other state. Thus, Taxpayer's apportionable income from all states other than Washington or Oregon is throw-out income unless Taxpayer can show it is subject to a business activities tax in a foreign state.

Taxpayer asserts it is taxable in each foreign state where it attributed income because it solicited sales in those states. Soliciting an out-of-state customer for a sale, however, does not [necessarily] mean that Taxpayer is capable of being taxed in that customer's state. Taxpayer's calculation of its receipts factor must be based on more than unsubstantiated assertions; some evidence must support Taxpayer's claim that it is taxable in a particular state [under one of the identified standards].

Taxpayer is correct that it need not pay tax to a foreign state to be subject to tax in that state, although payment would be evidence that Taxpayer was so taxable. A letter ruling or similar document from a foreign jurisdiction stating that Taxpayer is subject to a business activities tax in that state would also qualify, but Taxpayer has not provided us any evidence showing it is taxable in a foreign state. Accordingly, Taxpayer's apportionable income from all states other than Washington or Oregon was properly designated as throw-out income. We deny Taxpayer's petition with respect to this issue.

Taxpayer also claims that even if it was not taxable in other jurisdictions, Taxpayer's apportionable income from jurisdictions outside of Washington and Oregon, when combined, exceed the economic threshold for apportionable receipts in RCW 82.04.067(1)(c)(iii). However, RCW 82.04.462(3)(c) does not provide for combining income from multiple jurisdictions. "A taxpayer is taxable in *a state* in which it would be deemed to have a substantial nexus with *that state* under the standards in RCW 82.04.067(1) regardless of whether *that state* imposes such a tax." RCW 82.04.462(3)(c) (emphasis added). As RCW 82.04.462(3)(c) refers to foreign states only in the singular form, never plural, we find Taxpayer's argument unpersuasive.

Finally, Taxpayer claims that Washington's single factor receipts formula violates the fair apportionment requirement of the Commerce Clause.[7] According to Taxpayer, the formula prevents Taxpayer from fairly apportioning its income because it does not allow Taxpayer to combine apportionable income from multiple jurisdictions in order to satisfy the economic threshold in RCW 82.04.067(1)(c)(iii).

States have wide latitude in the selection of apportionment formulas. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978). Such a selection "will only be disturbed when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportion to the business transacted'. . . or has 'led to a grossly distorted result.'" *Id.* (citations omitted). Where a state has shown that some minimal connection exists, income attributed to the taxing state need only be "rationally related" to values connected with the state. *Id.* at 272-73; Det. No. 14-0342, 34 WTD 250 (2015).

RCW 82.04.462 and WAC 458-20-19402 describe Washington's single factor receipts formula, where a taxpayer's apportionable Washington income is divided by the taxpayer's worldwide apportionable gross income minus throw-out income. Under this apportionment method, throw-out income is "rationally related to values connected with the taxing state" because it only encompasses income from activities where at least some of the activity is performed in Washington. RCW 82.04.462(3)(c); WAC 458-20-19402(403).

Here, Taxpayer does not dispute that at least some of its activity attributable to foreign states took place in Washington. Taxpayer has not offered "clear and cogent evidence" that the taxation of income earned from apportionable activities in foreign states other than Oregon is arbitrary, is not in proportion to, or is not "rationally related" to the business Taxpayer transacted that was attributed to Washington. Therefore, we conclude that, as applied, Washington's single factor receipts formula does not violate the Commerce Clause.

To the extent the Taxpayer is arguing that the statutory definition of throw-out income in RCW 82.04.462(3)(c) is facially unconstitutional, we do not have authority to rule on that issue. *Bare v. Gorton*, 84 Wn.2d 380, 383, 576 P.2d 379 (1974) ("An administrative body does not have the authority to determine the constitutionality of the law it administers; only the courts have that power."); *see also* Det. No. 98-083, 17 WTD 271 (1998). Similarly, we will not proclaim the definition of throw-out income found in WAC 458-20-19402(403) to be unconstitutional, either. "We presume that administrative rules adopted pursuant to a legislative grant of authority are valid, and we will uphold such rules if they are reasonably consistent with the controlling statute." *Wash. Pub. Ports Ass'n v. Dep't of Revenue*, 148 Wn.2d 637, 646 (2003).

DECISION AND DISPOSITION

Taxpayer's petition is granted in part and denied in part. We grant the petition with respect to Taxpayer's substantial nexus with Oregon under RCW 82.04.462(3)(c) and RCW

[7] The U.S. Supreme Court has set out a four-part test to determine whether a tax violates the Commerce Clause. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). First, the tax must apply to an activity with "substantial nexus" to the taxing state. Second, it must be "fairly apportioned." Third, it must not discriminate against interstate commerce. And fourth, it must be fairly related to services or benefits provided by the state. *Id*.

82.04.067(1)(c)(ii); apportionable income attributable to Oregon during the Audit Period is not throw-out income. The remaining issues in Taxpayer's petition are denied. We remand this case to Audit for adjustment consistent with this determination. Audit will issue an adjusted assessment with a new due date.

Dated this 29th day of December 2016.