Cite as 6 WTD 59 (1988)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment)	D E T E R M I N A T I O N
)	No. 88-233
. . .)	Registration No. . . .

[1] **RULE 194 & RULE 224:** B&O TAX -- CLASSIFICATION -- SERVICE -- GROSS INCOME -- ROYALTY INCOME -- PATENTS -- DOMICILE OUTSIDE OF WASHINGTON. Royalties derived from granting the right to use a patented process are not taxable by Washington where the grantor's domicile, legal or commercial, is outside of Washington. Patents are intangible personal property whose situs is the domicile of the owner. ETB 355.04.194.

[2] **RULE 194:** B&O TAX -- ALLOCATION -- INTANGIBLE PROPERTY -- MOBILIA SEQUUNTUR PERSONAM. Income derived from intangible property is attributed to the domicile of the owner of the property under the doctrine of mobilia sequuntur personam. Cury v. McCanless, 307 U.S. 357 (1938).

[3] **MISCELLANEOUS:** AUDITS -- TEST PERIODS -- APPLICABILITY -- REASONABLE RESULTS. The use of test periods is an appropriate audit procedure if proper consideration is given to factors which could lead to other than reasonable results. In this case the use of an uncharacteristic year as part of a test period was disallowed because it did not reasonably represent what probably happened in an earlier year.

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.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: May 20, 1987

NATURE OF ACTION:

The taxpayer petitioned for the correction of two assessments issued as a result of routine audits.

ISSUES:

Potegal, A.L.J. --

Tax Assessment No. [1] - Document No. [1]

In Schedule V of the audit report the taxpayer contends that tax assessed on [A] Division sales included tax already paid by the taxpayer on sales by the [B] Division. On certain internal reports which identify sales by the state of destination [B] sales were lumped together with [A] sales. The auditor compared these reports with the business and occupation tax reported for [A] sales and, finding a difference, assessed additional tax. The taxpayer states that [B] sales were reported separately for business and occupation tax purposes. Therefore, the taxes assessed had already been paid.

In Schedule VI of the audit report the taxpayer objects to the disallowance of a deduction taken in a supplemental 1984 tax return for December 1983 sales from the [X] mill. With Department approval the taxpayer had been in the practice of filing supplemental returns each year in which it deducted the prior year's December sales and added the current year's December sales. The [X] mill was sold in 1984. Because there were no December 1984 sales to add, the taxpayer merely deducted the December 1983 sales in the 1984 supplemental return. The auditor believed that this resulted in tax being underreported in 1984. The taxpayer states that the auditor's action lead to December 1983 sales being taxed twice because it already reported December 1983 sales in the supplemental 1983 return.

In Schedule XII of the audit report the taxpayer objects to the assessment of tax on sales to the U.S. Government. The

taxpayer contends that, as in Schedule V, tax had properly been paid on these sales. The auditor found an internal report which included Government sales together with [A] sales. However, this report was not used by the taxpayer for business and occupation tax purposes.

Tax Assessment No. [2] - Document No. [2]

In Schedule VII of the audit report the taxpayer objects to the assessment of Service business and occupation tax on royalty income from [Y]. [Y] paid the taxpayer for the right to use a patented process developed at the taxpayer's . . . plant [in Washington]. For internal accounting purposes the royalty income is allocated to the [Washington] location. That, however, is the only connection with Washington. The taxpayer is not incorporated in Washington nor is its commercial domicile in this state.[1] The contract for the payment of royalties was negotiated in [another country]. The royalty payments themselves are sent from [the other country to a city outside of Washington], the site of the taxpayer's headquarters and commercial domicile. The taxpayer contends that Washington has no legal right to tax this income.

In Schedule IX of the audit report the taxpayer objects to the assessment of use tax on retail purchases made in 1982 upon which sales or use tax was not paid. The assessment was based on a projection of error rates for 1983, 1984, and 1985 to purchases made in 1982. The 1982 invoices had been lost so an actual examination of purchases for that year could not be performed. The taxpayer asserts that the error rate for 1985 should not be used in making a projection of errors in 1982. In 1985 the taxpayer was undergoing a reorganization. There was a tremendous amount of personnel turmoil in connection with the reorganization. This caused many problems including an inordinate amount of taxable but untaxed purchases and also the loss of the 1982 purchase invoices. In other years the

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[1] A corporation's commercial domicile is defined as a domicile:

> . . . which a corporation may be deemed to acquire by making its actual, as distinguished from its technical or legal, home in a state other than that of its incorporation.
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> 36 AM JUR. 2nd 51.

error rate was much lower. Because 1985 was not typical it should not be used to indicate what might have occurred in 1982.

DISCUSSION:

Tax Assessment No. [1] - Document No. [1]

The matters raised under this assessment are factual in nature. They will be referred back to the Audit Section for verification. The person representing the taxpayer did not participate in most of the audit process. He has stated that he can provide support for his contentions.

Tax Assessment No. [2] - Document No. [2]

[1] and [2]. With respect to Service business and occupation tax assessed on royalty income we agree with the taxpayer's petition. The Department has long taken the position that the only taxable situs attributable to patents, which are intangible personal property, is the commercial or legal domicile of the owner. We quote from a Determination issued in 1986:

> A long recognized maxim in the area of taxation is mobilia sequuntur personam which means that movable property follows the person.
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> . . .
>
> [T]his state has chosen to allocate income from intangible personal property under the doctrine of mobilia sequuntur personam. The constitutional source for this allocation is found in the Supreme Court decision of Cury vs. McCanless, 307 U.S. 357 (1938).
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> At pages 365 and 366, the U.S. Supreme Court is quoted as follows:
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> > Very different considerations, both theoretical and practical, apply to the taxation of intangibles, that is, rights which are not related to physical things. Such rights are but relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in courts. The power

> of government over them and the protection which it gives them cannot be exerted through control of a physical thing. It can be made effective only through control over and protection afforded to those persons whose relationships are the origin of the rights. . . . Obviously, at sources of actual or potential wealth -- which is an appropriate measure of any tax imposed on ownership or its exercise -- it cannot be dissociated from the persons from whose relationships they are derived. These are not in any sense fiction. They are undisputable realities. (Citations omitted.)
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> The power to tax "is an incident of sovereignty, and is co-extensive with that to which it is an incident. All subjects over which the sovereign power of a state extends, are objects of taxation; but those over which it does not extend, are, upon soundest principles, exempt from taxation." McCulloch vs. Maryland, 4 Wheat. 316, 429. But this does not mean that the sovereign power of the state does not extend over intangibles of a domiciled resident because they have no physical location within this territory, or that its power to tax is lost because we may choose to say they are located elsewhere. A jurisdiction which does not depend upon physical presence within the state is not lost by declaring that it is absent. From the beginning of our constitutional systems control over the person at the place of his domicile and his duty there, common to all citizens, to contribute to the support of government has been deemed to afford an adequate constitutional basis for imposing on him a tax on the use and enjoyment of rights in intangibles measured by their value. . . .

Also see Excise Tax Bulletin 355.04.194, ... Neither the taxpayer's legal nor commercial domicile is in Washington. Thus, Washington may not tax this income.

We also agree with the taxpayer on the question of use tax on 1982 purchases. Many years ago the Department of Revenue's predecessor, the Tax Commission, expressed its philosophy on the use of test periods in these words:

> [3] Much can be said about the merits of the use of test periods in audit examinations; however, we believe this practice represents acceptable audit methods and procedures when conditions warrant its use. We believe also that reasonable results may be had from a testing of certain periods providing the tests will disclose the normal and usual errors of omission and commission and will relate such errors to the full audit period under examination and to this end the Tax Commission subscribes to the following guiding principles.
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> First of all, an analysis of the business activities must be made to insure that if seasonal influences are available proper consideration must be given to this factor when selecting periods for testing. When errors are discovered they must be studied as to their nature and if representing an unusual and infrequent transaction, they should not be considered when making projections for the full audit period. In addition, the selection of test periods should be made with full understanding and agreement between representatives of the taxpayer and the Commission in order to insure the reasonable results desirable.

That philosophy still obtains. In this instance the use of 1985 data does not lead to a reasonable result. The error rate for 1985 is much higher than that for 1983 and 1984. The taxpayer has explained that this is due to changes taking place in its organization. We would be much more likely to reach a reasonable result by applying only the error rates for 1983 and 1984 when the taxpayer's organization and manner of operation were relatively unchanged from 1982.

DECISION AND DISPOSITION:

Tax Assessment No. [1] - Document No. [1]

This matter is referred back to the Audit Section for verification of the taxpayer's claims.

Tax Assessment No. [2] - Document No. [2]

The petition is granted both with respect to royalty income and use tax on 1982 purchases.

The assessments are referred back to the Audit Section for action consistent with the DISCUSSION section of this Determination. Should any amounts remain due the Audit Section will advise the taxpayer of the amounts and due dates.

DATED this 10th day of June 1988.