BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment and Refund of	)	D E T E R M I N A T I O N
	)	No. 98-188
. . .	)	Registration No. . . .
	)	FY . . . /Audit No. . . .

RULE 224; RULE 194; SERVICE B&O TAX – ROYALTY CONTRACT -- ASSIGNMENT OF DUTIES AND OBLIGATIONS – CONSIDERATION. Royalty payments received by Taxpayer for assuming Parent's rights and obligations under a licensing contract with a third-party licensee are subject to Washington's B&O tax

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:

A wholly owned subsidiary of a foreign holding company protests the imposition of service and other activities business and occupation (B&O) taxes assessed on income derived from royalties received from a third-party licensee and assigned to Taxpayer for consideration.

FACTS:

Okimoto, A.L.J. -- . . . (Taxpayer) is based in . . . , Washington and is a wholly owned subsidiary of . . . , (Parent), a holding company domiciled in the Russian Federation. Taxpayer's books and records were examined by the Audit Division (Audit) of the Department of Revenue (Department) for the period February 1, 1992 through December 31, 1995. This examination resulted in additional taxes and interest being assessed of $ . . . . Document No. FY . . . was issued in that amount on July 3, 1996. Taxpayer paid the assessment in full, and now petitions for a refund.

Taxpayer explains the facts in its petition as follows:

> Contracts were originally entered into by [parent] (a foreign corporation that is the parent and sole stockholder of [taxpayer] and other foreign corporations for the right to use and

> sell it's game . . . in exchange for royalty payments. [Parent] owned the distribution rights to the games. Several years after the contracts were made, [taxpayer], was incorporated. The royalty payments due under the [parent] contracts were assigned to [taxpayer] to provide funds to cover operating expense while [taxpayer] pursued its primary business activity of marketing technology originally developed in Russia. The underlying intangible rights in the game, however, remained the property of [parent].

Taxpayer states that the revenue at issue arises from the licensing of certain rights. Taxpayer argues that the intangible property giving rise to those rights and from which the royalties are derived are not owned by a Washington company. Taxpayer emphasizes that Parent owns the distribution rights to the game, . . . , and that these intangible property rights are not and have never been present in the State of Washington. Taxpayer further emphasizes that Parent is a foreign corporation domiciled in Russia. Taxpayer states that "the law in this area is clear; income derived from intangible property is attributable to the domicile of the owner of the property." Taxpayer relies on Det. No. 88-233, 6 WTD 059, ETB 355.04.194[1] and WAC 458-20-194 (Rule 194) in support of its position.

In the alternative, Taxpayer maintains that it performed no business activity within the State of Washington, and that therefore it can not be taxed on passive income. Taxpayer also relies on WAC 458-20-224 (Rule 224) and Rule 194 in support of its position. Taxpayer emphasizes that "None of what [taxpayer] or its employees does or has the ability to do, has any connection with the . . . game . . . ."

ISSUE:

Are royalty payments received by Taxpayer for assuming Parent's rights and obligations under a licensing contract with a third-party licensee subject to Washington's B&O tax?

DISCUSSION:

There is no dispute that Parent originally owned all copyrights and distribution rights relating to the . . . game . . . and was entitled to all income derived from their sale. On February 24, 1989, Parent conveyed a portion of this copyright by granting a license to reproduce and sell copies of [the game] to a foreign company (Licensee) for a designated royalty fee. Through the granting of this license, Parent became entitled to royalty payments pursuant to the licensing contract[2]. In this case, Taxpayer contends that because Parent originally owned the intangible distribution rights and Parent is a foreign corporation whose domicile is in Russia that the only taxable situs of that intangible is in Russia. Therefore, Taxpayer argues that no Washington taxes are due.

Had Parent retained all of its rights and obligations under the licensing contract with Licensee we would agree that the taxable situs of income derived from that intangible property was the

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[1] ETA 547 canceled Excise Tax Bulletin 355.04.194 on June 18, 1990.

[2] Sec. 2.1 of the contract provides: Under the terms and conditions of this Agreement, [Parent] hereby grants to [Licensee] the exclusive right to use the Licensed Properties to make, have made, duplicate enhance, modify, market, distribute and sell the . . . Games, throughout the Licensed Territory. (Bracketed material supplied.)

domicile of its foreign owner. Such income would not be subject to Washington's B&O taxes. See Det. No. 88-233, 6 WTD 059 (1988). However, Parent did not. Instead, on April 30, 1993, Parent assigned all of its rights and responsibilities under the licensing agreement with Licensee to Taxpayer. This assignment agreement provided in part:

> WHEREAS, as of December 31, 1992, [Parent] entered into a License Agreement with [Licensee] granting to [Licensee] certain rights related to the exploitation of the games . . . .
>
> WHEREAS, [Parent] now wishes to assign to [Taxpayer] all of its rights and obligations under the License Agreement; and
>
> WHEREAS, [Taxpayer] now wishes to acquire from [Parent] all of [Parent's] rights and obligations under the License Agreement,
>
> NOW THEREFORE, in light of the foregoing and for good and valuable consideration, the parties hereto agree as follows:
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> 1. Assignment. In accordance with Section 13.7 of the License Agreement, [Parent] hereby sells, assigns and transfers to [Taxpayer] all of its rights and obligations under the License Agreement. It is expressly understood, however, [Parent] does not by virtue of this Assignment Agreement sell, assign or transfer to [Taxpayer] any rights in [Parent's] trademark, copyrights or any other intellectual property rights referred to in the License Agreement.
>
> 2. Assumption. [Taxpayer] hereby assumes and agrees to perform all of the liabilities and obligations of Parent under the License Agreement. (Bracketed material added.)

Audit points to Section 1 of the assignment agreement and argues that the language transfers "all of its rights and obligations under the License Agreement" to Taxpayer. Audit contends that this includes ownership of the underlying copyrights. Taxpayer contends, however, that the assignment agreement specifically states that the assignment "does not … sell, assign or transfer to [Taxpayer] any rights in [Parent's] trademarks, copyrights or any intellectual property rights referred to in the License Agreement."

Based on our reading of the assignment contract, we cannot agree that the assignment of the license contract was solely a method of funding Taxpayer's operations. On the contrary, we view the contract as being a transfer of the right to receive royalty payments in exchange for the assumption of Parent's obligations and responsibilities under the licensing contract. Indeed, the assignment contract clearly states that the assignment of the licensing contract was transferred for "good and valuable consideration". At a minimum, such consideration involves the assumption and agreement to "perform all of the [Parent's] liabilities and obligations of [Parent] under the License Agreement" with Licensee. It also includes the "evaluation and review" of . . . games as provided for in Section 3 of the licensing agreement. Should these services need to be performed, the employees of Taxpayer, and not Parent, would be responsible to perform them.

Furthermore, the act of assuming these contractual obligations and responsibilities, itself, constitutes a valuable service to Parent. It not only frees Parent to perform other business activities, but also relieves Parent from potential problems or liabilities under the licensing contract.

WAC 458-20-224(2) (Rule 224) states:

> Persons engaged in any business activity, other than or in addition to those for which a specific rate is provided in the statute, are taxable under a classification known as service and other business activities, and so designated upon return forms.

RCW 82.04.140 defines "business" to include "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 82.04.150 further defines "engaging in business" to mean "commencing, conducting, or continuing in business and also the exercise of corporate or franchise powers . . . ." In Taxpayer's case, it is clearly assuming Parent's obligations and responsibilities under the licensing contract "with the object of gain, benefit or advantage…." Consequently, we find that this income is fully taxable under the service and other activities B&O tax classification pursuant to RCW 82.04.140 and .150. Accordingly, Taxpayer's petition is denied on this issue.

Nor do we agree that Taxpayer performs no business activities in Washington related to this income. In addition to assuming Parent's responsibilities under the licensing contract, Taxpayer clearly states that its primary business activity is "marketing technology originally developed in Russia." We note that [the game] is technology and it was originally developed in Russia. Based on the evidence presented by Taxpayer, we remain unconvinced that Taxpayer's collection of . . . royalty income is completely divorced from Taxpayer's in-state activities. Taxpayer's petition is denied on this issue.

DECISION AND DISPOSITION:

Taxpayer's petition for refund is denied.

Dated this 30th day of October 1998.