

Cite as Det. No. 15-0251, 35 WTD 230 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of) D E T E R M I N A T I O N
Assessment of)
)
 No. 15-0251
)
 Registration No. . . .
)
)

[1] RCW 82.04.066, RCW 82.04.067, ETA 3195. B&O TAX – APPORTIONMENT – ECONOMIC NEXUS – FOREIGN CORPORATION – ROYALTIES. A physical presence was not required to establish substantial nexus when a foreign company’s apportionable activities generated “gross income of the business” from sources within Washington in excess of the statutory thresholds set forth in ETA 3195.

[2] TREATY – FOREIGN GOVERNMENT – DOUBLE TAXATION. There was no double taxation of a German company when a U.S. treaty with Germany contained a provision that excluded from the measure of German taxes any “income from sources within the United States that may be taxed [in the] United States.”

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.

Bauer, A.L.J. – A German pharmaceutical company with no physical presence in Washington objects to the assessment of Washington’s business and occupation [(B&O)] tax on royalties it received that were based on the sales of its products in this state. Taxpayer’s petition is denied.¹

ISSUES

1. In accordance with RCW 82.04.2907, RCW 82.04.460, RCW 82.04.066, and RCW 82.04.067, was a foreign company with no physical presence in Washington State correctly assessed [B&O] tax under economic nexus?
2. Did a U.S.-Germany tax treaty preempt Washington’s [B&O] tax on a German company’s royalty income?

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

FINDINGS OF FACT

The Audit Division (Audit) of the Department of Revenue (Department) audited the books and records of the related entities of . . . , a German pharmaceutical company.

One such affiliate was [Taxpayer], whose U.S. business location was [out-of-state], where the audit was conducted. Taxpayer was not registered in Washington. Audit issued an assessment against Taxpayer on August 20, 2014 for the period June 2, 2010 through December 31, 2013 (audit period) in the following amounts:

\$. . .	B&O Tax - Royalties
\$. . .	Delinquent Penalty
\$. . .	Interest through 8/20/14
\$. . .	5% Substantial Underpayment Penalty
\$. . .	5% Unregistered Business Penalty
\$. . .	Total Assessed

Taxpayer's business activities during the audit period included receiving royalty income based on where its pharmaceutical products were sold. Audit assessed [B&O tax based on Taxpayer's] royalty income [related to] the sales of pharmaceuticals to Washington state customers.

The United States and Germany are parties to a treaty: Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-Ger., Aug. 29, 1989, 1708 U.N.T.S. 3 (Treaty).

Taxpayer argues it had no nexus in Washington, and the Treaty protects it from the assessment of Washington's [B&O] taxes.

ANALYSIS

1. Economic Nexus. RCW 82.04.2907 imposes a tax on "every person engaging within this state in the business of receiving income from royalties" (i.e., on the compensation for use of intangible property). RCW 82.04.460(4)(vii) provides that activities taxed under RCW 82.04.2907 are apportionable activities.²

² RCW 82.04.460(4)(a)(vii) provides:

(4) For purposes of this section, the following definitions apply unless the context clearly requires otherwise:

(a) "Apportionable income" means gross income of the business generated from engaging in apportionable activities, including income received from apportionable activities performed outside this state if the income would be taxable under this chapter if received from activities in this state, less the exemptions and deductions allowable under this chapter. For purposes of this subsection, "apportionable activities" means only those activities taxed under: . . .

(vii) RCW 82.04.2907 . . .

RCW 82.04.066 provides:

"Engaging within this state" and "engaging within the state," when used in connection with any apportionable activity as defined in RCW 82.04.460, means that a person generates gross income of the business from sources within this state, such as customers or intangible property located in this state, regardless of whether the person is physically present in this state.

(Emphasis added.). Thus, an out-of-state person that is not physically present in Washington may be held to be in the business of receiving royalties when it has customers or intangible property located in this state.

RCW 82.04.067(1) provides:

(1) A person engaging in business is deemed to have substantial nexus with this state if the person is:

...

(c) A nonresident individual or a business entity that is organized or commercially domiciled outside this state, and in any tax year the person has:

- (i) More than fifty thousand dollars of property in this state;
- (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.

(Emphasis added.) RCW 82.04.067(5) further directs the Department of Revenue ("Department") to review the "substantial nexus thresholds" (thresholds) in RCW 82.04.067 (1)(c)(i) through (iii) each December. When the cumulative percentage change in the consumer price index for all urban consumers (CPI-U) changes by five percent or more from the measurement date, the Department must adjust the thresholds to reflect that cumulative change in the CPI-U. Excise Tax Advisory 3195.2015 (ETA 3195) identifies a revised receipt threshold of \$267,000 for 2013, 2014, and 2015.

According to Audit's figures, Taxpayer met the substantial nexus requirements for apportionable activities under RCW 82.04.067(1), as updated by ETA 3195.2015, because the royalties paid [to Taxpayer] (based on total Washington sales during the audit period) far exceeded the above thresholds of \$250,000 (for 2010, 2011, and 2012) and \$267,000 (for 2013).³

³ According to Exhibit B, Department of Revenue letter (Andy Elfers, Revenue Auditor) dated October 2, 2014, in response to Taxpayer's appeal, royalties received by Taxpayer for tax years 2010 through 2013 were as follows:
2010: \$. . . , based on \$. . . in Washington sales, which constituted 0.4304% of total sales
2011: \$. . . , based on \$. . . in Washington sales, which constituted 0.3913% of total sales.
2012: \$. . . , based on \$. . . in Washington sales, which constituted 0.3474% of total sales
2013: \$. . . , based on \$. . . in Washington sales, which constituted 0.2997% of total sales

Taxpayer argues it is located Germany and has no physical presence in Washington or anywhere in the United States, and the above statutory authorities should be disregarded. Even though RCW 82.04.066 clearly provides that physical presence is not required in the case of apportionable activities so long as the taxpayer is generating gross income of its business from sources within the state, which is the case here, Taxpayer argues that the 2010 economic nexus statutes are unconstitutional under the Commerce and Due Process Clauses of the U.S. Constitution.

We note, however, that an administrative body such as Washington's Department of Revenue does not have the authority to declare the statutes it administers to be unconstitutional; only courts have that power. *Bare v. Gorton*, 84 Wn.2d 380, 526 P.2d 379 (1975); Det. No. 12-0126, 32 WTD 144 (2013). The Department must therefore presume the constitutionality of the laws it administers, and will not, and may not, rule upon assertions of unconstitutionality. Det. No. 90-144, 9 WTD 286-1 (1990).⁴

Accordingly, Taxpayer's petition as to this issue is denied.

2. Treaty. The Treaty contains the following relevant provisions:

Article 2 (Taxes Covered):

1. The existing taxes to which this Convention shall apply are:
 - a) In the United States:
 - aa) the federal income taxes imposed by the Internal Revenue Code (but excluding the accumulated earnings tax, the personal holding company tax, and social security taxes); and
 - bb) the excise tax imposed on insurance premiums paid to foreign insurers (hereinafter referred to as "United States tax"). . . .
 - b) In the federal Republic of Germany:
 - aa) the income tax. . . .
 - bb) the trade tax . . .
 - cc: the trade tax . . . and
 - dd) the capital tax(hereinafter referred to as "German tax")

Article 3 (General Definitions):

- a) the term "a Contracting State" and "the other Contracting State" mean the United States or the Federal Republic of Germany as the context requires.

⁴ . . .

Article 12 (Royalties):

1. Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State. . . .
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein

Article 23 (Relief from Double Taxation):

2. Tax shall be determined in the case of a resident of the Federal Republic of Germany as follows:
 - a) Except as provided in subparagraph b), there shall be excluded from the basis upon which German tax is imposed any item of income from sources within the United States . . . that, according to this [treaty], may be taxed in the United States. . . .⁵
- For the purposes of this paragraph, . . . income . . . of a resident of the Federal Republic of Germany shall be deemed to arise from sources in the United States if they are taxed in the United States in accordance with this [treaty].

Article 24 (Nondiscrimination):

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation . . . that is . . . more burdensome than the taxation . . . to which nationals of that other State in the same circumstances are or may be subjected. . . .
6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof.

Taxpayer argues that the nondiscrimination provision in the treaty's Article 24 applies to Washington's tax on royalties. Article 24 generally provides that one country cannot tax nationals or businesses of the other country any differently than it taxes its own nationals or businesses. Article 2 provides that, in the United States, the treaty applies to federal income taxes imposed by the Internal Revenue Code and the excise tax imposed on insurance premiums, and to any identical or substantially similar taxes that are imposed after the date of signature of this treaty in addition to, or in place of, the existing taxes. Article 24's paragraph 6, however, provides that nondiscrimination also specifically applies to "taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof" despite the limitation of Article 2 to federal income taxes. Arguably, then, Washington State is a "local authority" of the United States, and thus the Article 24 nondiscrimination provision may apply to Washington's tax on royalties. Even if Article 24 were to apply, however, the tax on royalties is

⁵ Subparagraph b) is inapplicable to this case, as it refers only to income from dividends, gains, directors' fees, artists and athletes, government service income, social security, securities trading, and

not discriminatory against non-U.S. businesses vis-à-vis U.S. businesses. The tax applies equally to both, and is imposed on any business deriving royalty income from Washington sources regardless of physical presence in the state. Thus, the tax on royalties does not violate the nondiscrimination provision of Article 24.

Article 23, paragraph 2, provides relief to double taxation for residents of Germany by excluding from the basis upon which German tax is imposed any item of income from sources within the United States that may be taxed [in the] United States. Taxpayer argues that the tax on royalties would result in double taxation because such royalties are taxed in Germany per Article 12. . . . [Under Article 12, royalties are taxable in the United States if the Taxpayer has a] permanent establishment in the United States. Taxpayer . . . maintains a permanent office [out-of-state]. . . . That being the case, Taxpayer should be able to exclude that income taxed by Washington from its German tax base, thus avoiding double taxation. [Furthermore, the treaty does not cover Washington's tax on royalties (or any state or local tax, for that matter), and thus, implicitly, the treaty permits taxation of royalties by Washington under Washington's tax system.]

...

Taxpayer's petition as to this issue is denied.

As a final matter, Taxpayer, both in correspondence dated November 10, 2014, and in the teleconference, indicated that Audit mistakenly taxed the wrong German entity. In response to the petition, Audit stated:

During the audit examination records were requested regarding the recipient of royalty payments from various affiliates. This entity was registered and the assessment issued when the business did not voluntarily complete a Master Business Application form. Any errant information on the name can be easily rectified if additional information is provided to the Department. The business can update this information online at <http://bls.dor.wa.gov/>.

The adjustments and legal entity indicated in this assessment are based on information provided by . . . with [Taxpayer]. No additional information has been provided to the audit division to correct this alleged error.

This assessment was based on information provided by Taxpayer to the Department. Because Taxpayer has failed to identify the entity that it claims received the royalty income or provide any records to substantiate its claim that the royalties were received by a different entity, we deny the petition.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 11th day of September, 2015.