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BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Review of Letter) DET E R M I N A T I O N
Ruling)) No. 16-0107
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)) Registration No. . . .
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RCW 82.04.067; WAC 458-20-193: NEXUS – PHYSICAL PRESENCE. A taxpayer establishes a physical presence nexus in Washington through the activities of its reseller where the taxpayer's website advertises its association with the reseller and where reseller contractually agrees to act as a sales representative of taxpayer's products and services in Washington, including maintaining and establishing relationships with consumers of taxpayer's products and services.

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.

Danyo, Tax Policy Specialist 4 – An out-of-state company that sells computer software to resellers or end users and provides online computer support services to customers in Washington could be liable for Washington’s wholesaling business and occupation (B&O) tax, retailing B&O tax, retail sales or use tax, and service and other activities B&O tax, if the company had nexus with Washington pursuant to RCW 82.04.067. The Taxpayer Information and Education (TI&E) tax ruling correctly informed Taxpayer on its potential tax liability for Washington state excise taxes and is affirmed.¹

ISSUE

Did the TI&E tax ruling correctly inform the taxpayer of its Washington State excise tax reporting responsibilities and potential tax liabilities under RCW 82.04.067 and WAC 458-20-193?

FINDINGS OF FACT

. . . (Taxpayer) sells computer software and provides technical support and online training on the use of the software to its customers worldwide, including Washington State. It sells the software primarily at retail but also for resale. It delivers its software and related services via the internet. Taxpayer is located in [out-of-state]. In September 2010, Taxpayer contracted with an unrelated

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

company located in Washington as an Authorized Reseller to promote and resell Taxpayer's software and services.

The Department of Revenue (Department) discovered Taxpayer, an unregistered out-of-state business, was selling and delivering its computer software to Washington consumers via the internet. On February 12, 2014, the Department sent Taxpayer a Washington Business Activities Questionnaire. Taxpayer completed the questionnaire. On March 13, 2014, the Department's Compliance Division (Compliance) sent Taxpayer a letter informing Taxpayer that, based on its responses on the questionnaire, it "appeared" that Taxpayer was required to be registered in Washington. Further, that the letter was "official notice of commencement of an audit" of Taxpayer's business activities in Washington for determining its excise tax liability, including sales and use tax. The letter informed Taxpayer that it was taxable because it had representatives marketing its products in this state, an activity that created nexus; it delivered its products in this state; and that nexus with delivery provides a taxable transaction.

The letter requested gross annual sales data separated by Washington tax classifications, a copy of any "agreements with Washington resellers, affiliates, technology vendors, and service providers enrolled in Taxpayer's Partner Programs at any point from 2007 to current" and a statement of how the company generates revenue. Thereafter, between April 3, 2014, and April 29, 2014, Taxpayer and the revenue agent had several discussions by telephone and email regarding Taxpayer's activities and the Department's audit.²

Taxpayer advised Compliance that it had contracted with a company located in [Washington], . . . (Reseller) to resell and market its products, but the association yielded no sales. The contract was signed in September 2010 by the principals of the two companies and unilaterally terminated by Taxpayer in April 2014. On April 16, 2014, Taxpayer informed Compliance via email that it appeared the Reseller was still operating a business in Washington, but it had no contact with the company and, as a result, was terminating the contract, effective April 19, 2014. Other than this contract, Taxpayer states it had no physical contact with Washington, had no employees or other representatives in this state, made no visits into Washington, and sold directly to its Washington customers from outside the state. Taxpayer explained it does not charge its resellers³ a fee, they are free to sell Taxpayer's products or not, and Taxpayer does not direct any marketing efforts or instruct the resellers on how to sell Taxpayer's products.

Compliance deemed that Taxpayer had established nexus with the state of Washington by entering into a nonexclusive value added contract with the Reseller to market and resell its products, regardless that no sales were generated. On April 30, 2014, Compliance informed Taxpayer that:

[B]ased on our conversations and the information available at this time, your software sales to Washington customers would be subject to Retailing Business and Occupation (B&O) tax as well as Retail Sales Tax and your training activities would be subject to Service and Other Activities B&O tax.

² On April 30, 2016, an email from Compliance to Taxpayer listed the dates of these communications.

³ Taxpayer states it had five resellers (not including the Reseller in Washington) who provide basic support for its software. It features these five on its website. Only one of these five is located in the United States.

Compliance did not include any reference to wholesaling B&O tax. Compliance again requested that Taxpayer provide gross sales numbers for tax years 2010 through Quarter 1 2014, and a narrative description of the business' operations. According to Taxpayer:

We were asked to provide gross sales revenue reports; copies of any agreements with Washington resellers, affiliates, technology vendors and service providers; and a written statement as to how our company generates revenue. This was provided ... as requested, through an email dated 4/03/2014.

Taxpayer provided a copy of the contract.

On December 9, 2014, the Department issued a letter informing Taxpayer that it had been registered. Taxpayer was advised that it needed to report monthly, effective January 1, 2015.

On January 7, 2015, Taxpayer wrote the TI&E section of Taxpayer Services Division, requesting a ruling regarding its tax status. Taxpayer wrote in pertinent part:

Our company generates revenue through computer software sales and support of [Taxpayer's] software We also offer Support Contracts for ... (our free and open-source software), Training [for this software] for individuals seeking proof of their . . . competencies. We also have a . . . Conference once per year that produces very little revenue.

We are writing to request a ruling as to the taxable status of our business ... which is located [out-of-state]. On March 13, 2014, we received a letter from [the Department] stating that we were subject to an "audit of our business activities in Washington for excise taxes, including sales and use taxes." The letter also stated that we were taxable due to having "representatives marketing our product to customers in Washington" and that since our product was delivered via the internet, this created Nexus.

We do not own or rent any property located in Washington, nor do we employ any persons that reside in or travel to Washington for any business purposes. We do not have more than \$250,000 in revenue from Washington. [The revenue agent] determined that we met substantial Nexus status due to the fact that we had a reseller of our product that is located in Washington. . . .

Taxpayer explained its relationship with the Reseller as follows:

[W]e have never had any sales generated by this particular reseller. In fact we had cancelled their reseller status with us as of 4/19/2014 due to lack of sales. During our relationship with [Reseller], we did not directly employ or compensate anyone from their company. We did not travel to Washington to meet with them or incentivize them to promote our products. They are simply a customer, whom in theory, would resell our products directly to the end users. Our end users have the option to purchase directly from us, but sometimes choose to work with a reseller due to an existing relationship.

On February 2, 2015, TI&E issued the tax ruling. The ruling confirmed Taxpayer's information as follows:

You represent here that your company generates revenue through sales of computer software and support, support contracts for your free and open-source software, and training to individuals seeking proof of competencies in using your software. In addition, you have an annual conference that produces some revenue.

The ruling noted that . . . Compliance had determined that Taxpayer had physical presence nexus under RCW 82.04.067(6) and that Taxpayer's

[s]ales of prewritten software are taxed as a retail sale when sold to consumers in Washington, and as a wholesale sale when sold to resellers that provide a valid reseller permit. Sales of software support contracts are generally taxed in the same manner when the contract includes updates, upgrades, patches, keys, etc. related to prewritten computer software.

The ruling concluded that Taxpayer's "sales of computer software and support contracts are subject to sales tax when sold to consumers in Washington. The income from sales to consumers is subject to retailing B&O tax."

With respect to the income generated from providing "live interactive instruction type training to customers in Washington," the ruling informed Taxpayer that the income from these types of activities:

[is] not subject to sales tax, and instead [is] taxed under an "apportionable B&O tax classification (the Service and other activities classification)." Also, income from optional software support contracts that involve mere help desk services [is] generally taxed in the same manner. In this case for this type of income we look to the economic nexus thresholds to determine whether the income would be taxed in Washington. You represent here that your company has not established economic nexus in Washington. In this case, your income from providing live interactive instructions, and software support contracts to customers in Washington would not be subject to Washington's tax.

(Emphasis ours.) Thus, based on Taxpayer's representation that it did not meet the economic nexus thresholds, the ruling informed Taxpayer it would not be liable for Washington's service B&O tax on the income generated from the activities that would be classified under the service B&O tax classification. The ruling also noted that in Washington, Taxpayer would have a "trailing nexus" liability (up to four years after the nexus creating activity ceased for retail sales tax and up to two years for retailing and wholesaling⁴ B&O tax).

⁴ RCW 82.04.220 – Business and Occupation Tax: "(2) A person who has a substantial nexus with this state in any tax year under the provisions of RCW 82.04.067 will be deemed to have a substantial nexus with this state for the following tax year." As of September 1, 2015, nexus for wholesaling B&O tax is no longer determined by establishing physical [presence]. However, physical [presence] nexus established before the effective date may continue under trailing nexus for the remainder of the year and the following year. See, WAC 458-20-193.

Having provided Taxpayer with information regarding its potential tax liability in the state of Washington, TI&E advised Taxpayer to continue to work with Compliance directly regarding the specific status of its account. On February 26, 2015, Compliance informed Taxpayer that:

“[T]he department has yet to firmly conclude that the agreement between [Taxpayer] and it’s [sic] Washington reseller establishes Nexus in Washington. ... Regarding the ruling Emailed to you on February 2, 2015, I have ... spoken with its author. She has confirmed that it pertained to proper reporting instructions and information on trailing nexus.

Taxpayer appealed the tax ruling. The petition substantially repeated the arguments contained in the request for a ruling on its tax liability status. Our review is limited to addressing the TI&E response based on Compliance’s preliminary determination that Taxpayer had physical nexus with Washington, pending further review of Taxpayer’s records.⁵

ANALYSIS

Washington imposes a B&O tax on “every person that has a substantial nexus” with Washington “for the act or privilege of engaging in business” in this state. RCW 82.04.220(1). The B&O tax is “extensive and is intended to impose . . . tax upon virtually all business activities carried on in the State.” *Analytical Methods, Inc. v. Dep’t of Revenue*, 84 Wn. App. 236, 241, 928 P.2d 1123 (1996) (quoting *Palmer v. Dep’t of Revenue*, 82 Wn. App. 367, 371, 917 P.2d 1120 (1996)). “Business” is defined broadly 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 82.04.140. The tax is measured by applying particular rates against the value of products, gross proceeds of sale, or gross income of the business as the case may be. RCW 82.04.220.

RCW 82.04.290(2) asserts a B&O tax upon the gross income of every person engaging within this state in any business activity other than or in addition to an activity taxed explicitly under another section in this chapter RCW 82.04.270 imposes the B&O tax on the gross proceeds of sales on entities making sales at wholesale. RCW 82.04.250 imposes the retail B&O tax on entities making sales at retail. Persons making sales at retail must collect and remit retail sales tax. RCW 82.08.020; RCW 82.08.050. A sale at retail and retail sale is defined [to include] the sale of tangible personal property [to consumers]. RCW 82.04.050(1)(a). The sale of prewritten computer software is specifically included in the definition of “sale at retail” and “retail sale.”⁶ RCW 82.04.050 provides:

(6)(a) The term also includes the sale of prewritten computer software to a consumer, regardless of the method of delivery to the end user. For purposes of this subsection (6)(a), the sale of prewritten computer software includes the sale of or charge made for a key or an enabling or activation code, where the key or code is required to activate prewritten computer software and put the software into use. There is no separate sale of the key or

⁵ Compliance has not completed its review nor issued an assessment, pending the issuance of this decision.

⁶ . . . RCW 82.08.010(7) provides [a definition of “tangible personal property”]: “For the purposes of the taxes imposed under this chapter and under chapter 82.12 RCW, ‘tangible personal property’ means personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses. Tangible personal property includes electricity, water, gas, steam, and prewritten computer software.”

code from the prewritten computer software, regardless of how the sale may be characterized by the vendor or by the purchaser.

Taxpayer sells computer software. RCW 82.04.215[(2)] provides that computer software is classified as either prewritten or custom. The sale of prewritten software is a sale of tangible personal property and is classified as a retail sale[, for purposes of applying the retail sales tax], when sold to end users. [It is classified] as a wholesale sale when the seller sells the prewritten software for resale without intervening use by the purchaser, provided the reseller has properly provided the seller with a reseller certificate. *See* WAC 458-20-15502 for further explanations of the taxation of the sale of computer software. The sale or charge for custom software or the customization of prewritten computer software is not a retail sale. RCW [82.04.050(6)(b)].

With respect to Taxpayer's potential liability under the service B&O tax classification, Taxpayer provided income figures that it claims are the total gross revenue generated from providing services that would be subject to service B&O tax and apportionment but do not meet the threshold amount of \$250,000.00 in sales, necessary to establish economic nexus under RCW 82.04.067(1)–(5). The TI&E tax ruling stated that if Taxpayer did not meet threshold requirements for economic nexus under RCW 82.04.067(1)–(5), it would not have a tax liability on these amounts. The tax ruling, however, did not conclude that the activities Taxpayer described would be subject to service B&O. The tax ruling concluded only that services that are classified under an apportionable B&O tax classification (service) must meet the economic nexus thresholds provided under the statute. With respect to this portion of the TI&E tax ruling, we agree that apportionable services income would need to meet the threshold requirements to incur . . . service B&O tax liability. RCW 82.04.067(1)–(5).

Compliance has not yet determined whether Taxpayer's records support a conclusion that these services are properly classified under the service and other activities B&O tax classification that the income is apportionable and attributable to Washington, or that Taxpayer has not established economic nexus.

Taxpayer claims it made no wholesale sales into Washington notwithstanding its contract with the Reseller.⁷ Taxpayer has stated the amounts it provided for Compliance's review reflect all retail sales only of computer software to Washington customers.

⁷ Effective [September 1], 2015, pursuant to RCW 82.04.067(1)(c) an economic nexus standard applies to out-of-state wholesaling activities where the out-of-state business is making wholesale sales to Washington customers. That business must review its Washington receipts, payroll and property to determine whether any of the economic nexus thresholds are met, even if the business does not have a physical presence in Washington. For purposes of counting receipts toward the dollar amount thresholds, receipts from wholesale sales are sourced to Washington according to the Streamlined Sales and Use Tax Agreement sourcing provisions set out in RCW 82.32.750. The economic thresholds are:

- More than \$267,000 of gross income in Washington
- More than \$53,000 of payroll in Washington
- More than \$53,000 of property in Washington
- At least 25 percent of total income, payroll or property in Washington

Thus, economic nexus is created in the year in which it meets at least one of the minimum thresholds. It is established in the following year when wholesale sales are subject to wholesaling B&O tax. Trailing nexus follows the year in which economic nexus is established. RCW 82.04.220(2).

Here, Taxpayer does not dispute that the gross sales amounts reflect its sales of computer software to retail customers who received the product and services in Washington via the internet covering tax year's 2010–Quarter 1, 2014. Taxpayer maintains it is liable for neither retail sales tax nor retailing B&O tax on any of the retail sales, because it did not have the requisite "substantial nexus" with Washington during the tax period at issue (2007–2014). RCW 82.04.067(6). RCW 82.04.270, RCW 82.04.250, RCW 82.08.020 and RCW 82.08.050.

. . . Nexus requirements flow from the United States Constitution's Due Process Clause and Commerce Clause provisions limiting a state's jurisdiction to tax out of state businesses. The limitations imposed by the two clauses are discussed in depth in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992); and *Lamtec Corp. v. Dep't of Revenue*, 170 Wn.2d 838, 246 P.3d 788 (2011). A tax on an out-of-state corporation must satisfy the requirements of the due process clause of the Fourteenth Amendment and the commerce clause. Det. No. 01-188, 21 WTD 289 (2002). See also Det. No. 01-074, 20 WTD 531 (2001); Det. No. 96-144, 16 WTD 201 (1996).

The United States Supreme Court identified the requirements under the Commerce Clause for a state to impose tax on an out-of-state business. In *Complete Auto*, the Court held that the Commerce Clause requires that the tax: (1) be applied to an activity with "substantial nexus" with the taxing state, (2) be fairly apportioned, (3) not discriminate against interstate commerce, and (4) be fairly related to the services provided by the state. *Complete Auto*, 430 U.S. at 279.

On June 1, 2010, the Washington legislature enacted RCW 82.04.067(6), providing a statutory definition for "substantial nexus,"⁸ which states:

For purposes of the taxes imposed under this chapter on any activity not included in the definition of apportionable activities in RCW 82.04.460. . . . a person is deemed to have a substantial nexus with this state if the person has a physical presence in this state, which need only be demonstrably more than a slightest presence. . . . A person is also physically present in this state if the person, either directly or through an agent or other representative, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in this state.

[RCW 82.04.067(6)(a) & (c)(i)] (emphasis added.) Thus, the standard for determining whether there is substantial nexus sufficient for imposing Washington's B&O and retail sales taxes is not whether the in-state activity directly solicits a sale, but rather whether the in-state activity is "significantly associated with establishing or maintaining a market within the state." See *Tyler Pipe Industries, Inc. v. Dep't of Revenue*, 483 U.S. 232, 250 (1987); *Standard Pressed Steel Co. v. Dep't of Revenue*, 419 U.S. 560 (1975); *National Geographic Soc. v. California Bd. of Equalization*, 430 U.S. 551 (1977); Det. No. 04-0148, 6 WTD 417 (1988).

⁸ [The same standard for] substantial nexus was cited with approval by the United States Supreme Court in *Tyler Pipe Industries, Inc. v. Dep't of Revenue*, 483 U.S. 232, 250 (1987).

Consistent with this requirement, the Department amended WAC 458-20-193 (Rule 193) in 2015 to provide further guidance on how Washington's B&O and retail sales taxes apply to interstate sales of tangible personal property. Rule 193(102) provides:

Nexus. A person who sells tangible personal property is deemed to have nexus with Washington if the person has a physical presence in this state, which need only be demonstrably more than the slightest presence. RCW 82.04.067(6).

(a) **Physical presence.** A person is physically present in this state if:

...

(d) **In-state activities.** Even if a person does not have property or employees in Washington, the person is physically present in Washington when the person, either directly or through an agent or other representative, engages in activities in this state that are significantly associated with the person's ability to establish or maintain a market for its products in Washington. It is immaterial that the activities that establish nexus are not significantly associated with a particular sale into this state.

For purposes of this rule, the term "agent or other representative" includes an employee, independent contractor, commissioned sales representative, or other person acting either at the direction of or on behalf of another.

A person performing the following nonexclusive list of activities, directly or through an agent or other representative, generally is performing activities that are significantly associated with establishing or maintaining a market for a person's products in this state:

...

(vii) Performing activities designed to establish or maintain customer relationships including, but not limited to:

(A) Meeting with customers in Washington to gather or provide product or marketing information, evaluate customer needs, or generate goodwill; or

(B) Being available to provide services associated with the product sold (such as warranty repairs, installation assistance or guidance, and training on the use of the product), if the availability of such services is referenced by the seller in its marketing materials, communications, or other information accessible to customers. . . .

[(Emphasis added.)] In this case, Taxpayer contends that its contract with the Reseller is not sufficient to establish taxable nexus because the Reseller did not resell any of its products or services and that at best, it was a customer. However, it is immaterial that the activities that establish nexus are not significantly associated with a particular sale into this state. Rule 193(102)(d). Nexus is established when a Taxpayer's in-state activities are "significantly associated with establishing or maintaining a market within this state." RCW 82.04.067(6). As the U.S. Supreme Court has stated:

[T]he relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay the use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate "some definite link, some minimum connection, between the State and the person . . . it seeks to tax."

National Geographic, supra, 430 U.S. 551, 557 (1977).

Here, Taxpayer had a contract with a representative to market and resell its products during the term of the contract, September 14, 2010, through April 29, 2014. According to Compliance, the Taxpayer's website at the time indicated that Taxpayer had an authorized reseller in Washington from whom customers could receive "support services in a localized fashion, with a local or nearby presence." Further, by the terms of the contract with the Reseller, Taxpayer agreed to pay the Reseller for products and service sales if the Reseller maintained its relationship with the end customer; would provide marketing materials to the Reseller; and would give discounts that the Reseller could pass on to customers or retain. Other terms included that the Reseller would act as a sales associate for Taxpayer's products and services, provide local representation for Taxpayer, and get new client leads. It is immaterial that no sales income was generated from these activities. Rule 193. Substantial nexus is not tied to a single sale, but to whether the activities engaged in are significantly associated with creating or maintaining a market for the out-of-state taxpayer's products and services in this state.

We find Taxpayer's website advertising of its association with the Reseller and by the Reseller's agreement to act as a sales representative of Taxpayer's products and services in Washington, including maintaining and establishing relationships with consumers of Taxpayer's products and services, was more than the slightest presence in this state. As RCW 82.04.067(6) makes clear, the physical presence in Washington "need only be demonstrably more than a slightest presence."

...

We conclude that under the limited facts and information provided, the Taxpayer established a physical presence nexus in Washington through its Washington Reseller's activities.⁹ Once it is determined that substantial nexus is established for a particular taxpayer, that nexus generally extends to all of that taxpayer's sales that are received in Washington, unless some specific exception applies. RCW 82.04.067(6) and Rule 193.

We conclude that the TI&E Letter Ruling, issued on February 2, 2015, correctly informed Taxpayer of its potential tax reporting responsibilities and liabilities.

DECISION AND DISPOSITION

The TI&E February 2, 2015, tax ruling is affirmed.

Dated this 22nd day of March 2016.

⁹ However, these nexus creating activities may have ceased when the Reseller's activities in Washington ceased. This is a fact that Compliance will have to determine.