Cite as Det. No. 21-0044, 41 WTD 355 (2022)

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. 21-0044 Registration No. …

[1] WAC 458-20-19402; RCW 82.04.462: BUSINESS & OCCUPATION TAX – APPORTIONMENT – ATTRIBUTION – BENEFIT OF SERVICE – RELATED BUSINESS ACTIVITY. Taxpayer's patent acquisition services relate to its customers' strategic planning business activity. The process of obtaining a patent is time-intensive and costly. The choice to initiate such a process requires broad strategic decisions from management and corporate legal counsel. We find that the customers' related business activity for the purpose of determining where the benefit of Taxpayer's service is received under Rule 19402(303)(c) is strategic planning and general corporate management. These decision-making personnel work at the customer's corporate headquarters.

[2] WAC 458-20-228; RCW 82.32.105: UNREGISTERED BUSINESS PENALTIES & SUBSTANTIAL UNDERPAYMENT – WAIVER – CIRCUMSTANCES BEYOND CONTROL – ERRONEOUS WRITTEN INFORMATION. Taxpayer requests waiver based upon asserted delays by the Department between February 2019 and December 2019. However, no such delay could have caused Taxpayer to fail to register prior to establishing substantial nexus with the Department in 2017 or to substantially underpay its tax liability over the entire Audit Period. Rather, Taxpayer's failure to register and substantial underpayment were caused by Taxpayer's misunderstood belief that it was not subject to taxation in this state. Such a misunderstanding or lack of knowledge is explicitly excluded from circumstances beyond the control of a taxpayer under Rule 228. Rule 228(9)(a)(iii)(B).

[3] WAC 458-20-228; RCW 82.32.105: PENALTIES – DELINQUENT PAYMENT – WAIVER – CIRCUMSTANCES BEYOND CONTROL – ERRONEOUS WRITTEN INFORMATION. Taxpayer requests waiver based upon asserted delays by the Department between February 2019 and December 2019. Such delay could not have caused Taxpayer's delinquent payment for the eight calendar quarters in 2017 and 2018, as the payment for the last of those quarters, quarter four of 2018, became due on January 31, 2019.

Similarly, regarding the delinquent payment penalty assessed for quarter one of 2019, we find that Taxpayer has not shown a circumstance beyond its control for its failure to pay by the initial due date of April 30, 2019. The May 13, 2019, email could not have caused Taxpayer's initial delinquent payment because it was sent after the April 30, 2019, due date. However, we find that the May 13, 2019, email represents erroneous written information given to the taxpayer by a department officer or employee, which constitutes a circumstance beyond Taxpayer's control under Rule 228(9)(a)(ii)(B), as pertaining to each of the ten percent increases to the penalty for Taxpayer's failure to pay for each of the two subsequent months.

Regarding the delinquent payment penalty assessed for quarter two of 2019, we find that Taxpayer has not shown a circumstance beyond its control for its failure to pay timely. Taxpayer knew on July 10, 2019, that the Department would not issue a ruling, and on July 22, 2019, that the Department would move forward with issuing an assessment for the Audit Period. Taxpayer's tax liability for quarter 2 of 2019, was due July 31, 2019.

[4] WAC 458-20-228; RCW 82.32.105; RCW 82.32A.020: INTEREST – WAIVER – WRITTEN INSTRUCTIONS. Taxpayer's failure to pay its tax liability for quarter one of 2019 between the dates of May 13, 2019, and July 10, 2019, was the direct result of the Department's written instructions in the May 13, 2019, email. Accordingly, under RCW 82.32.105(3)(a), we find that the Department is required to waive the interest it assessed against Taxpayer beginning on May 13, 2019, and ending on July 10, 2019.

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.

Ryan A. Johnson, T.R.O. – An out-of-state law firm protests the assessment of tax, asserting that it does not have substantial nexus with Washington, and that the Department incorrectly apportioned its income to Washington. Taxpayer further contests the assessment of interest and penalties on the basis that the Department delayed in explaining its position and issuing the tax assessment. We deny Taxpayer's petition in part and grant Taxpayer's petition in part.[1]

ISSUES

1. Whether a law firm's receipts are properly attributed to Washington State, based upon the location of the customer's headquarters, under RCW 82.04.462 and WAC 458-20-19402, when the firm's services relate to intellectual property, are provided to Washington-based customers engaged in business, and relate to the customers' protection of the market for their products.

2. Whether a taxpayer is entitled to waiver of penalties under RCW 82.32.105 and WAC 458-20-228, when the Department suggested that the taxpayer file a request for a tax ruling and did not issue such a ruling.

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

3. Whether a taxpayer is entitled to waiver of interest under RCW 82.32.105, RCW 82.32A.020(2) and WAC 458-20-228, when the Department suggested that the taxpayer file a request for a tax ruling and did not issue such a ruling.

FINDINGS OF FACT

. . . ("Taxpayer") is an out-of-state law firm specializing in legal services related to the procurement of patents from the United States Patent and Trademark Office ("USPTO"). Patents are a form of intellectual property that grant the patent holder the exclusive right to exclude others from making, using, importing, and selling the patented innovation for a limited period of time. *See* the U.S. Patent Act, 35 U.S.C. §§ 1 *et seq*. Taxpayer provides such legal services to customers headquartered in Washington.

In June 2018, the Department's Compliance Division ("Compliance") contacted Taxpayer to examine Taxpayer's business activity in Washington. Compliance asked Taxpayer to fill out and submit a Washington Business Activities Questionnaire ("WBAQ") reporting information about Taxpayer's business activities in Washington State. In February 2019, Taxpayer provided its annual sales data for the 2017 and 2018 calendar years. Compliance reviewed that data and concluded that, based upon its gross receipts, Taxpayer established a substantial nexus with Washington beginning January 1, 2017.

Taxpayer contested Compliance's conclusion and maintained that its gross receipts do not establish substantial nexus with Washington. Taxpayer provided calculations in support of this assertion in which Taxpayer took its total gross receipts from 2017 and 2018 and apportioned 1/64th, approximately 1.56%, of each figure to Washington. Taxpayer asserted that, when apportioned in this manner, its gross receipts do not meet the $267,000 threshold to establish substantial nexus with Washington set out in WAC 458-20-19401("Rule 19401")(3)(a).[2] In an email on February 25, 2019, Taxpayer explained its decision to apportion 1/64th of its gross receipts to Washington as follows:

> [Taxpayer] assists client in obtaining US patents by filing patent applications with the US patent office. The numerator of the apportionment factor is based on 1/64 of the total gross receipts based on the number of states, territories, and US possessions for which the patent protection applies. Income received from clients seeking foreign patents would be sourced to the country for which the patent is sought. The denominator is total gross receipts of the company.

Compliance reviewed Taxpayer's apportionment method and concluded that Taxpayer's gross receipts should be attributed to the headquarters of each customer rather than using the 1/64 receipts factor. Compliance explained its conclusion in an April 23, 2019, email to Taxpayer:

- The income should be attributed to the state or territory where the customer's headquarters is.
    - The "customer" in this situation is those who [Taxpayer] is providing legal services for obtaining patents to.

[2] 1/64th of Taxpayer's 2017 gross receipts of $. . . is $. . . . 1/64th of Taxpayer's 2018 gross receipts of $. . . is $. . . .

    - The income should not be attributed to where [Taxpayer]'s customers have the right to use intellectual property as a result of [Taxpayer]'s legal services.
    - [Taxpayer]'s patent acquisition services relate to its customers' general corporate or legal functions. Therefore, the Department assumes this activity occurs at their headquarters.
- [Taxpayer]'s method of attributing the receipts is not authorized since it appears that [Taxpayer]'s legal services do not relate to the market of their customer.
    - The Department presumes that these legal functions are carried on at the clients' headquarters rather than in each of the 64 states and territories suggested by the taxpayer.
    - Proportionally attributing the receipts equally between each of the 64 states/territories/possessions appears to be distortive.

In that same April 23, 2019, email, Compliance requested that Taxpayer provide updated sales data through March 31, 2019, based on this apportionment of income to the headquarters of each customer. On May 10, Compliance and Taxpayer had a phone conference to discuss the conclusions set out in the April 23, 2019, email.

On May 13, 2019, Compliance sent Taxpayer an email about the possibility of requesting a letter ruling regarding the proper method of apportionment. The email read in relevant part:

> We have come to the conclusion that the best route to take may be to have you submit a ruling request. This would be a formal written request from you regarding [Taxpayer]'s activity and suggested apportionment that will be reviewed internally. After this is reviewed you will receive a written letter ruling response that summarizes the Department's determination based on the information you have provided. You generally receive this response within 10 days of submitting it. I know you wanted to expedite this process for the sake of your client's time, and this is likely the most time-conscious route to take. Please include a detailed explanation of [Taxpayer]'s activities, your suggested apportionment method along with any new information the Department may not have. I have attached a link below where you can submit this ruling.

On May 16, 2019, Taxpayer informed Compliance that it planned to prepare a request for a letter ruling.

Taxpayer submitted a request for ruling dated June 18, 2019 (the "Request"). In the Request, Taxpayer asks the Department to rule that Taxpayer's proposed method to attribute 1/64th of its income to Washington based on the number of states, territories, and U.S. possessions, was a reasonable apportionment method. In the ruling request, Taxpayer asserts that patents are issued on a country-by-country basis and that it only obtains United States patents for its clients. Taxpayer describes obtaining a United States patent as a years-long endeavor.

Taxpayer describes three examples of patents that it obtained for its largest client during the Audit Period. The first example patent relates to . . . , the second relates to . . . , and the third relates to . . . .[3]

In the Request, Taxpayer acknowledges that its business activity is that of providing legal services and is taxable under RCW 82.04.290, the service and other activities business and occupation ("B&O") tax classification. Taxpayer further acknowledges that those activities are "apportionable activities" from which Taxpayer earned "apportionable income" under RCW 82.04.460(4)(a).

Then, in the Request, Taxpayer contends that the purpose of a United States patent is to provide the holder an advantage throughout the United States, and its possessions and territories, by guarding against others infringing upon the patent holder's rights. Based thereupon, Taxpayer maintains that its clients receive the benefit of its patent procurement services equally in each of the states, territories, and possessions in which it is enforceable. Taxpayer asserts, therefore, that its gross receipts are properly apportioned equally across the 64 United States, territories, and possessions under RCW 82.04.462(3)(b)(i) and WAC 458-20-19402 ("Rule 19402") (301)(a)(i).

Taxpayer goes on to assert that Example 16 in Rule 19402 is analogous to the circumstances at issue in this matter. Example 16 reads:

> Manufacturer hires Law Firm to defend Manufacturer in a class action product liability lawsuit involving Manufacturer's Widgets. The benefit of Law Firm's services relates to Manufacturer's widget selling activity in various states. A reasonable method of proportionally attributing receipts in this case would be to attribute the receipts to the locations where the Manufacturer's Widgets were delivered, which relates to Manufacturer's business activities.

Rule 19402(304)(c).

Then, Taxpayer uses Example 16 to assert that, like in the example, the apportionment of its receipts from its patent procurement activities should be determined by the location of its customer's related business activity. Taxpayer contends that if the law firm in Example 16 can source its legal fees to the location where the client is selling its products, the Taxpayer could reasonably do the same. Taxpayer asserts that its legal services are related to its customers' selling activity. Taxpayer asserts this is so because the patents it is hired to obtain relate to either: (a) an enhancement of existing products sold to customers throughout the United States, US possessions and territories; or (b) to new or prospective products. In either scenario, Taxpayer contends that the patents provide the holder a defensive strategy to protect the market for those products from competitors. Taxpayer asserts that, because those protections are enforceable in each state, possession and territory, the legal fees to obtain patent rights can reasonably be attributed proportionally throughout the United States, US possessions, and territories. Taxpayer maintains that this is true even if the patent holder has no sale of a corresponding product in a particular state, possession, or territory because the client still receives a benefit from patent protection in that location.

[3] These example patents were all obtained for the same client. It is unclear how many total patents Taxpayer worked on obtaining for its clients during the Audit Period.

Taxpayer further asserts in the Request that the market for its clients' products would also be a reasonable method to apportion Taxpayer's gross receipts, but states that Taxpayer does not have accurate information regarding where its customers sell their products.

On July 10, 2019, Compliance sent Taxpayer an email regarding the Request. The email reads in relevant part:

> I have reviewed this request with the Department's Taxpayer Services division. This division came to the conclusion that I would continue to work the case and be the contact regarding this. As I mentioned previously, the Department has reviewed your request. The Department has come to the conclusion [Taxpayer]'s income should be attributed based on the address of the headquarters for the company they are providing services for. Based on the sales data information you have provided, it appears that [Taxpayer] has economic nexus and a requirement to register in Washington.

Compliance also stated in the July 10, 2019, email that the Department would audit Taxpayer for the period of January 1, 2017 (or the date Taxpayer formed in 2017), through June 30, 2019 (the "Audit Period"). Compliance requested Taxpayer to register with the Department and to provide updated sales data for the Audit Period. Compliance further discussed the position it stated in the July 10, 2019, email with Taxpayer during a phone conference on July 19, 2019. The Department did not issue a letter ruling in response to the Request.

On July 22, 2019, Compliance sent Taxpayer an email stating that the Department would be moving forward with an excise tax assessment against Taxpayer for the Audit Period and again requesting updated sales data for the Audit Period. Taxpayer provided the requested data on August 14, 2019. Apportioning Taxpayer's gross receipts based upon the location of each customer's headquarters, Compliance found that Taxpayer's income attributable to Washington during the Audit period was $. . . in 2017, $. . . in 2018, and $. . . in 2019.

On December 3, 2019, the Department issued an excise assessment against Taxpayer for the Audit Period (the "Assessment"). The Assessment is in the amount of $. . . and comprises service and other activities B&O tax of $. . . , interest of $. . . , twenty-nine percent delinquent payment penalties of $. . . , a five percent unregistered business penalty of $. . . , and a five percent substantial underpayment penalty of $. . . . Compliance found that Taxpayer should have been reporting its taxes quarterly during the Audit Period and stated the tax due and the delinquent payment penalties on a quarterly basis in the Assessment.

Taxpayer timely filed a petition (the "Petition") for administrative review of the Assessment. In the Petition, Taxpayer asserts that it does not have substantial nexus with Washington. In support of this assertion, Taxpayer attached the Request to the Petition. Taxpayer additionally requests waiver of penalties and interest. Taxpayer asserts that the Department unfairly caused two delays in this matter. Taxpayer asserts that first delay occurred from February 2019 through July 2019 in its explanation of its position regarding the apportionment of Taxpayer's gross receipts. Taxpayer asserts the second delay occurred from August 2019 through December 2019 in issuing the Assessment. Taxpayer asserts that these delays resulted in additional penalties being assessed

against Taxpayer for the first and second quarters of 2019. Taxpayer maintains that such delays were circumstances beyond its control and were made solely for the convenience of the Department.

Taxpayer also objects to Compliance's May 13, 2019, email suggesting that Taxpayer submit a request for a letter ruling in light of the fact that the Department never issued a letter ruling in response to the Request. Taxpayer contends that it was misled by Compliance's suggestion and incurred significant expense in the preparation of the Request that was ultimately for naught.

On September 1, 2020, a hearing was held via teleconference. During the hearing, Taxpayer asserted that the core of the service it provides its customers is its relationships with the USPTO that facilitate its procurement of patents. Taxpayer also maintained that the value of protection a patent holder receives in a US territory like Guam is equal to that it receives in states like California, New York, or Washington. Taxpayer asserted that its proposed apportionment method to attribute 1/64th of its income to Washington based on the number of states, territories and U.S. possessions is the most uniform, consistent, and accurate method Taxpayer could think of. Taxpayer contended that such method is not distortive of the market for Taxpayer's services.

During the hearing, Taxpayer frequently used as an example its largest client, a . . . company headquarter in . . . , Washington. Taxpayer stated that legal services are provided to the customer's headquarters.

ANALYSIS

In Washington, "there is levied and collected from every person that has a substantial nexus with this state a tax for the act or privilege of engaging in business activities." RCW 82.04.220. This is the B&O tax. The B&O tax measure is "the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be." *Id.* The rate used is determined by the type of activity in which a taxpayer engages. *See generally* Chapter 82.04 RCW. Income from any business activity that is not explicitly taxed in Chapter 82.04 RCW is taxed under the Service and Other Activities B&O tax classification. RCW 82.04.290(2). There is no dispute that legal services, such as those performed by Taxpayer, are subject to service and other activities B&O tax.

Whether Taxpayer has Substantial Nexus with Washington:

A state cannot tax business activity that does not have sufficient connection or "nexus" with the state. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 97 S. Ct. 1076 (1977); *Tyler Pipe Indus., Inc. v. Dep't of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987); *Quill Corp. v. North Dakota*, 504 U.S. 298, 112 S.Ct. 1904 (1992); Det. No. 05-0376, 26 WTD 40 (2007). The concept of "nexus" flows from limits on a state's jurisdiction to tax imposed by the Due Process and Commerce Clause provisions of the United States Constitution. Det. No. 01-188, 21 WTD 289 (2002); *see also* RCW 82.04.4286. The U.S. Supreme Court has held that the Commerce Clause requires that the transaction being taxed has "substantial nexus" with the taxing state. *Complete Auto Transit, Inc.*, 430 U.S. at 279.

RCW 82.04.067 sets out substantial nexus standards consistent with the Due Process Clause and Commerce Clause of the United States Constitution. It states that if a person engaging in business is a nonresident that is organized or commercially domiciled outside of this state, and meets certain gross receipts thresholds, it is deemed to have taxable nexus. RCW 82.04.067(1)(c). During the Audit Period, the Department was required to make adjustments to the gross receipts threshold each December, based on the consumer price index. *See* Former. RCW 82.04.067(5)(a) (2010); Laws of 2010, ch. 23, § 104.[4] Rule 19401(3)(d) explains that the Department will publish these changes to the nexus threshold amounts in Excise Tax Advisory ("ETA") 3195.2020.[5] Relevant here, for calendar year 2017, nonresident entities who earned more than $267,000 in gross receipts from Washington per year, were deemed to establish substantial nexus with Washington. *See* Former. RCW 82.04.067(1)(c)(iii) (2017); ETA 3195.2020. The figure was increased to $285,000 for the calendar years of 2018 and 2019. *See* Former. RCW 82.04.067(1)(c)(iii) (2018 and 2019); ETA 3195.2020.

RCW 82.04.460 addresses the taxation of apportionable income. Apportionable income refers to income a person earns from an apportionable activity that is taxable in Washington and in at least one other state. RCW 82.04.460(1), (4)(a). RCW 82.04.460(4)(a) and Rule 19401(2)(a) set out a list of activities which constitute "apportionable activities." Here, it is undisputed that Taxpayer's legal services are an apportionable activity. For the purpose of computing a person's Washington tax liability from apportionable income, RCW 82.04.460(1) requires that the person must "apportion to this state, in accordance with RCW 82.04.462, that portion of the person's apportionable income derived from business activities performed within this state."

To determine taxable income in such cases, a taxpayer's total apportionable income is multiplied by a fraction referred to as the "receipts factor." RCW 82.04.462(3)(a). "The numerator of the receipts factor is the total gross income of the business of the taxpayer attributable to this state during the tax year from engaging in an apportionable activity." RCW 82.04.462(3)(a). The denominator is the total, worldwide, gross income of the business of the taxpayer from engaging in apportionable activity, minus any "throw-out income." *See id.*; Rule 19402(402). In essence, the receipts factor becomes the percentage by which a taxpayer's gross income is multiplied to derive the portion of that taxpayer's total gross income that is taxable in Washington.

Here, Taxpayer had apportionable income from providing legal services. Compliance calculated and applied a receipts factor to Taxpayer's worldwide apportionable income (less throw-out income) to calculate Taxpayer's Washington gross receipts. Then, Compliance determined that Taxpayer had established substantial nexus with Washington because the gross receipts apportioned to Washington exceeded the gross receipts threshold in RCW 82.04.067. Taxpayer disputes that it established substantial nexus with Washington and, therefore, contends that it is generally not subject to B&O tax in Washington. More specifically, Taxpayer disputes Compliance's calculation of Taxpayer's gross income attributable to Washington, the numerator of the receipts factor. Taxpayer asserts that, when its gross income is properly attributed to Washington and the receipts factor is corrected, the gross receipts apportioned to Washington under RCW 82.04.462 and Rule 19402 will be less than the thresholds set forth in RCW 82.04.067 and Rule 19401.

[4] This requirement was removed, effective January 1, 2020. Laws of 2019, ch. 8, § 102.
[5] Excise Tax Advisories are interpretive statements authorized by RCW 34.05.230.

Attributing gross income is governed by RCW 82.04.462(3)(b). It provides a series of cascading steps for attributing apportionable income to Washington and reads, in pertinent part, as follows:

> [F]or purposes of computing the receipts factor, gross income of the business generated from each apportionable activity is attributable to the state:
>
> (i) **Where the customer received the benefit of the taxpayer's service** or, in the case of gross income from royalties, where the customer used the taxpayer's intangible property.
>
> (ii) If the customer received the benefit of the service or used the intangible property in more than one state, gross income of the business must be attributed to the state in which the benefit of the service was primarily received or in which the intangible property was primarily used.
>
> . . .

(Emphasis added.)

In sum, if a taxpayer can reasonably determine the amount of a specific apportionable receipt that relates to a specific benefit of the service received in a state, the apportionable receipt is attributable to the state in which the benefit is received. Rule 19402(301). However, if the location of where the benefit of the service is received cannot be determined, use of this method is not appropriate. In such cases, the taxpayer should look to the other methods described in RCW 82.04.462(3)(b)(iii) – (vii), in descending order. *See* Det. No. 13-0319, 34 WTD 452 (2015).

Rule 19402 is the Department's administrative rule that applies RCW 82.04.462. Rule 19402(301) further explains how to attribute apportionable receipts:

> . . . Receipts are attributed to states based on a cascading method or series of steps. **The department expects that most taxpayers will attribute apportionable receipts based on (a)(i) of this subsection** because the department believes that either the taxpayer will know where the benefit is actually received, or a "reasonable method of proportionally attributing receipts" will generally be available. These steps are:
>
> (a) Where the customer received the benefit of the taxpayer's service . . . ;
>
> (b) If the taxpayer is unable to attribute an apportionable receipt under (a) of this subsection, the apportionable receipt must be attributed to the state from which the customer ordered the service.
>
> . . .
>
> (g) The taxpayer may not use an attribution method that distorts the apportionment of the taxpayer's apportionable receipts.

(Emphasis added.)

Here, both Taxpayer and Compliance agreed that Taxpayer's apportionable receipts should be attributed to the location where Taxpayer's customers received the benefit of Taxpayer's services under Rule 19402(301)(a). Taxpayer's service is obtaining US patents for its customers. Those customers are businesses and individuals who are seeking to use patents to protect the market for new or existing products. Taxpayer and Compliance differ on the location of where Taxpayer's customers receive the benefit of Taxpayer's services.

Taxpayer asserts that Taxpayer's customers received the benefit of Taxpayer's services throughout the United States, territories, and possessions, because the patents are enforceable in each state, territory, and possession. Taxpayer asserts that such receipts from patent procurement activities should be equally attributed to each state, territory, and possession, and, because there are 64 total states, territories, and possessions, 1/64 of Taxpayer's apportionable gross receipts should be attributed to Washington.

Compliance concluded that Taxpayer's customers received the benefit of Taxpayer's services at each customer's headquarters, because the patents relate to general corporate or legal business activities. Based on the information provided, Compliance was not persuaded that apportioning Taxpayer's gross receipts equally across 64 states and territories was reasonable, because Taxpayer had not shown that each of its customers sold products protected by the patents in all 64 of the states and territories. Compliance was further concerned by the equal weighting of each state and territory without regard to actual market. Taxpayer was given an opportunity to provide more detailed information and did not. In the absence of such information, Compliance concluded that Taxpayer's patent acquisition services relate to its customers' general corporate or legal activities. Compliance and Taxpayer agree that customers' general corporate or legal activities occur at each customer's headquarters. Therefore, Compliance concluded that under Rule 19402(303)(c), the customers receive the benefit of Taxpayer's services at their headquarters.

The "benefit of the taxpayer's service" is not defined in statute. Rule 19402(303), however, defines that term in a variety of ways, depending on the factual circumstances. Such circumstances include whether the taxpayer's service relates to real or tangible personal property and whether the taxpayer provides its service to customers engaged in business. There is no dispute that Taxpayer's patent acquisition service does not relate to real or tangible personal property and that Taxpayer provides its service to customers engaged in business. Relevant here, Rule 19402(303) reads:

> (c) If the Taxpayer's service does not relate to real or tangible personal property, the service is provided to a customer engaged in business, and the service relates to the customer's business activities, then the benefit is received where the customer's related business activities occur. The following is a nonexclusive list of business-related services:
>
> (i) Developing a business management plan;
> (ii) Commission sales (other than sales of real or tangible personal property);
> (iii) Debt collection services;

(iv) Legal and accounting services not specific to real or tangible personal property;
(v) Advertising services; and
(vi) Theater presentations

Rule 19402(303).

Taxpayer's legal services relate to patents, a form of intellectual property, which is intangible property. RCW 82.04.2907; *see also* Det. No. 99-063, 24 WTD 1 (2005) (generally, intangible rights include patents). As such, Taxpayer's customers receive the benefit of Taxpayer's procurement services where customers' related business activity occurs.

Here, Taxpayer's patent acquisition services relate to its customers' strategic planning business activity. Business entities and individuals pursue patents because they want to hold the exclusive right to exclude others from making, using, importing, and selling the patented innovation for a limited period of time. *See* the U.S. Patent Act, 35 U.S.C. §§ 1 *et seq*. Taxpayer describes obtaining a United States patent as a years-long endeavor aimed at defending the market for existing or future products from competitors. The process of obtaining a patent is time-intensive and costly. The choice to initiate such a process requires broad strategic decisions from management and corporate legal counsel. We find that the customers' related business activity for the purpose of determining where the benefit of Taxpayer's service is received under Rule 19402(303)(c) is strategic planning and general corporate management.

Taxpayer contends in the Request that its legal services are related to selling activity because the patents Taxpayer is hired to obtain relate to either: (a) an enhancement of existing products sold to customers throughout the United States and its possessions and territories; or (b) to newly invented or prospective products. Taxpayer asserts that the purpose of obtaining a patent is to protect the market for such existing or prospective products from competition. Taxpayer maintains that, because a patent allows the holder to protect the market for a given product by enforcing the patent against competitors, Taxpayer's patent acquisition service relates to the customer's selling activity. We disagree.

While patents do allow the holder to protect the market for its sale of a product that incorporates the patented invention, such protection requires litigation to enforce the patent. Taxpayer does not litigate to enforce patents, but only acquires patents for its customers. Taxpayer's services are detached from its customer's selling activity, if any. Rather, Taxpayer's services relate to its customers' more general strategic planning and corporate management.

Taxpayer cites to Example 16 from Rule 19402 for the proposition that its services are related to its customers' selling activity. That example describes a law firm that provides litigation services to a manufacturer to defend against a product liability lawsuit involving the manufacturer's products. Rule 19402(304)(c). Example 16 goes on to state that the law firm's services relate to the manufacturer's selling activity. *Id*. Taxpayer asserts Example 16 in Rule 19402 is analogous to the circumstances at issue in this matter. However, Taxpayer's legal services are distinct from those described in Example 16. Example 16 describes litigation involving products that have already been sold. Again, Taxpayer does not litigate to enforce patents. Also, Taxpayer does not

assert that the patents it obtained for its clients during the Audit Period have been enforced, only that they can be. Further, Taxpayer states that it does not have accurate information regarding its customers' sales of their products. Taxpayer also does not assert that all of its customers engage in sales of products involving the inventions for which Taxpayer obtained patents. Accordingly, we find that Example 16 is not analogous to the facts at issue.

Having determined that Taxpayer's services relate to its customers' related business activity of strategic planning and corporate management, we must now determine the location of such business activities. We presume that the decisions to order Taxpayer's patent procurement services were made by each customer's managers or corporate legal counsel. Because such personnel are integral to the management of a business, we also presume that each customer's managers, along with any corporate legal counsel, work from that customer's headquarters. Using its largest customer as an example, Taxpayer stated during the hearing that its legal services are provided to the customer's headquarters. This statement is consistent with Taxpayer's other statements about its patent procurement services. These decision-making personnel work at the customer's corporate headquarters. Here, we find that the customers' related business activities occur at those customers' respective headquarters and, therefore, determine that Compliance correctly concluded that Taxpayer's receipts from its patent procurement activity are properly apportioned to the location of each customer's headquarters under RCW 82.04.462(3)(b)(i), Rule 19402(301)(a)(i), and Rule 19402(303)(c).

We further find that Compliance properly apportioned Taxpayer's income to Washington during the Audit period of $. . . in 2017, $. . . in 2018, and $. . . in 2019. Taxpayer established substantial nexus based upon economic presence with Washington for those years under RCW 82.04.067 and Rule 19401.

Penalty Waiver

There are three different types of penalties at issue in this matter: an unregistered business penalty, a substantial underpayment penalty, and delinquent payment penalties. Taxpayer does not challenge the validity of the penalties, but only requests that they be waived.

RCW 82.32.090(4) imposes a five percent penalty on the tax due for any period of time where a person engages in a taxable activity and does not voluntarily register prior to being contacted by the Department. Here, Compliance assessed an unregistered business penalty on the total amount of tax it found due in the Assessment against Taxpayer because it found that Taxpayer had a substantial nexus with Washington during the Audit Period, but was not registered with the Department.

RCW 82.32.090(2) imposes the substantial underpayment penalty. It reads as follows:

> If the department of revenue determines that any tax has been substantially underpaid, there is assessed a penalty of five percent of the amount of the tax determined by the department to be due. [. . .] As used in this section, "substantially underpaid" means that the taxpayer has paid less than eighty percent of the amount of tax determined by the department to be due for all of the types of taxes included

> in, and for the entire period of time covered by, the department's examination, and the amount of underpayment is at least one thousand dollars.

RCW 82.32.090(2). Here, Compliance assessed a five percent substantial underpayment on the total amount of tax it found due in the Assessment because Taxpayer had not paid any of it.

RCW 82.32.090(1) imposes a delinquent payment penalty based upon the time at which a particular tax comes due. It reads:

> If payment of any tax due on a return to be filed by a taxpayer is not received by the department of revenue by the due date, there is assessed a penalty of nine percent of the amount of the tax; and if the tax is not received on or before the last day of the month following the due date, there is assessed a total penalty of nineteen percent of the amount of the tax under this subsection; and if the tax is not received on or before the last day of the second month following the due date, there is assessed a total penalty of twenty-nine percent of the amount of the tax under this subsection. No penalty so added may be less than five dollars.

RCW 82.32.090(1). Here, Compliance imposed twenty-nine percent delinquent payment penalties for each calendar quarter in 2017 and 2018, and for the first two calendar quarters of 2019, because Taxpayer had not paid its tax liability for these periods within two months of that liability coming due.

The Department has limited authority to waive or cancel penalties. RCW 82.32.105. The Department must waive the unregistered business penalty, substantial underpayment penalty, or delinquent payment penalties, if it finds that the underlying act giving rise to the penalty was the result of "circumstances beyond the control of the taxpayer."[6] RCW 82.32.105(1); WAC 458-20-228 (Rule 228); *see* Det. No. 16-0324, 36 WTD 135 (2017).

Rule 228 is the Department's administrative rule that implements RCW 82.32.105. Rule 228 explains that "[c]ircumstances beyond the control of the taxpayer are generally those which are immediate, unexpected, or in the nature of an emergency. Such circumstances result in the taxpayer not having reasonable time or opportunity to obtain an extension of the due date or otherwise timely file and pay." Rule 228(9)(a)(ii).

Rule 228(9)(a)(ii) sets out a non-exhaustive list of circumstances that are generally considered to be circumstances beyond the control of a taxpayer for the purpose of waiving taxes. One item on

[6] In the case of only the delinquent payment penalty, under RCW 82.32.090(1), the Department may waive the penalty based on good reporting and payment history, if the taxpayer has timely made all payments for the twenty-four months preceding the period for which the waiver is requested. RCW 82.32.105(2). However, RCW 82.32.105(2) is not applicable here because Taxpayer was unregistered and did not file or pay any taxes during the twenty-four months immediately preceding the Audit Period. WAC 458-20-228 ("Rule 228") explains that a Taxpayer may still be eligible for waiver under RCW 82.32.105(2) when it hasn't made timely payments for the preceding twenty-four months only if the taxpayer became registered with the Department prior to engaging in business activities in Washington for a period of less than twenty-four months. Rule 228(9)(b)(i). Here, Taxpayer did not register with the Department prior to engaging in business activities in Washington and is, therefore, not eligible for waiver of any of the delinquent payment penalties under RCW 82.32.105(2).

that list explains that circumstances beyond the control of the taxpayer include scenarios where a delinquent payment is caused by erroneous written information given to the taxpayer by a department officer or employee. Rule 228(9)(a)(ii)(B).

Conversely, Rule 228(9)(a)(iii) lists several circumstances that are generally not considered circumstances beyond the control of a taxpayer for the purpose of waiving taxes. Relevant here, a Taxpayer's misunderstanding or lack of knowledge are not circumstances beyond the taxpayer's control. Rule 228(9)(a)(iii)(B); *see also* Det. No. 01-096, 22 WTD 126 (2003) (lack of knowledge "is not a 'circumstance beyond the control of the taxpayer' because the law, regulations, and Department publications explaining all tax laws are publicly available not only to taxpayers, but to the tax professionals who support them."); Det. No. 18-0052, 37 WTD 108, 110 (2018) (a taxpayer's hired consultant's lack of knowledge that an activity gives rise to tax liability does not constitute a circumstance beyond a taxpayer's control). Further, a taxpayer acting in good faith and without intent to defraud Washington is not a circumstance beyond the control of a taxpayer for the purpose of waiving penalties. Det. No. 15-0151, 35 WTD 182, 190-1 (2016).

Here, Taxpayer requests a waiver of penalties on the basis that the Department unfairly caused two delays in this matter. First, Taxpayer asserts that the Department delayed from February 2019 through July 2019 before it explained its position regarding the apportionment of Taxpayer's gross receipts, including time Taxpayer spent preparing the Request at the Department's written suggestion for a letter ruling that the Department never issued. Second, Taxpayer contends that the Department delayed from August 2019 through December 2019, in issuing the Assessment. Taxpayer maintains that such delays were circumstances beyond its control and were made solely for the convenience of the Department. We address first the unregistered business penalty and substantial underpayment penalty.

Taxpayer has not shown that a circumstance beyond its control caused its failure to register or its substantial underpayment of its tax liability. Taxpayer requests waiver based upon asserted delays by the Department between February 2019 and December 2019. However, no such delay could have caused Taxpayer to fail to register prior to establishing substantial nexus with the Department in 2017 or to substantially underpay its tax liability over the entire Audit Period. Rather, Taxpayer's failure to register and substantial underpayment were caused by Taxpayer's misunderstood belief that it was not subject to taxation in this state. Such a misunderstanding or lack of knowledge is explicitly excluded from circumstances beyond the control of a taxpayer under Rule 228. Rule 228(9)(a)(iii)(B). Thus, Taxpayer has not shown that circumstances beyond its control caused its failure to register with the Department or substantial underpayment of taxes and we lack the authority to waive those penalties under RCW 82.32.105(1). We next address the delinquent payment penalties.

Delinquent payment penalties differ from the unregistered business and substantial underpayment penalties in that they are specific to the due date for the reporting period in which the tax came due. Unlike the unregistered business and substantial underpayment penalties, which are assessed against the total tax liability due in the Assessment, the delinquent payment penalties are assessed against Taxpayer's individual quarterly tax reporting periods during the Audit Period. Therefore, we consider Taxpayer's request for waiver of the delinquent payment penalties on a quarter-by-quarter basis. For taxpayers who report their tax liability quarterly, "tax payments are due on or

before the last day of the month next succeeding the end of the period covered by the return." RCW 82.32.045(2).

Again, Taxpayer requests waiver based upon asserted delays by the Department between February 2019 and December 2019. Such delay could not have caused Taxpayer's delinquent payment for the eight calendar quarters in 2017 and 2018, as the payment for the last of those quarters, quarter four of 2018, became due on January 31, 2019. Taxpayer did not provide any of its sales data to Compliance until February 2019.

The only two calendar quarters contained in the Audit Period for which Taxpayer could possibly show that a circumstance beyond its control caused its delinquent payment are quarters one and two of 2019, which had respective due dates for Taxpayer to pay its tax liability of April 30, 2019, and July 31, 2019. *See* RCW 82.32.045(2). For each of those two quarters, Compliance assessed a nine percent delinquent payment penalty when Taxpayer did not pay by the due date, then increased the penalty by ten percent for each of the two following months that Taxpayer did not pay.

Here, Compliance informed Taxpayer in an email on April 23, 2019, of its position that Taxpayer should attribute its gross receipts to the headquarters of each customer. Yet, on May 13, 2019, Compliance stated in an email to Taxpayer that it had "come to the conclusion that the best route to take may be to have you submit a ruling request" regarding Taxpayer's proposed apportionment method. Taxpayer submitted the Request on June 18, 2019. Compliance informed Taxpayer on July 10, 2019, that the Department would not issue a ruling and on July 22, 2019, and that it would move forward with issuing an assessment for the Audit Period. Taxpayer provided additional sales data for 2019, on August 14, 2019, and the Department did not issue the Assessment until December 3, 2019.

Regarding the delinquent payment penalty assessed for quarter one of 2019, we find that Taxpayer has not shown a circumstance beyond its control for its failure to pay by the initial due date of April 30, 2019. The May 13, 2019, email could not have caused Taxpayer's initial delinquent payment because it was sent after the April 30, 2019, due date. However, we find that the May 13, 2019, email represents erroneous written information given to the taxpayer by a department officer or employee, which constitutes a circumstance beyond Taxpayer's control under Rule 228(9)(a)(ii)(B), as pertaining to each of the ten percent increases to the penalty for Taxpayer's failure to pay for each of the two subsequent months. We remand this matter to Compliance to adjust the Assessment consistent with this finding.

Regarding the delinquent payment penalty assessed for quarter two of 2019, we find that Taxpayer has not shown a circumstance beyond its control for its failure to pay timely. Taxpayer knew on July 10, 2019, that the Department would not issue a ruling, and on July 22, 2019, that the Department would move forward with issuing an assessment for the Audit Period. Taxpayer's tax liability for quarter 2 of 2019, was due July 31, 2019. The May 13, 2019, email could not have caused Taxpayer's delinquent payment for this quarter because the Taxpayer knew before the due date that the Department would not issue a ruling and would be moving forward with issuing an assessment.

Interest Waiver

RCW 82.32A.020(2) and RCW 82.32.105 provide the only statutory authority to cancel interest. *See* Det. No. 16-0039, 35 WTD 301 (2016). RCW 82.32A.020(2) provides taxpayers with:

> The right to rely on specific, official written advice and written tax reporting instructions from the department of revenue to that taxpayer, and to have interest, penalties, and in some instances, tax deficiency assessments waived where the taxpayer has so relied to their proven detriment;

. . . Here, Taxpayer has not shown that it was given [specific, official] written instruction to not report tax. Accordingly, RCW 82.32A.020(2) does not apply. *Id.*

Under RCW 82.32.105, the Department is required to waive interest it has assessed against a taxpayer if either of two circumstances is present:

> (a) The failure to timely pay the tax was the direct result of written instructions given the taxpayer by the department; or (b) The extension of a due date for payment of an assessment of deficiency was not at the request of the taxpayer and was for the sole convenience of the department.

RCW 82.32.105(3).

Here, Compliance's May 13, 2019, email instructed Taxpayer to submit a ruling request, which Taxpayer did submit on June 18, 2019. On July 10, 2019, Compliance informed Taxpayer that the Department would not issue a ruling. We find that Taxpayer's failure to pay its tax liability for quarter one of 2019 between the dates of May 13, 2019, and July 10, 2019, was the direct result of the Compliance's written instructions in the May 13, 2019, email. Accordingly, under RCW 82.32.105(3)(a), we find that the Department is required to waive the interest it assessed against Taxpayer beginning on May 13, 2019, and ending on July 10, 2019. We remand this matter to Compliance to adjust the Assessment consistent with this finding.

DECISION AND DISPOSITION

Taxpayer's petition is granted with respect to our findings that: (1) a portion of Taxpayer's delinquent payment for the quarter one 2019 reporting period were caused by a circumstance beyond its control within the meaning of RCW 82.32.105(1); and (2) the Department is required to waive the interest it assessed against Taxpayer beginning on May 13, 2019, and ending on July 10, 2019; it is denied with respect to the remaining tax, penalties and interest due.

Dated this 24th day of February 2021.