

SPECIAL NOTICE

December 21, 2005

For further information contact:

Telephone Information Center
1-800-647-7706 or (360) 705-6676

Alternate Formats (360) 705-6715
Teletype 1-800-451-7985

Apportionment - Approved Methods

Note: The tax treatment in this Special Notice only applies to tax periods prior to June 1, 2010. For tax periods after May 31, 2010, taxpayers should see the Department's Special Notice titled *New Apportionment Method* dated May 28, 2010.

The Department of Revenue revised WAC 458-20-194 **effective January 1, 2006** to prescribe methods for apportionment of income taxable under the service and other activities B&O tax classification. This Special Notice provides instructions on:

- ◆ who must use separate accounting, and
- ◆ who can use the new cost method to apportion this income.

Licensed boarding homes and international investment management businesses also use the apportionment methods discussed here. Where this Special Notice addresses apportionment of income taxable under the service B&O tax classification, it also applies to the apportionment of income of licensed boarding homes and international investment management businesses.

NOTE: The apportionment methods prescribed under WAC 458-20-194 **do not apply** to financial institutions required to apportion income under WAC 458-20-14601.

When apportionment is required

You must apportion income taxable under the service and other activities classification of the business and occupation (B&O) tax if you generate such income from services performed both within and outside of Washington.

A separate accounting method must be used if you have records that provide an accurate reflection of the gross income from Washington activities. However, where it is not practical for you to apportion by separate accounting or the separate accounting is not accurate, a cost basis method of apportionment must be used.

Separate accounting methods

"Separate accounting" refers to a method of accounting that accurately segregates and identifies sources or activities that generate income within the state of Washington.

Separate accounting:

- ◆ Must be used when you have records that allow for the segregation of in-state activities and the income generated from those activities.
- ◆ Links taxable income to activities occurring in a particular state.

- ◆ Is distinct from cost apportionment, which assigns a portion of worldwide income to Washington, based on a ratio or formula.

Approved methods of separate accounting

Billable Hours

Billable hours may be used to apportion income when a business charges clients an hourly rate for services performed. The place the services are performed by the employee, contractor, or other individual whose time is billed, must be reasonably ascertainable. You must report the gross amount received from hours billed for services performed in Washington.

Specific Projects or Contracts

A business may assign revenue from specific projects or contracts, in or out of Washington, by the primary place of performance.

For example, a consulting business with no other presence in Washington agrees to provide on-site management consulting services for a Washington business, and receives \$500,000 in payment for the project. The consulting business must report \$500,000 in gross income to Washington.

Accuracy

A separate accounting method is accurate only if the activities that significantly contribute to income production can be geographically identified and segregated. For example, if a Washington-based investment advisor provides advice to only Washington clients, but performs the due diligence and research that is both necessary and required of investment advisors in another state, separate accounting cannot be used. But if the only out-of-state activities are billing clients and maintenance of business records, then separate accounting would be accurate.

Cost apportionment method

Cost-based apportionment method assigns a portion of worldwide service income to Washington based on a ratio or formula. Cost apportionment is allowed where you do not have records that allow for separate accounting of Washington income or separate accounting is not accurate.

The cost ratio is the cost of doing business in Washington divided by the total cost of doing business worldwide.

The cost ratio is calculated as follows:

- ◆ The numerator is all costs specifically assigned to Washington, plus all costs assigned to Washington (WA) by formula (see section "Costs Assigned by Formula" on page 4).
- ◆ The denominator is the worldwide costs of the activity to be apportioned for the tax period.
- ◆ The cost ratio is based on costs for the most recent full fiscal year for which information is available, unless there is a significant change in business activities.

$$\text{Cost Ratio} = \frac{\text{Specifically Assigned WA Costs} + \text{WA Costs Assigned by Formula}}{\text{Worldwide Costs}}$$

The income attributable to Washington is the total income times the cost ratio.

$$\text{WA Income} = \text{Total Income} \times \text{Cost Ratio}$$

Excluded expenditures

The following are examples of expenditures that are not included in the cost ratio:

- ◆ Costs exclusively related to non-service activities (retailing, wholesaling, manufacturing costs);
- ◆ Expenditures that exchange one business asset for another;
- ◆ Expenditures that reflect a revaluation of an asset not consumed in the course of business;
- ◆ Expenditures for federal, state, or local taxes measured by gross or net business income;
- ◆ Expenditures for acquiring a business by merger or otherwise, including financing costs.
- ◆ The cost of acquiring assets that are not depreciated or amortized, such as land and investments;
- ◆ Losses on the sale of non-depreciable assets.

Specifically assigned costs

Property costs (for real or personal property), employee costs, and certain payments to third parties are specifically assigned as follows:

Property costs - Real or tangible personal property costs are defined to include:

- ◆ Depreciation per taxpayer's books and records;
- ◆ Maintenance costs for specific property;
- ◆ Insurance costs for specific property;
- ◆ Utility costs for specific property;
- ◆ Lease or rental payments for specific property;
- ◆ Interest costs for specific property;
- ◆ Warranty costs for specific property; and
- ◆ Taxes for specific property.

Real or tangible personal property costs are assigned to the location of the property. An automobile assigned to a traveling employee is assigned to the state to which the employee's compensation is assigned (see next section) or to the state in which the automobile is licensed.

Employee costs

"Compensation" means wages, salaries, commissions, and any other form of remuneration paid or accrued to employees for personal services. Employer contributions under a qualified cash plan, deferred arrangement plan, and nonqualified deferred compensation plan, are considered compensation. Stock-based compensation is considered compensation under this rule to the extent that it is included in gross income for federal income tax purposes.

"Employee" means any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. It does not include corporate officers.

Employee costs include all compensation paid to employees. In addition, employee costs include the employer's share of all employment-based taxes and other fees, such as payments related to unemployment compensation, labor and industries insurance premiums, and the employer's share of Social Security and Medicare taxes. Employee costs are assigned to Washington if you report the employee's wages to Washington for unemployment compensation purposes.

Representative third-party costs

"Representative third party" includes an agent, independent contractor, or other representative **who provides services on behalf of the taxpayer directly to customers.**

Payments to a representative third party are assigned to the third party's place of performance. For example, if a business subcontracts with a representative third party to provide services on its behalf from a California location, the cost is assigned to California. This is true even if the third party provides services to Washington customers. Conversely, the cost of compensating a representative third party who provides services to California customers from a Washington location, is assigned to Washington.

Examples of specifically assigned costs

(1) X, a Washington business, hires you (Taxpayer) to design and write custom software for a document management system. You subcontract with Z, whose employees determine the needs of your client X, negotiate a statement of work, write the custom software, and install the software. Z's employees perform all of these services on-site at the X business location.

Your payments to Z are representative third-party costs specifically assigned to Washington. This is because your representatives (Z) provided services directly to your customer (X) in Washington.

(2) You (Taxpayer) are a service provider, and you subcontract with A, who agrees to maintain a customer service center where staff will answer telephone calls about your services. A then subcontracts with B, whose employees actually respond to questions from a phone center located in California.

Your payments to A are specifically assigned to California. This is because your representatives (A) subcontracted with B to provide direct contact with your customers from a location in California.

Costs assigned by formula

Costs not specifically assigned and not excluded from consideration, per the above discussion, are assigned by formula. These costs are multiplied by the ratio of sales in Washington over sales everywhere.

$$\text{Costs assigned by formula} = \text{Other Costs} \times \frac{\text{Washington Sales}}{\text{Total Sales}}$$

Sales are assigned to where the customer receives the benefit of the service. If the location where the services are received is not easily determined, the services are attributed to the location of the customer's office from which the services were ordered in the regular course of the customer's trade or business. If the ordering office cannot be determined, the services are attributed to the customer's office where the services are billed.

For example, if a business has \$1,000 in "other costs," and sales of \$10,000 in **each** of four states in which it has nexus under Washington standards (including Washington), 25 percent (10,000/40,000), or \$250 of those costs, are assigned to Washington.

Under the method described above, if a sale is attributed to a location where the taxpayer does not have nexus under Washington standards, the sale must be excluded from both the numerator and denominator of the sales ratio. For the purposes of this calculation only, the department will presume a taxpayer has nexus anywhere the taxpayer has employees or real property, or where the taxpayer reports income or business activity taxes in the state. The burden is on the taxpayer to demonstrate nexus exists in other states.

Calculating and reporting Washington income and the apportionment deduction

To determine what portion of your worldwide income is taxable in Washington, you must first determine the cost ratio as follows:

$$\text{Cost Ratio} = \frac{\text{Specifically Assigned WA Costs} + \text{WA Costs Assigned by Formula}}{\text{Worldwide Costs}}$$

Then you multiply the cost ratio times your worldwide service income to determine your Washington income:

$$\text{Washington Service Income} = \text{Cost Ratio} \times \text{Worldwide Service Income}$$

Excise tax return reporting instructions

For purposes of reporting on the excise tax return, under the "service and other B&O tax classification," or other appropriate B&O tax classification as discussed above, do the following:

1. Report **Worldwide Service Income** in Column 1 (Gross Amount),
2. Report the difference between **Worldwide Service Income** and **Washington Service Income** in Column 2 (Deductions). Also report this amount on the deduction detail sheet on deduction code 0404 Interstate & Foreign Sales (Apportionment)
3. Report **Washington Service Income** in Column 3 (Taxable Amount)
4. Multiply the Taxable Amount by 1.5 percent to determine the tax due in Column 5. (Licensed boarding homes and international investment management businesses use the appropriate tax rate for your activity.)

The Department will conduct a series of workshops on the new apportionment methods discussed in this notice. To request a workshop in your area, go to our web site at <http://dor.wa.gov/> and go to "Workshops" near the bottom of the page. Under "Future Tax Workshops," click on "Request a Workshop" and register to request an "Apportionment" workshop in your area. Depending on the number of persons that request a workshop in your area, we will consider setting up a workshop near you. If there is enough interest in your area, we will arrange a time and place for the workshop(s) and will contact those that have signed up by e-mail to inform them of the details.

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