WAC 458-20-19403 Single factor receipts apportionment – Royalties

Part 1: Introduction

101. General. Effective June 1, 2010, Washington changed its method of apportioning royalty receipts. This rule addresses how royalty receipts must be apportioned when a business receives royalty payments from both within and outside the state. This rule is limited to the apportionment of royalty receipts for periods on or after June 1, 2010. This rule does not apply to apportionment or allocation of income from any other business activity.

102. This rule is divided into six parts. Specifically, these parts are:

1. Introduction.
2. General overview.
3. How to attribute royalty receipts.
4. How to calculate the receipts factor.
5. How to determine Washington taxable income.
6. Reporting instructions.

103. Taxpayers may also find helpful information in the following rules:

(a) **WAC 458-20-19401 Minimum nexus thresholds for apportionable activities**. This rule describes minimum nexus thresholds that are effective June 1, 2010.

(b) **WAC 458-20-19402 Single factor receipts apportionment – Generally**. This rule describes the general application of single factor receipts apportionment that is effective June 1, 2010.

(c) **WAC 458-20-19404 Single factor receipts apportionment – Financial institutions**. This rule describes the application of single factor receipts apportionment to certain income of financial institutions that is effective June 1, 2010.

(d) **WAC 458-20-194 Doing business inside and outside the state**. This rule describes separate accounting and cost apportionment and applies only to tax liability incurred from January 1, 2006 through May 31, 2010.

(e) **WAC 458-20-14601 Financial institutions – Income apportionment**. This rule describes the apportionment of income for financial institutions for periods prior to June 1, 2010.

104. Examples. Examples included in this rule identify a number of facts and then state a conclusion; they should be used only as a general guide. The tax results of all situations must be determined after a review of all the facts and circumstances. The examples in this rule, unless otherwise stated, do not apply to tax liability prior to June 1, 2010.

105. Definitions. Unless the context clearly requires otherwise, the definitions in this subsection apply throughout this rule.

(a) "**Apportionable activity**" means those activities defined in WAC 458-20-19401(2)(a).

(b) "**Apportionable royalty income**" means royalty receipts including royalty receipts attributed to locations outside this state, less the exemptions and deductions allowable under chapter 82.04 RCW.

(c) "**Business activities tax**" means a tax measured by the amount of, or economic results of, business activity conducted in a state. The term includes taxes measured in whole or in part on net income or gross income or receipts. The term includes personal income taxes if the gross income from apportionable activities is included in the gross income subject to the personal income tax. The term "business activities tax" does not include a retail sales tax, use tax, or similar transaction tax, imposed on the sale or acquisition of goods or services, whether or not denominated a gross receipts tax or a tax imposed on the privilege of doing business.
(d) "**Customer**" means the person or entity that pays royalties or charges in the nature of royalties for the use of the taxpayer's intangible property.
(e) "**Intangible property**" includes: copyrights, patents, licenses, franchises, trademarks, trade names, and other intangible rights.
(f) "**Royalty activity**" means those activities conducted by a person as part of the business of receiving royalty receipts.
(g) "**Royalty receipts**" means all compensation for the use of intangible property, including charges in the nature of royalties regardless of where the intangible property will be used. "Royalty receipts" does not include compensation for any natural resources, the licensing of prewritten computer software to the end user, or the licensing of digital goods, digital codes, or digital automated services to the end user as defined in RCW 82.04.190(11).
(h) "**State**" means a state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any foreign country or political subdivision of a foreign country.
(i) "**Taxable in another state**" means either:

> (i) The taxpayer is actually subject to a business activities tax by another state on its income received from engaging in apportionable activities; or
> (ii) The taxpayer is not subject to a business activities tax by another state on its income received from engaging in apportionable activity, but the taxpayer meets the substantial nexus thresholds described in WAC 458-20-19401 in that state.

(j) "**Throw-out income**" is royalty receipts that are attributed under part 3 of this rule to a state where the taxpayer is not taxable (see definition of "taxable in another state") and part of the royalty activity is conducted in this state.
(k) "**Unable to attribute**:" A taxpayer is "unable to attribute" royalty receipts when the taxpayer has no reasonable means to acquire the information necessary to attribute the royalty receipts. The fact that the information is maintained by an office other than the office preparing the tax returns is not determinative. Further, the fact that a taxpayer chooses not to obtain information it is entitled to receive and from which it can attribute royalty receipts is not determinative of whether the taxpayer is able or unable to attribute royalty receipts. In determining whether a taxpayer has no reasonable means to acquire the information necessary to attribute royalty receipts, cost and time may be considered.

Part 2: General Overview

201. Apportionment generally: A person subject to royalties B&O tax who is also taxable in another state must use the apportionment method provided in this rule to determine its taxable income for royalties B&O tax purposes. Taxable income is determined by multiplying apportionable royalty income by the receipts factor. The formula expressed algebraically is:

(Taxable income) = (Apportionable royalty income) x (Receipts factor)

Apportionable royalty income is defined in part 1 of this rule. The receipts factor is explained below in part 3 and part 4. More detail on calculating taxable income is provided in part 5.

Part 3: How to Attribute Royalty Reciepts

301. **Attribution of Income.** Royalty receipts are attributed to states based on a cascading method or series of steps. However, the Department expects that most taxpayers will attribute royalty receipts based on subsection 301(a)(i) below. These steps are:

(a) Where the customer used the intangible property.

(i) If a taxpayer can reasonably determine the amount of royalty receipts related to the use in a state, that amount of royalty receipts is attributable to that state. This may be shown by application of a reasonable method of proportionally assigning the use of the intangible property among states. The result determines the royalty receipts attributed to each state.

(ii) If a taxpayer is unable to separately determine the use of the intangible property in specific states under (i), and as a result the customer used the intangible property in multiple states, the royalty receipts are attributed to the state in which the intangible property was primarily used. Primarily means in this case more than 50%.

(b) **Office of negotiation**: if the taxpayer is unable to attribute royalty receipts to a location under (a) of this Part 3, then royalty receipts must be attributed to the office of the customer from which the royalty agreement with the taxpayer was negotiated.

(c) **Billing state**: if the taxpayer is unable to attribute royalty receipts to a location under (a) or (b) of this Part 3, then royalty receipts must be attributed to the state to which the billing statement or invoices are sent to the customer by the taxpayer.

(d) **Payment state**: if the taxpayer is unable to attribute royalty receipts to a location under (a), (b) or (c) of this Part 3, then royalty receipts must be attributed to the state from which the customer sends payment to taxpayer.

(e) **Customer's address**: if the taxpayer is unable to attribute royalty receipts under (a), (b), (c), or (d) of this Part 3, then royalty receipts must be attributed to the state where the customer is located as indicated by customer's address:

(i) As shown in the taxpayer's business records maintained in the regular course of business; or

(ii) Obtained during negotiation of the contract for the use of the taxpayer's intangible property, including any address of a customer's payment instrument when readily available to the taxpayer and no other address is available.
(f) **Taxpayer's domicile**: if the taxpayer is unable to attribute royalty receipts under (a), (b), (c), (d) or (e) of this Part 3, then royalty receipts must be attributed to the commercial domicile of the taxpayer.
302. Framework for analysis of the "use of intangible property." The use of intangible property and therefore the attribution of income from the use of such will generally fall into one of the following three categories:

(a) **Marketing use**. Intangible property is used by the taxpayer's customer for purposes including, marketing, displaying, selling, and exhibiting. The use of the intangible property is connected to the sale of goods or services. Typically, this category includes trademarks, trade names, logos, or other items with promotional value. Receipts from the use of intangible property in this way are generally attributed to the location of the ultimate consumer.

Example 1. SportsCo licenses to AthleticCo the right to use its trademark on a basketball that AthleticCo manufactures, markets and sells at retail on its website. . This is a marketing use. SportsCo is paid a fee based on basketball sales in multiple states. SportsCo knows that sales from the AthleticCo website delivered to Washington represent 10% of AthleticCo's total sales. Pursuant to subsection 301(a)(i) it is reasonable for SportsCo to attribute 10% of its royalty receipts to Washington. The remaining 90% will be attributed based on sales to other states.

Example 2. Same facts as example 1 above except that AthleticCo sells its baseketballs at wholesale to MiddleCo a distributor with its receiving warehouse located in Idaho. MiddleCo then sells the basketballs to RetailerW a retailer with stores in Washington, Oregon, and California. SportsCo knows that 15% of AthleticCo's basketballs are sold by RetailerW in Washington. It is reasonable for SportsCo to attribute 15% of its royalty receipts to Washington. The remaining 85% will be attributed based on sales to other states.

Example 3. MusicCo licenses to RetailCo the intangible right to make copies of a digital song and sell those copies at retail on the internet for the U.S. market. This is a marketing use. RetailCo has a single copy of the song on its server in Virginia. Each time a customer comes to RetailCo's website and makes a purchase of the song, RetailCo creates a copy of the song (e.g. a new file) that is then available for access by the customer. MusicCo would generally attribute its royalty receipts to the location of RetailCo's customers. However, MusicCo does not have any data, and cannot reasonably obtain any data, relating to RetailCo's customer locations. Pursuant to subsection 301(a)(i) MusicCo will attribute receipts to each state based on the percentage that each state's population represents in relation to the total market population, which in this case is the U.S. population.

Example 4. A local baseball star, Joe Ball, plays for a professional athletic franchise located in Washington. Joe Ball licenses to T-ShirtCo the right to put his image on t-shirts and sell them on the Internet in the U.S. market. This is a marketing use. Joe Ball does not know where T-ShirtCo's customers are located. In the absence of actual sales data from T-ShirtCo, Joe Ball cannot use relative population data to attribute receipts to the states as was done in example 3 above. This is because Joe Ball is an overwhelmingly "local" celebrity in Washington. Joe Ball does not have a "national appeal" such that t-shirt sales by T-ShirtCo would be significant outside Washington. In this case, Joe Ball is unable to separately determine the use of the intangible property in specific states pursuant to subsection 301(a)(i). However, it is reasonable for Joe Ball to assume that sales by T-ShirtCo of Joe Ball shirts are primarily delivered to customers in Washington. Accordingly, Joe Ball should assign all receipts received from T-ShirtCo to Washington, pursuant to subsection 301(a)(ii).

Example 5. SoftwareCo licenses to MegaComputerCo ("Mega") the right to copy, and sell software that is installed inside its computers. This is a marketing use. Mega sells its computers to DistributorX that in turn sells the computers to RetailerY. Mega uses the intangible property at the location of the ultimate consumer. SoftwareCo knows the location of RetailerY stores, but not RetailerY's retail sales data for each location. Pursuant to subsection 301(a)(i) it is reasonable for SoftwareCo to attribute receipts in proportion to the number of stores RetailerY has in each state compared to all other locations that sell the Mega product containing SoftwareCo's software.

(b) **Non-marketing use** means the intangible property is used for purposes other than marketing, displaying, selling, and exhibiting. This use of the intangible property is often connected to manufacturing, research and development, or other similar non-marketing uses. Typically, this category includes patents, know-how, designs, processes, models, and similar items. Receipts from the non-marketing use of intangible property are generally attributed to a specific location or locations where the manufacturing, research and development, or other similar non-marketing use occurs.

> **Example 6.** RideCo licenses the right to use its patented scooter design to FunRide for the purpose of manufacturing scooters. This is a non-marketing use. FunRide, will market the scooter under its own brand. RideCo knows that FunRide will manufacture scooters in Michigan and Washington and that the scooter design is used equally in Michigan and Washington. Pursuant to subsection 301(a)(i), RideCo will equally attribute its receipts from the license of its patent to Michigan and Washington.

> **Example 7**. BurgerZ licenses to JoeHam the right to use its jumbo hamburger making process and know-how based on a percentage of sales. This is a non-marketing use, JoeHam markets the jumbo hamburgers under its own brand, JoeHam. JoeHam has two restaurant locations, one in Washington and one in Oregon. . BurgerZ knows the percentage of sales made at each JoeHam location. Pursuant to subsection 301(a)(i), BurgerZ will attribute receipts from its license with JoeHamr in proportion to JoeHam’s sales at each location.

> **Example 8**. WidgetCo licenses the use of its patent to ManuCo, a manufacturer of widgets. ManuCo has three manufacturing plants located in Michigan where it will use the patent for manufacturing widgets. ManuCo also has a single research and development (R&D) facility in Washington where it will use the patented technology to develop the next generation of its widgets. These are non-marketing uses. WidgetCo charges ManuCo single price for the use of the patent in manufacturing and R&D. It is reasonable for WidgetCo to assume ManuCo’s use of the patent is equal at all of ManuCo’s relevant locations. Pursuant to subsection 301(a)(i), because there are four locations where the patent is used equally, WidgetCo will attribute its royalty receipts 25% in each of the four locations. Accordingly, 75% of the royalty receipts will be attributed to Michigan to reflect the use of the patent at the three manufacturing locations and 25% of the royalty receipts will be attributable to Washington to reflect the use of the patent at the single R&D location.

(c) Mixed use means licensing the use of intangible property for both a marketing and non-marketing uses. Mixed use licenses may be sold for a single fee or more than one fee..

- **(i) Single fee**. Where a single fee is charged for the mixed use license, it will be presumed that receipts were earned for a “marketing use” pursuant to the guidelines provided in this subsection 302(a) except to the extent that the taxpayer can reasonably establish otherwise or the Department of Revenue determines otherwise.

(ii) **More than one fee**. Where the mixed use license involves separate fees for each type of use and the separate itemization is reasonable, then each fee will receive separate attribution treatment pursuant to subsection 302(a) and (b), above. If the Department determines that the separate itemization is not reasonable, the Department may provide for more accurate attribution using the guidelines in subsections 302(a) and (b).

Example 9. ProcessCo licenses to KimchiCo., the right to use its patent and trademark for manufacturing and marketing a food processing device for a single fee. . KimchiCo has a single manufacturing plant in Washington and markets the finished product solely in Korea.. This mixed use license for a single fee is presumed to be for a marketing use. Accordingly, ProcessCo must attribute receipts under the guidelines established for marketing uses. Pursuant to subsection 301(a)(i), KimchiCo is marketing the device only in Korea, therefore all receipts will be attributed to Korea.

Example 10. Same as example 9 above, except the license agreement states that the non-marketing use of the patent is valued at $45,000, and the marketing use of the trademark is valued at $55,000. This is a mixed use license with more than one fee. The stated values for the separate uses are reasonable. Pursuant to subsection 301(a)(i), the receipts associated with the non-marketing use are $45,000 and attributable to Washington where the patent is used in a manufacturing. The receipts associated with the marketing use are $55,000 and attributed to Korea where the trademark is used for marketing the finished product.

Example 11. FranchiseCo operates a restaurant franchising business and licenses the right to use its trademark, patent, and know-how to EatQuick for a single fee. This is a mixed use license for a single fee and will be presumed to be for marketing use. EatQuick has a single restaurant location in Washington. The marketing use is limited to marketing at the restaurant location (e.g. using the trademark on signs, menus, etc.). Pursuant to subsection 301(a)(i), the intangible property is used by EatQuick in Washington at its restaurant location. Taxpayer will attribute 100% of its royalty receipts earned under the EatQuick license to Washington.

Example 12. Same facts as example 11, except that EatQuick has five restaurant locations, one each in: Washington, California, Oregon, Idaho, and Montana. EatQuick pays an annual lump sum to FoodCo. This is a mixed use license for a single fee and will be presumed to be for marketing use. Further, FranchiseCo knows that EatQuick's use of the intangible property is equal at all locations. Pursuant to subsection 301(a)(i), the intangible property is used by EatQuick in five states including Washington. Because there are five locations where the intangible property is equally used, FoodCo will attribute 20% of its royalty receipts to each location, including Washington.

Part 4: How to Calculate the Receipts Factor

401. Receipts factor. The receipts factor is a fraction that applies to all royalty receipts for each calendar year. The receipts factor has:

(a) A numerator equal to the royalty receipts attributable to this state during the calendar year**.** Royalty receipts are attributed to this state using the rules provided in part 3 of this rule; and

(b) A denominator equal to the royalty receipts world-wide during the calendar year, less any throw-out income. The formula expressed algebraically is:

$$\text{(Receipts factor)} = \frac{\text{(Royalty receipts attributed to Washington)}}{\text{(Royalty receipts)} - \text{(Throw-out income)}}$$

Example 13. PDQ, Inc., is headquartered in California, where it manages its intangible property. PDQ licenses its intangible property for use in four states. Using the attribution rules provided in Part 3 of this rule, royalty receipts from this licensing activity are attributable to the various states as follows:

- Washington …$300,000
- Oregon ……...$200,000
- California……$400,000
- Idaho………...$300,000

PDQ pays a business activities tax in Oregon. PDQ is taxable in Washington, California, and Idaho under Washington's standards because it has exceeded the receipts threshold for economic nexus in those states pursuant to WAC 458-20-19401. PDQ's total receipts are $1,200,000 and its Washington receipts are $300,000. Therefore, PDQ's Washington receipts factor is $300,000/$1,200,000 or 25.00%.

Example 14. Same facts as example 13, except PDQ does not pay a business activities tax in Oregon and no royalty activities are performed in Washington. Although PDQ is not taxable in Oregon, the royalty receipts attributed to Oregon remain in the denominator because no part of the royalty activity is performed in Washington (i.e. no throw-out income).

Example 15. Same facts as example 13, except PDQ performs part of the royalty activity (e.g. management of the intangible property) in Washington. Because PDQ is not taxable in Oregon and some of the royalty activity is performed in Washington, the Oregon royalty receipts must be subtracted from the denominator (i.e. as throw-out income) of the Washington receipts factor. As a result, PDQ's Washington receipts factor is $300,000/ ($1,200,000– 200,000) or 30.00%.

Part 5: How to Determine Washington Taxable Income

501. General. Washington taxable income is determined by multiplying apportionable royalty income by the receipts factor. While the receipts factor is calculated without regard to deductions authorized under chapter 82.04 RCW, the apportionable royalty income is determined by reducing world-wide royalty receipts by amounts that are deductible under chapter 82.04 RCW regardless of where the deduction may be attributed.

Example 16. Same facts as example 15, with the addition that Taxpayer was entitled to a $100,000 deduction against its royalty receipts. Taxpayer's taxable income is determined as follows:

(Taxable income) = (Royalty receipts – Deductions) x (Receipts Factor)

or

(Taxable income) = (($1,200,00 - $100,000) x 30.00%) = $330,000

Part 6: Reporting Instructions

601. General. A taxpayer may calculate the receipts factor for the current calendar year based on the most recent calendar year for which information is available for the full calendar year. Taxpayers may refer to WAC 458-20-19402 for an example of the application of the use of the most current information available. If a taxpayer does not calculate the receipts factor for the current calendar year based on previous calendar year information as authorized in this rule, the business must use current year information to calculate the receipts factor for the current tax year. In either case, a taxpayer must correct the reporting for the current calendar year when complete information is available to calculate the receipts factor for that year, but not later than October 31st of the following calendar year. Taxpayers may refer to WAC 458-20-19402 for an example of this reconciliation process.