Cite as Det. No. 92-252E, 12 WTD 417 (1992).

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition) D E T E R M I N A T I O N
For Correction of Assessment of)
)
) No. 92-252E
)
. . .) Registration No. . . .
) . . ./Audit No. . . .
)

[1] RULE 194 -- SERVICE B&O -- APPORTIONMENT -- THIRD PARTY COSTS. Payments to a foreign subsidiary to provide services from an out-of-state facility for the benefit of the overall operation of a corporation domiciled in Washington are included in the numerator as the cost of doing business within the state when apportioning income under the cost method. Accord: Det. No. 89-448, 8 WTD 189 (1989).

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.

TAXPAYER REPRESENTED BY: . . .

DATE OF HEARING: . . .

NATURE OF ACTION:

The taxpayer appeals the apportionment computation by the Audit Division. . . . . This case has been considered at the Executive Level as evidenced by the signature of an Assistant Director. Therefore, this is the final action of the Department.

FACTS AND ISSUES:

Pree, A.L.J. -- . . . (INC) [is an out-of-state corporation] headquartered in Washington. It provides research and testing services to . . . companies around the world. INC owns . . . (LTD), a foreign corporation.

. . . .

INC created LTD because it wanted to operate . . . in [a foreign country]. . . . .

Both INC and LTD contributed to establishment of [a foreign] Lab. Each is the owner of specific property in the [foreign] lab. In fact, INC directly provided 56% of the capital while LTD provided 44%. As 100% shareholder of LTD, INC contributed all capital necessary for LTD.

INC provides its services to companies around the world. None of those companies are located in Washington or [LTD's country]. Many of the contracts with INC acknowledge that the research and testing will be performed in [LTD's country] by LTD.

LTD provides testing and research services only for INC from its [foreign] lab. A contract limits LTD's activities to only service for INC. INC directs all LTD's work. The contract establishes an intercompany pricing mechanism with research work on behalf of INC at a fee based upon cost plus 10%.

According to the taxpayer, both INC and LTD operate the research lab in [the foreign country]. INC employees make frequent trips to [that country] to plan and supervise work for clients and to work with the technicians . . . . The INC employees that travelled to [that country] included [managers, numerous officers, and technical support employees].

These INC employees determined which projects would be undertaken by LTD, the methods to be followed by LTD in performing the projects, and the order in which LTD was to perform the projects. The employees were responsible for insuring that LTD maintained INC's standards regarding the quality of the research work performed. They monitored the testing procedures used by LTD, corrected errors in LTD's application of the procedures, and implemented new procedures.

INC's employees monitored the data handling and documentation of LTD to ensure that it was done correctly. They designed LTD's accounting system, monitored it, and assisted LTD in resolving problems encountered with it.

INC's employees were responsible for all of the marketing related to all of the projects performed in Washington, as well as in [the foreign country]. They acted as liaison between the clients and LTD. INC employees were responsible for negotiating all client contracts for research services. They set the schedules and determined the research techniques to be followed in performing the contracts. They reported LTD's test results to the clients, including interpreting the research tests and answering questions.

> INC apportioned its income under the cost method. It included the payments to LTD as part of its out-of-state costs. The Audit Division recalculated the apportionment denying INC the right to include the cost-plus payments to LTD as out of state costs.
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> The taxpayer argues that it should be entitled to include the payments to LTD in apportioning its service income out of Washington. It contends that if the situation were reversed, Washington could tax a portion of INC's income computed by using the payments to LTD.
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> The taxpayer notes that Rule 194 provides in part:

Where it is not practical to determine such apportionment by separate accounting methods, the taxpayer shall apportion to this state that proportion of total income which the cost of doing business within this state bears to the total cost of doing business both within and without this state.

> This rule statement comes directly from RCW 82.04.460. Separate accounting methods are not available. Apportionment will be based on the cost method. The issue is, when calculating the proportion of income attributable to Washington under the cost method, how are the payments to LTD treated. To calculate the proportion of service income taxable by Washington, we must determine: 1) Whether the payments to LTD are included in total cost, and if so, 2) Whether those payments are considered part of the cost of doing business within this state. First, however, we must determine whether INC's activities in [LTD's country] were sufficient to allow INC to apportion some of its service income to [LTD's country].
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> . . . .

DISCUSSION:

[1] WAC 458-20-194 (Rule 194) provides in part:

When the business involves a transaction taxable under the classification service and other business activities, the tax does not apply upon any part of the gross income received for services incidentally rendered to persons in this state by a person who does not maintain a place of business in this state and who is not domiciled herein. However, the tax applies upon the income received for services incidentally rendered to persons outside this state by a person domiciled herein who does not maintain a place of business within the jurisdiction of the place of domicile of the person to whom the service is rendered.

> We find that under these circumstances, INC's contacts and activities in [LTD's country] were sufficient to allow it to apportion its income to [LTD's country]. INC maintains a place

of business outside the state which contributes to the rendition of the services being taxed. INC's extensive activities in [LTD's country] were more than incidental. INC maintained a place of business in [LTD's country], regularly visited and supervised by its employees over a period of years. If [LTD's country] had Washington's tax laws, INC's own employees' activities there would be sufficient to give [LTD's country] nexus to tax.

RCW 82.04.460(1) provides:

Any person rendering services taxable under RCW 82.04.290 and maintaining places of business both within and without this state which contribute to the rendition of such services shall, for the purpose of computing tax liability under RCW 82.04.290, apportion to this state that portion of his gross income which is derived from services rendered within this state. Where such apportionment cannot be accurately made by separate accounting methods, the taxpayer shall apportion to this state that proportion of his total income which the cost of doing business within the state bears to the total cost of doing business both within and without the state. (Emphasis supplied.)

No separate accounting method is available to apportion INC's Washington income. Therefore, we must examine INC's costs. The payments to LTD are part of the INC's total cost of doing business. We must determine whether they are part of INC's cost of doing business in this state.

LTD performs the research in [LTD's country]. INC does send its employees to [LTD's country] to oversee the research and administer its contracts with LTD. The travel costs of its employees in [LTD's country] as well as its costs of maintaining the facility there are not costs within this state.

The cost-plus payments to LTD are different. Washington State is not taxing LTD's income, nor is it concerned about where LTD's costs are incurred. What Washington is concerned about is whether the charges from LTD to INC are part of INC's cost of doing business in this state.

RCW 82.04.460 was amended following the Gwin, White & Prince, Inc. v. Henneford, 305 US 434 (1938) decision. The Supreme Court found Washington's tax measured by the entire volume of interstate commerce of a taxpayer's activities was not constitutional because it was not apportioned limiting the tax to activities occurring within the state. Businesses engaged in interstate commerce risked the burden of multiple taxation compared to local businesses who only paid a single tax.

With that in mind, the legislature crafted the law to limit taxation to income from activities occurring in Washington. If

> the taxpayer's only activities were in Washington, all its income was taxed here. If its activities were both in and out of Washington, the income had to be apportioned. When separate accounting methods did not accurately reflect where the income was earned, a formula based on costs was required.
>
> The taxpayer and the auditor agree that income from INC's services cannot be accurately apportioned by separate accounting methods. Therefore, the cost method must be used. In Det. 89-448, 8 WTD 189 (1989) we said:

The intent of the cost apportionment formula is to apportion income of the taxpayer fairly and equitably to where it performs the services that generate the income that is taxed. Obviously, where third parties perform services does not necessarily relate to where the taxpayer performs the service that generates the income. If a third party performs services in a location where the taxpayer is performing no service, we should not apportion the taxpayer's income to that location. We must consider how those costs relate to the service activity of the taxpayer and where those services are performed by the taxpayer to determine whether or not they are costs within the state.

If the [costs] ~~services~~ [sic] related to those [services] ~~costs~~ [sic] are incurred because of the taxpayer's activities within this state as opposed to the taxpayer's activities outside the state, they will be considered costs within this state for the purposes of the cost apportionment formula. On the other hand, if they are incurred because of the taxpayer's out-of-state activity, they will be considered out-of-state costs. Third party costs which cannot be identified as incurred because of the taxpayer's activities at any particular office will be attributed to the taxpayer's domicile. For instance, legal fees incurred by an out-of-state firm to clear title to land upon which an out-of-state office is located and billed to the Washington headquarters, should ~~be~~ [sic] not be part of the cost of doing business within this state, while charges by the same law firm for Federal tax planning regarding the overall organization of the taxpayer would be assigned to the domicile located in Washington.

> The taxpayer requests that the department follow this determination. It contends that the determination is squarely on point, and based on that determination, it should be allowed to treat the payments to LTD as out-of-state costs under <u>stare decisis</u>.
>
> In that determination, the taxpayer performed management services for affiliated corporations from a number of offices, some of which were located outside the state. The parties agreed that some of the income should be apportioned under the cost formula. One of the issues involving application of the cost formula was whether third party costs were considered costs inside or outside the state of Washington.

In the first paragraph quoted above, we said that where third parties perform services does not necessarily relate to where the taxpayer performs the service that generates the income. It is only the latter service income that we must apportion. In the example, costs related to supporting a specific office such as legal fees were out of state costs. However, costs performed by third parties out-of-state supporting the overall operation of the business would be attributed to the taxpayer's domicile.

It is an error to focus on where the third party (LTD) operates. The key question is, for what activity of the taxpayer (INC) are these costs incurred. We do not believe INC incurs the charges from LTD because of INC's activities in [LTD's country], but to support its overall operation. INC does go to [LTD's country] and incur its own costs because LTD is located in [LTD's country]. Those travel costs and its direct costs of maintaining its place of business there are costs outside of the State of Washington for the purpose of apportionment. However, those costs do not include LTD's costs or charges to INC.

While INC pays expenses because of LTD's activities in [LTD's country], the charges from LTD are not generated by INC's own activities in [LTD's country]. Rather, they are related to INC's overall activities, providing drug research for customers around the world (none of whom are located in [LTD's country], incidently). Under the holding in Determination 89-448, LTD's charges to INC would be considered a cost related to INC's overall operation. Those costs would be considered an in-state cost in the cost formula. INC's direct out-of-state costs of maintaining the [LTD's country] facility and travel there would still be considered as INC's out-of-state costs.

It is the Department's position that a Washington taxpayer who does nothing more in another tax jurisdiction than pay the costs of an out-of-state third party service provider does not entitle the Washington based service company to claim such costs as its own out-of-state costs for apportionment purposes in measuring its own services receipts taxable in this state. To rule otherwise in that case would clearly result in a substantial portion of such Washington service businesses' gross receipts being taxable "nowhere." This is because the taxing jurisdiction of the domiciliary state of the third party service provider is not sufficient in itself under the Commerce Clause, to reach the Washington business service income. We recognize that situation is different than this situation where INC also has a direct presence in [LTD's country] through its own place of business and regular visits of its own supervisory employees.

Washington's Rule 194 contemplates equity under the Commerce Clause and seeks to achieve apportionment methodology which taxes

> no more and no less than this state is entitled to receive in return for the benefits which it confers. To this end, under the rule, Washington based service providers may not allocate the direct costs of purchasing services from out-of-state independent service providers to the domicile of such service providers. It is immaterial that such services may be designated as "core" services of the same kind sold by the Washington based service business. In this respect, the Department views such arrangements as being tantamount to wholesale purchases of such services by the Washington based business. There is simply no statutory deduction under the Revenue Act of this state, nor any Commerce Clause requirement to exclude such costs in calculating the Washington service provider's tax measure here. Thus, such costs as these must be included in both the numerator (costs of doing business in Washington) and the denominator (costs of doing business everywhere) in the cost of doing business apportionment formula allowed under Rule 194.
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> LTD's costs cannot be considered part of the taxpayer's own activities in [LTD's country]. Under WAC 458-20-203 (Rule 203) affiliated corporations are recognized as separate entities. That rule states:

Each separately organized corporation is a "person" within the meaning of the law, notwithstanding its affiliation with or relation to any other corporation through stock ownership by a parent corporation by the same group of individuals.

Each corporation shall file a separate return and include therein the tax liability accruing to such corporation. This applies to each corporation in an affiliated group, as the law makes no provision for filing of consolidated returns by affiliated corporations or for the elimination of intercompany transactions from the measure of tax.

> LTD's services are performed for INC not to support INC's place of business in [LTD's country], but to support INC's worldwide activities. In this respect, they are tantamount to arms-length, wholesale services to INC.
>
> The taxpayer also argues that the costs of LTD are the costs of INC because INC has a cost plus contract with LTD. It states that INC is under a contractual obligation to reimburse LTD for its costs (ie employee salaries). Such an obligation does not make these costs the direct costs of doing business of INC. Under WAC 458-20-111 (Rule 111) they are considered costs of LTD unless they qualify as advances or reimbursements. To qualify they must meet the definition outlined in the Rule:

The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefor, either primarily or secondarily, other than as agent for the customer or client.

LTD is liable for its operating costs. INC's liability is to LTD, not LTD's vendors or employees. In applying the cost formula, we must keep in mind that we are not determining whether LTD's costs are costs within the state or not, but whether LTD's charge to INC is a cost of INC doing business within this state.

. . . .

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part. The assessment is remanded to the Audit Division for adjustment computing the apportionment based on its direct costs in [LTD's country] as out of state costs while its payments to LTD will be considered incurred in Washington. . . . .

DATED this 15th day of September 1992.