Cite as Det. No. 92-262E, 12 WTD 431 (1992).

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

In the Matter of the Petition For refund of	)	D E T E R M I N A T I O N
	)	No. 92-262E
. . .	)	Registration No. . . .
. . .	)	Registration No. . . .

[1] Rule 194 -- RCW 82.04.460 -- APPORTIONMENT. A taxpayer is entitled to apportion its gross receipts between Washington and other state(s) only if the taxpayer is directly and actively engaged in business in the other state(s) and from such activity it derives some part of its gross receipts.

[2] Rule 194 -- RCW 82.04.460 -- APPORTIONMENT. When a taxpayer's sole connection with another state is the payment of third party service provider costs, the taxpayer is not entitled to apportion out the costs associated with that service provider. PARTIAL ACCORD: Det. No.89-448, 8 WTD 189 (1989).

[3] RULE 194 -- RCW 82.04.460 -- APPORTIONMENT -- NEXUS. When a Washington taxpayer contracts with independent businesses in other states to perform services in those states for the taxpayer's purpose of realizing or continuing valuable contractual relationships there, nexus may be found. However, when the independent businesses are not chosen because of their location or to enter and maintain a place in the market of the other state, but rather for their independent expertise, then nexus is not created. Citing: Standard Pressed Steel Co. v. Dept. of Rev., 419 U.S. 560 (1975), Scripto, Inc. v. Carson, 362 U.S. 207 (1960), and Tyler Pipe v. Washington, 483 U.S. 232 (1987).

[4] RULE 194 -- RCW 82.04.460 -- FAIR APPORTIONMENT -- COMPLETE AUTO TRANSIT. An apportionment formula is required only when another state may constitutionally impose a tax. When no other state may constitutionally tax the activities of a Washington business, the state of Washington may tax 100% of its gross receipts.

[5] RULE 194 -- RCW 82.04.460 -- APPORTIONMENT -- INTERNAL CONSISTENCY. The costs incurred by a Washington state business for the acquisition of third party services must be attributed to the state which generates the business to which the services relate. Thus, if a Washington business has a New York office which generates business and uses the services of an independent business located in Washington state to perform part of the New York office's services, the costs associated with that contract are properly allocated to New York and vice versa. This method, if adopted by all states, results in no more than 100% of the taxpayer's gross receipts being subject to taxation.

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: . . .

DEPARTMENT REPRESENTED BY: Ed Faker, Assistant Director

DATE OF HEARING: . . .

NATURE OF ACTION:

The taxpayers request refunds of business and occupation taxes paid during the years 1987 through 1991. The taxpayers base their claim on the premise that their use of independent business entities in other states to perform certain services for the taxpayers' clients is sufficient for those other states to tax a portion of the taxpayers' gross receipts in this state. Therefore, the taxpayers claim that Washington must apportion their gross receipts. Further, the taxpayers have requested that the petition be treated as a request for prior determination of liability as to future periods pursuant to WAC 458-20-100(9). This case has been considered at the Executive Level as evidenced by the signature of the Assistant Director.

FACTS:

Coffman, A.L.J. -- . . . .

[THE FOLLOWING REPLACEMENT STATEMENT OF FACTS IS BEING USED TO INSURE THAT THE TAXPAYER IS NOT DISCLOSED.]

[The taxpayers are affiliated corporations. They will be referred to as TP-1 and TP-2 when necessary to distinguish them. The taxpayers engage in a business activity classified as "service" under the Washington Business and Occupation tax. TP-1's headquarters is located in the State of Washington and maintains offices in two other states. TP-2's only office is located in the State of Washington. The taxpayers' clients are located throughout the United States. The taxpayers have unique abilities and an industry reputation that attracts clients. Other local and national businesses provide services similar to those provided by the taxpayers.]

[The taxpayers have chosen not to provide all of their services through employees. Rather, they have contracted with independent parties (independent contractors) to provide some of them. The independent contractors are located both within and mostly outside the State of Washington. The taxpayers choose this method of operation for several reasons, but primarily because it is easier to change independent contractors than employees. The independent contractors perform what the taxpayers describe as "core services."]

[The independent contractors provide the same services for the taxpayers as they do for their own clients. TP-1 receives recommendations from the independent contractors for actions to be taken on behalf of its clients. TP-1 then either follows that advice or not as it determines is best for its client. TP-2 on the other hand allows the independent contractors to take certain actions on behalf of its client subject to the veto power of TP-2. Both taxpayers state that payments made to the independent contractors are a significant portion of their total cost of doing business.]

[The taxpayers from their Washington state offices handle all administrative functions, such as overall management, accounting, legal, and similar functions. The taxpayers' marketing activities occur in a variety of locations. These may be performed by employees or by marketing agents. The marketing function, however, is unrelated to location of the independent contractors and is not performed by them.]

[The taxpayers contend that they perform services both within and without the State of Washington, entitling them to apportion their income. The taxpayers argue that the law requires income be apportioned based on a formula, namely the Washington costs of doing business divided by the total costs of doing business. In this context, the taxpayers contend that the fees paid to out-of-state independent contractors performing "core services" should not be part of the instate costs.]

ISSUE:

Is a Washington based company entitled to apportion its gross receipts based solely on the fact that it contracts for services with independent businesses located outside of Washington?

DISCUSSION:

Washington is able to tax gross receipts from those activities which occur wholly within its borders. Dept. of Rev. v. Ass'n of Washington Stevedoring Co., 435 U.S. 734 (1978). Likewise, Washington may not tax gross receipts from activities that occur outside its borders. Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1938). Thus, in those cases where an entity engages in business both within and outside the state, the state of Washington must apportion the gross receipts. Separate accounting of the receipts is the preferred method when possible. However, when separate accounting is not possible, some method of apportionment must be provided. RCW 82.04.460 states:

> (1) 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.[1]

[1] WAC 458-20-194 (Rule 194) is the administrative rule implementing this method of apportionment. The first question is whether either taxpayer is engaged in business both within and

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[1] RCW 82.04.290 imposes the business and occupation tax on services and other activities not specifically enumerated elsewhere in Chapter 82.04 RCW. The taxpayers agree that they are subject to taxation under this section, however they dispute the measure of the tax. Further, it is clear that under subsection (1) there is no requirement that there be a physical business office located in the other state. See: Det. No. 87-186, 3 WTD 195 (1987).

outside this state. If we determine that either taxpayer was not engaged in business outside the state of Washington then there is no reason to apportion its gross receipts. The taxpayers argue that they are engaged in business in each state where at least one of the independent [contractors] is located. Therefore, they argue, they are entitled to apportion their gross receipts based on the costs incurred in each such state.

The Department faced a similar issue in Det. No. 89-448, 8 WTD 189 (1989) where the basic rule for apportionment of third party costs was set forth as follows:

> The issue centers around whether third party costs for services performed outside this state, billed to the taxpayer's location in this state are part of the cost of doing business within this state. We need to determine what the "cost of doing business within this state" includes. Certainly, third party costs are part of the total costs of doing business in the denominator in the Rule 194 apportionment formula.
>
> 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.

[2] Stated another way, a Washington taxpayer who does nothing more in another tax jurisdiction than pay the costs of an out-of-state third party service provider is not entitled 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 would clearly result in a substantial portion of such Washington service businesses' gross receipts being taxable "nowhere." This is because, under the commerce clause, the state of commercial domicile of the third party service provider could not, based solely on the service contract, tax the Washington business' service gross receipts. That is, there is no nexus between the Washington business and the other state.[2]

The taxpayers argue that these independent [contractors] perform "core services" for each taxpayer and are their agents. They claim that their relationship with the independent [contractors] is such that the taxpayers can be deemed to be engaged in business in those states. The taxpayers further argue that these "core services" contribute to their gross receipts and therefore the Department must apportion the taxpayers' gross receipts based on the costs incurred in each state.

[TP-1 and TP-2] state in their appeal that the test for a valid apportionment method is found in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). The Washington Supreme Court clarified the commerce clause test in Complete Auto by saying:

> Under this test, state taxation of interstate business must (1) tax only interstate activities having a sufficient connection to the taxing state (nexus requirement); (2) be fairly apportioned to taxpayer's activities in the state (apportionment requirement); (3) not discriminate against interstate commerce (nondiscrimination requirement); and (4) be fairly related to the services provided by the state.

American National Can v. Dept. of Rev., 114 Wn.2d 236, 241 (1990).

1. NEXUS.

The first requirement of Complete Auto is that the taxpayer have some nexus with the state seeking to impose the tax or in this

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[2] See discussion of nexus, infra.

case the state which the taxpayer believes could impose the tax. We find that the test for meeting the nexus requirement is the same as the test to determine if a party is doing business in the affected state.

The taxpayer in a memorandum dated [August 1992] argues that Standard Pressed Steel Co. v. Dept. of Rev., 419 U.S. 560 (1975) requires that Washington acknowledge the existence of nexus in states where the independent [contractors] are located. In that case the single employee in Washington "made possible the realization and continuance of valuable contractual relations between" [the company] and Boeing. ibid at 562. In Standard Pressed Steel the employee was located in Washington. The employer paid the costs of maintaining an answering service. The employee worked out of an office for the employer in his home on a full-time basis and provided the employer with essential information relative to its major customer in Washington.

[3] The taxpayers' use of the independent [contractors] is decidedly different. The location of the independent [contractors] is totally irrelevant to the taxpayers. They are not chosen for the state where they reside or for the purpose of the taxpayer's themselves entering into the marketplace of that state. They are chosen for their expertise in providing . . . advice. The taxpayers do not maintain the independent [contractors] in the various states. Rather, the taxpayers are just one of several clients for each independent [contractor]. The taxpayers' reliance on Standard Pressed Steel is misplaced.

The taxpayer points out that the use of independent contractors rather than employees will not, in and of itself, prohibit a state from taxing an out-of-state business' activity within its borders. In other words an entity may engage in business through the use of independent contractors. Citing: Scripto, Inc. v. Carson, 362 U.S. 207 (1960) and Tyler Pipe v. Washington, 483 U.S. 232 (1987). We agree. However, these cases are clearly distinguishable from the taxpayers' situation. In both cases the tax paying businesses used the independent contractors to enter the marketplace of the taxing jurisdiction, i.e., to do business in that state's marketplace. In the case of [TP-1 and TP-2], the independent [contractors] are neither promoting the taxpayer's business nor seeking business for them. Rather, these independent [contractors], scattered around the United States, are selling their own services at wholesale to the taxpayers.[3]

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[3] The taxpayers argue that the independent contractors are their agents. The mere fact that a taxpayer has an agent located in another state for some reason does not establish taxing nexus between the taxpayer and that other state. As

Further, the taxpayers rely on Burger King, Inc. v. Rudzewicz, 471 U.S. 462 (1985), Omni Hotels Management Corp. v. Round Hill Developments Ltd, 675 F. Supp. 745 (N.H., 1987), and Corinthian Mortgage Corp. v. First Security Mortgage Co., 716 F. Supp. 527 (Kan., 1989) for the proposition that a continuing obligation between [TP-1 and TP-2] and the independent [contractors] will establish nexus. However, these cases are clearly distinguishable: breach of franchise agreements was involved in Burger King; there was a long term management contract in Omni Hotels; and fraudulent misrepresentations and contract performance within the state in Corinthian. All three cases involved contracts to be performed in, or at least connected to, the state claiming jurisdiction and were limited to those contracts. They are all based on long-arm statutes and are not relevant to this appeal.

The taxpayer attempts to distinguish Helicopteros Nacionales de Columbia, S.A. v. Hall, 466 U.S. 408 (1984). The taxpayer states:

> Mere purchases of products in a state, even if occurring at regular intervals, may not be sufficient to support a cause of action unrelated to those purchases. Helicopteros Nacionales de Columbia, S.A. v. Hall, 466 U.S. at 418, 104 S. Ct. at 1874 (purchasing helicopters, parts and training in the forum state were insufficient contacts for assertion of wrongful death claims). Here, [TP-1] is purchasing services on a regular basis. However, unlike the typical impersonal commercial contract for goods, as in Helicopteros Nacionales de Columbia, [TP-1] is acquiring investment services which require a high degree of skill, confidentiality, care and personalized attention.

We agree that the taxpayers are acquiring for a fee, specialized skills, knowledge, and labor from the independent [contractors]. However, we disagree with the taxpayers' conclusion that this somehow creates a greater presence in the state of commercial domicile of the independent [contractor] than the purchase of helicopters, parts, and training of pilots. All the taxpayer is doing with the independent [contractors] is purchasing services. These independent [contractors] are selected because of their knowledge, high ratings, skills, and expertise in specific areas. That does not distinguish them from helicopter parts which, if

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discussed in this determination, the finding of taxing nexus requires a meaningful entry by the taxpayer into the other state's marketplace.

defective, may cause death or serious injury. In Helicopteros, the defendant was a foreign corporation which purchased 80% of its helicopters from a Texas business during the period of 1970 through 1977 and sent its pilots to Texas for training. However, the Supreme Court in Helicopteros, at 417, quoting Rosenberg Bros. & Co. v. Curtis Brown Co., 260 U.S. 516 (1923), stated:

> Visits on such business, even if occurring at regular intervals, would not warrant the inference that the corporation was present within the jurisdiction of [New York]. Id., at 518

[The taxpayer also argues that because of the nature of its business, it is subject to the jurisdiction of the courts in each state where it contracts with an independent contractor. We agree that certain federal statutes may grant special statutory jurisdiction to the courts where any one of the independent contractors reside. However, this is not synonymous with nexus for state taxation purposes.]
[TP-2] operates solely out of its offices in Washington. Its clients look to the Washington office to get answers to questions and for service.

In view of the above discussion we find that [TP-2] is not engaged in business within and outside the state. Therefore, [TP-2] is not entitled to apportion its receipts based on the activities of the independent [contractors]. All of its costs of doing business are incurred in Washington; therefore, even if the apportionment formula were used, 100% of its gross receipts would be attributed to the state of Washington.

As to [TP-1] different issues arise. It is clear that [TP-1] has a presence in [two other states]. It maintains offices there, has employees in each state, and solicits business from each state. Clearly, this amounts to doing business in each state. This does not mean, however, that the taxpayer is doing business in North Dakota simply because it has contracted with an independent [contractor] located there.

2. FAIR APPORTIONMENT.

[4] The second prong of Complete Auto is fair apportionment. This is required to prevent undue burdens on interstate commerce and to prevent the taxation of extraterritorial values. We concur that apportionment is required when a tax paying business conducts revenue producing activities both within and outside the state. See: RCW 82.04.460 quoted above and Rule 194. However, apportionment is only required when the other state has the constitutional ability under Complete Auto to tax the business' activities. There is no requirement to apportion when the other

state is unable to constitutionally tax the gross receipts business. The concept of apportionment is designed to assure that, on a theoretical basis, an interstate business is taxed on no more than 100% of its receipts. Container Corp of America v. Franchise Tax Bd., 463 U.S. 159, 169 (1983). This does not mean that every state must provide an identical apportionment methodology, Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978), rather it means that the apportionment methodology must be internally and externally consistent. Container Corp. of America, supra. By internal consistency the Courts have meant that the apportionment method must be such that if all states use the identical taxing scheme, no more than 100% of the gross receipts from the same income producing activity would be taxed.

The Washington apportionment formula must account for all costs of doing business. If the Washington business conducts no activities outside the state, then there is no need to apportion. However, if the Washington business is directly and actively engaged in business both within and outside the state, then the issue becomes where should the costs are attributed. The difficult question arises when purchased services are used in multiple states. In that case the costs must be attributed based on the actual use in each state.

[5] We believe that the following apportionment method is internally consistent. [TP-1] must attribute its third party costs to the state that receives the benefit of those costs. Thus, if [services for client "A"] are managed in Washington and the [TP-1] contracts with three independent [contractors] located in [three other states] to advise it on the [services to client] "A", the costs associated with those independent [contractors] would be properly attributed to Washington. Likewise, if the [account] was generated by the efforts of [TP-1's state "X"] office and is managed by the [state "X"] office, then the independent [contractor] costs would be attributed to [state "X"]. This methodology, if adopted by every state, does not tax more receipts than the taxpayer generates. Likewise, if [an account] is managed out of the Washington office and uses a [state "X" independent contractor], the costs of that independent [contractor] would be allocated to Washington.

> The second and more difficult requirement is what might be called external consistency--the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not "invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing state. . . ." Nevertheless, we will strike down the application of an apportionment formula if the taxpayer

> can prove "by `clear and cogent evidence' that the income attributed to the State is in fact `out of all appropriate proportions to the business transacted . . . in that State', or has `led to a grossly distorted result.'" (Citations omitted and emphasis in original.)

Container Corp of America, 463 U.S. at 169-170.

The taxpayer avers that the formula stated above results in a grossly disproportionate share of the taxpayers' receipts being apportioned to Washington. We believe that to adopt the taxpayer's rationale has the effect of making some of their gross receipts exempt from tax in every state. There is no basis for assuming that the state of commercial domicile of an independent [contractor] would be able to constitutionally tax the gross receipts of [TP-1 and TP-2]. Thus, if we assume for the sake of argument that the fees paid to the independent [contractor] are 5% of the taxpayers' total costs, then, under the taxpayers' theory, 5% of the taxpayers' receipts would be totally exempt from state taxation. This is not the result anticipated by the Courts. However, this is not to say the other state would be denied its tax base. It is clear that the state of commercial domicile of the independent [contractors] would be able to tax their gross receipts.

Therefore, we find that Washington's apportionment formula as stated above is both internally and externally consistent.

The last two prongs of Complete Auto are that the tax must be nondiscriminatory and fairly related to the services received by the taxpayer. The taxpayers do not question the validity of Washington's taxing scheme based on these prongs. Therefore, we will not address them.

JOINT VENTURE.

The taxpayers' representative has raised the issue of possible joint ventures between the taxpayers and the independent [contractors]. We find that the relationship between the taxpayers and the independent [contractors] did not amount to a joint venture during the periods in question here. The ability of the taxpayer to remove or replace an [independent contractor] at will is inconsistent with a joint venture. The control the taxpayers exert over the [services] is likewise inconsistent with a joint venture. This is not to say that if the taxpayers were to establish a joint venture with the [independent contractors] or another third party, that our decision, as a matter of first impression, might not be different.

DECISION AND DISPOSITION:

The taxpayer's refund request is denied. We find that the apportionment formula used by the state of Washington is both internally and externally consistent. Further, we find that the taxpayer does not establish commerce clause nexus in states where it uses the services of independent [contractors] solely by virtue of acquiring the services of those independent [contractors].

This matter has been considered at the Executive Level of the Department. This constitutes the final decision by the Department.

DATED this 5th day of October 1992.