BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 98-022
	)	
. . .	)	Registration No. . . .
	)	Audit Denial of Refund
	)	

RULE 194; RCW 82.04.460: SERVICE B&O TAX -- APPORTIONMENT -- SEPARATE ACCOUNTING METHODS -- COST OF DOING BUSINESS -- CLIENT BILLING. A separate accounting method, based upon the location of services billed to clients, accurately apportioned service income. Analysis of costs was unnecessary.

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.

NATURE OF ACTION:

A CPA firm requests to apportion its receipts under a cost method of accounting for the 1992 calendar year.[1]

FACTS:

M. Pree, A.L.J. -- . . . (the taxpayer) is an accounting firm with an office in Washington and its principal place of business located outside of Washington. The taxpayer derives its revenue from audit, accounting, tax, and management consulting services. The taxpayer performs these services in Washington. Out-of-state offices perform accounting, marketing, technology, recruiting, and research tasks. They also perform direct services for clients in Washington.

The taxpayer measured its gross revenue for Washington Business and Occupation (B&O) tax on a separate accounting basis. Receipts associated with clients of its Washington office were generally reported as Washington services, while receipts from clients for out of state offices were attributed to services performed at those locations. The exception to accounting by client location occurred when the taxpayer's Washington employees performed substantial services outside of Washington or when revenue was derived from the taxpayer's employees from out-of-

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

state offices rendering substantial services in Washington. The taxpayer deducted revenue derived from employees of its Washington office performing substantial services outside of Washington. Likewise, the taxpayer included in the measure receipts from substantial services rendered by its employees in Washington performed for out-of-state offices. The taxpayer states that interoffice billings were nominal compared to the overall Washington revenue.

The Audit Division clarifies "substantial" under the taxpayer's separate accounting method. If the service performed out-of-state resulted in a billing to the client for the specific services, the Audit Division allowed a deduction from the measure of Washington tax. Conversely, if the taxpayer's employees performed services in Washington, which resulted in billings to an out-of-state client, the receipts were included in Washington income. At issue are services, which were not directly billed to clients.

For the 1992 calendar year, the taxpayer reported . . . in gross receipts under the service and other activities classification. From that figure, the taxpayer deducted . . . for services performed outside of the state. The taxpayer paid business and occupation (B&O) tax on the net amount under the service and other activities classification.

The taxpayer determined that . . . % of its costs were attributable to costs incurred for out-of-state activities. The taxpayer submitted a refund claim for 1992 on December 31, 1996 using its cost method of accounting rather than its separate accounting method. The taxpayer determined that only . . . was properly reported under its cost method of accounting. The Audit Division denied the taxpayer's refund request.

Most of the costs the taxpayer attributed to out-of-state activities pertained to a pro rata share of its national office expenses. National offices performed necessary tasks (e.g., accounting, marketing, technology, recruiting, and research) for local offices such as the taxpayer's Washington office. The costs for these tasks included firm management, information systems, technology, legal, marketing, human resources, practice support, litigation and insurance.

Initially, the Audit Division stated that the taxpayer could apportion its income based upon the cost basis. Costs incurred as a result of services rendered to the Washington office by the out-of-state offices would be included as in-state costs in the cost apportionment formula. Later, the Audit Division stated that the taxpayer's separate accounting method accurately and fairly represented income attributable to its Washington office. The Audit Division also pointed out that to use a cost apportionment method, total income and expenses should be taken into consideration. Apparently, the taxpayer had used income from its Washington office only as a starting point. Finally, the Audit Division stated that many of the taxpayer's costs that benefited the taxpayer's Washington state employees were merely incidental to services rendered to its clients.

The taxpayer states that substantial and significant out-of-state services are provided by its out-of-state offices. The taxpayer claims that its separate accounting fails to account for the value created by its out-of-state activities. As a result, the taxpayer contends, separate accounting is impractical to apportion its Washington service revenue.

The Audit Division found that taxpayer's separate accounting method included receipts from clients who paid the taxpayer for the financial and advisory services performed in Washington. If the taxpayer billed clients for such services performed at out-of-state locations, under the taxpayer's separate accounting, such receipts were not included in the measure of Washington tax. Therefore, if the services performed by the out-of-state offices had more than an incidental benefit to specific customers, the taxpayer billed the customers for those services. Under the taxpayer's separate accounting method, they were not included in the measure of the taxpayer's receipts subject to Washington tax. The Audit Division contends that incidental costs and services rendered outside of Washington such as administrative and technical support for personnel of the Washington office, should not be included in the taxpayer's method of apportionment.

ISSUES:

Does the taxpayer's separate accounting method accurately apportion its receipts when the taxpayer performs administrative support services outside of Washington?

DISCUSSION:

Income from services rendered both within and without Washington is apportioned to the locations where the services generating the income are performed. RCW 82.04.460. If the apportionment cannot be accurately made by separate accounting methods, the income is apportioned by the ratio of costs in the state to total costs. The Department's apportionment rule, WAC 458-20-194 (Rule 194) provides:

> Persons engaged in a business taxable under the service and other business activities classification and who maintain places of business both inside and outside this state which contribute to the performance of a service, shall apportion to this state that portion of gross income derived from services rendered by them in this state. 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.

From either the statute or the rule, it is clear that separate accounting methods are the preferred manner of apportioning income. Det. No. 90-132, 9 WTD 280-15, 19 (1990).

"Separate accounting" means exactly what it says: a method of accounting that separates Washington income from the other income. Det. No. 90-163, 9 WTD 286-39 (1990). In this case, the taxpayer's records separate the billable income earned outside of Washington from the billable income earned from services performed in Washington.

We have held that commission sales separated by a "sold to address" did in fact reflect a proper separate accounting of gross income derived from services rendered to that customer location. Det. No. 90-132, 9 WTD 280-15 (1990). In that determination, the income in question was from commission sales. As in this case, the taxpayer incurred nonbillable expenses at an administrative office. The Audit Division disregarded the taxpayer's separate accounting method and assessed tax based upon the taxpayer's cost of doing business. We distinguished situations where the administrative services were performed for taxpayers' customers in the following manner:

> The Department has held that the provision of administrative services in Washington to customers located outside of Washington was sufficient to require apportionment on a cost-of-doing business basis. This holding has been sustained by the Washington Supreme Court. Department of Rev. v. J.C. Penny Co., 98 Wn.2d 38 (1981). See Also, Det. No. 94-031, 14 WTD 194 (1994). This case is factually distinguishable. Here, the administrative services are not rendered to the clients--the services are performed for the taxpayer's Washington employees.

Id. at 19. The taxpayer was allowed to apportion using its separate accounting method.

In our case, the taxpayer's national offices performed administrative services, which indirectly supported the services billed to the taxpayer's clients. The taxpayer computed its billings based upon the time and services performed by its employees rendering substantial services directly for its clients.

Washington taxes the receipts from the billings based upon the activity performed by the taxpayer. See, RCW 82.04.440. We are seeking to accurately apportion receipts from those billings. The taxpayer's separate accounting method accurately attributes income to the location where the taxpayer's employees performed the billed services. Under Rule 194, costs attributable to indirect services or administrative services performed for the taxpayer's employees are only considered when it is not practical to determine apportionment by separate accounting methods. The taxpayer's separate accounting method accurately apportions income. Analysis of costs is unnecessary.

DECISION AND DISPOSITION:

We deny the taxpayer's petition.

Dated this 27th day of February 1998.