

BEFORE THE INTERPRETATION 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. 88-476
)
) Registration No. . . .
) . . . /Audit No. . . .
)

[1] **RULE 194:** SERVICE B&O TAX -- INTERSTATE DEDUCTION -- SERVICES RENDERED SUBSTANTIALLY OR WHOLLY OUT OF STATE -- PLACE OF BUSINESS -- GEOPHYSICAL INVESTIGATION. Where Washington taxpayer performs its geophysical investigation substantially or wholly in Alaska and Canada by sending its employees there to do on-site investigation and report writing there in conjunction with other firms there for transmittal from there of the reports to out-of-state customers, its income is not subject to Service B&O tax without regard to whether or not the taxpayer has a place of business in the out-of state location.

These 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: November 17, 1988

NATURE OF ACTION:

Petition protesting assessment of Service B&O tax on services rendered out of state where taxpayer claims it had places of business.

FACTS AND ISSUES:

Krebs, A.L.J. -- . . . (taxpayer) is engaged in the business of performing geological, geophysical, and archeological investigations to provide pre-construction information and environmental clearance.

The Department of Revenue (Department) examined the business records of the taxpayer for the period from July 1, 1984 through September 30, 1987. As a result of this audit, the Department issued Document No. . . . on February 4, 1988 asserting excise tax liability in the amount of \$. . . , interest due in the amount of \$. . . and penalty due in the amount of \$. . . for a total sum of \$. . . which remains due.

The taxpayer's protest involves Schedule II of the audit report where the auditor disallowed "interstate deductions" taken by the taxpayer from its gross income. The auditor subjected such amounts to Service business and occupation (B&O) tax because the taxpayer, headquartered in . . . , Washington, did not maintain a "place of business" in the out-of-state locations where the services were rendered. The auditor did allow the interstate deductions for jobs performed in New Zealand and Nepal because all of the work was completed at the job sites. The taxpayer agreed that with respect to work done in California, Oregon, Idaho and Nevada, the auditor properly disallowed the deductions. However, with respect to work done in Alaska and Canada, the taxpayer contends that the auditor improperly disallowed the deductions because it had places of business there which qualified it under WAC 458-20-194 (Rule 194), . . . , for the interstate deduction.

The taxpayer asserts that the projects done in Alaska and Canada were accomplished at "real" office facilities, not merely a mail drop or telephone answering facility, which were permanent business locations and for which the taxpayer paid "rent" through the billing arrangements explained below.

ALASKA: The taxpayer does work in Alaska in conjunction with an unaffiliated entity named [H] which has business offices at . . . , Alaska. [H] has its own employees. The taxpayer has no employees permanently located there. The taxpayer has no telephone directory listing in Alaska but [H] will take messages and mail there for the taxpayer. The taxpayer is listed in a professional directory, " . . . ", as having an association with [H] in . . . , Alaska with its address and

telephone number. This directory also shows that the taxpayer has an association with "[R]" in . . . , Iowa

A letter dated June 1, 1984 from the taxpayer to [H] memorializes their agreement for the following:

1. to associate to pursue professional services.
2. to allow the taxpayer "to share office facilities" at [H]'s office in . . . , Alaska.
3. to use each other's personnel as needed at rates agreed upon.
4. [H] "will provide office space to" the taxpayer in return for a "proportionate share of the projects."
5. "No rent will be charged to" the taxpayer "for office use unless agreed to, prior to the beginning of a project or, as verbally agreed upon by the corporate officers, if no joint projects are in progress or anticipated."
6. The taxpayer may advertise and utilize the location of [H] as its Alaska base.

If either the taxpayer or [H] gets a contract to do a job in Alaska, the taxpayer sends one or two of its employees, as needed, to Alaska to work with the employee(s) of [H]. For example, if there is a mining site to be examined in Alaska, the taxpayer's employee(s) and [H]'s employee(s) go together to the site for examination. They then return to [H]'s office . . . where they put together a report which is delivered there in Alaska to the mining company or mailed from [Alaska] to the mining company in Denver or wherever the mining company is located. The entity which had the contract for the work will then send a bill --- the taxpayer from . . . and [H] from [Alaska]. The billing is based on the number of hours devoted to the job. When payment is received, it is shared between the taxpayer and [H] on the basis of contribution of hours worked by the professional employees of the taxpayer and [H]. The sharing is adjusted for what the taxpayer terms as the "wholesale" rate.

For example, the taxpayer bills and collects on its project \$1,000 (10 hours at \$100 per hour performed equally by one employee each of the taxpayer and [H]). The taxpayer and [H]

each get \$500. However, [H] was entitled to \$375 at the "wholesale" rate of \$75 per hour for 5 hours. The taxpayer explains that [H] in getting \$125 more is getting compensation for "rent" [use of [H]'s office space) and its overhead including taking phone calls and messages for the taxpayer.

Where [H] bills and collects on its project \$1,000 (similarly 10 hours at \$100 per hour performed equally by one employee each of the taxpayer and [H]), the taxpayer gets \$375 based on the "wholesale" rate of \$75 per hour and [H] gets \$625 which consists of \$500 for the work of its employee and \$125 for "rent" (use of [H]'s office and its overhead). Through this type of sharing of the receipts from customers, the taxpayer deduces and asserts that it pays rent for a "place of business" in Alaska.

CANADA: The taxpayer does work in Canada mainly on contracts given out by governmental agencies to Canadian firms only. Consequently, the taxpayer is retained by the Canadian firms on a joint venture basis by oral agreement. The taxpayer sends its employees, generally two in number, to the Canadian offices of the Canadian firms. The Canadian firm's employee(s) go with the taxpayer's employee(s) to the job site. Their report is then written at the office of the Canadian firm who sends the report to the Canadian customer. The Canadian firm bills the customer and shares the receipts with the taxpayer in the same manner as [H] does when it does the billing. Thus, as in the hypothetical example, the taxpayer gets \$375 based on the "wholesale" rate of \$75 per hour and the Canadian firm gets \$625 which consists of \$500 for the work of its employee and \$125 for "rent" (use of the Canadian firm's office and its overhead). Through this manner of sharing of the receipts from Canadian customers, the taxpayer deduces and asserts that it pays rent for a "place of business" in Canada.

The issue is whether the taxpayer's receipts for the above-described services rendered in Alaska and Canada are properly deductible from amounts reported for taxation purposes.

DISCUSSION:

The taxpayer and the Department are in agreement that whatever business income is subject to tax should be classified Service B&O because of the nature of the taxpayer's business activity which is the performance of on-site geological, geophysical and archeological investigations. Thus, the taxpayer falls within the ambit of RCW 82.04.290 which in pertinent part provides:

Upon every person engaging within this state in any business activity other than or in addition to those enumerated in [statutes enumerated]...as to such persons the amount of tax on account of such activities shall... This section includes, among others,...persons engaged in the business of rendering any type of service... (Bracketed words and emphasis supplied.)

The obvious question raised by the taxpayer's appeal is whether the investigations in Alaska and Canada constitute the "engaging within this state" of business activities so as to be subject to Washington's Service B&O tax.

We hold that they do not. The business activity which generates the Alaskan and Canadian income takes place entirely in Alaska and Canada respectively. The taxpayer is not paid for anything it does in Washington. The taxpayer sends its employee(s) to Alaska and Canada where they do on-site inspections and write their reports there working with the employee(s) of other firms located there from whose business offices the reports are transmitted to customers there or elsewhere.

[1] We do not reach the question of whether the taxpayer maintains places of business both within and without this state. Income derived solely from conducting on-site investigations out of state and completing the report out of state is not subject to tax in this state regardless of where the taxpayer maintains places of business. The tax assessment was based on WAC 458-20-194 (Rule 194), . . . , which provides in part:

When the business involves a transaction taxable under the classification service and other activities...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. (Emphasis supplied.)

However, Rule 194 does not address the situation where, as in this case, income is derived from services substantially or wholly rendered outside this state by a person domiciled herein who does not maintain a place of business in the state where the services are rendered. It cannot be said then that

the taxpayer's services were "incidentally" rendered outside this state. For services to have been "incidentally" rendered outside this state, some portion of the income-producing activity must have taken place within Washington. It did not in the instant case, so the out-of-state activity is not "incidental" and not subject to the above-quoted passage from Rule 194. In our view, such income is not taxable in this state. A state has no power to levy a tax upon activities that occur outside its territorial limits. Dravo Corp. v. Tacoma, 80 Wn. 2d 590 (1972).

We note that the auditor correctly did not subject to tax the taxpayer's jobs performed in New Zealand and Nepal "because all of the work was completed at the job sites." Similarly. all of the work was completed at the job sites in Alaska and Canada, but the auditor incorrectly subjected these jobs to taxation.

For the facts stated, reasons expressed and the applicable law, we conclude that the assessment of Service B&O tax on the amounts received as income from the services rendered substantially or wholly in Alaska and Canada is improper.

DECISION AND DISPOSITION:

The taxpayer's petition is granted. This matter is being referred to the Department's Audit Section for action in line with the holding in this Determination. It will then issue an amended assessment which will be due for payment on the date indicated thereon.

DATED this 13th day of December 1988.