

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)
and Refund of) No. 89-448
)
 . . .) Registration No. . . .
) Tax Assessment No. . . .
)

RULE 194: B&O TAX -- SERVICES -- APPORTIONMENT --
COST METHOD -- OUT-OF-STATE -- THIRD PARTY COSTS.
The cost of doing business for the cost
apportionment formula under Rule 194 includes third
party costs which are attributed to the location of
the office for which the expenses were incurred.

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: June 15, 1989

NATURE OF ACTION:

The taxpayer petitions for correction of assessment and refund
of Service B&O taxes based on apportionment of out-of-state
income. In addition to filing petitions for the correction of
assessment for . . . , the taxpayer has filed petitions for
refund based on the same issues. This determination applies
to all petitions.

FACTS AND ISSUES:

Pree, A.L.J. -- The taxpayer is a corporation with its
principal offices in Washington. It has several divisions, and

keeps separate books and records for each division. One of its divisions performs management services for related corporations in the hotel business. That division succeeded . . . and continues to provide management services.

The taxpayer's management division has five offices, three of which are located outside the state. All the offices contribute to the performance of services which generate income upon which the business and occupation tax was paid at the service rate. During the audit period, the taxpayer and the auditor agreed that not all the income should be apportioned to Washington, since the taxpayer had offices located outside the state which contributed to the performance of taxable services. They also agreed that the income from the management service division should be apportioned based on costs according to the formula in WAC 458-20-194 (Rule 194).

The auditor divided the direct costs of operating the specific offices outside of Washington by the total income of the division to arrive at the ratio it multiplied by the total service income. That product was multiplied by the service B&O tax rate to arrive at the amount to be credited to the taxpayer.

The taxpayer contends that the auditor misapplied the Rule 194 formula. First, the numerator in the formula should be costs of doing business in Washington rather than outside the state. That distinction is important to the taxpayer because it believes the burden of proof is on the Department of Revenue to show it has authority to tax the income, rather than on the taxpayer to show that the out-of-state income is exempt or somehow deductible from income presumed taxable by Washington.

Next, the taxpayer contends that the auditor should have used total costs in the denominator rather than income. In addition, the taxpayer and the auditor disagree on what costs should be considered as inside and outside the state of Washington. For instance, should travel costs by the taxpayer's employees and management and part of their salaries be considered costs outside the state of Washington? Probably more significant was the disagreement over third party expenses billed by out-of-state third party service providers. The auditor contended that those expenses should be considered costs of doing business within Washington, while the taxpayer asserted that those expenses should be treated as costs of doing business outside of Washington.

DISCUSSION:

The portion of WAC 458-20-194 (Rule 194) which is at issue states:

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 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. [Emphasis added.]

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 services related to those costs 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 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.

Regarding travel costs outside the state, actual travel costs for food and lodging incurred outside the state are inherently costs without the state and while part of the total costs in the denominator of the fraction, they are not to be included in the numerator. The taxpayer has also proposed apportioning the cost of airfare based on destination of the flights in the following manner:

1. If the travel originates in Washington and is to another state 50% of the cost is cost within this state.
2. If the travel begins and ends in another state, 100% of the cost is without this state.
3. If the travel ends in Washington and begins in another state, 50% of the cost is within this state.
4. If the flight begins and ends in Washington, 100% of the cost is within this state.

This method appears reasonable, and unless the auditor can identify circumstances that do not accurately reflect the costs of travel and proposes a more equitable method of apportioning these costs, this method should be used.

Regarding apportionment of salaries, we do not agree with the taxpayer. The employees are paid here. They enjoy the protection and benefit of this state's employment laws. The taxpayer has submitted no evidence that they claim domicile or pay income taxes elsewhere. Therefore, the employee cost factor should be allocated to the employee's base of operations in the same manner the compensation factor is allocated under RCW Chapter 82.56 Article IV (14):

Compensation is paid in this state if:

- (a) the individual's service is performed entirely within this state;

(b) the individual's service is performed both within and without the state, but the service performed without the state is incidental to the individual's service within the state; or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this state, or (2) the base of operations, the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

We believe this is fair as well as administratively convenient to allocate the cost of employment and should usually be consistent with the tax home they use for income tax purposes. Those salaries for employees assigned to the out-of-state offices may be allocated to those out-of-state office locations that they claim is their tax home for income tax purposes. While those based out of the Washington office will be allocated as a cost within the state for the purpose of the Rule 194 apportionment formula.

DECISION AND DISPOSITION:

This case is referred back to the Audit Division to revise the assessment apportioning income based on the total cost of doing business including third parties. Third party costs will be attributed to the state where the taxpayer performed the activities for which the expenses were incurred. If the third party costs cannot be identified as incurred because of any particular office, they will be attributed to the taxpayer's domicile located in Washington.

DATED this 30th day of August 1989.