Cite as Det. No. 89-459, 8 WTD 227 (1989)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 89-459A, 11 WTD 17 (1991) & DET. NO. 01-006, 20 WTD 124 (2001)

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

In the Matter of the Petition For Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 89-459
. . .	)	Registration No. . . .
	)	. . . /Audit No. . . .

[1] RULE 194: RCW 82.04.460 -- B&O TAX -- APPORTIONMENT --BANK -- METHOD. A bank which had previously requested and received Department approval to use a three factor formula to apportion income, permitted to switch to a cost method.

[2] RULE 194: RCW 82.04.460 -- B&O TAX -- APPORTIONMENT --BANK -- COST-BASIS METHOD. Under cost method, total income is apportioned by using an apportionment percentage which is obtained by dividing in-state costs by total costs. Deductions, but not exemptions, are taken after application of apportionment percentage.

[3] RULE 194: B&O TAX -- APPORTIONMENT -- BANK -- INTEREST COSTS. Under a cost method of apportionment, interest costs incurred by a bank are allocated to location where funds are used; administrative costs of loan are allocated to location where costs were incurred.

[4] RULE 228: RCW 82.321.105 -- INTEREST -- WAIVER -- CIRCUMSTANCES BEYOND CONTROL OF TAXPAYER. Where a bank chose to change its method of reporting its income to a cost formula from a previously approved three factor formula, and the Department had advised the taxpayer in writing that it would not accept the cost method that the bank used, the failure of the taxpayer to report correctly was not due to a circumstance beyond its control within the meaning of RCW 82.32.105.

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: . . .
. . .
. . .
. . .
. . .

DATES OF HEARINGS: October 2, 1987 and February 24, 1989

NATURE OF ACTION:

An international bank protests the method of apportionment of income.

FACTS AND ISSUES:

Roys, Sr. A.L.J. -- [Bank] (hereinafter referred to as . . . taxpayer) is a [foreign] corporation with its head office in . . . . Currently the Bank has seven offices in the United States, including Seattle. The Bank's records were examined for the period January 1, 1982 through March 31, 1986. As a result, the above referenced assessment for $ . . . was issued on November 20, 1986.
The taxpayer does not protest the assessment of $ . . . in use tax assessed. At issue is the reconciliation of the taxpayer's income in Schedule II. The taxable difference was the result of the taxpayer changing its method of apportioning income from a three factor formula to a cost of doing business formula. The auditor reclassified the income by using the three factor formula.

The taxpayer and the Department had agreed in 1977 that the bank should apportion revenue according to a three-factor formula. This method of apportionment was used by the taxpayer through the end of 1983. In December of 1983, the taxpayer requested that the apportionment formula be changed to a cost apportionment method. The Department denied the request. (. . .)

The taxpayer advised the Department by letter in July of 1984 that effective with that month's excise tax return, it intended to report its B & O tax liability on a cost apportionment formula basis. The letter stated that the taxpayer understood that a written revision of WAC 458-20-194 was forthcoming. The taxpayer's representative stated that the switch in reporting method was made after a meeting with the director of the excise tax division in which the taxpayer understood that the Department would approve a cost apportionment formula. The Department continued to review the cost apportionment issue throughout 1984 but never revised Rule 194 to include an apportionment formula.

The taxpayer contends the proper formula for apportioning income on a cost basis is expressed as follows:

$$\frac{\text{In State Costs}}{\text{Total Washington Related Costs}} \text{ or } \frac{A}{A+B+C} \text{ where:}$$

"A" represents total expenses incurred within Washington State such as office and administrative expenses, salaries, consumables, etc. and interest expense incurred in Washington State such as interest on deposits, on in-state borrowings, etc;

"B" represents head office expenses attributable to Washington State activities;

"C" represents out-of-state interest and related expenses to fund Washington State loans.

The resulting ratio is then multiplied times all income on the books of the Washington State branch (participation loans purchased and instruction loans not included) to produce a figure for gross income apportioned to Washington State on a cost basis. From gross Washington State income are taken allowable deductions to arrive at Washington State taxable income, which is then multiplied times the tax rate to produce the tax amount.

The issues presented, as framed by the taxpayer, are:

1) Is the Department authorized under RCW 82.04.460 and WAC 458-20-194 to require the use of the three-factor apportionment formula, or must the Bank's income be apportioned based on cost?

2) If cost apportionment is required, what is the proper cost apportionment formula?

3) Should penalty interest on any underpayment be assessed against the Bank?

DISCUSSION:

[1] Method of Apportionment. As the taxpayer is a financial institution with income derived from efforts both within and outside of Washington, the income is apportionable as provided by RCW 82.04.460. That statutory provision provides in pertinent part that:

(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.
>
> (2) Notwithstanding the provision of subsection (1) of this section, persons doing business both within and without the state who receive gross income from service charges, as defined in RCW 63.14.010 (relating to amounts charged for granting the right or privilege to make deferred or installment payments) or who receive gross income from engaging in business as financial institutions within the scope of chapter 82.14A RCW (relating to city taxes on financial institutions) shall apportion or allocate gross income taxable under RCW 82.04.290 to this state pursuant to rules promulgated by the department consistent with uniform rules for apportionment or allocation developed by the states.

The taxpayer argues that the statute only authorizes three methods of apportionment for financial institutions and that the cost apportionment method is the only one that is applicable. The taxpayer contends the "separate accounting method" is inappropriate where the business of the corporation cannot be conveniently divided between the states. Memorandum, p. 12, citing Hartman, Federal Limitations on State and Local Taxation Sec. 9:17 at 522 (1981). The taxpayer contends its income cannot be apportioned under rules promulgated by the Department for financial institutions, because no such rules have been promulgated.

The taxpayer also relies on the following language from a 1980 unpublished Determination issued in an appeal by another bank:

> It may be that the original intent of RCW 82.04.460(2) was for a three factor formula to be utilized in apportioning the income of a financial institution. But we do not believe that this intent can be accomplished without the promulgation of a rule. It has been our uniform position over the years that the three factor formula does not apply to this state's business and occupation tax as such formula is applicable only to net income taxes. Since the State of Washington does not impose an income tax, we are presently limited to apportionment pursuant to RCW 82.04.460 and Rule 194. True, we have authorized the use of a three factor formula in the past, but only at the request of the taxpayer involved. We therefore hold that separate accounting or apportionment on a cost-of-doing business basis are the only methods to be used to determine the amount of financial income which is to be allocated or apportioned to Washington. The audit will have to be amended.

Memorandum, pp.13-14, quoting Determination 80-20 at 16.

The present case, however, is one of those distinguished in Det. 80-20. The three-factor formula was authorized at the request of the taxpayer. The letter to the taxpayer's attorney authorizing the three-factor formula stated in pertinent part:

> The Department of Revenue accepts your proposal of March 22, 1977. Specifically,

> the Department agrees that this settlement will be effective September 1, 1977:
>
> 1. The [Bank] will report all past and future Business and Occupation Tax liability by application of a three-factor formula representing gross income, tangible property and payroll, unless there are statutory, constitutional, or interpretative changes in the law as now written, any such changes will be given prospective application only.

(. . .)

The taxpayer now argues that the Department is without authority to "impose" a three factor formula as that method is not stated in RCW 82.04.460. Memorandum p. 14. The taxpayer ignores the fact that the method was proposed by the taxpayer, not imposed by the Department.

In the audit at issue, the auditor used the apportionment formula which had been described to the taxpayer in a letter from an audit supervisor dated April 23, 1982. She noted that the three-factor formula had been proposed by the taxpayer after an appeal in 1972 and was to remain in effect unless the law changed. No such change in the law has occurred. We believe, therefore, that the auditor's use of the three factor formula in reconciling the taxpayer's income was reasonable and valid. Nevertheless, because of the language in RCW 82.04.460(2) and the fact that many other banks are permitted to use a cost apportionment method, we agree that the taxpayer may change to a cost method, even though no change in the law has occurred.

[2] Proper cost method of apportionment. In its December 1983 letter requesting a change to a cost method, the taxpayer proposed the same formula it is proposing in its present appeal. The Department's decision denying the request stated:

> We are unable to accept your alternative reporting proposal. Many banks which are located entirely within Washington find it necessary to borrow funds, some of which come from out of state sources. Those banks are not permitted to exclude interest income merely because of the out of state source of these funds.
>
> . . .
>
> The attempt to derive an apportionment percentage using only direct costs of the Washington operation and weighing those against the total dollar costs the bank incurs for its Washington operation does not appear appropriate. The method does not apply the percentage to total income both within and without the state, but the reduced percentage is to be applied to only Washington branch income.

(Letter of February 9, 1984, Director, Excise Tax Division)
We agree with the earlier conclusion not to accept the taxpayer's proposed cost method.

If the taxpayer wants to change its reporting method from the three-factor formula to a cost method,

the taxpayer may use a cost method that has been approved for other banks. Determination 85-117, affirmed in Det. 85-117B, 2 WTD 109 (1986), stated the cost method as follows:

> RCW 82.04.460(1) establishes alternative methods of apportionment. For purposes of determining Service business and occupation tax liability, a person subject to RCW 82.04.460(1) is required to "apportion to this state that portion of his gross income which is derived from services rendered within this state." Id. (Emphasis added.) This first method of apportionment, which is also the preferred method, is thus performed on the basis of the place where services are rendered. In cases where separate accounting methods will not support an accurate apportionment by this method, the statute provides an alternative method based on the cost of doing business. Under the second method, the taxpayer "shall apportion to this state that portion of his 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." RCW 82.04.460(1). (Emphasis added.)
>
> . . .
>
> To determine which method of apportionment is correct, it is necessary to determine what the legislature intended by the terms "gross income" and "total income." Either term appearing alone would suggest that total receipts from all sources were intended. But we must interpret the terms in such a way as to give effect to the purpose of the statute. Furthermore, our interpretation must take into account the fact that the legislature used two different terms to describe the amount subject to apportionment.
>
> Turning first to the term "gross income," we note that it is not specifically defined in the Washington Revenue Act; however, the term "gross income of the business" is defined as follows:
>
> "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.
>
> In our view, "gross income," as the term appears in RCW 82.04.460(1), is merely an abbreviated reference to "gross income of the business." We reach this conclusion because the legislature uses these terms interchangeably elsewhere in chapter 82.04

RCW. For example, under the business and occupation tax classifications created under RCW 82.04.255, RCW 82.04.260(13), RCW 82.04.280(1) through (7), and RCW 82.04.290, the measure of the tax is "gross income of the business." The measure of the taxes imposed by RCW 82.04.260(6), (10), and (11), however, is "gross income." Yet another tax is imposed by RCW 82.04.260(14) measured by the "gross income of such business."

But we cannot interpret "gross income" to literally mean all "gross income of the business," regardless of the source. This interpretation ignores the stated purpose of RCW 82.04.460, which is to provide methods of apportionment "for the purposes of computing tax liability under RCW 82.04.290, . . ." Id. Rather, the term must be limited to "gross income" derived from services taxable under 82.04.290. This interpretation gives effect to the purpose of the statute.

Our interpretation of RCW 82.04.290 must also take into account that the first method calls for apportionment of "gross income." Under the first method of apportionment, that portion of "gross income" which is derived from services rendered in this state is apportioned to this state. Thus, the measure of the tax will only include amounts derived from services rendered in this state. It is therefore appropriate to refer to these amounts as "that portion of . . . gross income."

Under the second method, however, the cost of doing business is considered rather than the place where services are rendered. It thus may be that amounts derived from services rendered outside this state are apportioned to this state (and vice versa, of course). It would not be appropriate to refer to such amounts as "that portion of . . . gross income." Since "gross income" is the statutory measure of various classifications of the Washington business and occupation tax, it should only be used to describe amounts received for business activities conducted in this state. Instead, the legislature used the term "total income" to describe these amounts. We are convinced, however, that their intent was to include only amounts derived from business activities of the type that, when performed in Washington, are taxable under RCW 82.04.290. In short, we believe "gross income" and "total income" refer to the same kind of receipts. The latter term merely recognizes that apportionment based on the "cost of doing business" method may result in the inclusion in the measure of the tax of amounts derived from services rendered outside this state.

Since "total income" includes only amounts derived from business activities of the type that are taxable under the Service and Other Activities classification (RCW 82.09.290) when performed in Washington, amounts which would be taxable under any other classification should be subtracted from total receipts prior to application of the apportionment percentage. Such amounts, when attributable to Washington, are fully taxable and are not subject to apportionment. When such amounts are attributable to out-of-state sources, they are neither taxed in Washington, nor are they

considered in the apportionment formula. While these amounts might constitute "gross income of the business," at lease when attributable to Washington, they do not constitute "gross income" or "total income" within the narrower meaning of RCW 82.04.460(1). Furthermore, amounts taxable under some classifications of the business and occupation tax (e.g., Retailing) are properly referred to as "gross proceeds of sales," rather than "gross income of the business."

It is also appropriate to subtract amounts which would be exempt from Washington business and occupation tax from total receipts prior to the application of the apportionment percentage, irrespective of whether those amounts relate to services rendered in Washington. The exemption statutes found in chapter 82.04 RCW invariably begin with, "This chapter shall not apply to . . ." or something to that effect. The definition of "gross income of the business" found at RCW 82.04.080, likewise, does not apply to exempt amounts. In other words, amounts derived from exempt business activities conducted in Washington are not included in "gross income." Nor, by analogy, are amounts derived from such activities conducted without this state included in the term "total income."

Deductions attributable to Washington sources, however, must be subtracted after the apportionment percentage has been applied. This is because deductions are included within the broad definition of "gross income of the business." These are amounts which would be included in the measure of the tax, but for some specific statutory deduction. Thus, deduction statutes found in Chapter 82.04 typically begin with, "In computing tax, there may be deducted from the measure of tax . . . ," to words to that effect. We note also that the administrative rule pertaining to financial institutions provides in part, "Deductible gross income should be included in the gross amount reported and should then be shown as a deduction . . ." WAC 458-20-146. (Of course, no allowance is made for "deductions" attributable to out-of-state sources.)

Based on the foregoing, we find that the following method of apportionment, which was employed by [bank] during the period 1982 through 1983, was the correct one:

Total receipts	$ 1,000
Less eliminations	(100)
Total Service income	900
Apportionment percentage applied	x 90%
Reportable Service income	810
Less deductions	(100)
Taxable Service income	$ 710
	=========

The auditors were concerned that [bank] would obtain a windfall under this method because 100 percent of deductions would reduce an apportioned amount which

> includes only a portion of those deductions. We note, however, that the apportioned amount might also include amounts attributable to out-of-state business which would be deductible had they been attributable to in-state sources. [Bank] gets to deduct 0 percent of these amounts.
>
> In any event, RCW 82.04.460(1) clearly and unequivocally mandates apportionment of "gross income" or "total income." The Department may not ignore the statute and impose apportionment based on some type of "net Service income" in order to increase the Washington tax base even though this may be perceived to be a more just or equitable division of tax liability. (Emphasis ours and brackets added.)

In the present case, the taxpayer contends the term "total income" in the apportionment statute can only mean income the state can reach. For support, the taxpayer relies in part on Pacific First Federal Savings and Loan Assoc. v. State, 92 Wn.2d 402 (1979). The taxpayer notes that the only income at issue in that case was Washington related income. The taxpayer contends the State was not attempting to apportion all income earned by PFF in Washington and Oregon.

The income at issue in Pacific First Federal was the liquid funds which were earned from deposits in Washington and Oregon and invested solely in Washington. The Department had argued that 100% of the income earned from the invested funds was subject to Service B&O tax, as the act of investing occurred only in Washington. One reading of that case is that the Department was apportioning the income earned by PFF according to source, i.e., by separate accounting. The income earned by the operations in Oregon was not included. The court concluded that the out-of-state office "contributed" to the performance of the service (short-term investment) by supplying approximately one-half of the funds employed. The court held that under the apportionment statute, PFF was entitled to apportion its income from liquid fund investments. Id. at 409.

The taxpayer distinguishes itself from the bank involved in Det. 85-117. That case involved a bank with a home office and most of its operations in this state. The taxpayer contends it has no responsibility for the Tokyo office. It distinguishes a taxpayer as itself, contending all of the income earned by a bank with its home office in this state is integrated and arguably related to this state.

We do not agree with the taxpayer that a different formula should be used for a bank with a home office in this state from one with a foreign home office; nor do we agree that a cost formula only can include Washington related costs and income. The formula used in Det. 85-117 uses a percentage of Washington costs over total costs. In this case, if most of the taxpayer's costs are incurred out of state, the apportionment percentage will be much lower than the one applied in Det. 85-117. A reasonable assumption is that costs are related to income and that the approved formula will result in a fair apportionment.

[3] Allocation of interest expense. The taxpayer relies on Pacific First Federal for support for its position that interest expenses are attributable to the situs where the personnel rendering services in connection with borrowing funds are located. The Department's position, however, is that interest

expense, other than administrative costs incurred in negotiating, managing, and ultimately paying the loan, follow the proceeds of the loan. This position was set forth in Det. 85-117 as follows:

> Under the "cost of doing business" method of apportionment, "total income" is multiplied by the so-called apportionment percentage in order to arrive at reportable service income. The apportionment percentage is calculated by dividing the cost of doing business within this state by the cost of doing business both within and without this state. Thus:
>
> $$\text{Apportionment percentage} = \frac{\text{Washington Expenses}}{\text{Total Expenses}}$$
>
> Thus, when apportioning total income on a "cost of doing business" basis, it is first necessary to differentiate between in-state expenses and out-of-state expenses.
>
> In this case, [bank's] foreign branches borrowed funds which were then made available to Washington branches for in-state lending transactions. The issue is whether [bank's] interest expense should be allocated to the foreign branch (where the loans were negotiated, managed, and ultimately paid), or to Washington (where the proceeds of the loans were used to fund further lending transactions).
>
> The auditors allocated this interest expense to Washington on the theory that this cost follows the proceeds of the loan. The taxpayer maintains that interest expense should be allocated to the foreign branch.
>
> It is a simple matter to distinguish in-state costs from out-of-state costs when those costs have a fixed and definite situs. For example, the administrative costs incurred by the foreign branch in negotiating, managing, and ultimately paying the loan are clearly costs which should be allocated out of state. In the case of interest on the loan, however, the task is not so simple. After careful consideration of the matter, however, we must concur with the auditors.
>
> Interest, broadly defined, is the compensation paid for the use of money, or forbearance in demanding it when due. In the narrower context of a negotiated loan transaction, interest clearly is compensation for the use of money. If it is meaningful at all to speak of interest on a loan as having a situs, then that situs must surely be where the loan proceeds are committed to use (in this case, to fund further lending transactions). This method matches the underlying cost of these funds with the income they generate.
>
> Under the taxpayer's method, the underlying cost of funds would be allocated out of state, even though those funds generate income within this state. This is an incongruous result.

> The auditors' method, on the other hand, is both rational and fair. It is also consistent with the position the Department takes with respect to funds borrowed by Washington branches to finance loans by foreign branches. Where this occurs, the interest expense is allocated to the foreign branch, and not the Washington branch.
>
> We conclude that when [bank] borrows funds to finance loans by its Washington branch, then, for purposes of apportionment, the interest expense associated with acquiring those funds is a Washington cost of doing business irrespective of where the funds were borrowed.

[4] Interest. The Department assessed interest on the taxes found due at the rate of nine percent per annum as required by RCW 82.32.050. The taxpayer argues no interest should be due as the Department refused to advise it as to what cost apportionment method the Department has accepted in the case of other financial institutions and failed to promulgate regulations. The taxpayer alleges this left the bank "to speculate at its peril what method of apportionment is required by the statute." Memorandum, p. 30.

The only authority to cancel interest is found in RCW 82.32.105. That statute allows the Department to waive or cancel interest or penalties if the failure of a taxpayer to pay any tax on the due date was the result of circumstances beyond the control of the taxpayer. WAC 458-20-228, the administrative rule dealing with interest and penalties, states two circumstances under which the Department will consider the waiver of interest upon assessments. Neither circumstance applies in this present case.

All of the written instructions to the taxpayer since 1977, when the Department agreed to accept the taxpayer's proposal for using a three factor method of apportionment, have stated that the taxpayer should continue to report under a three factor method. We do not find that the failure to report the taxes that were due as previously agreed was the result of circumstances beyond the control of the taxpayer. Nothing in the taxpayer's file indicates that the Department ever considered accepting the taxpayer's proposed cost method for apportioning its income. The taxpayer's attorney was aware of the cost formula approved in Det. 85-117, as he was the representative for the bank in that appeal. The taxpayer may have believed, and may continue to believe, that the cost method it used was correct. Nevertheless, we find that the method was not correct and that additional taxes and interest are due.

DECISION AND DISPOSITION:

1) The taxpayer is permitted to use the cost method set forth herein or the previously approved three-factor formula. The taxpayer shall inform the auditor within 20 days of this Determination if it wishes to have its liability computed under the cost method.

2) The taxpayer's petition for the waiver of audit interest is denied.

3) If a cost apportionment formula is chosen, an amended assessment shall be issued and due on the

date provided thereon. If the taxpayer prefers to continue to use a three factor formula, the amount remaining owing on Document No. . . . is $ . . . , plus extension interest of $ . . . , for a total of $ . . . is due by October 16, 1989.

DATED this 15th day of September 1989.