

Cite as Det. No. 01-006, 20 WTD 124 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of	)	<u>D E T E R M I N A T I O N</u>
Assessment and Refund of)	
	)	No. 01-006
...	)	Registration No. . . .
	)	FY. . . /Audit No. . . .
	)	Petition for Refund
...	)	Registration No. . . .
	)	FY. . . /Audit No. . . .
	)	Petition for Refund

- [1] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – WHEN AVAILABLE. When a taxpayer renders services taxable under RCW 82.04.290, maintains places of business both within and without the state, and those places of business contribute to the rendition of those services, the taxpayer shall apportion to Washington the portion of its total income derived from services rendered in Washington.

- [2] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – PLACE OF BUSINESS. For the purposes of RCW 82.04.460(1), a place of business does not mean a physical location. Rather, if a taxpayer conducts activities in a state sufficient to create nexus under Washington standards, then the taxpayer is deemed to have a "place of business" in that state for apportionment purposes. OVERRULING: Det. No. 86-297, 2 WTD 23 (1986); Det No. 92-117, 12 WTD 147 (1993).

- [3] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – SEPARATE ACCOUNTING PREFERRED. Separate accounting is the preferred method of apportioning income. However, if separate accounting is not accurate, then cost apportionment (formulary apportionment) shall be used.

- [4] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – SEPARATE ACCOUNTING DISTINGUISHED FROM COST APPORTIONMENT. Cost apportionment is the formulary apportionment method used by Washington. Cost apportionment focuses on costs and uses a formula based on those costs to

determine the income from Washington activities. This is distinctly different from separate accounting, which focuses on income. Therefore, separate accounting concepts are not applicable to cost apportionment.

- [5] RULE 194; RCW 82.04.290; 82.04.460(1): B&O TAX – APPORTIONMENT – INCOME SUBJECT TO COST APPORTIONMENT -- RELATED BUSINESS ACTIVITIES. Only income from related activities partially performed in Washington and subject to the B&O tax under RCW 82.04.290 is apportionable under RCW 82.04.460. When a taxpayer engages in related business activities subject to the B&O tax under RCW 82.04.290, the total income from the related business activities is subject to apportionment. However, if a taxpayer engages in an unrelated, discreet, out-of-state business activity, then the income from that discreet, out-of-state business activity is not subject to Washington's business and occupation tax.
- [6] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – INCOME SUBJECT TO COST APPORTIONMENT. When a bank, engages in lending activities and, related to that activity, it also engages in short-term and long-term interest rate swaps, servicing of loans, and sales of loans as well as receiving up-front fees, late-payment penalties, pre-payment payments, and interest, the income from these activities is related to the lending activity and is subject to apportionment.
- [7] RULE 194; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – COSTS USED TO CALCULATE COST APPORTIONMENT PERCENTAGE. The denominator of the cost apportionment formula is the total costs attributable to the related business activities partially performed in Washington. The numerator is the cost of doing the related business activities in Washington. The cost of doing business in Washington is not costs incurred in Washington, rather it is any cost, regardless of where incurred, that relates, directly or indirectly, to the Washington activities. OVERRULING: Det. No. 89-459, 8 WTD 227 (1989); Det. No. 93-172, 13 WTD 180 (1993); and Det. No. 94-031, 14 WTD 194 (1995), to the extent inconsistent with this determination.
- [8] RULE 14601; RCW 82.04.460(2): B&O TAX – APPORTIONMENT – INTERIM APPORTIONMENT METHOD – FINANCIAL INSTITUTION. The decision in Det. No. 89-459A, 11 WTD 17 (1991) was intended to be an interim method of apportionment applicable only to financial institutions pending the adoption of a uniform rule. Det. No. 89-459A was overruled by Rule 14601, which became fully effective as of January 1, 2000.
- [9] RULE 14601; RCW 82.04.460(1): B&O TAX – APPORTIONMENT – FINANCIAL INSTITUTION. Because the location where a financial institution manages its borrowing activity is not indicative of the cost of doing business at

that location, Det. No. 89-459A did not express a proper cost apportionment method under RCW 82.04.460(1) and is OVERRULED.

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 bank protests B&O taxes assessed and refunds denied, claiming:¹²

- I. The cost apportionment methodology specified in Det. No. 89-459A, 11 WTD 17 (1991) erroneously applies RCW 82.04.460;

...

BACKGROUND INFORMATION:

Coffman, A.L.J. -- The taxpayers are financial institutions. The petitions have been consolidated at the request of the taxpayers due to the similarity of issues. The taxpayers are engaged in the banking business in multiple states, including Washington where they are headquartered. The major income-producing activity of the taxpayers is lending money. . . . The taxpayers' lending activity may directly generate interest, loan origination fees, servicing fees, loan-processing charges, and/or inter-company brokered loan fees. The taxpayers also engage in interest rate swaps and the purchase (or origination) and sales of evidences of indebtedness and other securities.

PROCEDURAL HISTORY:

The Audit Division of the Department of Revenue (Department) reviewed the books and records of two of the taxpayers for the period January 1, 19xx through December 31, 19xx (the audit period) and issued separate tax assessments. These two taxpayers had filed refund requests with the Department for 19xx and 19xx. The two taxpayers appealed the tax assessments and all of the taxpayers requested refunds for the audit period. Subsequently, all of the taxpayers filed requests for additional refunds for calendar year 19xx.

The Appeals Division did not immediately address the taxpayers' petitions because the Department was reviewing its implementation of RCW 82.04.4292.³ In February 1999, we published Det. No. 98-218, 18 WTD 46 (1999), that addressed issues similar to the taxpayers' refund requests and petitions for correction of assessments, and announced the Department's position on the application of the business and occupation (B&O) tax deduction for financial businesses authorized in RCW 82.04.4292. On . . . , 1999, the Appeals Division provided the taxpayers' representative a copy of

¹ Nonprecedential portions of this determination have been deleted. See RCW 82.32.410.

² Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

³ The portion of this determination related to RCW 82.04.4292 has been redacted as non-precedential. We advised the taxpayers that this matter was on hold, pending resolution of the Department's application of the statutory deduction.

the published determination and requested the taxpayers provide additional documentation and facts in light of the determination. On . . . , 1999, the taxpayers provided additional documentation and a supplemental statement of facts for our consideration. For purposes of this determination, we will refer to all the taxpayers collectively in the singular unless the context requires otherwise.

ISSUE:

What is the proper method for implementing cost apportionment?

...

DISCUSSION:

I. COST APPORTIONMENT.

The taxpayer is engaged in banking activities in the states of Washington and _____. One of the taxpayer's business activities is the lending of money. In order to acquire money to lend, the taxpayer borrows funds. The interest expense from borrowing funds is one of the taxpayer's major expenses.

The taxpayer's lending activity is subject to the B&O tax under RCW 82.04.290. When a person engages in business activities in more than one state and those activities are subject to Washington's B&O tax under RCW 82.04.290 (the service and other activities classification of the B&O tax), apportionment may be required. RCW 82.04.460 explains apportionment, as follows:

Business within and without state--Apportionment. (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.⁴

⁴ RCW 82.04.460(3) is omitted because it is irrelevant to this determination.

In order to determine the taxpayer's gross income from Washington activities, the Audit Division apportioned the taxpayer's revenue according to a formula based on where the taxpayer incurred its costs. This method was prescribed in Det. No. 89-459A, supra:

. . . under the cost method of apportionment, interest costs incurred by a bank are apportioned, in the same manner as all other expenses, to the location where services associated with that expense were performed. Interest expenses are apportioned to the location that incurs the payroll and property expenses in managing the borrowing activities that give rise to the interest expense.

In applying the interest expense apportionment rationale dictated by Det. No. 89-459A, interest expense paid on deposits is allocated both within and without Washington based on the branch location associated with the expense. Interest expense on borrowings is entirely allocable to Washington since the payroll and property expenses in negotiating and managing the activity occurs in Washington.⁵

The taxpayer disagrees that Audit's method, based on Det. No. 89-459A, was correct. The taxpayer states:

The costs to be considered under Rule 194 [WAC 458-20-194] should be limited to payroll, occupancy and interest expenses, which represent most of the costs and is administratively more manageable. Interest expense on other borrowings should be allocated based on where the funds are used (e.g., where the loan proceeds are committed to use).⁶

Thus, the taxpayer, in disputing its assessments, challenged the apportionment method the Department applied to determine the portion of income subject to Washington's B&O under RCW 82.04.290.

A. General Apportionment Principles.

First, we think it will be helpful to lay out general apportionment principles that will be relevant to this determination. RCW 82.04.460(1) provides the general rules for apportionment of income. RCW 82.04.460(2) provides that, under certain circumstances, the Department may adopt specific rules for certain financial institutions or for businesses that receive service charges.

[1] RCW 82.04.460(1) provides a taxpayer shall apportion its income if:

- a) it renders services taxable under RCW 82.04.290; and
- b) it maintains places of business both within and without the state;
- c) that contribute to the rendition of those services.

⁵ Auditor's Detail of Differences and Instructions to Taxpayers, Tax Assessment FY. . . , June . . . , page 5.

⁶ Taxpayer's Petition of . . . (Taxpayer's petition), page 21.

Therefore, the taxpayer was required to:

- a) apportion to Washington
- b) the portion of its total income
- c) derived from services
- d) rendered in Washington.

[2] There is no dispute that the taxpayer engages in activities that are subject to the B&O tax under RCW 82.04.290. Under RCW 82.04.460, a business may apportion its income only when both Washington and out-of-state places of business contribute to activities subject to the B&O tax under RCW 82.04.290. The “place of business” requirement, however, does not mean that the business must maintain a physical location as a place of business in the other states in order to apportion its income. See, Det. No. 87-186, 3 WTD 195 (1987).⁷ If a taxpayer has activities in a state sufficient to create nexus under Washington standards, then the taxpayer is deemed to have a “place of business” in that state for apportionment purposes. Det. No. 92-252E, 12 WTD 417 (1992) and Det. No. 92-262E, 12 WTD 431 (1992). The taxpayer and the Audit Division agree that the taxpayer maintained “places of business” in multiple states that contributed to the taxpayer’s rendition of taxable services. Therefore, the taxpayer is entitled to apportion its gross receipts.

[3] RCW 82.04.460(1) sets forth two distinct methods of apportionment. The statutorily preferred method of apportionment under RCW 82.04.460(1) is separate accounting.⁸ However, if apportionment by the use of separate accounting cannot be accurately made, then cost apportionment⁹ shall be used. RCW 82.04.460(1); Det. No. 93-325, 14 WTD 82 (1994); and Det. No. 94-031, 14 WTD 194 (1995). Both separate accounting and cost apportionment attempt to accurately determine the measure of the B&O tax on a taxpayer’s business activities in Washington. However, both separate accounting and cost apportionment are, at best, estimates of the values or income generated from in-state activities. See Barclay’s Bank v. Franchise Tax Bd., 512 U.S. 298, 303-4 (1994). The taxpayer and the Audit Division agree that separate accounting is not available to the taxpayer. Therefore, the taxpayer must use cost apportionment to determine the gross income subject to Washington’s B&O tax.

1. **Cost Apportionment.**

[4] Cost apportionment is the formulary apportionment method used by Washington. Cost apportionment focuses on costs and uses a formula based on those costs to determine the gross

⁷ When the Department previously held that a Washington business must have a physical location as a place of business, the Department erred. Specifically, to the extent that Det. No. 86-297, 2 WTD 23 (1986), and Det. No. 92-117, 12 WTD 147 (1993), require a physical location in order for a taxpayer to apportion income subject to the B&O tax under RCW 82.04.490, these decisions were overruled *sub silentio* in Det. No. 93-276, 13 WTD 392 (1994) and Det. No. 94-31, 14 WTD 194 (1995) and are specifically overruled here.

⁸ Separate accounting is an apportionment method sometimes referred to as geographic or transactional accounting. See Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 164 (1983).

⁹ Also called formulary apportionment.

income from Washington activities. Cost apportionment, which focuses on costs, is unlike separate accounting (geographic allocation of income), which focuses on income. Because these two methods are based on entirely different factors, separate accounting concepts/principles are not applicable to cost apportionment.

RCW 82.04.460(1) states: “. . . the taxpayer shall apportion to this state that portion 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.” (Emphasis added.) This statute requires three calculations to determine the measure of the Washington B&O tax. First, we must determine what income is subject to apportionment. Second, we must determine the total cost of doing business related to that income. Third, we must determine the cost of doing business in Washington related to that income.

2. Income Subject to Cost Apportionment.

[5] “[A]pportionment is not applicable if the taxable incident or activity occurs entirely within the taxing jurisdiction.” Dravo Corp. v. The City of Tacoma, 80 Wn.2d 590, 602, 496 P.2d 504 (1972). Likewise, income from an out-of-state, “unrelated business activity which constitutes a discrete business enterprise” cannot be used to measure the B&O tax imposed on a taxpayer’s in-state activities. Hunt-Wesson, Inc. v. Franchise Tax Bd. of Cal., 528 U.S. 458 (February 22, 2000) (Internal quotation marks and citations omitted.) See also, Allied Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768 (1992). Only income from activities at least partially performed in Washington and subject to the B&O tax under RCW 82.04.290 is apportionable under RCW 82.04.460. When related business activities are performed in multiple states, the total income from the related business activities shall be apportioned to determine the measure of the B&O tax.

[6] The taxpayer engages in lending activities. The income from lending money includes all income related to the lending activity, which includes up-front fees charged to borrowers, late-payment fees, pre-payment penalties, and interest. We find that income from activities such as interest rate swaps, in which the taxpayer engages to reduce interest rate fluctuation risks, is part of and integral to the taxpayer’s lending activity. We also find that income from the servicing of loans, which occurs when the taxpayer either originated (or purchased) the loans and subsequently sold the loans and contracted to perform the servicing activity, or when the taxpayer otherwise acquired the servicing rights to a loan, is related to the taxpayer’s lending activities. Finally, “gains” from the sale of loans are also related to the taxpayer’s lending activities. Thus, we find that the income from interest, late-payment and pre-payment penalties, servicing fees, and gains from interest rate swaps and on sale of loans is the result of the taxpayer’s money lending activities and is apportionable under the cost method.

. . .

3. Costs to be Included in the Cost Apportionment Formula.

The taxpayer argues only personnel, occupancy, and interest costs, not all costs related to the related business activities, should be considered in determining the cost apportionment percentage.

However, limiting the calculation to only three categories of costs is inconsistent with RCW 82.04.460(1), which requires the calculation of the percentage of total costs that are costs of doing business in Washington.

[7] The denominator of the cost apportionment formula includes all costs of the related business activities subject to B&O tax under RCW 82.04.290 that are partially performed in Washington. The numerator includes the costs of doing business in Washington. The difficult task for calculating the numerator is determining which costs included in the denominator are “cost(s) of doing business within the state.” RCW 82.04.460(1). The statute does not limit the cost of doing business to costs incurred in Washington; rather, it refers to the “cost of doing business within” Washington. Costs of doing business within Washington may be incurred in Washington or at out-of-state locations. Where the costs are incurred is irrelevant. Costs are included in the numerator regardless of where incurred when the costs relate to the Washington taxable activity. The test is a relationship test. Is the out-of-state activity/cost, directly or indirectly, related to the Washington business activity? If the answer is “yes,” then the portion of the costs of that out-of-state activity related to doing business in this state is a Washington cost of doing business.

In the past, we have held that the location where the costs are incurred determines whether the costs are treated as in-state or out-of-state costs. Because RCW 82.04.460(1) focuses on the relationship of the costs of doing business to the Washington business activity not to the location where those costs were incurred, we were in error. We hereby overrule those determinations that held the administrative expenses are treated as in-state or out-of-state costs based on the location of the personnel who performed the services. Specifically, we hereby overrule: Det. No. 89-459, 8 WTD 227 (1989) to the extent that it quoted Det. No. 85-117; Det. No. 93-172, 13 WTD 180 (1993); and Det. No. 94-031, supra, to the extent they hold, or imply, the place a cost is incurred determines if it is an in-state cost of doing business; and Det. No. 89-459A, 11 WTD 17 (1991), which is discussed at length infra.

B. Det. No. 89-459A, 11 WTD 17 (1991).

The Audit Division apportioned the taxpayer’s income based on Det. No. 89-459A, supra. In so doing, the Audit Division attributed the taxpayer’s interest expense to Washington because the personnel who managed the borrowing activity were located in Washington. As discussed above, this approach was erroneous. The facts demonstrate that many of the taxpayer’s loans were made to persons outside of Washington. The taxpayer correctly argues Det. No. 89-459A is inconsistent with RCW 82.04.460 and should be overruled.

[8] Det. No. 89-459A was intended as an interim apportionment methodology for financial institutions pending the adoption of a formal rule. To partially implement RCW 82.04.460(2), the Department adopted WAC 458-20-14601 (Rule 14601) effective July 1, 1997 subject to a transition

period that expired on January 1, 2000.¹⁰ Rule 14601 is consistent with rules other States adopted for financial institutions. Therefore, Det. No. 89-459A was overruled by Rule 14601, which became fully effective as of January 1, 2000.

[9] Further, the apportionment methodology identified in Det. No. 89-459A is not acceptable under RCW 82.04.460(1) because it does not accurately measure the income from the taxpayer's Washington activities. The taxpayer is a financial institution engaged in the activity of lending money in Washington and other states. The interest the taxpayer pays is a cost related to its lending business activities and is a cost of doing that business. Lending money is the taxable activity, the measure of which is the interest received, other fees charged borrowers, and gains on sale and interest rate swaps. Generally, the lending activity occurs where the borrower is located. To treat the interest costs as a cost of doing business where the taxpayer manages its borrowing activity, regardless of where the taxpayer makes loans, is contrary to the principles of apportionment outlined above.¹¹ Yet, this is exactly what Det. No. 89-459A allows. Det. No. 89-459A's conclusion is contrary to RCW 82.04.460(1) because it sites the cost to where the cost was incurred and does not recognize that the borrowed funds were necessary to engage in business in Washington as well as in other states.

Det. No. 89-459A is overruled. The taxpayer's petition is partially granted on this issue.¹²

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¹⁰ Rule 14601 addresses financial institutions within the scope of chapter 82.14A RCW. It does not address those businesses that receive income from finance charges as defined in RCW 63.14.010(8) because there is no uniform rule adopted by the states relating to the receipt of services charges.

¹¹ It is also contrary to constitutional and practical considerations. Walter Hellerstein, the noted authority on state taxation, recently stated:

Ratio-based rules take the reasonable position that interest expense is fairly attributable to all of the taxpayer's activities when one does not (or cannot) know the precise activities--taxable or tax-exempt--to which the loans giving rise to the interest expense should be attributed. Although not perfect, over time such rules will, as the Court noted, "reflect approximately the amount of borrowing that firms have actually devoted to generating each type of income."

Constitutional Restraints on State Interest Expense Allocation After Hunt-Wesson, 10 Journal of Multistate Taxation 4 (October 2000).

¹² [For periods prior to December 31, 1999, the Department will accept a financial institution's use of the methodology outlined in Det. No. 89-459A relating to its interest expense under RCW 82.04.460(1) if the institution actually reported during those periods using that methodology. However, because taxpayer did not use the methodology outlined in Det. No. 89-459A when it apportioned its income, this issue is remanded to the Audit Division for computation of apportionment as provided in RCW 82.04.460(1) and explained in this Determination.

It is unclear how taxpayer calculated its administrative expenses for apportionment purposes. If taxpayer treated its administrative expenses by using the methodology in Det. No. 93-172, supra, Det. No. 94-031, supra, or Det. No. 89-459, supra, then the Department will accept that treatment for the periods prior to December 31, 1999. If taxpayer did not treat its administrative expenses under the methodology in Det. No. 93-172, Det. No. 94-031, or Det. No. 89-459, then the Department will apply the methodology explained in this determination for the period prior to December 31, 1999. For periods following December 31, 1999, the taxpayer, as a financial institution, must apportion its income as specified in Rule 14601.]

DECISION AND DISPOSITION:

The taxpayers' petitions are granted as to the apportionment of income

Det. No. 86-297, 2 WTD 23 (1986), and Det. No. 92-117, 12 WTD 147 (1993), are overruled to the extent that they state a physical out-of-state office is required before a taxpayer may apportion its income under RCW 82.04.460.

Det. No. 89-459, 8 WTD 227 (1989); Det. No. 93-172, 13 WTD 180 (1993); and Det. No. 94-031, 14 WTD 194 (1995), are reversed as to the treatment of administrative expenses.

Det. No. 89-459A is overruled.

Dated this 30th day of January, 2001.