

Apportionment

WHAT IS APPORTIONMENT?

- **"Apportionment" is a method for dividing the gross service income of a multi-state taxpayer among the states in which it does business.**

When a business generates income by providing services both inside and outside of Washington a method is needed to figure out what part of the businesses' gross service income is subject to Washington's business and occupation (B&O) tax. "Apportionment" is a method for dividing the gross service income of a multi-state taxpayer among the states in which it does business.

HOW DOES WASHINGTON'S CURRENT APPORTIONMENT FORMULA WORK?

- **Under current law, only service-taxable activities are apportionable .**

Washington's current apportionment formula, adopted in 1939, is based on the cost of doing business in Washington versus the cost of doing business everywhere. The apportionment formula is a fraction, the numerator of which is the cost of doing business in Washington, and the denominator is the total cost of doing business everywhere. The business' total income, earned inside and outside of Washington, is multiplied by the resulting fraction/percentage to determine the amount of service income subject to Washington's B&O tax.

Under Washington law only service-taxable activities are apportionable. A special provision is provided for the adoption of a different rule for financial institutions. The statute requires that the rules for financial institutions be consistent with uniform rules for apportionment developed throughout the nation. The department has issued a rule that provides a standard three-factor formula for financial institutions.

WHAT IS THE DEPARTMENT'S GOAL REGARDING APPORTIONMENT?

- **To modernize the B&O tax, as it applies to the taxation of service income.**
- **Accurately reflect the level of a business' activities in each state in which it operates, both as a market and as a producer.**

The department's goal is to modernize the B&O tax to more accurately reflect the contribution of the activities performed in Washington to the total revenues of the business. The change to the use of the three-factor apportionment formula is meant to do two things: accurately reflect the level of each business' activities in each state in which it operates, both as a market and as a producer; and to bring the B&O tax into better alignment with uniform rules for apportionment that have developed throughout the nation.

SHOULD THE CURRENT SYSTEM BE CHANGED?

- **Our in-state service businesses are often disadvantaged by current apportionment methods. This is critical issue since service businesses play an increasingly important role in our state's economy.**
- **Washington headquartered companies can be especially disadvantaged by our current cost apportionment method.**
- **Washington's cost apportionment method is out-of-step with a substantial majority of states and often results in an unfair representation of the amount of income subject to B&O tax, whether too much or too little.**
- **The cost apportionment method is difficult for businesses and the Department to administer and it is a continuous source of contention.**
- **Most common method of apportionment used throughout the nation is a three-factor apportionment formula.**

Our in-state service businesses are often disadvantaged by current apportionment methods. This is critical issue since service businesses play an increasingly important role in our state's economy.

The current tax policy of focusing solely on the costs of doing business may not provide the best environment in which to locate either a regional or national headquarters or expand business activities in Washington. This is because cost apportionment may apportion many costs to the headquarters of the business. Simply shifting a regional headquarters to Washington may have a significant impact on a business's tax liability, even if no additional business is done in Washington. This can place Washington at a disadvantage in relation to other states and can place Washington headquartered businesses at a competitive disadvantage. Conversely, shifting administrative functions outside the state can lessen a business's tax liability.

Washington's cost apportionment method is out-of-step with a substantial majority of states and in many cases the cost apportionment formula is no longer appropriate when applied to current business practices or trend. Often it results in an unfair representation of the amount of income subject to Washington's tax system, whether too much or too little. Moreover, the cost apportionment formula, while simply stated, is very difficult to calculate. Costs are not allocated by where the activity occurs, but are determined by the relationship of the costs to the taxable activity. Washington is somewhat unique in requiring this type of calculation, so multi-state businesses operating in Washington must maintain at least two separate sets of records.

The apportionment method used most commonly throughout the nation is a three-factor apportionment formula. The use of a three-factor formula would remove one of the competitive disadvantages of locating in Washington. In-state businesses that perform significant services outside the state will not be overburdened because they choose Washington as the place to locate their headquarters. Businesses with significant multi-state operations should lower their costs of compliance by reporting in Washington using an apportionment method that is consistent with other states, maintaining only one set of records and having similar compliance requirements for all multi-state operations.

WHAT IS A "THREE-FACTOR" APPORTIONMENT FORMULA?

- **The "three-factor" apportionment formula is composed of a property, payroll, and receipts factors.**
- **The three-factor formula is flexible, allowing a state to tailor its formula to suit a particular tax policy.**

The "three-factor" apportionment formula is composed of a property, payroll, and receipts factors. There is general agreement across the country that this is the fairest representation of the level of a business' activity in a state. The property factor is a fraction. The numerator is the average value of the taxpayer's Washington real and tangible personal property, and the denominator is the average value of all the taxpayer's real and tangible personal property used during the tax year. The payroll factor is a fraction. The numerator is the total compensation paid in Washington, and the denominator is the total compensation paid everywhere during the tax year. The receipts or sales factor is a fraction. The numerator is the total gross income earned in Washington, and the denominator is the gross income earned everywhere during the tax year.

The three-factor apportionment formula is flexible, allowing a state to tailor its formula to suit a particular tax policy or in Washington's case - a particular service activity. For example, the receipts factor in the formula may be multi-weighted. In this year's media and sports teams apportionment bills the receipts factor is double weighted. In these two bills, the property and payroll factors each represent twenty-five percent and the receipt factor represents fifty percent of the formula. The multi-weighting of the receipts factor recognizes the extent to which revenue generation contributes to the overall taxable presence of a business within the taxing state. More than twenty-four states have a multi-weighted receipts factor in their apportionment formula. Multiple weighting of the sales factor favors companies with high instate property and payroll factors that sell outside their "home" state. Conversely, the multi-weighted sales factor will increase the apportionment to the "market" state for companies that produce products elsewhere but make sales into the state.

Since apportionment formulas have been widely used for many years many questions concerning apportionment are relatively settled. The litigation occurring today in the area of apportionment is predominately in two areas: what is the tax base that is to be apportioned and how are the different aspects of the apportionment factor computed.

WHAT ARE THE MECHANICS OF THE THREE-FACTOR APPORTIONMENT FORMULA?

This example is meant only to show the mechanics of the three-factor formula. The numbers used and the result are purely fictional and should not be interpreted otherwise. Perkin's Video Productions, Inc. (PVP) produces infomercials and has offices in Washington and Idaho. PVP is headquartered in Spokane, Washington. The Spokane office performs all administrative functions, such as accounting and ordering supplies. What portion of PVP's multi-state income is subject to Washington's B&O tax?

Here is a breakdown of PVP's costs:

Spokane, Washington		Moscow, Idaho	
Direct Costs (Payroll)	\$130,000	Direct Costs (Payroll)	\$30,000
In-direct Costs	<u>\$120,000</u>	In-direct Costs	<u>\$10,000</u>
Total Costs	\$250,000	Total Costs	\$ 40,000
Real & Tangible Property located in Washington	\$200,000	Real & Tangible Property located in Idaho	\$100,000
Gross Sales made in Washington	\$300,000	Gross Sales made in Idaho	\$200,000

Under Washington's current cost apportionment formula:

$$\begin{array}{l} \text{Total Cost to operate in Washington*} \quad \underline{\$250,000} = 86\% \\ \text{Total Cost to operate everywhere} \quad \underline{\$290,000} \quad (\$250,000 + \$40,000) \end{array}$$

$$\text{Total Gross Sales } \$500,000 (\$300,000 + \$200,000) \times 86\% = \$430,000 \text{ Subject to B\&O}$$

$$\text{Service B\&O Rate } 1.5\% \times \$430,000 = \mathbf{\$6,450 \text{ B\&O tax liability}}$$

* This example is oversimplified for educational purposes. Its purpose is to illustrate the basic mechanics of the cost apportionment formula.

Under proposed three-factor formula:

$$\left(\frac{\text{Property in WA } \$200,000}{\text{All Property Owned } \$300,000} \right) \times 25\% + \left(\frac{\text{Payroll in WA } \$130,000}{\text{Total Payroll } \$160,000} \right) \times 25\% + \left(\frac{\text{Sales from WA } \$300,000}{\text{Total Sales } \$500,000} \right) \times 50\% = 67\%$$

$$\text{Total Gross Sales } \$500,000 \times 67\% = \$335,000 \text{ Subject to Washington's B\&O}$$

$$\text{Service B\&O Rate } 1.5\% \times \$335,000 = \mathbf{\$5,025 \text{ B\&O tax liability}}$$

CONCLUSION

The department's goal is to modernize the B&O tax to more accurately reflect the contribution of the activities performed in Washington to the total revenues of the business. The change to the use of the three-factor apportionment formula is meant to do two things: accurately reflect the level of each business' activities in each state in which it does business, both as a market and as a producer; and to bring the B&O tax into better alignment with uniform rules for apportionment that have developed throughout the nation.