

Introduction to B&O Tax Apportionment

Cost Apportionment (Pre-June 2010)

State and Local Tax Breakfast Series - B&O Tax Apportionment of Service Income

Example

Engineering Firm is based in Seattle and also has offices in Portland and Salt Lake City.

Engineering Firm's largest clients are headquartered in Seattle, Chicago and Houston.

Engineering Firm's clients' largest projects are in Alaska, South Dakota, the Gulf of Mexico and Saudi Arabia.

How much of Engineering Firm's gross receipts are subject to Washington B&O tax?

WAC 458-20-194 ("Rule 194") required apportionment of service income using the ratio of WA costs to overall costs of performing the services at issue.

Costs were first required to be categorized – sourcing method depended on type of cost.

Property, employee and some subcontractor costs sourced to location of property, employee or subcontractor.

All other costs were multiplied by the percentage of service receipts within WA to determine the amount considered WA costs.

For this purpose, receipts were deemed to be in WA if customer received the benefit of the service in WA.

This apportionment method was confusing to taxpayers and inconsistently applied by the Department of Revenue. Frustration and dissatisfaction were widespread.

The New Regime: Economic Nexus and Market Sourcing

New Apportionment Method enacted by Washington Legislature effective June 1, 2010.

Economic Nexus: Out-of-State service providers are subject to B&O tax if they have at least \$250K of WA-sourced receipts per calendar year, or at least \$50K of Washington property or payroll during the year.

For purposes of nexus determination, receipts are sourced in the same manner as is used in apportioning the tax base.

Sourcing of Service Receipts under the New Regime

For periods after June 1, 2010, receipts from services are attributed to the location where “the taxpayer’s customer receives the benefit of the service.”

If the service relates to real or tangible personal property, the benefit is received where the property is located or expected to be located.

Examples: Architectural, security, real estate brokerage, inspection/testing, and veterinary services.

Other services that are related to the customer’s business activities are attributed to the location where the customer’s “related business activities” occur.

Examples: Business consulting services, advertising, debt collection, legal and accounting services that are not specific to real or tangible personal property.

**Examples of Where the
Customer’s “Related
Business Activity” Occurs**

Rule 19402, Example 16:

Manufacturer hires Law Firm to defend Manufacturer in a class action product liability lawsuit involving Manufacturer’s Widgets. The benefit of Law Firm’s services relates to Manufacturer’s widget selling activity in various states. A reasonable method of proportionally attributing receipts in this case would be to attribute the receipts to the locations where the Manufacturer’s Widgets were delivered, which relates to Manufacturer’s business activities.

Rule 19402, Example 21:

Call Center provides “customer service” services to Retailer who has customers in all 50 states. Call Center’s services relate to Retailer’s selling activity in all 50 states, therefore Retailer receives the benefit of Call Center’s services in all 50 states. Call Center has offices in Iowa and Alabama that answer questions about Retailer’s products. Call Center records Retailer’s customer’s calls by area code.

Call Center may attribute receipts received from Retailer based on the number of calls from area codes assigned to each state. This would be a reasonable method of proportionally attributing receipts notwithstanding the fact that mobile phone numbers and related area codes may not exactly reflect the physical location of the customer in all cases.

Rule 19402, Example 22:

Taxpayer provides internet advertising services to national retail chains, regional businesses, businesses with a single location, and businesses that operate solely over the Internet. Generally, the benefit of the advertising services is received where the customer’s related business activities occur. Depending on what products or services are being provided by Taxpayer’s customers, the use of relative population in the customer’s market may be a reasonable method of proportionally attributing the benefit of Taxpayer’s services.

Examples of Where the Customer's "Related Business Activity" Occurs (cont.0

Rule 19402, Example 24:

Company A provides human resources services to Racko, Inc. which has three offices that use those services in Washington, Oregon, and Idaho. Racko sells widgets and has customers for its widgets in all 50 states. The benefit of the service performed by Company A is received at Racko's locations in Washington, Oregon, and Idaho. Assuming that each office is approximately the same size and uses the services to approximately the same extent, then attributing 1/3 of the receipts to each of the states in which Racko has locations using the services is a reasonable method of proportionally attributing Company A's receipts from Racko.

Default Methods for Attributing Service Receipts

If the taxpayer cannot determine where the benefit of its service is received and no "reasonable method of proportionally attributing receipts" is available, a series of default methods are provided and must be used.

The default methods are listed in order of preference. A taxpayer must use the highest method on the list that it is able to apply (sometimes referred to as a "waterfall" of attribution methods).

Default Attribution Methods:

- State in which the benefit of the service was primarily received. Primarily, in this context, means more than 50%.
- State from which the customer ordered the service.
- State to which the billing statements or invoices are sent to the customer by the taxpayer.
- State from which the customer sends payment to the taxpayer.
- Customer address as shown in the taxpayer's records maintained in the regular course of business, or obtained during consummation of the sale or negotiation of the contract (including address of customer's payment instrument if available to the taxpayer and no other address is available).
- Taxpayer's commercial domicile.

Throwout Rule Under the New Apportionment Regime

“Throwout” means receipts are excluded from the apportionment factor calculation entirely if the services were at least partly performed in WA and the receipts would otherwise be attribute to a jurisdiction where the taxpayer (1) is not “subject to” a business activities tax, and (2) would not have a “taxable presence” under Washington standards.

For purposes of the throwout rule, business activities taxes include income taxes and gross receipts taxes, and may also include net worth / franchise taxes. Business activities taxes do not include sales/use tax or other transaction taxes.

For purposes of the throwout rule, a “taxable presence” under Washington standards is determined by applying the state’s economic nexus rules.

This means receipts are not thrown out of the apportionment factor calculation if they are from customers in a jurisdiction (state or foreign country) where the taxpayer has at least \$250K of annual gross receipts, or at least \$50K of payroll or property.

Example

Consulting Firm has \$500K in receipts from WA customers, \$500K in receipts from CA customers, and \$200K in receipts from AZ customers. Consulting Firm does not have any property or employees in AZ and does not file tax returns there. Services to AZ customers are partially performed from WA.

AZ receipts are “thrown out” of the WA apportionment calculation. Thus, B&O tax apportionment factor is 50% and Consulting Firm pays B&O tax on \$600K of its \$1.2 million of total service receipts.

Engineering Firm Example: Questions to Ask

Are engineering firm’s services to its clients “related to real or tangible personal property?”

Options for Obtaining Certainty on Service Apportionment Issues

If yes, does Engineering Firm know where the associated property is located or expected to be located?

If no, does Engineering Firm know where its customers' "related business activities" occur?

Is a "reasonable method of proportionally attributing receipts" available? Population? Customer billing address? Other?

Taxpayers can request a letter ruling from Washington Department of Revenue's Taxpayer Information & Education (TI&E) division.

There is no fee to obtain a ruling; the normal turnaround time is approximately 4 – 6 weeks.

Ruling request must disclose the identity of the taxpayer; rulings are binding on both the taxpayer and the Department unless there is a change in facts or law.

If B&O tax has been overpaid, the taxpayer can submit a refund claim. All refund claims are reviewed by the Department (either Taxpayer Services or Audit Division).

Clark Nuber's State and Local Tax team includes:

Bob Heller, shareholder and SALT Practice leader – (425) 635-7424, bheller@clarknuber.com

Joe Haberzetle, senior manager – (425) 709-4848, jhaberzetle@clarknuber.com

Nicole Lyons, manager – (425) 709-4889, nlyons@clarknuber.com