

Model Rule

Apportionment of Service Receipts beginning January 1, 2020

(1) Introduction.

Substitute House Bill 1403 simplifies the administration of municipal business and occupation tax apportionment primarily by changing the definition of customer location to adopt market-based sourcing in the income factor. SHB 1403 further simplifies the administration of municipal business and occupation tax apportionment by excluding service receipts from the income factor denominator attributable to jurisdictions where the taxpayer would not be subject to tax and establishing guidelines for the application of an alternative apportionment method. No changes are made to the payroll factor. The intent of this rule is to provide guidance on the new method of apportioning service income beginning January 1, 2020.

(2) Apportionable Service revenue apportioned beginning January 1, 2020.

Gross income derived from service activities taxed under _____ [*insert city code reference to .050(1)(g) – any other business activity than those enumerated*] after January 1, 2020, shall be apportioned to the City by multiplying the apportionable income by a fraction, the numerator of which is the payroll factor plus the service income factor and the denominator of which is two (2).

- (a) The payroll factor is a fraction, the numerator of which is the total amount paid for compensation in the City during the tax period by the taxpayer and the denominator of which is the total compensation paid everywhere during the tax period. Compensation is paid in the City if:
- (i) The individual is primarily assigned within the City;
 - (ii) The individual is not primarily assigned to any place of business for the tax period and the employee performs fifty percent (50%) or more of his or her service for the tax period in the city; or
 - (iii) The individual is not primarily assigned to any place of business for the tax period, the individual does not perform fifty percent (50%) or more of his or her service in any city, and the employee resides in the city.

Per [*insert city code reference to .077(7)(f) – Individual*], “Individual” means any individual who, under the usual common law rules applicable in determining

Apportionment of Service Receipts beginning January 1, 2020

the employer-employee relationship, has the status of an employee of that taxpayer.

- (b) The service income factor is a fraction, the numerator of which is the total service income of the taxpayer in the City during the tax period, and the denominator of which is the total service income of the taxpayer everywhere during the tax period. Service income is in the City if the customer location is in the City.
- (c) Income Factor Denominator – Excluded Income. Gross income of the business from engaging in an apportionable activity must be excluded from the denominator of the service income factor if, in respect to such activity, at least some of the activity is performed in the city, and the gross income is attributable under (b) of this section (2) to a city or unincorporated area of a county within the United States or to a foreign country in which the taxpayer is not taxable.
- (d) If the allocation and apportionment provisions of this section (2) do not fairly represent the extent of the taxpayer's business activity in the city, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
 - (i) Separate accounting;
 - (ii) The exclusion of any one or more of the factors;
 - (iii) The inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in the city; or
 - (iv) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
- (e) The party petitioning for, or the tax administrator requiring, the use of any method to effectuate an equitable allocation and apportionment of the taxpayer's income pursuant to subsection (d) of this section (2) must prove by a preponderance of the evidence:
 - (i) That the allocation and apportionment provisions of this section (2) do not fairly represent the extent of the taxpayer's business activity in the city; and
 - (ii) That the alternative to such provisions is reasonable. The same burden of proof shall apply whether the taxpayer is petitioning for, or the tax administrator is requiring, the use of an alternative, reasonable method

Apportionment of Service Receipts beginning January 1, 2020

- to effectuate an equitable allocation and apportionment of the taxpayer's income.
- (f) If the tax administrator requires any method to effectuate an equitable allocation and apportionment of the taxpayer's income, the tax administrator cannot impose any civil or criminal penalty with reference to the tax due that is attributable to the taxpayer's reasonable reliance solely on the allocation and apportionment provisions of this section (2).
 - (g) A taxpayer that has received written permission from the tax administrator to use a reasonable method to effectuate an equitable allocation and apportionment of the taxpayer's income shall not have that permission revoked with respect to transactions and activities that have already occurred unless there has been a material change in, or a material misrepresentation of, the facts provided by the taxpayer upon which the tax administrator reasonably relied in approving a reasonable alternative method.
- (3) Definitions. The definitions in this section apply throughout this rule.
- (a) **"Apportionable income"** means the gross income of the business taxable under the service classifications of a city's gross receipts tax, including income received from activities outside the city if the income would be taxable under the service classification if received from activities within the city, less any exemptions or deductions available.
 - (b) **"Business activities tax"** means a tax measured by the amount of, or economic results of, business activity conducted in a city or county within the United States or within a foreign country. The term includes taxes measured in whole or in part on net income or gross income or receipts. "Business activities tax" does not include a sales tax, use tax, or a similar transaction tax, imposed on the sale or acquisition of goods or services, whether denominated a gross receipts tax or a tax imposed on the privilege of doing business.
 - (c) **"Compensation"** means wages, salaries, commissions, and any other form of remuneration paid to individuals for personal services that are or would be included in the individual's gross income under the federal internal revenue code.
 - (d) **"Customer"** means a person or entity to whom the taxpayer makes a sale or renders services or from whom the taxpayer otherwise receives gross income of the business.

Apportionment of Service Receipts beginning January 1, 2020

- (e) **"Customer Location"** means the following:
- (i) For a customer not engaged in business, if the service requires the customer to be physically present, where the service is performed.
 - (ii) For a customer not engaged in business, if the service does not require the customer to be physically present:
 - (A) The customer's residence; or
 - (B) If the customer's residence is not known, the customer's billing/ mailing address.
 - (iii) For a customer engaged in business:
 - (A) Where the services are ordered from; or
 - (B) At the customer's billing/ mailing address if the location from which the services are ordered is not known; or
 - (C) At the customer's commercial domicile if none of the above are known.

The customer location of a customer under (3)(e)(ii) and (3)(e)(iii) is determined based on a cascading method or series of steps. Only if the first step is unknown may the taxpayer move to the next step and so forth.

- (f) **"Individual"** means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee of that taxpayer.
- (g) **"Not Taxable"** means that the taxpayer is not subject to a business activities tax by that city or county within the United States or by that foreign country, except that a taxpayer is taxable in a city or county within the United States or in a foreign country in which it would be deemed to have a substantial nexus with the city or county within the United States or with the foreign country under the standards in RCW 35.102.050 regardless of whether that city or county within the United States or that foreign country imposes such a tax.
- (h) **"Primarily assigned"** means the business location of the taxpayer where the individual performs his or her duties.
- (i) **"Service taxable income"** or "service income" means gross income of the business subject to tax under either the service or royalty classification.
- (j) **"Tax period"** means the calendar year during which tax liability is accrued. If taxes are reported by a taxpayer on a basis more frequent than once per year, taxpayers shall calculate the factors for the previous calendar year for reporting in the current calendar year and correct the reporting for the previous year when the factors are calculated for that year, but not later than the end of the first quarter of the following year.

Apportionment of Service Receipts beginning January 1, 2020

- (4) Examples. The following examples identify a number of facts and then state a conclusion. The tax status of each circumstance must be determined after a review of all the facts and circumstances.
- (a) **Example 1:** An individual with health insurance seeks medical services at a doctor's office in Seattle. The individual is the customer for purposes of determining customer location even though the individual may utilize their insurance to pay for the medical services provided to them. The individual is required to be present at the doctor's office to receive the services, therefore the service receipts are sourced to the location of the doctor's office where the services are performed.
- (b) **Example 2:** PCA Co. provides electronic design plans for residential homeowners in Washington, Oregon and Idaho. The service is designed to allow home owners to be their own general contractors. Homeowners upload pictures of their home to PCA's website and PCA delivers electronic plans and projected work plans to the customer's email. PCA reports under the service activity classification and has its only business location in Seattle. Because PCA's service does not require the customer to be physically present and their customers are not engaged in business, PCA would source their receipts first to the customer residence. Only if the customer's residence is not known, PCA would source their receipts to the customer's billing/ mailing address.
- (c) **Example 3:** MNO Co. provides professional services to customers engaged in business throughout Washington. MNO maintains billing address information for all of its customers. In addition, MNO also has information about the location from which the services are ordered, contracts, invoices, and other communication with the customer. MNO must follow the sourcing hierarchy in subsection 3(e) above for sourcing service receipts to the customer location. MNO would first determine the location from which the services are ordered; if the location from which the services were ordered was not known, MNO would use the customer's billing or mailing address; and finally, if MNO did not know its customer's billing or mailing address, MNO would source the service income to the customer's place of domicile or where it is headquartered. In this example, MNO has information in its business records to identify the location from which the services were

Apportionment of Service Receipts beginning January 1, 2020

ordered. Therefore, MNO will source its service receipts to the location from which services were ordered and will not use the customer billing addresses.

- (d) **Example 4:** QRS LLC is located in Tacoma, Washington and provides architectural services to customers engaged in business throughout Washington State. TUV Co., a software company located in Seattle, contracts with QRS to draft plans to renovate their branch office in Bellevue. The order was made by TUV personnel located in Seattle. QRS will source the TUV service receipts to Seattle, the location from which the services were ordered.

- (e) **Example 5:** Safe-T Service LLC is a security company that provides building security to customers engaged in business throughout Washington State. Huge Software Co. contracts with Safe-T Service to perform afterhours security for their sales office in Seattle. The services were ordered from the sales office in Seattle and approved by the company's main office and procurement department in Bellevue. Safe-T Service will source Huge Software Co. service receipts to Seattle, the location from which the services were ordered and not from where the order was approved.

- (f) **Example 6:** Company MMM reports under the service classification and has its only business location in Seattle. MMM has employees but also maintains contracts with independent contractors who sell the company's services. The independent contractors are paid by commissions. The independent contractors are located partly outside of the state and partly within the state. MMM employs managers who visit the independent contractors but are assigned to the Seattle office. Company MMM has nexus outside of the state due to their independent contractors working with MMM's ultimate customer. MMM should compute their taxable service income using the two-factor method. Since their employees and the traveling managers are assigned to the Seattle office, 100% of the payroll is assigned to Seattle. Assuming that 75% of the service income is attributable to customer locations outside of Seattle (see subsection (3)(e) for definition of customer location) and 25% inside of Seattle, then the two-factor apportionment would be as follows:

$$\text{Apportionment Factor} = \frac{100\% (\text{Seattle payroll factor}) + 25\% (\text{Seattle income factor})}{2} = \frac{125\%}{2} = 62.5\%$$

Apportionment of Service Receipts beginning January 1, 2020

(g) **Example 7:** MNO Corp, a service corporation based in Seattle, provides web-based services through the means of the Internet to individual customers who are residents of Seattle and elsewhere. Sales of 20 percent of MNO Corp’s web-based services are attributed to customers within Seattle (see subsection (3)(e)) and 40 percent of MNO Corp’s service employees are located in Seattle. Assuming that no service income is excluded from the denominator because the taxpayer is taxable in all customer locations, the two-factor apportionment would be as follows:

$$\text{Apportionment Factor} = \frac{40\% \text{ (Seattle payroll factor)} + 20\% \text{ (Seattle income factor)}}{2} = \frac{60\%}{2} = 30\%$$

(h) **Example 8:** Same as Example 7, however 10 percent of MNO Company’s sales are attributable to cities in which MNO is “not taxable” (the taxpayer is not subject to a business activities tax and the taxpayer is not deemed to have substantial nexus in the customer location , see subsection 3(g) above). Furthermore, some of the service activity is performed in Seattle. As a result, 10 percent of MNO’s sales must be excluded from the income factor denominator. Therefore, the service apportionment factor and the two-factor apportionment would be as follows:

$$\text{Service activity income factor} = \frac{20\% \text{ (Service income)}}{100\% \text{ (Worldwide service activity income)} - 10\% \text{ (Excluded income)}} = \frac{20\%}{90\%} = 22.2\%$$

$$\text{Apportionment Factor} = \frac{40\% \text{ (Payroll factor)} + 22.2\% \text{ (20/90 Service income factor)}}{2} = \frac{62.2\%}{2} = 31.1\%$$

(i) **Example 9:** Hobbs & Smith Co. provides engineering consulting services to businesses. Hobbs & Smith has offices in Seattle, Bellingham and Tacoma. Hobbs & Smith’s service income is attributed 40-percent in Seattle, 40-percent in Bellingham, and 20-percent in Tacoma. Their office staffing is 60-percent in Seattle, 30-percent in Bellingham and 10-percent in Tacoma. Projects are shared among the various offices. A staff working a project may sit in one office and report to a specialist and managers that are in different offices. Therefore, some of the service activity is performed in all of Hobbs & Smith’s offices. The service income apportionment factor and two-factor apportionment would be as follows:

Apportionment of Service Receipts beginning January 1, 2020

$$\text{Seattle Apportionment Factor} = \frac{60\% (\text{Seattle payroll factor}) + 40\% (\text{Seattle income factor})}{2} = \frac{100\%}{2} = 50.0\%$$

$$\text{Bellingham Apportionment Factor} = \frac{30\% (\text{Bellingham payroll factor}) + 40\% (\text{Bellingham income factor})}{2} = \frac{70\%}{2} = 35.0\%$$

$$\text{Tacoma Apportionment Factor} = \frac{10\% (\text{Tacoma payroll factor}) + 20\% (\text{Tacoma income factor})}{2} = \frac{30\%}{2} = 15.0\%$$

(j) **Example 10:** Same as Example 9, however Hobbs & Smith only has offices in Seattle and Tacoma. Hobbs & Smith service income is 50-percent in Seattle, 30-percent in Tacoma, and 20-percent in Fife under (e) of section (3) above. Their office staffing is 40-percent in Seattle and 60-percent in Tacoma. Hobbs & Smith is “not taxable” in Fife because Fife does not impose a business activities tax and the taxpayer is not deemed to have a substantial nexus in Fife (see subsection (g) of section (3)). Fife customers travel to the Tacoma office for business meetings with Hobbs & Smith. Projects are shared among the various offices. A staff working a project may sit in one office and report to a specialist and managers that are in different offices. Therefore, some of the service activity is performed in all of Hobbs & Smith’s offices. The service income apportionment factor and the two-factor apportionment would be as follows:

$$\text{Seattle service income factor} = \frac{50\% (\text{Service income})}{100\% (\text{Worldwide service income}) - 20\% (\text{Excluded income})} = \frac{50\%}{80\%} = 62.5\%$$

$$\text{Seattle Apportionment Factor} = \frac{40\% (\text{Seattle payroll factor}) + 62.5\% (50/80 \text{ Service income factor})}{2} = \frac{103\%}{2} = 51\%$$

$$\begin{aligned} \text{Tacoma service income factor} &= \frac{30\% (\text{Service income})}{100\% (\text{Worldwide service income}) - 20\% (\text{Excluded income})} = \frac{30\%}{80\%} = 37.5\% \\ &= \frac{60\% (\text{Tacoma payroll factor}) + 37.5\% (30/80 \text{ Service income factor})}{2} = \frac{98\%}{2} = 49\% \end{aligned}$$

Apportionment of Service Receipts beginning January 1, 2020

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| Tacoma Apportionment Factor | 2 | 2 |
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(k) **Example 11:** Same as Example 10, except all work is done in the Seattle office and the Tacoma office handles the administrative operations of the business. Hobbs & Smith have nexus in Tacoma because of the presence of the office. However, because none of the work is done in Tacoma, none of the Fife income would be excluded from the service income factor for Tacoma. The service income apportionment factor and the two-factor apportionment would be as follows:

$$\text{Seattle service income factor} = \frac{50\% \text{ (Service income)}}{100\% \text{ (Worldwide service income)} - 20\% \text{ (Excluded income)}} = \frac{50\%}{80\%} = 62.5\%$$

$$\text{Seattle Apportionment Factor} = \frac{40\% \text{ (Seattle payroll factor)} + 62.5\% \text{ (50/80 Service income factor)}}{2} = \frac{103\%}{2} = 51\%$$

$$\text{Tacoma service income factor} = \frac{30\% \text{ (Service income)}}{100\% \text{ (Worldwide service income)}} = \frac{30\%}{100\%} = 30\%$$

$$\text{Tacoma Apportionment Factor} = \frac{60\% \text{ (Tacoma payroll factor)} + 30\% \text{ (30/100 Service income factor)}}{2} = \frac{90\%}{2} = 45\%$$