

# SENATE BILL REPORT

## SB 6637

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As of February 6, 2004

**Title:** An act relating to apportionment of gross income taxable under RCW 82.04.290 for entities engaging in business activities both within and outside this state.

**Brief Description:** Regarding apportionment of gross income taxable under RCW 82.04.290 for entities engaging in business activities both within and outside this state.

**Sponsors:** Senators Zarelli, Prentice and Rasmussen.

**Brief History:**

**Committee Activity:** Ways & Means: 2/5/04.

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### SENATE COMMITTEE ON WAYS & MEANS

**Staff:** Terry Wilson (786-7433)

**Background:** The federal Commerce Clause, which allows Congress to regulate commerce between the states, has been interpreted to prohibit multiple taxation of business income. To be valid under the Commerce Clause, apportionment of income or tax credits are required for firms engaged in business in multiple states.

The state business and occupation (B&O) tax applies to the gross proceeds from business conducted within the state. It applies to income from manufacturing, sales, and services in this state. Income from sales is not apportioned. If the product is delivered inside the state, the income is taxable. If the product is delivered outside the state, the income is not taxable. Only services are apportioned under the B&O tax.

Current law requires persons providing services in this state and maintaining places of business both within and without the state that contribute to providing the services to apportion that portion of the gross income which is derived from services rendered within this state. If apportionment cannot be done by separate accounting, the person must apportion to this state that portion of gross income which the cost of doing business within the state bears to the total cost of doing business both within and without the state. To comply with the interstate commerce clause, the department of revenue has construed the phrase "maintaining a place of business" to mean engaging in activities that would subject a taxpayer to tax in this state if performed in this state.

Under the Multistate Tax Compact, any state taxing net income that is a party to the compact must apportion income according to a formula. The formula is designed to apportion a percentage of the business' income to each state that can tax it. The percentage is determined by adding together a property factor, a payroll factor, and a sales factor, and dividing the sum by three. The property factor is a fraction, the numerator of which is the average value of real and personal property leased or owned of the business in the state for the taxable period, and the denominator of which is the average value of all property of the business for the taxable

period. The payroll factor is a fraction, the numerator of which is the amount paid in the state as compensation to employees in the state for the taxable period and the denominator of which is total compensation paid by the business for the taxable period. Finally, the sales factor is a fraction, the numerator of which is the total sales of the business in the state for the taxable period and the denominator of which is total sales of the business for the taxable period. Other states not parties to the compact provide for apportionment according to similar formulas. Some states exclude one or more factors, add additional factors, or double weight some factors. Nonbusiness income is allocated to the state of domicile of the business.

**Summary of Bill:** The Department of Revenue's construction of existing law is affirmed. Apportionment is required for a person taxable under the service classification of the B&O tax that engages in business activities outside this state that contribute more than incidentally to the performance of the in-state activities. Activities performed outside the state contribute more than incidentally to the performance of in-state activities if the activities would subject the person to the B&O tax if performed in this state.

Apportionment is required for any person providing Internet services in this state who is taxable under the service classification of the B&O tax and who engages in business activities outside this state that contribute to the provision of the Internet services. Activities performed outside the state contribute to the performance of the in-state activities if the activities would subject the person to the B&O tax if performed in this state. Income must be apportioned according to a three-factor apportionment formula using property, payroll, and sales. The percentage of income allocated to this state is determined by adding together the property factor, the payroll factor, and eight times the sales factor, and dividing the sum by ten.

If these apportionment provisions do not fairly represent a taxpayer's business activity in the state, the taxpayer may use a different method that fairly represents the taxpayer's business activity.

**Appropriation:** None.

**Fiscal Note:** Requested on January 27, 2004.

**Effective Date:** Ninety days after adjournment of session in which bill is passed.

**Testimony For:** This is the result of a workgroup. The apportionment method is difficult to apply because it is hard to tell where costs are. Costs are not accounted for by location. Cost apportionment falls heavily on in-state businesses. This provides certainty. The three-factor formula relies on a clear set of principles, fits with business records, and is used by other states. Microsoft gets income from worldwide Internet services. This is tax neutral for Microsoft. Other states have high sales weighting. The independent Internet service providers support the double-weighted sales factor.

**Testimony Against:** A double-weighted sales factor was the agreement. Using an 80 percent sales factor is an undesirable precedent. If we do it for Internet services, others will want the same treatment.

**Testified:** PRO: Kim Clauson, Amazon.com; Gary Gardner, WA Assoc. of Internet Service Providers; Bruce Reid, Microsoft; CON: Bob Heller, DOR.