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**Finance Committee**

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**HB 3157**

**Brief Description:** Concerning the state business and occupation tax.

**Sponsors:** Representatives Hunter, Ericks and Conway; by request of Department of Revenue.

**Brief Summary of Bill**

- Provides a statutory method for determining whether service businesses have substantial nexus for the purpose of imposing state business and occupation taxes.
- Establishes a gross receipts single-factor apportionment formula for allocating service and royalty income to Washington.

**Hearing Date:** 2/5/10

**Staff:** Jeffrey Mitchell (786-7139).

**Background:**

Nexus.

Nexus is the level of connection with a state necessary under the U.S. Commerce Clause to permit a state to impose a tax or a sales tax collection duty on out-of-state businesses doing business in the state. A state tax is constitutional under the Commerce Clause if it is assessed against a taxpayer with whom the state has a substantial nexus, is fairly apportioned, is nondiscriminatory, and is fairly related to the services provided by the state. Of these requirements, the substantial nexus requirement is often the most difficult to determine. In *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), the Court held that out-of-state businesses must have a "physical presence" in the state for there to be "substantial nexus" sufficient under the Commerce Clause to impose a sales tax collection duty. However, the Court was less clear in indicating whether the physical presence standard extends to other taxes. The proper nexus standard for state taxation of out-of-state businesses has been a contentious issue since the *Quill* decision. Numerous state courts have since affirmed economic presence standards, holding that a state may tax businesses with no physical presence within its borders.

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*This analysis was prepared by non-partisan legislative staff for the use of legislative members in their deliberations. This analysis is not a part of the legislation nor does it constitute a statement of legislative intent.*

The State of Washington uses a physical presence standard to determine whether a business has nexus with Washington. A physical presence standard requires a business to own or use real or personal property in this state, employ employees in this state, or engage, directly or through an agent, in activities in this state significantly associated with the business' ability to establish or maintain a market for its products or services in this state. A few examples of nexus-creating activities include: soliciting sales in this state through employees or other representatives; installing or assembling goods in this state, either by employees or other representatives; maintaining a stock of goods in this state; renting or leasing tangible personal property in this state; or making repairs or providing maintenance or service to property sold in this state.

#### Apportionment.

Generally, a business performing service-taxable activities inside and outside the state must apportion to Washington the gross income derived from Washington activities as determined by a separate accounting method. However, if a separate accounting is impractical or inaccurate, Washington law provides an apportionment formula based on the cost of doing business in Washington versus the cost of doing business everywhere. More specifically, 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. A 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 business and occupation (B&O) tax. Under Washington law, only service-taxable activities are subject to the apportionment formula.

Financial institutions are subject to a different formula for apportionment. State law requires that the rules for financial institutions be consistent with uniform rules for apportionment developed throughout the nation. The Department of Revenue has issued a rule that provides a standard three-factor formula for financial institutions. The apportionment percentage is the average of a receipts factor, payroll factor, and property factor. The financial institutions total gross income, earned inside and outside of Washington, is multiplied by the resulting percentage to determine the amount of income subject to Washington's B&O tax.

Royalty income is not apportioned in this state. Instead, royalties are allocated to the domicile of the business.

#### **Summary of Bill:**

##### Nexus.

For purposes of imposing the state business and occupation (B&O) tax on service activities and the activity of receiving royalty income, a business or individual will have substantial nexus with the state if the individual or business meets one of the following requirements: (1) An individual is a resident or domiciled in the state; (2) a business entity is organized or commercially domiciled in this state; or (3) the individual or business is organized or domiciled outside the state but has more than \$50,000 of property in the state, more than \$50,000 of payroll in the state, more than \$500,000 of receipts from this state, or at least 25 percent of the individual's or business's total property, total payroll, or total receipts in this state. This nexus standard only applies to service activities and the activity of receiving royalty income. A business or individual with substantial nexus in any tax year is deemed to have substantial nexus with the state for the following four tax years.

Property counting toward the thresholds is the average value of the taxpayer's property owned or rented in the state during the tax year.

Other than loans and credit card receivables, property is generally valued at its cost basis.

Loans and credit card receivables are generally valued at their outstanding principal balance.

Rented property is valued at eight times the annual rental rate, less any amounts received for subrentals.

Receipts counting towards the thresholds are the amounts included in the numerator for purposes of apportioning income to the state as described below.

Payroll counting towards the thresholds is the total amount paid by the business for compensation in this state. Compensation is paid in this state if the compensation is reportable to this state for unemployment compensation tax purposes.

The property, payroll, and receipts thresholds are adjusted annually for changes in the consumer price index (CPI) if the change in the CPI is 5 percent or more since the last adjustment. The Department of Revenue reviews the CPI every December, and an adjustment applies to any tax period that begins after the adjustment is made.

#### Apportionment.

Income derived from service activities and royalties is apportioned to Washington based on a receipts factor. The receipts factor is a fraction of which the numerator is the total gross income of the business attributable to this state for the activity and the denominator is the worldwide gross income of the business for the activity. The total worldwide gross income from the activity is multiplied by the receipts factor to determine the amount of income apportioned to Washington for purposes of the B&O tax. Apportionment using the receipts factor would replace the three-factor apportionment formula for financial institutions and the cost apportionment formula for other businesses providing services.

Except for financial institutions, gross income is attributable to this state based on the following series of hierarchical rules:

1. Income is attributable to this state if the customer received the benefit of the service in this state or used the business's intangible property in this state;
2. If the customer received the benefit of the service or used the intangible property in more than one state, income is attributable to the state where the service was primarily received or where the intangible property is primarily used;
3. If income cannot be attributed under the foregoing, then the income is attributable to the state where the customer ordered the service or where the royalty agreement was negotiated;
4. If income cannot be attributed under the foregoing, then the income is attributable to the state to which the billing statements or invoices are sent to the customer;
5. If income cannot be attributed under the foregoing, then the income is attributable to the state from which the customer sends payment to the business;
6. If income cannot be attributed under the foregoing, then the income is attributable to the state where the customer is located; and

7. If income cannot be attributed under the foregoing, then the income is attributable to the state where the business is domiciled.

For financial institutions, gross income is attributable to this state as follows:

1. Interest, fees, and penalties on credit card receivables, and net gains from the sale of credit card receivables, are attributable to this state if the billing address of the cardholder is in this state;
2. Interest, fees, and penalties on secured loans are attributable to this state if the property securing the loan is located within this state;
3. Interest, fees, and penalties on unsecured loans are attributable to this state if the borrower is located in the state;
4. Net gains on the sale of loans and loan servicing fees are attributable to this state in the same manner as provided in two or three for secured and unsecured loans; and
5. Interest, dividends, net gains, and other income from investment assets and activities and from trading assets and activities, are attributable to this state if the income is properly assigned to a regular place of business of the financial institution within this state. This would apply to income from investment securities, trading account assets, federal funds, futures contracts, forward contracts, swaps, and foreign currency transactions.

**Appropriation:** None.

**Fiscal Note:** Available.

**Effective Date:** The bill takes effect on July 1, 2010.