TAX EXECUTIVES INSTITUTE, INC.

September 2, 2010

Mr. Chris Coffman
Ms. Armikka Bryant
Interpretations and Technical Advice Division
Washington Department of Revenue
P.O. Box 47453
Olympia, Washington 98504-7453

Via email: ChrisC@dor.wa.gov
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Re: Comments on Emergency Regulations (WAC 458-20-19401, 458-20-19402 and 458-20-19403)

Dear Mr. Coffman and Ms. Bryant:

On behalf of Tax Executives Institute, I am pleased to submit the following comments on the Department of Revenue's Emergency Regulations adopted on June 2, 2010 interpreting provisions of Second Engrossed Substitute Senate Bill 6143, signed by the Governor on April 23, 2010, affecting nexus determinations and the sourcing of receipts for purposes of the Business and Occupation Tax. TEI supports the Department's goal of helping taxpayers understand these changes through the issuance of meaningful guidance, and to ensure that the regulations meet that goal, we suggest a number of changes be made.

Background

Tax Executives Institute was founded in 1944 to serve the professional needs of business tax professionals. Today, the organization has 54 chapters in North America, Europe, and Asia, including one in Washington. Our 7,000 members represent 3,200 of the largest companies in the world, many of which are either resident or do business in Washington. As the preeminent association of business tax professionals worldwide, TEI has a significant interest in promoting sound tax policy, encouraging the uniform and equitable enforcement of the tax laws, and reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. The Institute is committed to maintaining a system that works — one that builds upon the principle of voluntary compliance and is consistent with sound tax policy. We, along with federal, state, and local governments, have the most at stake in crafting a tax system that is administrable and efficient.

COMMENTS ON THE EMERGENCY REGULATIONS

1. WAC 458-20-19401 (Nexus)

Effective June 1, 2010, Washington statutes provide a bright-line test for determining when an out-of-state business entity providing services or receiving royalty payments has nexus in Washington for purposes of the state's Business and Occupation Tax ("B&O tax").[1] Pursuant to that test, taxpayers exceeding any one of the following three thresholds fall within Washington's taxing jurisdiction: (1) $50,000 worth of property in the state; (2) $50,000 of payroll in the state; or (3) $250,000 of sales to customers in the state – regardless of any physical presence in the state.[2] A business will continue to have nexus in Washington until one year after it no longer meets any of these three thresholds (a phenomenon commonly referred to as "trailing nexus").

The Questions and Answers section of the Department's website addressing economic nexus states: "If a foreign entity meets the minimum economic presence tests in 2ESSB 6143 § 104, Washington will impose its B&O tax on that entity unless the state is federally preempted."[3] The Department provided similar guidance in a Special Notice dated May 28, 2010, entitled "New 'Economic Nexus' in Washington State May Impact Foreign Corporations." The notice provided that "[u]nder the new economic nexus standard income of foreign corporations without a physical presence in Washington could become subject to Washington's business and occupation (B&O) tax on an apportioned basis."

TEI has long advocated that, consistent with constitutional principles, a physical presence is necessary for a state's assertion of nexus. Thus, we fundamentally oppose the imposition of economic nexus on constitutional and policy grounds. In connection with the Department's regulations, however, we are particularly concerned about extending economic nexus to foreign entities where inconsistent with federal law and international treaties. In order to avoid these conflicts, we urge the Department to refrain from enforcing economic in the context of a foreign (non-U.S.) business without a physical presence in the United States (*i.e.*, by imposing the B&O tax only on foreign businesses that file a U.S. federal Form 1120-F and that meet the new Washington nexus standards). Limiting the reach of the statute in this manner would be consistent with federal income tax rules, which provide that a foreign business must have some physical presence in the country before becoming taxable on income from its trade or business. Where a U.S. tax treaty applies, that presence must give rise to a "permanent establishment," which generally requires a physical presence in the form of a fixed place of business.

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[1] 2ESSB 6143 § 104.

[2] A business will also have nexus in Washington if it has at least 25 percent of its total property, payroll, or receipts are sourced to Washington. 2ESSB 6143 § 104(1)(iv).

[3] *See* http://www.dor.wa.gov/Content/FindTaxesAnd Rates/BAndOTax/EconomicNexusQnA.aspx.

Maintaining separate state and federal thresholds for establishing a taxable presence in the United States makes the nation less attractive to foreign investors and businesses. The Wisconsin Department of Revenue promulgated regulations last year that contained a provision aimed at rationalizing these varying standards. (Wisconsin also adopted an economic presence nexus standard that same year.) Under the Wisconsin rules, income excluded from federal taxation under a U.S. tax treaty is excluded from Wisconsin gross income.[4] If Washington State intends to apply the economic nexus standard to foreign businesses despite these arguments against doing so, TEI believes the proper location for that position is not in an informal forum such as the Question and Answer section of the Washington Department of Revenue's website but rather inclusion in the body of the Emergency Regulations.

2. WAC 458-20-19402 (Single Sales Factor – Generally) and WAC 458-20-19403 (Single Sales Factor – Royalties)

The Emergency Regulations note that, beginning June 1, 2010, taxpayers engaged in the business of providing services or intangibles must calculate their B&O tax liabilities by multiplying their gross receipts by a single receipts factor.[5] With the exception of businesses using a fiscal year beginning on June 1, the effective date of these rules occurs in the middle of a tax year necessitating the use of two methods for determining the B&O tax base. For calendar year taxpayers, the proper approach to filing their second quarter tax returns should be to use cost apportionment to allocate receipts generated during the months of April and May and use the single sales factor methodology for receipts generated after June 1, 2010.

To provide greater clarity for existing B&O taxpayers with tax years straddling the transition to a single receipts factor, an example should be added to the Emergency Regulations addressing this situation for both a service provider and a business involved in intangibles.

Service businesses must include sales in the numerator of the receipts factor when the customer receives the benefit of those services in Washington "determined on an activity by activity basis."[6] The Emergency Regulations do not define the term "activity," leaving taxpayers with precious little guidance on the scope of the concept. For example, the term could apply broadly to include all receipts from a particular business line, or could be interpreted narrowly as including only each separate transaction. This distinction could significantly affect the calculation of a business's B&O tax liability. TEI urges the Department to add language to the Emergency Regulations (and ultimately, the final regulations) defining the breadth of the term "activity."

Where the customer of a service business receives the benefit of those services in Washington and another state, the Emergency Regulations require taxpayers to include receipts

[4] Wisconsin Administrative Rules § 2.61(6)(a)3.

[5] Emergency Regulations §§ 458-20-19402(1)(a) & 458-20-19403(1).

[6] Emergency Regulations § 458-20-19402(5)(a)(i).

in the numerator of the receipts factor if the benefit of those services was received "primarily" in Washington.[7] The examples provided in the Emergency Regulations seemingly apply a "majority" test (*i.e.*, if the majority of the benefits are received in Washington, all of the receipts from that "activity" must be included in the numerator of the receipts factor). If the intent is truly to apply a majority test, TEI believes that the regulations should be amended to specify that interpretation in the body of the regulations rather than referring to the concept only in the examples.

Businesses receiving royalties must also use a single receipts factor to calculate their B&O tax liabilities beginning June 1, 2010. The numerator of that fraction includes all royalties attributable to Washington. Royalties are attributable to Washington if the location of the use of the underlying intangible asset is entirely in Washington "determined on a license use basis."[8] The intent of the statutory language seems to be that receipts from a license of an intangible used entirely in Washington must be included in the numerator. Perhaps the reference to a "license use basis" in the Emergency Regulations merely means that each license must be treated as a separate "activity" for purposes of determining whether the licensee uses the intangible solely in Washington. That conclusion, however, will remain uncertain unless the Department clarifies the meaning of "license use basis." TEI urges the Department to update the Emergency Regulations with language defining this term. Additionally, the royalty Emergency Regulation contains the same "primarily used" sourcing rule applicable to service providers discussed above. It contains no guidance, however, on whether "primarily" means the majority of the use of the underlying intangible or some other degree of use.[9] TEI encourages the Department to specify the degree to which a licensee must use a licensed intangible in Washington before this rule applies.

The Emergency Regulations also address the "throwout" rule contained in 2ESSB 6143 § 105(c), which requires receipts to be removed from the receipts factor denominator when at least some of the activity is performed by the taxpayer in Washington and the taxpayer is not taxable in the state where the customer receives the benefit of the services. The Emergency Regulations do not specify what level of activity rises to the threshold of "at least some activity." For example, if an information technology service provider has a team of 10 professionals working on a project for a small customer in Missouri (where the service provider does not have nexus), the throwout rule could apply if one of those 10 professionals performed services remotely for the Missouri customer while at Seattle's Sea-Tac airport on a layover. Applying this concept to the Emergency Regulation governing the apportionment of royalties presents additional issues. Often there are no "activities" that generate royalty income. Instead, a patent may be licensed to a manufacturing company located outside of Washington, with the business that owns the patent merely monitoring the licensee's use of the patent to ensure compliance with the licensing contract. If the owner of the patent stores backup paper copies of the licensing contract at an

[7] Emergency Regulations § 458-20-19402(5)(b).

[8] Emergency Regulations § 458-20-19403(5)(a).

[9] Emergency Regulations § 458-20-19403(5)(b).

office in Seattle, might that rise to the level of "some of the apportionable activity" being performed in Washington? TEI believes it should not. To provide additional clarity in this area and to make the throwout provision more administrable, TEI suggests adding a *de minimis* threshold to the Emergency Regulations.

Conclusion

TEI appreciates this opportunity to comment on the Washington Department of Revenue's Emergency Regulations. If you have any questions about the Institute's views or desire additional information regarding the comments contained in this letter, please do not hesitate to contact Linda Dickens, Chair of TEI's State and Local Tax Committee, at 972.917.6912 (linda-dickens@ti.com) or Daniel B. De Jong of TEI's legal staff at 202.638.5601 (ddejong@tei.org).

Respectfully submitted,

Tax Executives Institute, Inc.

Paul O'Connor
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