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Cost Apportionment – Treatment of Costs Incurred for Multiple Purposes

WAC 458-20-194 Doing Business Inside and Outside the State (Rule 194) implements RCW 82.04.460(1) by specifying how multi-state businesses providing services subject to the "service and other activities" and certain other business & occupation (B&O) tax classifications apportion their income. Businesses that apportion under Rule 194 must use separate accounting, if it is accurate. If separate accounting is not accurate, cost apportionment must be used. All examples in this excise tax advisory assume that separate accounting is not accurate and that cost apportionment must be used. Cost apportionment apportions total apportionable gross income to Washington based on the proportionate cost of doing business in Washington State compared to total costs.

As a general rule, costs of producing income not apportioned under RCW 82.04.460(1) are not relevant to this calculation. Rule 194(4)(c). So, for example, if ABC provides interior design services from offices in both Washington and Oregon and also operates separate retail furniture stores in both Washington and Oregon, then the costs associated solely with the retail furniture stores would be excluded from the cost apportionment formula for the interior design services.

However, Rule 194(4)(c)(iv) explains that shared costs (those supporting both apportionable and nonapportionable activities) must be included in the cost apportionment formula without segregating the service portion of the costs. For example, if ABC had a corporate office in Washington that provided administrative support for the interior design offices and retail stores located in both Washington and Oregon, those shared administrative costs would be included in the cost apportionment formula. The Department has been asked whether it would consider an alternative apportionment method under Rule 194(4)(i) if it can be demonstrated that including shared costs results in a cost apportionment calculation that does not fairly reflect the taxpayer's business activity in Washington.

Rule 194 provides for the limited use of alternative methods of allocating costs. An alternative method for cost apportionment is allowed only if the taxpayer or the Department can show by clear and convincing evidence that applying the Rule's prescribed method "does not fairly represent the extent of the taxpayer's business activity in Washington." Rule 194(4)(i)(v). In the following scenario, an alternative method of cost apportionment may be appropriate if it can be demonstrated by clear and

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convincing evidence that applying the prescribed method would "not fairly represent the extent of the taxpayer's business activity in Washington."

Assume XYZ has asked the Department that it be allowed to exclude a portion of the shared building lease and utility costs.

XYZ operates:

- A single Washington location, at which it operates a retail furniture store, provides interior design services, and performs administrative functions for all Washington and Oregon locations and activities;
- Two Oregon locations, one location operates a retail furniture store and the other location provides interior design services. Neither location supports the other.

With respect to the Washington location:

- Building lease and utility costs are \$3,750,000. These costs are consistent regardless of whether an area is used for retail sales, interior design, or administrative activities. The building has 125,000 square feet (sf), the retailing, interior design, and administrative activities are performed in separate and segregated areas, of which:
 - 10,000 sf is used for interior design activities;
 - 8,000 sf is used for administrative activities; and
 - 107,000 sf is used for retail sales activities.
 - The administrative activity supports the retail sales and interior design activities for both the Washington and Oregon facilities.
- Other costs (e.g., supplies, wages and benefits) are separately identifiable to the retail sales, interior design, and administrative activities; and are as follows:
 - \$525,000 for retail sales activities;
 - \$300,000 for interior design activities; and
 - \$200,000 for administrative activities.

With respect to the Oregon interior design location, total costs are \$400,000. The costs related to the retailing location are excluded from the cost apportionment formula per Rule 194(4)(c).

In this situation, the Washington costs would include:

Washington Building and utility costs (shared)	\$3,750,000
Washington Interior Design costs (exclusive)	300,000
Washington Administrative costs	<u>200,000</u>
Total Washington costs	\$4,250,000

Further, the total costs will include the above-identified Washington costs of \$4,250,000 plus the Oregon interior design costs (\$400,000) for total costs of \$4,650,000.

Thus, the prescribed cost apportionment formula will apportion approximately 91.4% ($4,250,000/4,650,000$) of the interior design income to Washington.

But if the building and utility costs were allocated based on square footage, the cost apportionment formula is different. The costs related to the Washington building are \$30 per sf. The cost apportionment formula would look like:

Washington Building and utility costs (interior design)	\$300,000
Washington Building and utility costs (administrative)	240,000
Washington Interior Design costs (exclusive)	300,000
Washington Administrative costs	<u>200,000</u>
Total Washington costs	\$1,040,000

The Oregon costs would be the same \$400,000, resulting in total costs of \$1,440,000.

Under this allocation, the Washington share of the interior design service income would be approximately 72.22% ($1,040,000/1,440,000$). Because the allocation of shared costs is reasonable and, based solely on the limited facts presented, Rule 194's method appears to not fairly represent the extent of XYZ's business activity in Washington; XYZ could elect to report using an alternative method of cost apportionment. Likewise, the Department could impose such an allocation of the building costs.

But if the Washington retailing and interior design services are not segregated within the building and the same Washington employees provide both retail assistance and interior design services, then it may not be possible to reasonably allocate the costs. In this case, the example in Rule 194(4)(c)(iv) is not an unreasonable allocation under the facts presented and an alternative cost apportionment method would not be allowed.

A determination as to whether an alternative cost apportionment method is appropriate for a particular situation can be made only after a review of all the facts and circumstances. Taxpayers are encouraged

to seek prior Department approval of any alternative cost apportionment method. Rule 194(4)(i)(iv). If a taxpayer does not obtain prior approval of the Department, the Department is not required to accept the taxpayer's alternative apportionment method for past periods if the Department determines: (1) that Rule 194's method fairly represents the extent of the taxpayer's business activity in Washington; or (2) that another alternative method more accurately represents the extent of the taxpayer's activity in Washington.
