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Senseless (in) Seattle

Confusing application of city's B&O tax leaves service businesses in a quandary.

More than 40 Washington cities impose local business and occupation (B&O) tax. This is in addition to the state's B&O tax on gross receipts. When a business engages in activities both inside and outside a B&O tax city, Washington law requires cities to "apportion" a business's receipts between its in-city and out-of-city activities so that local B&O tax is only paid on receipts attributed to the taxing city. Since 2008, cities have been required to apportion income according to a two-factor formula — a "payroll factor" and a "service income factor." Unfortunately, Seattle has given service businesses mixed signals about how to determine the service income factor, creating confusion and controversy as the city ramps up audits of businesses' apportionment calculations.

The two-factor apportionment formula is designed to allocate income based on a combination of the company's physical location and its customer base. The payroll factor captures where the company's employees are located. The service income factor captures where the company's customers are located. A company's taxable in-city income is calculated by multiplying the company's total income by the average of these two factors.

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Seattle has been inconsistent in its approach to the service income factor. Seattle has advised some businesses that the customer's billing address is a reasonable way to show customer location. Under that approach, a Seattle consulting firm (or other service business) would treat receipts from clients located in Bellevue as out-of-city revenue based on the Bellevue billing address. This approach is consistent with the purpose of the service income factor, which is to reflect the taxpayer's business market, i.e., where a company's customers are located.

However, Seattle has also (inconsistently) asserted that the customer's location should sometimes be ignored, with service income sourced instead to the taxpayer's own location instead of its customer's address. Going back to the Seattle consulting firm example, income from its Bellevue customer might be sourced to the firm's Seattle office instead of the customer's Bellevue location.

Seattle has increasingly taken the latter position in recent audits, often resulting in additional revenue apportioned to the city. Seattle's reasoning is fairly convoluted, but it boils down to the doubtful proposition that unless a service business's interaction with its customers occurs primarily through in-person or face-to-face meetings, then the customers have no location.

Seattle's approach is highly problematic, requiring businesses to track all interactions with customers — including emails, phone calls, video teleconferences and face-to-face meetings, as well as precisely where the interactions occurred. The approach can have an Alice-in-Wonderland impact as well, changing the source of the income depending on whether our hypothetical Seattle consultant visits the client in Bellevue, whether the Bellevue client visits the consultant in Seattle or how much of the work is performed outside of those client meetings. Moreover, pinpointing these locations is increasingly difficult. For our Seattle consultant serving a Bellevue customer, where are receipts sourced when the consultant is working remotely from her Redmond home for the day, or working remotely while on a business trip to California?

Even if the consultant always works out of her Seattle office, what if most of the work is performed on a database stored on a server located in Texas? What about a database or documents stored in the cloud?

In light of Seattle's confusing and inconsistent approach to apportionment of service income, businesses may be well served reviewing how they currently calculate their Seattle service income.

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