STATE OF WASHINGTON
DEPARTMENT OF REVENUE
OFFICE OF THE DIRECTOR
P.O. Box 47454 • Olympia, Washington 98504-7454 • (360) 534-1600 • FAX (360) 534-1606

December 23, 2024

TO: The Honorable June Robinson,
Chair, Senate Ways & Means Committee

The Honorable Lynda Wilson,
Ranking Member, Senate Ways & Means Committee

The Honorable April Berg,
Chair, House Finance Committee

The Honorable Ed Orcutt,
Ranking Member, House Finance Committee

Rob Duff,
Executive Director, Policy, Office of the Governor

FROM: Drew Shirk, Director
Department of Revenue

SUBJECT: Royalty Receipts Apportionment for Local Business Taxes Study

The Department of Revenue (department) is submitting this report as required by Section 139(15), Chapter 376, Laws of 2024 (amending the 2023-2025 fiscal biennium operating budget).

If you have any questions or need the report in an alternate format, please contact Steve Ewing, Legislative and External Affairs Liaison, Executive Division, at SteveE2@dor.wa.gov or (360) 534-1545.

Attachment

cc: Sarah Bannister, Secretary, Washington State Senate
Bernard Dean, Chief Clerk, Washington State House of Representatives
Members, Senate Ways & Means Committee
Members, House Finance Committee
Pat Sullivan, Director, Office of Financial Management
Sheri Sawyer, Executive Director, Legislative Affairs & Outreach, Office of the Governor
Roselyn Marcus, Director of Legal and Contract Services, Office of Financial Management
Rachel Knutson, Senior Budget Adviser, Office of Financial Management

Department of Revenue
Washington State

Royalty Receipts Apportionment for Local Business Taxes Study

Dec. 31, 2024

Drew Shirk, Director

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Introduction

This report is required by Section 139(15), Chapter 376, Laws of 2024 (amending the 2023-2025 fiscal biennium operating budget). This budget proviso requires the department of Revenue (department) to:

- Conduct a study and provide a report to the Legislature on royalty receipts apportionment for local business taxes throughout the state;
- Examine how gross income derived as royalties from the granting of intangible rights in RCW 35.102.130 could be apportioned uniformly by local jurisdictions;
- Consider apportionment options including those described in RCW 82.04.462(3)(b), as well as other options;
- Identify issues surrounding the definition of "customer" as applied to royalties and payments made or received for the use of a taxpayer's intangible property in RCW 35.102.130, and how it could be brought into conformity with RCW 82.04.462(3)(b)(viii) and applied uniformly;
- Document and evaluate the approaches to apportionment of royalties that have been adopted in other states and examine the feasibility of applying interstate apportionment methodologies to local business taxes; and
- Provide a report on the study to the Governor and the appropriate policy and fiscal committees of the Legislature by December 31, 2024.

Executive Summary

Currently, local city business and occupation taxes apportion gross receipts from royalties based on a taxpayer's commercial domicile. This study explores additional options for apportioning royalty gross income that may support apportioning royalty income uniformly among local jurisdictions. In addition to the options in RCW 82.04.462(3), the department examined the possibilities of applying the formula from RCW 35.102.130(3) (for local apportionment of gross income from services) and adopting a formula-based attribution method based on relative population percentages. Several comparisons to how other states and cities outside of Washington currently treat apportionable royalty income are included. This study also examines issues relating to the definition of "customer" as applied to taxable royalty income.

The department, as the state tax administrator, is neutral as to whether cities should change their apportionment methods and does not recommend one option over another. The department respects the ability of local governments to determine the method of apportionment best suited to their own needs. With that said, the department study of local royalty apportionment methods did reveal four main findings:

- While there are arguments in favor of adopting an alternative method for apportioning local royalty income, there are also arguments supporting continued use of the current method;
- Regardless of the ultimate apportionment method chosen, the Commerce Clause and Due Process Clause impose certain constitutional limits and requirements;
- Comparisons to other states and cities reveal that apportionment of income from intangibles is most often determined based on use, or utilization of the intangible within that jurisdiction; and

- The nature of intangibles and factors like intermediary licensee or sublicensee taxpayers can make it difficult to determine the location of use and attribute taxable income to the ultimate owner (taxpayer) of an intangible. However, a number of laws and regulations indicate that it may be less difficult to determine the location of use for some forms of intangibles, like copyrights and patents, than others, like trademarks.

Background - Taxability of Royalty Income in Washington Overview

Washington imposes a state-level business and occupation (B&O) tax for the act or privilege of engaging in business activities in Washington.[1] The B&O tax is applied to a taxpayer's gross income, and touches upon virtually all forms of business activities carried on within the state, including income received from royalties.[2] Under RCW 82.04.2907(2), "gross income from royalties" is compensation for the use of intangible property, including receipts in the nature of royalties, regardless of where the intangible is used.

Apportionment is a method of attributing taxable gross receipts between different jurisdictions where a taxpayer does business. If a taxpayer receives income in multiple states including Washington, the taxpayer is required to apportion the income to Washington that is derived from business activities taking place within this state, and those amounts are subject to B&O tax.[3] Under RCW 82.04.462, apportionable income is multiplied by a Washington "receipts factor," determined by dividing Washington gross income by worldwide gross income.

Gross income from royalties is attributed to Washington or another state through a series of cascading steps in RCW 82.04.462(3)(b). Royalty income is first attributed to the state where the customer *uses* the intangible property. This includes reasonable methods of proportionally attributing the use of an intangible. If the customer uses the intangible property in multiple states and the taxpayer is unable to *reasonably determine* the state where income should be attributed to, gross income is attributed to the state where the intangible property was *primarily* used.

If the steps above are insufficient to permit apportionment, the income is attributed to the state from which the customer *negotiated* the service, followed by the state to which the *invoices* are sent, then the state from which *payment* was sent, and then to the state of the customer's *address*. Finally, if a taxpayer is unable to attribute royalty income amounts to a single state under all these cascading steps, the income is attributed to the state of the taxpayer's commercial domicile.[4]

In addition to the state-level B&O tax, approximately 50 cities within Washington have their own local-level B&O tax.[5] The apportionment of taxable income to these cities is governed by RCW 35.102.130, which has been adopted into the cities' municipal ordinances.[6]Under RCW 35.102.130(2), all gross income from royalties for granting intangible rights *must* be attributed to the

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[1] RCW 82.04.220(1).
[2] RCW 82.04.2907.
[3] RCW 82.04.460(1).
[4] RCW 82.04.462(3)(b)(vii). The statute does not define "commercial domicile."
[5] As of January 1, 2024.
[6] Chapter 35.102 RCW was a result of EHB 2030 (2003), which was passed by the Legislature to provide for a more uniform system of municipal B&O tax administration.

commercial domicile of the taxpayer. The cities with a local B&O tax have therefore attributed 100% of royalty income to the specific city in which a taxpayer is physically headquartered.

Part I: Constitutional Basis for Apportionment of Royalties

Generally, state and local jurisdictions have taxing authority, but that authority is subject to constitutional constraints — primarily the Commerce and Due Process Clauses.[7] [8] [9]

In order for a state or local jurisdiction to impose tax, there must be due process nexus between the taxing state and the person, activity, transaction, or property sought to be taxed. The Due Process Clause requires that there be a minimum connection between a state and the person, property and/or operation it seeks to tax, focusing on "fairness."[10] This minimum connection standard is distinguished from commerce clause nexus, which requires a substantial nexus. In practice, if a state or local jurisdiction satisfies commerce clause nexus, it will satisfy due process clause nexus.[11] However, there are some recent cases that suggest potential new due process considerations. See Part III of this report.

Complete Auto Transit v Brady, 430 U.S. 274 (1977), established a four-prong test for determining if a tax is constitutional under the Commerce Clause.[12] To survive a Commerce Clause challenge, a tax must:

1. Apply to an activity with substantial nexus with the taxing state (i.e., there must be a sufficient connection between the taxpayer and the state);
2. Be fairly apportioned[13];
3. Not discriminate against interstate commerce (does not treat out-of-state taxpayers differently than in-state taxpayers)[14]; and
4. Be fairly related to the services the state provides to the taxpayer.

A tax that satisfies these requirements will generally be considered constitutional.[15] [16]

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[7] U.S. Const. art. 1, § 8, cl. 3.

[8] Contained in the 14th Amendment to the U.S. Constitution. The Due Process Clause also requires the establishment of nexus, which can be established through either general jurisdiction (where the taxpayer is physically present or domiciled in the state) or specific jurisdiction (where taxpayer activities constitute "minimum contacts" with the state and the tax is not deemed unfair or unreasonable). *See International Shoe Co. v. State of Wash., Office of Unemployment Comp. & Placement*, 326 U.S. 310 (1945).

[9] While intrastate commerce (among cities) can be distinguished from interstate commerce (among states), cities remain subject to constitutional legal challenges over apportionment methods.

[10] *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 344- 345 (1954).

[11] *Complete Auto Transit v Brady*, 430 U.S. 274 (1977)

[12] *Complete Auto*, 430 U.S. 274 (1977).

[13] Although post *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018), some posit this analysis may include due process considerations related to states attempting to tax beyond their legal reach. See Part III of this Report.

[14] This test was further clarified or added to in *South Dakota v. Wayfair Inc.*, 138 S. Ct. 2080 (2018), which establishes a test concerning discrimination and undue burden consistent with *Pike v. Bruce Church Inc.*, 397 U.S. 137 (1970).

[15] *Miller Bros. Co. v. State of Md*., 347 U.S. 340 (1954).

[16] "The *Complete Auto* test[s], while responsive to Commerce Clause dictates, encompas[s] as well the due process requirement that there be a 'minimal connection' between the interstate activities and the taxing State, and a

Nexus

As to the first prong *of Complete Auto*, courts historically found a taxpayer's physical presence to often be a *requirement* for "substantial nexus."[17] [18] But in the 2018 case, *S. Dakota v. Wayfair*, the Supreme Court held that physical presence was no longer required under the Commerce Clause; although physical presence was sufficient to create nexus.[19] Instead, the court found substantial nexus satisfied by virtual and economic contacts to a state. Attributing royalties based on the location of the taxpayer's headquarters, for example, would satisfy Commerce Clause nexus because it is established through physical presence.

Apportionment

When courts are determining whether a tax is apportioned properly, under the second prong of *Complete Auto,* two specific tests are applied: an "internally consistent test" and an "externally consistent test":

> To be internally consistent, a tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result. Thus, the internal consistency test focuses on the text of the challenged statute and hypothesizes a situation where other States have passed an identical statute. The external consistency test asks whether the State has taxed only that portion of the revenues from the interstate activity which reasonably reflects the in-state component of the activity being taxed.[20]

Discriminatory Tax

The third prong of *Complete Auto* prohibits taxes that discriminate against interstate commerce (not treat out-of-state taxpayers differently than in-state taxpayers). Prohibited discrimination can be either facial or in effect. Under the options reviewed there is no suggestion that there will be disparate treatment as between in-state and out-of-state taxpayers or even an undue burden on interstate commerce. Accordingly, this report does not otherwise address discrimination in the context of the options reviewed.

Fairly Related

The fourth prong of *Complete Auto* requires that a tax be fairly related to the services the state provides to the taxpayer.

The Court has held that the "test is . . . whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state."[21] Under the options reviewed, there is no suggestion that the taxpayers having apportionable royalty income do not enjoy the

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rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Trinova Corp. v. Mich. Dep't of Treasury,* 498 U.S. 358, 373 (1991).

[17] *See Quill Corp. v. N. Dakota*, 504 U.S. 298 (1992), overruled by *S. Dakota v. Wayfair, Inc*., 138 S. Ct. 2080, (2018).

[18] Substantial tax nexus can generally be viewed as a legally recognized connection between a jurisdiction and a taxpayer that subjects the taxpayer to tax liability in that jurisdiction.

[19] *S. Dakota v. Wayfair, Inc*., 138 S. Ct. 2080 (2018).

[20] *Goldberg v. Sweet*, 488 U.S. 252 (1989).

[21] *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940)

benefits of Washington and its local taxing jurisdictions. Accordingly, this report does not address the fairly-related prong in the context of the options reviewed.

Intrastate Apportionment

The Commerce Clause maintains states may apply taxes to interstate commerce if they comply with the four-prong test discussed above for determining if a tax is constitutional. There is some debate over whether and how the Commerce Clause applies to *intrastate* transactions. In particular, the Supreme Court has held that the Commerce Clause, and Congressional authority, applies to intrastate economic activities insofar as the activities "exert a substantial economic effect on interstate commerce."[22] The department was unable to find any precedent that directly addresses the constitutionality of intrastate apportionment among in-state taxing jurisdictions, and therefore, we omit anything further on this topic in this report.

Case Study: Philadelphia Eagles v. Philadelphia

During the 1980's and 1990's, the City of Philadelphia imposed a business privilege tax (BPT) on the gross receipts of every taxpayer engaging in business in the city. One such taxpayer was the owner of the Philadelphia Eagles football team. As a member of the NFL, this entity earned a shared percentage of NFL royalty revenues from broadcaster "media receipts." The city's policy was to attribute 100% of all royalty income to Philadelphia, if the taxpayer was domiciled there, unless the income could be attributed to activities conducted at a place of business regularly maintained outside of Philadelphia.[23] This resulted in 100% of the media receipts being taxed by the City of Philadelphia.

The football team challenged the City's position and claimed a refund for overpayments of BPT, arguing that since the Eagles only played half of their games in Philadelphia, only 50% (not 100%) of the media receipts' royalties should be attributed to Philadelphia. The Pennsylvania Supreme Court ultimately concluded that imposing the BPT on 100% of the income violated the Commerce Clause.[24] Instead, the court recognized that the Commerce Clause requires income, regardless of its form or characterization, to be apportioned to reflect the underlying activity that generates value.

Although Philadelphia argued that Commerce Clause apportionment was not necessary because the BPT was a gross receipts tax, the court found that gross receipts taxes were not "immune from the constitutional requirement of fair apportionment," for the U.S. Supreme Court has observed that a gross receipts tax is "simply a variety of tax on income, which [is] required to be apportioned to reflect the location of the various interstate activities by which it is earned." [25] [26]

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[22] *Wickard v. Filburn*, 317 U.S. 111 (1942).

[23] The city's Department of Revenue regulation read: "…where a taxpayer…maintains its commercial domicile in Philadelphia, all…royalties received are to be included in the measure of tax unless attributable to business conducted at a place of business regularly maintained by the taxpayer outside of Philadelphia."

[24] In *Philadelphia Eagles v. City of Philadelphia*, 573 Pa. 189 (2003).

[25] This argument had support from a trio of Washington B&O tax cases that involved gross receipts received by in-state sellers and manufacturers (*Tyler Pipe Industries, Inc, v. Washington Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel Co. v. Washington Rev. Dept.*, 419 U.S. 560 (1975); and *General Motors Corp. v. Washington*, 377 U.S. 436 (1964)). But the court refused to expand the holdings of these cases beyond the specific activities of manufacturing and sales.

[26] *Oklahoma Tax Comm'n v. Jefferson Lines*, 514 U.S. 175 (1995).

Part II: Options for Uniform Apportionment of Local Royalties Receipts

This section of the report identifies options for apportioning gross income from royalties. This report presents four potential options for apportioning gross income from royalties for the Legislature's consideration:

1. Adopt apportionment framework similar to Washington's state-level royalties apportionment
2. Adopt apportionment framework cities use for apportioning gross income from service activities;
3. Apportion royalties based on relative city population data or another measurable metric;
4. Status quo - continue to attribute all royalties to the commercial domicile.

Option 1—Adopt apportionment framework similar to Washington's state-level royalty apportionment

RCW 82.04.067 sets forth specific conditions for establishing Washington tax nexus, and RCW 82.04.460 requires taxpayers earning income in multiple states to apportion their income between those states and Washington. RCW 82.04.462 establishes a "receipts factor" that incorporates a taxpayer's Washington sales relative to sales made everywhere, and then provides cascading steps designed to determine which state has a stronger connection to a taxable activity (see "Background - Taxability of Royalty Income in Washington Overview" above for information on the cascading steps).

The receipts factor is multiplied by gross income from a taxable activity to determine tax due to Washington.

For royalty activity, gross income is attributed to the state or states where a customer uses the intangible property.[27] The department expects that most taxpayers will be able to attribute apportionable royalty receipts based on use because taxpayers will know the place of customer use or a "reasonable method of proportionally attributing" receipts will be available.[28] However, when a taxpayer does business in multiple states, the location of use, or even primary use, may not always be easy to determine.

If a taxpayer cannot determine the place of use or establish a reasonable method of proportional attribution, the taxpayer must use a series of cascading steps to attribute income as follows:

- To the office of the customer from which the royalty agreement with the taxpayer was negotiated.
- To the state to which the billing statements or invoices are sent to the customer by the taxpayer.
- To the state from which the customer sends payment to the taxpayer.
- To the state where the customer is located as indicated by the customer's address: (A) Shown in the taxpayer's business records maintained in the regular course of business; or (B)

[27] WAC 458-20-19403.

[28] WAC 458-20-19403(201).

obtained during consummation of the sale or the negotiation of the contract for services or for the use of the taxpayer's intangible property, including any address of a customer's payment instrument when readily available to the taxpayer and no other address is available.

- To the commercial domicile of the taxpayer.

In addition, state-level apportionment includes a "throw-out" rule. This provision excludes from the apportionment formula income attributable to a jurisdiction where the taxpayer is "not taxable" (i.e., not subject to a business activities tax), but at least *some* activity takes place in the jurisdiction apportioning income. This has the effect of increasing the amount of gross income attributed to the jurisdiction imposing B&O tax and recaptures lost tax revenue for jurisdictions who would otherwise lose that revenue from attributing a portion of taxpayer income to activities in locations that do not impose B&O tax. As part of this option, cities with a B&O tax could also benefit from a similar provision.

Legal and Fiscal Considerations

- **Tested Approach:** Applies a method for attributing income based on location of use, or the location of the customer (other cascading steps), which is used at the state level and in other state taxing jurisdictions (See "Comparative Analysis: Other States" below).
- **Nexus and Apportionment:** Substantial nexus would be conferred through physical and/or economic nexus, and there is a constitutional method of apportioning receipts, which are attributed to locations with significant connections between the taxpayer and the state.
  - While RCW 35.102.060 generally requires cities with a B&O tax to provide for a system of tax credits designed to prevent "an undue burden on interstate commerce or [the] violat[ion] [of] constitutional requirements" resulting from multiple taxation of receipts, *this provision does not apply to royalty receipts under current law*. This statute could be expanded to expressly include royalty income to provide adequate credit to overcome the issue.
  - This option does not impact revenues of the 231 Washington cities that do not currently have a local B&O tax. If they subsequently imposed a local B&O tax, then they may increase revenues if intangibles were used by a business in their jurisdiction that is domiciled in another city.
  - While B&O tax cities that have not previously benefited from attribution to the commercial domicile may see an increase in revenue if intangible use within their jurisdiction were taxable, cities taxing activities taking place within their jurisdiction that were attributed 100% to a business' domicile may lose some revenue that is apportioned to another city(ies).

Policy Considerations

- **Administrative Issues:** While there are administrative issues (see below), taxpayers earning royalty income in Washington and other states are already required to follow the cascading steps for purposes of Washington state-level B&O tax. As a result, this new method for apportioning local B&O tax may not come as a surprise or be viewed as a heavy burden to taxpayers. Here are other administrative considerations:
  - May increase disagreements among cities and taxpayers who cannot agree on the location where an activity that generates income occurs or with taxpayers who prefer

a single-location attribution method for income from intangibles, particularly if they have been reporting under the previous method for a long time.
  - Only when the cascading steps are insufficient, may taxpayers apportion to commercial domicile.
  - Some taxpayers may have challenges keeping sufficient records under this proposed method, and voluntary compliance may be lower, at least initially, than the current method.
  - Taxpayers may not accurately determine the cities in which they must be licensed and pay taxes.
  - Taxpayers who attempt in good faith to comply may not always be able to accurately track intangible usage across the state. It may therefore be difficult for cities to enforce this method, in some cases, if businesses do not report or make record of every jurisdiction where their intangibles are used (at least the activities generating royalty revenue).
  - Some taxpayers may conduct business through a customer who licenses the intangible to subsequent customers throughout the state. This may create an issue of identifying which taxpayers are liable for the tax, who the customer of the intangible really is, and whether income is attributable to a certain activity taking place in a specific location.
- **Tax Minimization:** Some of the cascading steps of this option may be more susceptible to tax minimization than commercial domicile. Commercial domicile is generally a fixed location. The cascading steps may increase the likelihood that taxpayers change business practices to limit their tax exposure.

Comparative Analysis: Other States

While other states may not have a gross receipts tax like the B&O tax, they do have an income tax or similar tax that is imposed on businesses. The apportionment methods states utilize do have some similarities to Washington, but also to each other. For comparison, below is a summary of apportionment laws enacted by several other states reflecting how they apportion income from intangibles like royalties.

ALABAMA

- Taxpayers having income from business activities taxable within and outside of Alabama must attribute and apportion net income.[29] Sales of intangible property are allocated to Alabama if the taxpayer's market for the sale is in Alabama.[30]
- In the case of a lease or license of intangible property, or of payments that are contingent on productivity, use, or disposition of intangible property, a taxpayer's market is in Alabama to the extent the intangible property is used in Alabama, provided that the property is used to market a good or service to a consumer in Alabama who purchases that good or service in Alabama.[31]
- Patent and copyright royalties are attributed to Alabama to the extent the patent or copyright is utilized in Alabama, or to the extent that the patent or copyright is utilized in a state in which

[29] Ala. Code Title 40, § 40-27-1, Art. IV.2.
[30] Ala. Code Title 40, § 40-27-1, Art. IV.12.
[31] Ala. Code Title 40, § 40-27-1, Art. IV.12.

the taxpayer is not taxable, and the taxpayer's commercial domicile is in Alabama. A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or if a patented product is produced in a state. If receipts from patent royalties do not permit attribution to states or if the accounting records do not reflect states of utilization, the patent is utilized in the state of the taxpayer's commercial domicile. A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the gross receipts do not permit attribution to states or if the accounting records do not reflect the state of utilization, the copyright is utilized in the state of the taxpayer's commercial domicile.[32]

California

- Any taxpayer with income taxable in both California and another state must attribute and apportion such income.[33] Sales from intangible property are attributed to California to the extent the property is used in California.[34]
- Patent and copyright royalties are allocable to California to the extent the patent or copyright is utilized by a payer in California, or to the extent that the patent or copyright is utilized in a state in which the taxpayer is not taxable, and the taxpayer's commercial domicile is in California.[35]
- California considers patents and copyrights to be utilized in a state under the same method as Alabama, and its provisions are nearly identical to the Alabama provisions above. [36]

Idaho

- Apportionable income includes income arising from intangible property if the property is integral or necessary to a trade or business.[37] Sales of intangibles occur in Idaho if the taxpayer's market is in Idaho, and a taxpayer's market is in Idaho to the extent that intangible property is used in Idaho to sell a good or service that is purchased by a consumer in Idaho.[38]
- Where a taxpayer uses intangible property in a specific geographic area, and that area includes Idaho, the property is being used in Idaho. A broadcaster's market is in Idaho if the commercial domicile of the broadcast customer is in Idaho.[39]
- When the state or states of assignment cannot be otherwise determined, they shall be reasonably approximated.[40] If a fair approximation is not possible, the taxpayer may petition for an alternative attribution and apportionment method, or the Idaho Tax Commission may apply one.[41]

Illinois

- All income included in base income earned by a resident shall be attributed to Illinois,[42] and income nonresidents earn from patent or copyright royalties shall be attributed to Illinois to

[32] Ala. Code Title 40, § 40-27-1, Art. IV.8.
[33] Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25121.
[34] Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25136(a)(2).
[35] Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25127.
[36] Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25127.
[37] Idaho Code Title 63, Ch. 30, § 63-3027(1)(a).
[38] Idaho Code Title 63, Ch. 30, § 63-3027(13).
[39] Idaho Code Title 63, Ch. 30, § 63-3027(13).
[40] Idaho Code Title 63, Ch. 30, § 63-3027(14).
[41] Idaho Code Title 63, Ch. 30, § 63-3027(17) & (18).
[42] Ill. Comp. Stat. Act 35 ILCS 5, § 301.

the extent the intangible is used by a customer in Illinois.[43] But such royalty income may alternatively be attributed to Illinois to the extent that the intangible is used in a state where the taxpayer is not taxable, and the taxpayer's commercial domicile is in Illinois.[44]

- Illinois considers patents and copyrights to be utilized in a state under the same method as Alabama and California, and Illinois' provisions are nearly identical to the Alabama provisions summarized above. [45]

KENTUCKY

- Taxpayers having income from business activity taxable both within and outside of Kentucky must attribute and apportion net income.[46] Receipts from sales of intangible property are in Kentucky if the taxpayer's market for the sales is in Kentucky.[47] The taxpayer's market for intangible property that is rented, leased, or licensed is in Kentucky to the extent the property is used in Kentucky, provided that intangible property is utilized in marketing a good or service to a consumer in Kentucky who purchases that good or service in Kentucky.[48] If the state of assignment cannot be determined, it is reasonably approximated.[49]
- Kentucky considers patents and copyrights to be utilized in a state under the same method as Alabama, California, and Illinois. Kentucky's provisions are nearly identical to the Alabama provisions summarized above.[50]

NEW YORK

- Business income must be apportioned to New York by an apportionment factor.[51] Receipts of royalties from the use of patents, copyrights, trademarks, and similar intangible property within New York are included in the apportionment factor, and intangible property is used in New York to the extent that the activities are carried on in New York.[52]
- If receipts cannot be apportioned according to use, they must be included in the apportionment factor if the location of the customer is in New York. Whether receipts are included as New York income is determined according to a hierarchy: (1) the benefit is received in New York; (2) the delivery destination is in New York; (3) taxpayer apportionment fractions based on the preceding, followed by current, taxable year; and if these steps are insufficient, the commissioner may determine a fair and proper apportionment. [53] [54]

OHIO

- All patent and royalty income are allocable to Ohio to the extent such property is utilized in Ohio.[55]

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[43] Ill. Comp. Stat. Act 35 ILCS 5, § 303(d)(1)(A).
[44] Ill. Comp. Stat. Act 35 ILCS 5, § 303(d)(1)(B).
[45] Ill. Comp. Stat. Act 35 ILCS 5, § 303(d)(2)(A) & (B).
[46] Ky. Rev. Stat. § 141.120(2).
[47] Ky. Rev. Stat. § 141.120(11)(a).
[48] Ky. Rev. Stat. § 141.120(11)(a).
[49] Ky. Rev. Stat. § 141.120(11)(b).
[50] Ky. Rev. Stat. § 141.120(8)(a) & (b).
[51] Cons. Laws of N.Y., Ch. 60, Article 9-A, § 210-A(1).
[52] Cons. Laws of N.Y., Ch. 60, Article 9-A, § 210-A(3)(b).
[53] Cons. Laws of N.Y., Ch. 60, Article 9-A, § 210-A(10)(a) & (b).
[54] Cons. Laws of N.Y., Ch. 60, Article 9-A, § 210-A(11).
[55] Ohio Rev. Code, Title 57, Ch. 5747, § 5747.20(B)(4).

- Ohio considers patents and copyrights to be utilized in a state under the same method as Alabama, California, Illinois, and Kentucky. Ohio's provisions are nearly identical to those states' provisions. [56]

Oregon

- Any taxpayer with income from business activity taxable both in and outside of Oregon must attribute and apportion net income.[57] Sales of intangible property occur in Oregon if the taxpayer's market for sales is in Oregon.[58] A taxpayer's market for intangible property is in Oregon to the extent the property is used in Oregon to sell a good or service to a consumer in Oregon, and if the state of assignment cannot otherwise be determined, the state of assignment shall be reasonably approximated. [59] [60]

Texas

- Apportionable gross receipts from business done in Texas includes receipts from the use of a patent, copyright, trademark, franchise, or license in Texas.[61] Any taxpayer having royalty income from business activity taxable in Texas and another state may attribute and apportion such income according to the laws of those states, but may also specifically apportion patent and copyright royalties to Texas to the extent that the patent or copyright is utilized by a customer in Texas, or to the extent that the patent or copyright is utilized in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in Texas. [62] [63]
- Texas considers patents and copyrights to be utilized in a state under the same method as Alabama, California, Illinois, Kentucky, and Ohio. The Texas provisions are nearly identical to the provisions of those states. [64]

Observations

- All of these states uniformly require apportionment of royalty income when that income can be attributed to that state; but they may apply slightly different options for attribution.
- Many states start with attributing royalty receipts "to the extent" that the intangible is used (utilized) in that state. It therefore appears that at least a majority of states, including Washington, assume that generally, taxpayers can determine the location where their customers use an intangible but that in some cases that may not be feasible.
- When the state of use cannot easily be determined, the states start diverging on what subsequent steps are taken to determine the state of attribution. But many appear to still retain the option of attributing income to the commercial domicile.
- While a number of states have uniform language for attributing copyright and patent income, revenue from trademark use seems to be addressed less often. This may reflect that trademark use/utilization is a somewhat more difficult determination.

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[56] Ohio Rev. Code, Title 57, Ch. 5747, § 5747.20(B)(4).

[57] ORS 314.615.

[58] ORS 314.665(4).

[59] ORS 314.666(2). Royalties, or the sale of intangible property "contingent on the productivity, use, or disposition of the intangible property" receive treatment under this section, per ORS 314.666(3)((b).

[60] ORS 314.666(4).

[61] Tex. Tax Code, Title 2, Sub. F, Ch. 171, Sub. C, § 171.103.

[62] Tex. Tax Code, Title 2, Sub. D, Ch. 141, § 141.001, Art. III.1.

[63] Tex. Tax Code, Title 2, Sub. D, Ch. 141, § 141.001, Art. IV.8.

[64] Tex. Tax Code, Title 2, Sub. D, Ch. 141, § 141.001, Art. IV.8.

- Some states allow the taxpayer, or particularly the state's taxing authority, to make a "reasonable approximation" for fair apportionment and attribution–like in Idaho, Kentucky, New York, and Oregon. Under RCW 82.04.462(3)(b)(i), Washington also allows taxpayers to "reasonably determine" intangible property used by a customer in this state.

Option 2—Adopt apportionment framework cities use for apportioning gross income from service activities

Another option is to apply the same method cities already use to apportion service income under RCW 35.102.130(3). Under that provision, gross income is apportioned by multiplying apportionable income by a fraction that equals "the payroll factor" plus the "service income factor" divided by two. [65] [66] Using multiple factors in an apportionment formula (as opposed to a single factor, like gross receipts or sales), was an approach that many states previously took.[67]

Local service income is determined partially by the service income factor. The first step is to seek to attribute gross income from services to the location of the customer.[68] If this first method is insufficient, an alternative method may be applied based on additional factors, including:

1. A separate accounting;[69]
2. The exclusion of one or more factors;
3. The inclusion of one or more other equitable factors;
4. Another method that results in an equitable attribution and apportionment of income;[70] and
5. (*Required*) Proof that apportionment based on the customer location does not fairly represent the extent of the taxpayer's activities in the city, and that the alternative method is reasonable.[71]

Cities may benefit from the "throw-out" provision of RCW 35.102.130(3)(c). Like RCW 82.04.462(3)(c) and many other states' apportionment statutes, RCW 35.102.130(3)(c) allows a city with a B&O tax to recapture income that would otherwise be lost from attributing income to cities without a B&O tax, provided that some activity took place in the taxing city.

According to the Association of Washington Cities (AWC), who testified at the House Finance and Senate Ways and Means Committee hearings on SHB 1403 (2019), these amendments represented agreed-upon changes (between the cities and taxpayers) that would work with modern business recordkeeping practices. They are also consistent with the model provisions of the Multistate Tax

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[65] The payroll factor is a fraction that equals the amount paid in a city for compensation divided by compensation paid everywhere.

[66] The service income factor is a fraction that equals service income earned in a city divided by service income earned everywhere.

[67] California, for example, generally apportioned business income prior to 2013 by multiplying the income by a fraction equal to a "property factor plus the payroll factor plus twice the sales factor" divided by four. Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25128. California (and a number of other states) now requires most businesses to use a single sales factor. Cal. Rev. & Tax. Code Div. 2, Pt. 11, Ch. 17, Art. 2 § 25128.7.

[68] Service income is paid in the city if the customer location is in the city. RCW 35.102.130(3)(b).

[69] The term "separate accounting" has been/is used by other states as well, and in general means the practice of keeping separate, distinguishable accounting records for different parts of the business (or businesses).

[70] RCW 35.102.130(3)(d).

[71] RCW 35.102.130(3)(e).

Compact.[72] But this methodology was tailored specifically to taxpayer service income, and royalty income does not appear to have been included in this analysis, nor was its taxation affected by the statutory amendments. If the Legislature were to propose that cities apply RCW 35.102.130(3) to both service and royalty income, the following are considerations:

Legal & Fiscal Considerations

- **Tested Approach:** Yes. Since cities already apply this formula to service income, there is familiarity with this approach.
- **Nexus and Apportionment:** Substantial nexus would be conferred through physical and economic nexus, while focusing on the location of the customer entails connection to intangible use that would align with constitutional requirements that a tax is required to be apportioned to reflect the location of the taxable activity.
    - There may be challenges in determining where a customer is "located" in a particular city at the time of use (i.e., is it the customer's city of residence, all the cities a customer uses an intangible in, or the city that the customer primarily uses the intangible in). But if the customer location is not a viable method, other methods are permissible to determine an equitable attribution and apportionment of income.
    - There are a number of legal theories involving intangibles that could present challenges by distinguishing royalty income from regular service income. For instance, the doctrine of "mobilia sequuntur personam" holds that an intangible follows its owner to the owner's domicile (and is therefore located and taxable in that jurisdiction). However, such challenges do not appear to be commonplace for state-level B&O tax purposes and may therefore be unlikely.
    - Overall, it is very difficult to predict the net effect of adopting this option on specific cities' revenues for several reasons.
        - Many cities do not impose a local level tax on all business income, particularly smaller cities that do not have the administrative resources to adopt and enforce a universal local-level tax scheme.[73] For instance, in Washington, only 50 of the 281 cities in the state administer a local B&O tax. Some cities simply require a business to pay for and obtain a local business license for a fee, regardless of the business activity.[74] This means there would be no revenue change under this option for the 231 non-local B&O cities. If they subsequently imposed a local B&O tax, then they may increase revenues if intangibles were used by a business in their jurisdiction.
        - This means that businesses currently domiciled in a local B&O tax city, who use an intangible in a non-B&O tax city and in another local B&O tax city in which the business is not domiciled may, under this option, apportion additional revenue to the local B&O city where the business is not domiciled.
        - Cities that have not previously benefited from the commercial domicile attribution may see an increase in revenue if income from intangibles can be

[72] Contained in Article IV, § 18.

[73] And even larger cities, like Vancouver, Washington have decided to simply eliminate their B&O tax system.

[74] However, many cities do appear to impose certain specialized taxes or fees targeting specific taxpayers (like utilities, lodging, or amusement businesses), and these may be based of gross receipts, location, or other factors.

attributed to such cities through either the payroll factor or the service income factor.

- For cities that face revenue loss, such losses may be partially offset in particular by the payroll factor, which takes into consideration wages paid within cities. Cities where taxpayers' commercial headquarters are located may benefit because those taxpayers' employees are likely also primarily located in that location. However, remote work policies and other factors may complicate this.

Policy Considerations

- **Statutory Clarification:**
  - RCW 35.102.130(3) refers to total compensation paid and total service income "everywhere." A number of cities have advised that they interpret "everywhere" to mean either in the U.S. or worldwide. It may be helpful to clarify whether RCW 35.102.130(3) factors in payroll and service income worldwide or within the U.S.

- **Administrative Issues:**
  - There would be a higher administrative burden under this option than determining the taxpayer's commercial domicile. However, this option could also lead to simplification of tax reporting if the services and other activities classification includes royalties, since all categories will use the same apportionment method.
  - The service income factor assumes that taxpayers can easily identify customer locations. It may be more difficult to identify every city that a customer uses an intangible in and, consequently, which cities a taxpayer must apportion their royalty receipts to. This is compounded when one considers that intangibles can be licensed to businesses that in turn conduct royalty-related transactions with local third-party customers. This option may require the owner of the intangible to track all subsequent usage of their property, even when they do not engage in those specific activities that their initial customers later conduct.

Comparative Analysis: Other Cities

In many states that have an income tax, cities may impose a local income tax on both individuals and businesses and rely on the taxpayer's federal income tax return to determine all taxable income, including revenue from royalties. A system of credits typically prevents double taxation where a taxpayer is a resident of one city but earns income in another city. Some cities appear to address tax on royalties specific to *tangible* personal property, but not necessarily intangible property. However, there are a number of cities outside of Washington that specifically address income from intangible royalties earned by businesses in their jurisdiction. Below is a summary of some of the codes and regulations enacted by several of these cities.

MOBILE, ALABAMA

- Mobile requires taxpayers who commence business in the city to pay an annual license fee based on either a flat rate or a percentage of receipts, but the city also levies an ad valorem tax on intangibles located within the corporate limits of Mobile, including those situated in

specifically described areas. [75] [76] [77] The rate of such levies is .007 of the value of the assessed property.[78]

San Francisco, California

- All persons with gross receipts from business activities both within and outside of San Francisco must attribute and/or apportion their gross receipts to San Francisco.[79] Gross receipts from intangible property are in San Francisco to the extent the intangible property is used in the city.[80]

Miami, Florida

- Cities in Miami-Dade County, including Miami, require every person engaged in the business of trading, buying, lending or selling intangible personal property, whether as owner, agent, broker, or otherwise, to pay a local business tax for each place of business.[81] The tax is $100.[82]

Kansas City, Missouri

- Kansas City imposes a net profits tax on business conducted in whole or in part by nonresidents and attributes a portion of net profits based on an attribution percentage consisting of a property factor, a payroll factor, and a gross receipts factor.[83] The gross receipts factor includes amounts from rentals or royalties from property situated in the city or from the use of patents within the city. However, if the taxpayer or the director believe that this method of attribution is inapplicable or inequitable, an alternative method of attribution or apportionment may be applied.[84]

Portland, Oregon

- A person is presumed to be doing business in Portland when engaging in any transaction involving the production of income from holding property or the gain from the sale of property. Such property may be personal, including intangible or real in nature.[85] Portland's Revenue Division considers royalties and residuals to be taxable business income under both city and county law, and patent and copyright royalties are apportionable to Portland to the extent that the patent or copyright is utilized by a licensee/payer in the city, or if the patent or copyright is utilized in a state where the taxpayer is not taxable, and the taxpayer's commercial domicile is in Portland.[86]

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[75] Mobile, Ala., Code Ch. 34, § 34-41.
[76] Mobile, Ala., Code Ch. 34, § 34-151.
[77] Mobile, Ala., Code Ch. 34, § 34-152.
[78] Mobile, Ala., Code Ch. 34, § 34-154.
[79] San Francisco, Cal., Code, Art. 12-A-1, § 956.
[80] San Francisco, Cal., Code, Art. 12-A-1, § 956.1(f). San Francisco is currently seeking to amend this provision to require the city tax collector to adopt regulations interpreting whether intangible property is used in the city, and to review and consider rules and safe harbor provisions adopted by California and other states.
[81] Miami-Dade County, Fl., Code Ch. 8A, Art. IX, § 8A-218.
[82] Miami-Dade County, Fl., Code Ch. 8A, Art. IX, § 8A-223.1.
[83] Kansas City, Mo., Code Ch. 68, Art. VI, § 68-384(a)(1).
[84] Kansas City, Mo., Code Ch. 68, Art. VI, § 68-384(a)(2) & (b).
[85] Portland, Or., Code, Title 7, Ch. 7.02, § 7.02.220.D.
[86] Revenue Division, *Apportionment of Royalty* Income, https://www.portland.gov/revenue/policy-apportionment-royalty-income (last visited Oct. 22, 2024).

- Similar to a number of states (identified above in Option 1), a copyright or patent is utilized in Portland to the extent that it is employed in the production, fabrication, manufacturing, or other processing in the city, or to the extent that a patented product is produced in Portland. A copyright is utilized in Portland to the extent that printing or publications originate in Portland.[87]

PHILADELPHIA, PENNSYLVANIA

- Philadelphia's Revenue Commissioner has adopted regulations under which patent, copyright and trademark royalty income is included in taxable business income if the property constitutes an integral part of a regular trade or business operation.[88] If a domestic or foreign corporation or other entity maintains its commercial domicile in Philadelphia, all patent, copyright and trademark royalties are included in the measure of the (BIRT) tax unless attributable to business conducted at a place of business regularly maintained by the taxpayer outside of Philadelphia.[89]
- Patent, copyright and trademark royalties are allocable to Philadelphia to the extent that the patent or copyright is utilized by the payor in Philadelphia.[90] Similar to a number of states, a patent is utilized in Philadelphia to the extent that it is employed in a production, fabrication, manufacturing, or other processing in Philadelphia or to the extent that a patented product is produced in Philadelphia. If patent receipts do not permit attribution or if accounting procedures do not reflect areas of utilization, the patent is utilized in the taxpayer's commercial domicile.[91]
- A copyright is utilized in Philadelphia to the extent that printing or other publication originates in Philadelphia. If the copyright receipts do not permit attribution or if accounting procedures do not reflect areas of utilization, the copyright is utilized in the taxpayer's commercial domicile.[92] A trademark is utilized in Philadelphia to the extent that the trademark is applied to goods in Philadelphia, or if not, to the extent that the goods are placed in a package or container bearing the trademark in Philadelphia. If trademark receipts do not permit attribution or if accounting procedures do not reflect areas of utilization, the trademark is utilized in the taxpayer's commercial domicile.[93]

DALLAS, TEXAS

- All persons are required to furnish annual statements/schedules of all personal property situated in Dallas, as well as all personal property situated elsewhere and subject to taxation in Dallas, if such property is owned, held or controlled by them or is in the possession of an agent, bailee, etc.[94] Every franchise, privilege, easement or right of an intangible character, whether owned by an individual or corporation, shall be "rendered" (reported) by the owner

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[87] Revenue Division, *Apportionment of Royalty* Income, https://www.portland.gov/revenue/policy-apportionment-royalty-income (last visited Oct. 22, 2024).

[88] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. I, § 101(E).

[89] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. III, § 322. This is the same provision that was at issue in the *Philadelphia Eagles* case.

[90] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. IV, § 406(A)(4)(a). "Trademark" was omitted from the second half of the subsection, even though patents and copyrights were included, and this may just be a scrivener's error.

[91] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. IV, § 406(A)(4)(b).

[92] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. IV, § 406(A)(4)(c).

[93] Philadelphia, Pa., Bus. Inc. Rec. Tax Regs., Art. IV, § 406(A)(4)(d).

[94] Dallas, Tx., Code, Ch. 44, Art. I, § 44-1.

or its agent and shall be assessed for tax separately and distinct from the real property and tangible personal property of the owner. Such property will be valued separately and be carried as a distinct item on the assessment sheets and tax rolls of the city.[95]

Observations

- These cities' attribution methods tend to essentially focus on whether an intangible is being used in their jurisdiction, though they vary as to whether that is evidenced specifically by an intangible being "used in," "located within," "situated in," "held in," etc. that jurisdiction.
- The option to attribute income to the commercial domicile is less prevalent among these cities than different states. And the option to permit an alternative "reasonable" method of apportionment is also not as commonly expressed within city codes.
- As with many state laws, apportionment methods for copyright and patent use are expressly referenced in several city codes, but overall, there is less mention of trademark use. This may indicate that tracking trademark usage is more difficult than tracking the use of other forms of intellectual property.
- These cities may reflect some of the practices of larger cities across the nation, but just like in Washington, this may not be reflective of what a majority of cities follow. This is because many cities do not have a uniform local tax, and instead utilize business licensing or another method to derive revenue from businesses (e.g., Miami).

Option 3—Apply a formula based on relative population data or similar measurable metric

Under this approach, royalty receipts attributed to B&O tax at the state level, are similarly subject to local B&O tax. Receipts are apportioned to localities based on the proportion of each city's population that imposes a B&O. This method presumes that a city's relative population size reflects its economic activity. It also assumes that taxpayers' royalty receipts are generally derived from these localities in proportion to their population.

For example, if a taxpayer has $300,000 in royalties receipts apportionable to Washington, the taxpayer will apportion $300,000 in royalty receipts amongst the localities imposing a local B&O tax based on the relative population sizes of those localities. To facilitate this process, some central authority is contemplated to provide taxpayers with the necessary population data and percentage breakdowns for each locality. Similar alternative measurable metrics could be considered.

This method of apportioning royalty receipts does not have precedent. Though it may offer taxpayers administrative ease compared to other options presented, it inherently raises Due Process and Commerce Clause questions.

In practice, though this approach may serve to uniformly apportion royalty receipts among jurisdictions, it may be susceptible to constitutional challenges.

Legal Considerations

- **Tested Approach:** No. The department is unaware of other jurisdictions using this approach.
- **Nexus and Apportionment:** This option raises constitutional questions. As proposed, this option may lack the necessary nexus protections required under the Due Process Clause and

[95] Dallas, Tx., Code, Ch. 44, Art. I, § 44-10.

the Commerce Clause. While it might be argued that nexus in Washington is sufficient to confer nexus to all of Washington local jurisdictions, it might be prudent to consider including in this option a specific nexus requirement such as physical presence nexus and/or economic nexus. Additionally, apportionment of these receipts is at issue because this option fails to account for the actual economic activity of the taxpayer within each city.

- Would cause a shift in royalty tax revenues among Washington cities, resulting in a potential gain for some cities and a potential loss by others. However, tax revenue would increase as a city's population increases relative to all other cities, providing greater support to more populous local jurisdictions that presumably have higher expenses.

Policy Considerations

- **Administrative Issues:**
    - This approach is arguably simpler for taxpayers to apportion their income as compared to other options.
    - It may be challenging to efficiently or effectively determine royalty receipts attributed to B&O tax at the state level.

Option 4—Status quo; continue to attribute all royalties to the commercial domicile

Cities could continue attributing royalty income based on a taxpayer's commercial domicile. Continuing this method discernably offers fewer administrative challenges. If the statute is retained, cities and taxpayers would require no adjustments to their current practices.

Taxpayers benefit through reduced administrative burdens as they only need to register where they are commercially domiciled.[96] There is also an argument that a taxpayer's activities anywhere are still inextricably linked to that taxpayer's commercial headquarters, which functions as a hub for all operations (management, marketing, R&D, etc.).

Legal Considerations

- **Tested Approach:** Yes, cities already apply this formula to service income so there is familiarity with this approach.
- **Nexus and Apportionment:**
    - Generally, we presume laws enacted by the Legislature are constitutional. Additionally, we note that there has been no litigation over the constitutionality of the tax to date.
    - The Due Process Clause maintains all levels of government, including cities, must follow the law and use fair procedures. Particularly, the states must show a link or connection to the property or transaction it attempts to tax. If legal concerns were raised by taxpayers, cities would need to demonstrate the link between their jurisdictions and the intangibles being taxed using the commercial domicile method.
    - There is no risk of shifting royalty revenues to other local B&O cities under this option. This options benefits cities where taxpayers who earn royalties are physically located, despite intangible use occurring in multiple locations. However, it may encourage

[96] Granted, the city of domicile may impose a higher B&O tax rate than other cities, resulting in the taxpayer paying more in royalty B&O tax than it would if the income were divided up among all jurisdictions where activity takes place.

large taxpayers to locate their commercial headquarters to cities that do not impose any B&O tax at all, reducing or eliminating taxes due.

Policy Considerations

- **Administrative Issues:**
  - Easiest option to administer for cities and taxpayers. Determining the location of a commercial domicile is a simpler and more straightforward method than the alternatives proposed in this report.
  - Avoids the challenge of identifying each of a taxpayer's customers and their locations of use (see Part III below).
  - However, many taxpayers already attribute state-level income from royalties based on market use, so this method may offer only limited administrative benefits.

Part III: Identifying Issues Surrounding the Definition of "Customer"

Statutory Definitions

Under state laws concerning apportionment (RCW 82.04.462(3)(b)(viii)), "customer" is defined as "a person or entity to whom the taxpayer makes a sale or renders services about or from whom the taxpayer otherwise receives gross income." A "customer" includes "*anyone* who pays royalties or charges in the nature of royalties for the use of the taxpayer's intangible property."

For cities, RCW 35.102.130(4)(d) defines "customer" similarly to RCW 82.04.462(3)(b)(viii): "a person or entity to whom the taxpayer makes a sale or renders services or from whom the taxpayer otherwise receives gross income." But unlike RCW 82.04.462(3)(b)(viii), this definition does not clarify that a "customer" includes "anyone who pays royalties or charges in the nature of royalties for the use of the taxpayer's intangible property." This makes sense given the commercial domicile provision in RCW 35.102.130(2) that attributes all income to the taxpayer's domicile. However, if the Legislature were to consider other options for apportioning gross income from royalties, it is advisable to also amend "customer" in RCW 35.102.130(4)(d) to specifically include anyone who pays royalties for using intangibles as a customer for apportionment purposes.

Tracking Intangible Usage

If the cities were to switch from a domicile-based attribution method to a market-based method, there is still the issue of whether a city could easily determine the location of a "customer's" direct use of an intangible and the location of the "customer's market" when intangibles are resold to third-parties. Determining whether an intangible is directly used anywhere in Washington is one matter; but it could be more challenging for cities to track the usage of an intangible within Washington that is first licensed to a customer, then sublicensed to a third party, and eventually sold as a good or service in a Washington taxing jurisdiction.[97]

[97] Likewise, it could be difficult to determine the exact location of usage when a customer uses an intangible simultaneously across different cities. Take a directions app used by a private transportation company to take passengers to destinations throughout western Washington. The app may begin usage in one city (passenger's home), be used while travelling across multiple other cities, and cease usage upon arrival at SeaTac Airport. Fairly and evenly apportioning the income to all of the jurisdictions may be difficult unless the driver keeps records of every moment of each trip, and this task is even more difficult if it is the cities that must make this determination.

It would be helpful to the cities implementing use-based royalties apportionment, if an owner tracks all subsequent usage across Washington (and some taxpayers may already do this), but some owners may not keep or even have access to such records.

Collectively, these challenges may negatively impact compliance and voluntary collections, at least initially. Some thought might be given to addressing these challenges.

Determining location of use may be easier to do with certain types of intangible property. As reflected in the state and city comparative analyses above, many jurisdictions expressly address utilization of copyrights or patents, finding that such property is used in a jurisdiction to the extent that it results in tangible or otherwise identifiable items (a production, fabrication, manufacturing, or other processed item, or a printing or other publication) being created within that jurisdiction. See also WAC 458-20-19403 concerning marketing and nonmarketing use. But a much smaller number of jurisdictions address trademarks, and this may be indicative of the difficulty in identifying every location a trademark is subsequently used in, particularly when a trademark is applied to wide-ranging universal products. However, these jurisdictions also have the option of attributing intangible royalties to the commercial domicile when a determination cannot otherwise be made, and it would appear that this may be the most reasonable attribution method available in certain cases, even if it indirectly presents a possible multiple taxation issue.

Out-of-state Owners of Intangibles with in-state Customers

For state-level B&O tax, an intangible owner who is located in another state that has either the requisite economic or physical presence in Washington is subject to tax. From the department's perspective, economic nexus can be established under certain circumstances through its "customer's market," provided at least some of that customer's market is located in Washington.[98]

Accordingly, while the taxpayer may not be conducting *any* direct business activity in Washington, it nonetheless may have economic nexus established through certain types of unrelated third-party sales, potentially resulting in at least some income (if not all) being attributed to Washington. However, there may be legal risks with taking this approach, as not all courts recognize an owner of intangible asset's nexus through such subsequent activities. This level of scrutiny is more likely when the taxpayer has no direct connections to the state seeking to tax its income. Several cases in other jurisdictions have shown that Constitutional due process limits can bar a state's attempt to tax out-of-state owners of intangibles, particularly where the owner has contracted with intermediaries who conduct the in-state sales to consumers.[99] Conversely, other similar cases have been favorable to the state taxing authority.[100] Two of the major concerns raised are:

[98] Washington considers a taxpayer to have taxable (i.e., substantial) economic nexus when it has more than $100,000 in gross receipts from the state, as opposed to physical nexus, which requires an in-state presence. RCW 82.04.067(1)(c).

[99] *See, e.g.*, *Scioto Insurance Co. v. Oklahoma Tax Commission*, 279 P.3d 782 (2012); *Griffith v. ConAgra Brands, Inc.*, 728 S.E.2d 74 (2012); *Robinson v. Jeopardy Productions, Inc.*, 19-1095 La. App. 1 Cir. (2020); and *NASCAR Holdings, Inc. v. McClain*, No. 2022-Ohio-4131 (2022).

[100] *Geoffrey, Inc. v. South Carolina Tax Commission*, 437 S.E.2d 13 (1993); *Geoffrey, Inc. v. Oklahoma Tax Commission*, 132 P.3d 632 (2005); and *Lanco, Inc. v. New Jersey Division of Taxation*, 188 N.J. 380 (2006).

- Whether the taxpayer establishes "minimum contacts" in the taxing jurisdiction;[101] and
- Whether taxation would offend "traditional notions of fair play and justice."[102]

No appellate court in Washington appears to have decided a case that challenged apportionment of royalty income under RCW 82.04.462 on due process grounds as applied. As far as the Ninth Circuit is concerned, some lower courts may simply choose to refuse to rule on a matter until a higher court establishes precedent. For example, in *ABC Inc. v. Oregon Department of Revenue*, the Oregon Tax Court could not decide, as a matter of law, whether a broadcaster (ESPN, as a subsidiary of ABC) had established substantial nexus in Oregon based on revenues derived from intangible property in that state.[103] [104]

Part IV Closing

In conclusion, the department, as the state tax administrator, is neutral as to whether cities should change their apportionment methods and does not recommend one option over another. The department respects the ability of local governments to determine the method of apportionment best suited to their own needs.

[101] "Minimum contacts" requires a taxpayer to "purposefully avail" itself of the privilege of doing business in the state. This is still not a clear test, despite numerous Supreme Court cases involving the issue.
[102] The "fairness" element has a five-factor balancing test that can be hard to predict and varies case-by-case.
[103] *ABC Inc. and Combined Affiliates v. Oregon Dep't of Revenue*, TC-MD 170364N Or. Tax Ct. (2020).
[104] The court felt that there were factors reflecting substantial nexus (revenues from Oregon for using trademarks and logos; a nation-wide audience; contracts with in-state businesses like Comcast; ESPN's control over programming content; and monthly fees based on subscriber volume), and other factors that did not (all ESPN contracts were executed outside of Oregon, and made no provision for Oregon; the in-state licensees conducted all business activities with Oregon customers, rather than ESPN; and gross receipts were only one of several statutory factors to be considered when determining substantial nexus). The Tax Court ultimately held that the issue was not yet "ripe," and instructed the parties to develop more facts rather than provide any immediate guidance.