WASHINGTON

Appeals Court: Design Firm Income Apportioned to State

by Andrea Muse

The income an industrial design firm received for designing the interior of planes Boeing sold to airlines was properly apportioned to Washington state for business and occupation (B&O) tax purposes, according to a state appellate court.

In a 2-1 decision, the Washington Court of Appeals, Division II, held in *Walter Dorwin Teague Associates Inc. v. Department of Revenue* that the firm's income from the Boeing Co. is apportioned to Washington because Boeing is the customer and receives the benefit of the design firm's work in the state.

> ***Noting that the decision was issued as a published opinion and has precedential authority, DeLappe said it 'seems a strong case for review given its broad impact on taxpayers and the need for more certainty in this area.'***

Michelle DeLappe of Fox Rothschild LLP told *Tax Notes* December 14 that the case "highlights how confusing it can be to apply the rules for sourcing income from services to real life." Noting that the decision was issued as a published opinion and has precedential authority, DeLappe said it "seems a strong case for review given its broad impact on taxpayers and the need for more certainty in this area."

"The main source of confusion in this case (and in many situations) is whether or when one should employ a look-through rule to sourcing and apportionment," DeLappe said. "Whether one should consider where the customer receives benefit or where the customer's customer receives the benefit can sometimes seem arbitrary," she added.

"This case appears to say that no look-through should ever occur, which is contrary to how DOR and its auditors often apply the rule," according to DeLappe. Noting that the court disagreed with the taxpayer's argument that the DOR's own rule supports looking through to the customer's

customers in its examples, she said that "in real life, DOR auditors often look through to customers' customers for apportioning taxpayer income."

"The big question going forward, if this decision stands, is whether the DOR will continue to look through to the customer's customers ever going forward," DeLappe continued. "Sometimes taxpayers pay less in B&O tax when there is no look-through, so those taxpayers who have been subjected to unfavorable look-throughs might want to seek refunds based on this decision."

Walter Dorwin Teague Associates (Teague) is headquartered in Washington and contracts with Boeing to provide interior design services at every stage of a plane's planning and production cycle. At the customization stage, the airline purchasing the plane works with Teague on the interior design. Teague provides the customized design and invoices to Boeing, which pays the invoices and uses the design to build the plane in its manufacturing facilities.

Teague submitted a B&O tax refund request in 2015 for $1.02 million, arguing that the DOR overapportioned its income to the state. The department issued a partial refund of $708,951, but denied a refund for taxes imposed on income received from contracting with Boeing.

Teague appealed, arguing that the income should have been apportioned to the locations that the airline companies used or received the aircraft interiors, instead of Washington. But the Thurston County Superior Court agreed with the DOR, that the income was properly apportioned to the state because Boeing is Teague's customer and received the benefit of the design work in Washington, where it manufactured the airplanes.

Appellate Decision

Noting that neither party disputed that Teague's design services are an apportionable activity, the appellate court stated that such activity is attributable to the state in which the customer received the benefit of the service under Rev. Code Wash. 82.04.462(3)(b)(i).

The court concluded that the trial court was correct in finding that Boeing was Teague's customer, stating that the undisputed evidence showed that Teague contracted with Boeing and received gross income from the company.

The court ruled that the Boeing received the benefit of Teague's service in the state because Boeing expected to use the interiors designed by Teague in Washington during the manufacturing process.

The court rejected Teague's argument that Wash. Admin. Code section 458-20-19402(303)(b), which addresses services related to tangible personal property, allocates the benefit of the service to the location where the property is used without regard to the identity of the customer.

The company's argument "ignores the key statutory inquiry" of where the customer received the benefit, the court said. "Because Teague's interpretation of Rule 19402 fails to give effect to the identity of the taxpayer's customer, which is required for the apportionment analysis, we hold that Teague's interpretation is misguided," the court continued.

Rule 19402(303)(b) states that the benefit of a service relating to tangible personal property "is received where the tangible personal property is located or intended/expected to be located."

In a dissenting opinion, Judge Bradley A. Maxa said that the majority's analysis finding that Boeing received the benefit where it manufactured the planes was not unreasonable, but it disregards the fact that another reasonable interpretation of the statute and Rule 19402 would be that Boeing received the benefit of the services when it sold the planes to the out-of-state airlines.

Calling the provisions ambiguous, Maxa contended that "it is well-settled that when a tax statute is ambiguous, the statute must be construed in favor of the taxpayer."

Gregg D. Barton of Perkins Coie LLP told *Tax Notes* that "this case is dependent on a proper interpretation of the administrative rule because the statute provides no guidance regarding how to apportion services relating to tangible personal property."

"The majority focuses on who the customer is, but should have focused on which tangible personal property is relevant," Barton said. "The majority says that Boeing received the benefit of the design services in Washington, presumably to build the interiors," he noted, adding that this conclusion is not unreasonable under Rule

19402(303)(3)(b)(i) if the designs, rather than the airplanes, are the tangible personal property. Barton added, however, that "if the pertinent tangible personal property is the airplane, then it seems that taxpayer's argument is sound." It appears the proper focus should be on the airplanes as the tangible personal property, Barton said, adding that the taxpayer's argument seems stronger.

Barton said that the dissent made an important point regarding statutory interpretation — that the apportionment provision is construed against the taxing authority — but said that to the best of his knowledge, the issue has not been directly addressed in case law.

Barton said that he believes the dissent's interpretation is proper and that the apportionment provision is part of the tax imposition statutes, which are construed narrowly against the taxing authority in Washington, and not given by legislative grace like exemptions and deductions, which are construed narrowly against the taxpayer.

The taxpayer in *Walter Dorwin Teague Associates Inc. v. Department of Revenue* (No. 54959-0-II) was represented by attorneys with Lane Powell PC. ■