71932-7

71932-7

No. 71932-7-I

COURT OF APPEALS OF THE STATE OF WASHINGTON,
DIVISION I

WEDBUSH SECURITIES, INC., a California corporation

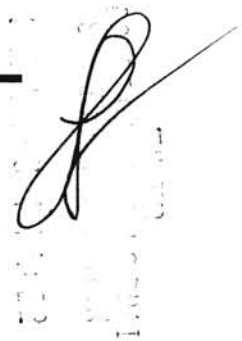
Petitioner-Appellant,

vs.

THE CITY OF SEATTLE, WASHINGTON,

Respondent,

BRIEF OF RESPONDENT



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I. INTRODUCTION AND OVERVIEW OF ARGUMENT

The City of Seattle ("the City") imposes a Business and Occupation ("B & O") tax on all persons engaging in business activity within the City limits. Seattle Municipal Code ("SMC") 5.45.050. The tax is not an income tax or a transactional tax, like a sales tax. Rather, it is imposed on businesses "for the privilege of engaging in business activities within the City," and is calculated "by application of rates against gross proceeds of sale, gross income of business, or value of products[.]" SMC 5.45.050. The tax is applied to gross receipts without any deductions for a business's expenses or costs of doing business. SMC 5.30.035E.

The City's ability to impose a B & O tax on a business entity engaged in business locally and elsewhere – in intrastate or interstate commerce – is limited by the Commerce and Due Process Clauses of the U.S. Constitution.[1] Generally, the City may impose the B & O tax if the activity of a business entity is sufficient to establish nexus with the City.

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[1] The Commerce Clause of the U.S. Constitution provides that "Congress shall have the power . . . (t)o regulate commerce with foreign nations, and among the several states, and with the Indian tribes". U.S. Const. Art. I, § 8, cl. 3. The idea behind "dormant" Commerce Clause doctrine is that this grant of power to Congress implies a negative converse — a restriction prohibiting a state from passing legislation, including imposing taxes, that improperly burdens or discriminates against interstate commerce. The Due Process Clause of the Constitution provides, in relevant part, that no state shall "deprive any person of life, liberty, or property, without due process of law". U.S. Const. Amend. XIV, § 1. The focus of a Due Process analysis of a state or local tax is the extent to which apportionment accurately reflects the taxpayer's activity in the taxing state.

SMC 5.30.030B. "Nexus" refers to the presence or amount of activity within the City that is sufficient to subject an individual, corporation, or other entity to the Seattle B & O tax. Some form of physical presence is usually required, such as having employees in the City making sales, providing services, or meeting with customers.

Wedbush does not argue that it lacks nexus with the City; it argues its tax was improperly apportioned. Where, as here, a corporation's business activities extend into more than one taxing jurisdiction, such that the corporation is or could be taxed by more than one state or municipality, the question arises as to how to determine the portion of the corporation's income attributable to each locality. A method of fair apportionment of income between jurisdictions is needed to mitigate the problem of double taxation.

In the City of Seattle, gross income subject to tax under the service and other business activities classification is apportioned using a two-factor formula. (Sales of tangible products are apportioned differently and are not at issue here.) The two factors are *payroll* and *service income*. The City is required under state law to use this two-factor apportionment formula. CP at 92-95. "Payroll" is generally assigned to the place where employees are primarily assigned. "Service income" is assigned to the location where the majority of contacts occur between the

business and its customer ("customer location") *or* where the service-income-producing activity is performed (place of performance based on "costs of performance"). In this case, the City applied the latter criterion, because Wedbush did not provide evidence of "customer location." Wedbush did not dispute in the proceedings below that it performs services in Seattle. Wedbush also did not argue that the income attributed to its Seattle office was actually earned elsewhere. It argued only that its service income should be based not on where the income was earned but where the customers were located. However, Wedbush and the City interpret the term "customer location" differently. The City's position is that customer location is only knowable when there is face-to-face or "physical" contact with a customer; in that instance, income can be sourced to a customer's location. Otherwise, income is sourced to the place where a business provides the income-generating services. Wedbush's position is that a customer's address is always the customer location, regardless of where or how the customer received services.

RCW 35.102.130[2] provides, in relevant part:

A city that imposes a business and occupation tax must provide for the allocation and apportionment of a person's gross income. . . as follows:

(1) Gross income derived from all activities other than those taxed as

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[2] The SMC analog to RCW 35.102.130 is section 5.45.081.

service or royalties must be allocated to the location where the activity takes place.

(a) In the case of sales of tangible personal property, the activity takes place where delivery to the buyer occurs.

. . .

(c) If a business activity allocated under this subsection (1) takes place in more than one city and all cities impose a gross receipts tax, a credit must be allowed as provided in RCW 35.102.060; if not all of the cities impose a gross receipts tax, the affected cities must allow another credit or allocation system as they and the taxpayer agree.

(2) Gross income derived as royalties from the granting of intangible rights must be allocated to the commercial domicile of the taxpayer.

(3) Gross income derived from activities taxed as services shall be apportioned to a city by multiplying apportionable income by a fraction, the numerator of which is the payroll factor plus the service-income factor and the denominator of which is two.

(a) The payroll factor is a fraction, the numerator of which is the total amount paid in the city during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period. Compensation is paid in the city if:

(i) The individual is primarily assigned within the city;

. . .

(b) The service income factor is a fraction, the numerator of which is the total service income of the taxpayer in the city during the tax period, and the denominator of which is the total service income of the taxpayer everywhere during the tax period. Service income is in the city if:

(i) The customer location is in the city; or

(ii) The income-producing activity is performed in more than one location and a greater proportion of the service-income-producing activity is performed in the city than in any other location, based on costs of performance, and the taxpayer is not taxable at the customer location; or

(iii) The service-income-producing activity is performed within the city, and the taxpayer is not taxable in the customer location.

(4) The definitions in this subsection apply throughout this section. (a) "Apportionable income" means the gross income of the business taxable

under the service classifications of a city's gross receipts tax, including income received from activities outside the city if the income would be taxable under the service classification if received from activities within the city, less any exemptions or deductions available.

. . .

> (d) "Customer location" means the city or unincorporated area of a county where the majority of the contacts between the taxpayer and the customer take place.
>
> (e) "Primarily assigned" means the business location of the taxpayer where the individual performs his or her duties.
>
> (f) "Service-taxable income" or "service income" means gross income of the business subject to tax under either the service or royalty classification.

. . .

> (h) "Taxable in the customer location" means either that a taxpayer is subject to a gross receipts tax in the customer location for the privilege of doing business, or that the government where the customer is located has the authority to subject the taxpayer to gross receipts tax regardless of whether, in fact, the government does so.

The City's Finance and Administrative Services website reflects the foregoing under "Allocation and Apportionment Procedures," and explains that "customer location" is where the majority of "physical contacts" take place. CP 137-38. Seattle Rules 5-032 and 5-045 provide additional explanation and examples. CP 143-56.

Because "customer location" was never established in this case, the City apportioned income under RCW 35.102.130(3)(b)(ii), using a "costs of performance" apportionment methodology to determine income. At issue on appeal is whether the City of Seattle's attribution of income to Seattle resulted in fair apportionment. Wedbush does not argue that the

two-factor method is incorrect, or that the payroll factor is incorrect, or that the denominator of the service income factor is incorrect; rather, it argues too much income has been attributed to Seattle. Specifically, Wedbush claims that its Seattle income attributable to commission revenue should be apportioned based on the addresses of its customers; Wedbush believes only commission revenue generated from customers with a Seattle address should be included. Because this calculation results in an apportionment factor that does not fairly represent the extent of the taxpayer's business activity in Seattle, the City's position is that all commission income generated in the Seattle office should be included – not just that generated from customers with a Seattle address.

II. STATEMENT OF THE ISSUE

If a service business has physical contact with a customer in the City of Seattle, the income from that transaction is attributed to Seattle and taxed accordingly. However, where, as here, a business has not shown that it performs its services face-to-face, customer location in Seattle has not been established, and the City is unable to determine income based on customer location; income generated solely from online or telephone transactions between Seattle residents and service businesses located *outside* Seattle is not taxable, and the City does not tax Seattle businesses based on these types of non-physical contacts either. Instead, when a

service business has no face-to-face customer contact, or has not tracked customer location, but performs its income-producing activity at an office in the City, its income is taxed based on the costs of performing that service. Wedbush did not show that it had *any* contact with Seattle customers, let alone physical, but merely wished to pay tax on income generated by performing services for Seattle residents. The lack of any evidence regarding customer location meant the City was required to move to the second "costs of performance" prong of the apportionment statute. Did the City properly source Wedbush's income to Seattle using the required "costs of performance" methodology?

III. STATEMENT OF THE CASE

A. Procedural Facts

The City conducted an audit of Wedbush for the period January 1, 2008 through June 30, 2012 to ensure compliance with the Seattle Municipal Code (SMC) Chapters 5.45 and 5.55 Business and Occupation (B & O) Tax, SMC 5.46 Square Footage Tax, and SMC 5.37 Employee Hours Tax. The audit found that Wedbush had gross revenues in the service category of $7,054,867.82 in 2008; $6,315,460.59 in 2009; $6,138,153.32 in 2010; $6,102,688.81 in 2011; and $3,059,688.81 for the audited period of 2012. Total service revenues for the audit period were $28,670,412.02. The tax owing was $118,982.21. Wedbush had earlier

paid $87,440.6; the unpaid taxes ($31,541.60) plus penalties and interest[3] ($2,909.92) left a balance of $34,451.52, for which an assessment was issued on January 22, 2013.

Wedbush appealed the assessment in a timely fashion, arguing its income was unfairly apportioned, and therefore the tax was too high. CP 15-16. Following a hearing on May 21, 2013, Hearing Examiner Sue Tanner affirmed the assessment. CP 15-19. Wedbush petitioned for and was granted a writ of review of that decision, and, after briefing and oral argument, The Honorable Monica Benton of King County Superior Court affirmed the decision of the Hearing Examiner. CP 181-82. Wedbush has timely appealed that decision. CP 184.

B. Substantive Facts

Wedbush is a registered securities broker/dealer headquartered in Los Angeles, California. It is one of the largest securities firms and investment banks in the nation, providing financial services through its private client services, capital markets, and clearing & execution divisions. Wedbush has over 90 offices, including one in Seattle, which is located at 601 Union Street. Two departments operate out of the Seattle office: one

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[3] Wedbush requested alternative apportionment schemes over the course of the audit; these requests, which are not the subject of this appeal, delayed completion of the audit, as did the auditor's maternity leave. So that Wedbush would not be prejudiced by these delays, interest did not accrue beyond December 31, 2010.

is a retail stock brokerage for online and telephone customers and one is a sales department for institutional investors. CP 15.

Shawn Keagy, Chief Financial Officer for Wedbush, testified that Wedbush's Seattle office executes orders to buy and sell stocks and earns commissions on these trades. He also testified that the only item of income at issue in the appeal was this commission income. CP 59. Of that income, the only portion that should be sourced to Seattle for tax purposes, Mr. Keagy argued, was the income generated from customers with a Seattle address. This was true, he maintained, even where a Wedbush branch office in another city executed a trade for a Seattle resident. Mr. Keagy also asserted that commissions resulting from trades for Seattle residents should be taxed by the City even if the Seattle resident initiated the trade from outside the City. CP 71.

Wedbush provided no evidence of contacts, physical or otherwise, with its customers. Its argument was based on the assumption that commission revenue resulted from telephone or online interaction, but no evidence of this was offered. Mr. Keagy offered an exhibit showing the commissions generated in the Seattle office from Seattle residents, but it was not admitted because it had not been provided previously. CP 102-04. He also testified that Wedbush's expenses included the lease of real

property in downtown Seattle as well as tangible personal property such as office equipment. CP 72.

Darryl David, Senior Vice President for Wedbush in the Seattle office, testified that Wedbush has maintained a Seattle office for 45 years to stay competitive with other firms and "in order to attract business to their locale." CP 75-76. He also stated that there were 28 employees in the Seattle office and that most business was transacted over the phone; only very rarely would a customer come into the office. CP 76-77. In addition, he testified that about 20% of the customers who did business with Wedbush's Seattle office had Seattle addresses. CP 78. There was no additional evidence, other than this testimony, regarding the amount of income generated by Wedbush clients with Seattle addresses.

Jinny Yi, an auditor for the City, testified that she did not attribute to Seattle only Wedbush's income generated by Seattle residents; she based the income factor on the costs to Wedbush of performing its services because Wedbush had no physical contact with its customers, and, as a result, had not shown what its customers locations were. She did not consider a Wedbush client's address to be the requisite customer location. CP 87.

Joseph Cunha, Tax Manager for the City, testified that, since 2008, the State of Washington has mandated that any city imposing a B & O tax

must use the statutory two-factor apportionment method (detailed above in the Introduction) for service businesses. CP 92. He also explained that, when customer location cannot be established under the first prong of the statute, income is evaluated based on the second prong – costs of performance. CP 93. Mr. Cunha explained that the physical contact requirement to establish customer location grew out of a desire for clarity:

> . . . [T]he City had always taken the position that contact under the definition of customer contact meant a physical contact – because I think one of the complexities is if you make a phone call to your clients and say you're sitting in a City of Seattle, well, where does that contact happen? Is it the business person's address or the location of the city that's originating the call, or is it where the call terminates where the customer location is? And so we looked at those facts, we looked at different nexus requirements and the position we took was that the contact under the definition of customer contact or customer location had to be physical contact.

CP 95.

In this case, there was no evidence indicating that the majority of contacts were happening in the City, so customer location was not established under the first prong of the statute. The audit therefore focused on the second prong – place of performance based on costs of performance. CP 94.

IV. ARGUMENT

A. The City Properly Interpreted "Customer Location" To Mean The Place Where The Majority Of Physical Contacts Occurs.

1. The City's interpretation is entitled to deference.

In this case, the City has interpreted RCW 35.102.130(3)(b) consistently with its position since 2008, when two-factor apportionment became the law. "Customer location" is "where the majority of the contacts between the taxpayer and the customer take place." RCW 35.102.130(4)(d). As it has stated since 2008 on its website, "The City of Seattle interprets this to be *physical contacts*. Phone contacts are assigned to the place of business." (Emphasis added.) CP 137-38. The City's witnesses testified to this long-standing interpretation of the Code. CP 87, 93-95.

"In interpreting a statute, great weight must be accorded to the contemporaneous construction placed on it by officials charged with its enforcement, particularly where that construction has been accompanied by silent acquiescence of the legislative body over a long period of time." *Newschwander v. Board of Trustees of Washington State Teachers Retirement System*, 94 Wn.2d 701, 710 620 P.2d 88 (1980); *Stroh Brewery Co. v. Washington State Department of Revenue*, 104 Wn. App. 235, 242, 15 P.3d 692 (2001).

When a statute is unambiguous, a court will determine legislative intent from the statutory language alone. But where an agency charged

with administering and enforcing an ambiguous statute has interpreted it, courts accord great weight to the agency's interpretation to determine legislative intent. *Boeing Co. v. Doss,* 180 Wn.App. 427, 434, 321 P.3d 1270 (2014).

The City's position is that "contacts" is ambiguous and in need of interpretation. Several definitions of "contact" are found in Webster's Third New International Dictionary 490 (1986), including "union or junction of body surfaces"; "a touching or meeting"; "association or relationship"; "direct experience through the senses"; and "a condition or instance of meeting, connecting, or communicating." The City has always taken the position that "customer contacts" means physical or face-to-face interaction; this interpretation is entitled to deference, as is clear from the aforementioned, recent case of *Boeing v. Doss.*

As the Hearing Examiner pointed out, the City's interpretation of "customer location" to mean the place where the majority of physical –not telephone – contacts with a customer occur has been applied and posted on the website since 2008, and the Seattle City Council has taken no action during the intervening years to indicate disagreement with that interpretation (CP 18); neither has the State Legislature.

Wedbush has never provided evidence establishing a "customer location." Mr. David testified that face-to-face or physical contact with

customers happened only "very rarely," and interaction with customers generally occurred via telephone. CP 76-77. But Wedbush did not even track its non-physical contacts; it simply wanted to isolate and pay tax only on the commissions it earned from its services for clients with Seattle addresses, regardless of where the Seattleites were when they initiated contact, and regardless of where the commission-generating services were performed. This position is untenable. As the City argued in the proceedings below, the sales factor for tangible property recognizes that the destination contributed to the corporation's income by providing a market. However, the factor for *services* focuses on income-producing activity and costs of performance, which does not recognize the customer's location unless the taxpayer sent its employees to the customer's physical location in order to provide a face-to-face service. Tangible personal property can be possessed remotely and still be of value to the customer, but the value of a service depends upon direct interaction with the customer. It is understood that a securities broker/dealer generally does not provide face-to-face service. But that fact is no reason to assume that income generated from clients who happen to have a Seattle address should necessarily be sourced to the City of Seattle. A Seattle resident could be in Palm Springs when she calls Wedbush and conducts a trade over the phone; the fact of her permanent address in

Seattle is no reason to source the income from that trade to Seattle, *unless* the Seattle office handles the service. Conversely, a Seattle resident might have his call from Magnolia or Capitol Hill or Wedgwood routed to an office in New York City or one of Wedbush's many other offices outside Seattle; it would make no sense to source the income from that trade to the City of Seattle simply because the client happens to have a Seattle address.

Wedbush cannot be considered "taxable at the customer location." Where, as here, no customer location applies because no physical contacts have occurred, then, under the cascading series of attribution rules contained in RCW 35.102.130, service income is assigned where the service-income-producing activity is generated by Wedbush's employees – in Seattle. It is appropriate to calculate Wedbush's service income based on place of performance and cost of performance. This interpretation of the Code does not represent a departure from the treatment of any other taxpayer and is entitled to deference.

2. The City's interpretation is correct under rules of statutory construction.

"[I]n interpreting a statute the court must construe the act as a whole, and effect should be given to all the language used." *State v. Newton,* 109 Wn.2d 69, 79, 743 P.2d 254 (1987). Every "provision must be viewed in relation to other provisions and harmonized if at all possible

to insure proper construction of every provision." *State v. S.P.* 110 Wn.2d 886, 890, 756 P.2d 1315, 1317 (Wash.,1988), *quoting Addleman v. Board of Prison Terms & Paroles,* 107 Wn.2d 503, 509, 730 P.2d 1327 (1986).

Here, the only way to give any meaning to RCW 35.102.130(3)(b)(ii) and (iii) is to read "customer location" in (i) as the place where *physical* contact occurs. If an address were all that was needed to show customer location, then the "place of performance" test would be superfluous. "Customer location" has to require physical contacts and mean more than an address alone; otherwise subsections (ii) and (iii) would never be needed. When the only interactions between a taxpayer and a client are presumed to have occurred via phone or email, there is another way to determine whether income is "in the City": place of performance based on costs of performance, under (ii). The place of performance test would never be considered if the customer's location was always known, based simply on address. To give meaning to all of the provisions of RCW 35.102.130(3)(b), "customer location" has to require physical contact.

The legislature is presumed to know the law in the area in which it is legislating. *Wynn v. Earin,* 163 Wn.2d 361, 371, 181 P.3d 806 (2008). The legislature is likewise presumed to enact laws with full knowledge of existing laws. *Jametsky v. Olsen,* 179 Wash.2d 756, 766, 317 P.3d 1003

(2014). In June 2010, the legislature mandated a single sales factor apportionment for service businesses paying *state* B & O tax. For purposes of the state B & O tax, income is apportioned to Washington based on a receipts factor that equals the taxpayer's gross income attributable to the state divided by the taxpayer's gross income everywhere. Gross receipts from the sale of services are assigned to the state in which "the customer received the benefit of the taxpayer's service." RCW 82.04.462(3)(b). If the customer received the benefit of the service in more than one state, the gross receipts are assigned to the state in which the benefit of the service was primarily received. If the taxpayer is unable to determine where the benefit is received, the gross receipts are assigned to a state under the following cascading series of attribution rules: the state from which the customer ordered the service; the state to which the taxpayer sends the customer's billing statements or invoices; the state from which the customer sends payment to the taxpayer; the state where the customer is located as indicated by the customer's address; or the commercial domicile of the taxpayer.

RCW 82.04.462(3)(b); see also WAC 458-20-19402.

The legislature specified a detailed sourcing hierarchy for purposes of the state B & O tax. Had it intended "customer location" to mean anything *other* than the place where the majority of *physical* contacts

occur, it clearly could have stated as much in RCW 35.102.130(3)(b). It did not do so.

3. The City does not tax business based only on telephone or online contact with customers in Seattle.

The City must show nexus in order to impose the B & O tax upon a business. SMC 5.30.030B. It is axiomatic that imposing a tax upon someone who has no nexus with the taxing authority is unconstitutional. As the examples in Argument section A. 1., above, show, Wedbush is asking the City to impose its tax on activity that would not produce nexus in any context – telephone conversations, emails, or online orders of intangible products – simply because one of the parties is a Seattle resident. The City cannot and does not ever point to telephone or online "contacts" and call them nexus-generating activities.

B. Wedbush's Income-Producing Activity Occurred In Seattle, So Its Income Was Properly Sourced To Seattle.

Because the apportionment of income to Seattle based simply on a client's address is not allowed under RCW 35.102.130, the City must apply the second criteria – place of performance based on costs of performance – to determine the source of income. Under RCW 35.102.130(3)(b)(ii), Wedbush is *not* taxable in the customer location because the customer location has never been established. The City

therefore looks to where the income-producing activity occurred, based on the costs of performance. In Wedbush's case, its costs of performance were incurred in Seattle. Wedbush leases real property in the City of Seattle in order to compete with other brokerage houses and attract a local clientele. CP 75-76. It employs 28 people in its Seattle office. Those employees render personal service and utilize the tangible personal property – such as office furniture and equipment – owned and leased by Wedbush while performing those services. Wedbush clearly undertakes income-producing activity and incurs costs of performance in the City. CP 72, 75-76.

Wedbush now argues that, even if the "costs of performance" methodology applies in this case, it performs most, if not all, of its income-generating activities outside Seattle. Wedbush has provided no evidence to support such a claim. It is the taxpayer's burden to preserve and present relevant records. SMC 5.55.060. But Wedbush's argument has always been that the City may only tax income from commissions generated by Seattle residents – not that it is generating all of its income elsewhere and Seattle is taxing it. If indeed its other offices perform the services that lead to commissions reflected on the Seattle office's books, Wedbush could have quantified and presented those figures. It has never shown that a greater proportion of its service income-producing activity

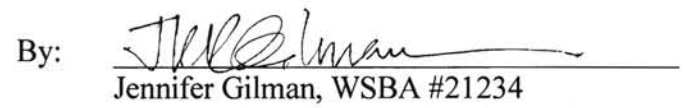
was performed outside rather than inside the City. As a result, the place of performance is Seattle and income was properly apportioned based on costs of performance.

V. CONCLUSION

The City correctly interprets "customer location" to mean the place where the majority of face-to-face or physical contacts occur between a service business and its customers. Wedbush has not established that it has any customer contact. Client addresses in the City of Seattle do not amount to customer contact. As a result, the customer location is not known, and Wedbush cannot be taxed based on customer location. The City properly sourced income to Seattle based on the costs to Wedbush of performing its service income-producing activities in the City. The decision of the Hearing Examiner should be affirmed.

DATED this 8th day of January, 2015.

PETER S. HOLMES
Seattle City Attorney

By: 

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DECLARATION OF SERVICE

MARISA JOHNSON states and declares as follows:

1. I am over the age of 18, am competent to testify in this matter, am a Legal Assistant in the Law Department, Civil Division, Seattle City Attorney's Office, and make this declaration based on my personal knowledge and belief.

2. On January 8, 2015, I caused to be delivered by ABC Legal Messengers, addressed as follows:

Scott Edwards
Daniel Kittle
Lane Powell PC
1420 Fifth Avenue, Suite 4200
Seattle, WA 98111-9402

a copy of the Brief of Respondent.

3. I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

DATED this 8th day of January, 2015, at Seattle, King County, Washington.

Marisa Johnson