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No. 71932-7-I

DIVISION I, COURT OF APPEALS
OF THE STATE OF WASHINGTON

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STATE OF WASHINGTON
COURT OF APPEALS DIVISION I
CLERK OF COURT

WEDBUSH SECURITIES, INC., a California corporation,

Petitioner-Appellant

v.

THE CITY OF SEATTLE, WASHINGTON,

Respondent-Respondent.

ON APPEAL FROM KING COUNTY SUPERIOR COURT
No. 13-2-22355-4 SEA
(Hon. Monica J. Benton)

BRIEF OF APPELLANT

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I. INTRODUCTION

The sole issue in this case is the proper construction of the term “customer location” in RCW 35.102.130, which requires Washington cities with a local B&O tax to apportion income from service activities under a two-factor formula. One of the two statutory factors, the service income factor, requires cities to source a taxpayer’s income based on “customer location.” When calculating its Seattle taxes, Wedbush Securities, Inc. (“Wedbush”) applied the statutory term according to its plain language—where Wedbush’s customers are located.

On audit, the City of Seattle (“Seattle”) asserted that Wedbush’s service income factor should be calculated based on the location of Wedbush’s account representative instead of the customer’s location. To justify this substitution, Seattle contends that Wedbush’s customers have “no” customer location because the customers primarily interact with Wedbush by non-“physical” means (e.g., mail, phone, email, or fax). This absurd contention violates multiple principles of statutory construction. Based on the erroneous premise that Wedbush’s customers have “no” customer location, Seattle purports to invoke an alternative statutory provision that only applies when a taxpayer “is not taxable at the customer location.” It is undisputed that Wedbush is taxable in Seattle. Thus, the

alternative provision is inapplicable, and Wedbush must source income from customers located in Seattle to the service income factor.

II. ASSIGNMENT OF ERROR

The trial court erred in affirming Seattle's allocation of service income based on taxpayer location instead of customer location as required by RCW 35.102.130.

III. STATEMENT OF ISSUES

1. Whether the statutory definition of customer location in RCW 35.102.130 includes a "physical" contact requirement.

2. Whether a customer has "no" customer location under RCW 35.102.130 where the majority of the customer's contacts with a service business are by other than "physical" means (e.g., by mail, phone, fax, or email).

3. Whether RCW 35.102.130(3)(b)(ii) can be invoked to substitute account representative location for the customer location of Seattle customers, when: (a) by its plain language, the statute only applies when "the taxpayer is not taxable at the customer location"; and (b) it is undisputed that Wedbush is taxable in Seattle.

IV. STATEMENT OF THE CASE

A. Statement of Facts.

Wedbush is a registered securities broker/dealer headquartered in Los Angeles, with offices and customers throughout the United States. CP 127. Wedbush has a small office in Seattle, where Wedbush employees (“account representatives”) assist customers nationwide by taking stock trade orders from the customers (primarily by phone or fax) and then forwarding those orders for processing in Wisconsin or other non-Seattle locations. CP 36-40. Once the Seattle account representatives forward the orders for processing, the involvement of Wedbush’s Seattle office ends. CP 41-42. From there, the processed orders are sent to floor brokers in New York, Los Angeles, or other non-Seattle locations for execution of the stock trades, with assistance from non-Seattle Wedbush offices. CP 36-38.

Because Wedbush’s revenues are derived from service activities conducted both inside and outside Seattle, Wedbush’s Seattle B&O taxable revenue must be determined by the apportionment formula set forth in RCW 35.102.130. The two-factor statutory formula multiplies Wedbush’s total apportionable income by the average of: (i) a payroll factor; and (ii) a service income factor.

The parties do not dispute Wedbush’s total apportionable income or Wedbush’s payroll factor, which is based on the percentage of Seattle

account representative payroll costs (including commissions) compared to Wedbush's nationwide payroll costs. BR¹ 000005, 000090. The sole dispute involves the numerator of Wedbush's service income factor. CP 50. The numerator of the service income factor is income from Wedbush's customers whose "customer location" is "in the city," while the denominator is Wedbush's total income. RCW 35.102.130(3)(b).

B. Procedural History.

From January 2008 through June 2010, Wedbush calculated its Seattle B&O tax using income from customers located in Seattle for the numerator of its service income factor. BR 000092; CP 39-40. During a routine audit of Wedbush's tax returns, Seattle asserted that it was inappropriate to source income based on the customer's location. BR 000023-000043. According to Seattle, a customer whose contacts with a service provider are not primarily "physical" face-to-face meetings has "no" customer location. CP 120.

In an effort to compromise the dispute with the City, Wedbush increased the amount of revenue it reported to Seattle for July 2010 through June 2012 by using a single-factor cost apportionment methodology. BR 000025, 000041; CP 48. As a result, Wedbush overpaid its Seattle taxes

¹ The Certified Appeal Board Record ("BR") was designated as part of the Clerk's Papers but was not numbered consecutively by the trial court with the Clerk's Papers. Rather, the BR was submitted to this Court "as original." Accordingly, citations herein are in reference to the numbering designated by the Seattle Hearing Examiner.

for the period July 2010 through June 2012 by \$16,128.61. BR 000097. However, Seattle ultimately rejected Wedbush's offered compromise and assessed an additional \$31,541.60 of B&O tax against Wedbush for January 2008 through June 2012, by sourcing service income based on the location of Wedbush's account representatives instead of the location of Wedbush's customers (the "Assessment"). BR 000023-000043.

Wedbush timely appealed to the City's Office of Hearing Examiner in accordance with SMC 5.55.140, and appeared before the Hearing Examiner *pro se* through its Chief Financial Officer. BR 000003, 000052. The Seattle Hearing Examiner issued a decision upholding the Assessment on May 24, 2013. BR 000003. Wedbush timely commenced this action by filing a Petition for Writ of Review. CP 1.

The parties filed cross-motions for summary judgment and argued the motions on April 11, 2014. RP (4/11/14). The trial court granted summary judgment in Seattle's favor and denied Wedbush's motion, stating in its order that "the May 24, 2013 decision of the City of Seattle Hearing Examiner . . . is AFFIRMED," without explanation. CP 187-88. Wedbush timely appealed.

V. ARGUMENT

The sole issue on appeal is the proper construction of the statutory term "customer location" in RCW 35.102.130. Wedbush properly applied

the statute according to its plain language—by sourcing its income to the numerator based on customer location. Seattle improperly replaced customer location with the location of Wedbush’s account representative on the theory that customers have “no” customer location when they primarily interact with a business by non-“physical” means (such as mail, phone, email, fax, etc.).

A. Standard of Review.

The sole issue on appeal is the meaning of the term “customer location” in RCW 35.102.130. The construction of a statute is a question of law that the court decides de novo, and an agency’s interpretation of the statute is not entitled to deference. *Chicago Title Ins. Co. v. Washington State Office of Ins. Com’r*, 178 Wn.2d 120, 133, 309 P.3d 372 (2013) (“The agency’s interpretation of pure questions of law is not accorded deference.”); *Evergreen Washington Healthcare Frontier LLC v. Department of Social and Health Services*, 171 Wn. App. 431, 445, 287 P.3d 40 (2012) (“an agency’s [statutory] interpretation does not bind us”); *Port of Seattle v. Pollution Control Hearings Bd.*, 151 Wn.2d 568, 593, 90 P.3d 659 (2004) (“This court interprets the meaning of statutes de novo; we may substitute our interpretation of the law for that of the agency.”).

B. The Statutory Definition of “Customer Location” Does Not Contain a “Physical” Contact Requirement.

As Seattle concedes: “Effective January 1, 2008, the State of Washington mandated that municipalities in Washington State use a prescribed two-factor apportionment method for service classification taxpayers” like Wedbush. CP 50. Seattle is required to multiply Wedbush’s total apportionable income by the average of two factors: (i) a payroll factor; and (ii) a service income factor. RCW 35.102.130(3)(b). The parties do not dispute Wedbush’s total apportionable income or the payroll factor. BR 000005, 000090. The sole issue in dispute is the proper construction of the statutory definition of “customer location” in the numerator of the service income factor. CP 50.

RCW 35.102.130(3)(b)(i) provides that the numerator of the service income factor is income from customers whose “customer location” is “in the city.” The term “customer location” is defined as “the city or unincorporated area of a county where the majority of the contacts between the taxpayer and the customer take place.” RCW 35.102.130(4)(d). Seattle’s municipal code and business tax rules simply repeat the statutory language of RCW 35.102.130(4)(d) verbatim. SMC 5.45.081(G)(4); Seattle Business Tax Rule 5-032(b)(iv)(D).

In its Assessment, Seattle replaced customer location with the location of Wedbush's account representatives. CP 46, 120. Seattle justified this substitution by concluding that Wedbush's customers have "no" customer location because they primarily interact with Wedbush by means other than "physical" contacts (i.e., face-to-face interactions), such as by mail or phone. CP 41-47.

Seattle's position violates several fundamental principles of statutory construction. First, it violates the precept that one cannot add words to a statute that the legislature did not include. When interpreting a statute, courts examine the plain language of the words used by the Legislature and are "required to assume the Legislature meant exactly what it said and apply the statute as written." *HomeStreet, Inc. v. Dept. of Revenue*, 166 Wn.2d 444, 451-52, 210 P.3d 297 (2009). Seattle "cannot add words or clauses to a statute when the legislature has chosen not to include such language." *Dot Foods, Inc. v. Department of Revenue*, 166 Wn.2d 912, 920, 215 P.3d 185 (2009); *Restaurant Development, Inc. v. Cannawill, Inc.*, 150 Wn.2d 674, 682, 80 P.3d 598 (2003).

Nothing in the statutory definition of "customer location" limits customer contacts with a taxpayer to only "physical" contacts. RCW 35.102.130(4)(d). Indeed, the word "physical" does not appear anywhere in the statute. Likewise, as Seattle concedes, nothing in Seattle's municipal

code or business tax rule imposes the physical contact limitation the City applied to Wedbush. CP 52 (City tax manager Joseph Cunha, when asked whether the City's rules states that the customer location is determined solely by "physical" contacts, admitted that "we don't have in our rule, any statement that states that"). When imposing a "physical" contact limitation, Seattle improperly adds language to the statutory definition of customer location that the legislature omitted.

In an analogous situation, the Washington Supreme Court in *Agrilink Foods, Inc. v. Dept. of Revenue*, 153 Wn.2d 392, 103 P.3d 1226 (2005) held that the Washington Department of Revenue erred when it imposed a "perishable *finished* product" requirement to the "processing perishable meat products" classification, when the statute did not include such a requirement. *Id.* at 395-97. The court noted that if "the legislature unequivocally intended to include a perishable *finished* product requirement, it might have done so by using a number of alternative constructions." *Id.* at 397. Similarly here, if the legislature had intended to limit the determination of the customer's location to only *physical* contacts, it could have done so. The addition of a physical contact requirement is erroneous.

Second, Seattle's unauthorized addition of a "physical" contact limitation contravenes the plain language of the term "contacts" in the

statute. Undefined, nontechnical terms are accorded their ordinary meaning as reflected by dictionary definitions. *State v. Kintz*, 169 Wn.2d 537, 547, 238 P.3d 470 (2010); *State v. Bernard*, 78 Wn. App. 764, 767, 899 P.2d 21 (1995). The ordinary meaning of “contact” encompasses *all* methods of communication, not merely face-to-face interaction. “Contact” is “used often where the *means is not precisely specified*” and can include “an instance of establishing communication with someone <a radio ~> or of observing or receiving a significant signal from a person or object.” Webster’s Third New International Dictionary (1981) at 490 (emphasis added); *see also* American Heritage Dictionary of the English Language (4th ed. 2007) (“Connection or interaction; communication As for the vagueness of contact, this seems a virtue in an age in which forms of communication have proliferated. The sentence [w]e will contact you when the part comes in allows for a variety of possible ways to communicate: *by mail, telephone, computer, or fax.*”) (emphasis added).

Third, Seattle’s position violates the principle that one must “avoid readings of statutes that lead to strained or absurd results.” *Wright v. Jeckle*, 158 Wn.2d 375, 379, 144 P.3d 301 (2006). An example from Seattle’s own briefing illustrates the problems inherent in Seattle’s position. Suppose a Bellevue-based Certified Public Accountant (“CPA”)

provided audit services to a customer located in Seattle. *See* CP 166 (referring to a non-Seattle CPA performing audit services). When the Bellevue CPA travels to its customer’s Seattle office to audit its customer’s books, Seattle acknowledges the obvious—that the customer’s “customer location” would be “in the City” of Seattle. CP 166. If the Seattle customer mails, emails, or faxes the CPA a copy of its books to audit, or sends the CPA log-in credentials to review its books remotely from Bellevue, the *customer’s* Seattle location **does not change**. Yet the City’s non-statutory “physical” contact requirement would cause the customer’s location to disappear—the Seattle customer would have “no” customer location—simply because the customer’s contacts with the CPA are accomplished by non-“physical” means (i.e., mailing the books to the CPA). That is nonsensical and must be rejected.

In short, Seattle is required to source Wedbush’s income based on “customer location.” RCW 35.102.130(3)(b). Seattle cannot add a “physical” contact requirement to the statute in contravention of the statute in order to source additional income to Seattle. The only logical construction of the statutory term “customer location” is where the customer is located—i.e., the customer’s address. Presumably, the legislature elected to define “customer location” as the location where the “majority of contacts” between the customer and taxpayer take place in

order to account for customers with multiple locations, such as a bank with branches in various cities. RCW 35.102.130(4)(d). In such a situation, the statute requires the taxpayer to source income based on the customer's main point of contact with the taxpayer—i.e., the customer's location where the customer receives invoices from the taxpayer and otherwise "contacts" the taxpayer. Wedbush correctly sourced income to the numerator based on the contact address of its customers.

C. RCW 35.102.130(3)(b)(ii) Does Not Authorize Substitution of Taxpayer Location for Customer Location and Only Applies When the Taxpayer "Is Not Taxable at the Customer Location"; Wedbush Is Taxable in Seattle.

Based on its erroneous contention that Wedbush's customers have "no" customer location, Seattle claims that RCW 35.102.130(3)(b)(ii) authorized it to substitute the location of Wedbush's account representatives for the customer location to calculate the service income factor. CP 120. Contrary to Seattle's position, that provision only applies when the taxpayer is "not taxable at the customer location":

(b) ... 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*; ...

RCW 35.102.130(3)(b)(ii) (emphasis added); CP 120. It is clear from the plain language of the statute that subsection (b)(ii) is not triggered by there being “no” customer location. Rather, subsection (b)(ii) first *requires* a determination of where the “customer location” is, and only applies when the taxpayer is “not taxable” there. *Id.* It is undisputed that Wedbush *is* taxable in Seattle, so this subsection cannot authorize the city to replace income from Wedbush’s customers located in Seattle. CP 116.

Moreover, although Seattle attempts to characterize its substitution of account representative location for customer location by claiming that it had engaged in a “cost of performance” analysis, it admits that it only considered the payroll costs of Wedbush’s account representatives. CP 49. Those costs are already accounted for in the *payroll factor*—the other factor in the two-factor apportionment formula in RCW 35.102.130(3)(b). Thus, Seattle’s position effectively double counts the payroll factor and disregards the service income factor in the statutory two-factor apportionment formula. In so doing, it violates yet another principle of statutory construction—that one must “read words within the context of the whole statute and larger statutory scheme.” *City of Auburn v. Gauntt*, 174 Wn.2d 321, 330, 274 P.3d 1033 (2012). Here, RCW 35.102.130 apportions income based on the average of *two* factors—a payroll factor *and* a service income factor. The definition of customer location relates

solely to the service income factor, the purpose of which is to “reflect the contribution of the ‘market’ state to the taxpayer’s income”—i.e., where the taxpayer’s *customer market* is located. Hellerstein & Hellerstein, *State Taxation* ¶ 9.18(5)(c) (3d ed. 2001 & Supp. 2014-1). The payroll factor, on the other hand, is designed to “assign a taxpayer’s income to the states in which it employs labor to generate income”—i.e., where the *taxpayer itself* is located. *Id.* ¶ 9.17(1).

The statute does not permit the substitution of taxpayer location for customer location to effectively disregard one of the statutorily mandated factors. Such an interpretation would render the legislature’s election to include a separate service income factor based on “customer location”—as one of *two* statutory factors—meaningless surplusage. *Homestreet, Inc. v. Department of Revenue*, 166 Wn.2d 444, 452, 210 P.3d 297 (2009) (“statutes are to be construed so no clause, sentence or word shall be superfluous, void, or insignificant”).

In addition, Seattle’s unauthorized reliance on RCW 35.102.130(3)(b)(ii) to substitute the location of Wedbush’s account representatives for the customer location also misapplies the statute by considering only the payroll costs of account representatives. By considering only those costs, Seattle completely ignores the costs of all of the other activities involved with processing and executing securities trades

for Wedbush's customers. When properly invoked (when the taxpayer is not taxable at the customer location), subsection (b)(ii) only sources income to a city in which the "greater proportion of the service-income-producing activity is performed in the city than in any other location, based on costs of performance." RCW 35.102.130(3)(b)(ii). Seattle made no attempt to determine the place where the greater proportion of income producing activity occurs based on a cost of performance analysis. Rather, it simply assumed that the sole cost of Wedbush's services was the compensation paid to account representatives. CP 49. That assumption is directly contrary to the undisputed evidence, which shows that the account representative plays a limited role and that Wedbush's activities and costs in processing and executing customer trades occur primarily outside Seattle (in Wisconsin, New York, and Los Angeles). CP 36-42. For both reasons, subsection does not authorize to substitute income from customers located in Seattle with income from accounts in which the account representative is located in Seattle to determine the numerator of the service income factor of the statutory two factor apportionment formula.

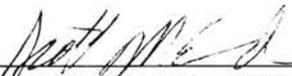
VI. CONCLUSION

"Customer location" under RCW 35.102.130 means the location of the customer. Because Seattle's substitution of account representative location for customer location is contrary to the plain language of the

controlling statute, the Superior Court's order should be reversed and the case remanded for entry of summary judgment in favor of Wedbush for a refund in the amount of \$16,128.61 plus interest.

RESPECTFULLY SUBMITTED this 24th day of October, 2014.

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CERTIFICATE OF SERVICE

I hereby certify under penalty of perjury that on October 24, 2014, I caused to be served a copy of the foregoing **BRIEF OF APPELLANT** on the following persons in the manner indicated below at the following address:

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