

State Ruling

204-241, Tax Topics: Interim Statement Regarding the Attribution of Receipts from R&D Services-- Business and occupation tax-- Business and occupation tax specific businesses-- Services and other business activities-- Research and development services

¶204-241. Tax Topics: Interim Statement Regarding the Attribution of Receipts from R&D Services, Washington Department of Revenue, June 22, 2017.

Business and occupation tax: Business and occupation tax specific businesses: Services and other business activities: Research and development services.— For business and occupation tax purposes, the Washington Department of Revenue has issued an interim guidance statement explaining the method to attribute receipts from providing research and development (R&D) services. When a service provider provides research, development, design, or similar R&D services to a business that uses those services in developing a product, the attribution of receipts from these services to such product market locations is limited to those situations where the product already has an established market. In situations where an R&D work relates to a new product in development, the R&D service provider should attribute the receipts to the specific location where the customer performs related work on the future product. The interim guidance provides further information pertaining to the relevant attribution rules, and the method for applying these rules to R&D services, with relevant examples.

Interim Statement Regarding the Attribution of Receipts from R&D Services

June 22, 2017

Introduction

The Department of Revenue is issuing this interim guidance statement to explain how to attribute receipts from providing research and development (“R&D”) services.

Issue

For apportionment purposes, to what location(s) should a service provider attribute its receipts from providing research and development (“R&D”) services to a customer that uses the services to develop or alter a product?

Answer

If the services concern an existing, available product, then proportionally attributing the receipts to the locations that comprise the market for the product is appropriate. Otherwise, the service provider should attribute its receipts to the location where the customer uses the services in developing the product.

Background

When a service provider provides research, development, design, or similar R&D services to a business that uses those services in developing a product, a common question is whether the benefit from the service provider's R&D services are received at the location where the product is ultimately sold. As explained below, attribution of receipts from R&D services to such product market locations is limited to those situations where the product already has an established market. In situations where the R&D work relates to a new product in development, the R&D service provider should attribute the receipts to the specific location(s) where the customer performs related work on the future product.

General attribution rules

A service provider earning apportionable income that is taxable in Washington as well as in another state must apportion the income to determine the amount taxable in Washington for B&O tax purposes.¹ The process of apportioning income typically requires attributing the receipts the service provider earns from each apportionable activity to the location(s) where the service provider's customer received the benefit of the service.²

The Attribution Rules

The approach for determining the location(s) where the customer received the benefit of the service varies depending on the service provided by the taxpayer. WAC 458-20-19402 ("Rule 19402") provides specific rules for determining where the benefit is received, including the following:

- If the taxpayer's service relates to tangible personal property ("TPP"), then its customer receives the benefit where the TPP is located or intended/expected to be located.³
- If the taxpayer's service does not relate to property, but instead relates to its customer's business activities, then the customer receives the benefit of the taxpayer's service at the location(s) where the customer's related business activities occur.⁴

Applying the above attribution rules requires answering several questions:

1. What service is the taxpayer providing?
2. Does that service most closely relate to TPP? If so, where is that property located or intended/expected to be located?
3. If the service does not relate to property, but relates to a business activity carried on by the customer, what is the customer's related business activity and where does that related business activity of the customer occur?

Applying the attribution rules to R&D services

Step 1: Identify the Service

The Department of Revenue examines the scope of the taxpayer's work, particularly its obligations and responsibilities to its customer, to identify the service the taxpayer is providing to its customer. Consistent with the Department's interim guidance on "staffing augmentation," the Department views a taxpayer as providing R&D services for a customer only if the taxpayer is responsible for achieving specific R&D milestones or work product deliverables. The Department expects the services contract between the taxpayer and customer to identify the taxpayer's responsibilities to the customer with respect to its R&D services.

Step 2: Determine Whether the Service Most Closely Relates to TPP

A service relates to TPP for attribution purposes when the service relates to specific and identifiable TPP.⁵ An R&D service relates to specific and identifiable TPP only if the taxpayer is (1) providing its services with respect to existing TPP or (2) designing new TPP that is specific/unique.⁶ Specific/unique TPP for this purpose means property intended for use by few users rather than, for example, a mass-produced product.⁷ Thus, R&D services for development of new TPP intended for mass production are not services related to TPP.

Receipts from services related to TPP should be attributed to the locations where the TPP is located or intended/expected to be located.⁸ If the taxpayer's service does not relate to TPP, the next step in the attribution analysis is to identify the business activity of the customer that relates to the taxpayer's service.

Step 3: If the R&D Service Most Closely Relates to a Customer Business Activity, Identify the Customer's Business Activity and Where the Activity Occurs

The customer's related business activity for attribution purposes means the customer business activity that most closely or directly relates to the services performed by the taxpayer. If the taxpayer performs R&D services for a specific product with an existing product market, then the taxpayer's service relates to its customer's selling activity or its customer service activity and should be attributed to the locations where the product is sold/used.

If the taxpayer's services do not relate to an existing product, then the taxpayer's service cannot relate to the customer's selling activity. Under these circumstances, the most closely related customer business activity is likely the customer's own R&D activity or a manufacturing activity, etc.

Examples

Example 1

Developer is performing software development services for Game Publisher in connection with a new computer game that Game Publisher will release in the following year. Under the contract between Developer and Game Publisher, Developer's primary duty is to deliver a software program that Game Publisher will use for beta testing.

Developer performs all of its software development work at its office in Seattle. After Developer delivers a beta version of the game to Game Publisher, Game Publisher will perform testing and additional development work on the game at locations in California.

Under the attribution analysis detailed above, Developer's software development services do not relate to TPP. Accordingly, the next step in the attribution analysis is to identify the business activity of Game Publisher that most closely relates to the services performed by Developer. The facts indicate that the business activity that most closely relates to Developer services is Game Publisher's R&D activity. Because this activity occurs in California, Game Publisher's receipts from its software development services should be attributed to California.

Example 2

QA is testing a video game system Game Publisher sells to consumers. Game Publisher received consumer complaints about the system overheating and hired QA to determine the cause of the problem. Game Publisher will use QA's findings to repair the video game system. The contract between QA and Game Publisher details the compensation Game Publisher will receive in exchange for QA's testing services specific to the game system. Because QA's testing services relate to specific TPP with an existing market, QA's receipts from the services should be attributed to the locations where the video game system is sold.

Footnotes

1	RCW 82.04.460(1).
2	RCW 82.04.462(3)(b)(i).
3	Rule 19402(303)(b). This document does not address services related to real property.
4	Rule 19402(303)(c).
5	See the descriptions in Rule 19402(303)(b)(iii).
6	See Rule 19402(303)(b)(iii)(A).

7	See, e.g., Rule 19402(304)(b), Examples 11 and 12. In addition, software is not TPP for B&O tax purposes, including for apportionment purposes.
8	Rule 19402(303)(b).