

Cite as Det. No. 14-0073, 34 WTD 019 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For) D E T E R M I N A T I O N
Correction of Assessment of)
)
) No. 14-0073
)
) Registration No. . . .
)
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[1] RULE 111; RCW 82.04.080: B&O TAX - GROSS INCOME - ADVANCES AND REIMBURSEMENTS - When a taxpayer is the employer of record of its affiliates' employees, it is presumed to be the employer with liability for the employer obligations. To overcome this presumption, the taxpayer must provide the Department with evidence to establish that the client is the employer with liability for the employer obligations. When a taxpayer has failed to rebut the presumption that it is the employer of record liable for the payment of employees' salaries and related payroll costs, the amounts the taxpayer received from its affiliates are not reimbursements under Rule 111 and the taxpayer cannot exclude the amounts from the measure of its gross income liability.

Headnotes are provided as a convenience for the reader and are not in any way a part of the decision or in any way to be used in construing or interpreting this Determination.

Callahan, A.L.J. – A corporation (“Taxpayer”) protests the disallowed deductions it took from the gross income it received for the services it provided to its affiliated entities, claiming the deductions were reimbursements for advances under WAC 458-20-111 (“Rule 111”). We deny the petition.¹

ISSUE

May Taxpayer exclude the payments that it received from its related entities for shared employees from the measure of its business and occupation (“B&O”) tax liability as reimbursements or advances under Rule 111?

FINDINGS OF FACT

Taxpayer² provides payroll services to related entities: [Affiliate #1], [Affiliate #2], [Affiliate #3], [Affiliate #4], and [Affiliate #5].³ The Department of Revenue’s (the “Department”) Audit Division (“Audit”) examined Taxpayer’s books and records for the period of January 1, 2008

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

² The Washington State Secretary of State website indicates that Taxpayer registered with Washington in 1988.

³ The Taxpayer and these entities have common ownership.

through December 31, 2011 (“audit period”). On October 10, 2012, Audit issued an assessment against Taxpayer for \$. . . , which consisted of a small business credit of \$. . . , retail sales tax of \$. . . , retailing B&O tax of \$. . . , service and other activities B&O tax of \$. . . , 5% assessment penalty of \$. . . , and interest of \$ Taxpayer did not pay the assessment and petitioned the Department’s Appeals Division for correction of the assessment.

Taxpayer licenses its trademark . . . to its related entities, which pay Taxpayer for the license to use the trademark.⁴ Each related entity operates a restaurant under this trademark.⁵ Each restaurant employs about twenty five employees and each one is responsible for its own payroll function for those twenty five employees. In addition to their own twenty five employees, each restaurant hired the same three key employees for accounting, management, and maintenance supervisor positions (hereafter referred to as shared employees).⁶

Prior to 2001, each restaurant processed its own payroll for the shared employees and issued bi-monthly paychecks and annual Form W-2s to them. Beginning October 2001, Taxpayer began handling the payroll for the shared employees. Taxpayer performs this payroll function only for its related entities (the restaurants) and only for the shared employees. During the audit period, Taxpayer reported payments it received from the affiliated entities under the services and other business activities B&O tax classification but also claimed a deduction of those amounts as a Rule 111 exclusion from taxable income on the combined excise returns filed during the audit period. Audit disallowed the deduction and assessed service B&O tax on the income Taxpayer received from its related entities.⁷ Audit also assessed retailing B&O tax and retail sales tax on the amounts Taxpayer received from the related entities for the maintenance services the maintenance manager provided to the entities. The maintenance services included maintaining the restaurants’ kitchen equipment. Taxpayer had also deducted these costs as pass-through payroll payments.

Taxpayer maintains a corporate office for its affiliated entities, where it keeps the records of those entities. Taxpayer provides financial, management, and maintenance services to the affiliated entities through the shared employees. One of the shared employees is the financial manager, who works at Taxpayer’s corporate office to provide accounting and financial services to the affiliated entities. Those services include sales tracking, bi-monthly payroll of the restaurant staff processing, corporate taxes filing, and bill paying. Each restaurant downloads its data to the corporate office daily, and periodically ships the data to the corporate office. The other shared employee is the district manager, who travels among the five restaurants to assist the restaurant managers, offers training, and oversees the restaurants’ operations. The district manager also maintains a home office and has video access to the activities at the restaurants. The shared employees also consist of a maintenance supervisor, who travels to the restaurants to assist with the routine maintenance work of the restaurants.

Taxpayer argues that the income it received from its related entities should be excluded from its gross income as reimbursement under Rule 111 because it is a payroll agent for its related entities. In support of its argument, Taxpayer provided a copy of an agreement, titled

⁴ Taxpayer reports this income to the Department under the royalty B&O tax classification.

⁵ Three of the restaurants are located in Washington and two are located outside Washington.

⁶ . . .

⁷ Audit also assessed service B&O tax on the interest income Taxpayer received from loans to the restaurants during the audit period. Taxpayer did not assert any argument against the tax assessed on its interest income in its petition.

“Agreement To Act as Payrolling [sic] Agent” (the “Agreement”) between the affiliated entities, . . . , and itself.⁸ The Agreement provided the following:

This written agreement, made and entered into as of the 1st day of April, 2003, by and between [Taxpayer], a Washington corporation, and all [affiliated entities], currently comprised of:

[Affiliate #1], a Washington Sub-S corporation
[Affiliate #2], a Washington Sub-S corporation
[Affiliate #3], Inc., a Washington Sub-S corporation
[Affiliate #4], a Washington Sub-S corporation⁹

[Taxpayer] will act as “payrolling agent” for the above corporations for those employees who work for four units. This is being done to expedite payroll, save costs, and eliminate multiple checks for the shared employees. It is understood that the individual restaurants will continue to be the actual employer for the employees in question, and will be liable to pay the payroll costs for these employees. To insure that the individual restaurants retain pervasive control of the employees in question, the following factors will be strictly adhered to:

[Affiliated Entities] will:

1. Ultimately decide as to hiring and firing of these employees.
2. Ultimately decide as to duration of employment.
3. Set the rate, amount, and other aspects of compensation.
4. Determine the worker’s job assignments and instructions.
5. Excise exclusive guidance and supervision over the work performed.
6. Evaluate the worker’s performance.
7. Determine the days and hours of work performed.
8. Provide the office space or other controlled work premises.
9. Provide the tools and materials applied in the workplace.
10. Compensate workers for vacation time, sick leave, and insurance benefits.

The individual restaurants will be liable for all payroll costs incurred by [Taxpayer], Inc. including all processing and reporting expenses. Reimbursements for payroll will be made to [Taxpayer], on a monthly basis. No additional fees will be charged for acting as payroll agent, as all costs will be assumed by and the sole responsibility of the individual units.

Taxpayer also provided copies of the Employee Payroll Agreement (the “Payroll Agreement”) that it entered with the shared employees, which provided:

This is a written agreement acknowledging that [Taxpayer] is acting solely as a payroll agent and has no liability to pay me for any payroll or to pay any associated payroll taxes. I acknowledge that since my hire date, I have had the understanding that the

⁸ . . .

⁹ Taxpayer amended the Agreement effective June 1, 2011 to [Affiliate #5] as a party to the Agreement.

individual [Affiliate] restaurants are my employers and are solely responsible for all employer obligations.

(Emphasis added).

Taxpayer's records show that it reported and paid the "shared" employees' wages plus related payroll costs, which include the employees' federal tax withholdings and Medicare and social security insurance liabilities and the employer's federal unemployment taxes and share of Medicare and social security insurance liabilities. It reported these liabilities under its own federal employer identification number (FEIN). It did not report the employees' withholding or payroll costs under the affiliates' FEIN. Taxpayer also reported the state's payroll liabilities for the "shared" employees to Washington's Employment Security and Labor & Industries Departments. Taxpayer claims it paid these payroll costs as the affiliates' payroll agent; not as the employer of the shared employees. Therefore, Taxpayer argues the payments it receives for these costs are not gross income to it but merely pass-through amounts under Rule 111.

ANALYSIS

The B&O tax is imposed for the privilege of engaging in business in Washington. RCW 82.04.220. The term "business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or another person or class, directly or indirectly." RCW 82.04.140. The legislature intended to impose the B&O tax on virtually all business activities carried on within the state. *Time Oil Co. v. State*, 79 Wn.2d 143, 146, 483 P.2d 628 (1971). Here, Taxpayer's payroll activities were performed "with the object of gain and benefit" for all the affiliated entities, and constituted engaging in business. RCW 82.04.140.¹⁰

The measure of B&O tax is the gross proceeds of sales, or the gross income of the business. RCW 82.04.220. RCW 82.04.080 defines "gross income of the business:"

"Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation for the rendition of services, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

Under this broad definition, a service provider may not deduct from its gross income any of its own costs of doing business, including its labor/payroll costs. *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 566-67, 782 P.2d 986 (1989); *Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 436, 49 P.3d 947 (2002). Thus, if the affiliates' payments to Taxpayer are compensation for services taxpayer provided, then the payments are gross income by reason of the transaction of the business in which Taxpayer is engaged and Taxpayer cannot deduct the payroll costs from the measure of tax.¹¹

¹⁰ RCW 82.04.140 defines the term "business" as "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly."

¹¹ During the 2013 legislative session, the legislature added a new section to RCW 82.04 that provides:

However, gross income of the business does not include amounts that merely pass through a business in its capacity as an agent. Rule 111 is the Department's administrative regulation, which excludes from the measure of tax amounts received as "advancements" and "reimbursements." Rule 111 provides in pertinent part:

The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefore, either primarily or secondarily, other than as agent for the customer or client . . .

The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

[. . . .]

The Washington Supreme Court addressed a similar [issue] in *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002), stating that once an agency relationship has been established, an inquiry must be made into whether the taxpayer's liability to pay third parties (the employees) "constituted solely agent liability." *Id.* at ___. The Court went on to explain that if a taxpayer assumes any liability beyond that of an agent, the payments it receives may not be excluded from the measure of the B&O tax as "pass through" payments. *Id.* at ___.

In 2011, the Washington State Supreme Court issued its decision in *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011), which again emphasizes Rule 111's agency requirement:

[A] true agency relationship between the client or customer and the taxpayer is required. "The existence of that agency relationship is not controlled by how the parties described themselves" and "standard agency definitions should be used in analyzing the existence of the agency relationship." *William Rogers Co.*, 148 Wn.2d at 177-78, 60 P.3d 79.

In computing tax there may be deducted from the measure of tax, amounts that a qualified employer of record engaged in providing paymaster services receives from an affiliated business to cover employee costs of a qualified employee. However, no exclusion is allowed under this section from any employee costs incurred in connection with a contractual obligation of the taxpayer to provide services, including staffing services as defined in RCW 82.04.540.

Part I of ESSB 5882 (Laws of 2013, 2d Spec. Sess., ch. 13, §§ 101-02). The legislature intended the deduction to be applied only prospectively, according to the final statement in the findings section that it "does not intend for part 1 of this act to retroactively create a right of refund for taxes paid on payroll cost reimbursements prior to the enactment of this statute." *Id.*, § 101.

Washington Imaging, 171 Wn.2d at 561-62.

Thus, Taxpayer must first establish that it received the funds as the affiliate's agent and second that it did not assume any liability to any third party in connection with the receipt of payment, including any liability to the workers, beyond that of an agent of the client. But, even if Taxpayer establishes that it is the agent of the affiliates, the inquiry does not end there. If Taxpayer assumes any liability for the payment owed to any of the third parties, other than as the agent of the affiliates, Taxpayer will not be entitled to exclude the payments from its gross income as pass-through payments. Instead, Taxpayer will be deemed to be engaged in the business for which it received the payment; in this case, selling the services performed by the shared employees. *Washington Imaging*, 171 Wn.2d at ____.

More recently, on September 27, 2013, the Department issued Excise Tax Advisory 3181.2013 ("ETA 3181"), which provides additional guidance in determining whether a taxpayer that is the employer of record qualifies as a paymaster or whether it is engaged in the business of selling labor or services provided by its own employees.¹² ETA 3181 explains that a taxpayer qualifies as paymaster and may exclude amounts received to pay client employer obligations only by meeting the Rule 111 requirements of:

1. The amounts received must be customary reimbursements or advances to the taxpayer for paying the employer obligations of a client.
2. The services performed by the employees must be services that the taxpayer does not or cannot render and for which no liability attaches to the taxpayer.
3. The taxpayer may have no liability to pay the employer obligations, except as the agent of the client.

A taxpayer that does not satisfy all the requirements of Rule 111 must include all amounts received from its clients as gross income of the business, even if those amounts are used to pay salaries, benefits or payroll taxes. ETA 3181.

ETA 3181 further explains that when the taxpayer is the employer of record, the taxpayer is presumed to be the employer with liability for the employer obligations:

- The employer of record is generally considered to be the employer liable for the employer obligations.
- When the client is the employer of record, the client is deemed to be the employer liable for the employer obligations.
 - For example, a taxpayer who is classified for federal tax purposes as a Form 8655 reporting agent or "payroll services provider" files employment tax returns **under its client's EIN**. Thus, the client is the employer of record. In these circumstances, the client is considered to be the employer with liability for the employer obligations.

¹² [...]

- When the taxpayer is the employer of record, the taxpayer is presumed to be the employer with liability for the employer obligations. To satisfy this element, the taxpayer must provide the Department with evidence to establish that the client is the employer with liability for the employer obligations.
 - For example, the following evidence will collectively establish that the client is the employer with liability for the employer obligations:
 - The client has all control over the employees (such as determining and supervising activities, setting compensation, hiring and firing authority, etc.);
 - The taxpayer has no such control; and
 - The client agrees in a writing enforceable by the employees that it is the employer liable for all employer obligations (e.g. through an employment contract or employee handbook).

As used in ETA 3181, “employer obligations” means employee salaries, benefits, payroll taxes, and similar obligations. Here, Taxpayer reported and paid the employees’ wages and related payroll expenses to the federal government under its own federal employer identification number (FEIN). Taxpayer paid Washington’s unemployment insurance tax, Labor & Industries tax, and Washington Employment Administration Fund. Taxpayer paid the shared employees’ salaries. Under these facts, and as explained in ETA 3181, Taxpayer is the employer of record.

Because Taxpayer is the employer of record, Taxpayer is presumed to be the employer with liability for the employer obligations. To overcome this presumption Taxpayer “must provide the Department with evidence to establish that the client is the employer with liability for the employer obligations.” A person seeking a tax deduction, exception, or exemption or exclusion has the burden of showing it qualifies. *Budget Rent-a-Car of Washington- Oregon, Inc. v. Dep’t of Revenue*, 81 Wn.2d 171, 500 P.2d 764 (1972); *Group Health Co-op v. Tax Comm’n*, 72 Wn.2d 422, 433 P.2d 201 (1967); Det. No. 01-198, 23 WTD 257 (2004). “When we interpret exemption provisions, the burden is upon the taxpayer to show the exemption applies and any ambiguity is “construed strictly, though fairly and in keeping with the ordinary meaning of their language, against the taxpayer.” Det No. 04-0147, 23 WTD 369, 375 (2004) (quoting *Simpson Inv. Co. v. Dep’t of Revenue*, 141 Wn.2d 139, 150, 3 P.3d 741 (2000)).

Here, Taxpayer has provided a copy of the Payroll Agent Agreement between itself and the affiliated restaurants, an employee payroll agreement wherein the employees declare that the restaurants are their employers and that Taxpayer has no liability for their payroll expenses. However, we find that the affiliates contracted with Taxpayer to provide the services performed by the shared employees.

Taxpayer provides the affiliates with administrative, financial, management, and maintenance support services. It maintains the affiliates’ business records in its corporate office, downloads the affiliates’ data daily, and supervises the affiliates’ finance and operations. It performs these services through the employees. The employees operate out of Taxpayer’s location as well as at the affiliates’ location. We do not find the evidence supports Taxpayer’s assertion that it acts merely as a payroll agent for these employees. The term “paymaster” generally refers to a person that acts as an agent for the purpose of paying the employer obligations of one or more clients. Here, we find that the Taxpayer is providing services through these employees, exercising some

control over their activities. We conclude, therefore, that Taxpayer has not shown that the affiliates are the employers liable for the employer obligations. Taxpayer has failed to rebut the presumption that it is the employer of record liable for the payment of employees' salaries and related payroll costs.

We conclude that the amounts Taxpayer received from its affiliates are not reimbursements under Rule 111 and Taxpayer cannot exclude the amounts from the measure of its gross income liability. We sustain the assessment.

DECISION AND DISPOSITION

We deny Taxpayer's petition.

Dated this 4th day of March 2014.