

Cite as Det. No. 12-0166ER, 35 WTD 82 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For
Reconsideration of

) FINAL EXECUTIVE
) LEVEL DETERMINATION
)
)
) No. 12-0166ER
)
) Registration No.
)

RULE 111; RCW 82.04.080; ETA 3100; ETA 3181: B&O TAX – AGENT – REIMBURSEMENT – AFFILIATE -- PAYROLL -- An affiliated payroll agent who had no primary or secondary liability to its affiliate's employees, and with no liability for the employees' performance, could exclude the affiliate's payroll reimbursements from its measure of B&O tax.

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.

M. Pree, A.L.J. – A company protests business and occupation (B&O) tax assessed on payments it received from affiliates for payroll. Because it had no liability other than as agent of the affiliates, we grant the petition subject to verification.¹

ISSUE

Under WAC 458-20-111 (Rule 111), could a company exclude from its measure of B&O tax payments received from its affiliates for payroll expenses, when it has no liability other than as agent to the employees?

FINDINGS OF FACT

[Taxpayer] is a Washington Limited Liability Company. The owners of the taxpayer also own two Washington construction limited liability companies, [Company 1] and [Company 2] (referred to collectively as the “affiliates”). The taxpayer handled the payroll for the affiliates. The affiliates paid the taxpayer [the total payroll amount], and the taxpayer [in turn] paid the employees, and also paid the other costs associated with their employment, including taxes and benefits. The taxpayer filed their employment tax returns with the appropriate agencies. The taxpayer did not file Washington excise tax returns on its own behalf.

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

The Department of Revenue (Department) examined the taxpayer's books and records for the period January 1, 2007 through December 31, 2009.² As a result of this examination, the Audit Division (Audit) found that the taxpayer had not included the affiliates' payments when it reported its gross receipts during the audit period. On November 5, 2010, Audit issued a tax assessment for \$. . . , consisting of \$. . . in B&O tax, \$. . . in penalties, and \$. . . in interest. . . . The taxpayer petitioned for Executive Level reconsideration. The taxpayer contends that we erred in treating the [affiliate payments to taxpayer] for payroll expenses as the taxpayer's income.

The taxpayer was organized on September 21, 2005, as a limited liability company. On December 6, 2006 the taxpayer obtained a general contractor's license.³ According to the taxpayer, while all the affiliates obtained general contractor licenses, the taxpayer was formed for payroll purposes only. The taxpayer states that it never performed any construction work, and did not perform services other than preparing the payroll.

On January 1, 2007, the affiliates signed an agreement with the taxpayer whereby the taxpayer agreed to act as the affiliates' agent to handle the affiliates' payroll requirements. They agreed that the affiliates, not the taxpayer, would supervise and control the employees. The affiliates agreed to defend, indemnify, and hold the taxpayer harmless for any employee claim for wages and benefits. Similarly, the affiliates agreed to indemnify and hold the taxpayer harmless for any third party claim related to the taxpayer's payroll responsibilities.

The agreement required that all employees receive a notice, which explained that they were employed by the affiliates and not the taxpayer. The notice explained to the employees that the taxpayer would issue the employees their paychecks, and pay, prepare, and file all payroll taxes, fees premiums, and contributions required with the appropriate government agency or other entity. [Thirty-four] employees signed an [agreement that the taxpayer was not liable to the employee for any employer obligations], and only provided the payroll service. [Those employees also agreed that the affiliates were the employers liable for all employer obligations].⁴

The affiliates' accounting staff processes the payroll. The taxpayer charges each affiliate \$. . . per month to cover the time spent on the payroll. Per the agreement, the affiliates provided the taxpayer two weeks written notice of the salary and benefits to be provided to each employee. Typically, the bookkeeper, originally hired by the affiliates, prepared the checks for the workers after making sure that the time for labor was properly recorded in the affiliates' job accounts for

² The Audit Division audited the taxpayer and the two affiliates. Additionally, there is a third affiliate, but the taxpayer has not said that it is the paymaster for this affiliate.

³ According to the Office of the Secretary of State, [Company1] was organized on August . . . , 2005, and according to the Department of Labor and Industries, also received its general construction contractor's license on December . . . , 2006.

⁴ The taxpayer explained that the employees signed their acknowledgements forms shortly after the taxpayer and the affiliates signed their agency agreements on January 1, 2007, or when the employee began working after that date. However, after the taxpayer provided acknowledgement forms for other employees, we could not identify the employees, and were unable to determine whether every employee had acknowledged that the taxpayer was not liable to pay them. Furthermore, Workpaper A, Sheet 1 of the assessment did not name the employees for the first year and a half of the audit period. Therefore, [for the reasons discussed below and in light of all the evidence in the record,] we will remand the assessment to the Audit Division to remove the payroll for the employees who acknowledged that the taxpayer was not liable to pay them during the audit period.

job costing purposes. The bookkeeper then recorded the same time in the taxpayer's books and prepared the payroll checks. On the same day, the bookkeeper prepared a bank transfer from the affiliates' accounts to the taxpayer for the amount of the payroll (wages, taxes, medical, etc.). The next day, the bank transferred the funds and the checks were issued. Later, the taxpayer paid the taxes and other amounts owed by the affiliates.⁵ [The taxpayer states that it has no employees.]

When the taxpayer was organized, the affiliates had in place accounting software, which was used for payroll, and which was also used for other financial purposes. Rather than purchase new software, the taxpayer continued to use the old program. The Audit Division noted that the taxpayer did not keep its books as those of an agent. The taxpayer kept its books showing the payroll payments from the affiliates as income, and the employees' wages and taxes as its expenses. According the taxpayer's books and records, the associated receivables were shown as assets, and payables as liabilities. The taxpayer explained that when it set itself up, it used the old software to calculate and accumulate information to process its payroll. It would have cost more to buy an additional license for the same software used by its affiliates. [Using the affiliates' software also avoided retraining staff to learn a new system.] The software created statements that appeared to give the taxpayer income and expenses, which the taxpayer states were cancelled out when its financial statements were consolidated. The net effect was to show the taxpayer's monthly \$. . . fee only.⁶

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). The taxpayer's payroll activities were performed with the object of gain and benefit for all the affiliated entities, and constituted engaging in business.

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,

⁵ During the audit period, the taxpayer paid the various government agencies using the taxpayer's Federal Employer Identification Number.

⁶ The taxpayer did not file its own excise tax returns or pay B&O tax on the amount it received for its payroll services. The amount received may have been less than the small business tax credit. The taxpayer does not contend that this amount should be excluded from gross income for B&O tax purposes.

interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

RCW 82.04.080. 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 costs. *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 582-583, 782 P.2d 986 (1989); *Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 436, 49 P.3d 947 (2002). If the funds advanced by the affiliates were the taxpayer's gross income, the taxpayer could not deduct the labor costs.

Rule 111 is the Department's administrative regulation, which excludes from the measure of tax amounts received [by agents] 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 therefor, 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.

Excise Tax Advisory No. 3100.2009 (ETA 3100.2009) discusses Rule 111 and its agency requirement:

The existence of an agency relationship is not controlled by the labels the parties use to describe themselves in their contract documents. Rather, standard common law agency principles are used in analyzing whether an agency relationship exists. The essential elements of common law agency are mutual consent to the relationship between a principal and an agent, and the right of control over the agent by the principal. If these elements are not satisfied, there is no agency relationship . . .

If a taxpayer assumes any liability to third parties in connection with the receipt of payment, including any liability to the workers, beyond that of an agent of the client, the payments it receives and uses to pay the third parties are not excludable [from the measure of the B&O tax.]

A taxpayer that does not satisfy these requirements of Rule 111 is deemed to be engaged in the business of providing employee laborers (e.g., a staffing company), leasing employees, or selling the services performed by the employees. Such persons must include all amounts received from its clients as gross income of the business, even if those amounts are used to pay the employees' salaries, benefits, or payroll taxes.

Excise Tax Advisory 3181.2013 (ETA 3181.2013) issued on September 27, 2013, clarifies when a taxpayer qualifies as a paymaster able to exclude amounts received to pay the employer obligations of its clients from gross income.⁷ As used in ETA 3181.2013, “employer obligations” means employee salaries, benefits, payroll taxes, and similar obligations. 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. A paymaster may or may not be affiliated with its clients, but a “captive paymaster” means a paymaster providing paymaster services to affiliates (persons under common control⁸) and not to unrelated persons. A paymaster paying an employer obligation shared by two or more of its clients is referred to as a “common paymaster.” An “employer of record” is the person who reports employees under its own UBI or EIN for state or federal tax, employment security, or insurance purposes. Using these definitions, we will apply ETA 3181.2013, and determine whether the taxpayer may exclude amounts received to pay client employer obligations.

A taxpayer qualifies as a paymaster and may exclude amounts received to pay client employer obligations only by meeting the requirements of WAC 458-20-111 (“Rule 111”) as follows:

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.

ETA 3181.2013. 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. *Id.*

To meet the first requirement, the reimbursement or advance must be both customary and made for the purpose of paying the employer obligations of the client. In other words, the affiliates must be the employer and have liability for the employer obligations. The employer of record is generally considered to be the employer liable for the employer obligations. ETA 3181.2013. The taxpayer acted as the “employer of record” because the taxpayer was the person who reported employees under its own UBI or EIN for state or federal tax, employment security, or unemployment insurance purposes. Because the taxpayer was the employer of record, the taxpayer was presumed to be the employer with liability for the employer obligations.

⁷ For periods beginning on or after October 1, 2013, certain taxpayers may qualify for the new deduction created by RCW 82.04.43393. That law provides a deduction for employee costs received from an affiliated business by a qualified employer of record engaged in providing paymaster services to its affiliates.

⁸ “Control” means the possession, directly or indirectly, of more than fifty percent of the power to direct or cause the direction of the management and policies of a entity. Because the owners of the taxpayer also owned the affiliates, the affiliates met the definition of “affiliates” in ETA 3181.2013.

However, under ETA 3181.2013, the taxpayer overcame that presumption for 34 employees because the taxpayer provided the Department with evidence to establish that the affiliates were the employers with liability for the employer obligations:

1. The affiliates had all control over the employees (such as determining and supervising activities, setting compensation, hiring and firing authority, etc.);
2. The taxpayer has no such control; and
3. The affiliates and 34 employees agreed in writing enforceable by the employees that the affiliates were the employers liable for all employer obligations [and that the taxpayer was not liable for those obligations].

The taxpayer has provided the agreement with its affiliates and statements from the employees. The affiliates, not the taxpayer, controlled the employees. The affiliates determined the employees' activities and supervised them. The affiliates, not the taxpayer, had all hiring and firing authority. The taxpayer has established that the affiliates were the employers with liability for the employer obligations. The affiliates regularly advanced funds so that the taxpayer could pay the affiliates' payroll obligations. We conclude that the affiliates' payments to the taxpayer were customary advances for the payment that the taxpayer would make on behalf of the affiliates and, therefore, the taxpayer met the first requirement of Rule 111.

To meet the second requirement, the services performed by the employees for the client must be services . . . for which no liability attaches to the taxpayer. In other words, the taxpayer cannot be selling the services or the employee labor to the affiliates or their customers. The taxpayer had no obligation to provide the services, nor was it obligated to furnish the employee or their labor to the affiliates or to their customers. The taxpayer had no liability for the services or the employees' performance.

The taxpayer did have a contractor's license, and was the employer of record. The taxpayer's books show the income and liabilities from the employees' services. These facts give the appearance that the taxpayer was in the business of selling the same services to others that the employees performed for the affiliates.

However, the taxpayer did not provide contractor services, either through employees, which it did not have, or through subcontractors. The taxpayer was only obligated to provide payroll services. The taxpayer had no obligation to provide the affiliates with employees or staffing, and had no liability for the employees' performance, including the quality or quantity of performance. The affiliates' contracts contained no contrary provisions, such as a provision for the taxpayer to indemnify the affiliates for any costs or damages arising out of any activities of the employees. Rather, the agreements provided that the taxpayer "is not responsible in any manner for any act or inaction of the Employees." The contracts were enforceable and consistent with the actions of the taxpayer acting solely as the affiliates' payroll agent. Under these facts, we conclude the taxpayer was not selling employee labor or construction services to the affiliates, and conclude that the second requirement of the rule, as outlined in the ETA, was met.

To meet the third requirement, the taxpayer must have had no liability to pay the employer obligations, except as the agent of the affiliates. The taxpayer must have been a bona fide agent of the affiliates and have had no liability to pay the employer obligations, except its agency liability. Standard common law agency principles are used to determine whether an agency relationship exists. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wash.2d 548, 562, 252 P.3d 885 (2011); *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 571, 782 P.2d 986 (1989). The essential requirements of common law agency are mutual consent and control. *Id.*; ETA 3100.2009.

The taxpayer acted as agent when it agreed to act on the affiliates' behalf and in accordance with their directions. But, because the taxpayer is the employer of record, it has liability for certain employer obligations under common law, and state and federal statutes. However, [the] taxpayer has provided the agreement with its affiliates and statements from 34 of the employees. The affiliates and the employees agreed that the affiliates, not the taxpayer, were liable to the employees. The affiliates' contracted to establish that the taxpayer was not liable to the affiliates for their employee obligations. [The weight of evidence in this case establishes that the taxpayer had no liability to pay the employer obligations. Therefore,] where the employees signed written acknowledgements that the taxpayer was not liable to pay them, the evidence establishes that only the affiliates were liable for any employer obligations.⁹

The taxpayer had no primary or secondary liability to the employees, or to any other person, to pay the affiliates' employer obligations. [Thirty-four] employees agreed that the taxpayer had no liability to pay any of the affiliates' employer obligations. . . . The taxpayer's only liability was its agency liability, meaning the taxpayer's liability to its affiliates was to pay their employer obligations as directed. Under these facts, we conclude that the taxpayer has met the third requirement under Rule 111.

We find, under the facts in this case, that the taxpayer has preliminarily shown that some of the payments it received from its affiliates were made as "advances or reimbursements" for the payments it made on behalf of its affiliates as their payroll agent and that it had no primary or secondary liability for those payments except as the affiliates' agent. See [*Washington Imaging*, 252 P.3d at 892]. We conclude, that the advances from its affiliates may meet the Rule 111 requirements that apply only when the customer or client alone is liable for the payment of the fees or costs and when the agent making the payment has no personal liability, either primarily or secondarily, other than as agent for its principle (customer or client). We further conclude that the taxpayer is entitled to claim the Rule 111 exclusion, as restated in ETA 3181.2013, for all such payments as it is able to verify with proper documentation. We are remanding to the Audit Division for review of additional documents that the taxpayer must produce in order for the assessment to be adjusted in accordance with our findings and conclusions herein; that is, for those employees who, during the audit period, acknowledged in writing that taxpayer was not liable to them for their wages and associated payroll expenses, except as agent for their employers. We conclude the taxpayer was entitled to exclude the amounts it received from the affiliates and which it used to pay the affiliates' payroll obligations as the affiliates' payroll

⁹ [However, a mere statement or acknowledgement that the client is liable to pay the obligations does not by itself establish that the paymaster has no such liability or satisfies the requirements under the ETA.]

agent. We, therefore, remand this matter to the Audit Division for adjustment of the B&O tax assessed based upon the taxpayer's timely submission of the requisite documentation

DECISION AND DISPOSITION

We conditionally grant the taxpayer's petition. The amounts advanced or reimbursed to the taxpayer for payments of the affiliates' employees payroll and payroll expenses will be removed from the measure of B&O tax provided the taxpayer submits the employees' written acknowledgements that the taxpayer was not their employer during the audit period and was not liable to them for their wages and associated employment taxes and expenses. And, provided also, that the taxpayer shall produce the substantiating documents as identified below.

Dated this 7th day of April, 2013.