Cite as Det. No. 16-0094, 35 WTD 557 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 16-0094
. . .	)	Registration No. . . .

RCW 82.04.43393 -- RULE 111 – ETA 3181.2013 -- B&O TAX – ADVANCES AND REIMBURSEMENTS -- EMPLOYER OF RECORD -- CAPTIVE PAYMASTER -- DEDUCTION – EMPLOYER OBLIGATIONS – AGENCY LIABILITY -- TEST. A captive paymaster that is an employer of record will be deemed to have satisfied the third element of Rule 111 – i.e., "the taxpayer may have no liability to pay the employer obligations, except as the agent of the client" – when either each employee agrees in writing that the paymaster has no liability to the employee pay any employer obligations, or, in the case of a captive paymaster, the paymaster is a Form 2678 Agent for the clients under 26 U.S.C. §3504 and the employees are provided with written notice of the paymaster arrangement, including the client's status as an employer liable to the employees for all employer obligations.

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.

Bauer, A.L.J. – An out of state limited liability holding company that provided payroll and benefits services to a subsidiary corporation, and that reported wages in this state as the employer of record, protests the assessment of business and occupation (B&O) tax under the services and other activities classification on payroll expenses, arguing that amounts received for payroll and benefits are excluded reimbursements under WAC 458-20-111 (Rule 111). Because Taxpayer did not prove it had solely agent liability to pay the employer obligations, we conclude the amounts received are not excludible reimbursements. The petition is denied.[1]

ISSUE

Whether, under WAC 458-20-111, a holding company that provided payroll and benefit services to its Washington subsidiary, and was the employer of record for the subsidiary's employees, could exclude amounts received from the subsidiary through a sweeps account from its gross income, because it had no liability to pay the subsidiary's payroll obligations other than as its agent.

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

FINDINGS OF FACT

The Audit Division (Audit) of the Department of Revenue (Department) audited the books and records of [Taxpayer] for the period January 1, 2010 through September 30, 2013 (audit period). On February 20, 2015, Audit issued the above-referenced post assessment adjustment in the following amounts:

$ . . .	Retail Sales Tax
. . .	Service and Other Activities B&O tax
. . .	Use Tax and/or Deferred Retail Sales Tax
. . .	Total Tax Due
. . .	Delinquent Penalty (25%)
. . .	Interest through Mar 23, 2015
. . .	5% Assessment Penalty (Substantial Underpayment)
$ . . .	Total Due[2]

Taxpayer did not pay the assessment, but on March 23, 2015, appealed the service and other activities tax on amounts it withdrew from a sweeps account to pay the wages and benefits of the employees that worked for its Washington subsidiary.

Taxpayer, an [out-of-state] limited liability corporation [(LLC)], was the parent of several subsidiaries, each of which operated a restaurant under the terms of franchise agreements with . . . .[3] Only one of Taxpayer's subsidiary restaurants was located in Washington during the audit period. [WA LLC] was incorporated in Washington and located in . . . , Washington.[4]

According to Taxpayer, even though each of its restaurants was independently operated, they all had similar receipts and expenses. In order to provide economies of scale, Taxpayer provided centralized cash management for all of its restaurants using a system of daily sweeps into and out of an account (sweeps account) maintained in Taxpayer's name. Although the arrangement was similar for all of the restaurants, this appeal involves only Taxpayer's transactions with [WA LLC], as that was Taxpayer's only Washington restaurant.

[WA LLC] received cash and other payments from its customers and deposited them into its own bank account, from which it paid some of its own expenses. The balance of the [WA LLC] account was swept daily into the sweeps account. [WA LLC] recorded a credit to its cash account and a debit to the intercompany "due to/due from" account. Taxpayer recorded a debit to the sweeps account to reflect [WA LLC's] receipts, with an offsetting credit to the "due to/due from" account. [WA LLC] calculated, reported, and paid Washington B&O tax on its gross retail sales from its restaurant operations.

---

[2] Interest has continued to accrue since March 23, 2015.

[3] The Washington Secretary of State's Corporations Division reports that Taxpayer is now inactive due to a merger on December 28, 2015, when it merged into . . . , as the nonsurviving entity.

[4] Taxpayer's other restaurants were [out-of-state]. [WA LLC's] account with the Department of Revenue was closed on February 25, 2016, and is also shown as "inactive" on the Washington Secretary of State's Corporations Division website. On December 29, 2015, it merged into Taxpayer as the nonsurviving entity before its merger into . . . .

Although [WA LLC] paid some of its operating expenses from its own account before the net cash was swept into the centralized account, many other of its expenses were paid from the sweeps account. Taxpayer, as the signatory on the sweeps account, paid [WA LLC's] expenses from that account, and those expenses were recorded with a credit to the sweeps account with an offsetting debit to the "due to/due from" account. [WA LLC] recorded a credit to its "due to/due from" account with a debit the appropriate expense.

Taxpayer paid [WA LLC's] expenses from the sweeps account, and these expenses included payments to [WA LLC] vendors and employees. [WA LLC] compensated Taxpayer in the form of a management fee, which Taxpayer reported and paid tax on under the service and other activities classification of the B&O tax.

Audit treated all credits to Taxpayer's intercompany "due to/due from" account from [WA LLC] as Taxpayer's business receipts. Audit allowed subtractions from these receipts for bills that were paid out of the account if they were addressed to [WA LLC] on . . . or if the invoice was billed directly to [". . . WA LLC"] or ["WA LLC."]

According to Taxpayer, the taxable base of net credits to the intercompany "due to/due from" account therefore included:

- [WA LLC] payroll
- [WA LLC] expenses mailed to Taxpayer for payment
- Restaurant net income remitted to the parent as a contribution
- Certain credits that were offset with adjusting debits.[5]

Of these, the payroll expense comprised the largest portion of receipts that were paid out for the [WA LLC] restaurant and is the subject of the controversy. Taxpayer argues that the payroll expenses should be subtracted from Taxpayer's tax base because Taxpayer was not liable for them – either primarily or secondarily – and was paying them only in a representative capacity. Thus, argues Taxpayer, WAC 458-20-111, Advances and Reimbursements, applies to permit the pass-through of [WA LLC's] payroll expenses because Taxpayer was not the employer. To demonstrate the fact that this contention was well-established, Taxpayer has provided a copy of the "[Taxpayer] & Affiliates Team Member Handbook" (Revised March 2010) (Handbook), whose title page stated:

> This handbook is designed to provide you with important information about your employment with [Taxpayer] and its affiliates . . . . Your employment is solely with [Taxpayer] and/or its affiliates.

Taxpayer points particularly to the next page, which states:

[5] Page 2, Taxpayer Petition for Correction of Assessment dated March 23, 2015.

Important Notice:

> . . . This Team Member Handbook represents the policies for [Taxpayer] and its subsidiaries, affiliates and related companies. Rather than use all company names throughout this handbook, you are notified that any reference to "the Company" or ["Taxpayer"] refers also to . . . [WA LLC], and any other affiliate or subsidiary of [Taxpayer]. Your employment is with the specific LLC, which is a subsidiary of [Taxpayer]. Each subsidiary is a separate legal entity. Utilization by the Company of a common handbook and a single payroll system does not change the fact that each [Taxpayer] restaurant is separately structured and operated.

(Emphasis added.)

ANALYSIS

Washington imposes the B&O tax on every person for the act or privilege of engaging in business activities in Washington. RCW 82.04.220. "[T]he legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state." *Impecoven v. Department of Rev.*, 120 Wn.2d 357, 841 P.2d 752 (1992). The tax is measured by applying particular rates against the value of products, gross proceeds of sale, or gross income of the business, as the case may be. RCW 82.04.220.

Gross income from providing payroll and benefits services, administrative services, and accounting services is generally taxable under the service and other activities classification measured by the "gross income of the business." RCW 82.04.290(2). "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business engaged in, without any deduction on account of any expense whatsoever paid or accrued. RCW 82.04.080. However, certain receipts are recognized as merely reimbursements for expenses advanced for a client, and not as income, and are excludable from gross income of the business. WAC 458-20-111 (Rule 111).

Rule 111 allows reimbursements to be excluded from gross income 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." Rule 111 has been interpreted as requiring that the taxpayer prove that the advance in question was made pursuant to an agency relationship, and prove that the taxpayer's liability to pay the advance constituted solely agent liability. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 561-62, 252 P.3d 885 (2011); *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 782 P.2d 986 (1989); *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002).

At issue in this appeal is whether Taxpayer has demonstrated that it had no liability to pay the employer obligations other than as an agent for the parent. Excise Tax Advisory 3181.2013 ("ETA 3181") addresses the application of Rule 111 to paymasters and employers of record, and provides guidance . . . in determining "when a taxpayer qualifies as a paymaster able to exclude

amounts received to pay the employer obligations of its clients from gross income."[6] ETA 3181 defines a "paymaster" as "generally . . . a person that acts as an agent for the purpose of paying the employer obligations of one or more clients." The term "employer obligations" includes employee salaries, benefits, payroll taxes, and similar obligations. *Id.*

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, 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.

If the elements of Rule 111 are not met:

> A taxpayer that does not satisfy all 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. In the present case, Taxpayer failed to establish it satisfies the third element -- that it had no liability except as [WA LLC's] agent:

> The taxpayer may have no liability to pay the employer obligations, except as the agent of the client. To meet this element, the taxpayer must:
>
> 1. Be a bona fide agent of the client; and
>
> 2. Have no liability to pay the employer obligations, except its agency liability.
>
> These requirements are discussed below.
>
> **1. The taxpayer must be a bona fide agent of the client.**
>
> Standard common law agency principles are used to determine whether an agency relationship exists. The essential requirements of common law agency are mutual consent and control. Therefore:
>
> - The client and the taxpayer must have consented to the taxpayer acting on behalf of and in accordance with the directions of the client; and

[6] RCW 82.04.43393, effective October 1, 2013, [also] provides a deduction from the measure of tax amounts that a qualified employer of record, engaged in providing paymaster services, receives from an affiliate to cover employee costs of a qualified employee [for periods beginning October 1, 2013].

- The taxpayer must be acting in some material degree under the direction and control of the client.

2. The taxpayer must have no liability to pay the employer obligations, except agency liability.

- The paymaster may not have any primary or secondary liability to the employees or to any other person, to pay the employer obligations.

- Secondary liability includes the liability of a surety or guarantor. It also includes any liability that does not arise until some event occurs ("conditional" liability).

- The paymaster may have only its agency liability, meaning the agent's liability to its principal (the client) to pay the employer obligations as directed.

Id. In the present case, Taxpayer was the employer of record, i.e., "the person who reports employees under its own UBI or EIN for state or federal tax, employment security, or insurance purposes." *Id.* Employers of record generally have primary or secondary liability to the employees to pay the employer obligations. However, with respect to employers of record, ETA 3181 provides a bright line test for satisfying the third requirement:

> An employer of record may have liability for certain employer obligations under common law and state and federal statutes. However, for purposes of this ETA, a taxpayer that is an employer of record will be deemed to satisfy this element when either:
>
> - Each employee agrees in writing that the paymaster has no liability to the employee to pay any employer obligation; or
>
> - In the case of a captive paymaster, the paymaster is a Form 2678 Agent for the clients under 26 USC Sec. 3504 and the employees are provided with written notice of the paymaster arrangement, including the client's status as employer liable to the employees for all employer obligations.

In the present case, Taxpayer is a captive paymaster, which is "a paymaster providing paymaster services to affiliates and not to unrelated persons." *Id.* Here, while Taxpayer did not confirm or deny that it was a Form 2678 Agent for [WA LLC] under 26 U.S.C. Sec. 3504, Taxpayer did assert that [WA LLC's] employees received written notification in its Handbook that there was a "single payroll system." The Handbook did not specifically advise employees that [WA LLC], as their employer, was liable to the employees for all employer obligations. Further, [WA LLC's]employees did not agree in writing that Taxpayer, as paymaster, had no liability to pay any employer obligation. We, therefore, conclude that Taxpayer did not prove it has no liability to pay the employer obligations, except agency liability. See Det. No. 14-0175, 34 WTD 210 (2015).

Because Taxpayer has failed to satisfy the third requirement, it is not necessary to discuss the other requirements of Rule 111.

We conclude that the amounts Taxpayer received from [WA LLC] are not reimbursements under Rule 111, and Taxpayer cannot exclude those amounts from the measure of its gross income liability. We sustain the assessment.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 10th day of March, 2016.