Cite as Det. No. 14-0175, 34 WTD 210 (2015)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Refund of	)	D E T E R M I N A T I O N
	)	
	)	No. 14-0175
. . .	)	
	)	Registration No. . . .
	)	

[1] RULE 111; RCW 82.04.080: B&O TAX – GROSS INCOME – ADVANCES AND REIMBURSEMENTS – PAYMASTERS AND EMPLOYERS OF RECORD. A captive paymaster failed to establish it had no liability to pay the employer obligations except as agent of its affiliates, under ETA 3181.2013. The taxpayer did not establish it was as Form 2678 Agent for the clients under 26 USC Sec. 3504, and the employees were not given notice of the client's status as the 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.

Chartoff, A.L.J. – An out of state corporation that provides payroll and benefits services to a parent corporation, and that reported wages in this state as the employer of record, protests the assessment of B&O tax under the services classification on estimated income, arguing amounts received for payroll and benefits are excluded reimbursements under WAC 458-20-111 (Rule 111). Because the taxpayer did not prove it has solely agent liability to pay the employer obligations, we conclude the amounts received are not excludible reimbursements. The petition is denied.[1]

ISSUE

Whether a corporation that provides payroll and benefit services to its parent corporation and is also the employer of record of the employees, has solely agent liability to pay the employer obligations, and therefore can exclude amounts received for the employees' payroll and benefit expenses from gross income under Rule 111.

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

FINDINGS OF FACT

The taxpayer, . . . , is a . . . Corporation engaged in providing employee payroll and benefits services, administrative services, accounting and other services to its parent-corporation, . . . , (Parent). The taxpayer's offices are located outside Washington State.

The Administrative Services Agreement (Agreement), dated December 8, 1993, provides that the taxpayer will provide the following services to the parent with respect to payroll and benefits:

> WHEREAS, [Parent] . . . desires to have the employee payroll, benefits services administration, tax and reporting functions and other general administrative services (collectively, the "Services") performed by the [taxpayer]. . . .
>
> WHEREAS, [Parent] shall provide the [taxpayer] with necessary information and data, as well as *direction and instruction* relating to the Services required by [Parent]
>
> In consideration for the Services, [Parent] shall pay the [taxpayer] a five (5%) percent mark-up on all expenses incurred to provide the Services . . .
>
> 1.2.1 Employee Payroll & Benefits Services. During the term of the agreement, the [taxpayer] shall provide the following employee payroll and benefits services and other general administrative services to [Parent]:
>
> > (a) General, administrative and managerial operations, and activities relating to employee payroll and benefits services;
> >
> > (b) Assistance with the supervision on both a short term and long term basis of employee payroll and benefits operations, including assistance and support in the planning of operations, the acquisition of equipment, software, the negotiation of related contracts and other operations;
> >
> > (d) Assistance in the selection, management and administration of employee benefit plans, including not but not limited to health welfare and retirement plans and benefits;
>
> 1.2.2 Administrative Services. During the term of the Agreement, the [taxpayer] shall provide the following administrative services to [Parent]:
>
> > (a) Assistance with the payment of payroll taxes and administration of employee benefit plans;

(Italics added).

From November 10, 2008 through August 16, 2012, the taxpayer reported to the Washington State Employment Security Department that it paid wages to one employee. The taxpayer provided copies of the offer letter, personnel action form, hiring requisition form, and I-9 Employment Eligibility Verification form related to that Washington employee. The documents

indicate that on November 10, 2008, Parent hired an employee for the position of Market Area Consultant, reporting to the Director of [Department]. The documents describe [Department] as a department of Parent. The employee was to work from a home office in Washington State, for a base salary of $. . . , plus commissions, benefits (401(k), medical, dental, life insurance, and disability), and expenses (home office allowance, mileage, hotel and meal allowances). The taxpayer also provided a termination statement indicating the employee was terminated on August 16, 2012.

The Audit Division (Audit) of the Department conducted a desk examination of the taxpayer to verify the taxpayer's business activities were properly reported on the taxpayer's excise tax returns. The audit period was January 1, 2009, through December 31, 2012. The examination did not include a detailed review of the taxpayer's accounting records. During the audit period, the taxpayer was registered with the Department and on active non-reporting status.

Audit found that the taxpayer was the employer of record of the Washington employee, and that the wages paid to this employee were more than $50,000 per year for each year of the audit period. Because employers of record have liability for employer obligation under common law and statute and federal statutes, Audit concluded taxpayer's liability for payment of wages and benefits was not solely agent liability. Audit also found it was unclear who was responsible for and had control over the employee. Therefore, Audit reasoned it was not possible to accurately determine who was ultimately liable for the employer obligations and whether the taxpayer was acting merely as an agent or paymaster.

Audit concluded that the taxpayer owed Service B&O tax on amounts received from the parent for all expenses incurred to provide the Services plus a 5% markup. Audit estimated the taxpayer's gross income by taking the wages taxpayer reported to Employment Security loaded at 20% to cover all related payroll costs as well as the 5% management fee. Audit assessed $. . . consisting in most part of $. . . service B&O tax, plus small business credit, penalties and interest.

The taxpayer petitioned for correction of the assessment, asserting Parent is the employer, and that the taxpayer paid wages solely as an agent of Parent. The taxpayer argues that the Agreement demonstrates the taxpayer provided payroll services for the Parent, under the Parent's "direction and instruction." The taxpayer argues this language demonstrates the taxpayer was an agent of the Parent. Furthermore, the taxpayer argues the employment records demonstrate that Parent was the controlling employer of the employee. Thus the taxpayer argues that it had solely agent liability to pay the employee, and amounts received for employee payroll and benefits were excludible from the taxpayer's gross income under Rule 111.

Taxpayer also asserts that since the amounts received for payroll and benefits are excluded from gross income, the taxpayer does not have nexus with Washington under any of the nexus thresholds in WAC 458-20-19401.

During the hearing, the taxpayer stated it did not know whether it was appointed a Form 2678 Agent under 26 U.S.C. Sec. 3504. The taxpayer was given additional time to obtain the information, but did [not] provide it.

We note that the taxpayer does not assert that it qualifies for the deduction for Professional Employer Organizations under RCW 82.04.540. Therefore, this determination does not address whether the taxpayer qualifies for the deduction. We also note that for periods beginning on or after October 1, 2013, RCW 82.04.43393 allows a deduction for amounts received by a qualified employer of record providing paymaster services to an affiliated business to cover employee costs of a qualified employee. Because this deduction does not apply to the audit period, and because the taxpayer terminated the Washington employee, this determination does not address whether the taxpayer qualifies for the deduction.

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 the 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." 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.
>
> 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.

In the present case, the taxpayer failed to establish it satisfies the third requirement, that the taxpayer has no liability to pay the employer obligations, except as the agent of Parent. ETA 3181 explains the third requirement, as follows:

> 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
>
> - 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.

In the present case, the taxpayer is the employer of record, which is "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, the taxpayer is a captive paymaster, which is "a paymaster providing paymaster services to affiliates and not to unrelated persons." *Id.* Here, the taxpayer would not confirm or deny whether it was a Form 2678 Agent for the Parent under 26 U.S.C. Sec. 3504. Also, the taxpayer did not assert that employees receive written notice of the paymaster arrangement, including the client's status as employer liable to the employees for all employer obligations. We therefore conclude that the taxpayer did not prove it has no liability to pay the employer obligations, except agency liability. Because the taxpayer has failed to satisfy the third requirement, it is not necessary to discuss the other requirements of Rule 111 at this time.

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

Taxpayer's petition is denied.

Dated this 3rd day of June 2014.