

Cite as Det. No. 16-0052, 35 WTD 589 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of)	<u>D E T E R M I N A T I O N</u>
Assessment of)	
)	No. 16-0052
)	
...)	Registration No. ...
)	

RULE 111: SERVICE B&O TAX - ADVANCES AND REIMBURSEMENTS.
Taxpayer may not exclude from taxable gross income the funds it receives for providing legal services to the parent.

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.

Lewis, A.L.J. – A firm that provides legal services to a parent petitions for correction of an assessment of business and occupation (B&O) tax on payments received as personnel expense reimbursements from its parent on the grounds that the employees were employed by the parent company. . . . Taxpayer’s petition is denied.¹

ISSUES:

Whether a firm that provided legal services is entitled to exclude from the measure of the B&O tax amounts received from a parent company as reimbursement for personnel expenses, under the provisions of WAC 458-20-111 (“Rule 111”), because such amounts are not “gross income of the business” as defined in RCW 82.04.080.

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FINDINGS OF FACT:

[LLC] is in the business of forming limited investment partnerships (“Funds”) with investment partners (“Investors”). The Funds acquire and own patents. Funds have two types of investors: strategic and financial investors. Strategic investors not only invest in Funds, but are also licensees of the intellectual property and directly benefit from the license rights. Typically, strategic investors are multinational entities that have business activities and offices located throughout the United States and in numerous countries. Financial investors are strictly investors in the Funds and are primarily made up of individuals, universities, and private equity companies, which are located throughout the United States.

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

Affiliates of [LLC] serve as general partners of the Funds, and each Fund is governed by a limited partnership agreement appointing [LLC] as a manager that is responsible for performing patent and related services. For business reasons, Taxpayer was formed by [LLC] to act as an employer of record for [LLC's] employees who provide certain intellectual property services.

Taxpayer's records separately categorized the services and allocated the approximate percentage of employees' efforts with respect to each category for payroll and workers' compensation reporting purposes. All of the categories of services are integrated and inter-dependent, as employees performed a single business activity under the umbrella of patent management services.

Taxpayer's employees of record are located and performed services from [out-of-state] and Washington. Most of the patent services were performed from [LLC's] offices located within Washington. The employees in Washington perform the following services:

- **Patent Acquisition (28% of the services performed):** The acquisitions group worked with companies and inventors during their invention process so the Funds ultimately acquired ownership of invention rights. Employees were responsible for identifying technologies that had small economic values at the time, but which would have significant future value. To create future value for acquired ownership rights, employees identified "core" technologies, evaluated what inventions were consistent with various goals of the Funds, and negotiated and closed patent acquisition.
- **Patent Intake & Contract Management (26% of the services performed):** The patent intake and control management group performed due diligence related to patent acquisitions. Specifically, employees were responsible for classifying invention rights, reviewing publicly available information about inventions, examining invention ownership histories, and detecting any existing encumbrances and licenses related to the invention assets.
- **Patent Prosecution (20% of the services performed):** The patent prosecution group was responsible for all services leading to the granting of a patent to the Funds and protecting their patent rights with respect to patent offices. Employees prepared and filed patent applications and performed post-filing services, including patent office negotiations, patent prosecutions, and additional acquisition due diligence.
- **Patent Licensing (21% of the services performed):** The patent licensing group was responsible for the selling and licensing of patents. The licensing group also performs factual and legal analysis concerning the viability of the Funds' patent infringement claims against third parties.
- **Litigation (5% of the services performed):** The litigation group performed litigation and related legal services to protect the Funds' patented invention rights. Among other things, the group pursued and litigated patent infringement claims against third parties, and represented the Funds in court and settlement negotiations. In many cases, settlement

negotiations would lead to adversaries becoming investors of the Funds, thus obtaining the right to use the Funds' patents.

Taxpayer and [LLC] operate under a law firm engagement agreement. The August 2006 Agreement, provided by Taxpayer, states in pertinent part:

1. **Representation and Results.** [Taxpayer] will be situated on-site with [LLC] at one or more locations, and will represent [LLC] at [LLC's] request on matters related to managing and administering certain intellectual property investment funds... subject to any conflicts of interest and [Taxpayer's] obligation to comply with applicable rules and professional responsibility. [Taxpayer] will be 100% dedicated to representing [LLC], unless authorized in writing to represent other parties unrelated to the business of [LLC]. With respect to results, [LLC] acknowledges that [Taxpayer] can make no guaranty of successful results from its representation; however, [Taxpayer] will diligently perform legal services on [LLC's] behalf and with [LLC's] full cooperation, and will handle each matter in accordance with its obligations under the applicable rules of professional conduct.
2. **Fees, Costs, and Expenses.** [LLC] will reimburse [Taxpayer] for 100% of [Taxpayer's] operating costs incurred representing [LLC], including without limitation, employee compensation and benefits, firm management fees, office rent, equipment costs, human resources, liability and other insurance, communications and IT costs, taxes and assessments, necessary third party vendor fees, professional licenses and memberships, mandatory professional education, and reasonable travel expenses. [Taxpayer] will use reasonable efforts to notify [LLC's] Finance department of any and all anticipated new and substantial costs and expenses prior to incurring the same.
3. **Periodic Statements; Payment Terms.** [Taxpayer] generally will render to [LLC] invoices for fees, costs and expenses at reasonable intervals, including once each month for routine vendor expenses, every two weeks for payroll and certain consulting fees, and otherwise on an as needed basis for new, substantial or immune expenses. Statements will be rendered to [LLC] indicating fees and costs incurred to the date indicated on each invoice. [LLC] will pay [Taxpayer] net five (5) business days, except for invoices related to [Taxpayer] payroll, which [LLC] will pay no less than one day net of [Taxpayer's] invoice.
4. **[Taxpayer] Employee Benefit Rights and [LLC] Infrastructure Obligations.** Without limiting the requirements of Paragraph 1 above, [LLC] shall reimburse [Taxpayer] for the following employee benefits and office infrastructure:

Employee Benefits. [LLC] shall reimburse [Taxpayer] for employee benefits that are comparable to the employee benefits received by comparable employees of [LLC], provided that if the preceding is not commercially reasonable, [LLC] shall reimburse [Taxpayer] for employee benefits for all its employees. Compensation adjustments and bonuses for employees and managers of [Taxpayer] shall be pursuant to the same general performance review, adjustment and bonus process

[LLC] uses for [LLC] and for other third party entities providing services to [LLC] from on-site locations

The paymaster account was formed as a unified source for payment of shared expenses of [LLC] and Taxpayer. The shared expenses are paid from money deposited into the paymaster account by [LLC]. Specifically, after deposits are made into the paymaster account by [LLC], the payroll payments are made to employees and employment related creditors. The payroll payments included salaries for employees that performed patent services, employee benefits, and related payroll expenses like taxes and attorney employees' state licensing fees. For insurance and tax purposes, Taxpayer served as the employees' employer of record, but does not receive or profit from any of the payroll payments.

The Audit Division audited Taxpayer's books and records for the period January 1, 2010, through December 31, 2012. On December 4, 2014, the Department issued a \$. . . assessment.²

During the audit period, the payments Taxpayer received for employee wages were treated as a tax-exempt pass-through and were not reported. Thus, Taxpayer only reported the fee income.

The Audit Division concluded that the total payments that Taxpayer received were for providing professional services and subject to tax. Accordingly, Taxpayer assessed B&O tax on the total payment received.

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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 activities were performed with the object of gain and thus constituted engaging in business. The correct tax reporting classification is determined by the business activity performed. Income derived from providing legal services is subject to the service and other B&O tax classification. RCW 82.04.290.

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

² The \$. . . assessment consisted of \$. . . service & other activities B&O tax, \$. . . interest, and \$. . . assessment penalty.

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 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). Thus, if the funds received from [LLC] are found to be part of Taxpayer's gross income, the cost of labor cannot be deducted from the measure of tax.

Under Washington law, 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 relief Taxpayer requests requires a finding that Taxpayer's only liability for payment of the employees was as the agent of [LLC]. In *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002) the Court stated that once an agency relationship has been established, an inquiry must be made into whether the taxpayer's liability to pay "constituted solely agent liability." The Court went on to explain that if a taxpayer assumes any liability beyond that of an agent, the payments it receives are not tax exempt "pass through" payments.

Following the Court's ruling in *William Rogers*, on December 28, 2009, the Department issued Excise Tax Advisory 3100.2009 ("ETA 3100"). ETA 3100 states:

In order to exclude these payments from the measure of tax, the Washington State Supreme Court has ruled that two conditions be met. The taxpayer must first establish that it received the funds as the agent of the customer or client. If this first condition is satisfied, the taxpayer must also establish that its use of the funds to pay a third party is solely as an agent of the customer or client. *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002).

ETA 3100 also provides direction in determining whether a staffing company is acting as an agent of its client. ETA 3100 explains:

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.

Thus, 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 “pass-through” payments. In such a case, the taxpayer is considered to be engaged in the business of providing employee laborers (i.e., a staffing company), leasing employees, or selling the services performed by the employees. As such, the taxpayer 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.

While issued outside Taxpayer’s audit period, on September 27, 2013, the Department issued Excise Tax Advisory 3181.2013 (“ETA 3181”) to give additional guidance in determining when a taxpayer that is the employer of record of workers is engaged in the business of selling labor or services provided by its own employees. ETA 3181 explains that when the taxpayer is the employer of record, the taxpayer is presumed to be the employer with liability for the employer obligations. ETA 3181 provides in part:³

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.

- 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:

³ We note that RCW 82.04.43393, which prompted the issuance of ETA 3181 is not retroactive.

- 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).

Example: Taxpayer is the employer of record for employees that perform services for Taxpayer's affiliate, A. Affiliate A has significant control over the employees, determining and supervising activities, with general hiring and firing authority. By agreement with A, Taxpayer may reject or ratify certain hiring decisions and determines all employee compensation and benefit levels.

Under these facts, Taxpayer does not qualify as a paymaster entitled to exclude payments received from A to cover employer obligations because Taxpayer, as the employer of record, is presumed to be the employer liable for all employer obligations. This presumption is not rebutted when Taxpayer has significant control over the employee, such as decisions over hiring and employee compensation and benefit levels. Thus, Taxpayer cannot establish the first element, that the payments from A are customary reimbursements or advances to pay employer obligations of the client.

ETA 3181 makes clear that a taxpayer seeking a tax deduction, exception, or exemption 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 is the employer of record and presumed to be the employer of the workers. While Taxpayer maintains it only acts as a pay-rolling agent, the Agreement between Taxpayer and [LLC] indicates that Taxpayer is responsible for providing professional services, not just paying employees that are controlled by [LLC]. Specifically:

Representation and Results: Taxpayer is hired to "perform legal services on [LLC's] behalf and with [LLC's] cooperation...."

Fees, Cost, and Expenses. "[LLC] will reimburse [Taxpayer] for 100% of [Taxpayer's] operating costs incurred representing [LLC], including without limitation, employee compensation and benefits, firm management fees, office rent, equipment costs, human resources, liability and other insurance, communications and IT costs, taxes and assessments, necessary third party vendor fees, professional licenses and memberships, mandatory professional education, and reasonable travel expenses. [Taxpayer] will use reasonable efforts to notify [LLC's] Finance department of any and all anticipated new

and substantial costs and expenses prior to incurring the same.” This describes representation on a cost plus basis, rather than [LLC providing the services for itself].

Taxpayer was formed to provide legal services for [LLC]. It has liability for the workers. Taxpayer functions like a law firm. Taxpayer has failed to meet the requirements set [forth] in the ETA [or in Rule 111] to allow [exclusion of income from the B&O tax as a mere payrolling agent]. Accordingly, we sustain the Audit Division’s conclusion that the payments for employee costs, which Taxpayer receives, are taxable.

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DECISION AND DISPOSITION:

Taxpayer’s petition is denied.

Dated this 4th day of February 2016.