

Cite as Det. No. 17-0302, 38 WTD 212 (2019)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 17-0302
)	
... )	Registration No. . . .
)	

[1] RULE 111; RCW 82.04.080: GROSS INCOME – EXCLUSIONS – PAYMASTER REIMBURSEMENTS – LIABILITY TO PAY EMPLOYEES. A paymaster may exclude amounts received to pay a client’s employer obligations only where, among other requirements, the paymaster has no liability to pay the employer obligations, except as a bona fide agent of the client. A paymaster that is an employer of record satisfies this element when either: (1) each employee agrees in writing that the paymaster has no liability to the employee to pay any employer obligation; or (2) in the case of a captive paymaster, the paymaster is a Form 2678 Agent for the client under 26 USC Sec. 3504 and the employees are provided with written notice of the paymaster arrangement, including the client’s status as the employer liable to the employees for all employer obligations.

[2] RCW 82.04.43393: B&O TAX DEDUCTIONS – CAPTIVE PAYMASTERS. To qualify for the captive paymaster deduction, a taxpayer must, among other requirements, establish that it is a qualified employer of record by showing that it has (1) no functional employment relationship with a qualified employee; and (2) no contractual liability with a qualified employee for the employee costs.

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.

Yonker, T.R.O. – A payroll processing services provider (Taxpayer) protests the assessment of service and other activities business and occupation (B&O) tax on amounts that Taxpayer claims are excluded from the measure of B&O tax. For a part of the relevant time period, Taxpayer also claims it is eligible to deduct those same amounts from its gross income. We deny the petition.<sup>1</sup>

---

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

## ISSUE

1. Whether Taxpayer has shown that it does not have any gross income under RCW 82.04.080, as a result of all amounts being excluded from gross income pursuant to WAC 458-20-111.
2. If Taxpayer does have gross income, whether Taxpayer has shown that it qualifies for the B&O tax deduction in RCW 82.04.43393 for amounts received after the effective date of that statute.

## FINDINGS OF FACT

. . . (Taxpayer) is [an out-of-state] corporation that provides payroll processing services to affiliated companies (Affiliated Companies). Taxpayer and all of the Affiliated Companies are part of the . . . family of companies.<sup>2</sup> Taxpayer performs its payroll processing services from its headquarters [out-of-state]. Taxpayer does not have any offices in Washington, but does process payroll for the Affiliated Companies' approximately 35 employees located in Washington. Taxpayer has historically reported those employees under its own Unified Business Identifier (UBI) when filing quarterly unemployment and industrial insurance reports with Washington.

Taxpayer represented that it does not have any written contracts memorializing the terms of the services that it provides to the Affiliated Companies. Taxpayer characterized the arrangement between it and the Affiliated Companies as "one-hundred percent pass through," and represented that it retains no portion of the money that passes from the Affiliated Companies through Taxpayer and then on to the individual employees employed by Affiliated Companies. Taxpayer did not report any income to Washington prior to the Department contacting it.

In 2013, the Department's Audit Division commenced a review of Taxpayer's books and records. The Audit Division initially delayed the review, and then resumed it in 2015. The Audit Division's revised review period was from January 1, 2012, through June 30, 2015 (audit period). During the audit, Taxpayer provided the Audit Division with federal income tax returns, trial balances, wages paid to employees based in Washington, a sample of four offer letters to new employees, two background check invoices, and a worker's compensation certificate. Taxpayer also provided the Audit Division with the . . . Employee Handbook (Handbook). The Handbook does not mention the arrangement Taxpayer has with the Affiliated Companies through which Taxpayer provides payroll processing services to the Affiliated Companies. The Handbook references the "Company" when referring to the . . . family of companies, and does not distinguish between Taxpayer or any of the Affiliated Companies.

Finally, Taxpayer provided the Audit Division with a signed, undated memorandum (Memorandum) between an employee and itself, which stated:

The purpose of the Memorandum is to provide you, the employee, with written notice of a common paymaster/agent arrangement utilized by [the family of Affiliated Companies]. Please note the term "common paymaster" is used interchangeably with "common pay agent" in certain states.

---

<sup>2</sup> The Affiliated Companies include . . .

Common paymaster status is an arrangement whereby an entity is designated as the employer of record for payroll tax and wage reporting purposes. This status requires approval by the IRS and is covered under 26 USC Sec. 3504. Once approved, the paymaster is granted the authority to file returns, make payments and provide statements to employees on behalf of designated functional employers. Forms include pay statements, W-2s and 1099s.

For purposes of this Memorandum, a functional employer has all control over the work schedule and activities of the employees as well as control over all employment decision such as salary, discipline, hiring or layoffs.

[Taxpayer] is the approved paymaster for your functional employer. Accordingly, you receive wage and tax statements, which identify [Taxpayer] as the employer of record.

Please note that [Taxpayer] does have a fiduciary responsibility to withhold taxes as wages are paid to remit the withheld taxes to proper taxing authorities. It is our obligation to notify you that [Taxpayer] bears no liability for employer obligations other than as agent; and, upon instances of non-payment of wages, the liability for the unpaid wages belongs to the functional employer for which you perform services.

Taxpayer did not provide the Audit Division with copies of this document for any other employees.

Through reviewing these records, the Audit Division found that Taxpayer was a payroll processing company providing payroll services to the Affiliated Companies. In order to determine whether Taxpayer was eligible for any Washington B&O tax exclusions or deductions, the Audit Division requested certain other records from Taxpayer. These records included which entity handled filing federal W-2 Forms, FICA tax information, FUTA tax information, IRS Form 8655, IRS Form 2678, and any other documentation that would indicate an agency relationship between Taxpayer and the Affiliated Companies. Taxpayer did not provide any of this documentation to the Audit Division.

Based on the available information, the Audit Division found that Taxpayer was not eligible to exclude or deduct amounts it received from the Affiliated Companies from its gross income because Taxpayer had not shown it was not liable to pay wages, benefits, etc. The Audit Division assessed service and other activities B&O tax on the full amount of wages reported to Washington during the audit period plus an additional estimated amount for attributed non-wage income. On November 30, 2016, the Audit Division issued Taxpayer a tax assessment for \$ . . . , which included \$ . . . in service and other activities B&O tax, a delinquent penalty of \$ . . . , a five-percent assessment penalty of \$ . . . , and \$ . . . in interest.

Taxpayer subsequently requested review of the full amount of the tax assessment. Taxpayer asserts that it was not compensated for providing its payroll processing services to the Affiliated Companies, and, therefore, any amounts it received were not part of its gross income. On review, Taxpayer provided a sample of ten offer letters issued by the Affiliated Companies to individual employees. While the letters contain different language, none of them mention Taxpayer. Most

of the offer letters contain language referencing the hiring Affiliated Company as the “Company,” similar to the Handbook.

## 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. Dep’t of Revenue*, 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. Thus, generally, a taxpayer providing payroll and benefits services will be liable for service and other activities B&O tax on the full amount of “value proceeding” from that taxpayer’s business activity, unless some specific deduction, exemption, or exclusion applies.

### 1. Taxpayer Does Not Qualify for the Rule 111 Exclusion

We have historically recognized certain receipts as merely advances or reimbursements for expenses, and not as income, and allowed such receipts to be excluded from gross income of the business. *See* WAC 458-20-111 (Rule 111). As we explained in Determination No. 14-0175, 34 WTD 210 (2015), Rule 111 allows “paymaster 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.” The Washington Supreme Court has interpreted Rule 111 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).

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.

Because we find it dispositive in this case, we will focus on the third requirement. ETA 3181 explains the third requirement further, 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.

...

### **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, it is undisputed that Taxpayer is the “employer of record,” which means “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 are presumed to have liability to the employees to pay the employer obligations. *Id.* However, ETA 3181 provides two alternative tests for an “employer of record” to satisfy 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.**

(Emphasis added.) Regarding the first test, Taxpayer has only provided one copy of a memorandum to one employee where the employee agreed in writing that Taxpayer had no liability to it to pay the employer’s obligations. Since this memorandum is undated, we cannot determine if it was executed during the audit period. Even assuming it was properly executed during the audit period, Taxpayer must show that “each” employee agreed in writing that Taxpayer has no liability to the employee to pay any employer obligations. Taxpayer has not done this, and, therefore, has failed to satisfy the first test under ETA 3181.

Regarding the second test, there is no dispute that if Taxpayer was a paymaster, it was a “captive” paymaster, meaning it was “a paymaster providing paymaster services to affiliates and not to unrelated persons.” *Id.* However, Taxpayer has neither (1) provided a Form 2678 nor (2) provided any evidence that more than potentially one employee was provided written notice of the paymaster arrangement whether through the Handbook or elsewhere. The Handbook does not mention the arrangement Taxpayer has with the Affiliated Companies, and the Handbook only references the “Company” when referring to the . . . family of companies, not distinguishing between Taxpayer or any of the other Affiliated Companies. Therefore, Taxpayer fails on the second test.

Because Taxpayer has failed to satisfy either test available to “captive” paymasters in ETA 3181, it, therefore, fails to satisfy the third requirement of Rule 111. Accordingly, we need not address the other Rule 111 requirements. We conclude that the amounts Taxpayer received from its affiliates do not qualify as reimbursements under Rule 111, and thus may not be excluded from the measure of its gross income liability under RCW 82.04.080. Thus, we deny Taxpayer’s petition on this issue.

## 2. Taxpayer Does Not Qualify for the Paymaster Deduction

Effective October 1, 2013, RCW 82.04.43393 provides a statutory deduction for “captive paymasters.” RCW 82.04.43393(1) states, in pertinent part:

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 for 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.

. . . The Department issued Excise Tax Advisory 3196.2015 (ETA 3196) on May 1, 2015, regarding the paymaster deduction in RCW 82.04.43393. ETA 3196 explains:

To qualify [for the RCW 82.04.43393 deduction], the following requirements must be met:

1. The taxpayer must be a qualified employer of record;
2. The taxpayer must be providing paymaster services;
3. The paymaster services must be provided to an affiliated business only; and
4. The amounts must be paid to cover costs of a qualified employee.

Regarding the first requirement, “qualified employer of record” is defined in RCW 82.04.43393(2)(f) as a person that:

1. Has no functional employment relationship with a qualified employee; and
2. Has no contractual liability with a qualified employee for the employee costs. A qualified employer of record may have statutory or common law liability to the qualified employees or to third parties for employee costs.

“Functional employment relationship” is defined in RCW 82.04.43393(2)(c) as “having control over the work schedule and activities of the employees and control over the all employment decisions such as salary, discipline, hiring, and layoffs.” In addition, “qualified employee” is defined in RCW 82.04.43393(2)(e) as “an employee with whom the affiliated business has a functional employment relationship. Neither the employer of record, nor any other affiliate, may have a functional employment relationship with the employee.”

As mentioned above, taxpayers bear the burden of showing that they qualify for a tax deduction. *Budget Rent-A-Car*, 81 Wn.2d 171. Further, taxpayers are required to maintain suitable records as may be necessary for the Department to determine a person’s tax liability. RCW 82.32.070.

Here, Taxpayer has not provided sufficient evidence for us to determine that it had no “functional employment relationship” with a “qualified employee.” First, the only evidence that Taxpayer has provided to this effect is the Memorandum. As we do not know when the Memorandum was effective, we conclude that the probative value of that document is very low. Further, the Handbook is silent as to the degree of control over employees that the “Company” has. Finally, the offer letters, like the Handbook, reference employment with the “Company,” and give the impression that the . . . family is the collective employer of the employees.

As Taxpayer has not provided any other evidence regarding which entity had control over all employment decisions of employees of the various Affiliated Companies in Washington, Taxpayer has failed to show that it did not have a “functional employment relationship” with a “qualified employee.” Thus, since Taxpayer has failed on the first requirement needed to qualify for the deduction in RCW 82.04.43393, we need not address the remaining three requirements, and we deny its petition on this issue.

DECISION AND DISPOSITION

We deny Taxpayer's petition.

Dated this 14th day of December 2017.