Cite as Det. No. 91-211, 11 WTD 395 (1992).

BEFORE THE INTERPRETATION AND 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. 91-211
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
("Taxpayer I")	)	
and	)	
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .
("Taxpayer II")	)	

[1] MISCELLANEOUS - BUSINESS AND OCCUPATION TAX - INCOME SHIFTING - AGREEMENT. There is no provision in the Revenue Act whereby multiple taxpayers can agree to shift income from one to another. A taxpayer will be taxed on its own "gross income of the business" as earned by its own activities. No income shifting between taxpayers -by agreement or otherwise - will be permitted or recognized for tax purposes.

[2] RULE 111 - REIMBURSEMENTS - EMPLOYEES - SALARIES - AFFILIATES. When a taxpayer has contractual employees over whom it exercises control, and it arranges for them to work part-time for an affiliate, it cannot claim to be acting merely as an agent of its affiliate in paying them. Thus, the Rule 111 exclusion will be inapplicable for reimbursement by the affiliate for payroll expenses. Accord: Rho Company, Inc. v. Department of Rev., 113 Wn.2d 561 (1989); Det. No. 91-062, 10 WTD 417 (1991); Det. No. 88-28, 5 WTD 67 (1988).

[3] RULE 111 - REIMBURSEMENTS - OVERHEAD EXPENSES - AFFILIATES. When a taxpayer is primarily or secondarily liable - other than as an agent - for the costs of services contracted for, reimbursement by an

affiliate is not excludable under Rule 111. Taxpayer was liable other than as an agent for payment of the overhead expenses at issue when taxpayer contracted for these services with no representation of agency, in part enjoyed these services, and was the entity to whom the service providers looked for payment. Accord: Professional Promotion Services, Inc., v. Department of Rev., Docket No. 36912 (Board of Tax Appeals 1990).

[4] RULE 258: BUSINESS AND OCCUPATION TAX - TRAVEL AGENTS AND TOUR OPERATORS - SALE OF PRE-PACKAGED TOURS -"AT RISK." When a taxpayer sells pre-packaged tours put together by someone else who is "at risk" for charges by third party providers, the taxpayer will be taxed like a travel agent under the special travel agent rate when (1) it is paid like a travel agent by way of commissions or internal discounts, and (2) will not be "at risk" for payment to third party providers if travellers cancel their journeys.

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.

TAXPAYER REPRESENTED BY: . . .
. . .

NATURE OF ACTION:

Petition concerning the taxability of two affiliated travel agencies.

FACTS:

Bauer, A.L.J.-- Taxpayer I's business records were examined for the period January 1, 1982 to March 31, 1986. The above-referenced assessment was issued [in October 1986] in the amount of $ . . . , which amount included interest.

Taxpayer II's business records were examined for the period March 1, 1983 through March 31, 1986. The above-referenced assessment was issued [in October 1986] in the amount of $ . . . , which amount included interest.

The taxpayers shared the same facility; Taxpayer I was downstairs, and Taxpayer II was upstairs.

The owners of both corporate taxpayers first operated one travel agency. Taxpayer I was incorporated in September 1979, opened for business in October 1979, and registered with the Department in February 1980. The owners concentrated on the East . . . because they were familiar with that area of the world. Because Taxpayer I was able to develop a high volume of travel, it was able to develop profitable contracts with [an airline]. Although Taxpayer I handled individual travelers, a special department was set up to handle group bookings.

In 1983 the owners separately incorporated and registered the department of Taxpayer I which had been handling the group bookings. This resulted in a second corporate entity, Taxpayer II. The owners, however, had little skill in accounting and continued to maintain one set of books for both corporate entities. They persisted in treating Taxpayer II as a department of Taxpayer I even though it had been separately incorporated. All expenses attributable to both taxpayers were still invoiced to and paid by Taxpayer I.

A joint operating agreement drafted in July of 1984 provided that both taxpayers would allocate their joint revenues and expenses at the end of the year. Income would be allocated 26% to Taxpayer I and 74% to Taxpayer II, which allocation was based on actual commission revenue. The salaries of the employees except for two were also to be allocated on a 26%/74% basis.[1] Interest expense was to be allocated on the basis of gross ticket sales - 66% to Taxpayer I and 34% to Taxpayer II. All other expenses were to be allocated 26% to Taxpayer I and 74% to Taxpayer II. The memorandum does not address whether this was an allocation agreement for all times, or just for 1984.

The Employment Security and Labor and Industries Departments' records indicated to the auditor that all employees worked for Taxpayer I.

In reporting its state excise taxes, the majority of net income from Taxpayer II was reported monthly on Taxpayer I's tax return. The auditor realigned this income to the appropriate taxpayer. Because all expenses were billed to Taxpayer I, and because the expense allocation method was made on an estimated vs. actual basis, the auditor assessed Taxpayer I with Service-Other tax on those expense amounts allocated to Taxpayer II.

Taxpayer II marketed packaged tours to the Far East, which tours included transportation, hotel accommodations, sightseeing

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[1] One employee's salary was to be allocated 75% to Taxpayer I and 25% to Taxpayer II. The second employee's salary was to be allocated 50% to each. These allocations, as for the remaining employees, were supposed to be based upon staff time actually spent on each company's business.

excursions, etc. Taxpayer II offered these packaged tours both to the general public and also to other travel agencies on a discounted or commission basis. Taxpayer II would acquire these tours from third party tour providers at a discounted or commissioned rate.

If customers (travellers) cancelled their trips, they would normally be charged a cancellation fee and Taxpayer II would cancel its purchase of the tour. Thus, it would not be liable for the cost of either the tour or its individual components.
The taxpayers' representative at the hearing explained that the Taxpayer II would be dissolved and again become a Department of Taxpayer I.

TAXPAYERS' EXCEPTIONS:

1. Reallocation of Revenues. The taxpayers protest the amount of gross revenues reallocated from Taxpayer I to Taxpayer II. The taxpayers have submitted a copy of a memorandum of agreement between the two of them under which Taxpayer II would be entitled to 26% of total gross income regardless of the sales or commissions actually generated by each other. The auditor based his reallocation on the taxpayers' own worksheets of sales and commissions. The taxpayers wish the reallocation to be accomplished on the basis of its own internal agreement.

2. Reallocation of Payroll Expenses. Taxpayer I protests the imposition of Service tax on its reallocation of payroll[2] expenses to Taxpayer II (Schedule III). It alleges that this is an agency advance/reimbursement situation in all cases, or, in the alternative, a cost-sharing arrangement. Taxpayer I contends that all employees actually worked for both corporations on an as-needed basis, that it was not in the "business" of providing services, and that the journal entries didn't increase income, but merely reduced its expenses.

3. Reallocation of Overhead Expenses. Taxpayer I similarly protests the imposition of Service tax on its reallocation of administrative (overhead) expenses[3] to Taxpayer II (Schedule

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[2] Payroll expenses were approximately $ . . . .

[3] Most expenses related to overhead items: advertising, bank charges, entertainment, computer expenses, telephone/telex, rent, insurance. All of these were broken down by percentage; no individual expenses were actually attributed to one or the other taxpayer.

III). It alleges that this is an agency advance/reimbursement situation in all cases, or, in the alternative, a cost-sharing arrangement.

3. Denial of "Travel Agent" rate. Taxpayer II protests the imposition of Service business and occupation tax on its gross receipts from its sales of pre-packaged tours. The taxpayer contests the Department's conclusion that it was "at risk" since, if the customer/traveller cancelled, Taxpayer II merely cancelled its order, too. Taxpayer II points out that the tours were not its own exclusive offerings. The brochures describing the various tours had been issued by the original tour promotor and were overprinted with the Taxpayer's name so that it appeared that it was its own offering (the taxpayer presented the same brochures overprinted with other agencies' names). The customer/traveller would have paid the same for a particular tour no matter who it was purchased from, since the agencies and tour promoters worked on an internal discount or commission basis.

DISCUSSION:

The issues will be discussed in the order presented above:

1. Reallocation of Revenues. The taxpayers argue that the Department should be bound by the taxpayers' own internal agreement
allocating income. We disagree.

The business and occupation tax is an excise tax imposed on taxpayers for the privilege of doing business in this state. The tax measure - generally, the "gross income of the business" - measures the degree of business activity a taxpayer has conducted in this state. See RCW 82.04.080. Thus, the "gross income of the business" serves first as a measure of a taxpayer's activity, and then as a tax measure.

[1] There is no provision in the Revenue Act whereby multiple taxpayers can agree to shift income from one to another. A taxpayer will be taxed on its own "gross income of the business" as earned by its own activities. No income shifting between taxpayers - by agreement or otherwise - will be permitted or recognized for tax purposes.

Thus, the taxpayer's petition as to this issue is denied.

2. Reallocation of Payroll Expenses. RCW 82.04.220 imposes a business and occupation tax on the "gross income of a business." For the purposes of the service business and occupation tax, RCW 82.04.080 defines "gross income of a business" to include

> the value proceeding or accruing by reason of the transaction of the business without any deduction on account of the expenses of the business.

WAC 458-20-203 (Rule 203) further provides that each separately-organized corporation is a "person" within the meaning of the law, notwithstanding its affiliation with or relation to any other corporation through stock ownership by a parent corporation or by the same group of individuals. Thus, administrative and personnel charges between affiliated corporations are normally subject to business and occupation tax under the service classification.[4]

In this case, the employees whose payroll is at issue were employees of Taxpayer I whose duties were to provide services to mutually benefit both Taxpayer I and Taxpayer II. The employees were paid by Taxpayer I, after which adjusting entries were made in the taxpayers' books to reflect "payment" by Taxpayer II to Taxpayer I for those employee services.

Similarly, overhead expenses benefitting both Taxpayer I and Taxpayer II, both separately and together, were ordered and paid for by Taxpayer I. Adjustments were made in the taxpayers' books to reflect "payment" to Taxpayer I by Taxpayer II.

The taxpayers characterize these payments as reimbursements from Taxpayer II excludable from Taxpayer I's gross income under WAC 458-20-111 (Rule 111).

Rule 111 provides an exclusion from gross income for

> amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.

Rule 111 limits the applicability of the exclusion to cases where the taxpayer being "reimbursed" was not liable for making the payment except as an agent, stating:

> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of fees or costs <u>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.</u> (Emphasis added.)

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[4] ETB 90.04.203 (. . .)

The critical issue, then, is whether or not Taxpayer I was acting only as an Taxpayer II's agent in paying the employees and in contracting and paying for the overhead expenses which benefitted Taxpayer II. If Taxpayer I was primarily or secondarily liable for these expenses except as Taxpayer II's agent, the Rule 111 exemption will not apply.

[2] When a taxpayer has contractual employees over whom it exercises supervisory control, and it arranges for them to work part-time for an affiliate, it cannot claim to be acting merely as an agent of its affiliate in paying them their full wages. Thus, the Rule 111 exclusion will be inapplicable for reimbursement by the affiliate for its payroll expenses.

In this case, it is evident from the facts that the employees at issue were contractually employed by Taxpayer I, which also ultimately exercised control over them. The decision that Taxpayer I's employees would devote work time to Taxpayer II was made by the common owners of both taxpayers; and Taxpayer I did not relinquish control over them. Thus, it cannot be claimed that Taxpayer I was acting merely as an agent of Taxpayer II in paying the employees or that it had no personal liability for the employees' payment for work done for Taxpayer II.[5]

The taxpayer's petition as to this issue must be denied.

3. <u>Reallocation of Overhead Expenses.</u>

[3] Similarly, when a taxpayer is primarily or secondarily liable - other than as an agent - for the costs of services contracted for, reimbursement by an affiliate is not excludable under Rule 111. Taxpayer I was clearly liable other than as an agent for payment of the overhead expenses at issue when taxpayer contracted for these services with no representation of agency, in part enjoyed these services, and was the entity to whom the service providers looked for payment.

The taxpayer's petition on this issue is denied.

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[5] See <u>Rho v. Department of Revenue</u>, 113 Wn.2d 561 (1989), which resolves the sole liability issue by requiring an analysis of the control over the employees by the taxpayer as compared with the party making payments through the taxpayer for the services of those employees. It must be determined whether the taxpayer's control over the performers was merely that of paymaster acting as agent for the other corporation. This is determined by looking to factors of control such as hiring, compensation, work assignment, supervision, and termination.

4. Denial of "Travel Agent" rate. Since this audit was conducted, the Department has promulgated a new version of WAC 458-20-258 (Rule 258), which applies to travel agents and tour operators. Rule 258, . . . , was published to clarify the taxability between "travel agents" who work on a "commission" basis and "tour operators" who are ultimately "at risk" for payment of third party providers of travel services.

[4] Rule 258 recognizes that a single taxpayer may be taxable in one or both categories of "travel agent" and "tour operator" depending on the nature of its activities. In a case such as this one, when Taxpayer II has sold pre-packaged tours put together by someone else who is "at risk" for charges by third party providers, the taxpayer will be taxed like a travel agent under the special travel agent rate when (1) it has been paid like a travel agent by way of commissions or internal discounts, and (2) will not be at risk for charges by third party providers even if travellers cancel their journeys. The appropriate measure is "gross commissions", which is defined in the rule as

> the fee or percentage of the charge or their equivalent, received in the ordinary course of business as compensation for arranging the service.

In this case, Taxpayer II was acting in a "travel agent" capacity, in that it was selling pre-packaged tours for which it was not "at risk" to third party providers in the event of cancellation by the travellers. Taxpayer II is thus taxable merely on its "gross commissions" as described in Rule 258.

Taxpayer II's petition as to this issue is granted.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part.

DATED this 9th day of August 1991.