Cite as 2 WTD 1 (1986)

BEFORE THE INTERPRETATION AND APPEALS SECTION
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. 86-293
. . .	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] **RULE 111**: B & O TAX -- ADVANCE OR REIMBURSEMENTS -- ENGINEERING SERVICE -- SUBCONSULTANT FEES -- LIABILITY FOR CHARGES -- ORAL UNDERSTANDING. A taxpayer may exclude payments received as an "advance" or "reimbursement" for a third party service provider only when the client alone is liable for payment of the fees or costs.

[2] **RULE 111**: B & O TAX -- ADVANCE OR REIMBURSEMENT -- ORAL UNDERSTANDING. An informal understanding that the client is liable for the third party's fees is not enough to support exclusion under Rule 111. Payments were excludable where taxpayer and subconsultants had oral understanding client alone would be liable, subconsultants had only looked to clients for payment, and subconsultants billed clients directly or in care of taxpayer. For future audit periods, taxpayer advised that arrangement with third party service providers must be in writing and clearly provide that the client alone is liable for the subconsultant's service.

Headnotes are provided as a convenience to 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: . . .

DATE OF HEARING: August 21, 1986

NATURE OF ACTION:

The taxpayer petitions for a correction of a tax assessment, specifically the assessment of Service tax on payments received from clients for subcontractors' services. The taxpayer asserts the amounts billed to clients for subcontractors' fees are excludable under WAC 458-20-111.

FACTS AND ISSUES:

Frankel, A.L.J. -- The taxpayer provides a civil engineering service, specializing in land planning, survey and design services. The taxpayer's records were examined for the period November 1, 1982 through December 31, 1985. The examination disclosed taxes and interest owing . . . .

The taxpayer protests the amount of Service tax assessed on subcontract services billed to clients. (. . . .) In its petition to correct the assessment, the taxpayer stated it is not "ultimately responsible" for these fees, contending the liability lies with the client.

The taxpayer began its practice of contacting subcontractors for clients after it had acquired some large out-of-state clients who were not familiar with this area. The taxpayer stated it only provided the contact with the subcontractors as a convenience to its clients, and that in all cases it had an oral understanding with the subcontractors that the client alone was responsible for payment. It stated its clients also understood they were responsible for paying the subcontractors.

Most subcontractors billed the clients directly. Service tax was not assessed in those cases. Some subcontractors sent their invoices to the taxpayer. In some cases, the subcontractor's bills were addressed to the client in care of the taxpayer and in other cases addressed to the taxpayer. In all cases, the invoices specified the particular client for whom the work was done and the amount of the charges.

The taxpayer's standard practice was to send its invoice requesting payment of the subcontractor's fee with a copy of the bill from the subcontractor. The taxpayer did not pay the subcontractor until payment was received from the client, and had never accepted liability for the payment of, or the work performed by, the subcontractors.

The issue is whether the funds received from clients for payment of subcontractors' fees should be excludable under WAC 458-20-111 (Rule 111), as "advances" for which the taxpayer was to pay the subcontractors' costs for the clients.

DISCUSSION:

[1] The taxpayer's income is taxable under the Service and Other Business Activities classification of the business and occupation tax. This tax is imposed by RCW 82.04.290 upon persons engaged in business activities other than or in addition to those for which a specific rate is provided elsewhere in chapter 82.04 RCW. Such persons are taxable upon the "gross income of the business" defined at RCW 82.04.080 as follows:

> "Gross income of 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 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.

The tax under consideration is a tax on gross receipts; clearly, a service provider may not deduct any of its own costs of doing business. The Department recognizes, however, that sometimes in the regular course of business a taxpayer may pay costs or fees which are properly the obligation of its client, and for which the taxpayer itself has no personal liability. When a taxpayer receives an advance of funds for such a purpose, or when a taxpayer having already expended its own funds for such a purpose receives reimbursement, then such amounts may be excluded from the measure of the tax.

Accordingly, the Department has promulgated WAC 458-20-111 (Rule 111) in order to explain the distinction between a taxpayer's own business costs and other payments a taxpayer might make merely as an accommodation for its client. The rule provides in part:

> The word "advance" as used herein, means money or credits received by a taxpayer from a customer or client with which the taxpayer is to pay costs or fees for the customer or client.
>
> The word "reimbursement" as used herein, means money or credits received from a customer or client to repay the taxpayer for money or credits expended by the taxpayer in payment of costs or fees for the client.
>
> 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 therefor, either primarily or secondarily, other than as agent for the customer or client.
>
> There may be excluded from the measure of tax 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.
>
> 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.

Strictly speaking, Rule 111 does not provide an exemption or deduction from the business and occupation tax. Rather, that rule merely recognizes that "advances" and "reimbursements," as defined therein, may be excluded from the measure of the tax because they do not fall within the definition of "gross income of the business."

In Christensen, O'Connor, Garrison & Havelka v. Department of Revenue, 97 Wn.2d 764 (1982), the court recognized that certain costs which were ostensibly incurred by attorneys in rendering legal services were actually the direct costs of their clients. Consequently, the court held that amounts received by attorneys with which to pay these costs were excludable from the measure of their business and occupation tax pursuant to WAC 458-20-111.

Christensen outlined the Rule 111 basis for the exemption:

I. Repayments are customary reimbursements for advances made to procure a service for the client.

II. Repayments involve services that the taxpayer did not or could not render.

III. Taxpayer is not liable for the initial payments. Christensen at 769.

Christensen and the Department stipulated that the first two requirements had been satisfied; the sole dispute involved the third requirement. On this issue, the parties stipulated that the associate firms understood that they were working for the named client with respect to the work performed. The Department argued, however, that Christensen was personally liable for payment to the associate firms; thus the payments were not excludable under Rule 111. The court found otherwise, based on its interpretation of the general agency rule stated in Restatement (Second) of Agency Section 79 comment a at 200:

> Whether or not the agent is authorized to employ agents of the principal depends upon the manifestations of the principal in light of the circumstances, including the usages of the business and of the parties inter se. The agents so employed are the agents of the principal and not of the employing agent, who is not responsible to them for their compensation unless he so manifests, and is no more responsible for their conduct to third persons or to the principal than he is for the conduct of other agents of the principal, unless he is negligent in their selection. (Emphasis the court's.) 97 Wn.2d at 770.

Although Christensen involved "reimbursements" for money expended by the law firm in payment of costs or fees for its

clients, the holding and rationale of the case also applies in the case of "advances." As in the Christensen case, the issue is whether the taxpayer is liable in its own behalf for payment to the subconsultants.

The auditor assessed Service tax on those consulting fees listed in the taxpayer's books under a separate account for "consulting fees/miscellaneous." The auditor noted the income had been incorporated into the taxpayer's total income for federal tax purposes and found no agency agreement existed between the taxpayer and its clients or between the taxpayer and the subcontractors.

Furthermore, the auditor reviewed a number of the client agreements which indicated the taxpayer's services would include procuring subconsultants if requested by a client. In many cases, the agreement actually specified the items that were not included in the taxpayer's proposal, but which could be added on a time and expense basis or a negotiated fee basis.

Although Christensen did not require the taxpayer to have entered into a written contract regarding the taxpayer's non-liability to find the payments at issue excludable as "advances," they were only excludable because the attorneys were not liable for them. Walthew v. Department of Revenue, 103 Wn.2d 183 (1984) was a subsequent case also dealing with attorneys' "advancements" and "reimbursements."

In Walthew, the court upheld Christensen and noted that reimbursements to attorneys for costs of litigation cannot by rules of court constitute compensation to the attorneys. Lawyers are bound by the Disciplinary Rules of the Code of Professional Responsibility which prohibit a lawyer from financing costs of litigation unless a client is ultimately liable for those costs. The court noted that attorneys are unique in this respect, adding that "[t]he Department's concern that other professionals will necessarily gain an exemption by our holding is misplaced." 103 Wn.2d at 188.

[2] In the present case, the taxpayer asserts that the subcontractors understood they would be paid from funds received from the clients, and that it would not be liable for payment to the subcontractors if no funds were received by the clients. The taxpayer concedes that this assertion is based on an informal understanding, not a written agreement.

The Department has not found payments excludable under Rule 111 on the basis of an informal understanding or agreement. To be excludable, the taxpayer must have evidence that the client alone is obligated to the third party consultant. This position is supported by both Christensen and Walthew. Where the subcontractors were provided for the client by the taxpayer, even though done at the client's request, the taxpayer must include the payments received for the subcontractor's services as part of its gross income.

For purposes of this audit period, however, the taxpayer may exclude those payments received where the subcontractor's invoice billed the client in care of the taxpayer. We do so, because of the persuasive evidence that the creditors would not and did not consider the taxpayer liable. We will agree that the overwhelming evidence, plus the oral understanding, supports a finding that the taxpayer was not liable for those payments.

For future reporting periods, the arrangements with the subcontractors and the clients must be documented in writing that the client alone is obligated for the subcontractors' fees and expenses in order to be excludable under Rule 111.

DECISION AND DISPOSITION:

The taxpayer's petition is granted to exclude payments received by clients for subcontractors' services where the subcontractors billed the clients in care of the taxpayer. In cases where the subcontractors billed the taxpayer, and the taxpayer in turn billed the clients, the payments received are not excludable.

DATED this 13th day of November 1986.