Cite as Det. No. 13-0336, 33 WTD 160 (2014)

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. 13-0336
. . .	)	Registration No. . . .
. . .	)	Registration No. . . .
. . .	)	Registration No. . . .

[1] RCW 82.04.080: GROSS INCOME OF THE BUSINESS. Employee wages paid directly by a hotel owner to a payroll processing company are taxable to a hotel management company as "gross income of the business" even though the hotel management company never actually received the employee wages.

[2] RULE 111: ADVANCES OR REIMBURSEMENTS. Employee wages paid by a hotel owner to a payroll processing company are not deductible by a hotel management company under WAC 458-20-111 as advances or reimbursements.

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.

Sohng, A.L.J. – Hotel management companies protest imposition of tax on the grounds that employee wages paid by hotel owners to a payroll processing company (i) are not gross income to the management companies, and (ii) are excludable under WAC 458-20-111. The petitions are denied.[1]

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

ISSUES

1. Are employee wages paid directly by a hotel owner to a payroll processing company taxable to a hotel management company as "gross income of the business" under RCW 82.04.080 even though the hotel management company never actually receives the employee wages?

2. Are employee wages paid by a hotel owner to a payroll processing company excludable by a hotel management company under WAC 458-20-111?

FINDINGS OF FACT

[Taxpayer A], [Taxpayer B], and [Taxpayer C] (each, a "Taxpayer," and collectively, "Taxpayers") are hotel management companies that provided hotel management services to the owners of three hotels (collectively, "Hotel Owners"). In June 2009, each Taxpayer entered into a Hotel Management Agreement (the "Management Agreement") with a Hotel Owner to manage and operate a hotel. The relationships of the parties and properties are summarized below:

Taxpayer/Management Company	**Hotel Owner**	**Property**
[Taxpayer A]	[Owner A]	[Property A]
[Taxpayer B]	[Owner B]	[Property B]
[Taxpayer C]	[Owner C]	[Property C]

Hotel Owners appointed Taxpayers as their agents in managing and operating the hotels. The Management Agreements provide:

> Owner hereby appoints [Taxpayer] as its sole and exclusive agent to supervise, direct, control, manage and operate the Hotel, and all of the facilities and amenities comprising any part of the Hotel. . . . [Taxpayer] hereby accepts said appointment and shall supervise, direct, control, manage and operate the Hotel during the Term strictly in accordance with the terms and conditions herein set forth . . . . In the performance of its duties and obligations hereunder, [Taxpayer] agrees that it shall at all times manage and operate the Hotel for the account and benefit of the Owner in a businesslike and efficient manner . . . offering the highest level of quality of guest amenities and services consistent with the Operating Standards for the Hotel, and consistent with the purpose and intention of maximizing patronage and profitability of the Hotel . . . .[2]

(Emphasis added.) Each Taxpayer was the designated employer for all personnel who worked at the hotels. Taxpayer was also contractually responsible for paying such employees. The Management Agreements provide:

[2] Management Agreement, Article 2.1(a).

> [Taxpayer] shall select, appoint and supervise all personnel for the proper operation, maintenance and security of the Hotel and in order to enable [Taxpayer] to perform its duties and obligations under this Agreement. All employees of the Hotel shall be the employees of [Taxpayer], and [Taxpayer] may reimburse itself out of the Operating Accounts for all Employee Costs.[3]

(Emphasis added.) Each Management Agreement also provides, ". . . Owner shall reimburse [Taxpayer] as follows: (i) for all Employee Costs with respect to employees of the Hotel . . . ." The term "Employee Costs" is defined as:

> [T]he aggregate compensation, including, without limitation, salary, fringe benefits, incentive compensation, bonuses, employee performance and service awards, and other such amounts paid or payable to Hotel employees, and other employee related costs such as payroll taxes less the net benefit of any tax credits received by [Taxpayer] . . . .[4]

In short, Taxpayers were contractually obligated to pay employees wages and payroll taxes, and Hotel Owners were contractually obligated to reimburse Taxpayers for such employee costs.

Each Taxpayer is 100% owned by [Holding Company], which is 50% owned by [Investor A]. [Owner A], [Owner B], and [Owner C] are each 100% owned by [Investor B]. [Investor A] is a holder of a Promissory Note dated June 30, 2009, under which (i) [Investor A] advanced $400,000 to [Investor B]; and (ii) [Investor B] was required to repay [Investor A] such amount. Taxpayers subsequently entered into a Note Purchase Agreement with [Investor A] and acquired its rights under the Promissory Note.

Hotel Owners used the funds borrowed by [Investor B] (their parent company) to pay the operating expenses of the hotels, including employee wages and payroll taxes. Hotel Owners paid the wages to . . . a . . . payroll processing company, which, in turn, paid the employees who worked at the hotels. Thus, even though Taxpayers were contractually responsible for paying wages and payroll taxes, Hotel Owners were the parties that actually paid such costs (albeit with funds advanced by Taxpayers' ultimate owner, [Investor A]).

Hotel Owners struggled financially and in 2011, [Investor B] defaulted on the Promissory Note. Hotel Owners notified Taxpayers that they would be terminating the Management Agreements.

The Audit Division examined Taxpayers' books and records for the period January 1, 2009, through December 31, 2011. On October 15, 2012, the Audit Division issued the following three assessments against Taxpayers:

Taxpayer	Document No.	Tax	Penalties	Interest	Total
[Taxpayer A]	. . .	$. . .	$. . . .	$. . . .	$. . .
[Taxpayer B]	. . . .	$. . . .	$. . . .	$. . . .	$. . . .

[3] Management Agreement, Article 3.3(a).
[4] Management Agreement, Article 1.1.

[Taxpayer C]	. . . .	$. . .	$. . . .	$. . . .	$. . .
					$. . .

The Audit Division asserted business and occupation ("B&O") tax on the management fees Taxpayers received from Hotel Owners, as well as on employee wages and payroll taxes paid to [the payroll processing company] by Hotel Owners.

ANALYSIS

1. Gross Income of the Business

The first issue is whether employee wages paid by Hotel Owners to employees (via [the payroll processing company]) constitute "gross income of the business" to Taxpayers. The B&O tax is calculated based on the "gross income of the business." RCW 82.04.290. "Gross income of the business" is broadly defined and means:

> [T]he 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.

RCW 82.04.080 (emphasis added). The phrase "value proceeding or accruing" is defined as "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued." RCW 82.04.090. "Business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140. Under this broad definition, a service provider may not deduct any of its costs of doing business from its gross income. *See Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 49 P.3d 947 (2002) (citing *Rho Co. Inc. v. Dep't of Revenue*, 113 Wn.2d 561, 570, 782 P.2d 986 (1989)). Thus, unless a specific exemption, deduction, or exclusion applies, a taxpayer's gross income is subject to B&O tax without any deduction for overhead or other expenses.

The payment of employee wages by Hotel Owners to the employees is essentially *Taxpayers'* cost of doing business because employing personnel was a necessary part of providing hotel management services to Hotel Owners under the Management Agreements. Taxpayers cannot escape this result by having Hotel Owners pay the employee wages. Because the payment of employee wages is a cost of doing business, they are not deductible by Taxpayers. The fact that Taxpayers did not actually receive these wages from Hotel Owners because Hotel Owners paid the wages directly to [the payroll processing company], which in turn, paid the employees, does not preclude those sums from inclusion in "gross income of the business" of Taxpayers. *See* Det. No. 98-219R, 19 WTD 416 (2000) (holding that a wholesale insurance broker was taxable on the full amount of the commissions paid by customers on insurance sold, even though the wholesale

insurance broker did not actually receive the full commission because the retail broker deducted its share of the commission prior to remitting the balance to the wholesale insurance broker). Taxpayers' petitions are denied as to this issue.

2. Rule 111

WAC 458-20-111 ("Rule 111") permits an exclusion from gross income for certain advances and reimbursements that a taxpayer receives and pays to a third party solely in its capacity as an agent. Rule 111 provides, in relevant 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.
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> * * *
>
> 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.

(Emphasis added.)

Rule 111 requires the existence of a true agency relationship between the client and the taxpayer. *See Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 562, 252 P.2d 885 (2011). Agency requires a factual determination that both parties consented to the agency relationship and that the principal exercised control over the agent. *Id.; see also Nordstrom Credit, Inc. v. Dep't of Revenue*, 120 Wn.2d 935, 941, 835 P.2d 1331 (1993); Det. No. 05-0206E, 25 WTD 72 (2006); Det. No. 03-0128, 24 WTD 168 (2005); Restatement (Third) of Agency § 1.01 (2006). The *Washington Imaging* court emphasized that "The proper focus is on the facts and whether they show a true agency relationship that requires payment to a third party on behalf of the recipient (e.g., client or patient) paying for the goods or services." *Washington Imaging*, 171 Wn.2d at 565, 252 P.3d 885.

Once an agency relationship has been established, an inquiry must be made into whether the taxpayer's liability to pay constituted "solely agent liability." *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 178, 60 P.3d 79, 83 (2002). The *Wm. Rogers* court explained that if a taxpayer assumes any liability beyond that of an agent, payments made pursuant to such liability are not excludable under Rule 111. *Id.* Therefore, for Rule 111 to apply in this case, Taxpayers must establish that they each had an agency relationship with Hotel Owners and that their liability to pay employee wages was solely in their capacity as Hotel Owners' agents. With respect to the

latter element, the Court in *Rho Co., Inc. v. Dep't of Revenue,* 113 Wn.2d 561, 569, 782 P.2d 986, 990 (1989), turned to the laws of agency for guidance, and stated:

> The question that the parties have primarily addressed in this regard is: Who employed the contract personnel, Rho or Rho's corporate clients? If Rho is the employer, then Rho is liable in its own right for the payment, and Rule 111 does not apply. If, however, the clients are deemed to be employers, then Rho is more easily characterized as the clients' paymaster agent in paying the personnel.

Here, Taxpayers were clearly designated as the employers in the Management Agreements, a fact that they do not dispute. As such, Taxpayers were liable in their own right for paying the employees.[5] Thus, Taxpayers' liability to the employees did not constitute "solely agent liability" and Rule 111 is inapplicable.[6] Taxpayers' petitions are denied with respect to this issue.

DECISION AND DISPOSITION

The petitions are denied.[7]

Dated this 13th day of November 2013.

[5] *See Washington Imaging*, 171 Wn.2d at 567 (given Washington Imaging's contractual obligation to pay professional services contractor, its obligations to pay "could not have been '*solely* agent liability'").

[6] Because we have concluded that Taxpayers' liability was not "solely agent liability," we need not engage in a factual determination of whether Taxpayers and Hotel Owners had a true agency relationship under the *Washington Imaging* case.

[7] In its appeal petition, Taxpayers also argued that they were entitled to a $. . . bad debt deduction under RCW 82.04.0284. Following the hearing, Taxpayers withdrew this argument and it will not be discussed in this determination.