Cite as Det. No. 13-0191, 33 WTD 116 (2014)

BEFORE THE 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. 13-0191 Registration No. . . .

[1] RCW 82.04.480: B&O TAX – GROSS INCOME OF THE BUSINESS. Wages directly paid by hotel owner to PEO constitute "gross income of the business" to a hotel management company, even though the management company did not actually receive wages.

[2] RULE 111: B&O TAX – ADVANCES AND REIMBURSEMENTS. Wages directly paid by hotel owner to PEO are not deductible by a hotel management company as advance or reimbursement.

[3] RCW 82.04.540: B&O TAX – PROFESSIONAL EMPLOYER ORGANIZATION. A coemployment relationship may exist only between a PEO and a single client.

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 company protests assessment of business and occupation ("B&O") tax on the grounds that employee wages paid by a hotel owner to a professional employer organization (i) cannot be taxable to the management company; or (ii) are excludable under WAC 458-20-111 as a pass-through payment. The management company also claims it is entitled to a deduction under RCW 82.04.540. The petition is 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 professional employer organization taxable to a hotel management company as "gross income of the business" under RCW 82.04.480 even though the hotel management company never actually receives the employee wages?

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

3. Does RCW 82.04.540 permit a "coemployment relationship" between a professional employer organization and more than one "client"?

FINDINGS OF FACT

[Taxpayer] is a Washington corporation that provides management, accounting, and consulting services for hotels and conference centers. The issue in this appeal relates solely to Taxpayer's management of the [the Hotel] in . . . Washington. On October 4, 2007, Taxpayer entered into a Management Agreement with [the Hotel Owner] under which Taxpayer would manage, operate, and maintain the Hotel in exchange for a management fee. This agreement required Taxpayer to hire, pay, supervise, train, and fire all personnel required for the operation of the Hotel. The Management Agreement provides that (i) the Hotel would bear the costs of all operating expenses incurred by Taxpayer in connection with the operation of the Hotel;[2] and (ii) Hotel Owner would reimburse Taxpayer for "personnel costs, including wages and benefits, associated with [Taxpayer's] corporate employees."[3]

On March 21, 2008, Taxpayer formed [PEO] . . . a single-member limited liability company wholly owned by Taxpayer. PEO is a "professional employer organization" as defined in RCW 82.04.540(3)(f). On April 23, 2008, PEO requested a written ruling from the Taxpayer Information & Education section ("TI&E") of the Department of Revenue (the "Department") regarding the applicability of a Special Notice that the Department issued in June 2006, which addressed the deductions that a professional employer organizations may take.

On June 13, 2008, TI&E issued a letter ruling (the "Ruling"), concluding, among other things, that:

1. The provision of professional employer services by PEO is taxable to PEO under the service and other activities classification of the B&O tax under RCW 82.04.290; and

2. PEO "will be allowed a deduction from the gross income of the business equal to the amount of the fee charged to each Owner that represents the actual costs of wages, salaries, benefits, workers' compensation, payroll taxes, withholding or other assessments

[2] Management Agreement, dated Oct. 4, 2007, art. 5.6.
[3] Management Agreement, art. 10.5.

paid to or on behalf of a covered employee by [PEO] under the [Professional Employer Agreement]."

On June 19, 2008, TI&E supplemented the Ruling to clarify that it only addressed the taxability of PEO, and did not address the taxability of Hotel Owner or of Taxpayer. [4]

On July 1, 2008, Taxpayer, PEO, and Hotel Owner entered into a Professional Employer Agreement (the "PEA"). Recital IV of the PEA provides that Hotel Owner and Taxpayer "wish to enter into a Coemployment Relationship (as defined under RCW 82.04.540) with PEO regarding wage and benefits administration as provided herein." Department records show that Taxpayer, not PEO, was the entity that reported employee wages to the Employment Security Department and to the Department of Labor & Industries.

Article 3.1 of the PEA provides for the rights and obligations of Taxpayer:

(a) [Taxpayer] shall . . . hire, train (using such training techniques and facilities as are customarily utilized in the training of personnel in the operation and management of facilities similar to the [Hotel]), supervise, direct, discharge, and determine the compensation and other terms of employment of all Covered Employees.

(b) All Covered Employees at the [Hotel] shall be employees of [Taxpayer] . . . subject to [Hotel Owner's] review and approval of the applicable annual plan and budget (as established pursuant to the Management Agreement).

Article 3.2 of the PEA provides for the rights and obligations of Hotel Owner:

(a) [Hotel Owner] shall ensure that [the Hotel's] operating accounts contain sufficient funds to pay [the Hotel's] operating expenses, including, without limitation, all taxes, unemployment compensation payments, benefit obligations and wages of all Covered Employees. Operating expenses shall be paid from [the Hotel's] operating accounts or from [Hotel Owner] promptly upon demand if the balance of such accounts shall be insufficient.

(b) [Hotel Owner] shall pay all out-of-pocket costs associated with termination of Covered Employees to the extent that such out-of-pocket costs are statutorily mandated.

(c) [Hotel Owner] shall establish and maintain (or cause [Taxpayer] to establish and maintain) Employee Plans for the Covered Employees in accordance with Legal Requirements.

[4] We note that Taxpayer asserts that the Department is bound by the Ruling under the Taxpayer Bill of Rights. However, the Department does not take the position that the Ruling is incorrect or no longer applicable. Thus, we will not further address this argument.

Article 3.3 of the PEA provides for the rights and obligations of PEO:

> (a) As directed by [Taxpayer and Hotel Owner], consistent with the terms of this Agreement and RCW 82.04.540 . . . PEO hereby agrees to provide the following wage and benefit administration services with respect to Covered Employees for [the Hotel] (collectively, the "Wage and Benefit Administration Services"):
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> (i) timely pay the salary and benefits of Covered Employees;
> (ii) pay all Taxes in respect of all Covered Employees;
> (iii) timely make all remittances to taxing authorities in respect of all Covered Employees;
> (iv) prepare and complete all necessary application, notices and reports to Governmental Authorities in connection with [the Hotel's] wage and benefit programs in accordance with the Legal requirements; and
> (v) otherwise use commercially reasonable efforts to comply with all Legal Requirements in connection with the Wage and Benefit Administration Services.

The Audit Division examined Taxpayer's books and records for the period January 1, 2007, through December 31, 2009. On May 23, 2012, the Audit Division issued Assessment No. . . . in the amount of $. . . , including $. . . in service and other activities B&O tax, $. . . in use tax/deferred sales tax, and $. . . in interest. Taxpayer protests the B&O tax, claiming that it relied on the Ruling in reporting amounts paid by Hotel to PEO as income of PEO and not of Taxpayer.

ANALYSIS

1. Gross Income of the Business

The first issue is whether employee wages paid by Hotel Owner to PEO is "gross income of the business" to Taxpayer. 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 Owner directly to PEO is essentially *Taxpayer's* cost of doing business because employing personnel is a necessary part of providing hotel management services to Hotel Owner under the Management Agreement. Taxpayer cannot escape this result by having its Hotel Owner pay the employee wages directly to PEO. Because the payment of employee wages is a cost of doing business, they are not deductible by Taxpayer. The fact that Taxpayer did not actually receive these wages from Hotel Owner because Hotel Owner paid the wages directly to PEO, which in turn, paid the employees, does not preclude those sums from inclusion in "gross income of the business" of Taxpayer.[5] *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). Taxpayer's petition is denied as to this issue.

Taxpayer also argues that the employee wages paid by Hotel Owner to PEO cannot simultaneously be income to both PEO and Taxpayer. We disagree. Taxpayer and PEO are different legal entities, and as such, are separate taxable persons under RCW 82.04.030. Moreover, there are two separate business activities occurring: (1) Taxpayer is engaged in providing hotel management services to Hotel Owner; and (2) PEO is engaged in providing wage and benefits administration services with respect to the Hotel's employees.

Washington imposes a B&O tax on the gross income received by each person for the act or privilege of engaging in business activities. RCW 82.04.220. Thus, each entity is subject to tax on the gross proceeds of its *own* business activities.

2. Rule 111

The next issue is whether Taxpayer can exclude the employee wages under WAC 458-20-111 ("Rule 111"). Washington imposes a B&O tax on gross receipts, as opposed to net income. *See* RCW 82.04.220, 82.04.070, 82.04.080. Rule 111 recognizes that certain advances or reimbursements that a business receives and pays out solely based on the business' capacity as

[5] "Value proceeding or accruing" is not limited to *money* actually received. It includes *any* consideration "whether money, credit, rights, or other property expressed in money, actually received or accrued." RCW 82.04.090. Under its agreement with the Hotel Owner, Taxpayer "actually received" consideration for its services, which included hiring, training, and supervising hotel employees, in the form of the Hotel Owner's provision of funds for employee salaries and benefits to the PEO. PEA, Articles 3.1 & 3.2. As "value proceeding or accruing" from the Taxpayer's business of providing hotel management services, the amount the Hotel Owner provided to the PEO for hotel employee wages was "gross income of the business" to the Taxpayer.

an agent for the customer cannot be attributed to the business activities of the agent and are not subject to B&O tax. *City of Tacoma v. Wm. Rogers Co.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2003); Det. No. 05-0105, 26 WTD 115 (2007). 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 therefor, either primarily or secondarily, other than as agent for the customer or client.
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> 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.
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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.

In *Wm. Rogers*, the Court had occasion to . . . explain that if a taxpayer assumes any liability beyond that of an agent, the payments it receives are not Rule 111 "pass through" payments. *Wm. Rogers*, 148 Wn.2d at 175, 60 P.3d 79.

In response to the *Wm. Rogers* case, the Department issued Excise Tax Advisory 2016.04.111 on September 23, 2003 (subsequently renumbered to ETA 3100.2009) ("ETA 3100") to discuss the implementation of the Court's holding. ETA 3100 states that in order to exclude such payments from the measure of tax, the following conditions must be met:

- The taxpayer must first establish that it received the funds as the agent of the customer or client. If this is satisfied, then:
- 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.

Therefore, in order for Taxpayer to be legally entitled to the exclusion under Rule 111, it must establish that it had an agency relationship with Hotel Owner and that it acted solely as Hotel Owner's agent when paying employee wages to PEO. To determine the existence of an agency relationship, we look to standard common law principles of agency. *Rho Co., Inc. v. Dep't of Revenue*, 113 Wn. 2d 559, 571, 782 P.2d 986, 992 (1989). According to ETA 3100, the essential elements of common law agency are mutual consent of the relationship between a principal and an agent and the right of control over the agent by the principal. *See also Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011); Det. No. 05-0206E, 25 WTD 72 (2006); Det. No. 03-0128, 24 WTD 168 (2005).

In the present matter, Taxpayer has failed to establish the existence of any agency relationship with Hotel Owner to pay employee wages to a third party. There is no evidence of mutual consent to such a relationship; nor is there evidence of any right of control over Taxpayer by Hotel Owner. There is no provision in either the Management Agreement or the PEA that establishes an agency relationship. Instead, the Management Agreement provides only that Hotel Owner must reimburse Taxpayer for the employee wages. Further, as the designated employer in the PEA, the Taxpayer would be ultimately liable for the payment of employee wages. Thus, the requirement under Rule 111 that a taxpayer has no liability other than as an agent has not been satisfied. Taxpayer's petition is denied.

3. PEO Statute – RCW 82.04.540

Finally, Taxpayer claims that it is entitled to a deduction under RCW 82.04.540(2), which provides:

> A professional employer organization is allowed a deduction from the gross income of the business derived from performing professional employer services that is equal to the portion of the fee charged to a client that represents the actual cost of wages and salaries, benefits, workers' compensation, payroll taxes, withholding, or other assessments paid to or on behalf of a covered employee by the professional employer organization under a professional employer agreement.

(Emphasis added.) A "professional employer organization" is defined as "any person engaged in the business of providing professional employer services." RCW 82.04.540(3)(f). "Professional employer services" means the service of entering into a coemployment relationship with a client in which all or a majority of the employees providing services to a client or to a division or work unit of a client are covered employees." RCW 82.04.540(3)(g)(emphasis added). "Professional employer agreement" means a written contract by and between a client and a professional employer organization . . . ." RCW 82.04.540(3)(e)(emphasis added). "Client" means any person who enters into a professional employer agreement with a professional employer organization. RCW 82.04.540(3)(a). And "coemployer" means either a professional employer organization or a client. RCW 82.04.540(3)(b).

Taxpayer argues that (i) both Taxpayer and Hotel Owner are "clients" of PEO under RCW 82.04.540(3)(a), because they both entered into the PEA with PEO; and (ii) Taxpayer, Hotel Owner, and PEO are all "coemployers" under RCW 82.04.540(3)(b) among whom employer rights and obligations are allocated under the PEA. On this basis, Taxpayer essentially contends that because it entered into a coemployment relationship with a client (*i.e.*, Hotel Owner), it is entitled to the deduction provided by RCW 82.04.540(2).

We disagree. First, the deduction under RCW 82.04.540(2) is available only to professional employer organizations. Taxpayer is not such an organization, but rather, a hotel management company. Second, Taxpayer has already stated that it is a "client" under RCW 82.04.540(3)(a). Taxpayer cannot be both a "client" and a "professional employer organization" simultaneously.

And finally, a "coemployment relationship" may only exist between a professional employer organization and a *single* client under the statutory scheme. RCW 82.04.540(3)(c) provides:

> "Coemployment relationship" means a relationship which is intended to be an ongoing relationship rather than a temporary or project-specific one, wherein the rights, duties, and obligations of an employer which arise out of an employment relationship have been allocated between coemployers pursuant to a professional employer agreement and applicable state law. In such a coemployment relationship:
>
> (i) The professional employer organization is entitled to enforce only such employer rights and is subject to only those obligations specifically allocated to the professional employer organization by the professional employer agreement or applicable state law;
>
> (ii) The client is entitled to enforce those rights and obligated to provide and perform those employer obligations allocated to such client by the professional employer agreement and applicable state law; and
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> (iii) The client is entitled to enforce any right and obligated to perform any obligation of an employer not specifically allocated to the professional employer organization by the professional employer agreement or applicable state law.

In determining the meaning of statutes, we must ascertain and carry out the legislature's intent. *City of Spokane v. County of Spokane*, 158 Wn.2d 661, 672-73, 146 P.3d 893 (2006). Washington courts employ a "plain meaning" approach to interpreting statutes, absent ambiguity. If the statute's meaning is plain on its face, then the court must give effect to that plain meaning as an expression of legislative intent. *State v. J.M.*, 144 Wn.2d 472, 480, 28 P.3d 720, 724 (2001). Plain meaning is discerned from all that the legislature has said in the statute and related statutes that disclose legislative intent about the provision in question. *Dep't of Ecology v. Campbell & Gwinn L.L.C.*, 146 Wn.2d 1, 11, 43 P.3d 4 (2002).

We must also construe statutes so as to "avoid strained or absurd consequences." *Deaconess Medical Center v. Dep't of Revenue.*, 58 Wn. App. 783, 788, 795 P.2d 146, 149 (1990). "To this end, the statute must be read as a whole; intent is not to be determined by a single sentence." *Human Rights Comm'n v. Cheney Sch. Dist. No. 30*, 97 Wn.2d 118, 121, 641 P.2d 163, 164 (1982)*; see also Cerrillo v. Esparza*, 158 Wn.2d 194, 142 P.3d 155, 159 (2006).

Upon examining the plain meaning of the entire statutory scheme as a whole, there is substantial evidence that the legislature intended that there be only *one* client in each co-employment relationship. In particular, we note that RCW 82.04.540(3)(c)(i)-(iii), allocates employer rights and obligations between the professional employer organization and "the client." Subsection (i) provides that the professional employer organization has only the employer rights and obligations specifically allocated to it in the professional employer agreement or otherwise under state law. In contrast, under subsection (ii), "the client" is given those employer rights and obligations specifically allocated to it in the professional employer agreement and also under

subsection (iii) any remaining employer rights or obligations not allocated to the professional employer organization in the professional employer agreement or under state law.

Consequently, if there is only one client, RCW 82.04.540(3)(c)(i)-(iii) clearly explains how employer rights and obligations are to be allocated, including those not specifically allocated under the agreement. If, however, RCW 82.04.540(3) were interpreted to allow two clients in a professional employer agreement, RCW 82.04.540(3) would be unclear as to which client should receive the unallocated employer rights and obligations. Thus, interpreting RCW 82.04.540(3) to allow more than one client in a professional employer agreement would create an ambiguity in the statute that would not otherwise exist.[6]

Another indication that the legislature intended only a single "client" to participate in a professional employer agreement is found in RCW 82.32.710, which was enacted as part of the same legislation as RCW 82.04.540. Laws of 2006, ch. 301, § 10. RCW 82.32.710(1) provides that:

> A client under the terms of a professional employer agreement is deemed to be the sole employer of a covered employee for purposes of eligibility for any tax credit, exemption, or other tax incentive, arising as a result of the employment of covered employees, provided . . . in this title."

(Emphasis added.) By reviewing the statutes as a whole, we view this as very strong evidence that the legislature intended to limit the number of clients involved in a professional employer agreement to a single client. There cannot be two or more "sole employers." If the legislature had intended RCW 82.04.540 to allow multiple clients as parties to a single professional employer agreement, it would have provided some indication of that in RCW 82.32.710, by designating which "client" was to be considered the beneficiary of the listed tax incentives.

Taxpayer may not deduct employee wages under RCW 82.04.540. Taxpayer's petition is denied.

DECISION AND DISPOSITION

We deny the petition.

Dated this 21st day of June 2013.

[6] We do note, however, that RCW 1.12.050 provides that "[words] importing the singular number may also be applied to the plural of persons and things." Thus, under this statute, the words "a client" or "the client" as they appear in RCW 82.04.540 could be interpreted to be plural. In general, courts have only applied this rule where there is no contrary intent in the statute. *Rabanco Ltd. v. King County* 125 Wn. App. 794, 801, 106 P.3d 802, (2005). In this case, we have already concluded that the plain meaning of the statute, when read as a whole, evidences a contrary intent. Therefore, RCW 1.12.050 is inapplicable.