Cite as Det. No. 99-218R, 20 WTD 240 (2001)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Interpretation of	)	F I N A L D E T E R M I N A T I O N
	)	No. 99-218R
. . .	)	
	)	Registration No. . . .
	)	Appeal of Letter Ruling

[1] RULE 111: B&O TAX -- PROSPECTIVE RULING. When the Department is asked to rule prospectively on whether a taxpayer's receipts will qualify for pass-through treatment under Rule 111, it relies upon the facts stated by the taxpayer and any written agreements. It cannot base its ruling on the taxpayer's representation that the parties' actual relationships will be quite different from those set out in the written agreements.

[2] RULE 111: B&O TAX -- RHO -- TAXPAYER'S INABILITY TO PERSONALLY RENDER THE SERVICE -- CONTRACTOR-SUBCONTRACTOR. Merely showing that the taxpayer lacked the technical skills to personally perform the services for which it received payment does not establish the second Rho element (the payments involve services the taxpayer did not or could not render), when the taxpayer contracted to provide the services, and the contract clearly contemplated that it would provide them by hiring or subcontracting personnel with the necessary expertise.

[3] RULE 111: B&O TAX – RHO – AGENCY -- THIRD-PARTY PAYEE'S AGREEMENT ABSOLVING TAXPAYER OF LIABILITY. The third Rule 111 element set out in Rho requires that the taxpayer have received and paid the funds as agent of its client. The agency relationship is created as a result of conduct between the taxpayer and its client. The taxpayer cannot make itself the agent of its client in procuring a service from a third party merely by getting the third party to agree to absolve the taxpayer of liability for paying the third party if the taxpayer is not paid by its client.

NATURE OF ACTION:

A personnel recruiting agency requests reconsideration of Det. No. 99-218, which sustained a ruling by the Taxpayer Information and Education Section (TI&E) of the Department of Revenue (Department) that amounts the taxpayer would receive under a particular arrangement were not excludable "reimbursements" under WAC 458-20-111 (Rule 111).[1]

FACTS AND DISCUSSION:

Prusia, A.L.J. -- The taxpayer is a sole proprietorship that operates a personnel recruiting agency in . . ., Washington. The taxpayer requests reconsideration of Determination No. 99-218, which sustained a TI&E ruling that the taxpayer could not exclude from the measure of its B&O tax amounts it received from a client and in turn paid out to an independent contractor the taxpayer had placed with the client. The taxpayer contends Det. No. 99-218 was based upon a factual misunderstanding and a misapplication of law, in particular Rule 111.

The facts are set out in Det. No. 99-218, and are repeated here only to the extent required for clarity. On September 22, 1997, the taxpayer submitted a ruling request to TI&E. The request stated the taxpayer was negotiating a contractual situation with an individual it would place with a bank. The individual would be an independent consultant. The bank would pay the taxpayer $X for each hour the consultant worked, the taxpayer would pay the consultant $X minus $8, the taxpayer keeping the $8 as its fee for placing the consultant and making certain he was paid regularly. The consultant would do his work at the bank, and the taxpayer would have no control over the consultant. The taxpayer contended it was eligible to deduct the amount it paid to the consultant ($X minus $8) from the measure of its tax, because it qualified as a payrolling agent under Revenue Policy Memorandum 90-1 (RPM 90-1) (now Excise Tax Advisory (ETA) 90-001).

TI&E concluded the taxpayer did not qualify as a payrolling agent under RPM 90-1, because the taxpayer would directly contract with the independent consultant and would have liability to compensate the consultant whether or not the taxpayer was paid.

The taxpayer appealed the TI&E ruling, arguing it met the requirements of RPM 90-1 and the requirements for exclusion of the income under Rule 111. It provided additional facts on appeal. The placement was completed and contracts entered into. The taxpayer's owner is the taxpayer's sole employee. The owner lacks the expertise, training, or experience to act in the capacity in which the independent consultant acted. The taxpayer is not obligated to pay the consultant if the taxpayer is unable to collect the fee from the bank. The taxpayer is not involved in any way in the rendering of the consultant's services. This placement arrangement was one of a kind.

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

On appeal, the taxpayer provided copies of its contract with the bank and the independent consultant. There is no contract between the bank and the consultant. Among the provisions of the taxpayer's agreement with the bank are the following. The taxpayer is identified as "consulting and recruiting firm," and referred to throughout the agreement as "Consultant." The taxpayer agrees to provide the bank with specified computer-related technical assistance. It agrees to "undertake and accomplish" the consulting tasks. The taxpayer will assign an "affiliate" to a particular work assignment. The taxpayer is responsible for supervising the "affiliate," and is solely responsible for paying compensation to the consultant. The taxpayer warrants the work will be performed in a "good and workmanlike manner to [bank's] satisfaction." The bank may interview, evaluate, and accept or reject applicants, and has the authority to direct the "affiliate's" activities. The "affiliate" is not the bank's employee or personnel. The taxpayer will be solely responsible for paying its "affiliates." The bank may not solicit or hire an "affiliate."

Among the provisions of the taxpayer's agreement with the independent consultant (the "affiliate" referenced in the taxpayer's agreement with the bank) are the following. The taxpayer "engages [the consultant] to perform services to clients of [the taxpayer]." The engagement is non-exclusive. The consultant will perform the services for the bank, on the bank's premises. The consultant must meet the bank's requirements. The bank controls the terms and conditions of the performance of services, and the taxpayer will have no control over the details of the consultant's work. The taxpayer will pay the consultant a specified amount per hour. If the taxpayer is unable to collect its fee from the bank, the taxpayer will not be obligated to pay the consultant. It is understood the taxpayer does not have the skill or expertise required to perform the consultant's services, and will not perform them if the consultant fails to perform.

The taxpayer stated that the agreement with the bank was a standard agreement the bank had used in the past with companies that provided contract employees, and, in the taxpayer's case, did not state the actual relationships among the parties or reflect the parties' intended actual course of dealing. The taxpayer contended it intended to perform only its usual service of recruiting personnel, and additionally handle the consultant's payroll as an accommodation to the bank. It contended the bank and the consultant understood the taxpayer's role was limited to those functions. It contended it is not involved in any way in the rendering of services.

The taxpayer argued the case law applicable to Rule 111 establishes that the payments are excludable from its gross income. It argued the facts show the factors set out in RPM 90-1 for determining whether a taxpayer is merely a payrolling agent are met in its case. It argued the facts of its case were virtually indistinguishable from those in Medical Consultants Northwest v. State, 89 Wn. App. 39, 947 P.2d 784 (1997), review denied, 136 Wn.2d 1002 (1998) ("MCN"), in which the court found the taxpayer's payments to independent contractors were reimbursements under Rule 111.

Det. No. 99-218

Det. No. 99-218 found that the TI&E ruling was correct. It was a ruling based upon a prospective situation and limited facts. The situation the taxpayer set out in its request to TI&E described a contractor-subcontractor relationship. It did not describe a situation in which the taxpayer would merely procure an independent contractor who would enter into an independent relationship with the bank. It found that the MCN decision did not require a ruling favorable to the taxpayer. It determined that, based upon the information provided it, TI&E correctly ruled the taxpayer would be liable on the entire amount the bank paid it.

[1] Det. No. 99-218 further concluded that even if the taxpayer had provided TI&E with the written contracts, the correct prospective ruling would have been that the taxpayer was taxable on the full amount it received. In its agreement with the bank, the taxpayer agreed to provide the services, and the agreement expressly contemplated that the taxpayer would assign another person to render the actual services. Nothing in the agreement indicated the bank contemplated that the taxpayer would act only as its agent in recruiting and paying a consultant. The language in the agreement between the taxpayer and the consultant absolving the taxpayer of liability if the bank failed to pay its fee, does not make the taxpayer an agent of the bank. The bank is not a party to that agreement. When the Department is asked to rule on a taxpayer's prospective tax liability, it relies on the facts stated by the taxpayer and any written agreements. It cannot base its ruling on the taxpayer's representation that the written agreements are just so much paper, and that the actual relationships will be quite different.

Det. No. 99-218 did not preclude the possibility that the taxpayer might, in an audit investigation of the actual performance of the parties under the agreement for a past period, establish that its written agreement with the bank did not state the actual agreement of the parties, and that by their conduct the parties created relationships different from those the taxpayer and the bank appeared to contemplate in their written agreement.

Alleged errors in Det. No. 99-218

The alleged errors of fact and law in Det. No. 99-218 relate to the requirements for pass-through treatment under Rule 111. The Supreme Court has held Rule 111 allows an exclusion from income for "pass through" payments when three conditions are met:

> (1) the payments are "customary reimbursements for advances made to procure a service for the client"; (2) the payments "involve services that the taxpayer did not or could not render"; and (3) the taxpayer "is not liable for paying the associate firms except as the agent of the client."

Rho Company v. Department of Rev., 113 Wn.2d 561, 567-68, 782 P.2d 986 (1989).

[2] The taxpayer argues Det. No. 99-218 misunderstood the facts in finding the taxpayer did not meet the second Rule 111 requirement, and specifically failed to understand that the taxpayer does not provide the technical services for which the bank has contracted, and lacks the technical skills to do so.

Det. No. 99-218 did not overlook that fact. It found the fact irrelevant. The contract between the bank and the taxpayer [contemplates] a contractor-subcontractor relationship [between the taxpayer and the consultant]. The taxpayer agrees to provide the technical services, for a price, and the parties expressly [anticipate] that the taxpayer will assign another person to render the actual services. Many people contract to provide services that they personally lack the expertise to perform. They perform their contractual obligations by hiring or (sub)contracting with qualified persons, with the obligor's assent. That a contractor lacks the technical skills to personally render services it has contracted to perform does not make the amounts it pays subcontractors "pass-throughs" for B&O tax purposes. See, Restatement (Second) Contracts, §§ 318, 323; Det. No. 86-293, 2 WTD 1 (1986).

The taxpayer alleges several errors of law in Det. No. 99-218. It argues:

> As to the law, if it were legally correct to claim that the one factor of being able to 'provide services' from some other 'subcontractor' eliminated 'paymaster' eligibility under Rule 111, then Medical Consultants Northwest (hereinafter 'MCN') could not possibly qualify for the exemption, which it did, as MCN routinely provides medical doctors who provide independent medical examinations, and if one doctor cannot provide the examination, it has a panel of other qualified doctors to do the same examination. As is apparent from the MCN decision, however, MCN did qualify for the exemption from B&O taxes under Rule 111 under those facts, to the extent of payments made to the doctors.

MCN was a decision that turned on stipulated facts. The second Rule 111 requirement was not at issue. Importantly, we find no suggestion in the Court of Appeals decision that there was a contractor-subcontractor relationship between MCN and the physicians who provided independent medical examinations. The opinion describes MCN as being in the business of providing objective medical opinions based on medical examinations performed by others. We find nothing indicating MCN contracted to perform medical examinations. In the present case, the taxpayer contracted to "provide [bank] with such technical assistance in design, development programming, implementation, consulting, project management . . . ." It contracted to "undertake and accomplish" these tasks. It warranted the services its "affiliate" would render. Unlike in MCN, it appears from the agreements in the present case that in contracting with the independent consultant, the taxpayer was procuring services on its own behalf, to fulfill its contractual obligations, and that it could and did provide the services, through a subcontractor. We cannot find that the taxpayer met either the first or second prong of Rule 111 under these agreements.

The taxpayer argues:

> The second Rho factor is a fundamentally factual one, which as noted is whether the taxpayer 'does not or can not render the service'. The taxpayer in this case does not render the service, and cannot render the service. The use of a generic contract by a Bank does not alter the basic facts of the agreement between the parties, a contract between a "headhunter" and an institution looking for one person to fulfill requirements for one specific project requiring highly technical and specialized skills. The second Rho factor has been met.

The problem with this argument is that the contract between the taxpayer and the bank is not a "headhunter" contract. The taxpayer undertakes extensive obligations related to the rendering of computer consultation services. A "headhunter" relationship is one in which the employment agency performs its whole function in finding employees or independent contractors for its client. The "headhunter" is an agent for that limited function. See Restatement (Second) Agency § 5. Here, the taxpayer has contracted to be more than a "headhunter."

The taxpayer argues Det. No. 99-218 misinterprets and misapplies the third Rule 111 requirement in at least two respects. The taxpayer argues that the Determination incorrectly focuses on the relationship between the bank and the taxpayer, whereas the focus of the third Rule 111 requirement is the relationship between the taxpayer and the third party, in this case the independent consultant. The taxpayer argues that the focus of the requirement is that the taxpayer not be liable to the independent consultant. It argues: "[The third requirement] does not 'focus' on the relationship between [taxpayer] and the Bank, other than to require that some 'agency' relationship exist." It argues that the language in the agreement between the taxpayer and the independent consultant absolving the taxpayer of liability for payment if the taxpayer is unable to collect the fee from the bank establishes that the taxpayer is not liable. It argues the bank and the taxpayer have "substantially entered into an agency relationship."

[3] We continue to believe the taxpayer has it backward. Rule 111 recognizes pass-through payments only in agency situations. A taxpayer must be receiving and paying the funds as an agent of the payor, the payor (principal) must be liable for payment, and the taxpayer must assume solely agent liability for payment. If the taxpayer is not the agent of the bank, the third requirement is not met. It cannot make the bank directly liable to the independent contractor, and itself the agent of the bank, by inserting a provision in an agreement to which the bank is not a party. The taxpayer's status as an agent must be established by the agreement of the bank and the taxpayer, or by a course of conduct between the parties. Here, looking prospectively, we cannot find there is an agency relationship between the bank and the taxpayer.

We find no error in Det. No. 99-218.

DECISION AND DISPOSITION:

The taxpayer's petition for reconsideration is denied.

Dated this 27th day of April, 2000.