Cite as Det. No. 99-126, 19 WTD 94 (2000)

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. 99-126
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 111: B&O TAX – ADVANCE OR REIMBURSEMENT – ORAL UNDERSTANDING. An informal understanding between employee-placement consultants that an employer-client is liable for either consultant's portion of a placement fee is not enough to support exclusion under Rule 111. Payments were not excludable where taxpayer and its co-consultants had understanding, sometimes oral and sometimes written, that the client alone would be liable; where co-consultants understood that failure of the client to pay would not result in the other consultant being liable for payment; but where co-consultants did not bill or collect directly from clients and the client was not a party to the contract or arrangement.

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.

NATURE OF ACTION:

Taxpayer protests assessment of Service & Other B&O tax on amounts disallowed as deductions under a fee-sharing arrangement for employee-placement services.[1]

FACTS:

Johnson, A.L.J. – Taxpayer's records were audited for the period January 1, 1994 through October 31, 1997. He is engaged in business as an employee-placement consultant. In that capacity, he attempts to match qualified professionals ("candidates") with job openings offered by law firms and businesses ("clients"). The clients, not the candidates, pay the taxpayer for

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

these matching services. For some transactions, the taxpayer alone will match both a candidate and a client. In those cases, he reported and paid B&O tax on the full amount of the fee received for his services.

At issue is a different type of placement. For these transactions, the taxpayer will work with another independent consultant or consulting firm to fill positions. These associations can be on a one-placement basis or can be for an indefinite period. For receipts from these joint placements, he took a deduction from his receipts for the amount of the fee earned by the other consultant. Taxpayer argues this type of arrangement is common in the employee-placement industry.

The normal joint placement works as follows: the taxpayer and another consultant join together to match one consultant's candidate with the other's client. Taxpayer provided a sample contract he says is representative of all the joint arrangements, whether they are memorialized in writing or not. The contract, called a "referral agreement", is for an indefinite period and "can be terminated by written notice at any time but does not void any work done in conjunction with this Agreement prior to such written notice." The agreement provides, in pertinent part:

> Sharing Percentage: A fee ("Fee") is earned after a referred Candidate who has been submitted to a Client has been interviewed by such Client, an offer has been made and accepted by the Candidate and the Candidate has begun to work. This constitutes a Placement. When a Placement of a referral has been made in accordance with 1. And 2. Above, [the other consultant] and [Taxpayer] agree to split the gross Placement Fee paid by the Client with 50 percent of such Fee accruing to each party (50% to [the other consultant] and 50% to [Taxpayer]).
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> Billing: The search firm working directly with the Client will bill such Client for the entire Fee due. The search firm supplying the Candidate shall be remitted their [sic] share of the Placement Fee no later than 10 working days after receipt of said Fee from the Client.
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> Rebate: If, for any reason, either search firm is required to rebate, in part or in full, a Fee to the Client, the referring search firm agrees to rebate its proportionate share of such rebate to the other search firm.

As an example of an oral agreement, the taxpayer also provided a Declaration from an individual consultant with whom he enters into referral agreements. The terms recited by the declarant match those of the written agreement. The declarant also states:

> The consultants are not obligated to pay fees to each other, except to forward the portion of the fee belonging to the other consultant. If no fee is received, the contact consultant

> does not owe any fee to the other consultant. Similarly, if only a portion of the fee is received, no consultant is entitled to a specified amount; rather, each consultant is entitled only to a share of the commission.
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> I never considered [Taxpayer] obligated individually for any fee to me. I always understood that if no fee was received from the client, for instance if no placement was made, that I would not receive a fee from [Taxpayer], regardless of the services that I provided. It was always our understanding that [Taxpayer] only owed me amounts that he received on behalf of my services from the client. I considered [Taxpayer] merely a conduit for payment of these amounts.
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> In placements in which I work with other placement consultants, including [Taxpayer], we work together to accomplish a single transaction. The services we provide are for the client, not for the other consultants. We receive a single fee, which we split between us.

The auditor reviewed a sample agreement between the Taxpayer and one of his client firms. She noted that the contract "was signed by [the taxpayer's firm] in its own capacity, not as an agent or representative of the other legal search consultant." The contract does not discuss liability for payment but states that the taxpayer will replace at no charge an employee who terminates within a short period of time, unless the termination was due to the client having an insufficient workload to retain the employee. The agreement also does not indicate that anyone other than the taxpayer will provide the placement services. The auditor concluded any other consultant involved was acting as a subcontractor and that the amounts paid to the subcontractor represented a nondeductible cost of doing business. She also believed the fees paid to other consultants could not be excluded under WAC 458-20-111 ("Rule 111") as advancements and reimbursements, because the taxpayer had failed to show that the client was solely liable for payment of the other consultant's portion of the fee. She cited Det. No. 86-293, 2 WTD 1 (1986), which held that, "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."

Taxpayer protests that assessment of the tax constitutes an improper double tax. He also argues the deduction was proper under Rule 111 and case law, since the three conditions for exclusion of a "pass through" payment have been met: (1) the payments are customary reimbursements or advances; (2) the payments involve services that the taxpayer did not render; and (3) the taxpayer is not liable for payment of the incurred expenses except as the agent of the client.

ISSUE:

Whether the taxpayer is entitled to deduct amounts paid to other consultants from his taxable receipts.

DISCUSSION:

RCW 82.04.080 defines "gross income of the business":

> . . .the value proceeding or accruing by reason of the transaction of the business engaged in and includes gross proceeds of sales, compensation of 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, paid or accrued and without any deduction on account of losses.

The question in this case is whether fees billed and received by the taxpayer in cases where he was the billing consultant represent gross proceeds of the taxpayer's business. If so, he is taxable on the full amount received.

This case presents facts similar to those considered by the Washington Board of Tax Appeals in Mills & Uchida Court Reporting, Inc. v. Department of Rev., Docket No. 46110 (BTA 1996). Mills & Uchida was a corporation whose two principals and their employees provided court-reporting services. For these transactions, Mills & Uchida reported one hundred percent of its gross receipts, as did the taxpayer in the present case. Mills & Uchida also entered into arrangements with independent court reporters to provide the same services. In those cases, Mills & Uchida scheduled the independent reporters' jobs but did not control their manner of work, work product, or other aspects of their performance. Unless an attorney requested a particular court reporter, the attorney would have no knowledge of who was to perform the court reporting services. For this type of transaction, as occurred in the taxpayer's case, Mills & Uchida deducted from its gross receipts the portion of the fee (65%) paid to the independent court reporters and included in its gross receipts only the portion of the fee (35%) which it retained. The Board of Tax Appeals noted:

> The fees charged by Mills & Uchida for reporter services are generally the same regardless of who (owner or non-employee reporter) performs the services. The reporter's initials following the date of the service are the only identification of who per-formed the service on the invoice. When Mills & Uchida receives the payment for services, it will deposit the funds in a trust account. Twice a month, Mills & Uchida will pay each non-employee reporter an amount calculated by totaling the gross receipts for each reporter's jobs during the period and multiplying that amount by 65 percent. The remaining 35 percent are transferred to the Mills & Uchida's corporate account. In the trust account books, the payment to the non-employee reporter was labeled as "commission" during July and August of 1990. That label was changed to "settlement" some time later.
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> In the event that an invoice is not paid, Mills & Uchida has no liability to pay the reporter. If there are billing disputes, they must be resolved between the attorney and the non-employee

reporter. If the attorney does not pay, the non-employee reporters do not get paid. Mills & Uchida has never sued an attorney for unpaid bills, nor has it ever been sued by either an attorney or one of its reporters. Mills & Uchida has attempted to collect an unpaid bill through a collection agency and bankruptcy court. In the case of the collection agency, it did so with the agreement of the reporters involved.

The reporters are not treated as employees of Mills & Uchida. Mills & Uchida does not file W-2 forms on the reporters or a 1099 at the end of the year. Reporters pay their own business and occupation (B&O) and self-employment taxes on their income, have their own licenses, and pay their own business expenses. Each reporter is listed in the Attorney Redbook by name.

The Board considered both the arguments against "pyramiding" tax and whether Rule 111 applied:

"The legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state." Impecoven v. Department of Revenue, 120 Wn.2d 357, 363, 841 P.2d 752 (1992). The result is a pyramiding tax, which is levied each time an entity does business. The act of conducting business triggers the tax and gross income is the measure of the tax. As with any tax exemption, exemptions to a tax are narrowly construed; taxation is the rule and exemption is the exception. Budget Rent-A-Car of Wash.-Or, Inc. v. Department of Revenue, 81 Wn.2d 171, 174, 500 P.2d 764 (1972). The burden is on Mills & Uchida to show entitlement to a legislative deduction. In re Sehome Park Care Center, Inc., 127 Wn.2d 774, 778, 903 P.2d 443 (1995).

Excluded from the definition of "gross income" are certain "advances and reimbursements" for which the taxpayer assumes agent liability. WAC 458-20-111 (Rule 111) provides, in part:

> The word "advance" as used herein, means money or credits received by a taxpayer from a customer or client with whom the taxpayer is to pay costs or fees for the customer or client.
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> 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.
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> 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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> 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.)

The Supreme Court has characterized the three requirements of Rule 111 as (1) repayments are customary reimbursements for advances made to procure a service for the client; (2) repayments involve services that the taxpayer did not or could not render; and (3) the taxpayer must not be liable for the initial payments.

Mills & Uchida must show that it has satisfied all of the elements of Rule 111 in order to exclude amounts from its gross receipts.

[The Board reviewed several cases that interpret Rule 111. In Christensen, O'Connor, Garrison, & Havelka v. Department of Revenue, 97 Wn.2d 764, 649 P.2d 839 (1982), the court held that the advances and reimbursements in question were the types intended for exemption, concluding that the Disciplinary Rules of the Code of Professional Responsibility prevented the attorneys from providing the services. In Walthew, Warner, Keefe, Arron, Costello and Thompson v. Department of Revenue, 103 Wn.2d 183, 691 P.2d 559 (1984), the court concluded that "pass-through payments of the type represented . . . in Christensen are not the type of reimbursements the Legislature contemplated for inclusion in gross income for services". Finally, in Rho Company, Inc. v. Department of Revenue, 113 Wn.2d 561, 782 P.2d 986 (1989), the court concluded that the first two requirements of Rule 111 were met because there was no dispute on those requirements, but it remanded to the Board the question of whether the third element was satisfied. The parties subsequently settled the case.

Mills & Uchida's argument is that it acts as an agent in procuring court reporter services for attorneys. Before Mills & Uchida can claim "only an agent's liability", it must first show that it was an agent. Christensen, Walthew, and Rho do not assist the firm in proving that it had the role of "agent" vis-a-vis the non-employee reporters. Rho remanded the agency issue to this Board, while Christensen and Walthew found an agency relationship between the law firms and their clients because of the "unique" requirements imposed on lawyers by the Disciplinary Rules of the Code of Professional Responsibility. The service that Mills & Uchida provides is that of procuring and scheduling reporters for attorneys. Mills & Uchida's income is dependent upon the services of the reporters. The payments did not involve services that Mills & Uchida did not or could not render as was the case in Walthew and Christensen. While Mills & Uchida may be regulated by the State for licensing purposes, it is not subject to the Disciplinary Rules of the Code of Professional Responsibility. Those "unique" circumstances do not exist in this case. Clearly, Mills &

> Uchida's business is offering court-reporting services. In that respect, this case also differs from Group Health Northwest v. Department of Revenue, BTA Docket No. 91-11 (1992). Group Health was not in the business of providing the specialty services it sought exemption for.
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> Mills & Uchida's version of the exemption would characterize revenue generated by subcontractor work as "pass-throughs." We decline to make that leap. Mills & Uchida is not prevented from hiring reporters as employees to provide court reporter services. The fact that Mills & Uchida chooses to subcontract some of its work to independent reporters does not change Mills & Uchida's customer relationship with attorneys. Such a conclusion would mean that any business who uses subcontractors could qualify subcontractor work as a "pass-through" if it had an agreement that it was not liable when the customer failed to pay. For instance, a real estate appraisal company and an appraiser-subcontractor could write an agreement that the company is not liable to the subcontractor for uncollected payments, use a trust account, and qualify for B&O tax exemption. The Walthew court made it clear that the "unique" situation of attorneys bound by the Disciplinary Rules of the Code of Professional Responsibility distinguishes them from other professionals. "The Department's concern that other professionals will necessarily gain an exemption by our holding is misplaced." Walthew, supra at 188.

(Emphasis and brackets supplied.)

We find the analysis in Mills & Uchida persuasive. It is illogical to read the language “does not or cannot render” to mean that, in cases where the taxpayer elects not to perform all the services of a placement, he may deduct a percentage of fees shared with another consultant.

DECISION AND DISPOSITION:

Taxpayer’s petition is denied.

Dated this 11th day of May 1999.