Cite as Det. No. 00-027, 19 WTD 947 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	DETERMINATION
	)	
	)	No. 00-027
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

RULE 111; RULE 194; RCW 82.04.290; RCW 82.04.460; ETA 90-1: SERVICE B&O TAX – PASS-THROUGHS – APPORTIONMENT – PROPERTY MANAGEMENT SERVICES. A foreign corporation/taxpayer providing real property management services was subject to service B&O tax on its gross income without the right to deduct reimbursements it received from the owners for on-site personnel salaries and other expenses.[1] The taxpayer did not meet all requirements of Rule 111 and ETA 90-1. However, the taxpayer was entitled to apportion its gross income because the taxpayer maintained places of business both within and without Washington that contributed to the rendition of services within Washington.

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:

A foreign corporation protests the assessment of service business and occupation (B&O) tax on portions of its gross income received for providing real property management services in Washington.[2]

FACTS:

De Luca, A.L.J. – The taxpayer is a foreign corporation that is headquartered in [State A]. The taxpayer has offices in other parts of the United States, including a regional office in Oregon from where it serves its business in the Pacific Northwest. The taxpayer does not maintain an office of its own in Washington. The taxpayer is in the real property management business. The taxpayer manages, leases, markets, and operates various apartment buildings and other commercial real estate. The taxpayer declares it has "experience in all phases of building management, leasing and operation." During the time in question, the taxpayer's activities in Washington consisted of fulfilling property management contracts to manage apartment complexes in Washington owned by different owners. The owner of one building is a pension

[1] But see RCW 82.04.394, effective July 1, 1998.
[2] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

fund located in [State A]. The owner of the other building is a partnership located in [State B]. Each owner employs an "asset manager" to represent it in dealing with the taxpayer and on-site managers.

Each of the two written property management agreements at issue referred to the taxpayer as the owner's "agent." The taxpayer's contractual duties were many. The taxpayer maintained and supervised a leasing office with sufficient personnel at each property site. The taxpayer showed dwelling units to prospective tenants. The taxpayer took and processed applications for apartment rentals. It prepared and executed all leases and parking permits. The taxpayer collected security deposits. It provided the owners an annual written business or management plan including a budget, as well as, marketing, maintenance, and administrative goals and procedures with respect to each property. The taxpayer advertised the properties through various media and displays. It made arrangements for utilities for each property. The taxpayer caused each property to be maintained and repaired in accordance with local codes and in a first class condition. The taxpayer also provided the owners with weekly marketing reports on each property, monthly financial reports on each property, and quarterly market surveys of competing properties. The taxpayer also established and maintained bank accounts for each property on behalf of the respective owner for receipts and disbursements.

Under the agreements, the taxpayer prescribed the number, qualifications, and duties of the personnel regularly employed in the marketing, leasing, and management of each property, including a manager, maintenance, bookkeeping, clerical, and leasing employees. The taxpayer hired, paid, supervised, and discharged all such personnel. The taxpayer prescribed the compensation, including fringe benefits, of all on-site employees. The agreements declared all on-site employees were employees of the taxpayer, but their compensation, including benefits, were paid from collection accounts owned by the owners. The taxpayer had between six and ten employees working at each site in Washington.

Each building manager was directly responsible to the taxpayer's designated supervisor or officer. The taxpayer was required by one agreement to inform the owners in advance with respect to the hiring or dismissal of a manager. In that agreement, the owner could instruct the taxpayer to increase or decrease the number of rental personnel, or otherwise staff and operate leasing offices. The agreement also required the taxpayer to provide the owner a list each year of the names, pay, and job descriptions of each on-site employee. In both agreements, the owners reimbursed the taxpayer for compensation including fringe benefits that the taxpayer paid to on-site management employees and to all other leasing, bookkeeping, clerical, and maintenance employees. Similarly, the owners reimbursed the taxpayer for all local, state, and federal payroll taxes the taxpayer paid for such employees. The owners also reimbursed the taxpayer for supplies and equipment necessary for the employees to perform their jobs. Under the agreements between the taxpayer and the owners, the taxpayer was to pay the on-site employees from funds held in the owners' accounts or as provided by the owners. The taxpayer was not obligated to make any advance for the account of the owners. In addition to these reimbursements, the owners paid the taxpayer as its fee 4.5% to 5% of the total monthly gross receipts from each property, depending on the agreement.

The Audit Division of the Department of Revenue (the Department) reviewed the taxpayer's books and records for the period January 1, 1994 through March 31, 1998 and assessed $68,432 in service B&O tax and interest. The assessment arises from the reimbursements the taxpayer received from the apartment owners for the payments the taxpayer made to the on-site employees to compensate them for the services they rendered at the apartment complexes. The Audit Division found these reimbursed expenses were part of the taxpayer's gross income and were subject to B&O tax. The Audit Division deemed the reimbursed expenses were not excluded from the taxpayer's gross income under WAC 458-20-111 (Rule 111), *infra*. The Audit Division found the taxpayer was not a mere paymaster, but exercised pervasive control over the on-site employees.

TAXPAYER'S EXCEPTIONS:

The taxpayer contends it is entitled under Rule 111 to deduct from its gross income the reimbursements it received from the owners for on-site personnel salaries and other expenses. The taxpayer first argues the payments are customary reimbursements for advances made to procure a service for its clients – the owners. The taxpayer states it is customary for real estate owners to hire and reimburse real estate property management companies for procuring personnel to operate the owners' rental property. The taxpayer believes this statement is supported by the intent of recent legislation passed by the state legislature and codified under RCW 82.04.394 along with the accompanying legislative notes. This statute became effective July 1, 1998 (after the audit period) and it exempts from B&O tax the money property managers receive from property owners for gross wages and benefits paid to on-site personnel.

Secondly, the taxpayer contends it is entitled to treat the money as pass-through payments because it did not render the services for which it received the reimbursement payments. The taxpayer cites *Rho Company v. Department of Rev.*, 113 Wn.2d 561, 782 P.2d 986 (1989) to support this claim. The taxpayer declares the Supreme Court in *Rho* did not consider the Rho Company "involved in the rendering of the engineering services" its temporary workers provided for Boeing and other clients even though the temporary workers were identified as Rho's employees by Rho and its clients in their agreements.

Finally, the taxpayer argues it meets the third requirement of Rule 111 that the taxpayer be liable for the advances paid to the on-site personnel only as an agent of the property owners. The taxpayer refers to sections of its agreements with the owners that specifically identify the taxpayer as the owners' "agent" who was acting for and on behalf of the owners and not for its own account. The taxpayer declares the way to resolve the question whether the taxpayer was obligated to pay the on-site personnel only as agent of the owners is determined by the level of control the taxpayer exercised over the personnel. The taxpayer contends if the owners exercised pervasive control over the on-site employees, then the taxpayer was obligated only as an agent to pay the employees. The taxpayer cites the ten factors in former Revenue Policy Memorandum No. 90-1 (revised on July 1, 1998 as Excise Tax Advisory. 90-1 or ETA 90-1) to determine who had pervasive control over the employees. Accordingly, the taxpayer argues the owners were the ones who exercised pervasive control over the employees. As additional evidence of the owners' pervasive control, the taxpayer references a provision in one of the agreements that prohibited the taxpayer for a period of 90 days after the property management agreement was terminated from soliciting any on-site employee to work for the taxpayer.

The taxpayer argues alternatively it may apportion its gross income under WAC 458-20-194 (Rule 194) because it maintains places of business outside Washington that contribute to its business of providing property management services in Washington. Specifically, as noted, its home office is in [State A] and its Pacific Northwest regional office is in Oregon. Both of those offices serve and support the taxpayer's business activities in Washington through supervisory, administrative, executive, etc., functions.

ISSUES:

Were the payments from the owners to the taxpayer for the expenses of on-site employee mere pass-through payments under Rule 111 and not part of the taxpayer's gross income?

If the subject payments were part of the taxpayer's gross income, may the taxpayer apportion that income?

DISCUSSION:

The B&O tax is imposed by RCW 82.04.220:

> **Business and occupation tax imposed.** There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. Such tax shall be measured by the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be.

"Gross income of the business" is defined in RCW 82.04.080 as . . .

> 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.

Thus, compensation for the rendition of services generally is taxable in full without deductions for labor costs, taxes, and other costs. Even though business expenses generally are not deductible, the Department adopted Rule 111 to recognize that certain pass-through expenses should not be included in determining gross income. Rule 111 excludes from the definition of

"gross income" certain "advances" and "reimbursements" for which the taxpayer assumes solely agent liability. *Rho*, 113 Wn.2d at 567.
Rule 111 provides in pertinent 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.

The Washington Supreme Court in *Rho* at 567-68 stated:

> This court has summarized the operation of Rule 111 by stating that the rule allows an exclusion from income for a "pass through" payment when the following 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." Christensen, O'Connor, Garrison & Havelka v. Department of Rev., 97 Wn.2d 764, 769, 649 P.2d 839 (1982); see Walthew, Warner, Keefe, Arron, Costello & Thompson v. Department of Rev., 103 Wn.2d 183, 186, 691 P.2d 559 (1984).

All three conditions must be met in order for reimbursement payments to qualify as pass-through exclusions from gross income. In *Rho*, the Supreme Court stated there was no dispute as to the applicability of the first two conditions. The clients customarily paid Rho for procuring the engineering services rendered by the technical personnel, and Rho did not itself perform these services. The court found the facts clearly revealed "that Rho itself did not supervise or otherwise become involved in the rendering of engineering services." Indeed, Rho was not even licensed to render such services. Therefore, on appeal the parties in *Rho* focused solely on the third condition – whether Rho's liability for paying the technical personnel was solely that of an agent. *Rho* at 568.

There are some similarities between *Rho* and the present matter. For example, Rho's contracts with its clients likewise described Rho as the employer of the temporary workers. Also like the present matter, Rho's corporate clients did not directly compensate the contract personnel. Instead they sent money to Rho, who then assumed responsibility as an employer for paying the personnel, paying employer taxes, and for withholding the appropriate amount of the employees' paycheck for tax purposes. *Rho* at 563.

The similarities between the present matter and *Rho* end there. Overall, the facts in *Rho* are quite distinguishable from the present matter. For instance, as noted, Rho was not licensed to render engineering services. In the present taxpayer's contracts with the owners, provisions specifically require the taxpayer to "obtain and keep in full force and effect all necessary registrations, licenses and permits as may be required for the operation of the Property . . . ." Moreover, the Supreme Court in *Rho at 564* described the following facts:

> When one of Rho's clients had a temporary need for engineers, the client provided Rho with a purchase order listing the number of workers needed and basic job qualifications. Rho checked its resume bank for suitable personnel, and if none seemed to match the client's requirements, it advertised in various newspapers. Rho then forwarded suitable resumes to the client, who decided which workers would receive offers. The client contacted Rho with offers of employment at a given salary, and Rho communicated this information to the workers. The worker either accepted the offer or countered with a higher proposed salary. In this manner, with Rho acting as intermediary, the worker and the client arrived at a final agreement as to salary, and if the worker did not live in the immediate area, the negotiations would also cover the possible payment of a per them amount and reimbursement of relocation expenses.
>
> Once the worker reported to the client's work facility, he was subject to the exclusive guidance of the client. The client determined the worker's job assignment and the duration of his employment. The client supervised the worker and evaluated his performance. Rho played no role in this supervision, and the only regular contact that Rho had with the workers once they were on the job was the mailing of paychecks. The client furnished the tools and materials for the contract personnel to use. Requests for raises were submitted to the client either by Rho or by the worker directly. The client decided when to terminate a worker, and the procedures called for Rho to inform a worker of his firing once the client so decided. In practice, however, the client often informed the worker that he was fired without going through Rho.

Unlike *Rho*, the present taxpayer did not forward resumes to the client owners to hire employees, with the exception of some managers. Accordingly, the owners did not decide which workers would receive job offers. The taxpayer did. Unlike *Rho*, the owners did not set the levels of compensation, and the taxpayer was not acting as a mere intermediary in determining salaries. The taxpayer set the levels of compensation. Unlike *Rho*, the on-site employees in the present matter were not subject to the exclusive guidance of the client owners. The owners did not determine the workers' job assignments and the duration of their employment. The taxpayer did. Unlike *Rho*, the owners did not supervise and evaluate the employees' performances. The taxpayer supervised the employees and had regular contact with the on-site employees beyond mailing paychecks. Unlike *Rho*, requests for raises were not routinely submitted to the owners for approval in the present matter. The owners did not decide when to terminate employees. Again, the taxpayer did.

It is clear Rho played a much different role than the present taxpayer. Rho operated an employment agency. Upon placing temporary workers with clients, Rho's contacts with the employees were at an end other than to process and mail their paychecks. By contrast, the present taxpayer is a property manager who was hired by the absentee property owners for its experience and expertise to operate the properties in all respects, including the hiring, supervising, paying, and firing of on-site employees. Indeed, the taxpayer's contracts with the owners declares the taxpayer is . . .

> engaged in the management, leasing, marketing and operation of various apartment buildings and other commercial real estate, and has experience in all phases of building management, leasing and operation.

Recital A. Further, § 1 of the agreement provides ". . . Owner grants to [the taxpayer] the sole and exclusive right to supervise and direct the management, leasing and operation of the Property for the account of the Owner." Therefore, the taxpayer does not meet the second condition of the three-condition test described in *Rho* because the payments to the taxpayer were for services the taxpayer could and did render.

In discussing the third condition of Rule 111, the court in *Rho* remanded the case to the Board of Tax Appeals to determine if an agency relationship existed. If an agency existed, the Supreme Court instructed the Board to determine if Rho's obligation to pay the temporary workers constituted solely agent liability. The court then stated:

> Resolution of this issue will require analysis of the control over the contract personnel that was exercised by Rho and by the clients. If the clients' control over the personnel was so pervasive that it should be deemed the employers of the personnel for purposes of B&O taxation, and Rho's control consisted of little more than paying the personnel once they were hired, then Rho should be deemed to be a mere paymaster who pays the personnel only as an agent for the clients. The areas in which control will be important will include hiring, compensation, work assignment, supervision and termination.

Rho at 573.

Following *Rho*, the Department issued then RPM 90-1 (as noted, now ETA 90-1). In ETA 90-1, the Department responded to the *Rho* court's conclusions that specific factors should be considered when determining whether a taxpayer is the employer or the agent for Rule 111 purposes. The party designated as the employer under the contract is taxed as the employer unless the other party has pervasive control. ETA 90-1 lists the following factors for determining pervasive control:

1. Ultimate decision as to hiring and firing the worker;
2. Ultimate decision as to duration of employment;
3. Setting the rate, amount, and other aspects of compensation;
4. Determining the worker's job assignments and instructions;
5. Exercising exclusive guidance and supervision over the work performed;
6. Evaluating the worker's performance;
7. Determining the days and hours of work performed;
8. Providing the office space or other controlled work premises;
9. Providing the tools and materials applied in the workplace; and
10. Compensating workers for vacation time, sick leave, and insurance benefits.

While ETA 90-1 is advisory only to taxpayers, it is binding on the Department and it continues to reflect the *Rho* court's requirements for determining pervasive control, including consideration of the terms of a contract. In addition to the factors listed above, ETA 90-1 provides:

> When these elements of control exist only in behalf of the business to whom the workers are provided, that business will be treated as the employer and the business providing the workers will be treated only as a payrolling agent, notwithstanding terms in any contract between the businesses.
>
> <u>When one or more of these elements exist in behalf of the business providing the workers, and any contract between the parties designates this business as the "employer," then it will be treated as the employer for state tax purposes as well.</u>
>
> When there is no written contract between the businesses, the elements of control, to the extent that they are determinable, must exist exclusively in the business to whom the workers are provided such that the business providing the workers is acting solely as an agent in procuring and paying the workers.

(Underlining added.) The written contracts between the present taxpayer and the owners designated the taxpayer as the employer. Furthermore, in light of ETA 90-1, the owners did not exercise pervasive control over the on-site employees. Rather than controlling all ten factors listed, the owners controlled only one by providing the office space and other work premises. As we have seen, the taxpayer did the hiring and determined the compensation levels, the work assignments, and terminations of the on-site employees. The taxpayer supervised and evaluated the on-site employees. The taxpayer determined the days and hours they worked. The taxpayer paid them directly and was named employer on various taxes reported. Clearly, the taxpayer was more than a mere paymaster. *See* Det. No. 98-203, 18 WTD 412 (1999). In short, the taxpayer also does not meet the third condition of Rule 111 and does not meet the requirements of ETA 90-1.

Finally, the fact that the legislature passed RCW 82.04.394 does not support the taxpayer's pass-through claim. The statute became effective July 1, 1998, which was after the audit period. The statute exempts property management companies from B&O tax on amounts received from property owners for gross wages and benefits paid directly to on-site personnel from property management trust accounts. The legislature did not state or imply that this legislation clarified existing law or that it was retroactive. *Marine Power and Equip. Co. v. Human Rts. Comm. Hearing Tribunal*, 39 Wn.App. 609, 614-15, 694 P.2d 697 (1985). We view this law as an exemption from the B&O tax that the legislature intended to create beginning July 1, 1998. Prior to that date, the exemption did not exist under then-existing law by statute, regulation, or common law.

We next discuss whether the taxpayer may apportion its gross income for B&O tax purposes. The audit report does not address the issue. RCW 82.04.460 provides in pertinent part:

> (1) Any person rendering services taxable under RCW 82.04.290 and maintaining places of business both within and without this state which contribute to the rendition of such services shall, for the purpose of computing tax liability under RCW 82.04.290, apportion to this state that portion of his gross income which is derived from services rendered within this state. Where such apportionment cannot be accurately made by separate accounting methods, the taxpayer shall apportion to this state that proportion of his total income which the cost of doing business within the state bears to the total cost of doing business both within and without the state.

See also Rule 194. The taxpayer is rendering services taxable under RCW 82.04.290. The taxpayer maintains places of business both within and without this state. Specifically, the taxpayer maintains places of business in Washington at the apartment complexes its personnel manage and operate. The taxpayer also maintains places of business outside Washington that contribute to the rendition of such services, such as its Pacific Northwest regional office in Oregon from where it supervises the Washington properties, and its home office in [State A]. Thus, the taxpayer must apportion to this state that portion of its gross income that is derived from services rendered within this state. Further, the taxpayer declares it does not maintain separate accounting methods. Whether the taxpayer may apportion by the separate accounting method or by the cost of doing business method depends on the accounting methods the taxpayer uses. We will allow the Audit Division to make that determination upon remand of the case.

DECISION AND DISPOSITION:

The taxpayer's petition is denied in part. The taxpayer may not exclude from its gross income the amounts received from the property owners as reimbursed expenses for on-site employee compensation, benefits, employment taxes, etc. However, the taxpayer shall apportion its gross income in accordance with RCW 82.04.460 and Rule 194. We will remand the matter of apportionment to the Audit Division to allow it adjust the assessment accordingly. Should the taxpayer disagree with the adjustment it may appeal the results to the Appeals Division in accordance with RCW 82.32.160. We note the taxpayer should review RCW 82.04.394 for periods after June 30, 1998 to determine if it qualifies for the B&O tax exemption afforded real property managers.

Dated this 29th day of February, 2000.