Cite as Det No. 10-0197, 30 WTD 61 (2011)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON[1]

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. 10-0197 Registration No. . . . Document No. . . ./Audit No.. . . Docket No. . . .

[1] Rule 224; RCW 82.04.290: SERVICE AND OTHER ACTIVITIES B&O TAX. Portion of judgment corporation received in a lawsuit for compensation for services rendered, that it paid to its attorney as a contingent fee, is subject to Service and Other Activities B&O tax. This is irrespective of attorney's lien on that portion of judgment.

[2] Rule 178; Rule 228; RCW 82.12.010; RCW 82.32.070; RCW 82.32A.030: USE TAX – DUTY TO KEEP SUITABLE RECORDS. Corporation did not provide Department with suitable records (e.g., invoices) to support its assertion that it did not consume or receive items in Washington that it purchased. Therefore, the corporation owes use tax on those items.

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.

Pardee, A.L.J. – A Washington corporation engaged in real estate management disputes the Department of Revenue's (Department's) assessment of Service and Other Activities business and occupation (B&O) tax on a portion of proceeds it received on a judgment entered in a lawsuit in which it sued for compensation for services rendered. The corporation argues that the portion of proceeds earmarked for its attorney under a contingent fee agreement, and for which the attorney had a statutory lien, is excludable from its gross income, and therefore not subject to

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

B&O tax. Taxpayer also disputes use tax assessed on items which it purchased, and argues that it never received or used the items in Washington. We disagree with the corporation, and affirm the Department's assessment of Service and Other Activities B&O tax and use tax.

ISSUES

1. Is the portion of a judgment taxpayer received from a defendant in a lawsuit for compensation for services rendered, that taxpayer paid out as attorneys' fees under a contingent fee agreement, not subject to Service and Other Activities B&O tax under RCW 82.04.290, because taxpayer's attorney had a lien on that portion of the judgment under RCW 64.40.010?

2. Under RCW 82.32A.030 and RCW 82.32.070, did taxpayer provide sufficient records that prove it did not receive or use items in Washington, and therefore does not owe use tax on such items under RCW 82.12.020 and WAC 458-20-178?

FINDINGS OF FACT

[Taxpayer], a Washington corporation, operates a property management office in . . . Washington. The shareholders of Taxpayer reside in [another state]. Taxpayer was instrumental in the development and construction of [a shopping area in Washington]. During the course of the development of [the shopping area], Taxpayer was discharged by the owner. Taxpayer subsequently sued the owner in . . . County Superior Court on a *quantum meruit* theory (i.e., a reasonable value for services it rendered the owner), [Taxpayer] prevailed, and . . . was awarded a judgment of $. . . (Judgment). . . . Taxpayer's attorneys filed a Judgment Lien against the real property which was the subject of Taxpayer's lawsuit, and Notice of Wage Lien Claim Against the Judgment, respectively. Both liens granted Taxpayer's attorneys a vested interest in the proceeds of the Judgment under RCW 64.40.010.

At the onset of the lawsuit, Taxpayer and their attorneys had entered into a contingent fee agreement. [Later], a dispute arose between Taxpayer and their attorneys regarding the amount of attorneys' fees due the latter. As is standard in such contingent fee agreements, the defendant in the lawsuit made the check for the judgment amount jointly payable to Taxpayer and their attorneys. The judgment check was received by Taxpayer's attorneys. An independent third party attorney was brought in to mediate the dispute between Taxpayer and their attorneys over fees, which was ultimately resolved, whereby Taxpayer's attorneys received $. . . .

[When] preparing Taxpayer's profit and loss statements [for the year judgment was paid], [Taxpayer's accountant] booked the gross proceeds . . . from the Judgment, rather than the net that Taxpayer actually received . . . . Taxpayer took a deduction [slightly less than the] amount [of fees paid to the attorneys]. . . . Taxpayer's profit and loss statements which the Department relied upon, [indicated these deductions were] "legal fees paid by others. . . ."

The Department's Audit Division (Audit) examined Taxpayer's books and records for the period January 1, 2005, through June 30, 2008 (Audit Period). On September 21, 2009, the Department

issued Taxpayer Document No. . . . (Assessment) totaling $. . ., including $. . . in Service and Other Activities B&O tax, $. . . in use tax and/or deferred sales tax, and interest of $. . . .

Schedule 2 of the Assessment concerning the Service and Other Activities B&O tax assessed, involved a reconciliation of income taxable under that classification, through a comparison of amounts Taxpayer recorded in its business records with amounts Taxpayer reported to the Department. The taxable differences identified on Schedule 2 were the result of Taxpayer not reporting the Judgment in its entirety, and Audit's conclusion that Taxpayer could not deduct attorneys' fees it paid out of the Judgment. Schedule 3 of the Assessment explains that Audit examined all of Taxpayer's purchases for the Audit Period, and at Workpaper A details Taxpayer's purchase of consumable supplies upon which retail sales tax, deferred sales tax, or use tax was not paid to the vendor or the Department. Taxpayer never provided Audit with copies of invoices or other documentation showing that the consumables were not subject to tax. Taxpayer argues that if it had collected the proceeds from the Judgment . . . in total, and then disbursed the fees to its attorneys, there would be some merit to the Department's position. Taxpayer asserts that its attorneys had total control over the funds during the entire fee dispute, however, and that it never actually or constructively received the entire proceeds of the Judgment. Taxpayer argues that the purpose and intent statement which accompanies RCW 60.40.010 mandates that Taxpayer is not liable for Service and Other Activities B&O tax on the portion of the Judgment that Taxpayer paid to its attorneys under its contingent fee agreement.

With regards to use tax assessed on consumables, Taxpayer asserts that according to its "best information and belief" certain items "were not consumed in the state of Washington and therefore not subject to tax nor were they received in the state of Washington."

ANALYSIS

Attorneys' Fees Taxpayer Paid out of Judgment

[1] There is levied and shall be collected from every person a tax for the act or privilege of engaging in business activities. RCW 82.04.220. 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. *Id.* "Gross income of the business" is defined as:

> [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).

Every person engaging within Washington in any business activity, not taxed explicitly under another section of RCW Ch. 82.04, or RCW 82.04.290(2)(b), is subject to Service and Other Activities B&O tax on the gross income of their business, at a specified rate. RCW 82.04.290(2)(a). *See also* WAC 458-20-224 (Rule 224); WAC 458-20-138 (Rule 138).[2] Taxpayer's assertion that is not liable for B&O tax on the portion of the Judgment its attorneys received under the contingent fee agreement with Taxpayer, ignores the reality that the B&O tax is pyramiding in nature, and that both Taxpayer and its attorneys are subject to taxation on that portion. In Det. No. 95-020, 15 WTD 118, the Department explained the pyramiding nature of the B&O tax as follows:

> The B&O tax is pyramiding in nature. Det. No. 88-370, 7 WTD 5 (1988); Det. No. 88-197, 5 WTD 369 (1988). The legislature intended to impose the B&O tax upon virtually all business activities carried on within the state. Impecoven v. Department of Rev., 120 Wn.2d 357, 363, 841 P.2d 752 (1992); Time Oil Co. v. State, 79 Wn.2d 143, 146, 483 P.2d 628 (1971). Because the B&O tax is on the act or privilege of engaging in business activities, and not upon the product or service itself, more than one taxpayer may pay B&O tax on proceeds from the sale of the same product or service. This is entirely proper.

A person claiming a tax exemption, exception, or deduction has the burden of proving he or she qualifies for the tax benefit. *Group Health Cooperative of Puget Sound, Inc. v. State Tax Comm'n*, 72 Wn.2d 422, 433 P.2d 201 (1967). Taxation is the rule; exemption is the exception. *Spokane County v. City of Spokane*, 169 Wash. 355, 358, 13 P.2d 1084 (1932). Exemptions from a taxing statute must be narrowly construed. *Budget Rent-A-Car, Inc. v. Dep't of Revenue*, 81 Wn. 2d 171, 174, 500 P.2d 764 (1972); *Evergreen-Washelli Memorial Park Co. v. Dep't of Revenue*, 89 Wn.2d 660, 663, 574 P.2d 735 (1978). The person claiming the benefit bears the burden of showing that he qualifies. *Budget* at 175. In addition, a specific statute or rule takes precedence over a general statute or rule. Det. No. 00-094, 21 WTD 58 (2002) (citing *State v. Q.D.*, 102 Wn.2d 19 (1984)). *See also* Det. No. 00-089ER, 24 WTD 25 (2005) ("[I]t is useful to return to the standard maxim that a specific statute controls a general one.") (Quoting *Martinelli v. Dep't of Revenue*, 80 Wn. App. 930, 940 (1996)).

Taxpayer's argument that 2004 amendments to RCW 60.40.010[3] prohibit the portion of the Judgment that Taxpayer pays to its attorneys from being subject to B&O tax, misses the point.

---

[2] In general, gross income from legal services is subject to Service and Other Activities B&O tax. WAC 458-20-207(3) (Rule 207(3)). The gross income of such business generally includes the amount of compensation paid for legal services, and amounts attributable to providing those services. Rule 207(3)(a).

[3] RCW 60.40.010 reads:

(1) An attorney has a lien for his or her compensation, whether specially agreed upon or implied, as hereinafter provided:

(a) Upon the papers of the client, which have come into the attorney's possession in the course of his or her professional employment;

Nothing in RCW 60.40.010 alters the language in RCW 82.04.080, which mandates that for purposes of B&O tax, costs and expenses, such as attorneys' fees are not deductible from the measure of "gross income of the business." Rather, the relevant amendments to RCW 60.40.010 were simply concerned with the federal income taxation of attorney's fees, addressed by the Ninth Circuit Court of Appeals in a 2003 decision. An examination of the legislative history behind the amendments explains this.

In 2004, via Engrossed Substitute Senate Bill 6270 (ESSB 6270 – "Bill"), Laws 2004, Chapter 73, the Washington legislature amended RCW 60.40.010, by adding new provisions concerning attorney's liens, to apply retroactively. Section 1 of the Bill contains a purpose statement, not incorporated into RCW 60.40.010, but which follows the language therein, and reads:

> The purpose of this act is to end double taxation of attorneys' fees obtained through judgments and settlements, whether paid by the client from the recovery or by the defendant pursuant to a statute or a contract. Through this legislation, Washington law

---

(b) Upon money in the attorney's hands belonging to the client;

(c) Upon money in the hands of the adverse party in an action or proceeding, in which the attorney was employed, from the time of giving notice of the lien to that party;

(d) Upon an action, including one pursued by arbitration or mediation, and its proceeds after the commencement thereof to the extent of the value of any services performed by the attorney in the action, or if the services were rendered under a special agreement, for the sum due under such agreement; and

(e) Upon a judgment to the extent of the value of any services performed by the attorney in the action, or if the services were rendered under a special agreement, for the sum due under such agreement, from the time of filing notice of such lien or claim with the clerk of the court in which such judgment is entered, which notice must be filed with the papers in the action in which such judgment was rendered, and an entry made in the execution docket, showing name of claimant, amount claimed and date of filing notice.

(2) Attorneys have the same right and power over actions to enforce their liens under subsection (1)(d) of this section and over judgments to enforce their liens under subsection (1)(e) of this section as their clients have for the amount due thereon to them.

(3) The lien created by subsection (1)(d) of this section upon an action and proceeds and the lien created by subsection (1)(e) of this section upon a judgment for money is superior to all other liens.

(4) The lien created by subsection (1)(d) of this section is not affected by settlement between the parties to the action until the lien of the attorney for fees based thereon is satisfied in full.

(5) For the purposes of this section, "proceeds" means any monetary sum received in the action. Once proceeds come into the possession of a client, such as through payment by an opposing party or another person or by distribution from the attorney's trust account or registry of the court, the term "proceeds" is limited to identifiable cash proceeds determined in accordance with RCW 62A.9A-315(b)(2). The attorney's lien continues in such identifiable cash proceeds, subject to the rights of a secured party under RCW 62A.9A-237 or a transferee under RCW 62A.9A-332.

(6) Child support liens are exempt from this section.

> clearly recognizes that attorneys have a property interest in their clients' cases so that the attorney's fee portion of an award or settlement may be taxed only once and against the attorney who actually receives the fee. This statute should be liberally construed to effectuate its purpose. This act is curative and remedial, and intended to ensure that Washington residents do not incur double taxation on attorneys' fees received in litigation and owed to their attorneys. Thus, except for RCW 60.40.010(4), the statute is intended to apply retroactively.

A closer look at the legislative history of the Bill clarifies the origin and meaning of the purpose statement in § 1 of the Bill. The Final Bill Report for the Bill states:

> **Background:** In Washington, prevailing plaintiffs in civil rights employment cases must pay federal income tax on the entire amount of the settlement or judgment, including any amounts awarded for attorney's fees. The attorney also pays federal income taxes on the same fees when the attorney receives them. The Court of Appeals of Washington found that adverse tax consequences caused by including attorney's fees as taxable income to the plaintiff, in an employment discrimination case, were part of the actual damages to be awarded in the case. *Blaney v. Ass'n of Workers*, 114 Wn.App. 80, 55 P.3d 1208 (2002).
>
> The United States Court of Appeals for the Ninth Circuit found that the question of whether attorney's fees paid under a contingent fee agreement are includable in the plaintiff's gross income is answered by a two part test: (1) how state law defines the attorney's rights in the action and (2) how federal tax law operates. The rationale of the test is that a party cannot escape tax liability through the assignment of not yet received income to another person. Washington attorneys have liens for compensation on judgments to the extent of the value of their services. The priority of an attorney's lien is determined at the time it is claimed. Liens, against the same judgment, that are filed prior to the time the attorney files have priority over the attorney's lien.
>
> **Summary:** An attorney has a lien upon the action and its proceeds to the extent of the value of the services performed by the attorney in that action. "Proceeds" are limited to monetary sums received in the action, so the lien is not enforceable against real or personal property. The attorney's lien is superior to all other liens upon the judgment, subject to the rights of secured parties under the Uniform Commercial Code. The Legislature expresses its purpose of making attorney's fees taxable solely to the attorney and its intention that the court will apply the statute retroactively. Child support liens are exempt from the statute.

. . . An earlier Bill Report originating from the Washington State Senate indicates that the Ninth Circuit Court of Appeals decision referred to in the Final Bill Report on the Bill is *Banaitis v. Comm'r of Internal Revenue*, 340 F.3d 1074 (2003). Due to conflicts in the Federal Circuit Courts of Appeals over the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent-fee agreement, and whether that was income to the plaintiff under the Internal Revenue Code, the United States Supreme Court granted certiorari. The Supreme Court heard consolidated appeals on the issue, including the appeal of the Ninth Circuit's

decision in *Banaitis*. The United States Supreme Court decided the attorney's fees issue in *Comm'r of Internal Revenue v. Banks*, 543 U.S. 426, 125 S.Ct. 826 (2005).

In *Banaitis*, the Ninth Circuit held that the portion of the recovery paid to the attorney as a contingent fee is excluded from the plaintiff's gross income for federal income tax purposes if state law gives the plaintiff's attorney a special property interest in the fee, but not otherwise. However, in *Banks*, the Supreme Court overruled *Banaitis*, and held:

> [A]s a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits.

543 U.S. at 430.[4]

Therefore, after *Banks*, for purposes of federal income taxation, courts no longer look to a state's attorneys' lien statute to determine whether the portion of a judgment due an attorney under a contingent fee agreement is taxable. Rather, the income is taxable to the client regardless of the attorney's interest. Regardless, under RCW 82.04.080, Taxpayer's gross income includes the

---

[4] In reaching its conclusion in *Banks*, the Supreme Court applied the anticipatory assignment of income doctrine, and wrote:

> A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. . . . The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed "to those who earned them," . . . a maxim we have called "the first principle of income taxation."
>
> . . . Respondents argue that the anticipatory assignment doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue here. The Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery. We agree with the Commissioner. . . .
>
> In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether assignor retains dominion and control over the income-generating asset, because the taxpayer "who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." . . .
>
> In the case of litigation recovery the income generating asset is the cause of action from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation.
>
> . . . The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.
>
> The rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship.

543 U.S. at 433-437.

entire Judgment, without any deduction for attorney fees it paid. To reiterate, nothing in § 1 of the Bill, or contained in RCW 64.40.010, mandates that attorneys' fees be deductible from "gross income of the business," as defined in RCW 82.04.080. Therefore, Taxpayer owes B&O tax on the entire amount of the Judgment.

Use Tax on Consumables

[2] Washington has both a retail sales tax and a use tax. Retail sales tax is an excise tax imposed on consumers when they buy tangible personal property. RCW §§ 82.04.050, 82.04.190, 82.08.020, and 82.08.050. The use tax is a "compensating" tax; it is imposed when the sales tax has not been paid. See *Henneford v. Silas Mason Co*., 300 U.S. 577, 57 S.Ct. 524, 81 L. Ed. 814 (1937); *Northern Pacific Railway Co. v. Henneford*, 9 Wn.2d 18, 113 P.2d 545 (1941). The use tax imposes a tax "for the privilege of using within this state as a consumer any article of tangible personal property purchased at retail" on which Washington's retail sales tax has not been paid, unless an exemption is available. RCW 82.12.020.

WAC 458-20-178 (Rule 178) is the administrative regulation implementing the use tax. It explains that the use tax and the retail sales tax "stand as complements to each other" and "provide a uniform tax upon the sale or use of all tangible personal property, irrespective of where it may have been purchased or how acquired." The rule defines use broadly to "include any act by which the taxpayer takes or assumes dominion or control over the article." Rule 178(3). In addition to explaining the nature of the use tax, Rule 178 specifies that the use tax applies upon the use of any tangible personal property, not previously subjected to the Washington retail sales tax. Rule 178(2). The person liable for the tax is the purchaser. Rule 178(4).

For purposes of the use tax, "use" means "the first act within this state by which the taxpayer takes or assumes dominion or control over the article of tangible personal property (as a consumer), and includes installation, storage, withdrawal from storage, distribution, or any other act preparatory to subsequent actual use or consumption within this state." RCW 82.12.010(4)(a).

Taxpayers are required under RCW 82.32A.030 to:

> (3) Keep accurate and complete business records;
>
> (5) Ensure the accuracy of the information entered on their tax returns.

See also WAC 458-20-228(1)(a)(Rule 228(1)(a)).

With regards to a person's obligation to keep and preserve records necessary to determine the amount of tax for which they may be liable, RCW 82.32.070(1) states:

> Every person liable for any fee or tax imposed by chapters 82.04 through 82.27 RCW shall keep and preserve, for a period of five years, suitable records as may be necessary to

> determine the amount of any tax for which he may be liable, which records shall include copies of all federal income tax and state tax returns and reports made by him. All his books, records, and invoices shall be open for examination at any time by the department of revenue.

Taxpayer's statements that according to its best information and belief that items it did not consume or receive items in Washington that it purchased, does not cure the fact that Taxpayer never supplied Audit with records (e.g., invoices) to support its assertions, and failed to meet the threshold of suitable records in RCW 82.32A.030 and 82.32.070. As such, use tax contained in the Assessment must be upheld.

DECISION AND DISPOSITION

Taxpayer's petition is denied

Dated this 18th day of June 2010.