

Cite as Det. No. 05-0046, 24 WTD 422 (2005)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of)	<u>D E T E R M I N A T I O N</u>
Notice of Beneficial Liability of)	
)	No. 05-0046
...)	
)	Registration No. . . .
)	Docket No. . . .
)	Warrant Nos. . . .

- [1] RULE 217; RCW 82.32.210: UNPAID TAXES -- BENEFICIAL INTEREST OF THIRD PARTIES -- LACK OF AGENCY RELATIONSHIP. There is no requirement under Washington law that parties have a formal agency/principal relationship for the beneficial interest provisions to apply.
- [2] .RULE 217; RCW 82.32.210: UNPAID TAXES -- LIABILITY OF THIRD PARTIES WHO HAVE A BENEFICIAL INTEREST IN THE BUSINESS. Where a franchisor enters into a royalty contract with a franchisee where the franchisor receives a percentage of gross receipts of the franchisee's business, this results in a "third party who receives part of the profit, a benefit or an advantage resulting from a contract . . . with the business" and, therefore has a "beneficial interest in the operation of the business."
- [3] RULE 217; RCW 82.32.210: UNPAID TAXES -- BENEFICIAL INTEREST OF THIRD PARTIES -- SUPPORTING FACTORS. The presence of all of the delineated factors supporting a finding of beneficial interest in a business is not required. Rule 217 does not purport to illustrate all of the factors that may support such a finding.
- [4] RULE 217; RCW 82.32.210: UNPAID TAXES -- BENEFICIAL INTEREST OF THIRD PARTIES -- determinative aspect. The determinative aspect of who has a "beneficial interest" is whether the success of the franchisee's business will result directly or indirectly in further gains to the third party franchisor. A beneficial interest will not be found where the third party is a mere lessor of tangible personal property or a creditor of the franchisee.
- [5] RULE 217; RCW 82.32.210: UNPAID TAXES -- BENEFICIAL INTEREST OF THIRD PARTIES -- ATTACHMENT OF SPECIFIC LIEN. A specific lien attaches to all "goods, wares, merchandise, fixtures, equipment or other personal

property” used in the conduct of the business, including property owned by persons who have a beneficial interest, direct or indirect, in the operation of the business. “[O]ther personal property” includes business assets such as accounts receivable, chattel paper, royalties, licenses, and franchises. A third party who has a beneficial interest in a business is not personally liable for amounts owing.

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.

STATEMENT OF CASE

Breen, A.L.J. – A franchisor petitions for correction of a notice of beneficial interest liability, arguing that it did not have a “beneficial interest” in a franchisee’s business. We deny the taxpayer’s petition.¹

ISSUE

Whether the taxpayer/franchisor had a beneficial interest in the franchisee’s business so that the Department of Revenue’s (DOR) tax lien attached to the franchisor’s property used in the conduct of the franchisee’s business.

FINDINGS OF FACT

. . . (taxpayer or franchisor) is the owner of the [product] trademark and national franchisor of the [product stores] chain. The taxpayer sells franchise opportunities to enter the [product] business. The taxpayer, as part of the franchise package, offers its franchisees site selection assistance, co-operative advertising, and training (both start-up and continuing).

The taxpayer entered into a number of franchise agreements with . . . (franchisee). The franchisee operated several [product stores] in and around . . . , Washington. The franchise agreements required the franchisee to select a location from which to operate its [store]. The franchisor had to approve of the location. The franchisor or one of its designees² was required to lease the selected premises and sublet the premises to the franchisee at cost.

The franchise agreements between the taxpayer/franchisor and the franchisee obligate the franchisee to comply with the taxpayer’s operations manual. The manual includes a number of requirements and restrictions regarding advertising, the purchase of equipment, consumable supplies, uniforms, and other materials required for the operation of the franchised business. The operations manual also covers such things as hours of operation, products offered, and pricing.

Pursuant to the franchise agreements, franchisee had a non-exclusive license to use the [product] name, service marks, and trademarks in connection with the operation of his [product] business.

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

² The lease of the real property is arranged through . . . , a separate corporate arm of the taxpayer.

Furthermore, the franchisor agreed to provide a training program for the operation of the shop using franchisor's . . . procedures, business methods, business forms and business policies. The franchisor also agreed to provide on-going consultation and assistance to generally support and promote the franchisee's ability to establish and operate a successful franchise.

The franchisee was required to refrain from conducting any business or selling any products other than those approved by the franchisor at the franchisor approved location. The agreements required that the franchisee be responsible for all costs associated with operating his unit including but not limited to advertising, insurance, . . . , labor and utilities, and taxes. In addition, the franchise agreements required the franchisee to [hold franchisor harmless] In the agreements, the franchisor and the franchisee agree that [the franchisee is an independent contractor, and not an agent or employee of the franchisor.]

A franchise fee and on-going royalty payments constituted the consideration paid by the franchisee for the use of the taxpayer's body of knowledge, systems, and trademark rights. In respect to the royalty payments, the franchise agreements specified that the franchisee shall pay to the taxpayer/franchisor, . . . , a royalty equal to . . . (. . . %) percent of the gross sales from each [product] shop which he operates throughout the term of each respective agreement. The franchisee was also required to pay into [an advertising fund] (. . . %) percent of the gross sales of his [product] shop. The franchise agreements provided for rights on behalf of the franchisor to audit or otherwise examine all of the franchisee's books and records connected to the operation of the respective franchise.

The agreements contemplated the possibility of the need for the franchisor [to purchase the equipment and/or leasehold improvements of the franchisee upon termination of the agreement under federal, state or local law.]

The franchisee registered with DOR and operated the franchises. Unfortunately, the franchisee began to have difficulties meeting its financial obligations, including its Washington excise tax liabilities. The franchisee filed a petition and proposed plan under Chapter 11 of the Bankruptcy Code on . . . , 2003. On . . . , 2003, the franchisor objected to the franchisee's proposed plan contending the plan was not feasible in that the debtor (franchisee) failed to provide for continued payments required by the sublease of the real property where the franchisee's restaurant was located. The franchisee's bankruptcy petition was later dismissed.³ DOR revoked the franchisee's registration certificate on . . . , 2004. The taxpayer's last franchise agreement with the franchisee terminated [eight days later].

Throughout the period of franchisee's financial difficulties, . . . , DOR issued the above referenced warrants against the franchisee for unpaid taxes, penalties, and interest. DOR's Compliance Division determined that the franchisee's outstanding tax liabilities were uncollectible from the franchisee and issued a Notice of Beneficial Interest Liability against the taxpayer/franchisor on Initially, the taxpayer was unaware of the exact franchisee to which

³ The record does not indicate the grounds for dismissal.

the notice related. However, after further correspondence between the taxpayer and the Compliance Division, the taxpayer acknowledged the franchisee and the franchise store number.

The taxpayer denies responsibility for the franchisee's unpaid tax liability to the state of Washington claiming the franchise agreement provides that franchisees are not agents for whom the taxpayer would be liable as principal. The taxpayer contends that the franchisee was an independent owner/operator who is responsible for his own debts. We accepted the taxpayer's petition as timely.

ANALYSIS

RCW 82.32.210 specifies that the Department may issue a tax warrant if taxes, increases, or penalties are not paid and further specifies the effect of filing the tax warrant with the superior court. RCW 82.32.210 states, in part:

Upon filing, . . . thereupon the amount of the warrant so docketed shall become a specific lien upon all goods, wares, merchandise, fixtures, equipment, or other personal property used in the conduct of the business of the taxpayer against whom the warrant is issued, including property owned by third persons who have a beneficial interest, direct or indirect, in the operation of the business

WAC 458-20-217 (Rule 217) is the administrative regulation that implements the above statutory provision. The rule provides a comprehensive explanation of the various collection remedies available to DOR and the procedures for executing upon these remedies. Rule 217 states in part:

Lien for taxes. (1) **Introduction.** This rule provides an overview of the administrative collection remedies and procedures available to [DOR] to collect unpaid and overdue tax liabilities

2) **Tax liens.** [DOR] is not required to obtain a judgment in court to have a tax lien. A tax lien is created when a warrant issued under RCW 82.32.210 is filed with a superior court clerk who enters it into the judgment docket. A copy of the warrant may be filed in any county in this state in which the department believes the taxpayer has real and/or personal property. . . . The tax lien is an encumbrance on property

(3) **Persons who have a beneficial interest in a business.** A third party who receives part of the profit, a benefit, or an advantage resulting from a contract or lease with the business has a beneficial interest in the operation of the business. A party whose only interest in the business is securing the payment of debt or receiving regular rental payments on equipment does not have a beneficial interest. Also, the mere loaning of money by a financial institution to a business and securing that debt with a UCC filing does not constitute a beneficial interest in the business. Rather, a party who owns property used by a delinquent taxpayer must also have a beneficial interest in the operation of that business before the lien will attach to the party's property

(a) **Third party.** A third party is simply a party other than the taxpayer. For example, if the taxpayer is a corporation, an officer or shareholder of that corporation is a "third party" with a beneficial interest in the operation of the business . . .

(b) **Beneficial interest of lessor.** In some cases a lessor or franchisor will have a beneficial interest in the leased or franchised business. For example, an oil company that leases a gas station and other equipment to an operator and requires the operator to sell its products is a third party with a beneficial interest in the business. Factors which support a finding of a beneficial interest in a business include the following:

- (i) The business operator is required to pay the lessor or franchisor a percentage of gross receipts as rent;
- (ii) The lessor or franchisor requires the business operator to use its trade name and restricts the type of business that may be operated on the premises;
- (iii) The lease places restrictions on advertising and hours of operation; and/or
- (iv) The lease requires the operator to sell the lessor's products.

The taxpayer first observes that the language in Rule 217(3)(b) states that "[i]n some cases . . . a franchisor will have a beneficial interest in the . . . franchised business." (Emphasis added.) Thus, the taxpayer contends that the rule does not necessarily address their situation. Obviously, this language can signify that not all franchisors will have such an interest. We agree with the taxpayer's analysis. Nevertheless, the present case does not require us to delve into all of the potential factual situations wherein a franchisor may or may not have a beneficial interest. We simply must decide whether the facts and circumstances in the taxpayer's case support such a finding.

In the instant case, the taxpayer denies responsibility for the franchisee's unpaid tax liability to the state of Washington claiming the franchise agreement provides that franchisees are not agents for whom the taxpayer would be liable as principal. The taxpayer contends that the franchisee was an independent owner/operator who is responsible for his own debts.

[1] There is no requirement under Washington law that parties have a formal agency/principal relationship for the beneficial interest provisions to apply. In Det. No. 91-166, 11 WTD 345 (1992), we said:

Under the law, a third person whose property is subject to [a specific] lien must have a beneficial interest in the operation of the business. Because of this requirement, there is a rational connection between the third person who owns the property and the business activity which led to the tax liability. The legislature, by enacting the law, has determined that it is reasonable that property owned by that third person and used in the business should be available to satisfy a tax liability arising out of the business activity.

[2] Regardless of the underlying policy supporting the reasonableness of making beneficially interested third parties available for satisfaction of unpaid tax liabilities, the taxpayer argues that they do not have a beneficial interest in the franchisee's business.

We find this argument unpersuasive. We have held that the determinative aspect of who has a “beneficial interest” is whether the success of the franchisee’s business will result directly or indirectly in further gains to the third party franchisor. A beneficial interest will not be found where the third party is a mere lessor of tangible personal property or a creditor of the franchisee. Det. No. 92-029, 12 WTD 333 (1992).

[3] The taxpayer notes that the factors in Rule 217(3)(b) that support a finding of a beneficial interest in a business speak of paying the lessor or franchisor a percentage of gross receipts as “rent,” the “lease” places restrictions on advertising and hours of operation, and the “lease” requires the operator to sell the “lessor’s” products. The taxpayer argues that these factors are inapplicable for determining whether it has a beneficial interest because the franchise agreement with the franchisee requires the payment of “royalties” to use the taxpayer’s trademark, etc., there is no “lease” between the taxpayer and the franchisee,⁴ but instead a franchise agreement, and, similarly, there is no lease that places restrictions on advertising and hours of operation or that requires the operator (franchisee) to sell the lessor’s products. The taxpayer distinguishes its license arrangement with its franchisees from the traditional lessor/lessee relationship that it believes is the focus of the above factors.

As a preliminary matter, we observe that the Rule 217(3)(b) factors supporting a finding of beneficial interest in a business are merely that – factors supporting. The rule does not purport to illustrate all of factors that may support such a finding, nor does the rule *require* each and every one of the delineated factors to be present in order to conclude that a third party has a beneficial interest in the operation of a business. Nevertheless, we find all of the rule’s factors present in this case.

[4] The subsection of Rule 217 that addresses persons who have a beneficial interest in a business, subsection (3), states that “[a] third party who receives part of the profit, a benefit or an advantage resulting from a contract or lease with the business has a beneficial interest in the operation of the business.” (Emphasis added.)

That is exactly the situation here. The royalty arrangement with the franchisee, as expressed in the franchise agreement, clearly results in a “profit, a benefit or an advantage” accruing to the taxpayer, and the franchise agreement which gives rise to this resulting profit, benefit or advantage is equally clearly a “contract.” The taxpayer/franchisor plainly receives benefits from the success of the franchisee’s business. The taxpayer received a percentage of the gross receipts generated by the franchise. The taxpayer required the franchisee (business operator) to use its trade name and the contract between the taxpayer and the franchisee restricted the type of business that the franchisee could operate on his premises. The franchise agreement and the taxpayer’s operation manual placed restrictions on the franchisee in respect to advertising and hours of operation. Finally, the franchise agreement required the franchisee to sell the taxpayer’s product.

⁴ See, n. 3.

[5] Having found that the franchisor did have a beneficial interest in the franchisee's business, we must determine the effect of such a conclusion. By the terms of both RCW 82.32.210 and Rule 217, the lien is a specific lien and solely attaches to property used in the operation of the business. In pertinent part, Rule 217(2)(a) provides:

Attachment of lien. The filed warrant becomes a specific lien upon all personal property used in the conduct of the business and a general lien against all other real and personal property owned by the taxpayer against whom the warrant was issued.

(i) The specific lien attaches to all goods, wares, merchandise, fixtures, equipment or other personal property used in the conduct of the business of the taxpayer. Other personal property includes both tangible and intangible property. For example, the specific lien attaches to business assets such as accounts receivable, chattel paper, royalties, licenses and franchises. The specific lien also attaches to property used in the business which is owned by persons other than the taxpayer who have a beneficial interest, direct or indirect, in the operation of the business.... The lien is perfected on the date it is filed with the superior court clerk. The lien does not attach to property used in the business that was transferred prior to the filing of the warrant. It does attach to all property existing at the time the warrant is filed as well as property acquired after the filing of the warrant. No sale or transfer of such personal property affects the lien.

Rule 217(3)(c) further provides:

A third party who has a beneficial interest in a business with a filed lien is not personally liable for the amounts owing. Instead, the amount of tax, interest and penalties as reflected in the warrant becomes a specific lien upon the third party's property that is used in the business.

Here, the taxpayer is a "third party" for purposes of the above-cited provisions. The amounts owing because of the filed warrants became a specific lien upon all personal property used in the conduct of the franchisee's business, including any of the taxpayer's property used in the franchisee's business.⁵ The specific lien attaches to all goods, wares, merchandise, fixtures, equipment or other personal property used in the conduct of the franchisee's business. Other personal property includes both tangible and intangible property. For example, the specific lien attaches to business assets such as accounts receivable, chattel paper, royalties, licenses and franchises. Rule 217.

We find that the taxpayer had a beneficial interest in the business of the franchisee. The tax lien created by the filing of the above referenced tax warrants against the franchisee attached to any of the property owned by the taxpayer/franchisor and used in the operation of the franchisee's sandwich business.

⁵ Because the franchisee was "the taxpayer to whom the warrants were issued" (RCW 82.32.210; Rule 217) the general lien provisions are inapplicable to the taxpayer/franchisor.

DECISION AND DISPOSITION

Taxpayer's petition is denied. The finding that the taxpayer/franchisor had a beneficial interest in the business of the franchisee is sustained. The file is returned to the Compliance Division for collection action consistent with Chapter 82.32 RCW.

Dated this 25th day February of 2005.