

Cite as Det. No. 02-0187R, 24 WTD 141 (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>
Assessment of)	
)	No. 02-0187R
)	
)	Registration No. . . .
...)	FY. . . /Audit No. . . .
)	Docket No. . . .
)	
)	

- [1] RCW 82.04.220; 82.04.140: B&O TAX -- CONSULTING BUSINESS -- SUBSTANCE OVER FORM. Income in the nature of a retainer and reported as consulting income is subject to tax. Bare assertions that the income should, instead, be treated as deferred compensation, does not result in a change of treatment, and the taxpayer must accept the consequences of his chosen form.
- [2] RULE 178; RCW 82.12: USE TAX -- PIERCING CORPORATE VEIL -- CORPORATE DISREGARD. The funneling of income that a taxpayer is entitled to receive through a wholly owned subsidiary does not extinguish the taxpayer's tax obligations. To the extent the income was the subsidiary's income, the corporate form will be disregarded where corporate formalities were not followed, funds were diverted to the taxpayer's personal use, the entity was not registered or reporting business income, misrepresentations were made concerning corporate interests, and the taxpayer used the subsidiary to avoid paying tax in 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.

Mahan, A.L.J. -- A taxpayer seeks reconsideration of a decision sustaining the assessment of service business and occupation (service B&O) tax on consulting income paid to an S corporation wholly-owned by the taxpayer and reported by the taxpayer as his income for federal

tax purposes. Based on the evidence and arguments presented, we deny taxpayer's petition for reconsideration.¹

ISSUES

1. Is the taxpayer's income listed on IRS Schedule C, Form 1040, for consulting services subject to Washington's service B&O tax?
2. Should the Department of Revenue (DOR) characterize the income as deferred compensation for state tax purposes and not impose service B&O tax?
3. Is the taxpayer entitled to apportion income, at least to the extent the income was for services performed both within and without Washington?
4. To the extent the payment was first made to a company owned by the taxpayer, is the taxpayer still liable for the tax? . . .

FACTS

Until recently, the taxpayer resided in Washington. Before 1993, a . . . business owned by the taxpayer's father employed the taxpayer. Since the taxpayer left the business, it or its owner has paid the taxpayer or his S corporation approximately \$. . . per year. One annual payment of approximately \$. . . is issued to him directly as compensation, and a form W-2 is issued for these payments. The remainder of the payments are to the taxpayer's wholly owned corporation, . . . (hereinafter "Entity A").

On reconsideration, the taxpayer provided copies of deposit slips, showing periodic deposits from a company purportedly owned by the taxpayer's father to Entity A. No written agreement memorializes these payments. The taxpayer identified these payments as consulting income on Schedule C, Form 1040, of his federal income tax returns. On reconsideration, the taxpayer provided a declaration from a member of an accounting firm stating that "the payments properly should have been reported by [Entity A], an S corporation all of the shares of which are and during the assessment period were owned by [the taxpayer], and the result thereof reported by [the taxpayer] as compensation or as an allocation of S corporate income, in either case taxable to [the taxpayer]." For at least years 1997-2000, however, federal tax returns were filed showing the income as being the taxpayer's income from consulting services. The taxpayer also filed a declaration that stated the "payments were made in connection with the termination of my full time employment [with his father's business]."

The taxpayer clearly treated these payments as funds under his direction and control. No explanation has been given as to why such payments were made to Entity A or what services were purportedly provided by Entity A in exchange for the payments. The taxpayer simply states that the payments were "duly deposited into the bank account of [Entity A]."

¹ Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410. Nonprecedential portions of this determination have been deleted.

The taxpayer previously appealed various use tax assessments that the Department had asserted against him. We affirmed those assessments in Det. No. 01-186 and Det No. 01-186R. In those determinations, we held that the taxpayer used Entity A as a dba or, alternatively, Entity A was an alter ego for the taxpayer. As a consequence, the taxpayer was liable for transactions where he used Entity A as a nominee or alter ego in order to avoid paying retail sales or use tax. We have no reason to question those findings and conclusions here and adopt them for purposes of this decision.

In this matter, the taxpayer has not produced corporate records, tax records, or other documents indicating Entity A was being operated as a distinct entity. During all periods relevant hereto, it was not registered with the DOR (as required by RCW 82.32.030 and WAC 458-20-101), but was registered only with the Washington Secretary of State and the Department of Licensing. The taxpayer treated Entity A as being inactive both during the audit period and during subsequent periods and has never filed a state tax return for the corporation.

On reconsideration, the taxpayer provided copies of various credit card charges indicating that the taxpayer traveled outside Washington during the audit period. No records were presented indicating the nature of these trips, whether they were in furtherance of the taxpayer's consulting business, taxpayer's other business activities (*see* Det No. 01-186R), or other reasons for travel. In producing the records, the taxpayer stated he "has made no admission regarding the characterization" of the income.

The taxpayer's "consulting business" was also not registered with the DOR, and he did not report any income from the same. Based on amounts the taxpayer reported on Schedule C of his federal income tax returns, the DOR assessed service B&O tax for the January 1, 1997 through December 31, 2000 period. The assessment, with penalties and interest, totaled \$ The taxpayer timely appealed the assessment.

ANALYSIS

1. Characterization of Income for B&O Tax Purposes.

[1] Income from providing consulting services is subject to B&O tax. RCW 82.04.220 levies a B&O tax "for the act or privilege of engaging in business activities" in Washington. Business activities subject to tax include "all activities engaged in with the object of gain, benefit, or advantage . . . directly or indirectly." RCW 82.04.140. The courts of this state have recognized that "[t]he legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state." *Impecoven v. Department of Rev.*, 120 Wn.2d 357, 363, 841 P.2d 752 (1992). As a general proposition, "[t]axation is the rule and exemption is the exception." *O'Leary v. Department of Rev.*, 105 Wn.2d 679, 682, 717 P.2d 273 (1986), quoting *Budget Rent-A-Car of Washington-Oregon, Inc. v. Department of Rev.*, 81 Wn.2d 171, 174, 500 P.2d 764 (1972). Consulting service activity falls under the other business or service activities classification. RCW 82.04.290.

As a general principle, a gross receipts tax on services performed both within and without the state by a taxpayer may be subject to apportionment. *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1938). In this regard, RCW 82.04.460(1) provides:

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.

An administrative rule, WAC 458-20-194 (Rule 194), implements this statute.²

The taxpayer argues either against any taxation of the income he received or, alternatively, the income should be apportioned. In his petition, the taxpayer claims the services were “rendered outside of the State of Washington, and all of which were rendered under the control . . . [of taxpayer’s father], for services rendered in prior periods as deferred compensation, and in connection with the parties arrangements entered in connection with the earlier termination of Taxpayer’s employment” At the hearing on this matter, the taxpayer asserted another, possibly inconsistent, argument. The taxpayer’s representative primarily argued that the taxpayer provided no services in exchange for the income and that the income was in the nature of a fee for the taxpayer to “stay away” from the . . . business.

With respect to the claim that no services were provided, such an argument does not change the outcome. RCW 82.04.140 broadly imposes B&O tax on all activities for gain, profit, or advantage. A taxpayer might not perform a service, but still engage in an activity for gain, profit, or advantage. For example, income in the form of a retainer, where no services are actually performed, is still subject to B&O tax. Whether characterized as a retainer or as a “stay away” fee, the taxpayer is still engaged in an activity for gain, profit, or advantage.

² Rule 194, in relevant part, states:

When the business involves a transaction taxable under the classification service and other business activities, the tax does not apply upon any part of the gross income received for services incidentally rendered to persons in this state by a person who does not maintain a place of business in this state and who is not domiciled herein. However, the tax applies upon the income received for services incidentally rendered to persons outside this state by a person domiciled herein who does not maintain a place of business within the jurisdiction of the place of domicile of the person to whom the service is rendered.

* * *

Persons engaged in a business taxable under the service and other business activities classification and who maintain places of business both inside and outside this state which contribute to the performance of a service, shall apportion to this state that portion of gross income derived from services rendered by them in this state. Where it is not practical to determine such apportionment by separate accounting methods, the taxpayer shall apportion to this state that proportion of total income which the cost of doing business within this state bears to the total cost of doing business both within and without this state.

As to the alternative claim that the income was deferred compensation, the taxpayer does not support the claim with any evidence. In fact, the taxpayer was paid amounts identified as compensation, which amounts are not at issue in this case. Even if the taxpayer produced some evidence to support a claim that the income at issue was deferred compensation—which he has not done—we would still be reluctant to alter the characterization of the income in this case. In essence, the taxpayer argues that we should look to the substance, not the form of the transactions at issue. In general, the doctrine of substance over form is not available to a taxpayer to eliminate the tax consequences of the taxpayer's structured form of the transaction. *See, e.g.*, Det. No. 85-112A, 1 WTD 343 (1985), *citing Higgins v. Smith*, 308 U.S. 473 (1940); Det. No. 92-166, 12 WTD 211 (1993); *see also Chevron USA, Inc. v. Department of Rev.*, Docket No. 99-94 (Bd. Tax Appeals 1999), *citing Commissioner of Internal Rev. v. Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974) (“This Court has observed repeatedly that, while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not.”). Having organized and recognized the payments as consulting income, the taxpayer must accept the tax consequences of having done so.

2. Apportionment of Income.

As to the apportionment of income, the taxpayer has the burden to keep and produce appropriate records from which apportionment could be made. In general, taxpayers must maintain suitable records as may be necessary for the Department to be able to determine a taxpayer's tax liability. Any person who fails to comply with this requirement shall be forever barred from questioning the correctness of any assessment of taxes for any period in which adequate records were not kept. RCW 82.32.070; WAC 458-20-254 (Rule 254); Det. No. 97-134R, 18 WTD 163 (1999).³

³ RCW 82.32.070 provides:

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. . . . Any person who fails to comply with the requirements of this section shall be forever barred from questioning, in any court action or proceedings, the correctness of any assessment of taxes, made by the department of revenue based upon any period for which such books, records, and invoices have not been so kept and preserved.

(Emphasis added). Rule 254(2) further provides:

(a) It is the duty of each taxpayer to prepare and preserve all books of record in a systematic manner conforming to accepted accounting methods and procedures. Records are to be kept, preserved, and presented upon request of the department which will demonstrate:

(i) The amounts of gross receipts and sales from all sources, however derived, including barter or exchange transactions, whether or not such receipts or sales are taxable. These amounts must be supported by original source documents including but not limited to all purchase and sales invoices and contracts or such other documents as may be necessary to substantiate gross receipts and sales;

(ii) The amounts of all deductions, exemptions, or credits claimed through supporting documentation required by statute or administrative rule, or such other supporting documentation necessary to substantiate the deduction, exemption, or credit.

(Emphasis added).

The taxpayer did not produce records to support any apportionment of income. The taxpayer did not produce records showing what services were provided, where services were provided, when services were provided, and the costs associated with such services. Accordingly, even if we were now to find the taxpayer actually provided services (given the alternative argument that no service was provided), DOR has no basis upon which to apportion such income.

3. Disregard of Corporate Entity.

[2] Taxpayer also contends that the Department effectively disregarded the separate corporate existence of Entity A, and it has not substantiated the basis to do so under the corporate disregard doctrine. In general, the doctrine of corporate disregard has been applied to hold shareholders liable for the debts of the corporate entity. *See generally* Harris, *Washington's Doctrine of Corporate Disregard*, 56 Wash. L. Rev. 253 (1981). But the present case involves a right of the taxpayer to receive income, which it did receive and reported on IRS Schedule C, Form 1040, in exchange for consulting services. It is not a case of the Department holding the taxpayer liable as a shareholder for a tax debt of Entity A. The funneling of the taxpayer's income through the bank account of a wholly owned company does not extinguish the taxpayer's tax obligation. . . .

DECISION AND DISPOSITION:

The taxpayer's petition for reconsideration is denied.

Dated this 30th day of October 2003.