

Cite as Det. No. 18-0298, 40 WTD 034 (2021)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS 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. 18-0298
)	
...)	Registration No. . . .
)	

RULE 111: SERVICE B&O TAX - ADVANCES AND REIMBURSEMENTS.
Taxpayer, when not acting solely as an agent, may not exclude from taxable gross income the payments it receives from its clients and pays to its consultants.

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.

Casselman, T.R.O. – A . . . architectural firm (Taxpayer) that provides services to Washington clients, petitions for correction of an assessment of service and other activities business and occupation (B&O) tax. Taxpayer claims that payments it received from its clients and paid to third-party consultants were non-taxable advances or reimbursements. Taxpayer further requests waiver of penalties. We deny Taxpayer’s petition.¹

ISSUES

1. Has Taxpayer shown that certain amounts it received from its clients, that it subsequently paid to third-party consultants, were advances or reimbursements excludable from its measure of B&O tax under RCW 82.04.080 and WAC 458-20-111 (Rule 111)?
2. Does Taxpayer qualify for a waiver of penalties under RCW 82.32.105 and WAC 458-20-228 (Rule 228)?

FINDINGS OF FACT

Based in . . . , Taxpayer is [an architecture firm]. Taxpayer has offices nationwide [and internationally]. Taxpayer provides architectural services to clients in Washington State.

On May 4, 2017, the Compliance Division (Compliance) of the Department of Revenue mailed the Taxpayer an Active Non-reporting Letter and Questionnaire (Questionnaire) with a request that it be completed and returned to the Department by May 26, 2017. On May 30, 2017,

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

Compliance received a completed Questionnaire from the Taxpayer and based on the information provided, Compliance determined that Taxpayer had economic nexus with Washington.² On June 9, 2017, Compliance emailed a Sales Data Sheet to Taxpayer requesting Taxpayer's gross Washington income, gross worldwide income, throw-out income and deductions for the audit period.³ On August 29, 2017, Taxpayer provided the completed Sales Data Sheet to the Department. Compliance disallowed the exclusions for the disputed consultant fees after determining Taxpayer had not shown the disputed amounts were excludable as advances or reimbursements. On October 12, 2016, the Department issued an assessment totaling⁴ Taxpayer timely filed a petition for correction.

Taxpayer claims that payments Taxpayer collects from its clients to pay Taxpayer's consultants should be excluded from its measure of gross income as advances or reimbursements. In its petition, Taxpayer provides that it uses consultants and that it pays these consultants from the payments it receives from its clients. As such, Taxpayer contends these payments are advances or reimbursements. Compliance noted that although Taxpayer did not include any figures in the deductions column in the Sales Data Sheet, Compliance would review and adjust the tax assessment if necessary if Taxpayer provided documentation that supported an advances or reimbursement deduction. Other than the information and documents described above, Taxpayer has provided no other original records in support of its claim that the disputed fees were advances or reimbursements. Additionally, Taxpayer requests a waiver of penalties.

ANALYSIS

1. Amounts Taxpayer received from its clients, that it subsequently paid to third-party consultants, are not advances or reimbursements excludable from Taxpayer's measure of B&O tax.

The B&O tax is imposed for the act or privilege of engaging in business activities in this state. RCW 82.04.220. Activities that are not taxable elsewhere in Chapter 82.04 RCW are taxable under the service and other activities B&O tax classification at a rate of 1.5% times the gross income of the business. RCW 82.04.290(2).⁵ "Gross income of the business" is defined in RCW 82.04.080(1) 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, . . . fees, . . . and other emoluments however designated, all without any deduction on account of the cost of, . . . labor costs, interest, . . . or any other expense whatsoever paid or accrued

RCW 82.04.080(1).

² Taxpayer provided information that showed it exceeded the economic nexus thresholds found in RCW 82.04.067 for tax years 2014, 2015, and 2016. Taxpayer does not dispute that it has nexus with Washington.

³ Audit period was January 1, 2014, to June 30, 2017.

⁴ The assessment, Document No. . . . comprised . . . in service and other B&O tax, a delinquent penalty of . . . , . . . in interest, and a 5% assessment penalty of

⁵ It is undisputed that Taxpayer provided services taxable under the service and other activities B&O tax classification.

In limited circumstances, taxpayers may exclude from gross income of the business, advances and reimbursements received from a customer or client, when the taxpayer holds the money or credit as an agent to make a payment on behalf of the customer or client. Such payments are addressed in WAC 458-20-111 (Rule 111), the Department's administrative rule that addresses advances and reimbursements. Rule 111 sets forth descriptions, and certain requirements for payments to be considered advances or reimbursements, as follows:

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.

Rule 111 (emphasis added).

In *Washington Imaging Services, Inc. v. Dep't of Revenue*, 171 Wn.2d 548, 252 P.3d 885 (2011), the Washington Supreme Court clarified that Rule 111 is meant to differentiate between [expenses that merely pass through a taxpayer in its capacity as an agent and] those that constitute a taxpayer's costs of doing business, which cannot be excluded from gross income of the business. In that case, Washington Imaging Services, Inc. retained Overlake Imaging Associates as an independent contractor whose radiologists interpreted the images that Washington Imaging generated. After the patients and insurance companies paid Washington Imaging for the imaging services, it paid Overlake a percentage of net receipts pursuant to the terms of contracts between itself and Overlake. Washington Imaging argued that it did not owe B&O tax on the entire amount paid by the insurers and patients, but instead could exclude the payments it made to Overlake as pass-through payments. *Id.* at 554.

The court stated, "A business that employs an independent contractor does not thereby become exempt from B&O tax liability for any income derived in whole or in part because of the work the independent contractor does for the taxpayer." *Id.* at 558. The court rejected the argument that just because Washington Imaging itself could not perform the interpretive services, that the payments should be excluded from gross income, noting that, like Taxpayer here, nothing barred Washington Imaging from contracting with an independent contractor to perform those services. *Id.* at 559.

Washington Imaging also argued that the amounts it paid to Overlake were not part of its gross income, because its contract with Overlake stated that it had no ownership in the Overlake portion of the billing. *Id.* at 556. The court rejected this argument, noting that "a private contract cannot absolve a taxpayer of taxes that are due. Whether payments qualify as 'pass-through' payments depends upon the facts and circumstances of the particular case." *Id.* at 563.

Therefore, Taxpayer must show that the facts and circumstances support . . . [exclusion] of the payments it makes to consultants. *Id.*

For Rule 111 to apply, . . . the taxpayer must not be liable for paying the associate firms except as the agent of the client.

See Rho Co. v. Dep't of Revenue, 113 Wn.2d 561, 782 P.2d 986 (1989). To satisfy the agency condition, “a true agency relationship between the client or customer and the taxpayer is required. The existence of that agency relationship is not controlled by how the parties described themselves” and “standard agency definitions should be used in analyzing the existence of the agency relationship.” *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 177–78, 60 P.3d 79, 83 (2002). We note that the person claiming agency status has the burden to prove the existence of the agency relationship. *Seattle-First National Bank v. Pacific National Bank of Wash.*, 22 Wn. App. 46, 587 P.2d 617 (1978); *see also* Det. No. 12-0284, 32 WTD 260 (2013).

Here, Taxpayer has submitted no documents in support of its argument that the disputed amounts are excludable under Rule 111. Taxpayer has not provided underlying contracts, invoices, or proof of its agency relationship with the clients associated with consultant payments. Generally, payments received by an architectural firm and thereafter used to pay consultants are part of the compensation or consideration for the service contemplated in that firm’s agreement with its client. In other words, payments to the consultants from those proceeds constitute Taxpayer’s own costs of doing business, and cannot be excluded from gross income of the business pursuant to RCW 82.04.080(1). *See generally* Rule 111; *Washington Imaging Services, Inc.*, 171 Wn.2d 548.

We conclude that Taxpayer has failed to meet its burden of showing that the disputed amounts are excludable from Taxpayer’s gross income per Rule 111. Therefore, the payments are subject to service and other B&O tax. RCW 82.04.080(1); RCW 82.04.220; RCW 82.04.290(2); Rule 111. Accordingly, we deny Taxpayer’s petition on this issue.

2. Does Taxpayer qualify for a waiver of penalties under RCW 82.32.105 and WAC 458-20-228 (Rule 228)?

The Department has limited authority to waive or cancel penalties, set out in RCW 82.32.105 and RCW 82.32A.020. Generally, the Department will not cancel penalties unless the failure that triggered the penalty was due to reliance on written instructions given the taxpayer by the Department, or was the result of “circumstances beyond the control of the taxpayer.” RCW 82.32A.020; RCW 82.32.105(1). There were no written instructions given to Taxpayer by the Department that Taxpayer relied on in this case, so RCW 82.32A.020 does not apply.

Rule 228 is an administrative rule that explains “circumstances beyond the control of the taxpayer” and provides a list of examples of circumstances considered to be beyond the control of the taxpayer. Rule 228 specifically provides that “[a] misunderstanding or lack of knowledge of a tax liability” is not a circumstance beyond the control of the taxpayer and will not qualify for waiver or cancellation of a penalty. Rule 228(9)(a)(iii)(B). Accordingly, we are unable to waive the penalties on the basis of the taxpayer’s lack of knowledge.

Furthermore, the fact that the Department placed Taxpayer on active nonreporting does not relieve the taxpayer from the responsibility of filing returns. Taxpayer had a duty to inform the Department when it no longer qualified for active nonreporting status. WAC 458-20-101 (Rule 101) explains:

Persons placed on an active nonreporting status by the department are required to timely notify the department if their business activities do not meet any of the conditions [for qualification for active nonreporting status]. These persons will be removed from an active nonreporting status, and must file tax returns and remit appropriate taxes to the department, beginning with the first period in which they do not qualify for an active nonreporting status.

Rule 101(3)(c); *see also* RCW 82.32.045. Thus, Rule 101 makes it clear that it is a taxpayer's responsibility to inform the Department that it did not qualify as an active nonreporter. *See* Det. No. 01-0193, 21 WTD 264 (2002). However, the taxpayer did not inform the Department that it did not qualify for active nonreporting status, and it did not file returns. Accordingly, we deny Taxpayer's petition on this issue.

DECISION AND DISPOSITION

Taxpayer's petition is denied.

Dated this 7th day of November 2018.