Cite as Det. No. 19-0201, 40 WTD 242 (2021)

BEFORE THE ADMINISTRATIVE REVIEW AND HEARINGS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition for Correction of Assessments of	)	D E T E R M I N A T I O N
	)	No. 19-0201
. . .	)	Registration No. . . .

RULE 111; RCW 82.04.220; RCW 82.04.080: GROSS INCOME – ADVANCES AND REIMBURSEMENTS – AFFILIATES – TRANSFER PRICING. An entity that receives assistance from affiliates to complete its contractual obligations to its customer, must include in its gross income monies the entity allocates through transfer pricing to its affiliates for their services.

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.

LaMarche, T.R.O. – Three affiliated entities that provide services related to investments and investment management petition for review of their assessments with regard to the common issue of whether certain monies transferred between affiliated but separate legal entities constitute gross income to each entity for Washington excise tax purposes. We deny the petitions.[1]

ISSUE

Under RCW 82.04.220, RCW 82.04.080(1), and WAC 458-20-111 (Rule 111), when an entity enters into a contract with a customer, and receives assistance from affiliates to complete the contract, are monies the entity allocates through transfer pricing to its affiliates for their services . . . included in its gross income?

FINDINGS OF FACT

This case involves three separate legal entities that fall under the umbrella of parent company, . . . , a large . . . investment management company based in . . . . The three entities are: [Entity A]; [Entity B]; and [Entity C] (generally, "Taxpayer" or "Taxpayers"). None of the entities conducts business with any other as a joint venture or partnership. Because the issue is the same for all three entities, their petitions have been consolidated for administrative purposes.

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

[Entity A]. [Entity A] operates as a portfolio manager and investment advisor and provides its services to a wide range of investors. [Entity A] also launches and manages many kinds of mutual funds for its clients. The [Entity A] accounts at issue are listed by [Entity A] as Account Nos. . . . [1] Client Business Expense; . . . [2] Expense; and . . . [3] Securities Lending Fees.

The Department of Revenue's (Department) Audit Division (Audit) audited [Entity A's] business activities for the period from June 30, 2010, through December 31, 2016. With regard to the disputed transactions, [Entity A] said that it entered into certain contracts with customers but could not perform some or all of the work itself, so it acquired the assistance of other [affiliated] entities to perform that work. [Those other affiliated entities did not themselves enter into contracts with the customers for this work.] [Entity A] indicated that under its transfer pricing policy, the work of the other entities would be evaluated based on the value each contributed, and that the fees earned from the contract would be split between them accordingly. [Entity A] stated that it used Account Nos. . . . [1], . . . [2], and . . . [3] to assign fee revenues to the entities for the work they performed.

Audit noted that [Entity A] recognized and recorded all revenue from the contracts and included it in its trial balance. [Entity A] posted the amounts owed to . . . affiliates for their work on the contracts in contra-revenue Account Nos. . . . [1], . . . [2], and . . . [3], which it used to offset gross revenues in its normal revenue accounts. For federal tax purposes, payments made to affiliates were applied as contra revenue, and netted when reporting income on line 1a of the federal return.[2]

[Entity A] also deducted the amounts in Account Nos. . . . [1], . . . [2], and . . . [3] from its measure of Washington B&O tax. Audit concluded that the accounts at issue were expense accounts and disallowed the deductions on the grounds that, for Washington State B&O tax purposes, the amounts in the accounts should be included in [Entity A's] gross income. The Department issued an assessment on July 16, 2018, Document No. . . . ,[3] in the amount of $ . . . . [4] [Entity A] did not pay the assessment, but timely filed a petition for review.

[Entity B]. [Entity B] provides financial advisory services to a variety of clients, and is registered as an investment advisor with the U.S. Securities and Exchange Commission (SEC). The [Entity B] accounts at issue are listed by [Entity B] as Account Nos. . . . [1] Client Business Expense and . . . [2] Expense.

Audit audited [Entity B's] business activities for the period from June 30, 2010, through December 31, 2016. Audit found that, like [Entity A], [Entity B] recognized and recorded all revenue from the contracts [for which it received assistance from affiliates], included it in its trial balance, and deducted the amounts [it paid affiliates] from its gross income when calculating its B&O tax

[2] A "contra account" is where events are recorded that are contrary to a general ledger parent account, also called a relating account. Contra accounts allow reporting of the true value of a firm's assets. The balance of the contra account will offset its parent account while still preserving the value of the transactions recognized in the relating account. https://study.com/academy/lesson/contra-account-definition-examples.html (last accessed August 31, 2020).]

[3] Document No. . . . , issued to . . . [Entity A] on July 16, 2018, totaled $. . . , which consisted of $. . . in International Investment Management Services (IIMS) B&O tax; $. . . in interest; $. . . in substantial underpayment penalties; and $. . . in delinquent return penalties. Taxpayer made a payment of $. . . [approximately 15 percent of total amount due].

[4] All figures are rounded unless otherwise noted.

liability. As with [Entity A], Audit disallowed the deductions on the grounds that the amounts in the accounts reflected expenses that should be included in [Entity B's] measure of gross income for Washington B&O tax purposes. The Department issued an assessment on July 13, 2018, Document No. . . . ,[5] in the amount of $ . . . . [Entity B] did not pay the assessment, but timely filed a petition for review.

[Entity C]. [Entity C] acts as a distributor of various [affiliate]-sponsored mutual funds, exchange-traded funds and certain municipal securities. The company receives distribution and service fees from the funds it distributes and, in turn, distributes fees to third-party broker-dealers selling the funds. The company is registered as a broker-dealer under the Securities Exchange Act of 1934 and is a member of the Financial Industry Regulatory Authority. The [Entity C] account at issue is listed by [Entity C] as Account No. . . . [4] (. . . Service Contra-Revenue).

Audit audited [Entity C] for the period from June 30, 2010, through December 31, 2016. Audit found that like [Entity A] and [Entity B], [Entity C] recognized and recorded all revenue from the contracts [for which it received assistance from affiliates], included it in its trial balance, and deducted the amounts [it paid affiliates] from its gross income when calculating its B&O tax liability. As with the other Taxpayers, Audit disallowed the deductions on the grounds that the amounts in the accounts reflected expenses that should be included in [Entity C's] measure of gross income for Washington B&O tax purposes. The Department issued an assessment on August 8, 2018, Document No. . . . ,[6] in the amount of $ . . . . [Entity C] did not pay the assessment, but timely filed a petition for review.

After filing their petitions, Taxpayers provided copies of contracts to serve as examples of the transactions that earned the kind of income that is in dispute here. All of the contracts indicate that only one [affiliated] entity enters into a contract with the customer. Taxpayers indicate that SEC rules and other restrictions often do not allow a single [affiliated] entity to perform all services contemplated in a contract. In these instances, the contracting entity obtains the assistance of other [affiliated] entities who have employees with the experience, knowledge, and credentials to perform the services the contracting entity cannot.

Taxpayers also provided documents showing the relationships between the [affiliated] entities in these kinds of transactions, and how each entity is paid for the services it provides, as follows.

SG and [Client] Services[7] document

Taxpayers provided an untitled document (hereinafter "Fees Document") that indicates in 2017, certain [Taxpayer] affiliates did business with each other with regard to certain investment management services provided to customers. The document explains that each entity receives a

[5] Document No., issued to [Entity B] on July 13, 2018, in the amount of $ . . . , consisted of $ . . . in IIMS B&O tax; $ . . . in interest; and $ . . . in delinquent return penalties. Taxpayer made a payment of $ . . . [approximately 18 percent of total amount due] applied to the balance.

[6] Document No. . . . , issued to [Entity C] on August 8, 2018, in the amount of $ . . . , consisted of $ . . . in IIMS B&O tax; $ . . . in interest; $ . . . in delinquent return penalties; $ . . . in unregistered business penalties; and $ . . . in substantial underpayment penalties.

[7] "ISG" refers to "Investment Strategy Group." "[Client Services]" refers to [another service provided by Taxpayer]. Neither are . . . [separate] entities, but rather represent functions within the . . . [Taxpayer] group.

portion of the services income, which is governed by a "transfer pricing policy." Fees Document, at 1. It explains how the entities determine the relative percentage of the fees to which they are entitled, as follows:

> The split is determined by the degree to which each function contributes to the creation of value for [Taxpayer]. [Taxpayer's] products require different degrees of involvement of PMs[8] based on the extent to which these are passively or actively managed. In addition, [Client Services] efforts on their distribution activities are correlated to the level of education needed by financial intermediaries and investors in each PM strategy.

Id., at 4. The Fees Document goes on to explain the reasons why some services may justify a larger fee than others:

> [M]anagement of the respective PM strategies requires different levels of activity and expertise, and accordingly, the ISG fee charged depends on the strategy (active versus passive) and asset class (equity versus fixed income). The fee split for [Client Services] is the difference from the investment management fee after the percentage corresponding to the fee split for ISG services in their respective strategies, and reflects the level of [Client Services] activity conducted for each strategy.

Id., at 4. The Fees Document also provides a chart setting forth relative percentages paid based on the nature of the activities performed.

Master Investment Delegation Agreement

The Master Investment Delegation Agreement (Delegation Agreement), effective . . . 2010, is an example of how [Taxpayer] entities facilitate the sharing of employee labor and other resources with regard to the fulfillment of certain services in contracts that a single [Taxpayer] entity cannot perform by itself. The Delegation Agreement provides that any one of the entities can act in the role of "Delegator" and delegate the performance of certain investment management services to another [Taxpayer] entity who acts as a "Delegatee." Delegation Agreement, at 1 Section 4 of the agreement states that the Delegatee is entitled to remuneration, consistent with the amount charged for a comparable transaction by unrelated parties in an arms-length transaction and in the manner set forth in the agreement's Schedule B. *Id*., at 2.

Schedule B of the Delegation Agreement provides that the Delegator is required to pay fees to the Delegatee, and indicates that the fees shall be paid to the Delagatee exclusive of any value added taxes or other indirect taxes, which shall be charged separately to the Delegator, if applicable. Schedule B also permits Delegatees to engage affiliates to provide ancillary services (not to include investment management services) or personnel in connection with Delagatee's performance of services for the Delagator, and the Delagatee may direct the Delegator to pay the applicable portion of any fees payable to that affiliate.

Section 13 discusses delegation and states, "[T]he Delegatee shall have the right to appoint any member in the [Taxpayer] Group as its subadviser or to subcontract with any member of

[8] "PM" stands for portfolio manager.

the [Taxpayer] Group to perform the services to be provided." Delegation Agreement, at 7 (emphasis provided). Section 14 discusses the relationship between the parties and states that nothing in the agreement "shall be construed" to create the relationship of employer and employee, or constitute the parties as "partners, joint venture partners, co-owners or otherwise as participants in a joint or common undertaking." *Id.*, at 7.

The Master Sales Support Services Agreement (Services Agreement)

The Services Agreement, effective . . . 2010, is similar to the Delegation Agreement, except that it pertains to sales support rather than investment management services. The [Taxpayer] entity that needs the sales support services of another is deemed the "Service Receiver," and the entity that provides the services is deemed the "Service Provider." Services Agreement, at 1. The agreement states in Section 10, "The Service Provider shall have the right to subcontract with any member of the [Taxpayer] Group to perform the services provided," subject to regulatory approval and the subcontractor's agreement and compliance with the terms of the Services Agreement. *Id.*, at 10 (emphasis provided). The Services Agreement provides that the Service Receiver is required to pay fees to the Service Provider in a manner virtually identical to that of the Delegation Agreement.

Taxpayers indicate that after each contract is completed, a third-party "Transfer Pricing Group" determines the value each entity contributed to the job, presumably per the terms listed in documents like the Fee Document, and facilitates the dispersal of the contract proceeds on that basis. For example, if [Entity B] completed a $100 contract with the help of a second [Taxpayer] entity, and the Transfer Pricing Group determined that the other entity provided 20% of the value of the services, $20 of the proceeds would be allocated to the second entity. However, [Entity B] would recognize the entire $100 on its trial balance and post the $20 allocated to the other entity in a contra-revenue account of the kind in dispute here.

Continuing with the example, when filing its federal income tax returns, [Entity B] would report a net of $80 in total gross income for federal income tax purposes (the $100 less a contra revenue amount of $20, representing the amount allocated to the second entity). The second entity would report the $20 as its own gross income.

When Taxpayers calculated gross income for Washington State B&O tax purposes, they apparently used an approach similar to the one they used when calculating income for federal tax purposes—subtracting the contra-revenue accounts from the gross proceeds of their contracts, and reporting the net amount as income. As indicated above, Audit concluded that the amounts in the contra revenue accounts were business expenses which, for B&O tax purposes under Washington law, must be included in gross income when calculating B&O tax.

ANALYSIS

The B&O tax is imposed for the act or privilege of engaging in business activities in this state. RCW 82.04.220. RCW 82.04.290(1) provides a tax classification for persons who provide international investment management services (IIMS).[9] "Gross income of the business" is defined in RCW 82.04.080(1) as:

[9] There is no dispute that Taxpayers provided services taxable under the IIMS B&O tax classification.

> [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) (emphasis provided). B&O tax is a gross receipts tax rather than an income tax, and "gross income" for purposes of Washington B&O tax, unlike gross income in the federal tax context, includes gross proceeds of sales *without* deductions for expenses.

Taxpayers assert that the accounts at issue are transfer pricing accounts and that the amounts one Taxpayer allocates to another entity for the value of services that entity contributed to the completion of a contract should not be included as taxable gross income to the one allocating the funds. However, characterization of the accounts as transfer pricing accounts is not helpful to Taxpayers' position. We address the issue of transfer pricing in Det. No. 15-0277, 35 WTD 246 (2016), and explain:

> Transfer pricing is a method used by controlled corporations to shift profits whereby affiliates charge each other for goods and services. *See* Treas. Reg. Section §1.482-7. The charges for these goods and services are gross income for one entity, and deducted as costs of goods sold or expenses for the affiliate to arrive at taxable income to compute income tax. *Id*. . . . Washington does not have an income tax, but subjects gross receipts and gross income to B&O tax without deducting costs of goods sold or business expenses paid to an affiliate. . . . There is no specific authority under Washington Excise Tax Law (Title 82 RCW), which allows a transfer pricing deduction. RCW 82.04.080 specifically provides that to determine gross income there is no deduction for costs of goods sold or other expenses.

Taxpayers assert that rather than one entity paying another as a business expense, they are sharing in the proceeds and that that the entries in the disputed accounts simply account for the relative value of the work each entity performed. However, although some entities contribute to the completion of a contract, this is not the same as the sharing of revenue as in a joint venture or partnership, which we note are expressly disallowed under the agreements.

Instead, in the transactions in dispute, only one [Taxpayer] entity entered into an agreement with the customer. Thus, only the contracting entity had the right to payment from the customer under the contract. It is clear that the contracting entity, whether it be [Entity A], [Entity B], or [Entity C], treated all receipts as its own. Each included the total gross receipts in its trial balance, reported the proceeds on its federal returns, and deducted from its gross income the amounts it transferred to the entity or entities who provided services under the agreement.

Washington generally treats transfer of consideration between persons as taxable transactions. RCW 82.04.030 defines "person" as:

> [A]ny individual, receiver, administrator, executor, assignee, trustee in bankruptcy, trust, estate, firm, copartnership, joint venture, club, company, joint stock company, business

> trust, municipal corporation, political subdivision of the state of Washington, corporation, limited liability company, association, society, or any group of individuals acting as a unit, whether mutual, cooperative, fraternal, nonprofit, or otherwise and the United States or any instrumentality thereof.

Based on this definition and other related B&O tax statutes, Washington courts have respected the distinction between different persons engaging in business in Washington State, even though those persons may be affiliated with each other. *See, e.g., Impecoven v. Dep't of Revenue*, 120 Wn.2d 357, 841 P.2d 752 (1992) (independent contractor insurance agents affiliated with broker are not one "person" for B&O tax purposes and not "group of individuals acting as a unit" under RCW 82.04.030.); *Nordstrom Credit, Inc. v. Dep't of Revenue*, 120 Wn.2d 935, 845 P.2d 1331 (1993) (subsidiary formed by parent to finance parent's accounts receivable engaged in arms-length transaction with parent and was a separate "person" for B&O tax purposes); *American Sign & Indicator Corp. v. State*, 93 Wn.2d 427, 429, 610 P.2d 353 (1980) ("The tax liability of a corporation must be considered without regard to its relationship to a parent or subsidiary company or to the existence of common officers, employees, facilities, or stock ownership."). Thus, Washington law treats affiliated entities as different persons, each subject to B&O tax on their taxable activities. *See* RCW 82.04.220. There is no authority for interpreting "person" as including two affiliated entities that contract with each other.

The relationship between the contracting [Taxpayer] entity and its affiliates that provided labor and other resources is a relationship between two persons, and the exchange of consideration between the two creates the B&O tax liability at issue here. The contracting entity alone enters into the contract with the customer, and is entitled to the proceeds from the contract. The entities that assist the contracting entity are not in contractual privity with the customer. Instead, the contracting entity uses part of the proceeds from the contract to pay the subcontractors that provided the services necessary to complete the contract.

The "fee splitting" described in the Fees Document and the involvement of the "Transfer Pricing Group" is simply a method of evaluating how much the contracting [Taxpayer] entity, as Delegator or Service Receiver, should pay to the [affiliated] entity or entities that provided services as Delegatee or Service Provider, respectively, under the Delegation Agreement or Services Agreement.

As is typical in many contractor-subcontractor agreements, the Delegation Agreement and Services Agreement provide that the contracting entity acting in the role of Delegator or Service Receiver has the legal duty to pay the Delegatee or Service Provider, respectively. We note that both agreements use the term "subcontract." *See* Delegation Agreement, at 7 and Services Agreement, at 10, respectively. Such payments are business expenses that are part of the "gross income of the business" under RCW 82.04.080(1) that must be included in the contracting entity's measure of B&O tax, pursuant to Chapter 82.04 RCW.

Washington law does provide, in some instances, that payments can qualify as advances or reimbursements that are not taxable as gross income. However, that is not the case here. WAC 458-20-111 (Rule 111), the Department's administrative rule that addresses advances and reimbursements, indicates that the taxpayer has the burden of showing that it is acting solely as an

agent on behalf of its customer with regard to payments to the subcontracting entities and has no liability other than that of an agent. *See, e.g., Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 555, 252 P.3d 885 (2011). [Rule 111 allows reimbursements to be excluded from gross income 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 therefore, either primarily or secondarily, other than as agent for the customer or client." WAC 458-20-111]. In other words, by requiring the taxpayer to prove that its liability is solely agent liability, Rule 111 distinguishes payments a taxpayer makes towards its own costs of doing business, from those where it acts solely as an agent in collecting and remitting money to a third party on behalf of its client. RCW 82.04.080(1); Rule 111; *See, e.g., Washington Imaging Services,* 171 Wn.2d 548.

Here, Taxpayers have provided no evidence that the customer and Taxpayer are in agreement that the Taxpayer is acting solely as an agent with regard to the payments to the subcontracting [affiliated] entity. Moreover, none of the Taxpayers treats any part of the proceeds as advances or reimbursements from its customer for payment to third parties on the customer's behalf. Instead, as we describe above, they treat all receipts as their own. Further, Taxpayers are personally liable to the subcontracting entities for payment for their services, pursuant to agreements like the Delegation Agreement and the Services Agreement. Therefore, Taxpayers have not shown they meet the requirements under Rule 111 for the disputed payments to qualify as nontaxable advances or reimbursements.

Taxpayers argue that they should not be taxed on their allocation of fees to other [affiliated] entities, because this constitutes impermissible "pyramiding" or double taxation of the same income. However, in the context of Washington tax law, this assertion is not supported by statute, administrative rule, or case law.

The Washington State Supreme Court states in *City of Seattle v. Paschen Contractors, Inc.,* 111 Wn.2d 54, 60, 758 P.2d 975 (1988), "[E]xposure to double taxation is not in itself evidence of unlawful discrimination." Similarly, "[t]here is no constitutional prohibition against double taxation, as applied to excise taxes." *Drury the Tailor v. Jenner,* 12 Wn.2d 508, 514, 122 P.2d 493 (1942). All taxpayers in this state are equally subject to the provisions of Title 82 RCW and, like Taxpayers, are subject to tax on their gross proceeds from their business activities in this state. RCW 82.04.220.

In Det. No. 16-0158, 36 WTD 038 (2017), we addressed the issue of transactions between related but separate legal entities. In that case, the taxpayer underwrote title insurance policies for a related entity and also earned management fee income for providing corporate and financial services for that entity. As we stated in that case:

> The question of whether transactions between related entities are taxable is not new. As Excise Tax Advisory ("ETA") 3134.2009 states:
>
> > The Department has addressed the question of transactions between related entities on many occasions. . . . . WAC 458-20-203 (Rule 203) states:

> Each separately organized corporation is a "person" within the meaning of the law, notwithstanding its affiliation with or relation to any other corporation through stock ownership by a parent corporation by the same group of individuals.
>
> Each corporation shall file a separate return and include therein the tax liability accruing to such corporation. This applies to each corporation in an affiliated group, as the law makes no provision for filing of consolidated returns by affiliated corporations or for the elimination of intercompany transactions from the measure of tax. . . .
>
> The principles of Rule 203 apply to all business organizations . . . . [*see also* RCW 82.04.030].
>
> While intra-company transactions are not taxable (*see* WAC 458-20-201), business transactions between different persons are subject to taxation unless there is a specific deduction or exemption. The fact that entities are related does not change the fact that they are separate persons for tax purposes. Rule 203; *Washington Sav-Mor Oil Co. v. Tax Comm.*, 58 Wn.2d 518 (1961).
>
> [*See also* ETA 3194.2015 ("Compensation for services is subject to B&O tax regardless of whether the services are provided by an affiliate or by an unrelated person.").]

36 WTD 038. Here, there are actually two taxable transactions. The first is the Taxpayer's sale of services to the *customer*, which is gross income only to the Taxpayer as the sole contracting [affiliated] entity. As we discuss above, gross income for Washington B&O tax purposes includes all gross proceeds, without deduction for expenses, including payment to the separate legal entities providing services. RCW 82.04.080(1).

The second transaction is the subcontracting entity's sale of its services to the *Taxpayer* under agreements like the Delegation Agreement or Services Agreement. The contract is not between the subcontracted affiliate and the customer. The subcontracting entity earns "compensation for the rendition of services" for the services it provides to the Taxpayer, which is included in the definition of "gross income of the business" under RCW 82.04.080(1). Such income is also subject to B&O tax, pursuant to RCW 82.04.220.

Taxpayers assert that not all income received from a contracting affiliate may be compensation for the rendition of services, and may include nontaxable bona fide dividends or distributions from a capital account. However, nowhere have Taxpayers shown they were assessed B&O tax on bona fide dividends or distributions from a capital account.

Taxpayers also cite *Getty Images v. City of Seattle* 163 Wn. App. 590, 260 P.3d 926, and Excise Tax Advisory 3194.2015, stating that the Department does not presume that a transfer of funds between affiliates is compensation for services, but rather must establish that the funds are compensation for services. Here, the facts show that there was a transfer of funds between [affiliated] entities, and that those funds were compensation the contracting entity paid to its . . .

affiliates for their services, pursuant to agreements like the Delegation Agreement and Services Agreement.

Based on the foregoing, we conclude that the transactions in dispute here do not qualify as advances or reimbursements under Rule 111 and constitute "gross income of the business" as that term is defined in RCW 82.04.080(1). As such, the amounts in dispute must be included in Taxpayers' measure of B&O tax as required by RCW 82.04.220. Accordingly, we deny the petitions.

DECISION AND DISPOSITION

Taxpayers' petitions are denied.

Dated this 14th day of August 2019.