Cite as Det. No. 21-0005, 41 WTD 306 (2022)

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

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. 21-0005
. . .	)	Registration Nos. . . .
	)	. . .

[1] WAC 458-20-111; WAC 458-20-218; RCW 82.04.080: B&O TAX – GROSS INCOME – ADVANCES AND REIMBURSEMENTS – ADVERTISING AGENCY. Operators of an advertising agency that have liability for client obligations cannot exclude amounts from gross income as advances and reimbursements.

[2] WAC 458-20-228; RCW 82.32.090: RETAIL SALES TAX – EVASION PENALTY – INTENT TO EVADE. Where Taxpayers collected retail sales tax throughout the audit periods, willfully failed to remit the retail sales tax, and reported amounts from the QuickBooks sales tax liability report under the service and other activities B&O tax classification, the Department made a *prima facie* case of evasion. Taxpayers failed to produce sufficient evidence to rebut the Department's evidence of evasion.

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.

Margolis, T.R.O. – Operators of a full-service advertising agency (Taxpayers) contest the assessment of retail sales tax and business and occupation (B&O) tax on grounds that the measure of assessed taxes includes non-taxable advances and reimbursements. Taxpayers also contest assessment of the evasion penalty on grounds that Taxpayers did not intend to evade their tax liabilities. We deny the petitions.[1]

ISSUES

1. Whether Taxpayers have established that income included in the measure of taxes reflects advances and reimbursements not subject to taxation under WAC 458-20-111 [and WAC 458-20-218].

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

2. Whether, under RCW 82.32.090, Taxpayers are liable for the evasion penalty.[2]

FINDINGS OF FACT

. . . [Taxpayer 1], and . . . [Taxpayer 2], collectively "Taxpayers," operated a full-service advertising agency in . . . , Washington. Taxpayers provided a wide range of services including digital advertising, billboard design and placement, magazine and print ad design, radio and television commercial production and placement, targeted direct mail campaigns, and branding. The Department of Revenue's Audit Division (Audit) reviewed [Taxpayer 1's] account for the period January 1, 2011, through June 30, 2014, and [Taxpayer 2's] account for the periods July 1, 2014, through December 31, 2014, and January 1, 2015, through March 31, 2019, and on October 16, 2019, issued 3 balance due notices.

The notice for . . . [Taxpayer 1] shows a balance due of $. . . , and is composed of $. . . in retail sales tax, $. . . in delinquent penalty, $. . . in 5 percent assessment penalty, $. . . in 50 percent evasion penalty, and $. . . in interest.

The notice for . . . [Taxpayer 2] covering July 1, 2014, through December 31, 2014, shows a balance due of $. . ., and is composed of $. . . in retail sales tax, $. . . in delinquent penalty, $. . . in 5 percent assessment penalty, $. . . in 50 percent evasion penalty, and $. . . in interest.

The notice for . . . [Taxpayer 2] covering January 1, 2015, through March 31, 2019, shows a balance due of $. . . , and is composed of $. . . in retail sales tax, $. . . in retailing business and occupation (B&O) tax, $. . . in service and other activities B&O tax, $. . . in delinquent penalty, $. . . in assessment penalty, $. . . in 50 percent evasion penalty, and $. . . in interest.

Audit examined Taxpayers' QuickBooks sales tax liability report and customer invoices to determine the amount of sales tax charged and collected from clients. Invoices showed amounts billed for services provided, sales tax separately stated . . . , and the amount received from the client as payment. The amounts received equaled the invoice totals including sales tax, showing that sales tax was collected from clients. However, Taxpayers remitted no retail sales tax to the Department. Taxpayers reported amounts on the sales tax liability report under the service and other activities B&O tax classification. Audit also discovered that . . . [Taxpayer 2] had not reported gross receipts for advertising services, but instead had reported net commissions, and it had failed to identify some billboard, business cards, printing, and sign income as retail sales subject to retailing B&O tax and retail sales tax.

Because Taxpayers did not have written agency agreements with [their] clients or vendors, Audit reviewed purchase invoices for evidence of an agency relationship. All [client] invoices were addressed to Taxpayers, stated the commission amount to Taxpayers, and showed that Taxpayers were responsible for paying the [vendor] invoices minus the commission to the [Taxpayers]. Taxpayers were responsible for collecting the entire invoice amount from the clients.

[2] At the hearing, Taxpayers also argued that the audit period was extended in error on grounds that there was no fraud/evasion. Because we find that Taxpayers did evade their tax liability, we do not reach this issue.

Taxpayers explain that . . . [Taxpayer 1] has been running the business for more than 20 years, and it does not use a standardized agency agreement, but when incurring costs of media outlets, Taxpayers act solely as an agent of their clients so funds paid to these outlets should not be included in the measure of taxes. Taxpayers provided client credit applications as evidence that clients, rather than Taxpayers, were liable for associated expenditures.

Taxpayers provided a . . . new account set-up document listing an advertiser and Taxpayers as the advertiser's agency. The application notes that all advertising placed by the agency on behalf of the advertiser shall be the responsibility of the advertiser. Taxpayers are selected as the "bill to" entity. The attached application for credit lists the advertiser as the business, along with credit-related information regarding the advertiser such as the advertiser's revenue and estimated monthly spend.

In another example, Taxpayers provided an agency liability form that notifies [the client] that an advertiser has appointed Taxpayers as its agent. The form has a section that reads as follows:

> **Select one of the following:**
> [X] Advertiser shall remain liable to [the client] for all costs, expenses and charges related to the advertising placed by Agent on behalf of Advertiser.
> [ ] Agency shall remain liable to [the client] for all costs, expenses and charges related to the advertising placed by Agent on behalf of Advertiser.

Following this agency liability form is a " . . . Credit Application" listing the advertiser as the business. This form includes a line that reads, "Who is responsible for payment: [X] Client [ ] Agency."

Taxpayer also provided a document titled, "Advertiser Terms and Conditions" which includes a section titled "2. BILLING AND PAYMENTS" explaining that "Advertiser agrees to pay all amounts payable under this Contract . . . In the event Advertiser fails to make such payments, Advertiser and/or Ad Representative ["Ad Representative" is defined in the previous section as "advertising agency or other representative"] will be jointly and severally liable for all amounts owed and reasonable expenses . . . incurred by [the client] in collecting such amounts."

Another sample "Advertiser Terms and Conditions" document imposes agency liability as follows:

> 1. BILLING AND PAYMENTS
>
> . . .
>
> (b) Advertiser shall pay each Invoice in full . . .
>
> (d) Other remedies notwithstanding, Invoices not timely paid as required by this contract shall be considered delinquent . . . until paid in full. In the event Advertiser fails to make such payments, Advertiser and/or Ad Representative, will be jointly and severally liable for all amounts owed and reasonable expenses . . . incurred by [the client] in collecting such amounts.

. . .

> (f) Failure of an agency . . . to receive adequate funds from an Advertiser does not relieve such agency . . . from the obligations to timely pay all amounts due to . . . hereunder. . . .

Taxpayers also explain that . . . [Taxpayer 1] did not intend to evade taxes, believed that taxes were correctly reported by accountants and bookkeepers, and incorrect reporting was due to mistakes and felonious actions by . . . , a prior bookkeeper, who was convicted of first-degree theft and ordered to pay $. . . in restitution. In support of this position, Taxpayers provided a letter from the . . . County Prosecuting Attorney's Office explaining that on . . . 2019, . . . [prior bookkeeper] was sentenced for first degree theft, and noting, "RESTITUTION . . . [Taxpayer 1] ADVERTISING $. . . .

ANALYSIS

RCW 82.04.220 imposes B&O tax on every person for the act or privilege of engaging in business activities in Washington. The tax is measured by applying particular rates against the value of products, gross proceeds of sale, or gross income of the business as the case may be. *Id*.

Service activities not taxed elsewhere in Chapter 82.04 RCW are generally taxable under the service and other activities classification measured by the "gross income of the business." RCW 82.04.290(2).

"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 <u>without any deduction</u> on account of the cost of, . . . labor costs, interest, . . . or <u>any other expense whatsoever paid or accrued</u> . . . .

RCW 82.04.080(1) (emphasis added).

WAC 458-20-218 (Rule 218), the Department's administrative rule regarding advertising agencies, addresses the subject of gross income and whether any of it is excludable as advances or reimbursements.[3] Rule 218(3) states: "Generally, advertising agencies are subject to business and occupation (B&O) tax on all gross income and commissions, including amounts received to pay media outlets, unless the amounts are valid advances and reimbursements under WAC 458-20-111." Such service income includes that received for "[p]rocuring advertising space or time in a media outlet for a client. A media outlet includes, but is not limited to, television and radio stations, newspapers, magazines, and websites." Rule 218(3)(a)(i).

[3 The references to Rule 218 in this determination are to the current version of the rule. The Department amended the rule in 2018 to clarify tax reporting classifications for advertising activities and exclusions for advances and reimbursements. WSR 18-03-060. The amendments merely clarified the Department's past interpretation and do not change the analysis in this case.]

Rule 218(3)(e) states:

> An advertising agency must meet all three of the following requirements to exclude advances and reimbursements from its gross income:
>
> (i) The amounts are reimbursements or advances made to pay obligations of a client;
>
> (ii) The advertising agency is not performing these services, either directly or indirectly, through independent contractors; and
>
> (iii) The advertising agency has no liability to pay the client's obligations, except as the agent of its clients.

Rule 218(3)(e)(i-iii). As explained in Rule 218(3), these three requirements are derived from WAC 458-20-111 (Rule 111), which addresses advances and reimbursements, or "pass-through" income.[4]

Taxation is the rule and exemption is the exception. *Budget Rent-A-Car of Washington-Oregon, Inc. v. Washington Dep't of Revenue,* 81 Wn.2d 171, 174 – 175, 500 P.2d 764 (1972) (citing *Fibreboard Paper Prods. Corp. v. State,* 66 Wn.2d 87, 401 P.2d 623 (1965)). Anyone claiming a benefit or deduction from a tax has the burden of showing that they qualify for it. *Budget Rent-A-Car of Washington-Oregon Inc.,* 81 Wn.2d at 174-175 (citing *Group Health Coop. of Puget Sound, Inc. v. Washington State Tax Comm'n,* 72 Wn.2d 422, 433 P.2d 201 (1967)).

Here, our focus is on the third requirement of Rule 218's three-part test. Under the sample Advertiser Terms and Conditions, if the client does not pay, Taxpayers are jointly and severally liable for all amounts owed and reasonable expenses. Because Taxpayers have liability to pay client obligations, regardless of whether Taxpayers' clients fill out credit applications and are also liable for amounts owed vendors, we conclude that Taxpayers fail to meet the third qualification of the three-part test. Since all three requirements must be met in order to exclude advances and reimbursements from a taxpayer's income, and Taxpayers fail to meet at least one of the requirements, we need not address the other two requirements, and we conclude that Taxpayers have failed to prove that they qualify for the exclusion.

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[4] Under Rule 111, for a payment to be considered an advance or reimbursement, it must meet three basic requirements: 1) be a customary reimbursement for advances made to pay costs or fees for the client; 2) involve goods or services that the taxpayer does not or cannot render; and 3) not involve an obligation the taxpayer is liable for, except as the agent of the client. *See* Rule 111; *see also Washington Imaging Services, LLC*, 171 Wn.2d 548, 561-562, 252 P.3d 885 (2011). The Department's Tax Topics article titled "Advertising agencies – Requirements for pass through deductions under WAC 458-20-111" also states that "[g]enerally, agencies aren't allowed an exclusion for advances and reimbursements from clients (WAC 458-20-111 or 'Rule 111,' Det. No. 01-124, 24 WTD 102 (2005))". *See* https://dor.wa.gov/get-form-or-publication/publications-subject/tax-topics/advertising-agencies-requirements-pass-through-deductions-under-wac-458-20-111 (last accessed January 5, 2021). It reaffirms that for the agency to exclude any advance or reimbursement it receives from its client, the agency must meet the three requirements under Rule 111. *Id.* And, it specifically provides that the third requirement has two parts, agency and solely agent liability. *Id.*

RCW 82.32.090(7) imposes a 50% evasion penalty when "the department finds that all or any part of the tax deficiency resulted from an intent to evade the tax . . . ." WAC 458-20-228 (Rule 228) is the Department's administrative rule that discusses the evasion penalty. Rule 228(5)(f) provides further explanation as follows (in pertinent part):

> The evasion penalty is imposed when a taxpayer knows a tax liability is due but attempts to escape detection or payment of the tax liability through deceit, fraud, or other intentional wrongdoing. An intent to evade does not exist where a deficiency is the result of an honest mistake, miscommunication, or the lack of knowledge regarding proper accounting methods. The department has the burden of showing the existence of an intent to evade a tax liability through clear, cogent, and convincing evidence.
>
> . . .
>
> (ii) . . . The following is a nonexclusive list of actions that are generally considered to establish an intent to evade a tax liability . . . .
>
> (B) The willful failure of a seller to remit retail sales taxes collected from customers to the department . . . .

Rule 228(5)(f).

Evasion requires that the taxpayers (1) know they have a tax obligation; and (2) intentionally do something, which is false or fraudulent to evade that obligation. Det. No. 92-133, 12 WTD 171 (1992). The Department has the burden to show the elements of evasion by clear, cogent, and convincing evidence. Det. No. 90-314, 10 WTD 111 (1990). Clear, cogent, and convincing evidence has been described as evidence convincing the trier of fact that the issue is "highly probable," or, stated another way, the evidence must be "positive and unequivocal." *Colonial Imports, Inc. v. Carlton Northwest, Inc.*, 121 Wn.2d 726, 735, 853 P.2d 913 (1993). Once the Department has demonstrated the existence of each element of evasion (i.e., *a prima facie* case), the taxpayer bears the burden of production to come forward with evidence of honest mistake, ignorance of the law, or some other fact which tends to rebut the Department's evidence. Det. No. 04-0098, 23 WTD 331 (2004). Mere subjective and self-serving statements by the taxpayer regarding intent, without more, are insufficient to meet this burden of production. *Id*.

Here, the [Department has made a prima facie showing of the] first element because Taxpayers collected retail sales tax [throughout the audit periods, but failed to remit the collected tax]. This shows that Taxpayers knew that they had a tax obligation. The [Department has made a prima facie showing of the] second element because Taxpayers willfully failed to remit the retail sales tax they collected from their clients, which establishes intent to evade under Rule 228(5)(f)(ii)(B). *See* Det. No. 15-0067, 34 WTD 424 (2015) (intent to evade found where the taxpayer's invoices indicated that it consistently collected retail sales tax, but did not remit the tax to the Department). In addition, Taxpayers reported amounts from its QuickBooks sales tax liability report under the service and other activities B&O tax classification. Det. No. 94-007, 14 WTD 174, 178 (1995) (evasion found where the taxpayer dishonestly reported retail sales under the wholesaling

classification). [We conclude that the Department has established by clear, cogent, and convincing evidence that Taxpayers knew to charge and collect retail sales tax, and report and pay their retail sales tax liabilities, but substantially underreported their retail sales with the intent to evade their known tax liabilities.] Thus, the Department has made a *prima facie* case of evasion.

Taxpayers assert that . . . [Taxpayer 1] thought taxes were being correctly reported by accountants and bookkeepers, Taxpayers were unaware that they were not correctly reporting and remitting, and a bookkeeper was making mistakes and stealing. In support of this position, Taxpayers provided evidence that one of its former bookkeepers was convicted of first-degree theft and ordered to pay Taxpayers restitution.

Rule 228 states that the department will waive penalties resulting from "circumstances beyond the control of the taxpayer," specifically including when the delinquent payment was caused by an act of "fraud, embezzlement, theft, or conversion on the part of the taxpayer's employee." Rule 228(9)(a)(ii)(F). However, that provision further states that the waiver in such circumstances is only applicable when "the taxpayer could not immediately detect or prevent" the fraudulent act and provided "that reasonable safeguards or internal controls were in place." *Id.* In this case, we do not find it credible that Taxpayers were collecting retail sales tax for years and keeping rather than remitting those taxes, yet were unaware of their failure to report and remit those taxes. We hold the evidence that a bookkeeper was convicted of theft and ordered to pay Taxpayers restitution does not show that Taxpayers could not immediately detect or prevent their systematic practice of collecting sales tax and not remitting it to the Department. We further hold that Taxpayers have failed to prove that they had sufficient safeguards or internal controls in place to prevent their failure to pay collected sales tax to the Department. For these reasons, we hold that [Taxpayers failed to produce sufficient evidence to rebut the Department's evidence of evasion,] Audit correctly assessed the evasion penalty and that Taxpayers do not qualify for a waiver of that penalty.

DECISION AND DISPOSITION

Taxpayers' petitions are denied.

Dated this 7th day of January 2021.