BEFORE THE APPEALS 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. 98-203 Registration No. . . . FY . . . /Audit No. . . .

RULE 111; RPM 90-1: SERVICE B&O -- GROSS INCOME -- PROPERTY MANAGEMENT COMPANY -- AGENT -- PAYROLL. Rent used to pay a property management company's on-site employees is gross income of the management company. Reimbursements to the company for paying the apartment owners' on-site employees may be excluded. ETA 90-1.

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.

NATURE OF ACTION:

An apartment management company protests an assessment of business and occupation (B&O) tax on rents it collected for payroll expenses.[1]

FACTS:

M. Pree, A.L.J. -- . . . (taxpayer) managed residential apartment complexes. The taxpayer did not own the apartments, rather it contracted with different owners to manage their apartments. Depending on the owner and the effective period, the contracts varied.

The Department of Revenue (Department) reviewed the taxpayer's books and records for the period from January 1, 1992 through March 31, 1996. On December 6, 1996, the Department's Audit Division issued assessment no. FY . . . for $ . . . additional tax and interest. The taxpayer disagreed and petitioned for correction of the assessment. The petition addressed only the

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

taxability of management fees received from the owners for on-site personnel, which made up the bulk of the assessment.[2]

According to the taxpayer, it always secured written agreements from each owner. While the agreements varied (from the information available) the taxpayer generally conducted business in the following manner. The taxpayer collected rent from the tenants and deposited the money into trust accounts. The taxpayer maintained a separate trust account for each building. From that trust account, a data processing company paid the wages for employees performing management, maintenance and other on-site services. While the taxpayer, the owners, and the data processing company all had authority to sign the payroll checks; in practice only the data processing company signed the payroll checks.

The bank sent the bank statements to the taxpayer. The taxpayer received the bills and grouped the invoices for the owners to review. According to the taxpayer, the owners then directed or authorized the taxpayer to pay the bills. The owners paid the taxpayer based on a percentage of rent. The taxpayer's fee was not dependent upon expenses or payroll. The Audit Division did not include reimbursements for other property expenses in the assessment. The issue pertains to the taxability of the payroll for on-site employees.

The taxpayer argues that it did not have constructive receipt of the rent. The taxpayer also contends that it did not control the on-site employees.

The taxpayer explains that it proposed to each owner the number of personnel required at each complex as well as suggesting the level of pay. The taxpayer then met with the owners who made the final decisions regarding the on-site personnel. According to the taxpayer, the decision to provide health insurance for on-site personnel was entirely up to each owner.

Following the hearing, the taxpayer provided an example of a proposal it made regarding on-site employees. The taxpayer proposed the level of pay for five on-site positions: manager, assistant manager, leasing agent, maintenance person, and janitor. In this particular example, the owner decided to change the level of compensation for four of the five positions.

During the audit, the taxpayer's bookkeeper told the Audit Division that the taxpayer managed the day-to-day activities of the employees. Many of the owners lived and worked out-of-state. The Audit Division reviewed the taxpayer's payroll documents, such as, Employment Security and Labor and Industry payments; and federal withholding records, FICA and FUTA.. The Audit Division found these records indicated the taxpayer was the employer, and considered the taxpayer responsible for these costs.

[2] The taxpayer's petition does not take issue with other portions of the assessment, ie. use tax . The taxpayer paid $4,862, the undisputed portion.

The Audit Division states it requested the taxpayer to provide an agreement representative of its contracts with the owners. The agreement provided to the Audit Division designated the taxpayer as its exclusive agent for managing the owner's account for a specific apartment complex. One provision stated in part:

> On behalf of the project and Owner, Agent [taxpayer] shall employ, discharge, supervise, and pay all employees and independent contractors considered by agent as necessary for the efficient management of said property. Agent [taxpayer] shall not be liable to Owner for any act or omission on the part of such employees if Agent [taxpayer] has taken reasonable care in their employment period. All employees including, but not limited to resident managers, shall be employees of the Agent [taxpayer], unless otherwise specified. Owner shall be ultimately responsible for the payment of all wages, salaries, and monies due all independent contractors and employees, and shall ultimately be responsible for the payment of all taxes and other charges required to be made to any government entity by reason of the hiring of independent contractors or employees. Agent [taxpayer] shall make payments such as expenses, taxes, and other charges to appropriate agencies out of the monthly gross revenues of the project on behalf of the Owner.

From the records reviewed, the Audit Division found the on-site employees looked to the taxpayer for payment. They considered the taxpayer their employer. The Audit Division contested the taxpayer's agency role regarding the on-site employees. Because the contract language designated the taxpayer the employer, the Audit Division found the on-site personnel aided the taxpayer in its role as "agent" by collecting rents and managing properties for the owners.

The taxpayer disputes the extent of control over the on-site employees. The taxpayer states all owners had the ultimate right to select, manage, and terminate employees. The taxpayer provided the example of how this occurred through its budget process, as explained above. Further, the taxpayer states the owners provided tools and determined whether the employees would receive health insurance.

Following the hearing, the taxpayer provided a second contract, which it considered more representative. That contract also designated the taxpayer as agent. That contract stated in part:

> "All employees, including but not limited to resident managers, shall be employees of the **Owner,** unless otherwise specified." [Emphasis supplied]

The taxpayer considered this contract representative. After the hearing this document was shared with the auditor. Obviously, the language in this document differed from the "representative" contract the auditor had reviewed. In its petition, the taxpayer acknowledged:

> The Department's auditor reviewed only one of our older management contracts in reaching her conclusion. Newer contracts state explicitly that on-site personnel are employees of the owner.

The auditor acknowledged she had not reviewed a contract with this language prior to issuing the assessment.

ISSUE:

Does the B&O tax apply to rent received by a management company and used to pay on-site employees?

DISCUSSION:

B&O tax is imposed on the gross income of business and service activities. RCW 82.04.220 and RCW 82.04.290. RCW 82.04.080 defines "Gross income of the business" as:

> . . . the 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, gains realized from trading in stocks, bonds, or other evidences of indebtedness, interest, discount, rents, royalties, fees, commissions, dividends, and other emoluments however designated, all without any deduction on account of the cost of tangible property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense whatsoever paid or accrued and without any deduction on account of losses.

The taxpayer contends that because the rent was deposited in a trust account,[3] it did not have "constructive receipt". The concept of constructive receipt is applied to cash basis taxpayers entitled to receive income, which because of their actions, they never receive. See WAC 458-20-199 (Rule 199). "Value proceeding or accruing" means the consideration actually received or accrued. RCW 82.04.080. In this case, the money is used to pay employees.[4] The issue really is whether the money was used to pay an obligation of the taxpayer, in which case the payment constitutes consideration to compensate the taxpayer for the rendition of services performed by its employees. If the taxpayer was obligated to pay employees of the owners merely as an agent of the owners, their payroll would not proceed or accrue to the taxpayer.

The taxpayer provides many services through employees to the property owners, for which services the owners agree to pay the taxpayer a percentage of rents. The taxpayer pays many expenses,

[3] RCW 18.85.310 and WAC 308-124F-014 provide that parties to property management agreements hold money in trust for the purpose of the agreement.

[4] Given that relief of an employer's obligation to pay its employees constitutes consideration, the issue of constructive receipt is really a timing issue, dependent upon when the employees performed the services (accrual basis) or when they were paid (cash basis).

which the owners reimburse. Those reimbursements were not included in the assessment because WAC 458-20-111 (Rule 111) allows taxpayers to exclude reimbursements. However, Rule 111 limits this exclusion for reimbursements to situations:

> . . . 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.

The taxpayer contends that it was acting as agent for the owners regarding the on-site personnel. Employers are liable to their employees for their wages. In Rho Company, Inc. v. Department of Rev., 113 Wn.2d 561, 782 P.2d 986 (1989), the Washington Supreme Court ruled that the determination of which company is to be regarded as the employer of workers for taxation purposes will depend upon the degree of control the business exercises over the workers. That case was remanded to determine whether Rho's obligation to pay the personnel constituted liability solely as an agent. Similarly, the taxpayer argues that its liability is solely that of agent. The Rho court stated:

> Resolution of this [agency] issue will require analysis of the control over the contract personnel that was exercised by Rho and by the clients. If the clients' control over the personnel was so pervasive that it should be deemed the employers of the personnel for purposes of B&O taxation, and Rho's control consisted of little more than paying the personnel once they were hired, then Rho should be deemed to be a mere paymaster who pays the personnel only as an agent for the clients. The areas in which control will be important will include hiring, compensation, work assignment, supervision and termination.

Rho, 113 Wn.2d at 573.

The Rho court did not resolve the issue of whether Rho was the employer. The Court remanded the case to the Board of Tax Appeals to determine that issue. The significance of Rho is the Court's conclusion that the Department cannot rely exclusively on the contract to determine that a taxpayer is the employer, but must examine the facts to determine who has pervasive control of the employees. Rho, 113 Wn.2d at 571.

Following the Rho decision, the Department issued Revenue Policy Memorandum (RPM) 90-1, now Excise Tax Advisory (ETA) 90-1.[5] In ETA 90-1, the Department responded to the Rho court's conclusions that specific factors should be considered when determining whether a taxpayer is the employer or the agent for Rule 111 purposes. The party designated as the employer under the contract is taxed as the employer unless the other party has pervasive control. ETA 90-1 lists the following factors for determining pervasive control:

[5] RPM 90-1 was replaced by ETA 90-1 on July 1, 1998. While ETA 90-1 is only advisory for taxpayers, the Department is bound by it.

1. Ultimate decision as to hiring and firing the worker;
2. Ultimate decision as to duration of employment;
3. Setting the rate, amount, and other aspects of compensation;
4. Determining the worker's job assignments and instructions;
5. Exercising exclusive guidance and supervision over the work performed;
6. Evaluating the worker's performance;
7. Determining the days and hours of work performed;
8. Providing the office space or other controlled work premises;
9. Providing the tools and materials applied in the workplace;
10. Compensating workers for vacation time, sick leave, and insurance benefits;

While ETA 90-1 is advisory only, it continues to reflect the Rho court's requirements for determining pervasive control, including consideration of the terms of a contract. In addition to the factors listed above, ETA 90-1 provides:

> When these elements of control exist only in behalf of the business to whom the workers are provided, that business will be treated as the employer and the business providing the workers will be treated only as a payrolling agent, notwithstanding terms in any contract between the businesses.
>
> When one or more of these elements exist in behalf of the business providing the workers, and any contract between the parties designates this business as the "employer," then it will be treated as the employer for state tax purposes as well.
>
> When there is no written contract between the businesses, the elements of control, to the extent that they are determinable, must exist exclusively in the business to whom the workers are provided such that the business providing the workers is acting solely as an agent in procuring and paying the workers.

(Emphasis supplied.)

In this matter, the taxpayer's contracts define its relationship with the owners and with the employees. The first sample contract provided to the Audit Division clearly designates the taxpayer as the employer. The burden is on the taxpayer to prove that these employees were under the pervasive control of the owners. We cannot find that either the taxpayer, or the owner, had all of the elements of control considered in Rho. Therefore, without either party having pervasive control, we cannot disregard the contract designations. In the absence of such additional evidence, the contract represents the agreement of the parties. The contract provides the best evidence of the intent of the taxpayer and the owner.

In this case, the taxpayer has written contracts with all the owners. In each instance, both the taxpayer and the property owner have some of the elements of control. The taxpayer directly

supervises the employees' day-to-day activities. The owners, through the budget, have other elements of control.

If the owners reduce the budget, compensation, duration of employment, availability of tools and materials in the workplace are all affected. As owners of the property, they provide on-site employees, the work premises and the necessary tools and materials. The owners also designate whether the employees receive health insurance.

The taxpayer directly supervises the employees. Under the contract reviewed by the Audit Division, the taxpayer hires and fires the employees that the taxpayer considers necessary for the efficient management of the property. The taxpayer distributes their paychecks and is named as their employer for various employment taxes.

Based on the information available, we find that the owners and the taxpayer share control of the on-site employees. Neither has pervasive control.

If the contract designates the taxpayer as the employer, the taxpayer is liable for the salaries of these employees. The compensation rate of employees may well be driven by the budget amounts set by the owners, but in these instances, it appears that the taxpayer initially determines each of its employee's compensation. Unless the owner intervenes, the taxpayer's recommendation determines compensation. We have not found with respect to these employees that taxpayer has met its burden that the owners had pervasive control. Upon remand to the Audit Division, the taxpayer may provide additional proof of the owners' pervasive control for consideration.

Likewise, where the property owner was designated as the employer in the contract, the owner shared the elements of control with the taxpayer. In the absence of evidence to the contrary, we find these employees were, as designated in the contract, the owner's employees. The amount taxpayer received from the owner for their wages may be excluded from the taxpayer's gross income in accordance with Rule 111. We find under these contracts, the taxpayer was the owners' payroll agent with respect to these employees.

Property management contracts existed for every property managed by the taxpayer. We have only been provided two for review. The taxpayer may exclude payments for owners when agreements were in effect which were similar to the contract provided after the hearing, which designates the owners as the employers.

We note recent legislation[6] created RCW 82.04.394, which may be applicable in the future. Effective July 1, 1998, property management companies may deduct amounts received from owners of property for on-site personnel under the following circumstances:

[6] Laws of 1998, ch. 338, SB 6662 Sec. 2.

> (1) This chapter[7] does not apply to amounts received by a property management company from the owner of a property for gross wages and benefits paid directly to or on behalf of on-site personnel from property management trust accounts that are required to be maintained under RCW 18.85.310.
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> (2) As used in this section, "on-site personnel" means a person who meets all of the following conditions: (a) The person works primarily at the owner's property; (b) the person's duties include leasing property units, maintaining the property, collecting rents, or similar activities; and (c) under a written property management agreement: (i) The person's compensation is the ultimate obligation of the property owner and not the property manager; (ii) the property manager is liable for payment only as agent of the owner; and (iii) the property manager is the agent of the owner with respect to the on-site personnel and that all actions, including, but not limited to, hiring, firing, compensation, and conditions of employment, taken by the property manager with respect to the on-site personnel are subject to the approval of the property owner.

(Footnote ours.) We note that if the taxpayer's on-site personnel meet these requirements, the B&O tax will not be applicable to amounts received by the taxpayer from the owners for gross wages paid to the on-site personnel from property management trust accounts that are required to be maintained under RCW 18.85.310. RCW 82.04.394 is applicable to receipts for on-site personnel after June 30, 1998.

DECISION AND DISPOSITION:

The file is remanded back to the Audit Division. The Audit Division will revise the assessment to the extent the taxpayer verifies specific payments were received under contracts designating the owners as the employers. Payments received under contracts designating the taxpayer as the employer, as well as payments during periods not covered by contracts will remain in the assessment.

Dated this 30th day of November, 1998.

[7] "This chapter' is 82.04 RCW, which is the one that imposes the B&O tax.