

Cite as Det. No. 15-0148, 35 WTD 10 (2016)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 15-0148 |
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[1] RCW 82.04.080; RCW 82.04.220: BUSINESS AND OCCUPATION TAX – GROSS INCOME – EXPENSE ACCOUNT CREDITS REPRESENTING PAYMENT FOR SERVICES RENDERED. Credits to expense accounts that represent compensation for services rendered to a taxpayer’s affiliate constitute gross income, as defined in RCW 82.04.080(1), subject to B&O tax pursuant to RCW 82.04.220.

[2] RCW 82.32.070; RCW 82.32.100: RECORDKEEPING – FAILURE TO KEEP RECORDS – ESTIMATE OF TAX LIABILITY. If a taxpayer fails to maintain and provide adequate records to determine the taxpayer’s excise tax liability, the Department is authorized to use the records available to arrive at its best estimate of the taxpayer’s tax liability.

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.

Eckholm, A.L.J. – Service affiliates [(Taxpayers)] object to the imposition of business and occupation (B&O) tax on amounts represented by credits to expenses they allocated to their affiliated entities, asserting that the credits do not constitute gross income as defined in RCW 82.04.080(1). [Taxpayers] also assert that the Audit Division employed faulty methodology in determining their use tax or deferred sales tax liabilities. The taxpayers’ petitions are denied.¹

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

ISSUES

1. Whether credits to expense accounts that represent compensation for services provided constitute gross income, as defined in RCW 82.04.080(1), subject to B&O tax, pursuant to RCW 82.04.220.
2. Whether the Department properly determined the taxpayer's tax liability, pursuant to RCW 82.32.100, where the taxpayer failed to provide adequate records, as required by RCW 82.32.070 and WAC 458-20-254.

FINDINGS OF FACT

[Taxpayers], headquartered [out of state], provide finance, marketing, sales, legal, credit and collections, customer support, public affairs, and procurement services to affiliated entities engaged in business in Washington.

The Department of Revenue (Department) Audit Division reviewed the taxpayers' records for excise tax purposes for periods between January 1, 2007, and December 31, 2013.² The Audit Division requested that the taxpayers provide detailed accounting records related to their Washington business activities on numerous occasions. The only records the taxpayers provided were federal income tax apportionment schedules and trial balance reports. The Audit Division used the records provided to determine the amount of the taxpayers' unreported income from their services and use tax or deferred sales tax due. As a result, the Audit Division issued two assessments against each taxpayer.³

[Taxpayers] appealed the assessments. In regards to the service and other activities B&O tax assessments, [Taxpayers] assert that they do not recognize any revenue from the services they provide to affiliated entities, as evidenced by their methods of accounting and, therefore, have no taxable income. [Taxpayers] explain in their appeal petitions that Federal Communications

² For the specific periods applicable to each entity see footnote 3, *infra*.

³ [Taxpayer 1]: Document No. . . . , issued February 6, 2014, for the period January 1, 2007, through December 31, 2009, included assessments of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , a delinquency penalty of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$ Document No. . . . , issued February 6, 2014, for the period January 1, 2010, through December 31, 2012, included assessment of retail sales tax of \$. . . , service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , a delinquency penalty of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$

[Taxpayer 2]: Document No. . . . , issued February 6, 2014, for the period January 1, 2008, through December 31, 2009, included assessments of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$ Document No. . . . , issued February 6, 2014, for the period January 1, 2010, through June 30, 2013, included assessment of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , a delinquency penalty of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$

[Taxpayer 3]: Document No. . . . , issued February 6, 2014, for the period January 1, 2007, through December 31, 2009, included assessments of retail sales tax of \$. . . , service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$ Document No. . . . , issued February 6, 2014, for the period January 1, 2010, through June 30, 2013, included assessment of service and other activities B&O tax of \$. . . , use tax and/or deferred sales tax of \$. . . , a delinquency penalty of \$. . . , interest of \$. . . , and an assessment penalty of \$. . . , for a total amount of \$

Commission (FCC) accounting rules and compliance requirements prohibit the taxpayers from recording revenue or making a profit on transactions involving shared expenses (via service companies) between regulated and non-regulated affiliated companies and, therefore, the assessments of service and other activities B&O tax were improper:

[The taxpayer], in accordance with [FCC] rule, credited the expenses allocated to its regulated affiliates to the original expense account charge and did not and could not record such allocated expense to a revenue account with the exception of the return on investment. . . . As a result, the only revenues that may be recognized by the non-regulated [company] which services a regulated company are the amounts attributable to interest and depreciation/amortization which are recorded in Account

. . .

Here, the accounting practice that [the taxpayer] is required to follow does not allow it to recognize any income or revenue from the services performed for their affiliates. Further, the method of accounting that is required and that is regularly employed by the regulated service companies requires that [the taxpayer] allocate the expenses to the original account charged and does not allow them to recognize revenue or income nor may they make a “profit” from their activities.

If [the regulated affiliate] were allowed to conduct business as one legal entity nationwide, all [taxpayer] activities would be performed within that legal entity and would certainly not be subject to the B&O tax as they would only be expenses of the business. The [FCC] accounting rules mirror the treatment that would exist “but for” the required regulatory separations. To require [the taxpayer] to pay B&O tax on the services performed for the regulated affiliates would create a discriminatory tax treatment on regulated companies in general. The [affiliated] regulated companies and [the taxpayer] is (sic) significantly different than a main street business that, for business reasons, decides to operate as a separate and distinct division of the business as a separate legal entity and account for the profits and expenses of that division separate and apart from those of the affiliated businesses. Regulated companies do not have the flexibility to operate as one nationwide telephone company due to long-standing regulatory service area divisions nor is it allowed to recognize any profit on [the taxpayer’s] activities. [The taxpayer] was created in order to achieve cost reductions to the ultimate rate payers as required by the FCC and merely provide a vehicle for sharing expenses between regulated companies and the methodology and accounting for the shared expenses are strictly governed by specific accounting practices. The FCC has clearly outlined the treatment that must be followed for [the taxpayer] and it is completely improper for the DOR to impose a treatment in conflict with that required treatment. . . .⁴

In addition, the taxpayers assert that the Audit Division erred in using their federal income tax apportionment schedules in determining their tax liability rather than their GAAP/FCC records, and that the Audit Division used faulty methodology in determining their use tax or deferred sales tax liability.

⁴ [Taxpayer 1’s] appeal petition at pages 2, 5-6 (the other two taxpayers’ appeal petitions are substantially similar).

The Audit Division responded that the B&O tax is a gross receipts tax without any deduction for costs of doing business, is not dependent on whether the business makes a profit, and applies whether the separate legal entity service provider is affiliated or an unrelated third party. The Audit Division also responded that the taxpayers did not provide their GAAP/FCC records for review and that the Audit Division determined the taxpayers' tax liability based on the records the taxpayers provided. In regards to the use tax or deferred sales tax assessments, the Audit Division indicated that though it was necessary to estimate tax liability for certain periods where the taxpayers failed to provide any records, the Audit Division conducted a review of actual purchase records provided by the taxpayers and the taxpayers' assertion that the assessments were based on faulty sampling procedures is incorrect.

The taxpayers were provided additional opportunities on appeal to provide records and failed to do so.

ANALYSIS

1. Credits to expense accounts that represent compensation for services provided constitute gross income, as defined in RCW 82.04.080(1), subject to B&O tax pursuant to RCW 82.04.220.

The B&O tax is calculated based on the "gross income of the business." RCW 82.04.290. "Gross income of the business" is broadly defined 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, 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.

RCW 82.04.080(1) (emphasis added). The phrase "value proceeding or accruing" is also defined broadly as "the consideration, whether money, credits, rights, or other property expressed in terms of money, actually received or accrued." RCW 82.04.090. "Business" includes "all activities engaged in with the object of gain, benefit, or advantage to the taxpayer or to another person or class, directly or indirectly." RCW 82.04.140.

Under these broad statutory definitions, a taxpayer is subject to B&O tax on the value proceeding or accruing from the taxpayer's business activities and there is no deduction of costs of doing business in determining the gross income taxable base. *See Pilcher v. Dep't of Revenue*, 112 Wn. App. 428, 49 P.3d 947 (2002)(citing *Rho Co. Inc. v. Dep't of Revenue*, 113 Wn.2d 561, 570, 782 P.2d 986 (1989)); *North Pacific Coast Freight Bureau v. State*, 12 Wn.2d 563, 574-575, 122 P.2d 467 (1942) (railroad members' payment to bureau for publishing services, where payment was based on the bureau's apportionment of expenses to its members, constituted gross income of the bureau as value accruing and compensation for its services subject to Washington B&O tax).

“The [B&O] tax is not a tax on either profit or net gain or capital gain or sales, but a tax on the total money or money's worth received in the course of doing business.” *Budget Rent-A-Car v. Dep't of Revenue*, 81 Wn.2d 171, 173, 500 P.2d 764 (1972)(citing *Young Men's Christian Ass'n v. State*, 62 Wn.2d 504, 383 P.2d 497 (1963)). Whether a profit is realized on a taxpayer's business transaction is immaterial, for the B&O tax is on the gross revenues received in the course of doing business. *Budget Rent-A-Car*, 81 Wn.2d at 173 (citing RCW 82.04.220). Thus, a taxpayer's claim that it realized no profit in its sales is without relevance for the statute imposes the tax regardless whether the business is losing or making money on the transaction. *Id.*

The taxpayers assert that the imposition of Washington's B&O tax on the credits to their expense allocations to their affiliated entities is “improper” where the FCC accounting rules and procedures dictate the corporate structure for service entities such as themselves and preclude them from making profits.⁵ The taxpayer is essentially arguing that it is unfair to tax its gross income from services rendered because it is not in a profit-making business. As noted above, whether the taxpayer makes a profit in its Washington business activities is immaterial as to the determination of a taxpayer's B&O tax liability pursuant to RCW 82.04.220. *Budget Rent-A-Car*, 81 Wn.2d at 173. The taxpayers' records evidence that the taxpayers received compensation for services rendered to their affiliates. Whether the compensation is represented in the taxpayers' records in the form of credits to expense accounts or debits to revenue accounts makes no difference. Compensation for services rendered constitutes gross income subject to B&O tax. RCW 82.04.080(1); RCW 82.04.220(1). The Audit Division properly assessed service and other activities B&O tax on the taxpayers' gross income from those services.⁶

2. The Department properly determined the taxpayer's tax liability pursuant to RCW 82.32.100, where the taxpayer failed to provide adequate records for review as required by RCW 82.32.070 and WAC 458-20-254.

RCW 82.32.070 requires taxpayers in this state to maintain records adequate for the Department of Revenue to determine the tax liability of such taxpayer. *See* WAC 458-20-254. If any person fails or refuses to make records available for examination, RCW 82.32.100(1) authorizes the Department to proceed, “in such manner as it may deem best, to obtain facts and information on which to base its estimate of the tax.” Once the Department obtains the available facts and information, the Department “shall proceed to determine and assess against such person the tax and any applicable penalties or interest due.” RCW 82.32.100(2). Where a taxpayer does not provide adequate records to provide a basis for the exact amount of income subject to tax, the Department is required to determine the tax due based on the best information available. *Id.*;

⁵ As persuasive authority, the taxpayer provided an Advisory Opinion of the New York State Department of Taxation and Finance (TSB-H-81 (24)C, Corporation Tax, April 10, 1981) issued to a gas company advising that it was not subject to a New York franchise tax on the company's sales of natural gas because the tax was not applicable to the company's sales for resale. Attachment to electronic message from the taxpayer, dated March 25, 2015. The Advisory Opinion is not helpful in addressing the issues in this appeal because it relates to a specific New York franchise tax statute that is substantially different from Washington's B&O tax statutory scheme and is based on substantially different facts.

⁶ Even if the Department were to agree with the taxpayers that it was unfair to tax their compensation where they are subject to the FCC requirements and restrictions, the Department does not have the authority to disregard the plain language of a statute. Det. No. 00-187, 20 WTD 272, 277 (2001); Det. No. 95-132ER 17 WTD 213, 218 (1998).

Det. No. 02-0115, 23 WTD 21, 24 (2004). Here, the Audit Division properly determined the taxpayer's tax liability based on the records the taxpayer provided. The taxpayer has not established the Audit Division committed any errors in its calculations.

DECISION AND DISPOSITION

The taxpayer's petition is denied.

Dated this 5th day of June, 2015.