DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 03-0032
INCOME TAX
For Years 1994, 1995, and 1996

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ISSUES

I. Gross Income Tax—Agency exemption

Authority: *Lindemann v. Wood*, No. 49T10-0204-TA-39, 2002 Ind. Tax LEXIS 81 (Ind. Tax Ct. 2002); 45 IAC 15-3-2(d)(3).

Taxpayer, as manager of a hotel chain, protests the imposition of gross income tax on transfers of money between the hotels' owners and taxpayer's employees who work in the hotels, claiming an agency exemption exists.

II. Gross Income Tax—Intercompany Royalties

Authority: IC 6-2.1-4-6

Taxpayer claims that the auditor has erroneously imposed gross income tax at the high rate on royalties paid within the company. As such, taxpayer believes these royalties should not subject taxpayer to gross income tax.

STATEMENT OF FACTS

Taxpayer is a corporation that, at the request of various hotel owners (hereinafter "owners"), manages all of the operations of the hotel for the account of the owner, including the hiring and management of the hotel's employees (hereinafter "employees"), on behalf of the owners. At various times throughout the audit period, taxpayer disbursed funds to the employees from accounts that the owners had with taxpayer. These disbursements covered the payroll expenses associated with the employees who work for the hotel. These employees work for taxpayer; taxpayer is their technical employer. Income tax was imposed on the receipt of funds by taxpayer from the owners when those funds were later disbursed to compensate taxpayer's employees as payroll expenses.

The owners furnish and own all of the tools, materials, and equipment the employees used in performing their jobs. The owners also incur the cost of training the employees. Taxpayer disburses salaries and benefits to the employees and remits payroll taxes to federal and state governments using the owners' funds.

All funds that are derived from the operation of the hotel are deposited in accounts under the owners' names, and all disbursements, including payroll, are made from these funds. These accounts are in the name of the owners and are subject to claims against them by owners' creditors. If revenues are insufficient to pay for the hotel's expenses, including payroll, the owners provide additional working capital to sustain hotel operations.

Journal entries record payroll disbursements sufficient to offset dollar-for-dollar the payroll disbursements shown on taxpayer's books, and taxpayer notes on its books that it is passing along directly to the employees the amounts advanced to taxpayer by the owners to cover payroll expenses. All federal and state employment credits flow back to the owners.

DISCUSSION

I. Gross Income Tax—Agency exemption

Taxpayer relies on two legal theories in its assertion that the funds were transferred to taxpayer's employees by taxpayer as an agent for the hotels' owners, and therefore not subject to income tax. The first is that the facts at hand fall squarely within the ambit of an unreported Tax Court opinion. The second is that the facts at hand fall squarely within the ambit of a previously written Supplemental Letter of Findings by the Department. Both cases found in favor of taxpayer's position.

First, as is the case with all unreported Tax Court decisions, the decision referenced by taxpayer has no weight as binding precedent. According to Rule 17 of the Indiana Tax Court:

> All judgments shall be incorporated in written memorandum decisions by the court. Unless specifically designated "For Publication," such written memorandum decisions shall not be published and shall not be regarded as precedent nor cited before any court except for the purpose of establishing the defense of res judicata, collateral estoppel, or the law of the case. Judgment shall be subject to review as prescribed by relevant Indiana rules and statutes.

The Tax Court has declared as much in *Lindemann v. Wood*, No. 49T10-0204-TA-39, 2002 Ind. Tax LEXIS 81 (Ind. Tax Ct. 2002). Because the case cited is an unpublished case, the Department declined taxpayer's request to apply its analysis to the case at hand.

Second, the Department also declines taxpayer's invitation to apply directly the reasoning in its former Supplemental Letter of Findings. As is the case with all tax protests, no two protests are created equal. Letters of Findings that are issued by the department, as a result of protested assessments, are to be considered rulings of the department as applied to the particular facts protested. 45 IAC 15-3-2(d)(3). Therefore, Letters of Findings are unique to each individual taxpayer and are of no precedential value to any other taxpayer's protest.

However, taxpayer's argument may clearly be determined through its submissions to the Department and through the language of the legal determinations upon which taxpayer wishes the Department to base its determination.

Taxpayer believes it acted as an agent when it transferred funds from the owners to taxpayer's employees as salaries. As one of the aspects of showing that the agency relationship exists, taxpayer must show that it does not receive any beneficial interest in the funds as they are transferred through taxpayer from the owners to the employees. Taxpayer insists, and has shown, that the funds that flow through match dollar for dollar the payroll expenses that the employees accrue. And while this is some indicia that taxpayer receives no benefit from paying the owners' expenses from the owners own accounts, to say that taxpayer has no beneficial interest in the funds would dramatically undermine the importance of the employer/employee relationship between taxpayer and the hotels' employees.

Taxpayer freely admits that the employees are its own, although it contends that without the owners, taxpayer would have no need for the employees. Taxpayer also admits that it has the power to hire and fire these employees at will, although taxpayer suggests that it does so only with the owners' best interests in mind. And while taxpayer has shown some evidence that the employees understand that they are working for the benefit of the owners, it cannot be disregarded the extent to which employees' efforts benefit taxpayer.

Part of taxpayer's submissions to the Department includes a management agreement between one of the owners and taxpayer. This agreement details the arrangement between owners and taxpayer and outlines the method of reimbursement of taxpayer by owners. This "management fee" structure clearly demonstrates how taxpayer takes a beneficial interest in both the performance of its employees and their compensation.

The "management fee" structure is made up of two parts: The Base Management Fee and the Incentive Management Fee. The Base Management Fee represents a percentage of the gross revenues, which flow from the hotels to their respective owners. These gross revenues are generated through a variety of manners, including (but not limited to) the renting of rooms, offices, and meeting space. For these revenues to be generated, customers must be willing to pay for them. Therefore, customer satisfaction plays a large role in the generation of gross revenues. If hotels' employees do not perform their jobs satisfactorily, customers will not do business with the hotels, and gross revenues will not be generated for the owners. Subsequently, taxpayer's Base Management Fee will suffer. Because taxpayer has a financial interest in the revenues it generates through its employees, and because taxpayer has the power to terminate any employee not performing his job to taxpayer's satisfaction, taxpayer has a beneficial interest in the conduct of its employees.

The Incentive Management Fee takes it one step further. Here, taxpayer receives a percentage of Available Cash Flow, at an amount not to exceed the Operating Profit for the fiscal year. Available Cash Flow, therefore, to some degree, is a function of Operating Profit. Operating Profit is defined as gross revenues minus certain enumerated deductions. Among these deductions are "[t]he cost of sales including *salaries, wages, employee benefits*, …" Here it is clearly demonstrated how employee wages affect taxpayer's compensation, because as taxpayer has a direct power over the number of employees and their salaries, it can manipulate its own Incentive Management Fee by increasing Operating Profit. This clearly demonstrates how taxpayer receives a beneficial interest in its employees, regardless of who their technical employer is.

FINDINGS

The taxpayer is respectfully denied.

II. Gross Income Tax—Intercompany Royalties

Taxpayer, under IC 6-2.1-4-6, as both the payer and the payee of the Intercompany royalties, was qualified and did file a consolidated Indiana gross income tax return for 1996. Therefore, these royalties are not to be included in taxpayer's gross income.

FINDINGS

The taxpayer is sustained, subject to verification by the audit department.

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