

TAX COMMISSIONER FINAL DETERMINATION DISCUSSES CAT AGENCY EXCLUSION FOR LAW FIRMS

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The Ohio Department of Taxation (the “Department”) issued a Final Determination dated March 17, 2017 to Jones, Day, Reavis & Pogue (“Jones Day”) affirming a Commercial Activity Tax (“CAT”) assessment issued against Jones Day for the period January 1, 2006 through December 31, 2007. Jones Day has 60 days from its receipt of the Final Determination to appeal to the Ohio Board of Tax Appeals (“BTA”). As of the date of this SALT Buzz, Jones Day has not appealed the Final Determination.

Jones Day is an Ohio-based law firm with offices worldwide. The assessment included as gross receipts reimbursements paid to Jones Day by its clients for various costs paid by Jones Day on behalf of the client. These costs are for items and services that almost all law firms would pay upfront for their clients and get reimbursed by their clients, such as witness fees and costs, expert fees, court reporter fees, local counsel fees, and mediation fees.

The CAT is imposed on “gross receipts,” which is defined broadly to include “the total amount realized by a person without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration.” R.C. 5751.01(F). The statute sets forth a number of exclusions from the definition of “gross receipts.” Jones Day argued that the reimbursements from its clients qualified for the agency exclusion in R.C. 5751.01(F)(2)(I), which excludes: “[p]roperty, money, and other amounts received or acquired by an agent on behalf of another in excess of the agent’s commission,

fee, or other remuneration.” An agent is defined in R.C. 5751.01(P) as “a person authorized by another person to act on its behalf to undertake a transaction for the other.”

Jones Day also argued that the expense reimbursements did not represent compensation earned by the firm for services rendered and were therefore not gross receipts. Instead, Jones Day argued the reimbursements represent amounts paid by Jones Day (for the convenience of the client) to satisfy the client’s obligation to the third party providing the goods or services. The Final Determination does not explicitly address whether the reimbursements fall within the general definition of “gross receipts” in R.C. 5751.01(F). Instead, the Final Determination focuses on the agency exclusion in R.C. 5751.01(F)(2)(I), which suggests that the Department’s position is that these reimbursements met the general definition of a gross receipt for CAT purposes.

Some of the expense reimbursements were not included in the assessment as CAT gross receipts pursuant to the agency exclusion, while other expense reimbursements were determined to be part of Jones Day’s CAT gross receipts. The primary difference appears to be whether the expense reimbursements were specifically described in the example in Ohio Administrative Code (“O.A.C.”) 5703-29-13(E)(2). O.A.C. 5703-29-13(E) describes the agency exclusion in R.C. 5751.01(F)(2)(I) where a person advances fees on behalf of a client. The rule provides the following example:

(2) For example, an individual retains an attorney to represent the individual in a personal injury suit against a company. The attorney advances a filing fee to the court in order to allow the client to file a complaint against the company. In addition to the attorney’s hourly rate, the attorney charges the client the filing fee, as well as copying charges for copies made and telephone charges for calls made all on the client’s behalf. When calculating the attorney’s commercial activity tax liability, the attorney may exclude the court fees that were advanced on the client’s behalf from the attorney’s gross receipts pursuant to division (F)(2)(I) of section 5751.01 of the Revised Code but may not exclude the copying fees or the telephone charges for calls made on the client’s case.

Even though it is just an example of the types of fees advanced by the firm and reimbursed by the client, the Final Determination appears to take a position that only the specific types of cost reimbursements specified in the example in O.A.C. 5703-29-13(E) qualify for the agency exclusion. The Final Determination concludes that the following reimbursements were not taxable gross receipts due to the agency exclusion:

Articles of Incorporation filing fees, Blue Sky filing fees, Certificate of Good Standing fees, certified copy charges, certified document charges, filing fees, fines, foreign debt note fees, land registry fees, local authority search fees, name reservation fees, patent and trademark office fees, probate fees, record deed costs, stamp duty fees, and UCC filing fees.

The Final Determination concludes that the following reimbursements were taxable gross receipts and did not qualify for the agency exclusion (collectively, the “Disputed Reimbursements”):

Agent fees, attorney fees, consultant fees, court reporter fees, CT Corporation fees, investigative services, litigation expenses, local counsel costs, local counsel fees, mediation fees, non-testifying expert fees, temporary employee expenses, testifying expert costs, testifying expert fees, translation services and witness fees.

In its listing of the Disputed Reimbursements, the Final Determination refers to each Disputed Reimbursement as paid on behalf of the client or an advancement of fees. Nevertheless, the Final Determination states that the Disputed Reimbursements were “part of the price of the service provided versus part of the cost incurred in fulfilling their agency relationship * * * and therefore contribute to the production of gross income.” Thus, Jones Day was considered to be an agent of its clients for certain reimbursements, but not for the Disputed Reimbursements. R.C. 5751.51(F)(2) (l) clearly excludes from CAT gross receipts amounts received by an agent in excess of the agent’s fee. The Final Determination does not provide any additional clarity as to why Jones Day could be considered to be an agent for certain reimbursements, but not for the Disputed Reimbursements.

It appears that the Final Determination is taking a narrow interpretation of O.A.C. 5703-29-13(E), such that very few costs advanced by law firms (or other professional firms) can be excluded from CAT gross receipts by the agency exclusion. The Disputed Reimbursements, even though Jones Day acts as a conduit of the payments, are viewed by the Department as a cost of doing business, similar to that of a law firm’s charges for copies or telephone use. For example, a law firm may be engaged to represent a client at a trial. The law firm engages a court reporter to transcribe the hearing. The Final Determination suggests that the cost of the court reporter is part of the price of the trial services.

The Final Determination also applies the general criteria for determining whether an agency relationship exists. The Final Determination states that there was no agreement between Jones Day and their clients setting forth an agency relationship with

regard to the Disputed Reimbursements. Jones Day argued the nature of the attorney/client relationship is one where an agency relationship is implicit through the Rules of Professional Conduct. Additionally, Jones Day argued that it clearly acted only as a conduit for the Disputed Reimbursements. The Final Determination asserts that O.A.C. 5703-29-13(C)(2)(c) requires that the agency agreement be in writing, even though a written agreement is not a requirement under the statute. The Final Determination also asserts that Jones Day failed to meet its burden of showing that an agency relationship existed.

The Department next examined the decision in *Willoughby Hills Development and Distribution v. Testa* (July 5, 2016), BTA No. 2015-1069¹, which is the only BTA decision discussing the agency issue for CAT. In *Willoughby*, because the contract between the parties did not explicitly contemplate an agency relationship, the BTA was required to examine whether an agency relationship existed based upon the facts and circumstances. The BTA identified the basic test as to whether an agency relationship existed as “whether the employer has the right of control over the manner and means of the work being done.”

The Final Determination concludes that Jones Day’s clients did not have control over Jones Day with respect to how the legal work will be performed: “Jones Day has control over its employees and equipment, and conducts its legal business more as an independent contractor than as an agent of its clients.” Additionally, the Final Determination reasoned that: “Jones Day’s clients hire it to do legal work which they do not have the training and knowledge to do for themselves,” and “Jones Day’s clients turn over legal matters to Jones Day to handle, with very little input from the clients.” Furthermore, the Final Determination stated that “clients pay the hourly rates for Jones Day attorneys to have access to the specialized expertise of these attorneys, and these clients do not have enough knowledge of law to control or manage how Jones Day performs its legal work and handles complex legal matters for them.” Based upon this analysis, the clients did not “control” Jones Day and there is no agency relationship. Therefore, the Final Determination concluded that the Disputed Reimbursements were required to be included in CAT gross receipts and subject to the tax.

The Final Determination concludes, based on the legal agreements and the common law definitions of an agent, that Jones Day was not an agent for its clients. Yet the Final Determination determined that some of the expenses reimbursements were received as an agent for the clients. There appears to be an inconsistency in those two conclusions. The Final Determination refers to the “price of the service,” but it

¹ The *Willoughby* decision was discussed in detail in a previous SALT Buzz. The SALT Buzz can be found at [BTA Denies Claim of Agency for Ohio Commercial Activity Tax](#). The decision was appealed to the Ohio Supreme Court and is currently pending as Ohio Supreme Court Case No. 2106-1137.

does not provide guidance on how that concept impacts an agency relationship or how to determine when an expense is incurred as a cost of doing business versus as a separate cost.

The Department has become increasingly aggressive in asserting a broad definition of “gross receipts,” including amounts received on behalf of another party. The question of whether the agency exclusion in R.C. 5751.01(F)(2)(I) applies has become one of the most disputed issues during audits. Additionally, it is troublesome that the Final Determination concludes that a law firm could be an agent for certain third party reimbursements, but not for all third party reimbursements. This result may create even more confusion for taxpayers trying to understand and apply the agency exclusion. Law firms and other companies that receive reimbursements of costs or receive payments as a conduit for another party should review their contracts with clients to ensure (if possible) that it is clear that the costs are being purchased as an agent for the client. Alternatively, they should consider having the client pay the third party directly.

If you would like to discuss the Jones Day Final Determination or the CAT Agency Exclusion generally, please contact Tom Fagan or any of the other professionals at Zaino Hall & Farrin LLC.

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