

65113-7

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No. 65113-7-I

**COURT OF APPEALS, DIVISION I
OF THE STATE OF WASHINGTON**

GETTY IMAGES (SEATTLE), INC.,

Appellant,

vs.

CITY OF SEATTLE, DIRECTOR OF THE DEPARTMENT OF
EXECUTIVE ADMINISTRATION, DIVISION OF REVENUE AND
CONSUMER AFFIARS, AND CITY OF SEATTLE, OFFICE OF THE
HEARING EXAMINER,

Respondent,

Brief of Respondent City of Seattle

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I. STATEMENT OF THE CASE

A. Introduction

The City of Seattle imposes a business and occupation tax on all companies doing business in Seattle. Getty Images (Seattle), Inc. (“Getty Seattle”) appealed the City’s tax assessment to the City of Seattle Hearing Examiner. The Hearing Examiner ruled that Getty Seattle cannot avoid City of Seattle taxes by attributing its gross income to an out-of-state corporation with no tangible property or employees. CP 55-61. The trial court affirmed the Hearing Examiner’s decision. CP 562-565.

B. Facts

The City’s Director of Executive Administration (“City”) conducted an audit of Getty Seattle to check for compliance with the tax provisions of the Seattle Municipal Code. CP 284 ¶ 4. The auditor met with Getty Seattle’s personnel and examined Getty Seattle’s financial records for the period January 1, 2002 through December 31, 2006 (the “audit period”). CP 393-395. On April 11, 2008, the City issued a Tax Assessment to Getty Seattle for additional taxes of \$1,552,486.61. CP 68-72, 392-395. On October 6, 2008, after an extension of the due date, the Director issued a revised assessment with additional interest totaling \$1,603,346.80. CP 72; 284 ¶ 5. Getty Seattle appealed the Tax Assessment. The City of Seattle

Hearing Examiner conducted a hearing on June 24, 2009 and issued a decision that affirmed the City's assessment. CP 55-61.

Getty Seattle is part of a network of affiliated companies, some of which are in the business of providing stock photographs, often over the Internet, for a fee. CP 68-69, 284 ¶ 6. Getty Seattle was formerly known as PhotoDisc, Inc., a company whose business included providing stock photographs. CP 68, 284 ¶ 3. In approximately 2003 Getty Seattle changed its name and reorganized its businesses. CP 68, 284 ¶ 3. Getty Seattle no longer provides stock photographs and that business is now run by affiliates located elsewhere. CP 371-373. Instead, since 2003 Getty Seattle has been in the business of providing management and administrative services. CP 284 ¶ 6, 372. Getty Seattle provides those services to affiliated Getty companies. CP 55-56, 68-69, 74-75, 372-373. Getty Seattle provides those services through the approximately 450 employees located in its main office in Seattle. CP 56; 284-285 ¶¶ 6, 7; 372-375.

The issue in this appeal arises from Getty Seattle's attempt to avoid City taxes through the creation of a California limited liability company called Getty Images (Management Company) LLC ("Getty California" or

“Getty Management”).¹ CP 58-59, 68-69. Getty Management is wholly-owned by Getty Seattle. CP 285 ¶ 8; 373. Getty Management has no employees and owns no real property and no tangible personal property. CP 56; 69; 285 ¶ 11; 373, 400. Getty Management did not have a City of Seattle business license during the audit period. CP 285 ¶ 8; 400.

Effective January 1, 2002, Getty Seattle entered into a General and Administrative Services Agreement (“Agreement”) with Getty Management. CP 56, 285 ¶ 6; 373. The same person signed the agreement on behalf of both parties and because Getty Management has no employees, there was no one to negotiate its position. CP 77, 373, 400. The auditor determined that this agreement was not an “arm’s-length” transaction. CP 400.

According to the Agreement, Getty Management is engaged in the business of providing general and administrative services to affiliated companies and will appoint Getty Seattle as an independent contractor to perform certain general and administrative services for those affiliated companies. CP 55-56, 69, 74. The services are provided to about 60 to 80 affiliated companies and include billing, payroll, IT support, legal, headquarters operations, and human resources. CP 69; 75 ¶ 1.3; 373-374.

¹ Getty Management was organized under California law on September 21, 2001. California limited liability companies are controlled by Title 2.5 of the California Corporations Code. Cal. Corp. Code T. 2.5.

Until recently, some of the affiliates did not have contracts with Getty Management for those services. CP 373-374. Getty Management pays Getty Seattle an annual fee of \$1 million for the services provided under the Agreement. CP 56; 69; 285 ¶9; 375-376. That fee is Getty Management's sole significant expense. CP 69.

Getty Management issues invoices, ranging between \$25 million and \$98 million per year, to other Getty affiliates for general and administrative services. CP 69; 285-286, ¶¶ 13-14; 373-376. However, Getty Management has no employees to issue the invoices or to provide any other services. CP 373-375. Thus, Getty Seattle's employees issue Getty Management's invoices. CP 286, ¶ 13; 373-375. In short, Getty Seattle's employees provide all of the services attributed to Getty Management because Getty Management has no employees or tangible property and is therefore incapable of providing any services. CP 373-375.

Getty Seattle incurs expenses providing services under the Agreement. CP 286, ¶ 15; 377. The expenses include the payroll expenses paid to Getty Seattle employees who perform services from the Seattle office. CP 373, 377. Getty Seattle's annual expenses are commensurate with the \$25 million to \$98 million annual fees that Getty Management charges the affiliated companies for services performed by Getty Seattle. CP 56, 396-399. The \$1 million per year fee that Getty Seattle receives from

Getty Management is insufficient to pay the expenses that Getty Seattle incurs providing services to the Getty affiliates. CP 377-379, 398.

Therefore, through a cash management program Getty Management and the Getty parent company make funds available to Getty Seattle that Getty Seattle then uses to pay its expenses. CP 376-379, 398-399.

Getty Seattle goes on at length in its brief about the cash management program. However, the details of the cash management program are not relevant to the appeal. Whether Getty Seattle receives those funds by withdrawing them from a joint account or by armored car delivery is not relevant. What is relevant is the undisputed fact that Getty Seattle incurs between \$25 million to \$98 million annually in expenses for providing services to the other Getty affiliates and then receives money from the Getty affiliates to pay those expenses. CP 56, ¶¶ 7-9. Getty Seattle could not perform those services without receiving money from the other affiliates to pay those expenses. CP 380-381.

Getty Seattle confuses the purpose of a cash management system, which everyone agrees is to maximize a business's short term return on cash, with Getty Seattle's subsequent withdrawals from the system's concentration account to pay its expenses. CP 354-355. The cash management system is simply a step in the process of providing Getty Seattle with the funds needed to pay its expenses. CP 378-379. The system operates by sweeping money

at the end of the day from the affiliates' accounts into a concentration account held by a single entity. CP 354. The primary purpose for this is to achieve a better interest rate. CP 354. At one point during the audit period, Getty Seattle held the concentration account. CP 378. Later, the concentration account moved up a tier to the ultimate parent company, Getty Images, Inc. CP 378.

Getty Seattle has its own bank account and pays its expenses itself. CP 57 ¶ 13; 377. In order to pay those expenses Getty Seattle was authorized to withdraw funds from the concentration account. CP 379-380. When Getty Seattle wrote a check to pay a bill, money automatically moved from the concentration account into Getty Seattle's bank account. CP 57 ¶ 13; 378-379. This is how Getty Seattle obtained the \$25 million to \$98 million each year to pay its expenses. CP 377-379. These funds, the funds that moved into Getty Seattle's separate account, are what the Hearing Examiner and superior court found to be gross income to Getty Seattle. CP 57 ¶ 13; 58. But the use of the cash management system to provide these funds to Getty Seattle was not the basis for including the funds in Getty Seattle's gross income.

Getty Seattle asserts that the money it receives from Getty affiliates to pay expenses is borrowed from those affiliates and is a debt. (Getty Seattle Brief, p. 4.) But Getty Seattle records the money received to pay its

expenses as an account payable, which is different than a loan. CP 379. The auditor testified that Getty Seattle never characterized the receipt of those funds as a loan on its books. CP 403-404. Getty Seattle also pays no interest on those funds. CP 217-219, 380. Furthermore, there is no evidence that Getty Seattle has ever repaid any of those amounts and it is unknown if Getty Seattle will ever do so. CP 218-220, 379-381. Moreover, according to Getty's Chief Financial Officer, there is no known promissory note or other document whereby Getty Seattle agrees to pay back the funds. CP 217-219, 380, 403-404. This differs from a loan from a third party that would be documented by a promissory note. CP 380. In short, Getty Seattle received hundreds of millions of dollars from Getty affiliates during the audit period, used the money to pay its expenses, and booked the funds as a payable with no intent to ever repay the funds.

After the audit, the Director determined that Getty Seattle underpaid its Seattle B&O tax. CP 68-69, 396-399. Getty Seattle reported and paid Seattle tax on \$1 million each year during the audit period (except 2005, when it reported and paid tax on \$1,000,002). CP 286 ¶ 17. The Director found that the \$1 million income Getty Seattle received from Getty Management for services under the Agreement did not accurately reflect Getty Seattle's gross income. CP 69, 402-403. The assessment stated:

The value of the services provided by [Getty Seattle] can be measured by the charges billed out by [Getty Management], ranging from \$25 million to \$98 million per year. . . . [T]he City believes that the \$1 million annual fee is not an accurate, “arms-length” transaction between separate entities, and because all of the services are provided by your firm in Seattle and are the basis for the management fee, the revenue booked on [Getty Management] should be reported by [Getty Seattle].

CP 69. The auditor concluded that under the definition of gross income in SMC 5.30.035D, Getty Seattle’s gross income included the amount of the services billed through Getty Management. CP 69, 397, 402-403.

Accordingly, the dispute in this appeal is whether Getty Seattle’s B&O tax should be measured solely by the \$1 million that Getty Seattle receives annually from Getty Management or whether the gross income should include the \$25 to \$98 million that was billed by Getty Management and that Getty Seattle received annually from the other affiliates and used to pay for the expenses incurred by Getty Seattle.

Getty Seattle concedes that it created Getty Management for the purpose of avoiding City of Seattle and State of Washington taxes. Getty Seattle’s CFO, Jeffrey Dunn, testified:

So it was critical to – critical for us to implement this process of – of charging these management fees and getting the deductions in the foreign countries. In doing so, we would have increased our exposure to B&O tax both in the state of Washington and the city

of Seattle, and so the management company structure was – was used to shield that increase in tax.

CP 364-365. Mr. Dunn confirmed that Getty Seattle could have performed the same role as Getty Management with respect to foreign taxes :

Q: You talked about the setting – the reorganization and the purpose to have these contracts with the foreign affiliates. There is nothing stopping Getty Seattle from entering into these contracts for services with the foreign entities instead of Getty Management; is that correct?

A: That's correct.

...

Q: What I'm asking is it wasn't necessary, the Getty Management portion of this arrangement, to resolve that situation. It could have been done without creating Getty Management.

A: Correct.

CP 383-384. Similarly, Mr. Dunn's predecessor conceded during the audit that the arrangement between Getty Management and Getty Seattle related to local taxes. CP 403, 428-430. In fact, the use of Getty Management added another layer of complexity to the corporate structure rather than simplifying it. CP 404. Thus, in order to avoid local and state taxes Getty Seattle billed for its services under Getty Management's name.

The Hearing Examiner affirmed the Director's determination that the amount received by Getty Management from its affiliates should have instead been reported as the gross income by Getty Seattle. CP 58-60, 395-

397, 402-403. Getty Management received a total of \$306,968,528 from its affiliates during the audit period. CP 286 ¶ 17. This amount corresponds to the money received by Getty Seattle from the affiliates to pay the expenses incurred by Getty Seattle during the audit period. CP 395-397, 402-403. The Hearing Examiner affirmed the City's assessment of \$1,603,346.80 in taxes on Getty Seattle's \$306,968,528 gross income. CP 55-60. Judge Paris Kallas of the King County Superior Court affirmed the Hearing Examiner's ruling. CP 562-565. This court should affirm the decision of the Hearing Examiner and the superior court.

II. SUMMARY OF ARGUMENT

Getty Seattle is engaged in business in Seattle and is underreporting its gross income. Getty Seattle has 450 employees in Seattle who perform administrative services in Seattle for affiliated corporations. Getty Seattle receives between \$25 million to \$98 million per year for the services it performs. This \$25 million to \$98 million per year is the value of the services, as measured by the cost of those services billed out by Getty Management. Although Getty Management pays an annual fee of \$1 million to Getty Seattle for providing those services, the \$1 million fee reported by Getty Seattle does not accurately reflect the company's gross income as defined by SMC 5.30.035D. The gross income should include the value of the services performed and billed to the affiliates, which is the same amount

as the \$25 million to \$98 million that Getty Seattle receives each year to pay expenses. Getty Seattle cannot avoid the City's tax simply by creating an out-of-state company and designating the payments for Getty Seattle's services as payments to the out-of-state company. The City is entitled under its tax code to look to the substance of this arrangement and disregard the form used by Getty Seattle to avoid paying state and local taxes.

III. ARGUMENT

A. Under The Standard Of Review On Appeal The Court Reviews The Hearing Examiner's Conclusions Of Law De Novo And Reviews The Facts And Reasonable Inferences Therefrom In The Light Most Favorable To The City.

Getty Seattle appealed the Hearing Examiner's decision under a writ of review, governed by RCW 7.16.120. CP 1. Under this statute, the superior court and other appellate courts review issues of law de novo.

Vonage America, Inc. v. City of Seattle, 152 Wn. App. 12, 19, 216 P.3d 1029 (2009); *General Motors v. City of Seattle*, 107 Wn. App. 42, 47, 25 P.3d 1022 (2001).

In reviewing findings of fact, the appellate court decides whether the factual determinations are supported by substantial evidence. *General Motors*, 107 Wn. App. at 47. The court's review of the facts is deferential, viewing the evidence and reasonable inferences therefrom in the light most favorable to the prevailing party (in the instant case, the City). *Washington State Dep't of Corrections v. City of Kennewick*, 86 Wn. App. 521, 536, 937

P.2d 1119 (1997), *rev. denied*, 134 Wn.2d 1002, 953 P.2d 95 (1998); *State ex. rel Lige & Wm. B. Dickson Co. v. County of Pierce*, 65 Wn. App. 614, 631, 829 P.2d 217, *rev. denied*, 120 Wn.2d 1008, 841 P.2d 47 (1992).

In addition, challenges to the City's tax assessments are governed by SMC 5.55.140(B), which states that the assessment is *prima facie* correct and that the taxpayer has the burden of establishing the correct amount of tax. *Ford v. Seattle*, 160 Wn.2d 32, 41, 156 P.3d 185, 189 (2007) ("the burden is on the taxpayer to prove that a tax paid by him or her is incorrect"). A reviewing tribunal "gives considerable deference to the construction of an ordinance by those officials charged with its enforcement." *Ford*, 160 Wn.2d at 42; *General Motors*, 107 Wn. App. at 47. In the present case, both the Hearing Examiner and the trial court correctly determined that the City's assessment was correct.

B. Getty Seattle Is Subject To Seattle's B&O Tax Because Getty Seattle Engages In Business In The City.

The City's B&O tax is a tax on the privilege of engaging in business activities in the City. SMC 5.45.050. The court described the B&O tax in *City of Seattle v. Paschen Contractors*, 111 Wn.2d 54, 758 P.2d 975 (1988):

A B&O tax is an excise tax imposed upon the act or privilege of engaging in business activities, for which the taxing authority provides services, measured by the application of a legislatively set rate against a valuation of

the operation of the business, established by some standard such as gross revenues, gross sales, gross income, or the valuation of products.

Paschen, 111 Wn.2d at 54; *Ford*, 160 Wn.2d at 39-40. The “incident” of the tax is the act of engaging in business in the City:

To any tax system, there are three basic elements. First, there must be an incident that triggers the tax; a taxable incident is an identifiable activity that the legislature has designated as taxable. The second element, the tax measure, is the base upon which the amount of tax is determined. Finally, there is the tax rate that is multiplied by the tax measure, to determine the amount of the tax due.

1B Wash. Prac. § 72.3 (1997); *Ford*, 160 Wn.2d at 39. The measure of the City’s B&O tax for a company engaged in business in the City is the “gross income of the business.” 5.45.050H. In this case, Getty Seattle is subject to the tax for engaging in business within the City.

C. Getty Seattle Received Gross Income In The Form Of Funds Billed Through Getty Management, Which Getty Seattle Then Received From Other Getty Affiliates And Used To Pay Its Expenses.

Getty Seattle’s gross income includes the tens of millions of dollars each year that Getty Seattle billed through Getty Management and then received to pay the expenses incurred providing services to other Getty affiliates. The definition of “gross income of the business” reads:

“Gross income of the business” means the value proceeding or accruing by reason of the transaction of the business activity 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.

SMC 5.30.035D. The definition of gross income of the business

incorporates the phrase “value proceeding or accruing,” which is defined

as:

“Value proceeding or accruing” means the consideration, whether money, credits, rights, or other property expressed in terms of money, a person is entitled to receive or accrue or which is actually received or accrued. The term shall be applied, in each case, on a cash receipts or accrual basis according to which method of accounting is regularly employed in keeping the books of the taxpayer.

SMC 5.30.060F (emphasis added).

The operative words in this case for the definition of gross income of the business are “the value proceeding or accruing by reason of the transaction of the business activity engaged in and includes . . .

compensation for the rendition of services . . . and other emoluments

however designated . . .” SMC 5.30.035D. The value proceeding or

accruing means: “the consideration, including money, credits or rights that a person is entitled to receive or accrue or is actually received or accrued.”

SMC 5.30.060F. The term “consideration” means something “bargained

for and received by a promisor from a promisee; that which motivates a

person to do something, esp. to engage in a legal act.” Black’s Law Dictionary (8th ed.). CP 59, ¶ 21. The Hearing Examiner found:

“Consideration” means “*a recompense, as for a service rendered; fee; compensation,*” Webster’s New World Dictionary (emphasis added), “something given as a recompense,” Webster’s Third International Dictionary (unabridged), or something “bargained for and received by a promisor from the promise; *that which motivates a person to do something, esp. to engage in a legal act.*” Black’s Law Dictionary (emphasis added).

CP 57, ¶ 21.

The City’s tax code defines gross income broadly by including “other emoluments however designated.” SMC 5.30.035D. “Emolument” means compensation or, more formally, “Any advantage, profit, or gain received as a result of one’s employment or one’s holding of office.” Black’s Law Dictionary, (8th ed.). The Hearing Examiner found that “emolument” was defined as:

that which is received as a compensation for services, or which is annexed to the possession of office as salary, fees and perquisites; advantage; gain, public or private.

CP 58, ¶ 22 (emphasis by Hearing Examiner).

The use of the term “other emoluments however designated” in the definition of gross income prevents taxpayers from avoiding taxes by unilaterally designating gains as something other than gross income. In effect, any compensation or gain received by a taxpayer constitutes gross income under SMC 5.30.035D. In this case, the auditor determined that

Getty Seattle's gross income should be measured by the amount billed by Getty Management and received by Getty Seattle for the services performed by Getty Seattle's 450 employees in Seattle. CP 58, 69, 397-398, 402-403, 430-431.

The Washington Supreme Court acknowledged the broad definition of gross income in the similarly worded state statutes in *Engine Rebuilders, Inc. v. State of Washington*, 66 Wn.2d 147 401 P.2d 628 (1965). The court stated:

Broader language could hardly be devised to convey the idea implicit in the foregoing definitions that the tax applies to everything that is earned, received, paid over to or acquired by the seller from the purchaser or the latter's alter ego.

Id. at 150. Like the state statute, the City's tax code broadly defines gross income to include anything that is earned, received, paid over or acquired.

The Hearing Examiner correctly concluded that the approximately \$306 million that Getty Seattle actually received from Getty affiliates over the audit period is gross income for Getty Seattle. CP 58 ¶¶ 1-2. These funds are consideration that Getty Seattle actually received by reason of the transaction of business activity in Seattle. CP 58, ¶¶ 1-2; 397-398; 402-403. The superior court concurred and ruled:

The hearing examiner correctly determined that Getty Seattle received consideration for the services it provided to Getty affiliates in the form of amounts transferred into

Getty Seattle's accounts. The hearing examiner also correctly determined she is not bound by Getty Seattle's practice of designating the income as an account payable on its books. These determinations are justified under the existing code, which defines gross income to include "other emoluments however designated . . ." SMC 5.30.035D.

CP 563.

Getty Seattle incorrectly contends that the only consideration it received was the \$1 million received pursuant to the services agreement. First, this amount was set arbitrarily and has no relation to the amount of services provided. Getty Seattle's CFO told the auditor that they could have set the fee at \$1.00 if they had desired. CP 401, 429-430.² Second, Getty Seattle's contention is contradicted by the fact that they actually received \$306 million during the audit period. Getty Seattle used that money to pay expenses that were incurred providing services to other Getty affiliates. CP 56 ¶¶ 7-9. Indeed, Getty Seattle's CFO, Jeffrey Dunn, testified that Getty Seattle was authorized to withdraw funds from the concentration account system to pay its expenses. CP 379. This actual receipt of funds fits the definition of consideration. CP 59, ¶ 21.

² Getty Seattle was in fact dealing with itself whenever it dealt with its wholly-owned LLC, Getty Management. Because Getty Management has no employees, all acts purportedly taken by Getty Management are actually performed by Getty Seattle personnel. CP 56; 69; 285 ¶ 11; 373-375; 400. Thus, anything done by Getty Management was done with Getty Seattle's consent and vice-versa.

The Hearing Examiner and superior court correctly ruled these payments constitute “other emoluments however designated” and are included in the definition of gross income under SMC 5.30.035D. CP 57-58, 397-398, 402-403, 430-431, 563. The definition of gross income allows the City to look beyond the taxpayer’s designation of the income. The City is not prevented from taxing Getty Seattle’s in-city business merely because Getty Seattle designates the income as income to an out-of-state LLC.

D. Getty Seattle’s Internal Accounting Procedures Are Not Determinative Of The Income Received Or Tax Owed.

Getty Seattle contends that the hundreds of millions of dollars it received to pay expenses are not gross income because Getty Seattle booked that money as an account payable and not as income. (Getty Seattle’s Brief, p. 10.) Getty Seattle also argues that income booked to Getty Management is not part of Getty Seattle’s gross income. As the Hearing Examiner concluded, Getty Seattle’s position is based on the erroneous view that a taxpayer can avoid taxes simply through internal accounting measures. CP 58, ¶ 4. The Hearing Examiner concluded:

The Hearing Examiner is not bound by Getty Seattle’s internal accounting practice of designating the income it received as an account payable on its books, or by the fact that the income was passed through a paper LLC before being paid to Getty Seattle.

CP 58, ¶ 4. The superior court concurred. CP 563.

The ruling of the Hearing Examiner and superior court is consistent with the Washington Supreme Court's decision in *Chicago Bridge & Iron Co. v. Dep't of Revenue*, 98 Wn.2d 814, 823, 659 P.2d 463 (1983). In *Chicago Bridge*, the taxpayer was an Illinois corporation that designed, manufactured, and installed large steel-plate structures such as storage tanks. The taxpayer bifurcated its contracts, creating three separate contracts for design and manufacture and three other contracts for installation. *Id.* at 822. The taxpayer contended that there was no nexus with Washington for the three contracts covering design and manufacturing. *Id.* at 822. The court ruled that the taxpayer's internal accounting procedures could not negate nexus:

Furthermore, CBI's isolation, for taxing purposes, of its contracts for design and manufacturing from those for installation appears an exaltation of form over substance. *See Time Oil Co. v. State*, 79 Wn.2d 143, 483 P.2d 628 (1971). On several occasions the United States Supreme Court has recognized that a company's internal accounting techniques are not binding on a state for tax purposes. *See, e.g., Exxon Corp. v. Department of Rev., supra.* . . .

These . . . contracts were entered into with sister corporations, and the bifurcation was done at the request of the purchaser. Moreover, a single, lump-sum price was negotiated for the entire project, as with all other CBI contracts. Thus, from CBI's standpoint, and from the standpoint of CBI's taxation obligation, the contracts are indistinguishable from all the others.

Chicago Bridge, 98 Wn.2d at 823 (emphasis added).

The Washington Supreme Court ruled similarly in *Ford Motor Co. v. City of Seattle*, 160 Wn.2d 32, 41, 156 P.3d 185, 189 (2007). In *Ford*, the taxpayer sought to avoid the City's B&O tax on wholesale sales to customers in Washington by contending that under the terms of its contracts the sales occurred outside the City. *Id.* at 43. The court disagreed and held that under Washington law, regardless of the contract language, "the substance of each transaction occurs in Washington where the customer is located." *Id.* at 43 (citing *General Motors Corp. v. State*, 60 Wn.2d 862, 876, 376 P.2d 843 (1962), *aff'd on other grounds*, 377 U.S. 436, 84 S.Ct. 1564, 12 L.Ed.2d 430(1964)). The court in *Ford* did not permit the taxpayer to avoid taxes by an arrangement that put form over substance through internal accounting procedures.

In this case, Getty Seattle's internal accounting strategies are not binding on the City for tax purposes. CP 58, ¶ 4; 563. The measure of the tax is gross income which, under SMC 5.30.035D, includes "other emoluments however designated." Getty Seattle cannot avoid the City's tax by labeling its income as another entity's income or by designating the money received from other affiliates as an account payable. Getty Seattle's Chief Financial Officer conceded that there are no promissory notes or other documents obligating Getty Seattle to pay back the funds and that Getty Seattle pays no interest on the funds. CP 215-219; 380. There is no

evidence that Getty Seattle has ever paid back any of the funds and it is unknown if Getty Seattle will ever pay back any of the funds. *Id.* There is no evidence of any obligation to pay back the funds other than Getty Seattle's designation of the funds as an account payable. Getty Seattle's accounting practices do not change these funds from gross income to loans.

Getty Seattle is incorrectly characterizing the City's position and the Hearing Examiner's ruling regarding the cash management system. Getty Seattle's use of a cash management system did not create tax liability. Rather, Getty Seattle owes additional taxes because it received \$306,968,528 from its affiliates to pay the cost of providing those services. CP 58, 379-380. Getty Seattle confuses the purpose of a cash management account, which is to maximize a business's short term return on cash, with Getty Seattle's subsequent withdrawals from the account. CP 354-355.

The City is not attempting to tax money swept into the concentration account as part of the cash management system. In fact, during the early part of the audit period, Getty Seattle held the concentration account. CP 378. The City did not include in Getty Seattle's gross income the money swept into the concentration account during this time. But the City did include in the gross income the \$306 million that the other affiliates paid to Getty Seattle. CP 58, 563. The fact that the cash management system was the mechanism for obtaining this money is not relevant.

This situation involves much more than a loan or the mere borrowing of money. Getty Seattle created a wholly-owned California LLC, Getty Management, for the express purpose of avoiding City taxes. CP 365, 383-384. Getty Seattle then billed for its services and collected payment in the name of Getty Management. In order to pay expenses associated with providing those services, Getty Seattle then obtained funds from its affiliates and booked it as an account payable. Getty Seattle created and used Getty Management as an intermediary to avoid the City's tax. The City is not bound by Getty Seattle's internal accounting procedures for tax purposes.

Getty Seattle also asserts that the funds it received are not income because "if Getty Management were sold, the sales price received by Getty Seattle would include the value of the accounts receivable." (Getty Brief, p. 5.) This argument is just another attempt to rely on the creation of Getty Management to avoid the City's tax. First, the possibility of Getty Management being sold is nonexistent. The company was created by Getty Seattle to receive income for services performed by Getty Seattle in order to avoid Seattle and state taxes. It is not a viable entity that would be sold to a third-party. Second, Getty Seattle is not financially capable of paying off its accounts payables. If Getty Seattle's position is accepted, then Getty Seattle incurs huge losses with minimal income. CP 69. Third, Getty Seattle fails to

explain that because it is the sole owner of Getty Management, Getty Seattle's debt to Getty Management is essentially owed to itself. The accounts receivable held by Getty Management are assets that are ultimately owned by Getty Management's sole owner, Getty Seattle. Consequently, if Getty Management were sold, the sales price received by Getty Seattle would include the value of the accounts receivable. In addition, if the accounts payable at issue were forgiven, that would not create taxable income under the City's tax code for Getty Seattle. The City has already assigned that income to Getty Seattle.

E. The City Is Permitted To Look To The Substance Rather Than The Form Of A Business Transaction To Prevent A Taxpayer From Avoiding City Taxes By Creating An Out-Of-State Corporate Entity To Receive Gross Income.

Getty Seattle performed services in Seattle valued at hundreds of millions of dollars and is attempting to avoid taxes by passing the gross income through a California entity that has no physical existence. Getty Seattle owns Getty Management and performs all of Getty Management's business functions because Getty Management has no employees, no office, and no tangible property. CP 56; 69; 285, ¶ 11; 373, 400. As the Hearing Examiner concluded, in these situations, the taxing authority is permitted to look to the substance and not the form of the transaction. CP 58, ¶ 4.

The Washington Supreme Court held that a taxing authority was not required to exalt form over substance in a similar situation in *Time Oil Co. v. State of Washington*, 79 Wn.2d 143, 483 P.2d 628 (1971). In *Time Oil*, the taxpayer contended that the use of a subsidiary corporation as an intermediary in the exchange of petroleum products exempted the taxpayer from the State's wholesaling B&O tax. In order to save shipping costs Time Oil exchanged oil products with companies in other geographic markets ("the exchange companies"). For example, Time Oil would supply products to the exchange companies in the Tacoma area and the exchange companies would reciprocate by supplying a like quantity of similar products in another market. Time Oil agreed that these exchanges were subject to the Washington B&O tax on wholesaling. *Time Oil*, 79 Wn.2d at 145. However, in some situations, Time Oil's subsidiary corporation, U.S. Oil, would act as an intermediary and provide the exchange companies with oil products. U.S. Oil would invoice Time Oil for the products. Time Oil would pay U.S. Oil and debit the exchange companies with the quantity of product delivered. *Id.* at 145. Time Oil argued that these transactions were not subject to the state tax on wholesaling because title or possession of the oil supplied by U.S. Oil never resided in Time Oil. *Id.* at 145.

The court rejected Time Oil’s argument and stated that “it is obvious that the legislature intended to impose the business and occupation tax upon virtually all business activities within the state.” *Id.* at 146. The court then held that the substance rather than the form of the transaction subjected Time Oil to the tax on the transactions involving its subsidiary:

Conceding, as Time does, that its direct intercompany exchanges of petroleum products constitute a taxable event to be classified as a wholesaling activity under RCW 82.04.270, it is inconceivable that the accomplishment of the same result—an exchange of petroleum products—through the convenient conduit of U.S. Oil in anywise alters or dilutes the basic taxable activity. To hold otherwise would be to exalt form over substance, and would import an exemption into the tax statutes where none now exists.

Time Oil, 79 Wn.2d at 146-147 (emphasis added). The court explained that although a taxpayer may choose to use a particular business arrangement, the taxing authority is not required to recognize that arrangement for tax purposes. The court said:

Time’s argument is ingenious and in some other fields of legal liability revolving around the manner, time, and place of passage of possession and actual title to the petroleum products involved the argument well might prevail. However, here we are not concerned with the technicalities of the transference of title and possession. Rather, our primary concern is whether the transactions involved constitute a taxable business activity within the contemplation of the business and occupation tax statutes.

Id. at 146. According to the court, Time Oil's use of an intermediary may serve a function in other contexts, but the state was able to disregard it for tax purposes. In fact, the court said it was "inconceivable" that the transaction would allow Time Oil to avoid the tax. *Id.*

Similarly, the Washington Department of Revenue has looked to the substance of a transaction in numerous tax determinations. For example, in Det. No. 90-397, 10 WTD 341 (1990), the Department imposed use tax on the taxpayer despite the taxpayer's claims that it used the airplane as a sublessee instead of as an owner. In Det. No. 90-397 (copy at CP 222), the taxpayer purchased an airplane but did not pay sales tax. The taxpayer then entered into a lease and leaseback agreement with a flying service under which the taxpayer leased the plane to the flying service and the flying service agreed to lease back the plane to the taxpayer at an hourly rate. The taxpayer claimed that the purchase was exempt from the state sales and use tax under a lease/leaseback exemption. The Department found that the owner failed to meet the requirements of the exemption because the rental payments paid by the flying service were not reasonable and that the rentals to the owner were not at the same rate as rentals to the general public. The Department found that, in reality, the purchase of the airplane by the taxpayer was for his own use and that the arrangement with the flying service was primarily for maintenance and not

for renting to outside parties. The Department held that it would not ignore the substance of the arrangement:

Finally, even assuming arguendo, that the taxpayer had completely and correctly complied with required procedural and organizational structure described above, we would still be inclined to rule against the taxpayer's petition. In essence, the taxpayer asks the Department to evaluate these transactions based strictly on its form without examining the substance of the matter. This, we must decline to do. The U.S. Supreme Court, in *Higgins vs. Smith*, 308 U.S. 473 (1940) when faced with a similar problem stated:

... A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages.

On the other hand, the government may not be required to acquiesce in the taxpayer's election of that form of doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serve's the purpose of the tax statutes. To hold otherwise would permit the schemes of taxpayers to supersede the legislation in the determination of the time and manner of taxation.

Id. (emphasis added). CP 230-231. Thus, in Det. No. 90-397, the Department looked at the substance of the arrangement and required the owner to pay use tax on the full purchase price of the airplane. *See also* Det. No. 94-320ER, 23 WTD 307 (2004) (Department looks to substance of lease arrangement involving yacht and rules that taxpayer is liable for use tax) (copy at CP 234); Det. No. 92-133, 12 WTD 171 (1993)

(Department looks to substance and refuses to allow the owners of a motor home to avoid the State use tax and the motor vehicle excise tax despite the taxpayer's claim that the vehicle was owned by an out-of-state trust). (Copy at CP 245.)

In this case, the Hearing Examiner similarly ruled that the City is allowed to look at the substance of Getty Seattle's business rather than the form. The State Supreme Court acknowledged this in *Time Oil, Chicago Bridge, and Ford*. The Department of Revenue has based tax determinations on these grounds. Getty Seattle is not able to avoid taxes on services it performs merely by using the name of a subsidiary company to send out the invoices. If that were permitted, virtually any other service provider could avoid state or local B&O taxes by entering into a contract with a subsidiary and sending out invoices in the name of the subsidiary. As held in *Time Oil*, these types of arrangements do not permit companies to avoid the B&O tax. The City is allowed to look at the substance of the business. The substance here is that Getty Seattle provides services in Seattle and received \$306 million during the audit period for doing so.

Getty Seattle cites to *Estep v. King County*, 66 Wn.2d 76, 401 P.2d 332 (1965) to contend that the City is not allowed to look to the substance of the matter. First, as discussed above, the City's definition of gross income in SMC 5.30.035D includes "other emoluments however

designated.” This allows the City to look past the taxpayer’s designation of income and look at the substance. Here, the City is not bound by Getty Seattle’s attempt to designate income as income of Getty Management or as an account payable. The Hearing Examiner correctly recognized this and ruled that Getty Seattle’s designation of income as an account payable or as belonging to Getty Management was not dispositive for tax purposes. CP 58.

Second, the *Estep* case involved the payment of the real estate excise tax on an isolated transaction. The court declined to apply the Kimball-Diamond rule, a federal income tax rule that fixes the cost basis of property that is acquired as a result of a corporate liquidation. *Id.* at 80. The *Estep* case did not involve the measurement of a company’s gross income for B&O tax purposes like the present case. Moreover, unlike *Estep*, the present case involves determining the gross income of an ongoing business of 450 employees located in the City of Seattle. For the five-year audit period, Getty Seattle reported only an arbitrarily chosen amount of income and failed to report over three hundred million dollars that it received to pay its expenses and invoiced under the name of a paper out-of-state corporation. Neither *Estep*, *Ban-Mac v. King County*, 69 Wn.2d 49, 416 P.2d 694 (1966), nor any of the other the legal authorities cited by Getty Seattle address this situation.

F. The City Is Not Attempting To Impute Income As Was Attempted In *Weyerhaeuser*.

The Hearing Examiner correctly rejected Getty Seattle's argument that the City is imputing income to Getty Seattle. CP 58, ¶ 4. The situation in this case is not like that in *Weyerhaeuser Co. v. Dep't of Revenue*, 106 Wn.2d 557, 723 P.2d 1141 (1986) cited by Getty Seattle. In *Weyerhaeuser*, the taxpayer sold timber under contracts requiring a ten percent down payment and the payment of the balance in several annual installments. *Id.* at 564. In a few of the contracts, Weyerhaeuser charged its customers interest on the unpaid balance. Weyerhaeuser and the Department of Revenue agreed that the interest was subject to the "service" B&O tax rate and the income from the sale of the timber was subject to the "wholesale" rate. *Id.* However on the majority of the contracts, Weyerhaeuser did not charge or receive interest. The reasons for not charging interest included convenience, simplicity and trade custom. But pursuant to accounting principles and New York Stock Exchange rules, Weyerhaeuser internally accounted for an interest component on all the sales contracts. *Id.* at 565. The Department of Revenue attempted to impute this internally-calculated interest to Weyerhaeuser and tax it at the higher service rate. The court rejected the

Department's position on the grounds that Weyerhaeuser never received the interest. The court stated:

In this case, however, the contracts did not specifically provide for interest. No interest was separately contracted for with the corporation's timber buyers and no interest was separately "received." Weyerhaeuser's own interest computations were merely an internal bookkeeping device.

Weyerhaeuser, 106 Wn.2d at 565.

As recognized by the Hearing Examiner, the *Weyerhaeuser* decision actually supports the City's position in this case. CP 58, ¶ 4. The Hearing Examiner noted that the court in *Weyerhaeuser* looked to the substance of the transaction and was not bound by the company's internal accounting practices. CP 58, ¶ 4. Weyerhaeuser did not receive interest from its customers. In accordance with trade custom and for reasons of convenience and simplicity, Weyerhaeuser entered into arms-length contracts with unrelated third parties that did not include interest payments. Weyerhaeuser did not receive interest under those contracts and the court correctly held that Weyerhaeuser's internal segregation of an interest component did not mean that Weyerhaeuser received the income for tax purposes. *Weyerhaeuser*, 106 Wn.2d at 565.

In contrast, Getty Seattle is receiving income for providing services. Getty Seattle is relying on internal accounting procedures to avoid paying taxes and the City is not bound by such internal

arrangements. Unlike the situation in *Weyerhaeuser*, Getty Seattle is not relying on arms-length contracts with third-parties. The Hearing Examiner correctly found that Getty Seattle is issuing invoices for services that it provides in the name of an out-of-state subsidiary corporation. CP 56, ¶¶ 7-9. Getty Seattle receives revenue from the affiliates for those services, but in order to avoid taxes has arranged internally to designate the income as Getty Management's income. In *Weyerhaeuser*, the taxpayer did not receive income and the court looked at the substance of the transaction and did not look at internal accounting practices that would have led to a different result.

The Hearing Examiner also ruled that Getty Seattle's position is not supported by *Simpson Investment Co. v. State of Washington, Dep't of Revenue*, 92 Wn. App. 905, 965 P.2d 654 (1998), *rev'd* 141 Wn.2d 139, 3 P.3d 741 (2000). CP 59. Simpson was an investment company that invested in and provided services to its subsidiaries. Simpson received a portion of its income in the form of interest, stock dividends, and profits from stock trading. *Simpson*, 141 Wn.2d at 144. Although Simpson did not charge its subsidiaries for its services, Simpson did receive the majority of its income in the form of dividends from its subsidiaries. *Id.* at 144.

Neither the taxation of the dividends nor the compensation arrangement between Simpson and its subsidiaries was addressed by the court's decision. Rather, the issue addressed by the court was whether Simpson was a "financial business" and whether it could take the tax deduction for investment income that is available to companies that are not financial businesses. *Id.* at 142. The supreme court ruled that Simpson was a financial business and therefore could not take the deduction for investment income. Getty Seattle relies on a portion of a statement, later negated by the supreme court, that the court of appeals made in discussing the underlying facts. The court of appeals said, "Nothing prevents Simpson from avoiding B&O tax by taking its compensation from its subsidiaries in the form of dividends rather than as explicit payments for services provided." *Simpson*, 92 Wn. App. at 918 n. 14 (emphasis added). This statement was not part of the court's ruling and Getty Seattle, by omitting the underlined language (from an overruled opinion), misstates the holding of the case. (Getty Brief, p. 15.)

The disputed issue addressed by the supreme court in *Simpson* was not the taxability of the compensation for Simpson's services. The issue was whether the state could tax Simpson on its investment income. *Simpson*, 141 Wn.2d at 142. That is not the issue in this case and the Hearing Examiner recognized that *Simpson* is "not on point." CP 58, ¶ 5.

Moreover, Simpson did not create a wholly-owned subsidiary to charge for its services like Getty Seattle has done. In the present case, Getty Seattle received income for providing services to its subsidiaries and that income is included in the City's definition of gross income. The *Simpson* case does not apply here.

G. The City's Enactment Of New Code Sections To Address Transactions Between Affiliated Entities Does Not Affect The Applicability Of The Tax Code Provisions Governing This Case .

In 2009, after Getty Seattle brought this appeal, the City adopted a new ordinance to govern related-party transactions similar to the ones at issue in this case. SMC 5.45.085. The code states:

The purpose of this section is to ensure taxpayers clearly reflect their true gross income attributable to business activities or transactions between related, controlled or affiliated persons, and to prevent the avoidance of taxes in regards to such activities or transactions. Business activities or transactions between one related, controlled or affiliated person and another will be subject to special scrutiny by the Director to ascertain whether common control is being used to reduce, avoid, or escape taxes.

SMC 5.45.085. The code allows the director to consider several criteria to “determine whether an arrangement between related, controlled, or affiliated persons results in an improper or inaccurate valuation of the activity.” *Id.*

The new code provisions establish an explicit procedure for determining the gross income of a taxpayer that engages in transactions with related entities. Getty Seattle contended at oral argument in superior court

that the code amendments showed that the City previously lacked authority to include revenue from such transactions in gross income. That is not correct. The trial court recognized this in its order stating that the definition of gross income under SMC 5.30.035D included Getty Seattle's revenue from its affiliates:

That the new code makes this more explicit does not invalidate the hearing examiner's decision.

CP 563. The new code creates explicit procedures but does not affect the calculation of Getty Seattle's gross income under the prior code provisions. The Hearing Examiner and superior court applied the code in effect during the audit period and correctly upheld the City's tax assessment.

IV. CONCLUSION

Getty Seattle has 450 employees in Seattle providing services to other Getty affiliates. In order to avoid paying the City's B&O tax, Getty Seattle entered into an agreement with Getty Management, a wholly-owned out-of-state entity with no employees or offices. Getty Management and other affiliates pay Getty Seattle for the expenses that Getty Seattle incurs providing services. Getty Seattle contends that that money is a debt despite the fact that there are no loan documents, no interest payments, no intention or obligation to repay the funds. The Hearing Examiner and superior court correctly affirmed the Director's Tax Assessment and this Court should affirm their rulings.

DATED this 9 day of August, 2010.

PETER S. HOLMES
Seattle City Attorney

By:

A handwritten signature in black ink, appearing to read "Kent Meyer", written over a horizontal line.

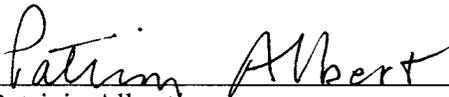
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CERTIFICATION OF SERVICE

The undersigned certifies that she caused to be filed with the court and served by legal messenger, on this day, the foregoing Brief of Respondent City of Seattle to:

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DATED this 9th day of August, 2010.


Patricia Albert

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