Cite as Det. No. 92-117, 12 WTD 147 (1992)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 01-006, 20 WTD 124 (2001)

BEFORE THE INTERPRETATION AND APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition	)	D E T E R M I N A T I O N
For Correction of Assessment	)	
and Refund of	)	No. 92-117
	)	
. . .	)	Registration No. . . .
	)	. . ./Audit No. . . .

[1] RULE 111: B&O TAX -- ADVANCE AND REIMBURSEMENT -- SOLE LIABILITY FOR PAYMENT -- COMMISSIONS. Advance and reimbursement exclusion held to apply to amounts received by taxpayer from issuer of securities for payment of independent commissioned salespersons directly under contract with issuer, since issuer, and not taxpayer, was primarily and solely liable for their payment.

[2] RULE 111: B&O TAX -- ADVANCE AND REIMBURSEMENT -- LIABILITY FOR PAYMENT -- COMMISSIONS. Advance and reimbursement exclusion held not to apply to amounts received by taxpayer from issuer of securities for payment of independent commissioned salespersons under contract with taxpayer, since taxpayer was liable on its own right for payment of commissions.

[3] RULE 162: B&O TAX -- SECURITY HOUSES -- DEDUCTION -- PAYMENTS TO "OTHER ESTABLISHED SECURITY HOUSES." Although Rule 162 allows a deduction for commissions paid to "other established security houses associated in such transaction," deduction not applicable when commissions are paid to independent salespersons.

[4] RULE 208: B&O TAX -- DEDUCTION -- ACCOMMODATION SALES -- COMMISSIONS -- INAPPLICABILITY. The "accommodation sale" deduction applies to B&O retailing or wholesaling tax liability, not the rendition of services. Rule 208 inapplicable to the payment of commission income relative to the sale of securities.

[5] RULE 194 and RULE 162: B&O TAX -- ALLOCATION -- THIRD- PARTY COSTS. Third-party costs in the nature of commissions to out-of-state independent salespersons held not to be allocable to another state when they were not incurred because of taxpayer's out-of-state activities. Costs properly attributable to the Washington office from which expenses were incurred. ACCORD: Det. No. 89-448, 8 WTD 189 (1989).

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.

TAXPAYER REPRESENTED BY: . . .
. . .

NATURE OF ACTION:

Petition concerning the taxability of commission income received from an issuer and paid out to salespersons for the sale of the issuer's securities.

FACTS:

Bauer, A.L.J.-- Taxpayer's business records were audited for the period from . . . to . . . and an assessment was issued. Taxpayer seeks a cancellation of the assessment in full and a refund of taxes it claimed it erroneously paid.

Taxpayer began business on July 1, 1979. Its stated purpose on its Application for Certificate of Registration with the Department of Revenue is

> Broker or Dealter [sic] selling securities of only one issuer or Associated issuer.

(Brackets supplied.)

Taxpayer is a wholly-owned subsidiary of . . . (hereinafter, "MM"). MM issues securities (typically, preferred stock or debentures) on a regular and ongoing basis. These securities are sold to the general public. Taxpayer's sole function is to be the broker-dealer for the sale of MM's securities. Various federal and state agencies and associations preclude MM from selling its own securities and require them to be sold by an independent broker-dealer. Taxpayer fulfills this purpose.

On July 16, 1979, MM and taxpayer entered into a "Selling Agreement" whereby MM committed itself to paying all expenses incurred in offering and selling its debentures, including reimbursing taxpayer for

> the commissions it pays to its licensed securities representatives . . . .

Until October 1984, MM itself entered into contracts with independently-registered salespersons in different states, and commission dollars flowed from the issuer MM through taxpayer to the salespersons who made the sales. Some of the terms of the pre-October 1984 representative contract entered into evidence are as follows:

> I. All money received in behalf of [MM] will be securely held by the Agent in a fiduciary capacity and paid to [MM] immediately upon receipt. . . .
>
> III. [MM] will pay commission to the Agent on a monthly basis for securities sold by the Agent according to the following terms . . . .

Prior to October 1984, then, MM routed commission payments through taxpayer to the independent salespersons.

In September 1984, the SEC required that taxpayer (as an entity separate from the issuer) enter into the contracts with the independent salespersons. Since October 1984, then, taxpayer has entered into contracts with the numerous independent securities salespersons in a number of states. These salespersons might sell securities for other broker-dealers or have relationships with other issuers. These independently-registered representatives sell the securities issued by MM to the general public. Taxpayer does no actual selling itself.

Pertinent provisions in the post-October 1984 representative contract between taxpayer and its sales representatives are as follows:

> . . . WHEREAS, Representative is an independent contractor desiring to associate him/herself with [taxpayer] for the purpose of selling the investment securities of [MM]. . . .
>
> 3.1 [Taxpayer] agrees to timely pay all commissions owing to Representative in the course of his/her business with [taxpayer] . . .
>
> 5.1 [Taxpayer] is the owner of all investor accounts.

(Brackets supplied.)

MM was not a party to these post-September 1984 contracts.

Taxpayer has submitted a prospectus relating to MM's securities dated February 3, 1986. A footnote

therein provides:

> (1) There is no sales charge to the investor. [MM] will reimburse taxpayer for commissions paid to licensed sales representatives. Sales commission rates depend upon the terms of the Debentures sold and upon whether the sales are renewals or new purchases. . . .

According to taxpayer, MM bears all expenses of the securities distribution, including commission payments to securities salespersons. Checks are issued in the taxpayer's name to pay commissions to third-party salespersons only after MM transfers the exact amount necessary to fund those checks into taxpayer's account. The only reason the checks are issued by taxpayer rather than by MM is to comply with the requirement of the existence of an broker-dealer independent of the issuer.

When a securities dealer sells one of MM's securities to the public, he or she remits the gross proceeds directly to MM, not to taxpayer. At the end of each month, the dealer sends the statement of commissions due to MM, not to taxpayer. MM then reconciles this statement to the amounts of gross securities sales proceeds received, and funds the issuance of the commission check.

TAXPAYER'S EXCEPTIONS:

Of the footnote in the prospectus, the following proposition is made:

> The prospectus forms a part of the contract and legal relationship between [MM], on the one hand, and the independent securities dealers who sell its securities and the public who purchase those securities on the other hand. That is, with respect to the independent securities dealers, the prospectus is an integral part of their contract for the sale of securities, and its representations are intended to be and are relied upon by those securities dealers.

(Brackets supplied.)

Taxpayer thus contends in its principal argument that it doesn't really exist except for the requirement that a separate entity sell MM's securities. In doing so, it acts only as an agent for its principal, MM.

Taxpayer further argues that commission payments were transmitted from MM through taxpayer to the independent salespersons and that taxpayer does no actual selling itself, but merely acts as the agent for MM. Economically, taxpayer bears no expenses incident to the offering of the securities and plays no role other than that of an agent for the offeror. All expenses are borne directly by the offeror, MM.

Thus, taxpayer concludes that the receipt of commission dollars by taxpayer and the forwarding of those dollars to the registered representatives who are independent contractors is merely the act of an agent, giving rise to "wash" transactions. These transactions are in the nature of "advances" or

"reimbursements" as contemplated by WAC 458-20-111 (Rule 111). As such, taxpayer is entitled to have the entire additional assessment cancelled and to a refund of taxes previously paid on commissions passed through to independent contractors for the periods involved.

Alternatively, taxpayer argues that:

(1) it is entitled to correction of the assessment in its entirety and refund of taxes previously paid with respect to commissions passed on to independent contractors by virtue of WAC 458-20-162 (Rule 162);

(2) the relationship and payments between taxpayer and the independent contractors is in the nature of accommodation sales, as contemplated by WAC 458-20-208 (Rule 208);

(3) the additional assessment is erroneous, pursuant to RCW 82.04.460(2), in that taxpayer has used an appropriate method of allocation of gross income taxable to this state.

ISSUES:

The issues, based on the taxpayer's arguments, are:

1. Were commissions passed through taxpayer's books before October 1984 from the issuer, MM, to independent salespersons exempt under Rule 111 as "advances" or "reimbursements" when: (a) there was an agency agreement between the taxpayer and the issuer which provided that the issuer would reimburse taxpayer for commissions paid to salespersons; and (b) the taxpayer, not the issuer, was contractually bound to pay commissions to the salespersons?

2. Were commissions received by a taxpayer after September 1984 from an issuer exempt under Rule 111 as an advance or reimbursement when: (a) such payments were actually passed through to salespersons who actually made the sales; (b) there was an agency agreement between the taxpayer and the issuer which stated that the issuer would reimburse taxpayer for commissions paid; (c) the issuer itself was not contractually bound to the salesperson to pay their commissions; and (d) the prospectus stated that commissions taxpayer pays to salespersons would be reimbursed by the issuer?

3. Was commission income received from an issuer and paid to out-of-state salespersons deductible under Rule 162?

4. Were commissions received from an issuer and paid to out-of-state salespersons deductible as accommodation sales under Rule 208?

5. Was commission income received for sales of securities to out-of-state customers made by out-of-state independent salespersons properly allocated to another state under RCW 82.04.460(2)?

DISCUSSION:

Issues #1 and #2: Advances/Reimbursements.

Rule 111 provides in pertinent part:

> The words "advance" and "reimbursement" apply 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.
>
> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.
>
> The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. . . .

(Emphasis supplied.)

According to taxpayer, MM contracted directly with the independent salespersons prior to October 1984. Under these contracts, MM was directly liable for payment of these salespersons' commissions. Absent a corresponding contractual obligation on behalf of taxpayer to pay these commissions, we must agree that taxpayer was receiving advances or reimbursements if the commission payments were funnelled through taxpayer by MM.

[1] Accordingly, we find that the advance and reimbursement exclusion applies to amounts received by taxpayer from MM for payment of independent commissioned salespersons directly under contract with MM, because MM, and not taxpayer, was primarily and solely liable for their payment.

Relief is granted as to the first issue.

[2] On the other hand, we find that the advance and reimbursement exclusion does not apply to amounts received by taxpayer from MM for payment of independent commissioned salespersons under contract with taxpayer, since taxpayer was liable for payment of commissions.

The 1979 agency agreement between taxpayer and MM admittedly provided for "reimbursement" of taxpayer's commission expenses, as did the 1986 prospectus footnote. Even if there is legal authority for the proposition that either of these created a direct obligation upon which the salespersons could sue MM for their unpaid commissions, however, taxpayer was still independently

liable for their payment in its own right as a result of the contracts it directly entered into with the salespersons involved. Therefore, taxpayer cannot be said to have "no liability" for these payments in accordance with Rule 111.

Accordingly, relief is denied as to the second issue.

Issue #3: Deduction for payments to other security houses under Rule 162.

We disagree with taxpayer's contention that commission income paid to the independent salespersons was deductible. Rule 162 provides in pertinent part:

> (3) No deductions are allowed on account of salaries or commissions paid to employees or salesmen, . . .
>
> GROSS INCOME FROM COMMISSIONS. Gross income from commissions is the amount received as commissions upon transactions for the accounts of customers over and above the amount paid to other established security houses associated in such transactions: PROVIDED, HOWEVER, That no deduction or offset is allowed on account of salaries or commissions paid to salesmen or other employees.

(Emphasis supplied.)

[3] Although Rule 162 allows a deduction for commissions paid to "other established security houses associated in such transaction," the deduction is not applicable when commissions are paid to independent salespersons.

In this case, payments were to independent salespersons, not to established security houses. No deduction is allowed under the rule for commissions paid to salespersons.

The taxpayer's petition is denied on this issue.

Issue #4: Accommodation Sales under Rule 208.

Rule 208 provides a definition of "accommodation sales":

> The term "accommodation sales" means only sales for resale by persons regularly engaged in the business of making sales of the type of property so sold to other persons similarly engaged in the business of selling such property where (1) the amount paid by the buyer does not exceed the amount paid by the seller to his vendor in the acquisition of the article and (2) the sale is made as an accommodation to the buyer to enable him to fill a bona fide existing order of a customer or is made within fourteen days to reimburse in kind a previous accommodation sale by the buyer to the seller.

[4] The "accommodation sale" deduction applies to B&O retailing or wholesaling tax liability, not the rendition of services. Rule 208 is inapplicable to the payment of commission income relative to the sale of securities.

The taxpayer's petition is denied as to this issue.

Issue #5: Apportionment under RCW 82.04.460(2).

The taxpayer has argued that it has correctly allocated its sales under the apportionment principles set forth in RCW 82.04.460(2).

The Department has directly addressed the apportionment of income of those who sell securities in Rule 162:

> (4) No deductions are allowed from commissions received from sales of securities which are delivered to buyers outside the state of Washington. . . .
>
> SERVICES INSIDE AND OUTSIDE THE STATE - APPORTIONMENT. Stockbrokers and security houses rendering services and maintaining places of business both inside and outside the state may, in computing tax, apportion to this state that portion of the gross income which is derived from services rendered or activities conducted inside this state. Where such apportionment cannot be made accurately by separate accounting methods, the taxpayer shall apportion to this state that portion of his total income which the cost of doing business inside the state bears to the total cost of doing business both inside and outside the state.

Rule 162 thus clearly provides that, to apportion income to another state, a security house must actually maintain a place of business in that state.

In addition, Det. No. 89-448, 8 WTD 189 (1989) has spoken to the matter of third-party services performed out-of-state in the context of apportionment. The Administrative Law Judge therein stated:

> The intent of the cost apportionment formula is to apportion income of the taxpayer fairly and equitably to where it performs the services that generate the income that is taxed. Obviously, where third parties perform services does not necessarily relate to where the taxpayer performs the service that generates the income. If a third party performs services in a location where the taxpayer is performing no service, we should not apportion the taxpayer's income to that location. We must consider how those costs relate to the service activity of the taxpayer and where those services are performed by the taxpayer to determine whether or not they are costs within the state.
>
> If the services related to those costs are incurred because of the taxpayer's activities

> within this state as opposed to the taxpayer's activities outside the state, they will be considered costs within this state for the purposes of the cost apportionment formula. On the other hand, if they are incurred because of the taxpayer's out-of-state activity, they will be considered out-of-state costs. Third party costs which cannot be identified as incurred because of the taxpayer's activities at any particular office will be attributed to the taxpayer's domicile. For instance, legal fees incurred by an out-of-state firm to clear title to land upon which an out-of-state office is located and billed to the Washington headquarters, should be not be part of the cost of doing business within this state, while charges by the same law firm for Federal tax planning regarding the overall organization of the taxpayer would be assigned to the domicile located in Washington.

(Emphasis supplied.)

[5] Third-party costs in the nature of commissions to out-of-state independent salespersons are not allocable to another state when they were not incurred because of taxpayer's out-of-state activities.

The third-party costs here at issue involved commissions paid to out-of-state independent salespersons. These costs were not incurred because of the taxpayer's out-of-state activities, since the taxpayer maintained no office outside the state nor itself engaged in any out-of-state activities. These costs were therefore properly attributed to the Washington office from which expenses were incurred. See Det. No. 89-448, 8 WTD 189 (1989).

Accordingly, the taxpayer's petition as to allocation outside the state is denied.

DECISION AND DISPOSITION:

The taxpayer's petition is granted in part and denied in part.

DATED this 30th day of April 1992.