BEFORE THE BOARD OF TAX APPEALS
STATE OF WASHINGTON

NEAL W. SPRINGER, Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	)	Docket No. 42420
KENNETH E. WAGAR, Appellant, v. STATE OF WASHINGTON DEPARTMENT OF REVENUE, Respondent.	)	Docket No. 42434 Re: Excise Tax Appeals FINAL DECISION

This matter came before the Board of Tax Appeals (Board) for an informal hearing on January 13, 1994. Neal W. Springer and Kenneth E. Wagar (Appellants) appeared and represented themselves. H. Byron Norton, Administrative Law Judge, appeared for Respondent, Department of Revenue (Department).

This Board heard the testimony, reviewed the evidence, and considered the arguments made on behalf of both parties. This Board now makes its decision as follows:

ISSUES

Kenney, Member--RCW 82.04 levies a business and occupation (B&O) tax on all persons for the privilege of doing business in Washington State. An exemption for employees is created by RCW 82.04.360(1): "This chapter shall not apply to any person in respect to his or her employment in the capacity of an employee or servant as distinguished from that of an independent contractor."

The first issue before this Board is determining if Appellants are employees and exempt from taxation under RCW

82.04, or if they are independent contractors and subject to the tax.

If it is determined that Appellants are subject to the tax, we must decide if the Department acted in a manner that misled Appellants as to their liability and, as a result, should be estopped from assessing the tax.

HISTORY OF THE DEPARTMENT'S EFFORTS TO IMPOSE TAX ON LIFE INSURANCE AGENTS

In 1973, the Department issued a letter that set out a five-point test for establishing life insurance agent employee status.[1] The information was made available to agents through the Washington State Association of Life Underwriters (WSALU). Agents were encouraged to register with the Department or to submit a letter describing the conditions that they believed entitled them to employee status. Apparently, reductions in the Department's budget reduced activities for the next several years, and the matter was not pursued further. In 1985, the Legislature made additional funds available to the Department for collection and enforcement activities. A review of several occupations, including life insurance agents, was begun. It was determined that there were some 40,000 life insurance agents in the state and that turnover in the industry was 25 percent per year. The Department began assessing the tax.

An effort was begun by the industry to obtain a legislative exemption. While the legislative proposals were being considered, efforts to collect the tax were put on hold. In addition, discus-sions were held with representatives from the industry to provide for orderly implementation of the tax. In 1991, the Legislature enacted an exemption for "statutory employees", as defined in the Internal Revenue Code. The exemption became effective July 1, 1991. The exemption was not retroactive, and the Department began assessing taxes for the previous seven years. By agreement with the industry, the Department said it would not go back more than four years or assess penalties on agents who had registered with the Department, even though they had not paid the tax.

PROCEDURAL FACTS

Appellants are life insurance agents for Northwestern Mutual Life Insurance Company (NML), a national company with

[1] The criteria in the 1973 letter are the same as those in the Department's 1989 Special Notice to Life Insurance Agents cited on pages 6 through 7 of this decision.

headquarters in Milwaukee, Wisconsin. The Yakima office is a part of the Spokane general agency. The Spokane office is under the super-vision of a general agent. A district agent is responsible for the operation of the Yakima office, where Appellants worked. Special agents, the position held by Appellants during the audit period, are responsible for selling policies, although district agents also do some selling.

The Department audited Appellants for the period January 1, 1988, through December 31, 1991. During that period, Appellants were registered as life insurance agents with the Department but did not report or pay B&O tax. The Department ruled that they were engaged in the business of selling life insurance and subject to the tax. B&O taxes were assessed for the four years, plus interest. Interest was not charged for a short period in 1989 and 1990 for administrative reasons. Because Appellants had registered with the Department, no penalties were assessed.

Appellants contend that they are employees of NML. In support of their position, they cite the fact that NML does not sell insur-ance through brokers but will accept only policies sold by its own agents. Even though both Appellants could sell other company policies, NML requires them to offer any policies to NML before offering them to another insurer.

NML imposed a great many restrictions and requirements on Appellants and monitored their performance on a continuing basis. Office space, supplies, and secretarial support were provided by NML. Social security contributions, but not federal income tax, were withheld from Appellants' commission income under a special clause of the Internal Revenue Code, enacted in 1954. The provi-sions of the social security law were extended to some taxpayers who were considered as self-employed. Full-time life insurance agents and three other groups were classified as "statutory employees" for social security purposes only. The 1986 Tax Reform Act provided that "statutory employees" were also eligible for most fringe benefit programs. Appellants received company fringe benefits such as a pension plan and group life, medical, and disability insurance.

Appellants annually received a W-2 form from NML showing social security deductions but none for income tax. Appellants received non-employee income from other insurance companies during the period audited. Commissions received from those companies were reported to the Internal Revenue Service (IRS) on a Form 1099. The classification of that income is not in dispute in this appeal.

The Department contends that the contracts with NML give Appellants a great deal of flexibility and autonomy. Contract clauses cited by the Department include:

> **4. Relationship**--Agent shall be an independent contractor and nothing herein shall be construed to make Agent an employee of the Company, General Agent or First Party. Agent shall be free to exercise his own judgment as to the persons from whom he will solicit Applications and the time, place and manner of solicitation, but the Company from time to time may adopt regulations respecting the conduct of the business covered hereby, not interfering with such freedom of action of Agent.
>
> **12. Bond**--Agent shall maintain a fidelity bond acceptable to the Company.
>
> **13. Expenses**--Agent shall pay all expenses incurred by him in the performance of this agreement.
>
> **14. Conduct**--Agent shall comply with all applicable laws and regulations and shall so conduct himself as not to affect adversely the business, good standing or repu-tation of himself, First Party or the Company.

The Department states that it recognizes that the actions of the parties can override the language of the contract. In this case, however, it "found no evidence that the parties did not act according to their contract. . . . [The NML restrictions] appear to be connected with its contract authority to create a good busi-ness reputation." Prehearing Brief of Department at 7.

Even though NML provides an office, office supplies, and secretarial support, the contract does not require it to do so, the Department contends. As a matter of fact, the contract specifies that such costs are the responsibility of the agent. NML can change the practice of paying office costs any time it wishes to do so, according to the Department.

Appellants contend that the contract language does not square with the reality of their relationship with NML. Section 4, which gives NML the authority to "adopt regulations", gives the company the right to control what they may or may not do, Appellants contend.

Despite the fact that Section 13 states that agents are liable for all expenses, NML pays all office costs except long-distance telephone charges and the cost of the fidelity bond

required by Section 12. The liability for office expense is that of the district agents, not special agents who are responsible for soliciting clients and selling policies.

Appellants contend that Section 14 allows NML to exercise substantial control over their activities through various require-ments which they must comply with or be subject to termination. Those requirements include attendance at company meetings and completion of industry-related courses, as well as meeting produc-tion goals and keeping detailed records of work activities.

The contracts between NML and Appellants can be compared to franchise agreements, according to the Department. Franchisors often impose detailed restrictions on the activities and opera-tions of franchisees. Meeting attendance, training requirements, inspections, geographic limitations, restrictions on where supplies may be purchased, dress codes for employees, details of buildings and equipment, and even price lists may be required by the fran-chise agreement. Despite the detailed requirements, however, fran-chisees are not considered employees of the franchisor.

The relationship of Appellants and NML should also be reviewed as possibly that of agent and principal. Appellants contend, in effect, that they offer their services to potential policyholders on behalf of NML. Payments are made to NML, not to Appellants.

Black's Law Dictionary (6th ed. 1990) at 63, 1192, defines "agency relationship" as follows:

> Agency relationship. An employment for purpose of representation in establishing legal relations between principal and third persons.
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> . . .
>
> Agent. . . . A business representative, whose function is to bring about . . . contractual obligations between principal and third persons.
>
> Principal, n.
>
> . . .
>
> Law of agency. The term "principal" describes one who has permitted or directed another (i.e. agent or servant) to act for his benefit and subject to his direction and control, such that the acts of the agent become binding on the principal.

The principal's control or right to control the actions of his agent is an essential element of an agency relationship.

How-ever, the agency relationship in this appeal, to the extent that it may exist, extends only to the initial contact. NML has the right to accept or reject any policy or policyholder submitted by Appellants. To accept, or refuse to accept, a policy is a matter solely within the discretion of NML. If Appellants act as an agent after the initial contact, it is for the potential policyholder rather than for NML.

The general rule in the state of Washington is that exemptions from a taxing statute must be strictly construed. Budget Rent-A-Car, Inc. v. Department of Revenue, 81 Wn.2d 171, 500 P.2d 764 (1972); Evergreen-Washelli Memorial Park Co. v. Department of Revenue, 89 Wn.2d 660, 574 P.2d 735 (1978). Statutory language is to be construed strictly, though fairly, and in keeping with the ordinary meaning of the language employed (Group Health Coop. of Puget Sound, Inc. v. Wash. State Tax Comm'n, 72 Wn.2d 422, 433 P.2d 201 (1967))--in favor of the public and the right to tax. Thurston County v. Sisters of Charity of House of Providence, 14 Wash. 264, 44 P. 252 (1896). Taxation is the rule; exemption is the exception. Spokane County v. City of Spokane, 169 Wash. 355, 13 P.2d 1084 (1932). Exemptions are not to be extended by judicial construction. Pacific Northwest Conference of the Free Methodist Church v. Barlow, 77 Wn.2d 487, 463 P.2d 626 (1969). Nevertheless, statutes must be construed to effect their purpose, and unlikely, absurd, or strained consequences should be avoided. State v. Stannard, 109 Wn.2d 29, 742 P.2d 1244 (1987).

The determination of employee status is a question of fact that must be based upon the particular circumstances of each case. Washington courts have emphasized control or the right of control. Hollingbery v. Dunn, 68 Wn.2d 75, 80, 411 P.2d. 431 (1966). The court, in that case, said: "A servant or employee may be defined as a person employed to perform services in the affairs of another under an express or implied agreement, and who with respect to his physical conduct in the performance of the service is subject to the other's control or right of control." Hollingbery, at 79.

In Hollingbery, the court provided a test to determine whether one is an employee or an independent contractor, emphasizing that with the exception of the element of control, it is not necessary that all the other factors be present. No one factor is conclu-sive, the court said. Hollingbery, at 81. The factors listed by the court are more extensive and more general than the five crite-ria cited below, used by the Department for life insurance agents, but are consistent with those criteria.

WAC 458-20-164(3)(c) states:

> Every person acting in the capacity of agent, broker, or solicitor is presumed to be engaging in business and subject to the business and occupation tax unless such person can demonstrate he or she is a bona fide employee. The burden is upon such person to estab-lish the fact of his or her status as an employee.

In March 1989, the Department issued a Special Notice to Life Insurance Agents outlining five criteria for determining whether an agent is an employee or an independent contractor. The Department emphasized: "The first three criteria are critical. If the life insurance agent's relationship with the life insurance company fails to meet any one of these three criteria, then the agent is an independent contractor." The notice stated that an employee is:

> **1) One who has no direct interest in the income or profits of the business other than a wage or commission.**

(Emphasis added.) To meet this criterion, the Department stated in the notice, "the life insurance agent's sole compensation must be in the form of wages or commissions for insurance policies **which he or she has sold.** If the agent receives commissions for insurance policies sold by others, he or she is not an employee . . .". (Emphasis in original.)

Appellants received commission income only on their own sales. They had no financial interest in the income or profits of NML or of the Yakima office in which they worked.

> **2) One who has no liability for the expenses of main-taining an office or place of business, or for overhead or for compensation of employees.**

(Emphasis added.) The Department's notice stated that even if office expenses are ultimately reimbursed, the agent is not an employee if he or she is responsible for those costs. Despite the clause in the contract making them responsible, these Appellants were not liable for any office expenses other than their own long- distance telephone calls. Appellants were required to use the office furnished by NML and could not establish or use another office.

The Department's notice also stated that an agent required to file a Schedule C, Profit or Loss from a Business or Profession, on his or her federal income tax return for the purpose of claiming deductions for business expenses is not an

employee. Although both Appellants filed a Schedule C, they were not required to do so. They testified that they are eligible to use Form 2106, Unreim-bursed Employee Business Expenses. Mr. Wagar testified that he was audited one year and that the IRS auditor advised him to file a Schedule C. Both Appellants were advised by their accountants to use Schedule C for the purpose of simplifying the preparation of their income tax returns.

> **3) One who has no liability for losses or indebtedness incurred in conducting the business of selling life insurance.**

(Emphasis added.) Appellants state that they met this criteria. No evidence was introduced to indicate otherwise.

> **4) One for whom the insurance company provides office space, a telephone and office supplies.**

(Emphasis added.) The company paid all office costs except long-distance telephone charges.

> **5) One for whom the insurance company provides training, continuing supervision and clerical service.**

(Emphasis added.) The company provided training and required agents to attend training courses. The Department contended that the meetings and training courses were for the benefit of the agents, providing an opportunity to learn about new products and discuss selling techniques. Whatever the purpose of the meetings and courses, and whoever may benefit, Appellants point out that attendance is mandatory. As noted earlier, NML supervises the special agents and provides clerical services.

In April 1990, the Department issued Excise Tax Bulletin 546.04.164 stating that the bulletin did "not change the way that life insurance agents are taxed but formalizes criteria for making that determination of taxability."

The bulletin set the following criteria for employees:

> 1. They have no direct interest in the profits or losses of the insurance business including no liability for maintaining a place of business and overhead; and
> 2. Meet one of the following:
>
> A. They are subject to the control or right of control of the insurance company in the perform-ance of the details of the work; or
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> B. They are treated as employees for Federal income tax purposes as evidenced by the filing

> of a W-4 form, and the withholding of income tax, when necessary.

(Emphasis in original.) Appellants both meet criterion 1, but not criterion 2B.

In arguing that they meet criterion 2A, Appellants testified that NML imposed numerous requirements including production quotas, office location, meeting attendance, completion of company sales and industry-related courses, dealing only with a company-selected broker, detailed record keeping, dress codes, territorial restric-tions, and limitations on the types of policies they could offer to prospective clients, as well as some restrictions on the types of clients they could solicit.

The Department also cited an IRS ruling, Rev. Rul. 69-288, 1969-1 C.B. 258, which essentially described the terms of a contract similar to that between NML and Appellants. On the basis of that contract language, the IRS determined that life insurance agents are independent contractors. If the practice of NML followed the language of the contract, we would find the IRS ruling persuasive. However, there are significant differences between the terms of the contract and the practices of the company.

ANALYSIS AND CONCLUSIONS

The substantive issue in this case--whether insurance agents are independent contractors or employees of an insurance company--has been addressed by this Board in two prior decisions: Mohr v. Department of Revenue, BTA Docket No. 40089 (1992) and Philip v. Department of Revenue, BTA Docket No. 42050 (1993). In answering the independent contractor versus employee issue, this Board looked at the evidence addressing two factors, "employee status" and "being in business". We used substantially the same criteria for determining the status of the individuals in those two cases. The right to control was the overriding consideration but other key factors were the insurance company's treatment of the agent for federal income tax purposes and the liability for office expenses.

When reviewing the evidence on employee status, this Board looked at the contracts between the parties as well as the general relationships the agents had with the companies. We recognized the importance of the parties' actions as well as the wording of the contract in determining that relationship. We emphasized the element of control or the right to control as an essential element in the relationship of employer and employee.

When reviewing the issue of being in business, we found in both cases that the agents were liable for some expenses and over-head. Mr. Mohr was partially reimbursed by New York Life

(NYL). Mr. Philip was reimbursed for expenses attributable to Equitable's business. In both cases, the agent was primarily responsible for office expenses and overhead.

This Board found that Mr. Mohr was an independent contractor rather than an employee of NYL. Our decision was based on the fact that the company had no right to control. Mr. Mohr was liable for the office expenses and overhead, even though he received partial reimbursement. In addition, NYL did not withhold federal income tax. Mr. Mohr was covered by a standard agent's contract which stated that the agent was not an employee. Before agents could attain independent status, however, NYL required extensive training. The purpose of the training was to assure that the trainee would become "a successful Agent capable of directing and controlling the Agent's own time and efforts." During the training period, the agent was considered an employee, "subject to its [NYL] direction and control", according to the terms of the contract. The evidence was clear that NYL knew the difference between employee and independent contractor status, as well as the requirements of the Internal Revenue Code.

This Board found that Mr. Philip was an employee of Equitable but not of Great West Life, another company for which he sold policies. This distinction was based on Equitable's right to control, the fact that it withheld federal income taxes, and liability for office expenses. Mr. Philip was an agency super-visor for Equitable and subject to its control in that capacity. Equitable also withheld federal income tax. Although Mr. Philip was liable for some office expenses, that liability was the result of his work for insurance companies other than Equitable.

On the surface, our decision that Mr. Philip was an employee does not square with the showing that he was liable for business expenses. However, there are instances when an insurance agent wears two hats: as an employee for supervisory or servicing duties and as an independent contractor for sales for the agent's own account. According to the Department, some insurance companies recognize the difference by providing three tax reporting forms to a single person: a W-2 as a common-law employee for federal income tax withholding, another W-2 as a "statutory employee" for social security purposes, and a Form 1099 for income such as expense reimbursements.

The decision finding employee status in the Philip case is consistent with the criteria for "employees" set forth in the Department's April 1990 Excise Tax Bulletin 546.04.164, cited on page 8 of this decision. Mr. Philip, as agency supervisor, met the Department's criteria. Although he was liable for some office expenses and overhead, those were a result of selling insurance for other companies. Equitable reimbursed him for all

expenses attrib-utable to their business. Equitable had the right to control his work as agency supervisor by contract; they paid him a monthly salary and withheld federal income tax. Mr. Philip was an employee of one company but "in business" as an agent for other companies.

Perhaps, in this appeal, we should turn the question around. What evidence is there that Appellants were in business? During the time at issue, they did not rent their own office space, pay overhead costs, hire their own employees, or assume personal liability for expenses and losses incurred in the operation of the office.[2] See Armstrong v. State, 61 Wn.2d 116, 120-21, 377 P.2d 409 (1962).

The weight of the evidence shows that Appellants were not "in business" but were employees of NML. The company controlled the activities of Appellants. NML prescribed and enforced rules that restricted the activities and authority of Appellants. The contract clearly gave it the right to do so. Appellants had about the same level of autonomy and independence of action one would expect to find in a mid-level administrative position.

We find that Appellants are employees of NML. The determina-tion of the Department is hereby reversed.

Because we have found that Appellants are employees and not liable for tax, we need not determine if an estoppel remedy is appropriate in this case.

DECISION

The Determination of the Department of Revenue is set side and Appellants are determined to be employees and exempt from B&O tax.

DATED this _____ day of _____, 1994.

BOARD OF TAX APPEALS

_____
LAWRENCE KENNEY, Member

[2] The wages shown on one Schedule C form were for services provided by family members. The office expenses were calendars and similar "business stimulaters" distributed to clients or potential clients.

I concur:

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LUCILLE CARLSON, Vice Chair

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Pursuant to WAC 456-10-755, you may file a petition for reconsideration of this Final Decision. You must file the petition for reconsideration with the Board of Tax Appeals within ten days of the date of mailing of the Final Decision. You must also serve a copy on all other parties. The filing of a petition for reconsideration suspends the Final Decision until action by the Board. The Board may deny the petition, modify its decision, or reopen the hearing.