Cite as Det. No. 88-205, 5 WTD 387 (1988)

THIS DETERMINATION HAS BEEN OVERRULED OR MODIFIED IN WHOLE OR PART BY DET. NO. 89-467, 8 WTD 247 (1989).

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

In the Matter of the Petition for Correction of Assessment of	)	D E T E R M I N A T I O N
	)	No. 88-205
[Taxpayer I]	)	Registration No. . . .
	)	Tax Assessment No. . . .
[Taxpayer II]	)	Registration No. . . .
	)	Tax Assessment No. . . .

[1] **RULE 233:** B&O TAX - DEDUCTION - MEDICAL BUREAU - FEES PAID TO MEMBER PHYSICIANS - PORTION WITHHELD FOR RETIREMENT FUND. The portion of a fee withheld by a retirement fund pursuant to a physician's agreement with a medical bureau is taxable to that physician when withheld, since that doctor has constructively received that portion of the fee. That portion is simultaneously deductible from the gross income of the medical bureau.

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: . . . [Taxpayer I]

DATE OF HEARING: March 3, 1986

NATURE OF ACTION

Action concerning the deduction allowable under WAC 458-20-233 when a portion of doctors' fees are withheld and invested in a retirement/disability fund for later payment to those physicians.

FACTS:

Burroughs, A.L.J. --- As a result of an audit covering the period from January 1, 1981 to December 31, 1984, Taxpayer I (. . .) was assessed taxes due . . . . Taxpayer II (. . .) was audited for the period January 1, 1983 to December 31, 1986, and was assessed a total tax due of . . . .

The taxpayers are medical service corporations which have deferred compensation plans covering member doctors who desire to participate. Generally, the individual doctors and taxpayer-corporations enter into supplemental agreements, whereby the doctor agrees to accept a lower present rate of compensation (a percentage of the fee schedule otherwise applicable) and the taxpayer-corporation agrees to make retirement, disability, and death payments to the doctor if certain future conditions are met. Doctors will also be eligible to receive benefits if they leave the area.

The taxpayers, through appointed trustees, have entered into group annuity contracts with an insurance company, which is paid in monthly payments equal to the aggregate amount by which the compensation of participating doctors has been reduced pursuant to their supplemental agreements.

For periods prior to 1978, the taxpayers deducted the amounts of reduced compensation as if they were present payments to doctors deductible under WAC 458-20-233 (Rule 233). On audit, the department determined that these amounts were not payments to member physicians so as to be deductible under the rule.

By subsequent letter dated March 6, 1978 an Assistant Director in the Department of Revenue agreed with the audit staff. His letter provided in pertinent part:

> The problem which has arisen, and which accounts for the assessments issued against [the taxpayers], is that the corporations have deducted the amounts of reduced compensation as if they were present payments to doctors deductible under Rule 233.
>
> Our auditors concluded, and rightly so, that these amounts were not payments to member physicians so as to be deductible under the rule. You and the corporations agree with this conclusion. Deductions will be allowable only at such time as the corporations actually make the payments to the physicians pursuant to the deferred compensation plan. (The doctors have no present vested rights to the funds in the group annuity fund.)
>
> So, the state of affairs is that, the deductions are not deductible now, though they may be at some future date. And, at that future date the amounts received by the doctors will be income subject to business tax payable by each doctor on his deferred compensation receipts.

The letter went on to cite and discuss an alternative proposal of payment, which proposal was not subsequently agreed to, so will not be addressed herein.

Since the time of the letter, then, the taxpayers have not deducted retained amounts when originally withheld from the participating doctors' fees and paid into the retirement fund under Rule 122. The taxpayers have instead deducted all amounts paid to doctors as part of their fund benefits - amounts which represented not only the portion of the fees originally retained, but appreciation on those amounts earned while in the annuity fund. The respective amounts actually paid to doctors from the fund and deducted under Rule 233, then, were substantially greater than those amounts which had been originally withheld from their fees. The audit staff estimated that 70% of such payments from the annuity fund consisted of "interest" which has never been taxed. This increased 70% increment was disallowed as a deduction because

> [o]ne can only deduct from the measure of the tax that which is being reported or which has been previously reported.
>
> [Auditor's Detail of Differences and Instructions to Taxpayer dated August 26, 1985 (Taxpayer I) and May 1, 1987 (Taxpayer II)]

The auditors instructed the taxpayers that, for future reporting periods,

> 1) Deductions will only be allowed at the time the money is contributed to the deferred compensation plan. The doctors participating in the plan will be taxable at that time.
>
> 2) No deduction will be allowed for amounts paid out as benefits from the deferred compensation plan.
>
> 3) During our discussion it has been mentioned that the [taxpayer] may wish to work out an agreement with the Department of Revenue to forgo any deduction and effectively pay the doctors' B&O Tax liability for them. In exchange, since the Medical Bureau would effectively pay the tax for the doctors the Department would not tax the doctors on this income to [the taxpayers]. If an appropriate written agreement to this effect were reached with the department, this would be a possible reporting procedure for the future.
>
> 4) We will expect that records indicating contributing doctors and amounts of contribution will be available for examination by the Department per RCW 82.32.070. These records will be used in determining proper deduction for the [taxpayer] as well as tax liability of the individual doctors.

TAXPAYERS' EXCEPTIONS:

The taxpayers have argued:

1. Benefits are not taxable until received. The taxpayers cite federal revenue rulings and a 9th Circuit federal tax case in support of their argument that money paid into a retirement fund is not taxable until it is actually received by the retiree. The taxpayers argue that the payments to the physicians are general obligations owed by them, and it is not necessary that benefit payments come from any particular source to qualify for a Rule 233 deduction.

2. Estoppel. The taxpayers state they are merely complying with the clear instructions contained in the Assistant Director's March 6, 1978 letter to not deduct amounts until they are actually paid to the participating doctors. It is argued that the Department should be bound by its 1978 instructions.

ISSUES:

The issues for our resolution are:

1. Whether the percentage of a doctor's fee withheld for the retirement fund should be deductible under Rule 233 simultaneously with that portion of the fee actually paid to that doctor, or whether the deduction on that amount should be delayed until the doctor is ultimately paid by the fund.

2. Whether the analysis in the March 6, 1988 letter is binding on the department for the audit period and, if so, whether the taxpayers were in compliance with that advice.

DISCUSSION:

WAC 458-20-233 reads in pertinent part as follows:

> All medical service bureaus, medical service corporations, . . . engaging in business within this state are subject to the provisions of the business and occupation tax and are taxable under the service and other business activities classification upon their gross income. The term "gross income" as defined in RCW 82.04.080 is construed to include the total contributions, fees, premiums or other receipts paid in by the members or subscribers. Insofar as tax liability is concerned it is immaterial that such organizations may be incorporated as charitable or nonprofit corporations.
>
> Certain of these organizations operate under contracts by the terms of which the bureau or association acts solely as the agent of a physician, hospital, or ambulance company in offering to its members or subscribers medical and surgical services. In computing tax liability such bureaus and associations, therefore, will be entitled to deduct from their gross income the amounts paid to

> member physicians, hospitals and ambulance companies. No deduction will be allowed with respect to amounts retained as surplus or reserve accounts or to amounts expended for the purchase of supplies or for any other expense of the bureau or association other than as provided herein.

The underlying principle of this rule is that an agent is subject to business tax on his own gross income (in the usual case this consists of a commission), but amounts which an agent receives on behalf of his principal should be taxable to that principal.

In the usual principal-agent situation under the Washington business and occupation tax, the principal is liable for business tax on 100% of gross receipts. Additionally, the agent is taxable for the portion of such receipts received or retained for services. That is, there is a pyramiding of the tax insofar as the amount received by the agent is taxed twice - once when received by the principal, and again when "received" by the agent.

Rule 233 similarly intends to say that medical service organizations operating under contracts - whereby they are merely acting as agents in offering medical services - are not subject to business tax upon amounts collected in behalf of those for whom they are acting as agent. Such organizations are subject to business tax only on amounts retained by them for their services performed as agents, as well as upon any gross receipts from services which they themselves provide. To the extent that Rule 233 does not result in the normal principal-agency tax treatment in that there is no pyramiding of taxes on that portion of physicians' income retained by a medical service bureau, it is an aberration for which there is no statutory authority.

The import of Rule 233, then, is that a medical service bureau ("agent") may deduct from its "gross income" those amounts paid to its doctors ("principals"), the theory being that tax will be collected on that income from the doctors who finally receive the payment instead of the bureau. Essentially, then, the deduction mechanism of Rule 233 merely places actual tax liability on the appropriate parties. Normally, the deduction is taken in the reporting period in which payments to the doctors are made.

The Assistant Director's March 6, 1978 letter to the taxpayers' attorney administratively determined that, for Rule 233 deduction purposes, that part of a doctor's fee retained for retirement fund purposes should be properly deferred until its actual payment to the doctor, at which time the doctor would be taxable on its receipt. The taxpayer has additionally cited Internal Revenue Service rulings and case law on federal taxation in support of its position that money paid into a retirement fund should not be taxed until received.

The federal tax treatment of retirement contributions and payments is specifically prescribed by the Internal Revenue Code. Absent specific provisions contained therein for the deduction of contributions and the exclusion of retirement fund earnings, those amounts would be immediately includable in taxpayers' gross income. Congress has prescribed special treatment for retirement contributions and earnings in order to encourage citizens to themselves provide for their retirement years. The Washington Revenue Act contains no such corresponding policies or provisions.

[1] Having reviewed the 1978 letter here at issue, we are not in agreement with the writer's conclusion that amounts withheld for retirement/deferred compensation purposes are not taxable until received by the participating physician. Because without the supplementary agreement the doctor would be entitled to his or her full fee, and because that portion of the fee retained for retirement/deferred compensation is withheld only at the doctor's direction, we hold that the doctor has constructively received that portion of the fee, and is properly taxable on it at the time it is withheld. The amount withheld is likewise deductible by the medical bureau under Rule 233 when withheld, since it is at that time taxable to the doctor.

We are therefore in substantial agreement with the auditor's instructions 1), 2), and 4) for future reporting periods. A Rule 233 deduction will be allowed on the portion of the doctor's fee retained by the retirement fund at the time the portion of the fee paid to the doctor is deducted. Doctors participating in the plan will likewise report the retained portion of the fee along with the portion which has been actually received.

The taxpayers have expressed interest in coming to an agreement with the Department to forgo any deduction on the retained portions of the fees, therefore effectively paying the B&O tax on those amounts instead of the doctors who would not be taxed. Such an agreement, as outlined in 3) of the Auditor's Detail of Differences and Instructions to Taxpayer would be a viable alternative to the reporting method set forth above.

The taxpayers contend that the Department should be bound by the March 6, 1978 letter for the audit period. We agree that estoppel should and will apply. However, as to the taxpayers' argument that the March 6 letter stands for the proposition that the taxpayers' Rule 233 deductions may include not only those amounts which were originally withheld, but also the substantial appreciation (interest) subsequently earned on those amounts - we must disagree. The March 6 letter merely stated

> Deductions will be allowable only at such time as the corporations actually make the payments to the physicians pursuant to the deferred compensation plan.

and

> . . . the deductions are not deductible now, though they may be at some future date. And, at that future date the amounts received by the doctors will be income subject to business tax payable by each doctor on his deferred compensation receipts. [Emphasis added.]

Read in context, "the payments" and "the amounts" referred to were clearly only those fee amounts that were originally deferred - not to include those increased amounts earned in the annuity fund. To interpret the letter otherwise would thwart the purpose of Rule 233, which was simply to transfer tax liability from the medical bureau (agent) to the doctor (principal) who performed the medical services which generated the fee. To grant an additional deduction on untaxed investment income earned by the retirement fund would allow the taxpayer a "double dip" never intended by the rule and unsupported by statutory law.

In the original audit, the auditors adjusted the taxpayers' Rule 233 deductions to delete only the appreciation ("interest") which had accrued on those doctors' fees which had originally been retained by the retirement fund. It was estimated that 70% of total payments made out of the retirement fund was interest earned on the original contributions. This percentage has not been challenged, and will therefore be accepted as accurate. Because the auditors did allow the remaining 30% - representing the originally retained portions of the doctors' fees - as a Rule 233 deduction, we hold that the provisions of the March 6 letter were complied with. Accordingly, the audits here at issue are upheld.

DECISION AND DISPOSITION:

The taxpayers' petitions are denied.

DATED this 3rd day of May 1988.