Cite as Det. No. 02-0053, 21 WTD 329 (2002)

BEFORE THE 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. 02-0053
. . .	)	
	)	Registration No. . . .
	)	FY . . . /Audit No. . . .
	)	Docket No. . . .

[1] RULE 128: B&O TAX -- REAL ESTATE BROKERS – FEES RECEIVED FROM SALES AGENTS – NOT IN EXCHANGE FOR SPECIFIC GOODS/SERVICES. Real estate brokers are taxable on their "gross income of the business," which term includes "fees," even if such fees are not in exchange for particular goods or services.

[2] RULE 128: REAL ESTATE BROKERS – FEES RECEIVED FROM SALES AGENTS –CLASSIFICATION. Fees received by a real estate broker from its sales associates are taxable as "gross income of the business" under the brokers' rate provided by RCW 82.04.255. Accord: Det. No. 00-090, 20 WTD 500 (2001).

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.

NATURE OF ACTION:

Petition concerning business and occupation (B&O) tax on non-distinct fees that are offset from real estate commissions paid to real estate agents.[1]

FACTS:

Bauer, A.L.J. -- The books and records of . . . (Taxpayer) were audited by the Audit Division (Audit) of the Department of Revenue (Department) for the period January 1, 1997 through December 31, 1999 (audit period). As a result, the above-referenced assessment was issued on

[1] Identifying details regarding the taxpayer and the assessment have been redacted pursuant to RCW 82.32.410.

April 25, 2001 in the total amount of $ . . . , which amount included $ . . . in interest accrued as of that date. Taxpayer is a real estate broker that maintains approximately . . . branches in Washington, ... Taxpayer derives commission revenues on the sales of homes, and not commercial properties. It shares its commission income with its independent contractor agents.

Taxpayer protests the B&O tax imposed under the "other business or service activities" classification[2] in the following amounts on approximately $ . . . of revenues received from its shared commission agents:

. . .

Taxpayer points out that the revenues on which this tax was levied constitute less than 1% of its revenues for the entire audit period. They represent fees that merely serve to reduce the share of its agents' commissions.

Taxpayer explains that it charges various fees to its agents. In Taxpayer's Policy Manual effective January 1, 2001, the following fees are listed:

> 1) **Professional Services Fee.** Sales Associates who generated Gross Commissions totaling at least $ . . . during the previous year shall pay a Professional Services Fee equal to . . . of Gross Commissions until the Sales Associate has earned $ . . . in Gross commissions during the current Year. All other Sales Associates shall pay a Professional Services Fee of $ . . . per month. Professional Services Fee includes . . . , Magazine (2 ads per issue), . . . , Internet, . . . , Institutional Promotions, Marketing, L&I, Legal Defense subsidy, Technology Services . . . .
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> 2) **Transaction Fee**. A fee of $ . . . shall be deducted from the Agent's Net Commission for each side of the Sales Associate's first 50 transactions involving Broker each Year, except that (i) a listing sold by the listing agent shall be subject to a single transaction fee, and (ii) transaction fees for referrals shall be prorated according to the percentage of commission received.
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> 3) **Legal Defense Fee**. A fee of $ . . . shall be deducted from the Agent's net Commission for each side of the Sales Associate's first 12 transactions involving Broker each Year, except that (i) a listing sold by the listing agent shall be subject to a single Legal Defense fee, and (ii) legal Defense fees for referrals shall be charged according to the applicable commission split.

Taxpayer does not object to paying B&O tax on its "Professional Services Fee," because it is Taxpayer's charge for goods and services actually supplied to its Sales Associates. Taxpayer objects to the imposition of tax on its "Transaction Fee" and "Legal Defense Fee," both of which Taxpayer describes as nonspecific fees in exchange for which it provides no services or supplies,

[2] Formerly called "service and other activities."

and for which there are no special accounts or slush funds established. These fees are "collected" at the time they are offset against Sales Associates' commissions in Taxpayer's books – by branch -- under their respective account titles.

According to Taxpayer, its "nonspecific fees" exist merely to allow Taxpayer to represent to potential Sales Associates that it pays a higher percentage of sales commissions than do its competitors, a practice that apparently allows Taxpayer to successfully compete for sales agents with other brokers. Use of these "nonspecific" fees, according to Taxpayer, allows Taxpayer to look like it pays a higher percentage of commissions to its agents, even though, in reality, the imposition of these fees reduces this percentage.

TAXPAYER'S EXCEPTIONS:

Taxpayer agrees with the principle that, to the extent a broker takes back or charges its agent for expenses, the broker is liable for taxes thereon. Taxpayer, however, does not agree that nonspecific offsets to an agent's share income should be taxable to the broker. Taxpayer contends that the "Transaction Fee" and the "Legal Defense Fee" that generated the B&O tax here at issue did not constitute additional income, but were merely a derivative of the compensation arrangement that Taxpayer reached with its Sales Associates that effectively reduced their share of commissions. Taxpayer argues that, because the fees at issue are not paid to Taxpayer for services or supplies, but are a merely a reduction in the percentage of commission payable to its Sales Associates, the Department is taxing the same gross commission income twice.

Taxpayer does not agree that ETA 563 contains any provisions that would support the Audit's argument that these fees are taxable. Taxpayer states it is aware of the provisions of ETA 563, and has properly reported any charges received in exchange for services or supplies as taxable service income. Taxpayer argues the fees under dispute are not connected with any services or supplies that Taxpayer provides to its agents, and hence they are not covered by the scope of this provision.

Taxpayer further argues that Audit's suggestion that another provision of ETA 563 somehow applies to this case is faulty. The ETA, according to Taxpayer, states that a brokerage may be liable to pay tax on income where certain expenses are collected from the agent after his/her share of a sale's commission has been determined. Taxpayer argues the fees being disputed in this case are not similar in nature to the expenses referred to in this ETA provision because they are not a collection of the broker's expense, but are merely the result of a compensation arrangement that has been agreed to by the agents.

Taxpayer provides the following examples:

> 1. A broker and agent agree that they will split gross commissions earned on a 50/50 basis. Gross commissions on a sale total $10,000. The broker will receive $5,000 and the agent will receive $5,000. It is undisputed that the broker must pay B&O tax on both

> the broker's share of the gross commission and the agent's share of the gross commission. The taxable service income in this case would be $10,000.
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> 2. Assume now that because of a very competitive job market for agents that the Broker wants to design a compensation package that appears on its face more appealing than its competitors. It offers its agents a 45/55 split but also assesses a $500 "processing fee" to the agent before paying the agent his/her share of the gross commission. Assuming that gross commissions again are $10,000 on a sale, then both the broker and the agent would receive $5,000 from this sale. However, the auditor would like to suggest that there is now $10,500 of service income to be taxed. We believe that there is no basis in the law as we know it to support this conclusion.

Taxpayer refers us to the ETA 563 provision that provides: "The tax status of each situation must be determined after a review of all facts and circumstances." Taxpayer believes that, after a thorough review of all of the facts and circumstances of this case, we will agree with its position as to the non-taxability of the disputed fee income that it characterizes as a mere adjustment to its agents' percentage split.

ISSUES:

1. Whether "Transaction Fees" and "Legal Defense Fees" charged to a Taxpayer-broker's Sales Associates are taxable when these fees are not a charge for specific services or supplies, but serve merely to reduce the percentage of commission paid to Taxpayer's Sales Associates.

2. If such fees are taxable, under what B&O tax classification should they be taxed?

DISCUSSION:

RCW 82.04.255 provides:[3]

> Upon every person engaging within the state as a real estate broker; as to such persons, the amount of the tax with respect to such business shall be equal to the gross income of the business, multiplied by the rate of 1.5 percent.
>
> The measure of the tax on real estate commissions earned by the real estate broker shall be the gross commission earned by the particular real estate brokerage office including that portion of the commission paid to salesmen or associate brokers in the same office on a particular transaction: PROVIDED, HOWEVER, That where a real estate commission is divided between an originating brokerage office and a cooperating brokerage office on a particular transaction, each brokerage office shall pay the tax only upon their respective shares of said commission: AND PROVIDED FURTHER, That where the brokerage office

[3] The Legislature amended RCW 82.04.255, effective July 1, 1998, reducing the B&O tax rate on real estate brokers from 1.75% of gross income of their business to 1.5%, the current service B&O tax rate.

> has paid the tax as provided herein, salesmen or associate brokers within the same brokerage office shall not be required to pay a similar tax upon the same transaction.

(Emphasis added.) WAC 458-20-128 (Rule 128), which concerns the taxation of real estate brokers and salesmen, provides in part:

> A real estate broker is engaged in business as an independent contractor and is taxable under the service and other activities classification upon the gross income of the business.
>
> . . .
>
> The term "gross income of the business" includes gross income from commissions, fees and other emoluments however designated which the agent receives or becomes entitled to receive, but does not include amounts held in trust for others . . . .[4]

[(Emphasis added.)]
ETA 563[5] announces the Department's policy concerning real estate brokers and their shared commissions and expenses by providing in part:

> It is not unusual for brokers to make a charge to sales staff or associate brokers for providing space and other facilities such as telephone, advertising, multiple listing service, and office supplies. These charges may be a fixed amount per month or may be computed as a percentage of commissions or a percentage of sales. Generally brokers are subject to B&O tax on these charges, as well as on the gross commissions. The B&O tax applies to these charges even if the broker is simply attempting to recover the costs without markup which are incurred by having the sales staff or associate broker within the office. The recovery of these costs does not qualify as a nontaxable reimbursement under WAC 458-20-111 because the broker is not acting as the agent of the associates or agents in incurring the costs, but has primary or secondary liability to pay the provider of the supplies or services.
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> In some cases, brokers may enter into commission sharing agreements with sales staff or associate brokers where it is agreed that the broker will be liable for all expenses. In these situations, the agreement may provide that the expenses will be subtracted from the gross commissions to arrive at the amount of commissions to be shared. These net commissions

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[4] We note this definition correlates with that of RCW 82.04.080, which defines "gross income of the business" as follows:

> "Gross income of the business" means the value proceeding or accruing by reason of the transaction of the business 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.

(Emphasis added.)

[5] ETA 563 was originally issued on October 1, 1993 as Excise Tax Bulletin (ETB) 563. It was converted without substantive change to ETA 563 on July 1, 1998.

> will then be shared based on predetermined or formula-derived percentages. If commissions are less than expenses, the associate broker or sales staff will not be entitled to any commissions, nor be liable for payment to the broker for any share of the expenses. If the agreement is of this type, the broker is not considered to have received income from the associates for payment of the expenses. (See Option 3 in particular.)

In this case the payment of "Transaction Fees" and "Legal Defense Fees" have been negotiated and agreed to by both Taxpayer and its Sales Associates. Although Taxpayer asserts that these fees are not in exchange for specific services and supplies, we are constrained to note that they are represented in its Policy Manual to be equivalent in nature to its "Professional Service" fees, which Taxpayer admits are taxable. Further, not only is their payment a condition of (and thus in exchange for) the privilege of working as one of Taxpayer's Sale Associates, but Taxpayer must, in fact, incur expenses when transactions close and when legal challenges are mounted. We are, therefore, reluctant to accept, at face value, Taxpayer's assertion that its "Transaction" and "Legal Defense" fees were not, at least indirectly, in exchange for services rendered on sales transactions. There is no requirement that individual funds or accounts be earmarked for fees that are paid.

[1] Even if, for purposes of this decision, we accept Taxpayer's assertion that its "Transaction" and "Legal Defense" fees are not in exchange for any particular goods and services, we must note that the Revenue Act does [not] require that they be so in order to be taxable. Taxpayer's sales agents are contractually obliged to pay "Transaction" and "Legal Defense" fees by virtue of their contracts with Taxpayer in the course of conducting its business of being a broker. Such fees paid to Taxpayer are not legally required to be in exchange for any specified goods or services in order to be taxable because they constitute "gross income of the business" for which no deduction or exemption exists. Thus, we conclude that Taxpayer is taxable on its "gross income of the business," which term includes "fees," even if such fees are not in exchange for particular goods or services. See Impecoven v. Department of Rev., 12 Wn.2d 357, 841 P.2d 752 (1992).[6]

We note that ETA 563 has provided a formula for brokers to either subtract fees from gross commissions before they are split (in which case they are not taxable) or to collect them after commissions are split (in which case they are taxable). This eliminates, both for the industry and the Department, guesswork as to whether they will be taxed. Taxpayer can eliminate tax on the fees it collects from its Sales Associates if it subtracts them from the gross commissions before they are split.

Taxpayer's practice during the audit period was to calculate the gross commission split before the collection or offset of its fees. Accordingly, we conclude Taxpayer's fees are fully taxable as "gross income of the business."

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[6] "This court has held the legislative purpose behind the B&O tax scheme is to tax virtually all business activity in the state. . . . . The statute, itself, allows a 'person' who engages in separate but related activities to be taxed on each activity unless exempted. See RCW 82.04.440." 120 W.2d at 363 (citations omitted).

[2] Real estate brokers are taxable on their "gross income of the business." RCW 82.04.255, Rule 128. "Gross income of the business includes "fees" collected from a broker's agents or Sales Associates and are taxable under the brokers' rate provided by RCW 82.04.255. See Det. No. 00-090, 20 WTD 500 (2001).[7] Accordingly, any fees collected by brokers from their Sales Associates are taxable under RCW 82.04.255, and not the "other business or service activities" classification as used by Audit.

DECISION AND DISPOSITION:

Taxpayer's petition for correction of assessment is denied.

Dated this 17th day of April 2002.

[7] Holding that Desk Fees are subject to the B&O tax rate specifically applicable to real estate brokers.