Cite as Det. No. 98-219R, 19 WTD 416 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of	)	F I N A L D E T E R M I N A T I O N
	)	No. 98-219R[1]
. . .	)	Registration No. . . .
	)	FY. . ./Audit No. . . .

[1] RULE 164: B&O TAX – INSURANCE COMMISSIONS – WHOLESALE BROKER – RETAIL AGENTS. A wholesale insurance broker is taxable on the full amount of the commission paid on insurance it markets even when the retail broker on the transaction collects the gross premium and deducts a share of the commission prior to remitting the balance to the wholesale broker, when the wholesale broker alone has a contractual relationship with the insurance company, and the retail broker's commission is set under an agreement solely between the two brokers. See: Det. No. 88-370, 7 WTD 5 (1988); Det. No. 88-383, 7 WTD 11 (1988).

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:

The taxpayer, a wholesale broker of marine insurance, seeks reconsideration of Det. No. 98-219, which affirmed the assessment of B&O tax on insurance commissions. The primary issue is whether the taxpayer is subject to B&O tax on commission income that is retained by retail brokers when the taxpayer is acting as a wholesale broker.[2]

FACTS:

Prusia, A.L.J. -- The taxpayer is an insurance agent and broker specializing in marine liability insurance. This appeal concerns the taxpayer's tax liability on commission income when it acts as a wholesale insurance broker, occupying a position between the insurance companies (insurers) and the insurance agents (retail brokers) who represent the insured.

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[1] The original determination, Det. No. 98-219, is published at 19 WTD 410 (2000).

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

Performing as a wholesale broker, the taxpayer enters into agreements with both the insurance companies and the retail brokers with whom it deals. The taxpayer has agency agreements with the insurance companies that authorize it to accept applications for insurance. Those agreements provide that the insurance company will pay the taxpayer a specified commission on each policy written and paid for under the agreement. The agreements provide that the taxpayer is to collect the insurance premiums and to withhold any and all commissions from the gross premium before remitting the balance to the insurance company.

The taxpayer has arrangements with numerous retail brokers. The established course of dealing between the two provides that the retail broker will bill for and collect the gross premium, then deduct its commission prior to remitting the balance of the premium to the taxpayer. The specifics of the flow of premiums and commissions are as follows. The retail broker first collects the entire gross premium and deposits it to its own account. The retail broker then writes a check to the taxpayer for the balance remaining after it has deducted its commission. The taxpayer then deposits the retail broker's check to its own account and writes a check for the net premium to the insurance company. Thus, although the taxpayer's agreement with the insurance company allows it to collect the gross premium, the taxpayer never actually receives that amount. It receives the premium net of the retail broker's commission. In reporting its gross income, the taxpayer did not include the amount of the commissions the retail brokers withheld.

The retail brokers have no contractual relationship with the insurance companies.

The Audit Division of the Department of Revenue ("Department") examined the taxpayer's books and records for the period January 1, 1993 through March 31, 1997. The audit investigation found miscellaneous accounting errors totaling $. . ., and $. . . in unreported retail broker commissions. On December 17, 1997, the Audit Division issued Assessment No. FY. . . for those amounts, plus interest, for a total of $. . . . . The assessment taxed the unreported commissions under the insurance agents and brokers business and occupation (B&O) tax classification. The Audit Division cited Det. No. 88-370, 7 WTD 5 (1988), and Det. No. 88-383, 7 WTD 11 (1988), as supporting the assessment on the commissions. The taxpayer remitted $. . . of the assessment. The balance remains unpaid.

The taxpayer petitioned for correction of the assessment of B&O tax on the unreported retail broker commissions. It contended the retail brokers' commissions do not come within the definition of "gross income of the business" in the Department's special rule for insurance agents, brokers, and solicitors, WAC 458-20-164 (Rule 164), and therefore are not taxable.

Det. No. 98-219 sustained the assessment. It concluded the commissions the retail brokers withheld were income to the taxpayer, and were a cost of doing business for the taxpayer. The Determination concluded the tax treatment of the amounts in question is governed by principles set out in the determinations relied upon by the Audit Division, Det. Nos. 88-370 and 88-383, supra.

The taxpayer petitions for reconsideration of Det. No. 98-219, alleging it contains several mistakes of fact and law. It contends the Determination incorrectly classified the retail brokers as sub-agents, which assumes a level of dominion and control by the taxpayer that does not exist in this case. It contends the Determination is based on an incorrect finding and premise that the taxpayer is liable to the retail brokers for their commissions. It contends the Determination fails to properly apply Rule 164 to the facts of the case. It contends the Determination improperly applies state tax principles to the facts of this case. It contends the Determination improperly applies certain federal tax law principles.

ISSUE:

When the taxpayer acts as a wholesale insurance broker, is it taxable on the full amount of the commission paid on insurance it markets?

DISCUSSION:

Det. No. 98-219 contained a footnote reference to certain federal income tax principles and cases. On reconsideration, we believe the reference is unnecessary, and therefore modify Det. No. 98-219 to exclude footnote number 1.

We will restate the applicable law governing the issue presented, then address the taxpayer's arguments made in its original petition and amplified on reconsideration, as well as its claims of error in Det. No. 98-219.

The B&O tax is imposed on the "gross income of the business". RCW 82.04.220. Gross income of the business is defined in RCW 82.04.080 as:

> 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.

The term "value proceeding or accruing" is defined in RCW 82.04.090 as:

> the consideration, whether money, credits, rights, or other property expressed in terms of money, 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.

Rule 164 is the administrative rule that deals with the B&O tax liability of insurance agents, brokers, and solicitors. Rule 164 provides in relevant part:

> Every person acting in the capacity of agent, broker, or solicitor is presumed to be engaging in business and is taxable under the insurance agents and brokers classification upon the gross income of the business.
>
> (a) The gross income of the business is determined by the amount of gross commissions received, not by the gross premiums paid by the insured. The term "gross income of the business" includes gross receipts from commissions, fees or other amounts which the agent, broker, or solicitor receives or becomes entitled to receive. The gross income of the business does not include amounts held in trust for the insurer or the client. (see also WAC 458-20-111, Advances and reimbursements.)
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> No deduction is allowed for commissions, fees, or salaries paid to other agents, brokers, or solicitors nor for other expenses of doing business.

The taxpayer's argument that it was not taxable on the commissions retained by retail brokers is as follows. Under Rule 164, an insurance broker's taxable gross income includes only commissions, fees, or other amounts the taxpayer "receives or becomes entitled to receive." By reason of the arrangements between the taxpayer and the retail brokers, the taxpayer neither receives nor is entitled to receive any of the retail broker's commission. The taxpayer negotiates and reaches an agreement with the retail broker before the insurance is written and the premium is collected. Therefore, the taxpayer has bargained away its right to receive any portion of the retail broker's commission before any insurance is written or premium is collected.

The taxpayer argues that Det. No. 88-370 and Det. No. 88-383, upon which Det. No. 98-219 relied, concern different relationships, contemplate a different payment arrangement, and do not support the assessment in this case. It argues both determinations concern the traditional general agency/sub-agency relationship in which the insured pays the gross premium to the insurance company, which then pays the full commission to the general agent, who in turn pays a commission to the retail agent. In the traditional arrangement, the wholesale broker actually receives the full commission. Under the taxpayer's arrangement with its retail brokers, it never receives nor becomes entitled to receive the full commission.

The taxpayer argues that a literal application of Rule 164 would see the Department tax the retail broker on the full amount of the commissions, rather than tax the wholesale broker. This is because the retail broker actually receives the wholesale broker's commission, whereas the wholesale broker never receives or became entitled to the retail broker's commission.

We are not persuaded by the taxpayer's argument. The taxpayer is in the business of selling insurance policies as an agent or a broker. A commission is an amount agreed upon between the insurance company and the agent or broker to compensate the agent or broker for selling an insurance policy. It is a cost of doing business for insurance companies. See Det. No. 86-299, 2 WTD 35 (1987); Armstrong v. State, 61 Wn.2d 116, 377 P.2d 409 (1962); Laws of 1991, ch. 275, §

1 (statement of intent). The taxpayer's agreements with the insurance companies provide that the insurers will pay the taxpayer the full commission.

The taxpayer earns the agreed-upon commission when the policyholder pays the premium. At that point, the insurance company owes the taxpayer the full amount of the agreed-upon commission. Under its agreement with the entity obligated to pay the commission, the taxpayer is "entitled to receive" the full amount of the commission. The full commission is taxable gross income of the taxpayer's business. Rule 164.

The insurance company does not owe any portion of the commission to anyone else. Its only contractual relationship is with the taxpayer. That the taxpayer has agreed with a third party to split the commission, and worked out a payment arrangement with the third party that results in less than the full commission flowing into the taxpayer's hands, does not reduce what the taxpayer has earned under its agreement with the insurer.

The taxpayer's argument would have us view the commission as an amount the policyholder owes the retail broker for services performed for the policyholder. That view does not reflect the relationships and obligations in the insurance context. A policyholder does not negotiate a fee with an insurance agent for arranging insurance coverage. The policyholder may not even know how much the agent is earning on the transaction. The only activity that is compensated is the service performed for the insurance company.

It is the taxpayer who is obligated to compensate the retail broker for the retail broker's service, not the policyholder. The taxpayer owes the retail broker the amount of the agreed-upon share of the commission when the policy is placed and the gross premium paid.

The retail brokers with whom the taxpayer deals are not taxable on the full commission, even though the full commission passes into their hands. They are entitled to compensation only by virtue of their agreement with the taxpayer. They earn only the portion of the commission agreed upon with the taxpayer. They are never "entitled to receive" any greater amount, and merely pass through the taxpayer's net commission and the net premium.

While Det. Nos. 88-370 and 88-383 involved affiliated agents or sub-agents, we believe the principles set out in those determinations apply to the taxpayer's situation, and require a similar result.

Det. No. 88-370, supra, concerned the taxation of insurance commissions where an insurance broker held several appointment contracts with insurance companies, and had an arrangement with an independent sales agent that allowed the independent agent to sell insurance through the broker. All commissions were paid to the broker, which then paid the independent agent 60% of the commission. The Determination held that the broker could not deduct the commissions paid to the independent agent from the measure of its B&O tax, and the agent was liable on commission income he received unless he had a contractual relationship with the insurer. As in the present case, the insurance companies contracted only with the taxpayer.

Det. No. 88-383, supra, further clarifies when the wholesale broker is liable on the full amount of the commission, and when it is not. Det. No. 88-383 concerned the taxation of insurance commissions where a general agent appointed sub-agents (soliciting agents) for and on behalf of the insurance company, subject to the insurance company's approval. The sub-agents had a contractual relationship with both the general agent and the insurance company. The insurance company set the amount of the sub-agents' commissions. The insurance company paid insurance commissions by means of a consolidated check sent to the general agent, with instructions as to the amount of commission income to be retained by the taxpayer and the amount to be paid to the various agents. The Determination held that the commissions paid to the sub-agents were not part of the general agent's gross income. The Determination stated:

> In following [Rule 164], the Department has distinguished situations where the sub-agent has a contractual relationship with the insurance company from situations where the only contractual relationship is with a broker, district manager or general manager. In cases where the insurance company contracts directly with the soliciting agents to pay them their commissions, a broker or manager who receives the commissions does not incur B&O tax liability on the portion of the commission income earned by the sub-agents. In such cases, the broker or manager is not primarily or secondarily liable to pay the commissions to the sub-agent if not paid by the insurer. This position is consistent with the Department's position with other businesses, as contractors or service providers. Only "reimbursements or advancements" are excludable. See WAC 458-20-111.
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> On the other hand, where the insuring companies only have a contractual relationship with the broker or manager, the broker or manager is liable for B&O tax on the total amount of commission income received. The broker or manager may not deduct commissions paid to sub-agents, even though the broker or manager may have a contractual obligation with the sub-agents to pay them a portion of the commission income.

In the present case, the insurance company's only contractual relationship is with the taxpayer. The taxpayer is entitled to the full commission coming from the insurance company under its contract with the insurance company.

That the flow of monies in this case is the reverse of that in Det. Nos. 88-370 and 88-383, resulting in the full commission not passing into the taxpayer's hands, also is a distinction that makes no difference. In Det. No. 88-370, we adopted the following passage from an unpublished 1982 determination as the Department's position on this issue:

> We find that the insuring companies have no contractual relationship with the soliciting agents and irrespective that the solicitor retains his commission from the premium collected prior to turning the balance over to the taxpayer, the taxpayer is entitled to the full commission forthcoming from the insuring company with whom it has a contractual relationship to represent the insurers business interests. Clearly,

> under RCW 82.04.080, the taxpayer's tax liability is measured by values proceeding or accruing by the reason of the transaction of the business engaged in which included commissions without deduction for expense.
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> We recognize in this instance that factually the soliciting agents retain their commissions and forward the balance of the premium collected to the taxpayer; however, such agents have a right only to receive commissions from the taxpayer, and the taxpayer has the right to receive the entire premium.
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> Under WAC 458-20-164, the tax assessment on brokerage commissions must be upheld since the taxpayer either received or was entitled to receive the commissions retained by such sub-agents. Rule 164 specifically provides that there is no deduction for commissions paid to other agents.

We sustain Det. No. 98-219, as modified herein.

DECISION AND DISPOSITION:

The taxpayer's petition for reconsideration is denied.

Dated this 29th day of December, 1999.