Cite as Det. No. 98-219, 19 WTD 410 (2000)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

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| 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. 98-219[1] |
| . . . | ) | Registration No. . . . |
| | ) | FY. . ./Audit No. . . . |

[1] RULE 164: B&O TAX – INSURANCE COMMISSIONS – WHOLESALE BROKER – SUB-AGENTS. A wholesale insurance agent who accepts applications for insurance that come through sub-agents cannot deduct the commissions retained by the sub-agents from the measure of its B&O tax, if the wholesale broker alone has the contractual right to receive the commissions from the insurer. 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 a correction of a tax assessment. The primary issue concerns the assessment of B&O tax against the taxpayer on the commissions earned by sub-agents (retail brokers).[2]

FACTS:

Prusia, A.L.J. -- The taxpayer is a wholesale broker of marine insurance. That is, it occupies a position between the insurance companies (insurers) and the insurance agents (retail brokers) who represent the retail customers (the insured).

The taxpayer has agency agreements with the insurance companies that authorize it to accept applications for insurance. Those agreements allow the taxpayer to collect the insurance premiums and to withhold any and all commissions (the taxpayer's and any sub-agents') from the gross premium before remitting it to the insurance company.

[1] The reconsideration determination, Det. No. 98-219R, is published at 19 WTD 416 (2000).

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

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 retail brokers' commissions.

The Audit Division of the Department of Revenue examined the taxpayer's books and records for the period January 1, 1993 through March 31, 1997. The audit found taxes and interest owing in the amount of $. . . . The Department issued Assessment No. FY. . . in that amount on December 17, 1997. The taxpayer remitted $. . . of the assessment. The balance remains unpaid.

The taxpayer protests Schedules 2 and 3 of the assessment. Schedule 2 is a reconciliation of income taxable under the insurance agents and brokers business and occupation (B&O) tax classification. The Audit Division compared amounts recorded in the taxpayer's records with amounts the taxpayer reported. It found miscellaneous accounting errors in 1993, and assessed the difference, in the total amount of $. . . .

Schedule 3 assesses tax under the insurance agents and brokers tax classification on the unreported sub-agent (retail broker) commissions. The amount assessed under Schedule 3 is $. . . . The Audit Division found that only the taxpayer has a contractual arrangement with the insurance companies; the retail brokers have no contractual relationship with the insurance companies. It concluded therefrom that the taxpayer was entitled to receive the overall commission including commissions retained by the retail brokers, and the full amount of the overall commission was taxable to the taxpayer. It cited Det. No. 88-370, 7 WTD 5 (1988), Det. No. 88-383, 7 WTD 11 (1988), and WAC 458-20-111 (Rule 111) as supporting the assessment.

The taxpayer contends that the retail broker's commission does 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 is not taxable. It argues that the definition includes only commissions the taxpayer "receives or becomes entitled to receive," and 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 argues Det. No. 88-370 and Det. No. 88-383 contemplate a different payment arrangement, and do not support the assessment in this case. It argues that 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 the retail agent its commission. In the traditional arrangement, the wholesale broker does receive 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 describes several aspects of the arrangements between the insurance companies, the wholesale brokers, and the retail brokers in its segment of the insurance industry that differ from those in the traditional insurance lines. Although the agreements between the insurance companies and the wholesale brokers do not reference retail brokers, all of the insurance companies are quite aware that retail brokers are involved in the equation and will be sharing the commission. The industry is highly competitive. The retail broker's commission is negotiated between the wholesale broker and the retail broker on each transaction. One result of this competitive environment is that neither the insurance company nor the wholesale broker can establish a predetermined rate at which the retail broker will share in the commission. Another result is that the wholesale broker must negotiate and reach an agreement with the retail broker before the insurance is written and the premium collected. Thus, the wholesale broker has to bargain away its right to receive any portion of the retail broker's commission before any insurance is written or premium collected.

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, because the retail broker actually received the wholesale broker's commission, whereas the wholesale broker never received or became entitled to the retail broker's commission.

The taxpayer argues that its situation is more analogous to the manufacturer-distributor-retailer situation for the provision of goods than to the traditional insurer-agent-subagent relationship. The monies flow upward. Taxation reflects the money flow, in that the retailer pays B&O tax on the full amount of the retail sale, the wholesale distributor on a smaller amount, and the manufacturer on a yet smaller amount.

ISSUE:

When an insurer has a contractual relationship with the wholesale broker only, and the wholesale broker has its own arrangements with retail brokers that allow the retail brokers to remit the insured's premium net of the retail broker's commission, must the wholesale broker include the retail brokers' commissions in the measure of its B&O tax?

DISCUSSION:

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 "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.

WAC 458-20-164 (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.)
>
> No deduction is allowed for commissions, fees, or salaries paid to other agents, brokers, or solicitors nor for other expenses of doing business.

[1] Applying the above statutes, the retail brokers' commissions are income to the taxpayer if they constitute consideration to the taxpayer. We find that the retail brokers' commissions are consideration to the taxpayer, and therefore are taxable to it.

We do not doubt that the insurance companies contemplated that retail brokers would be involved in the sale of the insurance and would share in the commissions. We realize that no part of the retail broker's commission actually flowed into the taxpayer's hands. Nonetheless, the fact is the retail broker was entitled to a commission only by virtue of its agreement with the taxpayer. Upon the purchase of the insurance and payment of the premium, the taxpayer, and the taxpayer alone, became liable for the retail broker's commission. The taxpayer thus benefited from the retail brokers' direct receipt of their commissions, because it eliminated the taxpayer's personal liability for the commissions. The insureds' direct payments to the retail brokers were consideration received by the taxpayer and are considered gross income to the taxpayer. See Det. No. 93-166, 14 WTD 22 (1995). See also John Davis & Co. v. Cedar Glen, # Four, Inc., 75 Wn.2d 214, 450 P.2d 166 (1969). The taxpayer simply has negotiated a payment arrangement

that allows the retail agent to receive the commission the taxpayer owes the agent without the moneys first flowing through the taxpayer's hands.

The phrase "receives or becomes entitled to receive" in Rule 164 thus should not be taken to literally mean that a commission must physically come into the hands of the taxpayer in order to be income of the business.[3]

While the flow of monies in this case may be the reverse of that found in Det. Nos. 88-370 and 88-383, supra, the principle is the same. As we stated in Det. No. 88-383:

> [W]here 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.

The amount retained by the retail broker is simply a "cost of doing business" for the taxpayer, and is not deductible. RCW 82.04.080; Rule 164.

We also find specific support for this result in the following passage from an unpublished 1982 determination that is quoted in Det. No. 88-370:

> 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.
>
> 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.

[3] We note that in federal income tax law, which deals with a similarly expansive definition of income, a payment attributable to a taxpayer's earnings that bypasses the taxpayer and goes to one designated by the taxpayer is taxed as a payment to the taxpayer. See, e.g. Matter of Larson, 862 F.2d 112 (7th Cir. 1988). Taxation cannot be escaped by contracts designed to prevent money when paid from vesting even for a second in the taxpayer who earned it. Lucas v. Earl, 281 U.S. 111 (1930). The United States Supreme Court has stated that "[t]he power to dispose of income is the equivalent of ownership of it. The exercise of that power . . . is the enjoyment, and hence the realization, of the income by him who exercises it." Helvering v. Horst, 311 U.S. 112 (1940).

> 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.

The Department distinguishes cases where the insurance company contracts directly with the retail brokers to pay them the commissions. In such cases, the retail broker's commissions are not considered gross income to the taxpayer. See Det. No. 88-383, 7 WTD 11 (1988).[4]

If the taxpayer believes the special circumstances of its segment of the insurance industry justify a different tax treatment, its remedy lies with the legislature. The Department, as an administrative agency, is empowered only to administer the laws as written by the legislature.

The taxpayer did not present evidence or argument on the Schedule 2 assessment. Therefore, it did not meet its burden of coming forward with evidence to rebut the Department's evidence with respect to that part of the assessment.

DECISION AND DISPOSITION:

Taxpayer's petition is denied.

Dated this 16th day of December 1998.

[4] In such cases, even if the wholesale broker receives the commissions, the Department has held that the wholesale broker can deduct the commission income which only the retail brokers have the right to retain. This position is consistent with the Department's position with other businesses, like contractors or service providers. Only "reimbursements or advancements" are excludable. See WAC 458-20-111; Rule 164.