Cite as Det. No. 05-0105, 26 WTD 115 (2007)

BEFORE THE APPEALS DIVISION
DEPARTMENT OF REVENUE
STATE OF WASHINGTON

In the Matter of the Petition For Correction of Assessment of and Petition for Refund of	)	D E T E R M I N A T I O N
	)	No. 05-0105
. . .	)	Registration No.. . .
	)	FY. . . /Audit No.. . .
	)	FY. . . /Audit No.. . .
	)	Docket No.. . .
	)	Registration No.. . .
	)	Refund Request . . .
	)	Docket No.. . .

[1] RULE 162; RCW 82.04.080: SERVICE B&O TAX – COMMISSION INCOME – DEDUCTION – AMOUNTS PAID TO ACCOUNT REPRESENTATIVES. A brokerage company was not allowed to deduct from gross commission income amounts received from clients for security trading services and paid to its account representatives.

[2] RULE 111; RCW 82.04.080: SERVICE B&O TAX – ADVANCE & REIMBURSEMENTS – SECURITIES TRADING COSTS. A brokerage company was allowed to exclude from its gross income amounts received from clients as a reimbursement for costs paid to clearing brokers for executing a securities trade made on its client's behalf.

[3] RULE 111; RCW 82.04.080: SERVICE B&O TAX - ADVANCE & REIMBURSEMENT – OVERHEAD EXPENSES. A brokerage company was not allowed to exclude from its gross income amounts received from account representatives as reimbursements for a pro-rata share of overhead costs incurred by the company.

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.

Okimoto, A.L.J. – A brokerage company protests business and occupation (B&O) taxes assessed on commissions received and paid to its associates. A brokerage company also protests B&O tax assessed on payments from associates which the taxpayer had excluded from the measure of tax on the basis that these amounts were reimbursements of transaction-related fees, overhead costs and other miscellaneous fees. We deny Taxpayer's request to cancel B&O taxes assessed on commissions paid to associates and on amounts it treated as nontaxable reimbursements received for overhead costs and other miscellaneous fees. We conclude that the amounts received to pay transaction-related fees for clients were properly excluded from the measure of tax due and cancel the B&O tax assessed on those amounts.[1]

ISSUES

1) May a brokerage company exclude from its gross income amounts paid to associates for their share of commission income?

2) May a brokerage company exclude from gross income amounts received from clients for transaction-related fees?

3) May a brokerage company exclude from gross income amounts received from associates for overhead reimbursements?

4) May a brokerage company exclude from gross income amounts received from associates for other miscellaneous reimbursements?

FINDINGS OF FACT

. . . (Taxpayer) operates a brokerage office in . . . Washington. The Audit Division (Audit) of the Department of Revenue (DOR) examined Taxpayer's books and records for the period January 1, 1995 through December 31, 1995. The examination resulted in additional taxes and interest owing of $. . . . A second audit assessment covering the period January 1, 1996 through December 31, 1999 was issued . . . . This second assessment was later adjusted by a post assessment adjustment that reduced the additional taxes and interest owing . . . . Taxpayer protested the two assessments (including the PAA) in full and they remain due.

In addition, Taxpayer timely filed a request for refund of overpaid B&O taxes for the year 2000. Because the same issues are contained in the two audit assessments, the refund petition has been consolidated into this appeal.

Taxation of gross Commissions received by [Taxpayer].

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

This issue involves whether the total gross commissions earned by Taxpayer as commissions for services rendered to customers should be included in Taxpayer's gross income reconciliation. The auditor used figures from an audit performed by the National Association of Securities Dealers, Inc. (NASD)[2] to determine the gross commission income earned by Taxpayer. Taxpayer contends that these figures are inflated, because they include 100% of the commission generated by a securities transaction, both Taxpayer's and the independent associate's portion. Taxpayer contends that it should only have to pay taxes on the net amounts it receives after excluding commissions split and paid directly to its associate brokers.

Taxpayer explains that a typical securities transaction occurs as follows:

A customer contacts the associate broker and asks the associate to make a purchase for the customer's account. The associate prepares a trade ticket identifying the customer, account [number], order, price and quantity. Next, the associate prepares a . . . checklist, which lists items orally confirmed with the customer prior to trade. Although Taxpayer claims that the commission split between the associate and Taxpayer is orally confirmed at this time, there is nothing on the . . . checklist to corroborate this statement. Once the trade information is orally confirmed, the associate electronically transmits the information to a clearing broker.[3] The clearing broker executes the securities transaction and generates a confirmation slip based on the transmitted information. At month end, the clearing broker prepares a [report] showing all trades by each associate. A copy of the report is distributed to the associates and to Taxpayer's administrative office, where the report is utilized to calculate the split of commissions and the expense reimbursement billed to the associates. Once calculated, Taxpayer's administrative office informs the clearing broker the amount of each wire transfer that the clearing broker is to issue directly to the associates and Taxpayer. The associate's wire transfer equals the gross commission earned, less Taxpayer's split of commission and the associate's share of expenses.

In support of its position, Taxpayer explains that it has very carefully structured its relationship with its associates whereby the revenues reported to and by the associates are paid directly from the clearing broker and never appear in Taxpayer's banking records or general ledger income accounts. Taxpayer states that it has entered into Independent Contractor Agreements with associates that specifically provide that associate brokers are:

> [R]esponsible for their own business expenses, federal income taxes, and any other state or local taxes.
>
> All fees generated by [Taxpayer] and [independent contractors] are to be treated as "split" upon the point of receipts and each party (independent contractor) is responsible for proper accounting of these "fee splits" from that point.

[2] Taxpayer is a member of the NASD.

[3] The clearing broker holds all securities and money for the customers and provides statements and transaction reports directly to customers.

Taxpayer contends that the independent contractor associate brokers are not closely supervised, have their own clients, trade whatever securities they want, maintain trading accounts as separate and distinct entities, have their own trading partners or assistants, bear the risk of profit or loss in their trading accounts, may be dually registered with more than one firm, and may terminate the relationship at any time. Taxpayer further stresses that it pays no federal withholding taxes, no social security taxes, no worker's compensation taxes and no unemployment taxes for the associates. Taxpayer acknowledges that it does file a 1099 with the Internal Revenue Service indicating the amount of commissions paid to each associate broker. In addition, on each customer's monthly statement of account, [Taxpayer] is identified as the broker and the associates are referred to as account representatives. Similarly, the securities confirmation statements sent to customers to confirm transactions identify the broker as [Taxpayer].

Finally, each associate's business card identifies the brokerage firm being represented as [Taxpayer's name and address]. Associate brokers are identified as account executives. Based on these facts, we conclude that customers are clients of . . . [the] Taxpayer, and that the associates are account representatives acting on Taxpayer's behalf. We further conclude that the gross commission income is earned 100% by Taxpayer, even though the clearing broker, (based on instructions from Taxpayer) pays a portion of it directly to the associate broker.

Taxation of Amounts Received From Associates as Reimbursement for Expenses.

Taxpayer gives each associate a monthly breakdown of how the wire transfer amount was calculated. Reimbursed expenses are deducted from net commission income to arrive at a balance owed to the associate. Included in the deductions are:

> a. Retail ticket charges: The charge assessed by the clearing broker to the associate for each trade. Typically, an associate will place an order for a customer with the clearing broker and receive a $. . . commission. [a portion] of that commission is paid to the clearing broker for its services, which is principally executing the transaction at the clearing house.
> b. Trading ticket charges: The charge assessed by the clearing broker to the associate for wholesale transactions. These clearing broker ticket charges relate to trades made by the associate on the associate's own account.
> c. Blue sheet: The charges assessed by the clearing broker for a report to the NASD for trades in a specific security.
> d. Professional fees: Reimbursement to [Taxpayer] for securities violation checks and credit checks on customers of independent associates.
> e. Postage: Direct reimbursement of actual charges incurred by each associate.
> f. Desk charges: Each associate's actual charge for the use of his or her desk and surrounding area.
> g. Telephone: Reimbursement for each associates use of his or her own "800" line.
> h. Quotes: Actual charge incurred by each associate for use of security quote resources (NASDQ).

i. . . . Reimbursement for fees assessed by the clearing broker to associates for trade cancellations, trade write-offs and late paying customers.
j. Market fee: Reimbursement for those fees incurred by associate brokers assessed by NASDAQ.
k. Act fee: Reimbursement for transaction reporting fees incurred by associate brokers.
l. Office Supplies: Reimbursement to [Taxpayer] for office supplies used by associates.
m. Wire. Reimbursement to [Taxpayer] for wire fees assessed by clearing broker for wiring money to an associate's individual bank account.
n. Tickets . . . : Reimbursement to [Taxpayer] for transaction data input and other clerical services performed for associates by . . . employees of [Taxpayer].

Taxpayer argues that these reimbursements should be exempt from taxation under WAC 458-20-111 (Rule 111).

ANALYSIS

[1] WAC 458-20-162 (Rule 162) explains how stockbrokers and security houses are taxed. It provides:

> With respect to stockbrokers and security houses, "gross income of the business" means the total of gross income from interest, gross income from commissions, gross income from trading and gross income from all other sources: PROVIDED, That:
>
> (1) Gross income from each account is to be computed separately and on a monthly basis;
>
> (2) Loss sustained upon any earnings account may not be deducted from or offset against gross income upon any other account, nor may a loss sustained upon any earnings account during any month be deducted from the gross income upon any account for any other month;
>
> (3) No deductions are allowed on account of salaries or commissions paid to employees or salesmen, rent, or any other overhead or operating expenses paid or incurred, or on account of losses other than under "2" above;
>
> (4) No deductions are allowed from commissions received from sales of securities which are delivered to buyers outside the state of Washington.

Rule 162 further clarifies that:

> GROSS INCOME FROM COMMISSIONS. Gross income from commissions is the amount received as commissions upon transactions for the accounts of customers over and above the amount paid to other established security houses associated in such transactions: PROVIDED, HOWEVER, That no deduction or offset is allowed on account of salaries or commissions paid to salesmen or other employees.

Taxpayer is in the business of being a stockbroker for customers. Therefore, Taxpayer is taxed on the gross income from all commissions earned on securities transactions made on behalf of those customers, including commissions paid to associates.

Nor can Taxpayer deduct the commissions paid to its associates. Rule 162 clearly provides:

> That no deduction or offset is allowed on account of salaries or commissions paid to salesmen or other employees.

Taxpayer argues that the Rule 162 restriction only applies to employees and therefore does not apply to Taxpayer's independent contractor associates. We disagree. The restriction in Rule 162 applies to all salespersons or other representatives acting on behalf of the brokerage firm, and not just those salespersons who are labeled employees. Such commission payments are a cost of taxpayer engaging in the brokerage business.[4]

Furthermore, Taxpayer's reliance on *Davenport, Inc. v. Department of Rev*., 6 Wn. App. 581, 494 P.2d 1376 (1972) is misplaced. In *Davenport*, the court held that a real-estate brokerage office consisting of a designated broker and several associate brokers working as independent contractors was a "group of individuals acting as a unit" within the meaning of RCW 82.04.030. Consequently, the court held that the B&O tax could be imposed only once on each commission generated by that office. The designated broker was liable for tax on the portion of the gross commission retained and the associate broker was liable for tax on its share. However, the *Davenport* rationale does not apply to other industries. As we explained in Det. No. 88-370, 7 WTD 005 (1978):

> We do not agree that *Davenport* is controlling. The case involved real estate brokers. The court noted that the department, prior to 1969, had interpreted the statutes defining gross income of the business and persons subject to tax in a way as to allow a broker to deduct commissions paid to associate brokers. Davenport was being taxed under an amended rule which denied the original or designated broker such a deduction. In 1970, the legislature changed the law to eliminate the effect of the amended rule. RCW 82.04.255
>
> The court found the amended rule did not reflect legislative intent. The court noted that the legislature had "silently acquiesced" in the earlier interpretation by the Department to allow a deduction for commissions paid to associates. That fact, coupled with the subsequent change of the statute after the amended rule became effective, was evidence that the double tax was not intended.

[4]We note that Rule 162 provides that amounts paid to employees may not be deducted. However, the inverse is not true; *i.e*., that amounts paid to non-employees are deductible.

> The Departments' position has been and is that *Davenport* and the exemption provided for salesmen or associate real estate brokers in RCW 82.04.255 only applies to real estate brokers. This is in accordance with the general rule of statutory construction that exemptions to taxing statutes must be narrowly construed. Unlike the situation in *Davenport*, the legislature has "silently acquiesced" in the Department's position that the tax does pyramid in situations where the broker is contractually entitled to the full commission from the insuring company and the agent's right to receive a commission is from the contract with the broker. Also, a real estate agent can only sell through an agency. An insurance agent can affiliate with an agency or can seek an appointment contract directly with an insurer.

Taxpayer's situation is similar to the insurance agent's in Det. No. 88-370. Both Rule 164 and Rule 162 clearly provide that "no deduction or offset is allowed on account of salaries or commissions paid to salesmen or other employees." Rule 162 has been in effect in substantially the same form since 1983. Consequently, we conclude that the legislature has silently acquiesced to this interpretation. *In re Sehome Park Care Ctr, Inc. v. Department of Rev*., 127 Wn. 2d 774, 903 P.2d 443 (1995). Accordingly, Taxpayer is not allowed to deduct commissions paid to salespersons under contract as either employees or independent contractors. Rule 162. Taxpayer's petition is denied on this issue.

[2] Taxation of Amounts Received From Independent Associates as Reimbursement for Expenses.

The B&O tax is imposed for the privilege of engaging in business and is measured by the gross income of a business.[5] RCW 82.04.220. Normally, any value proceeding or accruing to a business must be included in the measure of the business' B&O tax. RCW 82.04.080. Independent contractors are "persons" within the meaning of Washington's Revenue Act, and, in general, transactions between persons are fully subject to the B&O tax. RCW 82.04.030. In this case, Taxpayer allocated some administrative and payroll expenses to its independent contractor associates and charged them for these expenses. These charges fall within the broad definition of gross income of the business[6] and must be included in the measure of the B&O tax unless exempted by statute or rule.

While RCW 82.04.080 does not allow a business to deduct its expenses from the measure of the tax, DOR has recognized that some funds that pass through a taxpayer's hands fall outside the definition of "gross income of the business," and may be excluded from the measure of the tax. DOR adopted WAC 458-20-111 (Rule 111), which allows a taxpayer under limited

---

[5] Depending on the particular activity, the B&O tax may be measured by value of products or gross proceeds of sales.

[6] RCW 82.04.080 defines the term "Gross income of the business" to mean: ". . .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, . . .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."

circumstances, to exclude amounts received from a customer solely for the payment of the customer's obligation to a third party.

Rule 111 provides in part:

> The words "advance" and "reimbursement" apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefore, either primarily or secondarily, other than as agent for the customer or client.
>
> There may be excluded from the measure of tax amounts representing money or credit received by a taxpayer as reimbursement of an advance in accordance with the regular and usual custom of his business or profession.
>
> The foregoing is limited to cases wherein the taxpayer, as an incident to the business, undertakes, on behalf of the customer, guest or client, the payment of money, either upon an obligation owing by the customer, guest or client to a third person, or in procuring a service for the customer, guest or client which the taxpayer does not or cannot render and for which no liability attaches to the taxpayer. It does not apply to cases where the customer, guest or client makes advances to the taxpayer upon services to be rendered by the taxpayer or upon goods to be purchased by the taxpayer in carrying on the business in which the taxpayer engages.

Rule 111 recognizes that certain "advances and reimbursements" pass through a business solely in the business' capacity as an agent for a customer or client. Those receipts meeting the requirements of Rule 111 are not attributed to the business activities of the business, and may be excluded from the measure of the tax. Rule 111 expressly states: 'The words 'advance' and 'reimbursement' apply only when the customer or client alone is liable for the payment of the fees or costs and when the taxpayer making the payment has no personal liability therefore, either primarily or secondarily, other than as agent for the customer or client."

In order to exclude these receipts from the measure of the tax, the Washington Supreme Court has ruled that two conditions must be met. The taxpayer must first establish that it received the funds as the agent of the customer or client. If this first condition is satisfied, the taxpayer must also establish that its use of the funds to pay a third party is solely as an agent of the customer or client. *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 60 P.3d 79 (2002). If a taxpayer has any liability beyond that of an agent, the payments it receives are not "pass through" payments, even if the taxpayer uses the payments to pay costs related to the services it provided to its client. *Ibid*, 148 Wn.2d at 178; *Walthew, Warner, Keefe, Arron, Costello & Thompson v. Deptartment of Rev.*, 103 Wash.2d 183, 189, 691 P.2d 559 (1984).

Direct costs of the Transaction:

In Taxpayer's case, an agency relationship clearly exists between the customer and Taxpayer (and its associates). Taxpayer and its associates act as agents for customers when an associate arranges stock or securities transactions for a customer. Consequently, amounts which Taxpayer

and its associates advance to a customer and for which they incur no liability, except as agent of the customer, may be excluded from income under Rule 111. In Taxpayer's case, this includes any amounts received for the purchased security, SEC fees and other direct costs of the transaction for which Taxpayer has no liability except as agent for the customer.

Retail ticket charges:

Trading ticket charges are amounts that the clearing broker charges to Taxpayer or associates for effecting the stock transactions requested by associates on behalf of their customer.

Rule 162 only requires brokerage houses to include in their gross income from commissions the amount received as commissions upon transactions for the accounts of customers "over and above the amounts paid to other established security houses associated in such transactions." In this case, Taxpayer pays retail ticket charges to the clearing broker to execute the requested customer transaction at the clearing house. This constitutes an "amount paid to other established security houses associated in such transaction" within the meaning of Rule 162. Even though the clearing broker performs some other administrative services that may not be directly related to a specific transaction, they are insignificant when compared to actually executing the securities transaction requested. Consequently, we conclude Taxpayer is allowed to exclude amounts paid to clearing brokers from its gross commission income. Accordingly, Taxpayer's petition is granted on this issue.

Trading Ticket charges – wholesale.

We similarly conclude that trading ticket charges incurred by associates when trading in their own name may be excluded from Taxpayer's gross commission income. Associate brokers are independent contractors engaged in their own business activities. They are separate persons for B&O tax purposes. RCW 82.04.030. Consequently, when an associate broker places an order with a clearing broker, the associate broker is the customer and principal and Taxpayer is the agent through which the order is placed. Under Rule 162, Taxpayer is only required to report commission income "over and above the amounts paid to other established security houses associated in such transactions." If Taxpayer receives no commission income over and above the amounts paid to other established security houses then no part of the reimbursement is taxable. This issue is remanded to Audit for verification.

Overhead Reimbursements:

[3] Included in these amounts are advances made by Taxpayer to its associates for postage, desk charges, telephones, office supplies and clerical services performed by Taxpayer's employees. Even though the associates may be receiving the benefit of these services or costs, Taxpayer has not incurred the costs as agent for the associates. Instead, Taxpayer incurs these costs, at least initially, for its own benefit and charges out a pro-rata portion to its associates. Furthermore, Taxpayer's liability for the costs incurred is not solely as agent. Accordingly, Taxpayer's petition is denied on these issues.

Other Cost Reimbursements:

As for the other costs or fees incurred, Taxpayer has not shown that the customers or Taxpayer's associates are solely liable for the fees or costs or that Taxpayer's liability is merely as agent. Therefore, we conclude that Taxpayer has failed to show that the remaining reimbursements of fees and costs qualify as advances under Rule 111. Accordingly, we deny Taxpayer's petition on these remaining issues.

DECISION AND DISPOSITION

Taxpayer's petition is denied in part and granted in part.

Dated this 17th day of May, 2005.