Cite as Det. No. 05-0139, 26 WTD 6 (2007)

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. 05-0139 Registration No. . . . Doc. No. . . . Audit No. . . . Docket No. . . .

[1] RULES 164 AND 111: INSURANCE AGENT/BROKER B&O TAX – COMMISSIONS – TAXABLE – NOT PASS-THROUGHS. A general insurance agent (the taxpayer) does not qualify for Rule 111 pass-through payments of commissions to its independent contractor sub-agents because (1) the taxpayer can and does render the service of selling insurance for the insurance company and (2) the taxpayer does not receive and pay the sub-agent commissions from the insurance company solely as its agent. Instead, under the contract with the insurance company, the taxpayer is personally and primarily liable to the sub-agents for the commissions.

[2] RULE 230(4) and (7) (b); RCW 82.32.050(3) (b): MISREPRESENTATION – ASSESSMENT OF ADDITIONAL TAX. DOR is not time-barred from amending an assessment due to the taxpayer's misrepresentation of a material fact.

[3] RULES 105 AND 164; RCW 82.04.360: B&O TAX - GENERAL INSURANCE AGENT – ENGAGING IN BUSINESS – NOT AN EMPLOYEE. In light of the criteria in Rule 105, the facts overwhelmingly support the finding and Rule 164's presumption that the taxpayer is engaged in business and subject to the B&O tax on his gross income, and is not an employee of the insurance 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.

De Luca, A.L.J. -- A general agent for a life insurance company protests the amendment of a tax assessment two years after the Department of Revenue (DOR) issued the original tax assessment. In the amended assessment, DOR additionally assessed business and occupation (B&O) tax on commissions the taxpayer received from the insurance company and paid to the taxpayer's sub-agents. We hold that the commission payments to the sub-agents are not excludable from the general agent's gross income, but are taxable to him. We further hold that the amended assessment is not time-barred due to a misrepresentation of a material fact by the general agent. Finally, we hold the taxpayer is not an employee of the insurance company. We affirm the assessment.[1]

ISSUES:

1. Were the commission payments the taxpayer/general agent received from the insurance company that he paid to his sub-agents excludable from his gross income?

2. Is DOR time-barred, at least for the first two years of an audit period, from amending a tax assessment two years after issuing the original assessment if the taxpayer misrepresented a material fact during the time of the original audit?

3. Is the taxpayer an employee of the insurance company or is he doing business in Washington in his own capacity as a general agent?

FACTS:

The taxpayer is a general agent for an insurance company that sells various types of insurance, including life insurance. DOR's Taxpayer Account Administration (TAA) Division initially audited the taxpayer for the period January 1, 1997, through September 30, 2001, and assessed him $. . . in insurance agent/broker B&O tax, penalties, and interest after crediting the taxpayer for making a payment of $. . . . TAA issued the original assessment on December 13, 2001. The taxpayer paid the assessment and then filed a refund action in Thurston County Superior Court (No. . . .). In that action, the taxpayer claimed the payments he received from the insurance company for business expenses were tax exempt pass-through payments. In a hearing held on . . . 2004, the Superior Court granted DOR's motion for summary judgment and upheld the tax assessment in full. On . . . 2004, the Court of Appeals, (Division II) dismissed the taxpayer's appeal from the summary judgment (No. . . .). Thus, the judgment is final as to the original assessment.

The original assessment did not assess B&O tax on the commission payments the taxpayer received from the insurance company and paid to his sub-agents. TAA did not assess tax on the commission payments because during the original audit it considered the payments excludable from the taxpayer's gross income based upon a letter the taxpayer's attorney wrote to TAA . . . .

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

In that letter, the attorney acknowledged that the taxpayer was authorized by the insurance company to retain sub-agents and he wrote the "sub-agents had to be retained under a written agreement provided by [insurance company]." The letter continued by stating that "under the sub-agent's contract with [insurance company], when the sub-agent sells [an insurance company] product, the agent becomes contractually entitled to a commission from [insurance company], not from the [taxpayer]." The letter also cited Det. No. 88-383, 7 WTD 11 (1988), *infra,* by stating that the facts relating to the taxpayer's situation as a general agent were "essentially the same as the facts set forth in Det. No. 88-383." According to TAA, neither the taxpayer's attorney nor the taxpayer provided TAA copies of the taxpayer's contracts with the insurance company and the sub-agents during the initial audit. The taxpayer disagrees and claims he provided TAA all of his records, including the contracts, during the initial audit.

We find that TAA did not have copies of the subject contracts during the initial audit because it was during the subsequent pretrial discovery for the refund action filed by the taxpayer in [court] that DOR obtained copies of the taxpayer's contracts with his sub-agents and the insurance company.

The taxpayer's contract with the insurance company provides in part:

> The General Agent, Individually and for and on the General Agent's own behalf, may appoint and contract with agents and brokers to carry out the purposes of this contract but <u>they shall be compensated by the General Agent at the General Agent's own cost and charge and they shall not be deemed agents under contract with the Company.</u>
>
> The General Agent shall be responsible to the Company for all business done by or entrusted to agents or others appointed or employed by the General Agent, and <u>no such appointee or employee shall have any claim against the Company for commissions or otherwise.</u>

(Underlining ours.)

Similarly, the taxpayer's contract with the sub-agents provides that it is "between [the taxpayer] General Agent . . . and [the named sub-agent], hereinafter called Special Agent." Their contract states that the taxpayer as General Agent "will allow the Special Agent, and Special Agent hereby agrees to accept as full compensation, commissions at the rates shown in the agreement . . . ."

Upon review of these contracts in the fall of 2003, TAA amended the original assessment of 2001 to include the commissions paid to the sub-agents as part of the taxpayer's gross income. On October 9, 2003, TAA issued the revised assessment in the amount of $. . . , minus the previous payment of $. . . by the taxpayer, for a net assessment of $. . . . TAA amended the assessment because it determined that the taxpayer's September 14, 2001, letter had

misrepresented the taxpayer's contractual obligations to the sub-agents and the insurance company. The balance plus extension interest remains due.

ANALYSIS:

[1] We first address whether the commission payments to the sub-agents were excludable from the taxpayer's gross income. The Superior Court did not specifically address the question of these commission payments because they arose in the amended assessment that was issued after the taxpayer filed suit in Superior Court for his refund of the original assessment. Nonetheless, the taxpayer asserted in his petition for correction of the amended assessment that was filed with DOR's Appeals Division prior to the order granting summary judgment, that the litigation in Superior Court "should resolve all of the factual and legal issues that would be subject of this Petition for Correction, except for the statute of limitations issue . . . ." In effect, the taxpayer conceded if the payments he received for business expenses were part of his taxable gross income, which the Superior Court found to be the situation, so would the commissions he paid the sub-agents.

But in a June 10, 2005, memorandum the taxpayer asserts many of the same arguments he made at the Superior Court where he unsuccessfully claimed the other payments by the insurance company to him for business expenses were tax exempt pass-through payments. For example, he claimed in Superior Court and now claims that he is a "captive" agent of the insurance company, which imposes substantial restrictions on his ability to carry out his general agent duties. By "captive" he notes the insurance company prescribes the types of insurance policies he can sell and where he can sell them. It requires him to follow a marketing program and a marketing conduct manual. It audits his books and records and provides him and his sub-agents regular training. The insurance company investigates and approves the sub-agents he employs as independent contractors, and the sub-agents must be hired under a written agreement provided by the insurance company. He states the taxpayer's general agency is located in building space that is leased by the insurance company and not by him. The insurance company also leases all of the business equipment used in that location and provides all of the normal insurance forms and stationary, which identify the insurance company by name and not the taxpayer. Additionally, the business telephone listings are for the insurance company.

Like the Superior Court in the earlier action concerning the other business expenses, we are not persuaded by the taxpayer's arguments that these facts support a conclusion that the commission payments from the insurance company are non taxable pass-through payments. Specifically, these facts do not address the key issue whether the taxpayer is personally liable, other than as an agent, to pay the sub-agents their commissions.

The taxpayer further argues that the sub-agents by contract are entitled to commissions from the insurance company, not from the taxpayer. We disagree and conclude the commission payments the taxpayer made to the sub-agents were a part of his gross income as we will explain.

WAC 458-20-164 (Rule 164) is DOR's rule pertaining to insurance agents, brokers, and solicitors. An "agent" is defined as "any person appointed by an insurer to solicit applications for insurance on its behalf." RCW 48.17.010. Insurance agents must be licensed by this state. RCW 48.17.060. The taxpayer is licensed as an agent and by contract with the insurance company has been granted the authority by the insurance company to solicit applications for the insurance company on its behalf. The taxpayer is an insurance agent. In fact, he is a general agent. Rule 164(3) (b) provides that "[n]o deduction is allowed for commissions, fees, or salaries paid to other agents, brokers, or solicitors nor for other expenses of doing business." Thus, the commissions the taxpayer pays his sub-agents are not deductible from his gross income.

The commissions also are not deductible under WAC 458-20-111 (Rule 111), which is DOR's rule that pertains to advances and reimbursements. Rule 111 recognizes that certain advances or reimbursements "pass through" a business solely in the business's capacity as an agent for the customer or client. The payments meeting the requirements of Rule 111 are not attributed to the business activities of the taxpayer and may be excluded from the measure of the tax. In order for there to be an advancement or reimbursement under Rule 111, the payments by the taxpayer must: 1) be made as part of the regular and usual custom of the taxpayer's business or profession, 2) be for services to a customer which the taxpayer does not or cannot render, and 3) not involve fees or costs for which the taxpayer is personally liable, either primarily or secondarily, except as the customer's agent. *Christensen v. Department of Rev.*, 97 Wn.2d 764, 769, 649 P.2d 839 (1982). With regard to the third element, the Washington State Supreme Court has ruled that 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.*, 149 Wn.2d 169, 60 P.3d 79 (2002).

We find the taxpayer does not meet the second and third elements of Rule 111. As to the second element, the taxpayer can and does render the service of selling insurance for the insurance company. The contract with the insurance company specifically provides that the taxpayer can hire sub-agents at his own cost to carry out the purposes of the contract. As we have seen, the taxpayer does hire sub-agents to sell such insurance. As to the third element, the taxpayer does not receive and pay the sub-agent commissions from the insurance company solely as its agent. Instead, under the contract sections quoted above, the taxpayer is personally and primarily liable to the sub-agents for the commissions. In fact, the insurance company expressly disavowed in its contract with the taxpayer any liability to the sub-agents for their commissions, *supra*. Consequently, the sub-agent commissions are part of the taxpayer's gross income and subject to B&O tax.

[2] The second issue is whether DOR was time-barred from amending the assessment in 2003 for the years 1997 and 1998. Normally, DOR may not assess or correct an assessment for additional taxes, penalties, or interest more than four years after the close of a tax year. RCW 82.32.050(3). Thus, under normal circumstances DOR would have been barred from assessing additional taxes in 2003 for the years 1997 and 1998. But RCW 82.32.050(3) also allows for exceptions to the

normal time limits for assessing taxes, which include "(b) upon a showing of fraud or misrepresentation of a material fact by the taxpayer." In such circumstances, there is no time limit for DOR to correct an assessment. WAC 458-20-230(4) (Rule 230).

Similarly, Rule 230(7) provides that DOR may issue a revised assessment to correct errors based on a review of the taxpayer's records. Once issued, DOR may revise an audit assessment subject to the following restrictions: (a) an assessment generally may not be increased from an amount originally assessed for those years for which the statute of limitations would have expired if it were an original assessment, but (b) "an assessment may be increased upon discovery of fraud/evasion or misrepresentation of a material fact." (Underlining ours.)

Neither RCW 82.32.050 nor Rule 230 defines the word "misrepresentation." In the absence of a statutory or administrative definition, it is proper to resort to the use of a dictionary to find the meaning of a word. Webster's Third New International Dictionary 1445 (1993) defines "misrepresent" to mean "an untrue, incorrect, or misleading representation (as of a fact, event, or person); specif: a representation by words or other means that under the existing circumstances amounts to an assertion not in accordance with the facts." The same dictionary defines "misleading" to mean "tending to mislead: deceiving."

We agree with TAA that the taxpayer's letter of September 14, 2001, to TAA misrepresented a material fact when it declared that the sub-agents were contractually entitled to their commissions from the insurance company and not from the taxpayer. This statement is contrary to the language of the contracts that the taxpayer has with the insurance company and the sub-agents, quoted above. Specifically, the taxpayer's contract with the insurance company provides that the taxpayer as the general agent may, on his own behalf, contract with the sub-agents and he shall compensate them at his own cost. Moreover, the sub-agents shall not be deemed agents under contract with the insurance company and shall have no claim against the insurance company for their commissions. In short, the taxpayer's contract with the insurance company does not provide that he will receive the commissions and pay the sub-agents only as agent of the insurance company as required by Rule 111 and *William Rogers Co., supra,* for a payment to be a pass-through. Further, the taxpayer's contract with the sub-agents provides that the taxpayer will pay the sub-agents commissions at the rates listed in their contract with him. In other words, under both contracts, the taxpayer is personally liable to the sub-agents for their commissions.

Had TAA seen these contracts during the initial audit period it would have included the commissions paid to the sub-agents as part of the taxpayer's gross income. Instead, it excluded them from his gross income when calculating taxes due because of the taxpayer's September 14, 2001, letter. Once TAA saw the contracts it amended the assessment pursuant to Rule 230(7)(b).

We further note that the taxpayer in its September 14, 2001, letter to TAA and in its June 10, 2005, memorandum to the Appeals Division cited Det. No. 88-383, *supra,* and claimed the

taxpayer's facts were essentially the same as those in that determination. We disagree with that statement. Det. No. 88-383 declared:

> [T]he 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.

A review of the present taxpayer's contracts clearly shows that the sub-agents had contractual relations with the taxpayer (the general agent) making him primarily liable to pay them their commissions. Consequently, the commission payments are not excludable from the taxpayer's gross income and DOR is not barred from amending the assessment due to the taxpayer's misrepresentation of this material fact. RCW 82.32.050(3) (b), Rule 230(4) and (7) (b).

[3] The last issue is whether the taxpayer is an employee of the insurance company and therefore not subject to the B&O tax. RCW 82.04.360 and WAC 458-20-105(1) (Rule 105). We have shown that the taxpayer is the general agent of the insurance company. Rule 164(3) (c) provides:

> Every person acting in the capacity of agent, broker, or solicitor is presumed to be engaging in business and subject to the business and occupation tax unless such person can demonstrate he or she is a bona fide employee. The burden is upon such person to establish the fact of his or her status as an employee. (See WAC 458-20-105, Employees.)

Rule 105 states in part:

> (2) While no one factor definitely determines employee status, the most important consideration is the employer's right to control the employee. The right to control is not limited to controlling the result of the work to be accomplished, but includes controlling the details and means by which the work is accomplished….
>
> (3) **Persons engaging in business.** The term "engaging in business" means the act of transferring, selling or otherwise dealing in real or personal property, or the rendition of services, for consideration except as an employee. The following conditions will serve to indicate that a person is engaging in business.
>
> If a person is:

(a) Holding oneself out to the public as engaging in business with respect to dealings in real or personal property, or in respect to the rendition of services;

(b) Entitled to receive the gross income of the business or any part thereof;

(c) Liable for business losses or the expense of conducting a business, even though such expenses may ultimately be reimbursed by a principal;

(d) Controlling and supervising others, and being personally liable for their payroll, as a part of engaging in business;

(e) Employing others to carry out duties and responsibilities related to the engaging in business and being personally liable for their pay;

(f) Filing a statement of business income and expenses (Schedule C) for federal income tax purposes;

(g) A party to a written contract, the intent of which establishes the person to be an independent contractor;

(h) Paid a gross amount for the work without deductions for employment taxes (such as Federal Insurance Contributions Act, Federal Unemployment Tax Act, and similar state taxes).

We will review the taxpayer's activities in light of these factors:

(a) The taxpayer does hold himself out as engaging in business as the general agent of the insurance company. He is licensed as an agent and is registered with DOR to do business in Washington.
(b) The taxpayer admits he is entitled to receive part of the gross income of the business. The premiums paid by the insured go to the insurance company and part of that gross income is paid to the taxpayer from which the taxpayer pays business expenses and commissions to his sub-agents.
(c) The taxpayer is liable for business expenses. The Superior Court ruled that he is taxable on the income he received from the insurance company for business expenses. As we have shown he also is personally liable for the commissions he paid his sub-agents.
(d) The taxpayer controls, supervises and, as the employer, is personally liable for the payroll of two persons on his office administrative staff.
(e) The taxpayer hires sub-agents to carryout the duties and responsibilities of soliciting insurance sales and, as shown, he is personally liable for their commissions.
(f) The taxpayer files a Schedule C for federal income tax purposes.
(g) The taxpayer's contract with the insurance company expressly states that he is not an employee of the insurance company.
(h) The taxpayer admits he does not meet this factor because he is paid an amount by the insurance company without deductions for employment taxes.

In light of these criteria, the facts overwhelmingly support our finding and Rule 164's presumption that the taxpayer is engaged in business and subject to the B&O tax on his gross income.

Rule 105 also provides criteria for employees:

> (4) **Employees.** The following conditions indicate that a person is an employee. If the person:
>
> (a) Receives compensation, which is fixed at a certain rate per day, week, month or year, or at a certain percentage of business obtained, payable in all events;
>
> (b) Is employed to perform services in the affairs of another, subject to the other's control or right to control;
>
> (c) Has no liability for the expenses of maintaining an office or other place of business, or any other overhead expenses or for compensation of employees;
>
> (d) Has no liability for losses or indebtedness incurred in the conduct of the business;
>
> (e) Is generally entitled to fringe benefits normally associated with an employer-employee relationship, e.g., paid vacation, sick leave, insurance, and pension benefits;
>
> (f) Is treated as an employee for federal tax purposes;
>
> (g) Is paid a net amount after deductions for employment taxes, such as those identified in subsection (3)(h) of this section.

Our review of these criteria shows:

(a) The taxpayer does receive commissions based on a fixed percentage of the business obtained by him and his sub-agents.

(b) There are company policies that the taxpayer must meet, but the contract with the insurance company states that he is "free to exercise judgment as to the persons from whom applications will be solicited for insurance and the time and place of solicitation."

(c) As shown, the Superior Court ruled the taxpayer is personally liable for the business expenses of maintaining the office. He admits he is liable for compensating his office staff employees.

(d) The taxpayer has liability for indebtedness incurred in conducting business, including the sub-agent commissions, as discussed above.

(e) The taxpayer is entitled to some fringe benefits.

(f) The taxpayer admits he is not treated as an employee by the insurance company for federal tax purposes.

(g) The taxpayer admits he is not paid a net amount after deductions for employment taxes.

The taxpayer fails to meet a majority of these employee criteria and, as shown, he overwhelmingly meets the criteria for engaging in business. Reviewing the facts in light of these criteria, we find the taxpayer is not an employee, but is engaged in business as a general agent and his gross income is subject to B&O tax. *See* Det. 99-063, 24 WTD 001 (2005).

DECISION AND DISPOSITION:

The taxpayer petition for correction of amended assessment is denied.

Dated this 27th day of June, 2005.