Cite as Det. No. 98-220, 18 WTD 306 (1999)

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. 98-220
. . .	)	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 insurance broker, seeks a correction of a tax assessment. At issue is the assessment of B&O tax against the taxpayer on the commissions earned by sub-agents (retail brokers). [1]

FACTS:

Prusia, A.L.J. -- The taxpayer is an insurance broker. It procures or negotiates insurance coverage on behalf of large public entities but accepts no underwriting risk. In some cases it acts as an intermediary between the insured and the insurance underwriter (insurer or insurance company). In other cases a retail broker represents the public entity, and the taxpayer acts as a wholesale broker between the retail broker and the insurer. In yet other cases it acts as an

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

intermediary between insurance underwriters – a reinsurance broker. This appeal involves commission income when the taxpayer acts as a wholesale insurance broker.

The Audit Division of the Department of Revenue examined the taxpayer's books and records for the period January 1, 1993 through June 30, 1997. The audit found taxes and interest owing in the amount of $. . . . The Department issued Assessment No. FY. . . in that amount on October 8, 1997. The assessment remains unpaid.

The assessment assesses tax under the insurance agents and brokers business and occupation (B&O) tax classification on unreported commissions that retail brokers received on insurance the taxpayer negotiated during the audit period. The Audit Division assessed the additional tax on the grounds that no deduction is allowed for commissions paid to other agents.

The taxpayer protests the assessment. It contends that it is not subject to tax on the commissions earned by the retail brokers, because it neither receives nor is entitled to receive those commissions.

The taxpayer explained the relationships between the insurers, itself, and the retail brokers when it acts as a wholesale insurance broker. Because the insurance risks of public entities are typically large and complicated, most local retail brokers are not able to procure adequate insurance coverage through their own contacts and relationships with insurance underwriters. For that reason, retail brokers utilize the services of the taxpayer, which has exclusive or convenient access to additional insurance capacity, to put together an insurance package. The taxpayer locates and procures insurance coverage for the various insurance risks of the public entities. When the taxpayer has the package together, the retail agent collects the premium from the public entity, deducts its commission, and remits the balance to the taxpayer. The taxpayer then deducts its commission and remits the net premium to the insurer(s).

The taxpayer has agency agreements with the insurers. Those agreements authorize the taxpayer to solicit insurance on behalf of the insurer, issue and deliver policies which the insurer may authorize to be issued and delivered, and collect premiums. The agreements allow the taxpayer to retain a specified commission out of the premiums collected. The typical agency agreement provides that the insurer will not be responsible for expenses incurred by the taxpayer, such as rent, advertising, and solicitor's fees.

There are no written agreements between the taxpayer and the retail brokers or between the insurer and the retail brokers. However, the established course of dealing between the taxpayer and retail brokers always has been for the retail broker to bill for and collect the gross premium, and to retain its commission before remitting the remainder of the commission and the premium payment to the taxpayer.

Thus, although the taxpayer's agreement with the insurer 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. For internal bookkeeping purposes, the taxpayer shows the gross

commission as income and the retail broker's commission as a deduction, but in its audited public reports, prepared in accordance with general accounting methods, it shows only the net commission as revenue. In reporting its gross income to the Department, the taxpayer did not include the amount of the retail brokers' commissions.

The taxpayer contends that it is taxable only on the net amount of commissions it actually receives on insurance policies placed by it. That is, it is subject to tax only on the difference between the gross amount of commissions paid by the insured and the amount of the commissions retained by the retail brokers.

The taxpayer argues that this result is dictated by the plain language of the applicable Washington statutes, particularly RCW 82.04.260(11), RCW 82.04.080, and RCW 82.04.090. Its argument is as follows. It is an accrual basis taxpayer. The statutes impose B&O tax on the consideration actually received or accrued in accordance with the method of accounting regularly employed in keeping the taxpayer's books. Because the taxpayer never actually receives the portion of the commission retained by the retail broker, and does not reflect those commission amounts on its audited financial statements, the retail broker's share of the commissions does not represent "value proceeding or accruing" to the taxpayer, as that phrase is used in RCW 82.04.080. The applicable rule adopted by the Department, WAC 480-20-164, defines gross income somewhat more broadly, but also provides that gross income of the business only includes commissions the taxpayer "receives or becomes entitled to receive." The taxpayer states that it never receives nor becomes entitled to receive the retail agent's portion of the gross premium.

The taxpayer argues that if there is any ambiguity in the applicable statutes, any doubts as to their meaning must be construed against the Department. It cites Paccar, Inc. v. Dept. of Revenue, 135 Wn.2d 301 (1998), and other cases cited therein.

The taxpayer contends that prior Department determinations that impose tax on the gross insurance commissions received by a general agent from an insurer concern a fundamentally different agent/subagent relationship. Specifically, in Det. No. 88-370 and in Det. No. 88-383, gross premiums were paid by the insured to the insurer, the insurer then paid the gross premium to the general agent, and the general agent then paid the procuring sub-agent a portion of the commission. In contrast to the taxpayer's situation, the general agent in those cases did receive the gross commission.

The taxpayer argues that the practice followed in its case is a well-established industry practice that is fully contemplated by all the parties. It argues that by treating the taxpayer as being entitled to the gross commissions paid by the insured, the Audit Division disregarded the contractual relationship between the taxpayer and the retail brokers which has been established by and is based upon prior dealings and long-standing industry practice.

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; RCW 82.04.260(11).[2] 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:

> [T]he 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.

[2] RCW 82.04.260(14) prior to its amendment in 1998.

[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 realize that no part of the retail broker's commission actually flowed into the taxpayer's hands. We also understand that the insurers contemplated that retail brokers would be involved in the sale of the insurance and would share in the commissions. 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 "actually received or accrued" in RCW 82.04.080, and 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:

---

[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).

> 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. . .
>
> 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 recognize that the result is a partial pyramiding of B&O taxes. However, it is an intended effect of the Revenue Act to assert a tax on the gross receipts of each separately organized entity doing business in this state.

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 and established practice 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.

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.