

02.25.11

LEGAL RULING 2011-02

Subject: Payments to Nonresident Former Insurance Agents Subject to Income Tax Withholding

BACKGROUND

Questions have been raised as to whether, under the following scenarios, payments made by an insurance company to nonresident former insurance agents for personal services previously rendered are subject to withholding of California personal income tax.

ISSUES

Which, if any, payments made to former insurance agents for past services are sourced to California and subject to California income tax withholding?

FACTS

For purposes of the following scenarios, assume that each former insurance agent performed services in California for the insurance company, but that the agent is a California nonresident at the time some payments for those services are received. Additionally, all payment amounts are assumed to be substantially equal.

Situation 1: A sells life insurance full-time under a remuneration agreement with X, an insurance company. Under the terms of this remuneration agreement, former insurance agents are entitled to payments from X based upon a percentage of the policies sold and serviced that remain in force during the year immediately following the completion of the agreement. Further, under this agreement, former agents may opt to receive payments over a period of five years following conclusion of the remuneration agreement. Agents may alternatively choose payout periods of 10 years, or their life, or their life expectancy. A former agent may elect to receive payments on either an annual or monthly basis.

Situation 2: B sells life insurance and property and casualty insurance under a remuneration agreement with Y, an insurance company. Upon the conclusion of this agreement, an agent is entitled to receive payments based upon a percentage of the policies sold and serviced that remain in force during the year immediately following the completion of this agreement.

Situation 3: C sells life insurance full-time under a remuneration agreement with Z, an insurance company. Under the terms of this agreement, an agent may elect to defer a portion of current remuneration to a later year in the form of deferred compensation distributions. One of four options for the payment of the deferred compensation may be elected:

1. Payments over a period of not less than ten years.
2. Payments for life.
3. Payments until the amount deferred is fully paid.
4. Lump sum payment.

LAW & ANALYSIS

I. Sourcing

Under Revenue and Taxation Code (R&TC)¹ section 17041, subdivisions (b) and (i), nonresidents and part-year residents of California are taxed on income attributable to California. Taxable income of a nonresident is determined by taking into account only gross income from sources within California. (R&TC § 17951.) In the case of services, it is well settled that the source of income is determined by examining the location where services are performed, without regard to a taxpayer's state of residency. (See *Appeal of Robert C. Thomas and Marian Thomas*, 55-SBE-006, April 20, 1955; *Appeal of Charles W. and Mary D. Perelle*, 58-SBE-057, Dec. 17, 1958; *Appeal of Janice Rule*, 76-SBE-099, Oct. 6, 1976; and *Appeal of Oscar D. and Agatha Seltzer*, 80-SBE-154, Nov. 18, 1980.) Furthermore, California Code of Regulations ("CCR"), title 18, section 17951-2, states that "[i]ncome from sources within this State includes income from real or tangible personal property located in this State; from a business, trade or profession carried on within this State..."

R&TC section 18662 generally requires any person to withhold an amount which reasonably represents the amount of tax due on income from sources within California, including the tax due on compensation for personal services performed within the State. Under CCR, title 18, section 18662-2, persons must withhold tax due on nonresident compensation for personal services rendered within the State, including remuneration for independent contractors (but excluding wages subject to withholding under Section 13020 of the Unemployment Insurance Code).

California follows federal law, which provides special rules concerning the taxation of "qualified retirement income." Title 4 of the United States Code, section 114 (hereinafter "4 U.S.C. section 114") provides that "no state may impose tax on any retirement income of an individual who is not a resident or domiciliary of such State." R&TC section 17952.5 implements 4 U.S.C. section 114 by excluding "qualified retirement income" from a nonresident's California gross income from sources within this State. Thus, regardless of source, "qualified retirement income" is not subject to California tax if it is received by a nonresident.

II. Nonqualified Deferred Compensation

As discussed above, R&TC section 17952.5 excludes "qualified retirement income" from a nonresident's California gross income from sources within this state. R&TC section 17952.5 enumerates specific types of retirement payments as "qualified retirement income," such as trusts, annuities, or other specific statutory retirement plans in paragraphs (1) through (8) and (10) of subdivision (b). Since the payments made under the factual situations in this ruling do not meet the requirements set forth in paragraphs (1) through (8) or (10) of subdivision (b),

¹ All section references will be to the California Revenue and Taxation Code, unless otherwise specified.

these payments must be examined under R&TC section 17952.5, subdivision (b)(9). R&TC section 17952.5, subdivision (b)(9), defines "qualified retirement income" to include:

Any plan, program, or arrangement described in Section 3121(v)(2)(C) of the Internal Revenue Code, ... if that income is . . . :

(A) Part of a series of substantially equal periodic payments (not less frequently than annually), ... made for either of the following:

(i) The life or the life expectancy of the recipient (or joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient).

(ii) a period of not less than 10 years.

Thus, the first question is whether the payments fit the description of nonqualified deferred compensation ("NQDC") as outlined in Internal Revenue Code ("IRC") section 3121(v)(2)(C). The second question is whether the payments are substantially equal periodic payments provided for either (i) the life or life expectancy of the recipient or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient, or (ii) for a period of not less than 10 years.

IRC section 3121(v)(2)(C) defines NQDC as any plan or arrangement for deferral of compensation, other than one described in IRC section 3121(a)(5). IRC section 3121(a)(5) describes various types of statutory plans. Since the payments that are the subject of this Legal Ruling do not fit the definition of any of the statutorily defined plans as described in IRC section 3121(a)(5), the next consideration is whether they fit the definition for an NQDC as provided in the relevant Treasury Regulations ("Treas. Reg.").

The requirements for a NQDC plan are set forth in detail in Treas. Reg. section 31.3121(v)(2)-1. Specifically, Treas. Reg. section 31.3121(v)(2)-1(b)(1) defines an NQDC as any plan or other arrangement that is set up by an employer for one or more employees and provides for the deferral of compensation within the meaning set forth in subsection (b)(3) of that regulation. Subsection (b)(3) goes on to state an employer may unilaterally adopt such a plan or negotiate with one or more employees to agree upon such a plan. Subsection (b)(3) further states "[a] plan may constitute a nonqualified deferred compensation plan under this section without regard to whether the deferrals under the plan are made pursuant to an election by the employee or whether the amounts deferred are treated as deferred compensation for income tax purposes." Additionally, an NQDC plan is not required to meet the definition of an employee benefit plan under section 3(3) of Employee Retirement Income Security Act ("ERISA").

Treas. Reg. section 31.3121(v)(2)-1(b)(2)(i) requires the material terms of the plan, such as the amount of the deferral and the time of the distribution of the deferred compensation, to be specifically provided for in the details of the plan.

Treas. Reg. section 31.3121(v)(2)-1(b)(3)(i) defines the term "deferral of compensation." A deferral of compensation occurs when an employee has a legally binding right to compensation during the calendar year, which has not actually or constructively been received, and pursuant

to the terms of the plan the compensation is payable in a later year. The regulation further provides that "[a]n employee does not have a legally binding right to compensation if that compensation may be unilaterally reduced or eliminated by the employer after the services creating the right have been performed." Finally, the regulation explains that any reduction or elimination by means of the operation of the plan is not considered a unilateral reduction or elimination.

Assuming each payment plan sets forth the specifics of the exact calculation of the future payments, the length of the payments and that the payments are to be distributed on a monthly basis, the remaining question is whether each payment plan provides for the deferral of compensation within the meaning set forth in Treas. Reg. section 31.3121(v)(2)-1(b)(3); specifically, is there a legally binding right to compensation during the calendar year, which has not actually or constructively been received, and pursuant to the terms of the plan the compensation is payable in a later year?

III. The Definition of Employee under the Federal Insurance Contributions Act

Under the Federal Insurance Contributions Act ("FICA"), employees are subject to payroll tax. Under FICA, employees are generally defined under IRC section 3121(d), but only IRC section 3121(d)(3)(B), which defines full time life insurance salesmen as employees, is relevant to this ruling. This definition applies for all FICA purposes, including IRC section 3121(v)(2)(C), which defines a "nonqualified deferred compensation plan". IRC section 3121(d)(3)² defines full time life insurance salesmen as employees. The Senate Finance Committee Report with respect to this amendment specifically set forth the congressional intent behind the term "full time life insurance salesmen:"

An individual who is engaged in the general insurance business under a contract or contracts of service which do not contemplate that the individual's principal business activity will be the solicitation of life insurance and annuity contracts for one company, or any individual who devotes only part time to the solicitation of life insurance or annuity contracts, and is principally engaged in other endeavors, is not within paragraph (3) of the definition. (Sen. Rep. No. 1669, 81st Cong., 2d Sess., p. 96 (1950), reprinted in 1950 U.S. Code Cong. & Admin. News, p. 3443; 1950 WL 1787(Leg. Hist.))

As such, the Senate Report specifically excludes salesmen engaged in the sale of any insurance other than life insurance, or any agent who only engages in the sale of life insurance part time, from the definition of an employee. Thus, for purposes of this ruling, only full-time life insurance agents will be treated as employees.

Analysis

Situation 1: The first consideration under Situation 1 is whether A is considered an employee of X under FICA, and thus is considered an employee for purposes of IRC section 3121(v)(2)(C).

² The provisions of this section were initially codified in the IRC of 1939 as section 1426(d)(3) and subsequently reclassified as IRC sec. 3121(d)(3) when the IRC of 1954 was adopted.

Here, A sells life insurance full-time. Since IRC section 3121(d)(3)(B) specifically defines full-time life insurance agents as employees, A is an employee under FICA.

In the present case, the right to the payments is described in A's remuneration agreement with X and the agreement provides for the distribution of the payments as is required by Treas. Reg. section 31.3121(v)(2)-1(b)(2)(i).

Next, these payments must be examined under IRC section 3121(v)(2)(C) to determine whether A has a binding right to the payments, and whether these rights vest in a year prior to the year of payment. In this situation the details of the calculation of the payments provide for contingencies that may impact the amount of the payment from year to year. For instance, if the policyholder dies or cancels his policy during the year directly following the agent's retirement, X is not obligated to make the related payments. However, these contingencies do not affect A's right to payment under the agreement with X. These contingencies are due to the operation of the plan and would not be considered unilateral reductions or eliminations. As such, A has a binding right to receive such payments.

As described in Treas. Reg. section 31.3121(v)(2)-1(b)(3), this income must not be actually or constructively received in the current year and must be payable in a future year. Here, the right to the payment is binding at the time of A's signing of the employment agreement with X and it is a right to income that has not been actually or constructively received as it is payable upon completion in a future year.

Furthermore, under R&TC section 17952.5 the payments must be substantially equal periodic payments (paid no less often than annually) paid for at least ten years or the life or life expectancy of the recipient or beneficiary. Payments in Situation 1 are substantially equal and since they may be paid on either a monthly or annual basis, they also fulfill the periodic payment requirement. If A opts to receive payment over a period of five years and not at least ten years as required under R&TC section 17952.5, the payments do not fit the definition of "qualified retirement income" and thus are not excludable from gross income and are subject to withholding. However, if A opts to receive the payments for at least ten years or the life or life expectancy of the recipient, the payments fit the requirements of R&TC section 17952.5 and are excludable from gross income of a nonresident and not subject to withholding under R&TC section 18662.

Situation 2: As discussed above, the first consideration is whether B is an employee under FICA. Here, B sells life insurance as well as fire and casualty insurance. Under IRC section 3121(d), only full-time life insurance agents are specifically designated as employees.

Because B only sells life insurance part time, he does not fit this definition and is not considered an employee for purposes of IRC section 3121(v)(2)(C). As such, the payments made to B do not fit the requirements of R&TC sections 17952.5 and are not excludable from gross income under that statute and are subject to withholding under R&TC section 18662.

Situation 3: As previously discussed, a full-time life insurance agent is considered an employee under FICA. C may elect to defer a portion of C's current remuneration to a later year, and receive either periodic payments or a lump sum payment. Under these facts, it appears that Z's plan fits the binding right requirement of IRC section 3121(v)(2)(C). Should C choose to

receive this income in the form of periodic payments no less often than annually over a period of at least 10 years or C's life or life expectancy (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient), this plan would fulfill the requirement for substantially equal periodic payments under R&TC section 17952.5. However, the lump sum payment plan or any plan that would distribute the funds over fewer than 10 years would not satisfy the requirement for periodic payments.

With an exception for lump sum payments and a payment plan with distributions over fewer than 10 years, this plan fulfills the definition of non-qualified deferred remuneration as defined in R&TC section 17952.5, and thus the income is excludable from C's California gross income and not subject to withholding under R&TC section 18662.

HOLDINGS

Situation 1(a): Payments made to a full-time life insurance agent as remuneration for personal services rendered in California which are distributed over a period of less than ten years are not excluded from California gross income of a nonresident and subject to withholding under R&TC section 18662.

Situation 1(b): Payments made to a full-time life insurance agent as remuneration for personal services rendered in California which are distributed over a period of ten years or more are excluded from California gross income of a nonresident and not subject to withholding under R&TC section 18662.

Situation 2: Payments made to an insurance agent, who is not a full time life insurance salesman, as remuneration for personal services rendered in California are not excluded from California gross income of a nonresident and subject to withholding under R&TC section 18662.

Situation 3: Payments, with an exception for lump sum payments and plans distributed over fewer than 10 years, are excluded from California gross income of a nonresident and not subject to withholding under R&TC section 18662.

DRAFTING INFORMATION

The principal author of this ruling is Maria Brosterhous of the Franchise Tax Board Legal Division. For further information regarding this ruling, contact Ms. Brosterhous at the Franchise Tax Board Legal Division, P.O. Box 1720, Rancho Cordova, California 95741-1720.