Cite as Det. No. 14-0224, 34 WTD 340 (2015)

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. 14-0224
. . .	)	Registration No. . . .
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[1] RULE 111: ADVANCES AND REIMBURSEMENTS – FUNDS RECEIVED FOR ADVERTISING CAMPAIGNS. A franchisor may not exclude from taxable gross income the funds it receives from franchisees for providing adverting services.

[2] RCW 82.04.2907: B&O TAX – ADVERTING FEES. The funds a franchisor receives from a franchisor for providing advertising services are taxable under the service and other activities B&O tax classification.

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.

Lewis, A.L.J. – Taxpayers protest the service and other activities business and occupation ("B&O") tax assessed on amounts collected from franchisees for local and national advertising. We conclude that the amounts are received for providing advertising services, and are not excludable from tax under WAC 458-20-111 ("Rule 111"). Taxpayer's petition is denied.[1]

ISSUES:

1. Are advertising fees Taxpayers received from franchisees to conduct national and local advertising campaigns "gross income of the business" as defined in RCW 82.04.080 or are they excludable from the measure of B&O tax under Rule 111?

2. If the advertising fees are taxable, should they be taxed under the royalty B&O tax classification (RCW 82.04.2907) rather than the service and other activities B&O tax classification (RCW 82.04.290(2))?

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

FINDINGS OF FACT

Taxpayers are subsidiaries of a parent company. Taxpayers operate as franchisors that develop and sell franchises for family dining restaurants . . .

The franchise agreements require the franchisee to pay Taxpayers a percentage of their sales for national and local advertising. The Disclosure Statement explained that the franchisee will pay Taxpayers an Advertising Expenditure Fee which will not exceed 3% of the franchisee's total gross sales. The Advertising Expenditure Fee includes a National Advertising Fee . . . and a Local Advertising Fee . . . .

Taxpayers may spend the funds collected for national advertising for:

- advertising, public relations and promotional campaigns and materials designed to promote and enhance the value of all . . . restaurants;
- reimbursing Taxpayers for actual expenses incurred in providing administrative services with respect to the National Advertising Fund;
- the actual, general, and administrative expenses of Taxpayers' internal marketing departments incurred by Taxpayers' affiliates, which may perform the services, consultants and third party agencies and,
- providing contributions to Regional Advertising Cooperatives in an amount Taxpayers may determine at their discretion, for local advertising.

The advertising funds may be spent on various media, including television, radio, print, point of sale, outdoor banners, billboards, and online. In general, Taxpayers' marketing departments direct advertising promotions run primarily by a national advertising agency.

Taxpayers also spend funds for local advertising. The franchise disclosure statement explains that a portion of the local advertising fee may be used to fund national network media. Even if the franchisee chooses to spend its own funds on local advertising, Taxpayers' marketing departments must approve the expenditures.

The franchise disclosure statement explains that there is no advertising council composed of franchisees that advises Taxpayers on advertising policies.

The franchise disclosure statement explains that Taxpayers may develop or assist in the development of Regional Advertising Cooperatives. If established, Taxpayers are responsible for administration of the Regional Advertising Cooperatives. Under the terms of the Franchise Agreement, franchisees will not have the right to vote to form a Regional Advertising Cooperative or to determine the amount of contribution. Rather, Taxpayers will designate Regional Advertising Cooperatives, and franchisees will be required to participate in the cooperatives and contribute on an equal basis with all of the franchisees who are obligated to or who voluntarily elect to participate.

Financial statements recognize the advertising fees as revenue as the fees are earned and become receivables from the franchisees in accordance with US GAAP governing the accounting for franchise fee revenue. Similarly, in accordance with US GAAP governing advertising costs, related advertising obligations are accrued and the costs expensed at the same time the related

revenue is recognized. Thus, the Consolidated Financial Statements list ". . . Advertising" as separate line items under Franchise Revenues and Franchise Expense. Taxpayers spend the money they receive. Thus, for example, in 2010 the consolidated income statement shows ". . . Advertising" revenue as $. . . and ". . . Advertising" expense as the same amount, $. . . million.

The Department's Audit Division audited Taxpayers for the period January 1, 2009 through December 31, 2012. [Taxpayer A] was the only active company registered with the Department of Revenue during the audit period. [Taxpayer A] reported all the equipment lease revenue to the Department, although the income belonged to the other two taxpayers, [Taxpayer B] and [Taxpayer C]. Taxpayers did not report advertising franchise fees during the audit period. The Audit Division assessed tax on the entity that received the fees. [Taxpayer C] began recording advertising franchise fees in its books and records during 2010.

On June 26, 2013, the Department issued an assessment for each entity. The Audit Division assessed service and other activities B&O tax on unreported amounts collected from franchisees for advertising. The audits apportioned the advertising amounts to Washington using the cost apportionment formula in WAC 458-20-194 for periods through May 2010 and the single factor receipts formula as described in WAC 458-20-19402 for periods beginning June 2010.

Taxpayers disagreed with the assessment of service and other activities B&O tax on advertising fees received from franchisees.[2] On July 25, 2013, Taxpayers filed petitions requesting correction of the assessments. Taxpayers argued that the advertising fees were exempt "pass-throughs." Taxpayers maintained they had a principal-agent relationship with the franchisees.

In the alternative, Taxpayers argued that, if taxable, advertising fees should be taxed under the Royalties' B&O tax classification as the funds are received for the use of intangible property to promote and enhance the value image and brand image of all restaurants.

ANALYSIS:

The B&O tax is imposed on every person "for the act or privilege of engaging in business activities" and applies to the "gross income of the business." RCW 82.04.220. The "legislature intended to impose the business and occupation tax upon virtually all business activities carried on within the state." *Simpson Inv. Co. v. Dep't of Revenue*, 141 Wn.2d 139, 149, 3 P.3d 741 (2000).

As a result, unless an exemption or deduction applies, a taxpayer owes B&O tax on all income received for the rendition of services. Under RCW 82.04.080, "gross income of the business" means:

> [T]he 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

[2] Taxpayer did not disagree with the apportionment methodology.

> 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.

WAC 458-20-111 ("Rule 111") allows a taxpayer to exclude from gross income "advances" or "reimbursements" that merely "pass through" a business when the taxpayer acts solely as an agent for a client to pay the money to a third party. An exclusion from taxable income is allowed because such income is not attributed to the business activities of the agent. *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2003). The Rule 111 exclusion from taxation is very limited. Rule 111 imposes very specific conditions for taxpayers to qualify:

> 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 therefor, either primarily or secondarily, other than as agent for the customer or client.
> . . . .
> The foregoing [exclusion] 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.
> . . .
>
> On the other hand, no charge which represents an advance payment on the . . . cost of doing or obtaining business, even though such charge is made as a separate item, will be construed as an advance or reimbursement. Money so received constitutes a part of . . . gross income of the business,

Washington's Supreme Court set out the requirements for exclusion under Rule 111 in its decision in *Washington Imaging Services, LLC v. Dep't of Revenue,* 171 Wn.2d 548, 252 P.3d 885 (2011). The Court wrote:

> [F]or the rule to apply, three conditions must be met: "(1) the payments are 'customary reimbursement for advances made to procure a service for the client'; (2) the payments 'involve services that the taxpayer did not or could not render'; and (3) the taxpayer 'is not liable for paying the [third party] except as the agent of the client.'" To satisfy the third condition, a true agency relationship between the client or customer and the taxpayer is required. "The existence of that agency relationship is not controlled by how the parties described themselves" and "standard agency definitions should be used in analyzing the existence of the agency relationship."

171 Wn.2d at 561-62 (citations omitted).

The first requirement to qualify for the Rule 111 exclusion is that "the payments are 'customary reimbursement for advances made to procure a service for the client." There are few limitations to the advertising franchise fees that franchisees pay Taxpayers. Taxpayers' marketing

departments direct advertising programs. Taxpayers treat the advertising franchise fee revenues as income and direct how the money will be spent. The franchise fees received are not reimbursements for advances made to procure services for the franchisees. Thus, we conclude that Taxpayers do not fulfill the first requirement.

The second requirement to qualify for the Rule 111 exclusion is that "the payments 'involve services that the taxpayer did not or could not render." [Taxpayers are obligated to provide advertising. The actual cost of the media is a cost of procuring the advertising.] *See Washington Imaging*, 171 Wn.2d at 558 (taxpayer's use of independent contractors to fulfill its obligations to client does not allow taxpayer to exclude payments to contractors from B&O tax). Taxpayers are receiving funds to operate its marketing department. . . . We conclude that Taxpayers do not fulfill the second requirement.

The third requirement to qualify for the Rule 111 exclusion is that "the taxpayer 'is not liable for paying the [third party] except as the agent of the client." The third requirement has two components: a taxpayer must [establish] the agency relationship with its client and also establish that its liability to pay the providers constitutes solely agent liability. An agency relationship "generally arises when two parties consent that one shall act under the control of the other." *Rho Co. v. Dep't of Revenue*, 113 Wn.2d 561, 782 P.2d 986 (1989). A taxpayer has the burden of establishing an agency relationship. *William Rogers Co*., 148 Wn.2d at 177-78,.

The facts in this case do not indicate an agency relationship. Franchisees are required to pay Taxpayers an advertising franchisee fee, which the Taxpayers have control over to spend in a manner that they decide will promote and enhance the value of all [of the] restaurants. The franchise disclosure statement does not indicate an agency relationship and there appears to be little if any advisement, let alone control, by the franchisees as to how the advertising franchisee fees will be spent. Accordingly, we conclude Taxpayers were not acting as agents of the franchisees and do not need to address the liability of the Taxpayers to advertisers.

Thus, we conclude that Taxpayers have not met the requirements of Rule 111. We deny Taxpayers' petitions. Taxpayers may not exclude from the measure of their B&O tax liability the advertising franchise fee payments they receive from their franchisees under Rule 111.

In the alternative, Taxpayers argued that, if taxable, the advertising franchise fees should be taxed under the royalty B&O tax classification and not the service and other B&O tax classification.

Washington imposes a B&O tax "for the act or privilege of engaging in business" in this state. RCW 82.04.220(1). The B&O tax measure is "the application of rates against value of products, gross proceeds of sales, or gross income of the business, as the case may be." The rate used is determined by the type of activity in which a taxpayer engages.

RCW 82.04.2907 imposes the royalty B&O tax classification stating:

> (1) Upon every person engaging within this state in the business of receiving income from royalties, the amount of tax with respect to the business is equal to the gross income from royalties multiplied by the rate of 0.484 percent.

> (2) For the purposes of this section, "gross income from royalties" means compensation for the use of intangible property, including charges in the nature of royalties, regardless of where the intangible property will be used. For purposes of this subsection, "intangible property" includes copyrights, patents, licenses, franchises, trademarks, trade names, and similar items. "Gross income from royalties" does not include compensation for any natural resource, the licensing of prewritten computer software to the end user, or the licensing of digital goods, digital codes, or digital automated services to the end user as defined in RCW 82.04.190(11).

In order for gross income to qualify as income from royalties, the income must be received for "the use of intangible property." RCW 82.04.2907 also makes clear that the "intangible property" at issue must be similar to copyrights, patents, licenses, franchises, trademarks, and trade names, in order to qualify. A taxpayer has the burden of showing its entitlement to a particular B&O tax rate. *See* Det. No. 89-3, 7 WTD 105, 114 (1989); Det. No. 91-110, 11 WTD 163 (1991) ("The burden is therefore upon the taxpayer to provide acceptable documentation to substantiate the sought tax classification for the income in question").

Here, while the amounts at question are described as a fee and are payment by a franchisee to a franchisor, the money is paid for advertising, not for the use of the tradename or trademark. Accordingly, we conclude that the royalty B&O tax classification does not apply to Taxpayers' advertising franchise fees.

The franchise fees that Taxpayers receive were correctly taxed under the Service & Other Activities B&O tax classification at the rate specified in RCW 82.04.290(2), which serves as a catch-all classification. If there is no specific statutory classification applicable to a business activity the default classification is Service and Other Activities B&O tax classification.

DECISION AND DISPOSITION:

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Taxpayers' petitions are denied.

Dated this 15th day of July 2014.