Cite as Det. No. 13-0334, 33 WTD 414 (2014)

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. 13-0334 Registration No. . . .

[1] RULE 111: BUSINESS AND OCCUPATION TAX – ADVANCES AND REIMBURSEMENTS – COOPERATIVE ADVERTISING – SALES PROMOTION FEE REVENUE. The cooperative advertising exclusion test is derived from the authority of WAC 458-20-111 (Rule 111) and requires an agreement between a licensor and licensee that (1) the subject funds may only be used for advertising and sales promotion, (2) the subject advertising mention the trade name of products, and (3) the payer require proof of actual advertising cost. In this case, the taxpayer was not required to spend sales promotion funds on advertising and was not required to actually show proof of advertising or the cost of the advertising to its licensees. Further, the taxpayer does not hold the sales promotion fees in trust for licensees and does not use the sales promotion program fees it collects from licensees to pay for the licensees' advertising. Taxpayer is not acting as a conduit or an agent of licensees, does not meet the requirements of Rule 111, and, therefore, fails to meet the cooperative advertising exclusion test.

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.

Weaver, A.L.J. – Taxpayer appeals the assessment of service Business and Occupation (B&O) tax on receipts from member licensees to cover local and national advertising expenses, contending that the receipts are [excludable] reimbursements for cooperative advertising expenses as described . . . . Taxpayer's petition is denied.[1]

ISSUE

Whether sales promotion program fee revenues are excluded under WAC 458-20-111 as advances for cooperative advertising. . . .

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

FINDINGS OF FACT

Taxpayer, . . . , is the franchisor of [food]. . . franchises across the United States. Taxpayer is headquartered [out of state] with numerous franchise agreements in the state of Washington. Taxpayer's business activities in question include the collection of fees from the franchise owners ("Franchisees") in Washington. As part of the franchise agreement, Franchisees pay Taxpayer a monthly license fee equal to six percent of gross sales, from which Taxpayer pays the business and occupation ("B&O") tax on the gross proceeds.

Additionally, Franchisees pay Taxpayer between four and seven percent of gross sales as a sales promotion program fee. These "sales promotion fees" are the fees at issue in this appeal. The first seven percent of the [total] "sales promotion fees" collected from Licensees are used by Taxpayer to pay its own administrative expenses. Taxpayer paid B&O tax on the amount of the sales promotion fees it uses to pay its own administrative expenses.

[After paying its own administrative expenses, Taxpayer uses the] . . . remaining sales promotion fees [on] . . . regional and national advertising [.] Approximately 50 percent [of the remaining sales promotion fees] is used for marketing in the local regions, 43 percent is used for national advertising, and seven percent is used for local store advertising. Taxpayer has not paid B&O tax on the sales promotion program fees paid to third-party advertisers (approximately 93% of the ad fund fees Taxpayer collected from its Licensees). Taxpayer takes the position that the portion of the "sales promotion program" it paid to third-party advertisers are not subject to the B&O tax.

The Operating Agreement between Taxpayer and Licensees states that: "the [sales promotion program] fees are not held by Company in trust and become the property of Company to be spent in accordance with Paragraph 8 of this agreement." *See* Operating Agreement, p. 17, ¶ 9(C).[2] Paragraph 8 of the Operating Agreement reads, as follows:

> Licensee acknowledges and agrees that Company has had in the past, and has in the future, the right to determine how such sales promotion program fees will be spent including the selection of promotional materials and activities, and that Company and its affiliates have no fiduciary obligation to . . . [trade names omitted] . . . licensees with respect to the sales promotion activities or expenditures of sales promotion program fees; provided, however, that Company shall make a good faith effort to expend such fees in the general best interest of the . . . [trade name omitted] . . . system (or one or more of its brands or components). Licensee acknowledges and agrees that Company has the right to compensate itself and/or its affiliates for the expense of administering and promoting such sales promotion activities . . . Company shall annually advise Licensee of the receipts and expenditures of the fees collected in respect to said sales promotion activities. Company is not required to audit the sales promotion receipts and expenditures or any portion thereof.

[2] A representative copy of the Operating Agreements between Taxpayer and Licensees was provided by Taxpayer's counsel at the appeals hearing. The sample copy was dated June 17, 2004, and was signed by representatives of one particular Licensee and by Taxpayer's Vice President.

Id. at p. 15, ¶ 8(A) (emphasis and listed omissions added).

Taxpayer was audited by the Audit Division of the Department of Revenue ("Department") for the period of January 01, 2007, through March 31, 2011. On March 14, 2011, the Audit Division issued an Assessment totaling $. . . , which consists of $. . . in wholesaling B&O tax, $. . . in service and other activities B&O tax, $. . . in litter tax, a delinquency penalty of $. . . , $. . . in interest, and a 5% assessment penalty of $. . . . Taxpayer disagrees with this assessment and timely appealed Audit's findings.

ANALYSIS

The B&O tax is imposed for the act or privilege of engaging in business activities in this state. RCW 82.04.220. Service activities are taxable at a rate of 1.5% times the gross income of the business. RCW 82.04.290(2). "Gross income of the business" is defined in RCW 82.04.080 as:

> [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, … fees, … 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.

RCW 82.04.080(1).

Under WAC 458-20-111 ("Rule 111"), a taxpayer may exclude [certain] receipts from the calculation of gross income. Specifically, taxpayers may exclude advances and reimbursements received from a customer or client when the taxpayer holds the money or credit to make a payment on behalf of the customer or client. Rule 111. If the taxpayer making the payment has no personal liability, primarily or secondarily, to the recipient of the funds, then the advance or reimbursement is [not included in taxable gross income]. *Id*. [The concept is that amounts provided to a business solely in its capacity as an agent for a client cannot be attributed to the business activities of the agent and therefore are not taxable. *Washington Imaging Services, LLC v. Dep't of Revenue*, 171 Wn.2d 548, 560, 252 P.3d 885 (2011); *City of Tacoma v. William Rogers Co.*, 148 Wn.2d 169, 175, 60 P.3d 79 (2003).]

Taxpayer contends the advertising receipts are excludible from gross income as cooperative advertising. [The Department has recognized a limited] exclusion for cooperative advertising [in contexts involving manufacturers and retailers. The exclusion is based on Rule 111], and was most recently described in Det. No. 98-172E, 18 WTD 387 (1999), which explains, in part:

> . . .

> COOPERATIVE ADVERTISING ALLOWANCES
>
> Cooperative advertising allowances are not subject to tax under the "Service and Other Activities" classification, provided such amounts are received by the automobile dealer in trust for the manufacturer or distributor. There must be a specific agreement between the car dealer and the one making the allowance that:
> 1) The credits or allowances must be expended for advertising or sales promotion only; and
> 2) The advertising must mention the name of the manufacturer or the trade name of the products; and
> 3) As a condition for payment, the manufacturer must require proof of actual advertising and its cost.
>
> . . .
>
> The underlying basis for the exclusion is that the retailer is a mere conduit. Id. at 314. The funds earmarked for advertising are paid to advertisers. The retailer retains nothing. The three requirements specified in the Automobile Dealers' Tax Manual assure the retailer's role remains as a conduit only.
>
> . . .
>
> Cooperative advertising receipts are excludible because the retailer acts as a conduit, committing to spend the money for advertising or sales promotion only. Without such an agreement, the funds accrue or proceed to the taxpayer until the taxpayer directs their expenditure. The taxpayer is not acting as a conduit, but a reseller of services.

See 18 WTD 387 [(citing Det. No. 89-493, 8 WTD 309 (1989), and earlier Automobile Dealers' Tax Manual)].

In the present case, the funds received do not meet the standards of Rule 111 and . . . fail to meet the [cooperative] advertising exclusion, because Taxpayer is not acting solely as an agent on behalf of the Licensees. The sales promotion program fees paid to the Taxpayer from the Licensees become Taxpayer's property, and Taxpayer then uses those funds to pay third party advertisers on its own behalf. Additionally, the funds received by Taxpayer do not meet the criteria of cooperative advertising allowances described [above]. The cooperative advertising exclusion applies only to income received by retailers. In this case, Taxpayer is not a [retailer]. It is a franchisor receiving funds from its [Licensees].

While the cooperative advertising test is derived from the authority of Rule 111, it specifically requires [an agreement between the parties that]: (1) revenues may only be used for advertising and sales promotion, (2) the advertising must mention the trade name of products, and (3) the payer must require proof of actual advertising and cost . . . . Taxpayer does not meet these criteria.

First, Taxpayer represents that the funds are only spent for advertising purposes minus the administrative fee. However, the Operating Agreement does not require Taxpayer to spend the funds on advertising. Indeed, the Operating Agreement states Taxpayer has "the right to determine how such sales promotion program fees will be spent." Operating Agreement, p. 15, ¶ 8(A). Therefore, [the Operating Agreement does not reflect that the payments are excludable as cooperative advertising allowances]. [The payments may] satisfy the second criterion [for a] cooperative advertising [allowance], because [the Taxpayer] mentions the correct trade names in its advertising. However, [the Operating Agreement] fails to meet the third cooperative advertising criterion, because Taxpayer is only required . . . to advise licensees regarding receipts and expenditures of the fees collected, but Taxpayer is not required to actually show proof of advertising or the cost of that advertising to Licensees.

Finally, the Taxpayer [does not hold the funds "in trust" for Licensees and] is not acting merely as a "conduit," paying advertisers on behalf of Licensees. . . . Taxpayer does not use the sales promotion program fees it collects from Licensees to pay for Licensees' advertising. Taxpayer uses the fees to fund Taxpayer's own national advertising. and Taxpayer completely controls the use of those funds. The Operating Agreement makes it clear that the sales promotion fees are income to Taxpayer that Taxpayer can use for any purpose upon receipt. Operating Agreement, p. 15, ¶ 8(A). The fact that Taxpayer may use the sales promotion program fees collected from its Licensees to pay third-party advertisers does not sustain a finding that Taxpayer is acting as a conduit [or agent] on behalf of Licensees.

For all the reasons stated above, the sales promotion program fees in this case do not qualify as excludable cooperative advertising allowances and are gross income to Taxpayer under RCW 82.04.080. Accordingly, we deny the taxpayer's petition.

DECISION AND DISPOSITION

The taxpayer's petition is denied.

Dated this 7th day of November 2013.