Excise Tax Advisory

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Taxability of Cooperative Advertising Receipts

Purpose

This Excise Tax Advisory (ETA) explains when an amount received as a reimbursement for cooperative advertising expenses is not gross income for business and occupation (B&O) tax purposes.[1]

What is cooperative advertising?

Cooperative advertising is the sharing of advertising costs between businesses with common business interests. Typically, under a cooperative advertising arrangement, a business that has products to promote (Business B) will pay another business (Business A) for a share of the advertising expenses that Business A incurs from promoting the products.

For example, automobile dealers often receive payments for advertising from an automobile manufacturer. In another case, a fast food franchisee may make payments to the franchisor company for the franchisee's share of national advertising costs.

Taxability of cooperative advertising receipts, generally

In general, amounts received by a business as a reimbursement for its cooperative advertising expenses represent gross income to the business subject to the service and other activities B&O tax. RCW 82.04.080(1) defines "gross income of the business" as the value proceeding or accruing from the business engaged in. It includes gross proceeds of sales and compensation for services. No deductions are allowed for the cost of property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense or loss.

[1] An amount treated as a reimbursement under WAC 458-20-111 must be reported as a deduction on the excise tax return and therefore, such an amount is referred to as an amount that may be deducted from gross income throughout this ETA.

However, WAC 458-20-111 (Rule 111) provides that the definition of "gross income" does not include "advances" or "reimbursements" that a business receives when the business receives those payments solely as an agent for a third party. Rule 111 recognizes exclusions from taxable income for these receipts because these amounts are not income attributable to the business activities of the agent, but to those of the principal. The following section addresses the requirements that must be satisfied for a business to deduct these receipts from its gross income under Rule 111.

Amounts that may be deducted from gross income: Requirements of Rule 111

A business entity ("Business A") may deduct from its taxable gross income amounts received as cooperative advertising reimbursements from a different business entity ("Business B") if **all** of the following requirements of Rule 111 are satisfied:[2]

(1) Business A must pay the obligations of Business B to another party;
(2) Business A cannot render or have liability for providing the services; and
(3) Business A must act as an agent of Business B and cannot have any liability, except as agent.

What if all the requirements of Rule 111 are not met?

A business that does not satisfy all of the requirements of Rule 111 must include all cooperative advertising amounts received from the other business in its gross income.

Requirement 1: Business A must pay the obligations of Business B

Amounts received by Business A (the taxpayer) as cooperative advertising payments from Business B may be deducted from Business A's gross income only if the amounts received are used to fulfill payment obligations that Business B has to a third party (advertising firm). In other words, Business B must have an obligation to pay the advertising firm.

Example 1. Franchisor (Business A)/Franchisee (Business B)

Facts:

- MegaShop (Business A) is a national corporation that is the franchisor.
- KwikMart (Business B) is a local convenience store that is a franchisee of MegaShop.
- A contract between Mega Shop and KwikMart requires KwikMart to spend $1,000 annually on advertising. The agreement states that MegaShop will procure the advertising for KwikMart and facilitate payment of the advertising expenses.
- Under a separate agreement, KwikMart purchases advertising services from an advertising firm. In this agreement, KwikMart designates MegaShop as

[2] *Washington Imagining Services, LLC v. Dep't of Revenue*, 171 Wn. 2d 548 (2011) is the Supreme Court's most recent decision discussing and reaffirming the application of RCW 82.04.080(1) and Rule 111 and the requirements thereunder.

the party that will facilitate payment to the advertising firm of KwikMart's advertising expenses. Under the contract, KwikMart has an obligation to pay the advertising firm.
- MegaShop pays the advertising firm $1,000 for advertising on behalf of KwikMart. KwikMart then reimburses MegaShop $1,000 for the advertising costs.

Result:

- The first requirement is met because KwikMart has an obligation to pay the advertising firm. Mega Shop may deduct from gross income the amounts it received as reimbursements from KiwiMart, assuming the other requirements are also met.

Example 2. Manufacturer (Business A)/Retail Outlet (Business B).

Facts:

- SportsCo (Business A) is a national manufacturer of shoes.
- Fast Feet Store (Business B) is a local retail outlet selling running shoes.
- A contract between Fast Feet Store and SportsCo requires Fast Feet Store to pay $1,000 annually in cooperative advertising payments to SportsCo.
- SportsCo pays $1,000 to an advertising firm for advertising services.
- No agreement exists between Fast Feet Store and the advertising firm.
- Fast Feet Store may not be aware of which advertising firm is used for the ads.

Result:

- Fast Feet Store has no obligation to pay the advertising firm.
- SportCo's payment to the advertising firm is discharging its own obligations, not the obligations of Fast Feet Store.
- The first requirement that SportsCo pay the obligations of Fast Feet Store is not met. Therefore, SportsCo is not entitled to deduct the $1,000 it receives from Fast Feet Store as cooperative advertising payments from its gross income.

Requirement 2: Business A cannot render or have liability for the services

Under this requirement, Business A cannot render the advertising services. Additionally, Business A cannot have any liability for providing the advertising services to Business B or for the quality of such services or goods.

For example, in establishing that Business A does not render or have any liability for providing the advertising services, Business A cannot have control over the quality or content of the advertising services.

Example 3. Franchisor (Business A)/Franchisee (Business B)

Facts:

- Meaty Corp (Business A) is a Franchisor.
- Tasty Burger (Business B) is a Franchisee.
- Meaty Corp is a large corporation with an internal advertising division.
- Under the terms of a franchise agreement between Tasty Burger and Meaty Corp, Meaty Corp charges Tasty Burger an annual $1,000 fee for advertising services.

Results:

- Under these facts, the second requirement of Rule 111 is *not* met because Meaty Corp renders the advertising services. Under the agreement, Meaty Corp sells advertising services and is contractually obligated to provide them to Tasty Burger.
- The existence of the advertising division creates a presumption that Meaty Corp is providing the services. However, this conclusion is the same whether Meaty Corp renders the advertising services itself (via its own advertising division) or hires a third-party advertising firm to render the services.

Example 4. Manufacturer (Business A)/Manufacturer (Business B). Two manufacturers share advertising expenses for one product.

Facts:

- Computer Co. (Business A) is a manufacturer of computers.
- SpeedPro (Business B) is a manufacturer of processors used in Computer Co.'s computers.
- Computer Co. has a contract with SpeedPro to advertise SpeedPro's logo when it advertises computers that are manufactured with SpeedPro's processor.
- Under the terms of the agreement, SpeedPro agrees to pay Computer Co. $100,000 annually for its share of the advertising costs of the joint advertising campaign.
- Computer Co. is required to use the funds to develop and arrange advertising for the computers that use a SpeedPro processor.

Results:

- Under these facts, the second requirement of Rule 111 is *not* met because Computer Co. is contractually obligated to provide the advertising services to SpeedPro.
- This conclusion is the same whether Computer Co. renders the advertising services itself through an internal advertising division or it hires a third

party advertising firm because Computer Co. is selling the service of providing advertising to SpeedPro.

Example 5. Franchisor (Business A)/Franchisee (Business B)

Facts:

- TaxPrep Inc. (Business A) is a franchisor of tax preparation services.
- EZ Taxes (Business B) is a local franchisee of TaxPrep Inc.
- In order to obtain access to lower-priced advertising services for its franchisees, TaxPrep Inc. enters a contract with an advertising firm for local ads for all of its franchisees at a reduced rate.
- EZ Taxes also signs the contract with the advertising firm and agrees to pay the advertising firm for EZ Taxes' share of the local advertising fees. However, EZ Taxes could have opted to use the ad services of a different firm than the firm selected by TaxPrep Inc.
- The contract between EZ Taxes and the ad firm provides that EZ Taxes retains authority to determine the ad content and messaging in its respective local market.
- In a separate contract between TaxPrep Inc. and EZ Taxes, TaxPrep Inc. collects $1,000 annually from each franchisee as a payment for the franchisee's respective share of the local advertising expenses. TaxPrep Inc. then pays the ad firm for all of the local advertising.

Results:

- Tax Prep Inc. has no control over the advertising services in respect to determining which advertising firm is used or the content and messaging of the local ads.
- Because Tax Prep Inc. does not provide or have any obligation to provide the ad services, and because Tax Prep Inc. has no control over the quality and content of the ads, the second requirement of Rule 111 is met. Tax Prep Inc. may deduct from gross income the amounts received as reimbursements from its franchisees for the local advertising fees, assuming the other requirements are also met.

Requirement 3: Business A must act as an agent of Business B and cannot have any liability, except as agent.

Under this requirement, Business A (the taxpayer) must be an agent of Business B *and* have no liability to pay Business B's expenses, except as the agent.

Business A (the taxpayer) has the burden to establish that an agency relationship exists. The existence of an agency relationship is not governed by how the parties describe themselves. An agency relationship generally exists when two parties agree that one will act under the *control* of the other. If Business A has direction

and control over how the services are provided, an agency relationship does not exist.

Further, Business A's liability must match its role as agent. That is, Business A's liability to make the payment to the advertising firm must be limited to "solely agent liability." Business A cannot have liability, with respect to the amounts it is attempting to deduct, to the advertising firm in its own right (i.e. to pay its own obligations).

Example 6. Franchisor (Business A)/Franchisee (Business B)

Facts:

- Global Gems (Business A) is a worldwide jewelry company franchisor.
- Polished Joy (Business B) is a local jewelry retail store and franchisee.
- Global Gems selects and contracts with an advertising firm to provide advertising services for its global franchise. Global Gems selects the type of advertising and has approval of all materials that are used in the advertising.
- Polished Joy does not have input into the type of advertising services that the advertising firm provides, is not a party to the contract between Global Gems and the advertising firm, and may not know which advertising firm provides the services.
- Global Gems bills Polished Joy $1,000 per year for Polished Joy's share of the global advertising expenses.

Results:

- Under these facts, Global Gems is not acting on behalf of Polished Joy as an agent. Polished Joy does not have direction or control over Global Gems because Polished Joy has no control over the choice of the advertising firm, the amount Global Gems pays the firm, or the type of advertising services.
- Polished Joy agreed to pay Global Gems, not the advertising firm. Global Gems is not acting solely as agent for Polished Joy because Global Gems has a liability to the advertising firm other than as Polished Joy's agent. First, Global Gems is making payment to fulfill its own obligation to provide an advertising campaign for its global franchise, which includes Polished Joy. Second, Global Gems is liable to the advertising firm for payment regardless of whether Polished Joy makes payment. For example, if Polished Joy failed to make any payments for its share of the global advertising, Global Gems would still be liable to the advertising firm for the full amount of the advertising.
- Therefore, Global Gem is not an agent of Polished Joy and Global Gem's obligations to pay the advertising firm are not solely agent liability. Instead, Global Gem's payments are its own costs of doing business.

- The third requirement is *not* met and Global Gems cannot deduct the cooperative advertising reimbursements received from Polished Joy from its gross income.

Example 7. Automobile dealer (Business A)/Automobile manufacturer (Business B)

Facts:

- Puget Dealership (Business A) is a local automobile dealer that sells Motown Motor's automobiles.
- Motown Motors (Business B) is an automobile manufacturer.
- Puget Dealership does not perform any advertising services itself.
- Under an agreement between Motown Motors and Puget Dealership, Puget Dealership procures local television and newspaper ads on behalf of Motown Motors. Motown Motors has the right to reject any advertising firm selected by Puget Dealership. Motown Motors determines the type and content of the advertising that will be used in the Puget Sound area, and Motown Motors must approve all invoice amounts before Puget Dealership is authorized to pay the advertising firm. All ads must be submitted to Motown Motors for approval of the ads' design and content prior to public release.
- Puget Dealership enters into a contract with the local ad agency once approved by Motown Motors. Motown Motors is a party to the contract. This agreement states that Motown Motors is responsible for payment of the advertising fees. It also states that Motown Motors has ultimate decision-making authority when it comes to the creation of the ad content.

Results:

- The third requirement is met. Puget Dealership is an agent of Motown Motors because Puget Dealership acts under the control and direction of Motown Motors when procuring local advertising. Puget Dealership has solely agent liability for payment.
- Puget Dealership may deduct the cooperative advertising payment received from Motown Motors from its gross income, assuming the other requirements are met.

Example 8. Automobile manufacturer (Business A)/Automobile dealer (Business B)

Facts:

- Motown Motors (Business A) is a national automobile manufacturer.
- Puget Dealership (Business B) is a local automobile dealer that sells Motown Motor's automobiles.

- In an agreement, Puget Dealership is required to pay Motown Motors for Puget Dealership's share of digital advertising on national websites. Motown Motors procures the advertising services for Puget Dealership and agrees to facilitate Puget Dealership's payment of the services.
- The agreement also provides that Puget Dealership has the right to approve the content of the ads in respect to information relating to its dealership. However, Motown Motors retains the right to approve the quality of all ads before the ads are released to the public.
- Puget Dealership is a party to the agreement with an advertising firm, in which Puget Dealership is solely responsible for payment of the advertising services. The invoice is sent to Motown Motors, who pays the fee.
- Motown Motors pays Puget Dealership's share of the advertising costs to the advertising firm on behalf of Puget Dealership. Puget Dealership then pays Motown Motors for its share of the advertising costs.

Result:

- Motown Motors is not acting as an agent. Motown Motors retains control over how the services are provided by having approval authority of the ads. Motown Motors also selects the advertising agency. Therefore, Motown Motors is not acting under the direction or control of Puget Dealership.
- Motown Motors has liability other than as an agent. Because Motown Motors is not acting as an agent, it cannot have solely agency liability. Even though Puget Dealership is the only party required to pay the advertising agency under the contract, Motown Motors retains control over the advertising and is therefore liable for the services or quality thereof. Thus, Motown Motors is the party entitled to the funds and the payment to the advertising agency is a cost of doing business. Motown Motors cannot deduct amounts it is entitled to receive by requiring that Puget Dealership be solely liable to the advertising agency.
- Although Motor Motors is not contractually liable to the advertising firm for payment, the third requirement is *not* met because Motown Motors is not acting as an agent of Puget Dealership and its liability is not solely that of an agent.
- Because the third requirement is not met, Motown Motors cannot deduct the advertising reimbursements received from Puget Dealership from its gross income.