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TERRITORY OF HAWAII

DEPARTMENT OF THE ATTORNEY GENERAL

HONOLULU

November 19, 1958

Honorable Earl W. Fase
Tax Commissioner
Territory of Hawaii
Honolulu, Hawaii

Attention: Mr. John A. Bell
Deputy Tax Commissioner

Dear Sir:

Your letter of September 24, 1958 presents the question whether under the practices being followed by certain radio and television stations since October 1956 the "gross income" of the station is the net after the allowance of the so-called agency discount or whether on the other hand the "gross income" of the station is the total amount determined as if there were no agency discount.

The usual charge by a radio or television station for time hereinafter is referred to as the rate card amount. When the time buyer, hereinafter referred to as the sponsor, has an advertising agent the station's cash receipts are only 85% of this rate card amount. The question is whether the 15% difference is a true trade discount, in which event the "gross income" of the station is only the 85%, or is it a commission from the station to the advertising agency in which event it is one of the station's cost of doing business, is not deductible from the "gross income", and the gross, income is the 100% rate card amount.

This question, under the facts as they were before the above referred to practices initiated in October 1956, was considered by us on August 11, 1950. At that time we advised you that the 15% amount was a commission and was a nondeductible expense. This has been our position ever since and still is, unless, under the practices initiated by certain stations in October 1956, the 15% is being allowed by these stations as a true trade discount.

In connection with a recent audit you have been confronted with the question as to the effect of these practices on the position previously taken by the Attorney General and the Tax Commissioner. We have concluded that the 15% presently is being allowed

by these stations as a true trade discount.

While our letter of August 11, 1950 did not go into all the facts involved, it is advisable to do so at this time.

As a result of the litigation in the United States District Court for the Southern District of New York, Civil No. 100-309, United States v. American Association of Advertising Agencies et al., there has been considerable discussion in trade journals as to the nature of an advertising agency. The matter also is discussed in textbooks on advertising and in a number of cases. There seems to be general agreement that prior to 1917 the advertising agents were salesmen employed by the media. Gradually the services of these agencies to advertisers increased and they came to be regarded as agents of the advertisers. We are satisfied that the relationship between an advertising agency and a client is a fiduciary relationship and that the advertising agency is a true agent working in the interest of the advertiser and under his continued control.

This being the case the next question is who pays the agent for his services.

There of course are many situations in which an agent is paid by a seller for his services. The typical case is that in which the agent is the agent of the seller, or the agent for both the seller and buyer, and is paid by the seller for his services. That the advertising agent is the agent of the media as well as the client is stated in Carpenter v. People, 148 P.2d 371 (Colo. 1944).

Assuming for purposes of discussion that an advertising agent is wholly the agent of the buyer, this does not necessarily mean that the agent is paid by the buyer. Although the Robinson-Patman Act prohibits the payment by the seller of the buyer's agent, this statute is limited to goods, wares or merchandise in interstate commerce (15 U.S.C. Sec. 13(c)), and in respect of services there are many instances in which the seller does pay such a commission. Usually the question of who pays the agent does not even arise. The agent is not responsible for the seller's charge, the buyer is. The buyer pays the seller direct and the seller in turn pays the agent his commission. Or the buyer pays the agent as agent of the seller (the agent being responsible to the seller because of this collection but not otherwise) and the agent holds out his commission remitting the balance. The method of payment in the present instance is reviewed below.

One of the practices peculiar to the advertising agency business is the "recognition system". Under this system advertising agencies must be recognized as independent agencies, not house agencies. They also must have experience, ability and financial standing. If the agency is not recognized the 15% is not allowed. However, this recognition system has been affected by the stipulated judgment in the above cited case in the United States District Court.

Another significant feature is the fixing of the agency commission by the media, not the client. For many years the standard conditions in all contracts made by the members of the American Association of Advertising Agencies provided that the agency agreed it would not rebate to the client any part of the commission allowed by the station. It is this feature which has been affected by the practices initiated in October 1956 by the radio and television stations under discussion.

These stations have deleted from their contracts the “no rebate” clause. For reasons explained below that clause had to be eliminated if a true trade discount was to be allowed. In addition to eliminating this clause these stations, in October 1956, sent out letters to advertising agencies informing them that hereafter the contracts will contain the following two paragraphs:

> “A discount is allowed to AGENCY because AGENCY performs services for the advertiser that othewise would be performed by STATION. STATION does not know or in any way control the amount paid by the advertiser to AGENCY for services rendered by AGENCY to the advertiser with respect to the programs and/or announcements covered by this agreement.
>
> “In billing the advertiser, AGENCY shall state the cost of the programs and/or announcements covered by this agreement as the net cost, and any additional amount shall be stated to be for agency services.”

Without conceding that the 15% allowance previously had not been a discount the letter expressed the intention of allowing the 15% as a discount.

The above quoted provisions have been stamped on the contract forms. In some cases, where a local advertising agency is involved, a contract form is not used but the above quoted provisions were stamped on the invoice sent to the advertising agency until the invoice form was revised.

In investigating this matter, in order to determine whether an additional assessment should be made to tax the 15% not returned for taxation, you have not found an advertising agency which has changed its billing practices. According to the position taken by the stations, the question whether the 15% is a fair amount for the agencies to receive for their services is open to discussion between the advertising agency and the client the same as any other charge for services, but the clients may not have been so informed.

The question of who is allowed the 15%--the agency or the sponsor--has been a key issue, as illustrated by an article in "Tide", June 8, 1956, vol. 30, p.19. If the net charge to the sponsor is at 85% of the rate card amount then the media have a dual rate system which previously they did not have. The rate is 100% if there is no agency but 85% if there is. On the other hand if the allowance is to the agent, not the client, the situation is comparable to that under the Internal Revenue regulations concerning the manufacturer's excise tax. These regulations provide:

> “Commissions to agents, or allowances, payments, or adjustments made to persons other than the manufacturer’s vendee are not deductible from the sale price under any conditions for purposes of computing the tax.”

We have concluded that a dual rate system has been instituted by the stations in question and that the 15% is being allowed by these stations to the sponsors, not the agencies, even though the sponsors may not have been so informed. The situation is as follows:

The practice is for the advertising agencies to contract to pay and be solely liable for payment for the advertising placed by them. Although the agent in fact may collect from the advertiser before paying the media, in any event he is solely responsible to the media for the advertising bill. If it were not for this unique situation in the advertising agency field, it would be expected that the buyer would be informed by the media of the discount allowed him. But since the agency pays all the media bills and the sponsor is not directly liable to the media for the bills, the stations have issued their explanation of their new practices to the agencies, not the sponsors. Perhaps a clearer understanding of the whole matter will result from the review being made by this letter.

These stations definitely have stated they are charging only the 85% amount and that it is the sponsors, not these stations, who are agreeing upon the 15% as the agency commission.

Another matter which requires review is the question whether the 15% is allowed only if there is an independent advertising agency. Under the recognition system a "house agency" (one controlled by advertisers) did not receive the commission. From the standpoint that this is a trade discount what would be the explanation for such a distinction? We have not been informed that these stations are making such a distinction; if it should develop that they are this would have to be considered.

Some sponsors have work which an advertising agency might do done by their own employees and in that case the 15% allowance is not made. From the standpoint that this is a trade discount, what is the explanation of this? These stations have taken the position that the writing of copy and other services rendered by advertising agencies saves the media expense to which they otherwise would be put, but on this reasoning the same allowance should be made when employees of the sponsor do the work which the media othewise would do. However, it also is pointed out that besides these services the advertising agency undertakes to hold the station harmless against liability for libel or slander resulting from the broadcasts and undertakes responsibility for the media's bill as before noted. This centralization of responsibility in the advertising agency no doubt is of benefit to the media and explains the practice of allowing the discount where an advertising agency is employed but not where employees of the sponsor write copy and lay out the advertising.

Very truly yours,

Rhoda V. Lewis

RHODA V. LEWIS
Deputy Attorney General

APPROVED:

Herbert Y.C. Choy

HERBERT Y. C. CHOY
Attorney General