STATE OF CALIFORNIA

100.0164

BOARD OF EQUALIZATION

LEGAL DIVISION, APPEALS REVIEW SECTION

In the Matter of the Petitions for Redetermination and Claims for Refund Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
S--- A---, Inc.	)	Nos. SR -- XX XXXXXX -020
	)	-030
	)	-005
Petitioner and Claimant	)	-006

The Appeals conference in the above-referenced matters was held by Senior Staff Counsel James E. Mahler on September 25, 19XX, in Van Nuys, California.

Appearing for Petitioner and Claimant (hereinafter "petitioner"):

J--- A. V---
Attorney at Law

J--- Q---
Controller

Appearing for the Sales and Use Tax Department (hereinafter "the department"):

George Ito
Supervising tax Auditor

Carol Sawa
Senior Tax Auditor

Subject of Claims and Protested Items

For the period January 1, 1981, through December 31, 1984, petitioner protests (the -020 file) and seeks a refund of (the -006 file) an unstated portion of tax measured (net reaudit adjustments) by:

Item	State, Local & County	LACT
D. Taxable charges relating to finished art and mechanical production understated based on four tests	$2,014,454	$246,300

For the period January 1, 1985, through September 30, 1988, petitioner protests (the -030 file) and seeks a refund of (the -005 file) an unstated portion of tax measured (net reaudit adjustments) by:

Item	State, Local, County & LACT
A. Creative service fees (part of finished art) claimed as preliminary art	$2,274,470
C. Ex-tax consumable purchases related to finished art	461,661
E./F. Excess tax reimbursement on preliminary art, less offset for ex-tax purchases of preliminary art supplies	-2,191,425
G. Excess tax reimbursement on sales in interstate commerce	- 539,362
	$ 5,344

Petitioner's Contentions

1. The department is bound by Mr. Adamo's Decision.

2. Since the second reaudit is based on criteria developed in part by the Assistant Chief Counsel, Appeals Review Section, there may be a conflict of interest.

3. One of petitioner's competitors was allowed exemption for preliminary art while identical exemptions claimed by petitioner were disallowed.

4. Petitioner was relying on advice issued by the Board's staff, so the claimed deductions cannot be disallowed.

5. Even if a customer issues a single purchase order for an entire job, the customer is not committed to purchase the finished art until it approves the preliminary art.

6. Charges for preliminary art prepared before the customer approves and agrees to purchase the finished art are nontaxable even if they are not billed until after the customer orders the finished art.

7. The creative service fee on invoice #3906-09-142 is not subject to tax.

Summary

Petitioner is a corporation which operates an advertising agency and commercial art studio. Most if not all of its customers are in the motion picture industry. Its principal business is creating ideas and artwork for use in advertising its customers' films, particularly in print ad campaigns (including posters as well as newspaper and magazine ads). It sometimes also designs letterheads, brochures, and similar materials.

The customer usually contacts petitioner before production of the motion picture begins. Petitioner works with the customer to develop strategies for the ad campaign, and also creates ideas and concepts for the necessary artwork. If the customer likes petitioner's ideas, petitioner prepares the finished artwork and delivers it to the customer. Petitioner does this work and bills the customer in stages, from rough sketches through layouts, comprehensives, and mechanicals (finished art). Petitioner's standard form invoice includes a statement that petitioner retains title to preliminary artwork, and that "production of finished art shall be contingent upon [petitioner's] receipt of Studio approval of the preliminary art."

At the start of the job, petitioner orally informs the customer that there will be a "creative service fee" (usually about $25,000) in addition to the charges for various production expenses. A portion of this fee (usually $10,000 or $15,000) is billed to the customer on the invoice for the first stage of the job. As the work progresses, petitioner gives the customer detailed cost estimates and requests purchase orders for each successive stage. According to petitioner, if the customer ultimately approves petitioner's work, the balance of the creative service fee is added to the final billing for finished art. If the customer does not approve petitioner's work and does not order finished art, the balance of the creative service fee is not billed.

Petitioner and a related entity (SN -- XX XXXXXX) were previously audited for March 1, 1974, through December 31, 1980. The audit found that the initial billings for creative service fees were not subject to tax, but that tax did apply to the final stage creative service fees. Petitioner protested, contending that about two-thirds of each disallowed fee was for preliminary art, and should be allowed as nontaxable, even though the remaining one-third was a charge for finished art. The Board denied the protest after an oral hearing. Petitioner requested a rehearing

and claimed a refund on the ground that the entire creative service fee was for nontaxable preliminary art, but the Board denied the request and claim because petitioner failed to submit supporting evidence. Petitioner filed suit. The suit was settled before trial for a refund of about one-fourth of the disputed amount (excluding credit interest). The undersigned was the Hearing Officer who handled the case during the Board proceedings and assisted the Attorney General in the litigation.

In the meantime, an audit for the period January 1, 1981, through December 31, 1984 (the -020 period at issue herein) also asserted tax on some creative service fees. Petitioner's protest of that audit was reviewed by Hearing Officer John B. Adamo, who found that:

> "...[B]eginning June 1, 1982, however, there was a perceptible difference in the manner in which the invoices were completed. Some included solely taxable charges for finished art, e.g., invoice #2095-08-88B, with the preliminary art billed on separate invoices. In those instances where petitioner billed the preliminary and finished art on the same invoice, we conclude that the charge for prelinminary [sic] art was sufficiently separately stated."

Mr. Adamo's Decision and Recommendation was dated March 11, 19XX, and mailed to petitioner on April 6, 1988, which was almost a year before the Board created the independent Appeals Review Unit. As required by the Board's policy at the time, the Decision and Recommendation was initialed by Senior Staff Counsel Donald J. Hennessy and approved by Mr. William D. Dunn for the Principal Tax Auditor before it was mailed to petitioner.

Mr. Adamo recommended that "claimed exempt charges for preliminary art should be allowed commencing June 1, 1982." The --- --- District prepared a reaudit in accordance with the recommendation. This reaudit showed a $962,389 reduction in the audited measure of state, local and county tax, from $2,666,416 to $1,704,027, as well as a reduction in the measure of LACT tax.

Neither petitioner nor the audit staff was happy with the reaudit. Petitioner requested a Board hearing and also asked Mr. Adamo to change his decision. Petitioner contended that the reaudit was inconsistent since tax was asserted on some invoices while other, allegedly identical invoices were found nontaxable. The audit staff also requested reconsideration, contending that the factual premise of the decision (that petitioner had revised its billing procedures as of June 1, 1982) was erroneous.

Mr. Adamo decided that another hearing should be held to discuss these issues. Before that could be done, however, the Petition Unit audit staff performed a second reaudit. This reaudit showed a substantially lower reduction in the measure of tax than had been found by the first reaudit: the $2,666,416 measure was reduced only by $651,962, to $2,014,454.

Mr. Adamo left state service before these issues could be resolved, so the case was reassigned to the undersigned.

The second reaudit was based on guidelines developed by Mr. Dunn in consultation with Mr. Hennessy. Specifically, as stated in a memo from Mr. Dunn to the --- --- District Principal Auditor dated December 1, 1989:

"1. Where the description of the fee [on the invoice] indicated only preliminary art was involved, the creative service fee was considered exempt.

"2. Where the description of the fee indicated that only finished art was involved, the creative service fee was considered taxable.

"3. In some cases, the description of the fee indicated both finished art and preliminary art were involved. If there was a separate charge for mechanical productions either on the same or a separate invoice, the creative service fee was considered exempt. If no separate charge could be found for mechanical productions, the creative service fee was considered taxable.

"4. In examining these invoices, the words comprehensives, illustrations, etc., were considered to be descriptions of preliminary art. The charges for mechanical production were considered the charges for the actual finished artwork."

Like the original audit, the second reaudit examined a block sample of invoices for four periods (February 1981, June through September 1981, the third quarter of 1982 and the third quarter of 1983). The reaudit scheduled 227 invoices for those periods, with total creative service fees of $1,174,250. Most of these fees were found nontaxable, but fees totaling $156,000 on 21 of the invoices were found taxable. (Charges for "production expenses" and similar items were also taxed, but petitioner does not dispute that aspect of the reaudit.) The audited error factors for the four sample periods were 62.81%, 30.02%, 14.33% and 5.05%, respectively, revealing a progressive and substantial improvement in petitioner's reporting practices.

Applying the audited error rates to petitioner's claimed nontaxable sales yielded an understatement of $2,014,454. Most of this amount represents the disallowance of claimed nontaxable production expenses which petitioner does not now dispute, and neither petitioner nor the staff has calculated the portion which is disputed. We estimate (very roughly) that the protested measure of creative service fees is about $590,000.

Petitioner was next audited for the period January 1, 1985, through September 30, 1988 (the -030 petition). This audit was based on a random statistical sample, and tax was assessed on some creative service fees in accordance with the guidelines outlined in Mr. Dunn's December 1, 1989 memo.

The test sample included 239 transactions totaling $1,248,336; 51 of those invoices were questioned and listed on schedule 12A-1a. (Questioned interstate sales were listed on another schedule.) Of the 51 questioned invoices, 20 contained charges for creative service fees (or sometimes "creative design fees") totaling $117,050; 14 of those invoices charging $87,050 were found taxable. Four other invoices charging $46,500 for "preliminary artwork" or "additional copy" were also found taxable and are protested. The remaining invoices found taxable in the test charged for messenger fees, supervision, and other production expenses and are apparently not protested.

The test revealed an error factor of 31.07% which, when applied to claimed nontaxable sales, yielded an understatement of $2,302,056 (later adjusted to $2,274,470). As above, only part of the understatement relates to the protested transactions, and neither petitioner nor the staff has calculated the protested amount. We believe about $1,600,000 of the measure is protested.

Analysis and Conclusions

Issue 1 According to petitioner, Board policy in effect when Mr. Adamo issued his Decision and Recommendation precluded the audit staff from taking any action inconsistent with the recommendation. Petitioner notes that the recommendation was approved on behalf of the Principal Tax Auditor before it was mailed to petitioner. Petitioner seems to believe that the recommendation became final when it was approved and could not thereafter be changed.

We know of no such Board policy. To the contrary, the policy has always been to have the staff present recommendations to the Board based on as accurate an understanding of the facts and law as possible. If a reaudit initiated pursuant to a Decision and Recommendation discovered that the recommendation was incorrect in any way, the staff was not only entitled, but indeed obligated, to bring those errors to the attention of the recommendation's author.

Here, both petitioner and the audit staff advised Mr. Adamo that they believed the reaudit performed upon his recommendation was incorrect. It was therefore entirely proper to disregard that reaudit and investigate further.

Issue 2 As petitioner notes, Mr. Hennessy assisted Mr. Dunn in developing guidelines for use in the second reaudit of the -020 matter. Over a year later, Mr. Hennessy was promoted to Assistant Chief Counsel, Appeals Review Section. Petitioner does not suggest how it might be prejudiced by these circumstances, nor does it propose any remedy. The undersigned is also unaware of any prejudice or potential prejudice.

Issue 3 Revenue and Taxation Code Section 6051 imposes sales tax on retail sales of tangible personal property. Under section 6012(b)(1) of the Code, tax applies not only to charges for the property itself, but also to any charges for "services that are a part of the sale". No deduction is allowed for "labor or service cost ... or any other expense." (Rev. & Tax. Code § 6012(a)(2).)

Subdivision (b)(4)(A) of Sales and Use Tax Regulation 1540 applies these rules to the specific context of preliminary art. During the periods in question it provided:

> "`Preliminary art' means roughs, visualizations, layouts and comprehensives, title to which does not pass to the client, but which are prepared by an advertising agency, commercial artist or designer solely for the purpose of demonstrating an idea or message for acceptance by the client before a contract is entered into or before approval is given for preparation of finished art to be furnished by the agency, commercial artist or designer to its client. Tax does not apply to separate charges for preliminary art except where the preliminary art becomes physically incorporated into the finished art, as, for example, when the finished art is made by inking directly over a pencil sketch or drawing, or the approved layout is used as camera copy for reproduction. The charge for preliminary art must be billed separately to the client, either on a separate billing or separately charged for on the billing for the finished art. It must be clearly identified on the billing as preliminary art. Proof of ordering or producing the preliminary art, prior to the date of the contract or approval for finished art, shall be evidenced by purchase orders of the buyer, or by work orders or other records of the agency, commercial artist or designer. No other proof shall be required."

Preliminary art is tangible personal property and tax therefore applies when a retailer sells it at retail. Thus, as a condition for nontaxability, the Regulation requires that the preliminary art not be sold; that is, that title not pass to the customer, and that possession of the preliminary art not be transferred to the customer by physical incorporation into the finished art.

If the preliminary art itself is not sold, its creation may be regarded as a service. Nevertheless, tax still applies if the service is part of the sale of finished art or other tangible personal property. As additional conditions for nontaxability, to show that a charge for preliminary art is not part of the sale of other property, the Regulation thus requires that the charge be separately stated; that it be clearly identified as a charge for preliminary art; and that the preliminary art was ordered by the customer before the customer contracted to purchase or approved the preparation of the finished art (the "proof of ordering requirement").

Petitioner contends that charges labeled "creative service fee" were allowed as nontaxable preliminary art in a Decision and Recommendation issued after an audit one of its competitors, B--- S--- & M--- S--- (SR -- XX XXXXXX). At petitioner's request, Mr. S--- has waived confidentiality and consented to disclosure of information in his file to petitioner.

According to the Decision and Recommendation in the S--- matter, the audit of that company found as a factual matter that all the requirements for nontaxable preliminary art had been satisfied, save one - the requirement that the charge for preliminary art be clearly identified on the billing. The only issue was whether the words "creative service fee" qualified as a clear identification of preliminary art. The Decision and Recommendation found those words acceptable and concluded that the claimed deductions should be allowed.

To the best of our knowledge, the audit staff has never disallowed petitioner's claimed preliminary art deductions for failure to meet the "clear identification" requirement. In the first audit, final stage creative fees were disallowed primarily because petitioner (at least initially) conceded that it did not meet the requirement for a separately stated charge, arguing only that the requirement should be ignored. In the second and third audits at issue here, the staff's principal contention is that petitioner did not meet the "proof of ordering" requirement. Indeed, by partly allowing petitioner's claimed preliminary art deductions in all three audit periods, the staff has conceded by implication that the words "creative service fee" do qualify as a clear identification of preliminary art.

Petitioner points out that Mr. S---'s company issued billing invoices for "creative service fees" which were allowed as nontaxable. Petitioner does not even allege, however, and there is no evidence to indicate, that the creative service fees were partly intended as compensation for finished art, as the fees reviewed in petitioner's first audit concededly were. Petitioner also does not allege, and there is no evidence to indicate, that the records accepted as sufficient proof of ordering in the S--- audit were in any way similar to the records kept by petitioner in its second and third audit periods. In short, the only apparent similarity between the two companies is that both use the term "creative service fee"; in audits of both companies, that term has been accepted as sufficient to meet the "clear identification" requirement. There is no unequal treatment.

Issue 4 Revenue and Taxation Code Section 6596 allows the Board to grant relief from tax if certain requirements are satisfied. Among other things, the taxpayer must have relied on written advice received from the Board in response to the taxpayer's written request. The taxpayer must present a copy of its written request for advice, a copy of the Board's written response, and a statement under penalty of perjury setting forth the facts on which the claim for relief is based.

Petitioner contends that it was previously advised by the Board's staff that its records were sufficient to meet the proof of ordering requirement of Regulation 1540. Petitioner does not identify any specific written advice; it is apparently referring to the fact that the second reaudit in the -020 matter allowed preliminary art deductions based solely on the language of the invoices, without reference to the proof of ordering requirement. However, the second reaudit was done in November or December 1989, well after the years at issue here, and petitioner therefore could not have relied on that reaudit when filing its returns for these periods. Further, petitioner has not presented a copy of any written request for advice, a copy of any written advice received from the Board, or the required statement under penalty of perjury. Petitioner is thus not entitled to relief.

Issue 5 The audits found several instances where the customer had issued a purchase order for finished art at the inception of the job. The auditors viewed this as evidence that Regulation 1540's proof of ordering requirement had not been met and therefore asserted tax.

For example, on job #3887-06-766, W--- B---' purchase order quoted a price of $128,000 for "conception and execution of all stages of the advertising campaign [including] Creative, Concept, Development and Finishing." The total was billed in four $32,000 stages over a ten-month period, the first three of which were apparently described as "creative service fees", and the last of which was described as "finishing stage". (Only the initial invoice was picked up in the audit sample.)

Similarly, a purchase order from an organization called "PSO" dated November 26, 1984 (job #3238-29-639) quoted a price of $2,000 for "[d]esign and layout of corporate stationary ... including the preparation of final inked logo." The order also specified that the billing would be "taxable".

At the Appeals conference, petitioner's representatives agreed that customers on small jobs (such as the stationary for PSO) might sometimes commit to buying the finished art before reviewing preliminary art. They also alleged, however, that customers on large jobs (such as the W--- B--- ad campaign) would never make such a commitment. They pointed out that it makes no economic sense for a business to agree to spend large sums of money for artwork sight unseen. They indicated that customers such as W--- B--- sometimes issue purchase orders up front in order to "keep a lid on" or control the costs for the entire job, but they always retain the right to cancel the order at any time if they are not satisfied with the preliminary art.

We agree with petitioner, in principal, that a purchase order for finished art does not necessarily preclude a deduction for preliminary art prepared thereafter. If the purchase order requires customer approval of preliminary art as a condition precedent or a condition subsequent to the sale of the finished art, there is no binding obligation to purchase the finished art until such approval is given, and a preliminary art deduction may still be allowable. Thus, the

Regulation does not require that preliminary art be prepared before a purchase order for finished art, but rather states in the disjunctive that preliminary art is used to demonstrate ideas "before a contract is entered into or before approval is given for preparation of finished art...."

As we see it, therefore, the issue in these types of cases is factual rather than legal - did the purchase order include a condition precedent or a condition subsequent requiring customer approval of the preliminary art before the customer would be obligated to purchase the finished art? This is simply another way of stating the proof of ordering requirement, and the question may be answered by reference, not only to the purchase order itself, but also to "work orders or other records of the agency...."

No work orders have been presented for the W--- B--- job to show that the proof of ordering requirement was satisfied. However, we have reviewed petitioner's business practices extensively, not only for the two audits at issue here, but also as part of the first audit and the ensuing litigation. We have no doubt that customers in these types of jobs (print ad campaigns for motion pictures) always have the right to refuse to purchase finished art if they do not approve the preliminary art. Indeed, petitioner's standard invoice states that production of finished art is contingent on customer approval of preliminary art. Finally, as petitioner pointed out in connection with Issue 4 above, the Board's Headquarters audit staff has apparently conceded this point; in the second reaudit of the -020 period, they allowed deductions for creative service fees based solely on the language of the invoice, without requiring any additional proof of ordering.

For these reasons, we find that the proof of ordering requirement was satisfied on job #3887-06-766 for W--- B---. The $32,000 creative service fee is not subject to tax, and we recommend another reaudit to make the adjustment.

Several other jobs are similar to job #3887-06-766 for W--- B---. Petitioner was hired to work on a major job such as a print ad campaign for a motion picture; and it billed creative service fees separately from charges for finished art, either on the same invoice or a different invoice. In accordance with Paragraph 3 of Mr. Dunn's December 1, 1989 memo, creative service fees on the following invoices should therefore also be considered nontaxable in the reaudit. (Invoice numbers up to 2100-29-540B are from the -020 audit; higher ones are from the -030 audit.)

1341-06-398	1353-05-149	1354-05-149
1499-29-468	504-02-549-557	1533-06-431A
1843-06-491	3234-06-709A	3887-06-766A
3936-06-767A	3986-10-89	4043-06-773
4266-29-791	349-02-735	4578-14-13
4812-04-25	5806-900-002	6131-5000049

For job #3238-29-639 with PSO, work orders show that petitioner prepared 10 tissue layouts for customer approval on November 30, 1984, five tissue layouts on January 8, 1985, and comprehensives on January 9 and 16, 1985. We find this evidence sufficient to satisfy Regulation 1540's proof of ordering requirement. If there was a separate billing for the finished art, the creative service fee is nontaxable. (The creative service fee would be taxable if there was no other billing, either because the entire $2,000 was for the finished art, or because it was partly for finished art and thus does not meet the requirement for a separately stated preliminary art charge.) The reaudit should determine whether there was a separate invoice for finished art and, if there was, the $2,000 creative service fee should be allowed as nontaxable.

Some other invoices are for small jobs like that for PSO. Petitioner agrees that customers on such jobs may sometimes commit to the purchase of finished art at the inception, before reviewing preliminary art. Despite the form language on the invoices, therefore, we are unable to make a blanket finding that the proof of ordering requirement was satisfied. Further, unlike the PSO job, no work orders or other relevant documentation is included in the audit workpapers. The creative service fees on the following invoices should thus be considered taxable unless petitioner presents additional evidence to show that the proof of ordering requirement was met.

1528-29-478	1535-02-574	3275-29-681A
3629-10-39A	4016-09-153	

Issue 6 According to petitioner, some invoices for creative service fees were found taxable solely because they were dated after the customer approved the preliminary art and ordered the finished art. Petitioner alleges that the fees were in fact for the preparation of preliminary art before the finished art was ordered, and that the billings were simply delayed for one reason or another. Petitioner says that its normal policy is to bill part of the creative service fee on the final billing (or not bill it if the customer fails to order finished art) even though the fee represents compensation for design work done earlier. Petitioner concludes that the billing date should not determine whether or not the fee is taxable.

Petitioner does not cite an example of this type of transaction, but it appears that invoice #1791-08-60C may be one. That invoice was labeled "Finish Stage/Ad Creation" and charged a $10,000 creative service fee for: "Finish stage of print advertising campaign including the preparation of finished art. Also including the preparation of final one-sheet design." The invoice charged an additional $4,083.96 for production expenses.

Again, we agree with petitioner in principal; the date of the invoice for the creative service fee does not control the application of tax. As a matter of evidence, however, since invoices of this type appear to charge solely for finished art, we agree with the audit staff's decision to treat them as taxable. To obtain a deduction, petitioner must present evidence (such

as work orders or other documentation) to show that the charge was in fact for preliminary art and not for finished art, and that the requirements of Regulation 1540 are satisfied.

Creative service fees on the following invoices appear to have been no more than an additional mark-up on the charge for finished art. As petitioner states, the appearance may simply be the result of a delay in billing the fee. However, unless petitioner presents evidence during the reaudit to show that the billings were in fact for preliminary and not for finished art, the creative service fees should be considered taxable.

1356-03-52	1509-06-433	1523-02-575
1534-02-573A	1780-06-476A	1789-15-431
1791-08-606	2029-05-327	2040-05-316
2045-05-337	4049-16-152(-164)	

Invoice 2100-29-540B, which included a $5,000 creative service fee found taxable in the -020 second reaudit, is missing from the workpapers and has not been reviewed.

Issue 7 Petitioner claimed exemption for all charges on invoice #3906-09-142 on the ground that the property was shipped to the customer outside California. Tax was asserted in the -030 audit for failure to submit supporting evidence, and petitioner agrees that the claimed exemption was properly disallowed. However, the invoice included a $10,000 creative service fee of the type found nontaxable in Paragraph 3 of Mr. Dunn's December 1, 1989 memo. We agree with petitioner that the creative service fee be considered nontaxable in the reaudit.

* * *

Petitioner raised a number of other issues in correspondence or in discussions with the audit staff. At one time or another, for example, petitioner claimed that it was operating as an agent of its clients pursuant to subdivision (a)(2)(A) of Sales and Use Tax Regulation 1540; that all its sales were nontaxable sales for resale; and that the audit computations of excess tax reimbursement were incorrect. Our discussion herein has been limited to the issues discussed at the September 25, 1992 Appeals conference, and we assume that all other issues have been abandoned or conceded. If our assumption is incorrect, and other issues remain, petitioner should inform the audit staff during the reaudit or file a Request for Reconsideration with the undersigned. (We will advise petitioner of the procedures for filing such a Request when the reaudit is completed.)

Finally, petitioner advises us that it made a payment of $105,031.74 on or about October 20, 1990, and requests that the payment be allocated entirely to tax for the -020 period. The staff should verify that the payment has been allocated as requested.

Recommendation

Reaudit in accordance with the views expressed herein. Redetermine the determinations and partially grant the refund claims in accordance with the reaudit results.

James E. Mahler, Senior Staff Counsel Date

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