

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

100.0015

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
For Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
B--- K---, INC.) No. SR -- XX XXXXXX-010
)
)
Petitioner)

The Appeals conference in the above-referenced matter was held by Senior Staff Counsel Stephen A. Ryan on September 9, 1993 in Van Nuys, California.

Appearing for Petitioner:

Mr. B--- K---
President

Mrs. S--- K---
Vice President and Treasurer

Appearing for the
Sales and Use Tax Department:

Mr. Albert Lai
Senior Tax Auditor

Mr. Ira Anderson
Supervising Tax Auditor

Protested Item

The protested tax liability for the period January 1, 1987 through December 31, 1989 is measured by:

| <u>Item</u> | <u>State, Local and County</u> |
|--|------------------------------------|
| Gross receipts from sales of copy and layout not constituting preliminary art | \$65,146 |

Petitioner's Contentions

Petitioner acted solely as an agency, and an agent for its clients. Its charges are not taxable.

Petitioner's charges for copy and layout are nontaxable as charges for preliminary art. Petitioner's clients approved these items prior to the production of finished art. Title to preliminary art did not pass from petitioner to its clients until one year after each job was finished.

The Board had approved petitioner's activities, including its use of resale certificates and invoicing methods. Relief should be granted from any applicable tax.

Summary

Petitioner was an advertising agency which acted at various times as a[n] agent, seller, and retailer. It began business in 1974. This was the first Board audit.

Petitioner reported approximately \$1.2 million in gross receipts on its sales tax returns, with tax paid on \$267,761 because the remainder was claimed as deductions for nontaxable items. The revised audit disallowed some deductions which petitioner had claimed for "media" plus one deduction which was not identified.

The audit also allowed numerous other deductions which petitioner had claimed for media and labor. The audit scheduled that petitioner had not collected sales tax reimbursement or paid sales tax on separate charges for labor, planning, concept, copy, layout, supervision, coordination, design, outline, review, and organizer. The audit established a sales tax deficiency on a portion of the charges for "copy" and "layout" which the auditor found to have been taxable as charges for "planning". The other charges were found to be nontaxable apparently as compensation for services unrelated to the sale of tangible personal property. The audit indicates the reasons for taxing these "copy" and "layout" charges included the following: title to artwork passed from petitioner to each client prior to use pursuant to each contract agreement which provided that title passed "as soon as payment has been made therefore"; petitioner issued resale certificates to its vendors when petitioner sometimes contracted for outside service on these copy and layout portions of jobs; and petitioner then marked up its cost when charging its clients on such jobs.

There are two invoice examples in the audit workpapers. Each contains separate charges in three primary categories: planning, production, and reproduction. Sales tax reimbursement was added to the many separate charges in the production and reproduction categories. Such charges were for property such as illustrations, negatives, prints, mechanicals, color separations, photographs and printed items; plus it includes a fairly large separate charge for "art direction". Separate charges in the planning category were not included in the measure of sales tax reimbursement, such as for outline and review, organizer, copy with revisions, layout with diagram and revisions, concept, and copy and layout.

At the conference, the auditor described in more detail as follows:

Although petitioner's written agreements with its clients indicated petitioner was an agent, petitioner did not act as an agent regarding these specific charges in issue because it failed to follow the requirements of Regulation 1540. Petitioner issued resale certificates to its vendors, and then charged its own clients a markup above its cost. Petitioner took title to property obtained from those vendors, yet true agents do not take title to property acquired as an agent for a principal.

Each agreement provided for petitioner's transfer of title in all property to the client after each job was done. Petitioner made or obtained materials which actually constituted preliminary art, and then showed those materials to each client in order to obtain oral approval before petitioner made the separate finished art. Petitioner invoiced each client for separate charges for such materials but not in the name of "preliminary art". Petitioner needed written proof of each client's approval of the preliminary art.

Mr. and Mrs. K--- represented as follows:

Petitioner worked for only several clients pursuant to a written "agreement" with each which did not constitute a "contract". Petitioner acted only as an agent, even when it took title to materials acquired from a vendor under petitioner's resale certificate. Its agreement form so provided, and its standard purchase order identified it as the agent for a disclosed client.

It maintained both a corporate bank account and a "trust" account. All payments to petitioner were deposited into the trust account. All payments to vendors and to petitioner were made from the trust account. When a client desired anything from petitioner, the client met with Mr. K--- to describe desires, and to sometimes obtain a cost and time estimate. Petitioner's employees performed the layout work which typically consisted of pencil drawings. Copywriter businesses usually performed copy work, but petitioner did not mark up petitioner's cost because the excess charge over cost was for petitioner's commissions which were not separately charged. Language in the agreement about mark-up and profit really meant petitioner's 20 percent commission.

Petitioner physically delivered the preliminary art to the clients for the purpose of review and approval. Some clients signed or initialed the preliminary art, but the auditor never bothered to check. With one or two rare exceptions, petitioner kept possession of the preliminary art following review and approval by the clients. Every several years, petitioner purged such art. Petitioner was never paid for a job prior to approval of preliminary art, and it never was paid for preliminary art services if no approval for that art was obtained.

The preliminary art ultimately was owned by petitioner's clients but not until one year after the job was finished because petitioner had the right to reproduce those materials for that one-year. Petitioner first invoiced each client once approval of the preliminary art was obtained, but that was only for a deposit.

The “art direction” charge covers Mr. K---’s specific time expended in the job at \$100.00 per hour up to a maximum charge of 10 percent over any original estimate provided to the client. Petitioner did not operate as a studio which sold layouts to customers.

A Board employee in the Hollywood office in 1974 suggested to Mr. K--- personally that the above-mentioned three categories for petitioner’s invoices be used. This suggestion was repeated by other Board auditors twice in the 1980’s.

Analysis and Conclusions

The Board has promulgated Regulation 1540 on the subject of advertising agencies, commercial artists and designers. Multiple provisions are applicable to petitioner.

An advertising agency (“business”) may sometimes act as an agent on behalf of its client-principal, and may sometimes act as a principal rather than an agent (Regulation 1540 (a) (1); and Civil Code section 2295). If the business acts merely as an agent in acquiring property from a third person for transfer to the client without intervening use in exchange only for cost reimbursement (plus a possible agency fee), then the business will not have acted as a principal-purchaser-seller (Reg. 1540 (a) (1) and (2) (A)).

The business must clearly establish an agency status regarding each item of property so handled (Reg. 1540 (a) (2) (A)). If the business does not so clearly establish such an agency, it will be treated as a principal, and a purchaser and seller of that property (ibid.). The Board has established the following requirements to establish an agency status as to each item of property: (1) written evidence of agency status; (2) disclosure to the supplier of the client; (3) no use of a resale certificate in the name and permit number of the business; (4) no intervening use of the property for the business’ own account; and (5) billing by the business to the client only for cost reimbursement plus a possible reasonable agency fee (ibid.).

The business will be treated as a principal-seller regarding property which it produces or fabricates itself (Reg. 1540 (a) (2) (B)). When the business acts as a principal regarding an item of property, its consideration received for the property and all services related thereto are subject to sales tax (Reg. 1540 (b) (1)).

A business’ charges for legitimate agency reimbursement plus any agency fee related to the property, and for services unrelated to the sale of tangible personal property, are not subject to sales tax (Reg. 1540 (b) (2), (3), and (4) (H)). Charges for “preliminary art” as defined in Regulation 1540 (b) (4) (A) are not taxable (Reg. 1540 (c)). Charges for property such as drawings, designs and sketches (non-“preliminary art”) which are transferred to a client are taxable (ibid.). Charges for copy writing, consultation, research, and supervision in a situation when the business acted as a seller of property, are subject to sales tax (Reg. 1540 (b) (4) (C), (D) and (E)).

A general overall fee charged to a client for all business services performed is taxable/nontaxable in accordance with the ration in each contract between true agency charges and principal-seller charges (Reg. 1540 (b) (4) (K)). Subsection (b) (4) (A) reads as follows:

“‘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.... 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. Not other proof shall be required.” (Emphasis added.)

Pursuant to Regulation 1540, petitioner may have generally acted as an agent for its clients, but the evidence shows it did not act merely as an agent regarding the items of property for which petitioner charged the \$65,146 in question. Some of these charges involved property which petitioner acquired from suppliers with a disclosed client and agency status, but pursuant to petitioner’s own resale certificate. This is contradictory.

Although this factor is only a rebuttable presumption against agency status, the other factors also indicate petitioner did not act as an agent regarding the property in issue. Petitioner then charged its customers both a copy charge in excess of its cost, plus an art direction charge to cover its time at \$100.00 per hour. This was not the action of a mere agent who would only be collecting an agency commission plus cost reimbursement. The remaining charges were for layout which was produced and sold by petitioner as a seller rather than as an agent.

None of these copy or layout preliminary materials constituted “preliminary art” as defined in Regulation 1540 (b) (4) (A) because petitioner transferred title in these items to its customers. The written agreements provided for such transfer of title. Whether the documents were agreements or contracts is irrelevant. Although the agreement language attempted to delay the title transfer time to when petitioner was paid, that retention of title following petitioner’s initial delivery to each customer for review and approval purposes, is limited to a security interest (Revenue and Taxation Code section 6006(e), and Commercial Code section 6401(1)). Title in these materials passed from petitioner to each customer when petitioner physically delivered them to the customer for review and approval even if they were then returned to petitioner for use and/or safekeeping (see Comm Code § 2401 (2)). The separate right which petitioner held to reproduce such materials for one year did not prevent the transfer of title or sale at the time of delivery.

Therefore, the full \$65,146 is subject to sales tax. We point out for petitioner's knowledge in its future activities that: Petitioner has the legal opportunity to take title in each item of property from vendors and then transfer that title to its client with petitioner acting only as an agent but the evidence must prove that particular status; a charge for "preliminary art" as defined in Reg. 1540 can be labelled as other than "preliminary art" as long as the charge is actually for preliminary art; and petitioner can comply with Reg. 1540 (b) (4) (A) to prove the client's ordering or producing of preliminary art prior to the date of contract or approval for finished art, by evidence of oral action by the client – written proof is not required but makes its burden easier. It is suggested however that petitioner show "preliminary art" and the approval in writing so that it can easily present that evidence to the Department and make a more efficient process.

It appears that a portion of petitioner's art direction charges is nontaxable pursuant to Regulation 1540 (b) (4) (K) since portions of its contracts involved some nontaxable services and charges. A reaudit is thus necessary on this latter subject. We cite Regulation 1700 (b) regarding the procedures for petitioner to obtain an offset of any excess tax reimbursement amounts against its liabilities on these same transactions.

We conclude that there is insufficient evidence to conclude that petitioner is entitled to relief for alleged Board misinformation upon which petitioner relied. Initially, the alleged Board advice which petitioner sets forth was not provided to petitioner in writing as required by Revenue and Taxation Code section 6592. Secondly, we do not know what advice was actually provided. This is a complicated area of the Sales and Use Tax Law, and as indicated, *infra*, the existence or nonexistence of one of many factors can result in a different tax application. Petitioner did not understand these factors. It could have acted as an agent under Regulation 1540 regarding preliminary art if its actions had followed that law.

Recommendation

Reaudit regarding the art direction charges, and adjust accordingly. Make no other adjustments.

Stephen A. Ryan, Senior Staff Counsel

12-31-93
Date