

**STATE BOARD OF EQUALIZATION**

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May 5, 1994

Mr. D--- H. W---  
D--- H. W--- A---, Inc.  
XXXX --- Court  
---, CA XXXXX

Dear Mr. W---:

This is in reply to your August 17, 1993 letter regarding the application of sales tax to charges by advertising agencies. As I noted during our telephone conversation, I could not find a record of having received your original letter. We are responding to the copy you later sent by fax.

You noted that Sales and Use Tax Regulation 1540, subdivision (a)(2)(B) provides that advertising agencies are sellers of all items of tangible person property "produced" or fabricated by their own employees. You asked for clarification of the word "produce". You provided the following facts:

"Agencies typically use freelance artists such as copy writers, production supervisors, art directors, etc. to supplement the in-house creative staff. On one extreme, the freelancer's function is analogous to temporary clerical help. The freelancer allows the agency to maintain a nucleus of creative talent that can use the freelance services to accommodate the work overload. The freelance may work on the agency premises or in their own facilities, but they are under the control and supervision of the in-house agency creative staff.

"The other extreme situation occurs when the agency may have a small creative staff and farms out all creative work to another business entity that could be a single operator, another agency or design shop. In some cases the agency may even set up and own another business entity that is a design shop or studio so that agency employees never fabricate tangible personal property. However, clearly the agency must interface between the client and the studio that will produce the

tangible personal property. The agency must give some creative direction so that the other entity will know what to produce."

Given this information, you asked the following specific questions:

"1. (a) What does the term 'produce' mean in the regulation as it applies to the situations that I have described above?"

The word has its common meaning; that is, to make or manufacture or to bring into being. In each of the situations you cited, the subcontractor's charge to the agency is subject to tax if the subcontractor produces tangible personal property which the agency will use rather than sell in the regular course of business. Under the facts you provide above, when an agency owns a design shop, the design shop's charge for designs is taxable whether the retail sale is to the agency or to the agency's client.

"1. (b) What is meant by agency employees? Is the term limited to only those people who are on the payroll of the agency? If not, what is the test for employee status?"

Generally, the term "employees" means persons who are on the payroll of the agency. However, we have recognized situations where one company may "loan" employees to another. In essence, we treat the loaned employee as an employee of the "borrower" company. In order to qualify for treatment as a loaned employee, the loaned employee must be an employee of the "lender", the borrower/customer must provide the tools or equipment used, the raw materials and the premises at which the work is done, and the charge must be at an hourly rate. In addition, the customer must have other persons who clearly are employees performing similar work or the customer must employ persons who are capable of giving meaningful direction to the loaned employees beyond describing only the result desired. Also, the customer, not the lender, must supervise the loaned employees. We would consider the loaned employee as performing employment services for the client under those facts. If you have a specific set of facts for which you wish an opinion, please provide us with a description.

"1. (c) In our conversations, I have been told that Mr. Levine on the CSBE legal staff wrote an opinion on this topic. If that opinion is relevant, a copy is requested."

The opinion to which you refer was a 1988 internal memorandum which Mr. Levine wrote. I reviewed the memorandum, and it pertained to charges for supervision of fabrication labor not related to advertising agencies and irrelevant to these facts. The conclusions Mr. Levine reached were based upon the specific facts before him in that case.

Your next questions concern the sale of tangible personal property to an agency to use in providing finished art or items which become an ingredient of the finished art. You asked us to assume that an agency has a title passage clause in its contract with its client and to also assume that the agency complies with all requirements to act as an agent purchasing tangible personal property on behalf of the client as provided in subdivision (a)(2)(B) of Regulation 1540. You asked whether, under those conditions, the agency may purchase photography, artwork, illustrations, and other materials as an agent on behalf of the client when the agency purchases the property to use to prepare finished art or to incorporate as an ingredient into the finished art sold by the agency.

In this regard, subdivision (a)(2)(B) of Regulation 1540 provides:

"Advertising agencies are sellers of all items of tangible personal property produced or fabricated by their own employees. Advertising agencies are not agents of their clients with respect to the acquisition of materials incorporated into items of tangible personal property prepared by their employees."

So, no, an advertising agency does not act as an agent on behalf of the client in purchasing materials the agency incorporates into tangible personal property it sells to the client. On the other hand, an agency may purchase as an agent tangible personal property it uses as a manufacturing to produce other property it sells to the client. The following examples may clarify this point.

Assume an agency contracts to prepare a mechanical for a client and purchases a 3" x 5" sketch which the agency physically pastes onto the mechanical the agency sells to the client. The agency does not act as an agent of the client in purchasing the sketch. The agency purchases the sketch as a material which is incorporated into the tangible personal property sold. The agency should issue a resale certificate to the vendor of the 3" x 5" sketch.

Next, assume the agency contracts to prepare a mechanical and again needs to physically paste down a 3" x 5" illustration onto the mechanical. In this instance, however, the agency purchases a 6" x 10" sketch and makes a copy of it to reduce the image to the 3" x 5" size needed. The agency in this case does not physically incorporate the 6" x 10" sketch into a mechanical. Rather, it uses the sketch as a manufacturing aid to produce the 3" x 5" copy. The agency may follow the procedures in the regulation to act as an agent on behalf of the client to buy the 6" x 10" sketch.

Finally, you refer to "fair retail selling price" at subdivision (b)(1) of Regulation 1540 which defines the term to mean an amount sufficient to cover both (i) the net labor costs of employees of the agency plus an allowance for overhead and profit of not less than 100 percent of such labor costs, and (ii) the cost of purchased items incorporated into the tangible personal

property as to which the agency is a seller. That subdivision of the regulation goes on to provide that the board considers an agency has charged a fair retail selling price if the agency has furnished a firm quoted price based on estimated labor costs plus overhead and profit of not less than 100 percent of the labor cost and bills in accordance with the quoted price.

You asked what the ramifications are when an agency sells tangible personal property produced or fabricated by its employees but does not keep a record of the labor cost by jobs.

If the agency does not keep records and there is no evidence that the agency charged a "fair retail selling price" as defined in the regulation, the Board's audit staff would need to estimate the selling price based on any other evidence available. Depending on the circumstances, the agency may run the risk of being penalized for failure to maintain proper records.

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

Ronald L. Dick  
Senior Tax Counsel

RLD:plh

cc: --- District Administrator - --