

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

100.0159

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
J--- R--- C---) No. SR --- XX-XXXXXX-010
)
Petitioner _____)

The Appeals conference in the above-referenced matter was held by Staff Counsel Sharon Jarvis on January 27, 19XX in Covina, California.

Appearing for Petitioner: J--- R--- C---
Petitioner

O--- C---
Witness

S--- M. Y---
Certified Public Accountant

Appearing for the
Sales and Use Tax Department: Tina M. Tinucci
Tax Auditor

Robert L. Sayles, Jr.
Supervising Tax Auditor

Protested Items

The protested tax liability for the period January 1, 1987 through March 31, 1991 is measured by:

| <u>Items</u> | <u>State, Local and County</u> |
|--|------------------------------------|
| A. Taxable sales not reported for the period 1/1/87 to 9/30/87 | \$ 96,358 |

B. Claimed exempt design fees disallowed \$ 228,032

A 10% failure to file penalty also was imposed for the period January 1, 1987 to September 30, 1987.

Petitioner's Contentions

Petitioner does not dispute Audit Item A.

As to Audit Item B, petitioner contends that he has correctly charged sales tax as advised by a Board employee and according to Board publications.

Petitioner contends that the failure to file penalty should be deleted because he was misadvised by a Board employee to ignore his period in business prior to applying for a seller's permit.

Summary of Petition

Petitioner is a sole proprietor in the graphic arts business doing business as C--- D---. This is the first audit of this account.

At the Appeals conference petitioner indicated that most of his clients are long-term clients with whom he has a high level of trust, and that there is rarely a need for a written contract. Petitioner stated that most jobs are small, ranging from \$100 to \$5,000. He agreed when questioned at the conference by Supervising Tax Auditor Robert Sayles that there was usually a verbal agreement or contract before any work or art work was done. Petitioner stated that in nearly all cases the job is ultimately performed even though mock-ups are done; and that it is rare that he leaves without satisfying the client and doing the job. He stated that less than 1% of his work is done "on spec", meaning the client does not pay unless the client takes petitioner's design. Petitioner also stated that sometimes clients will pay just to have a design done.

Petitioner stated that preliminary art or "comps" (comprehensives) or mockups are done to show what the final idea will look like and for clients to approve or make changes. The art work is usually a two-part process: (1) presentation and mock-ups, (2) final product. Typically a client will review the preliminary art and approve or make changes to it before the final product is done. Mrs. C--- stated that they refer to preliminary art as "design" and to the finished art as "production". Petitioner stated that these "comps" are not useable for reproduction or to make the final product; and that he does not make the final art out of the "comp" art. The "comps" are shown to clients as something which will look similar to the finished product so that the client can make a decision; the clients can approve or change the

"comps". Petitioner had a sample "comp" at the conference; it showed where text and photos would be in the finished piece but lacked the actual client photos or text. (Copy attached as Exhibit A.)

Both Mr. and Mrs. C--- stated that the billing is usually all one process including charges for design and production, but that if the project is long-term, it might be billed in portions such as one-half, one-third, or one-quarter. Mrs. C--- said that once a client says to proceed with a project, the billing starts, and sometimes where there is a measure of trust between petitioner and client, the billing starts before a concept is agreed to. Petitioner stated that while the billing is all one process, the artwork, etc. is not.

Petitioner's representative at the conference, Mr. Y--- stated that he had been a client of petitioner's; that he had wanted to develop a logo and discussed the logo several times with petitioner and looked at various ideas before he approved a logo.

Mr. Sayles on behalf of the Sales and Use Tax Department (Department) framed the main issue as finished art versus preliminary art. He asserted that there were verbal contracts before work or art work was done. He argued that the applicable regulation (Sales and Use Tax Regulation¹ 1540(b)(4)(a)) requires a purchase order from the buyer or a work order or other records to prove the ordering or producing of preliminary art before the date of the contract or approval for finished art; and that petitioner could not demonstrate that this requirement was met.

Relative to the failure to file penalty, Mrs. C--- described what happened the day petitioner applied for a seller's permit as follows. She stated that on October 6, 19XX petitioner applied for the permit and filled out a form. (Copy attached as Exhibit B.) The Board employee who assisted them asked about the length of time in business and checked a box on the form showing that there were no delinquencies for prior periods, saying that it would be too much of a hassle to go back and audit for the period when petitioner had operated without a seller's permit. Mr. Sayles indicated that the Board employee did not recall the incident.

Mrs. C--- indicated that the employee knew that petitioner was already in business because they had shown her some prior invoices and asked her how they should structure the invoices. The employee advised petitioner to tax "production", but not "design" because that was thinking time. Mrs. C--- stated that before talking to the Board employee, petitioner's invoices had "design" and "production" as one charge. Petitioner submitted a sample of this kind of billing. (Copy attached as Exhibit C.) Mrs. C--- stated that after talking to the Board employee, petitioner broke out "design" and did not tax it, and broke out "production" and did tax that. Petitioner submitted a sample of this form of billing. (Copy attached as Exhibit D.) Mrs. C--- stated that petitioner's bookkeeper also called the Board office to see if the invoices were being done correctly and was told the same thing.

¹All references to regulations are to the Sales and Use Tax Regulations.

Petitioner agreed that he had received copies of Tax Tip Pamphlets 37 ("The Graphic Arts Industry") and 38 ("Advertising Agencies") at the time of applying for his seller's permit. Petitioner stated that he has read these publications and still believes based upon the publications that he is correctly charging sales tax on his invoices.

Analysis and Conclusions

Revenue and Taxation Code section² 6051 imposes sales tax on retail sales of tangible personal property. Under section 6012 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." (Section 6012(b)(1).) No deduction is allowed for "labor or service cost...or any other expense." (Section 6012 (a)(2).)

Subdivision (b)(4)(A) of Sales and Use Tax Regulation 1540 applies these concepts to the specific context of preliminary art. The subdivision provides:

"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 ready 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 the property is sold at retail. Thus, as a condition for exemption, the regulation requires that title in preliminary art not pass to the customer, and that preliminary art not be physically incorporated into finished art sold to the customer.

²All references to code sections are to the Revenue and Taxation Code.

If the preliminary art is not itself sold, preparation of the preliminary art may be regarded as a service. Tax nevertheless applies if the service of preparing the preliminary art is "part of the sale" of finished art or other property. To show that preliminary art is not part of the sale of other property, the regulation requires that: the charge for preliminary art be separately stated; that the charge be clearly identified as for preliminary art; and that the preparation of preliminary art be ordered by the customer before the contract or approval for finished art. The regulation specifies that evidence of this must be shown by purchase orders of the buyer, or by work orders or other records of the seller.³

While petitioner's separate charges for "design" may be liberally interpreted to come within the requirement that charges for preliminary art be billed separately to the client, unfortunately for petitioner the regulation is very specific as to what documentation is required to prove that the preliminary art was ordered or produced prior to the date of the contract or approval for the finished art. I believe the statements of petitioner and his wife that the preliminary art is shown to the client for approval or changes. The statements of petitioner, his wife and Mr. Y--- all indicate that it is petitioner's normal business practice to enter into final verbal contracts or agreements for finished art only upon approval of the preliminary art.

Since this is petitioner's first audit I would like to accept these statements as sufficient to meet the proof-of-ordering requirement for the transactions in issue. However, the language of the regulation precludes me from granting relief absent some further documentation to show that the preliminary art was ordered before there was a contract or agreement or approval to produce the finished art.

If petitioner is able to produce purchase orders of buyers, or work orders or any other records to prove the ordering or production of the preliminary art before the date of the contract or approval for the finished art, this should be submitted to me with a Request for Reconsideration.

I additionally note for petitioner's information, that in the future petitioner must retain work orders or other documentary evidence for each transaction upon which exemption from sales tax is claimed, showing that the preliminary art was ordered or produced prior to the date of the contract or approval of finished art.

As to the failure to file penalty (see section 6511), section 6592 permits relief of the penalty if the failure to make a timely return or payment is "due to reasonable cause and

³Petitioner's contention regarding misadvice from a Board employee must be addressed. The law is well settled that reliance upon an oral communication from a Board employee will not suffice to prove entitlement to an exemption from a tax. (See Market Street Railway Co. v. State Board of Equalization (1955) 137 Cal.App.2d 87, 103.) There is a limited provision for relief if a person relied upon written advice from the Board which is in response to a written request for advice from the person. (See section 6596.) There is no evidence that there was either a written request for advice or a written response in this case.

circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect..." The section also requires that anyone seeking relief from the penalty shall file with the Board a statement signed under penalty of perjury setting forth the facts upon which he bases his claim for relief. Since this is petitioner's first audit and I find his confusion over the accurate completion of the application for a seller's permit understandable and believable, I would be inclined to grant relief from the penalty if petitioner submits a Request for Reconsideration accompanied by such a statement signed under penalty of perjury.

Recommendation

It is recommended that the determination be redetermined without adjustment.

Petitioner is advised to submit a Request for Reconsideration within 30 days along with (1) any documentation to show that the preliminary art was ordered before there was a contract or agreement or approval to produce the finished art; and (2) a statement signed under penalty of perjury setting forth the facts upon which he bases any request for relief from the failure to file penalty.

Sharon Jarvis, Staff Counsel

Date

Exhibits attached.