



### Petitioner's Contention

No costume designer has ever been required to pay sales tax on his services.

### Summary

N--- M--- Ltd. was a limited partnership engaged in the business of designing and manufacturing women's clothing. N--- -. M--- took over operation of the business as a sole proprietor effective March 1, 19XX. For convenience, we hereinafter use the term "petitioner" to refer to both the partnership and the proprietorship collectively.

As part of the business, petitioner contracted to design costumes for motion pictures and television series. Sample copies of numerous such contracts are included in the audit workpapers. These contracts required petitioner to design, but did not require petitioner to fabricate or sell costumes.

The design contracts sometimes required petitioner to loan the design services of Mr. M--- to the customer for a fee. More typically, however, petitioner simply contracted to perform the design services for a set fee (for motion pictures) or for a set fee per episode (for television series). Petitioner billed the customers periodically for these design fees. If the customers later ordered petitioner to fabricate costumes (as they almost invariably did), petitioner's charges for the costumes were billed on invoices separate from the invoices for design fees. According to the audit staff, petitioner's customers were usually on budgets, and the amounts of those budgets may have limited the prices that petitioner could charge for costumes.

In a few cases, it appears that the entity with which petitioner contracted to perform design services was different from the entity which ordered costumes. For example, the design contract for the television series "D---" was between petitioner and "The O--- Company", and petitioner's bills for design fees were sent to that entity. The bills for costumes, on the other hand, were sent to A--- S--- P---.

According to the audit staff, the customers were not required to order costumes from petitioner and could have the costumes fabricated by someone else if they so desired. The audit staff assumes that petitioner would have transferred sketches and patterns to the customers in those cases, so that the customer could have the clothing fabricated in accordance with petitioner's designs, but the staff does not know how often that might have occurred.

Petitioner reported and paid tax on all billings for costumes, unless otherwise exempt. It did not report tax on the design fees. The audit staff found that the design services were sometimes performed by Mr. M--- as an employee of the customer (when the customer deducted withholding taxes from petitioner's billings) and did not assert tax on the design fees in those cases. In all other cases, however, the design fees were found to be part of the sale of

costumes, and tax was assessed unless the sales of costumes were otherwise exempt (such as sales in interstate commerce).

### Analysis and Conclusions

Sales tax is assessed on the “gross receipts” from the retail sales of retailers. (Rev. & Tax. Code § 6051.) “Gross receipts” means the total amount of the sale price, without deduction on account of the “cost of the materials used, labor or service cost, interest paid, losses, or any other expense.” (Rev. & Tax. Code § 6012(a)(2).) The total sale price includes charges for any “services that are a part of the sale.” (Rev. & Tax. Code § 6012(b)(1).)

There is no general exemption for sales of custom-made property. Although the manufacture or production of custom-made property necessarily involves design work or similar types of created services, the services are required to produce the property in the form desired by the customer and are therefore generally taxable as “part of the sale” of the property.

The Board has nonetheless recognized a limited exemption to this rule in cases where the design and sale of the property are performed under separate contracts. If the customer contracts solely for design services, tax does not apply (assuming there is no associated transfer of tangible personal property). If the customer then contracts separately for production of the property in accordance with the design, charges for the property might well be taxable, but the charges for design work remain nontaxable. (See Sales and Use Tax Annots. 515.0440 [2/27/64] and 515.0460 [4/16/70].)

The contracts in question required petitioner to design costumes, but did not mention fabrication or sale of the costumes. The customers were not required to purchase costumes from petitioner and petitioner was not required to fabricate or sell costumes to the customers. We therefore conclude that the design services and the subsequent fabrication and sale of costumes were performed under separate contracts. The design services were thus not “part of the sale” of the costumes.

We would reach a different conclusion if petitioner’s charges for the costumes were unrealistically low. We would view that as evidence that a portion of the design fees was in fact being paid for the costumes, which would lead us to conclude that the design services and costumes were being sold together as a “package deal.” There is no evidence to indicate that such is the case here, however.

According to the audit staff, petitioner sometimes transferred sketches and patterns to customers who had elected not to purchase costumes from petitioner. Unless otherwise exempt, tax would apply to these transactions measured by the portion of the design fees allocable to the sketches and patterns transferred. The tax applies not because the design is part of the sale of costumes, but because the transfer of sketches and patterns is itself a sale of tangible personal property.

N--- M--- LTD., SR – XX XXXXXX-XXX  
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Recommendation

Reaudit to delete design fees from the measure of tax, except to the extent the design fees are allocable to patterns and sketches transferred to customer who elected to have the costumes fabricated by other persons.

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James E. Mahler, Hearing Officer

5/16/91

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Date