

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

515.0006

APPEALS DIVISION

In the Matter of the Petition)	HEARING
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)	
)	
L--- D---, INC.)	No. SR -- XX XXXXXX-010
)	
<u>Petitioner</u>)	

The above-referenced matter came on regularly for hearing before Hearing Officer James E. Mahler on October 12, 1990, in Culver City, California.

Appearing for Petitioner: C--- D. P---
Certified Public Accountant

P--- D. L---
Certified Public Accountant

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

Appearing for the Sales and
Use Tax Department

David J. Slechta
District Principal Auditor

George T. Ito
Supervising Auditor

Protested Items

The protested tax liability for the period January 1, 1986, through September 30, 1989, is measured by:

<u>Item</u>	<u>State, Local, County & LACT</u>
B. Unreported receipts from rental of sets	\$3,173,937

Petitioner's Contentions

1. Petitioner's customers desire design services and art direction, not tangible personal property.
2. If any tax is due, deductions should be allowed for design services and art direction.
3. Deductions should also be allowed for installation and other types of labor.

Summary of Petition

Petitioner is a corporation whose principal shareholder is Mr. V--- L---. It is engaged in the business of designing and building sets for video productions. Most of the sets are for use in television commercials and music videos.

Each of petitioner's jobs is unique, but the work generally progresses in the following manner. Mr. L--- and his assistants first meet with the customer to get a general idea of the customer's desires. They read the script for the proposed video and research historical texts and photographs in order to visualize how the set should appear. They may also take photographs of the location where the filming will be done and draw rough sketches of the set.

If the customer hires petitioner for the job, Mr. L--- and his associates then prepare more detailed drawings, renderings and overlays to illustrate the proposed appearance of the set. These drawings include ideas for camera positions and lighting effects. Mr. L---'s assistants may also visit costume shops and property houses to photograph available types and styles of costumes and props. The drawings and photographs are presented to the customer for final approval. According to testimony at the appeal hearing, the customers might then use Mr. L---'s ideas to fabricate their own sets, or hire someone else to construct the sets, but it appears that petitioner constructed the sets on all jobs during this audit period.

The walls, platforms and other components of the set are usually prefabricated at petitioner's shop. Petitioner purchases new materials ex-tax under resale certificates, but also uses old materials left over from previous jobs (which were also purchased ex-tax under resale certificates). Props and costumes are usually furnished by the customer or by other persons who contract directly with the customer.

A construction crew loads the set components onto vehicles for transportation to the location of the shoot, unloads the components upon arrival and builds the set. It appears that the vehicles are usually provided by the customer. The members of the construction crew are normally petitioner's employees, although employees of the customer may sometimes assist.

Mr. L--- then “dresses” the set by positioning props, cameras and lighting. According to testimony at the appeal hearing, Mr. L--- “controls the art production crew” and directs necessary changes in the positioning of cameras and props. When shooting is completed, the construction crew “strikes” or disassembles the set. Usable materials are returned to petitioner’s shop for reuse on other jobs, but most of the material is simply thrown away by petitioner.

Petitioner’s invoices to its customers were often issued prior to beginning the job, and served a dual function as both invoices and bid sheets. Some of the invoices included a detailed list of set components and other items, but the amount billed was a lump sum for “set construction” with no separate allocation among the various items. (See, e.g., the invoice for job no. 203-88.) Most invoices, however, simply billed a lump sum for “cost of sets” or “set construction” or “set construction: rental” without listing the separate components. (See, e.g., the invoice for job no. 203-88.) A few invoices did include a generalized breakdown of costs among specific sets or set components. (See, e.g., the invoice for job no. 163-86.)

None of the invoices presented for our review included any separate charge for design services, are direction or supervision. In fact, there is only one invoice (for job no. 188-87) where such services were even mentioned. On that invoice, design, drawings, a scale model, art direction and supervision were listed as included in the lump-sum charge for “construction fees”.

Two invoices (for jobs 163-86 and 197-87) includes separate charges for striking the set, and a few other invoices mentioned strike labor but did not quote a separate price. No invoice charged separately for loading, unloading or erection at location, although “trucks” was listed as a part of “set construction” on some invoices. One invoice (for job 209-88) stated that the lump-sum charge included an “assistant” for five days at the rate of \$275 per day.

Most of the invoices also included a separate charge for “materials”. According to the audit staff, these amounts represented the costs of new materials purchased by petitioner for the specific job, and did not include the costs of old materials previously used on other jobs.

Petitioner charged tax reimbursement and reported tax measured by the separately stated charges for materials. It did not charge or report tax on the lump-sum charges for set construction. (Those charges were apparently claimed as nontaxable sales for resale on petitioner’s returns.) Upon audit, the staff concluded that petitioner was leasing the sets to its customers and that tax applies to the total amount charged. Petitioner contends that it performs artistic design services and does not sell or lease tangible personal property, so that no part of the charge should be taxable. Alternatively, petitioner contends that a portion of the charge was for nontaxable design services and other labor.

In support of its alternative contention, petitioner has presented an analysis of one job (for a [name] commercial). This particular job was performed in January or February 1985, almost one year before the start of the audit period, but petitioner alleges that it is typical of the audit period transactions. The customer was billed a lump sum \$180,000 for “total set cost”. Petitioner alleges that it incurred expenses of \$86,009.87 for this job, of which \$56,646 was for labor as follows:

Art director	\$22,800
Production assistants	2,700
Carpentry	24,571
Move to stage	2,390
Prop persons	2,025
Strike	<u>2,160</u>
	\$56,646

Petitioner explains that "art director" represents the cost of Mr. L---'s creation and visualization of the set design, including art renderings and overlays. The "production assistants" and "prop persons" researched and photographed props for use on the set and, during shooting, monitored and positioned the placement of props on the set. "Move to stage" includes loading, transportation and unloading the set components at location, and apparently also includes erection or installation of the set.

Excluding carpentry, the other labor expenses total \$32,075. Petitioner contends that all labor charges except carpentry are nontaxable. The alleged nontaxable labor thus represents 56.6 percent of total labor expenses (\$32,075 divided by \$56,646) and 37.3 percent of total job expenses (\$32,075 divided by \$86,009.87).

Petitioner's invoice to the customer for this job added tax reimbursement to the entire \$180,000 lump-sum charge. As noted above, petitioner's policy during the audit period was to add tax reimbursement and report tax only on the separately stated charges for new materials. We do not know why petitioner changed its tax reporting policy.

The District audit staff reviewed petitioner's analysis after the hearing and advised the Hearing Officer of their conclusions by memo dated January 8, 1991. The staff concluded that petitioner would be entitled to exemption for any installation labor (not including setup or assembly) and "possibly a portion" of the charges listed as "art director".

Analysis and Conclusions

1. With certain exceptions not relevant here, Revenue and Taxation Code Sections 6006(g) and 6010(e) defined "sale" and "purchase", respectively, to include leases of tangible personal property for a consideration. Section 6006.3 of the Code defines "lease" to include "rental, hire and license". Petitioner transfers possession of the sets to its customers for a consideration. These transactions are leases and are therefore sales and purchases.

Petitioner nevertheless contends that the true object of the transactions is the service of designing the sets, not the sets themselves. We disagree. Sales and Use Tax Regulation 1501 provides that the basic distinction in determining whether a particular transaction is a sale or a service is: "...is the real object sought by the buyer the service per se or the property produced by the service". Petitioner's customers desire the property produced by the design services, not the services per se, and the transactions are therefore not service transactions.

Petitioner relies on recent decision by the Board's staff involving persons who design printed circuit boards. The staff has concluded that such transactions are service transactions, even if the designs are transferred to the customer on mylar or other tangible personal property. We find those decisions distinguishable, however, since petitioner's customers desire the completed sets, not just the set designs. Accordingly, we agree with the staff that petitioner is engaged in the business of leasing tangible personal property.

2. The tax on leases is generally a use tax measured by the "sales price". (See Sales and Use Tax Reg. 1661(c)(1).) The term "sales price" means "the total amount for which tangible personal property is sold or leased or rented...without any deduction on account of...(2) the cost of materials used, labor or service cost, interest charged, losses, or any other expenses." (Rev. & Tax. Code § 6011(a).) The "total amount for which the property is sold or leased or rented" includes any charges for "services that are a part of the sale." (Rev. & Tax. Code § 6011(b)(1).)

The manufacture or production of custom-made property necessarily involves design work or similar types of creative services. There is no general exemption for custom-made property in the Sales and Use Tax Law, however. The design services are required to produce the property in the form designed by the customer, and such charges are therefore generally taxable as "part of the sale" of the property.

The Board has nonetheless recognized a limited exception 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 the production of the property in accordance with the design, charges for the property might well be taxable, but the charges for the design work remain nontaxable. (See Sales and Use Tax Annotation 515.0440 [2/27/64].)

Sales and Use Tax Annotation 515.0460 (4/16/70) applies these concepts to the specific context of leases of exhibits for expositions and fairs. The annotation provides:

"A designer's charges for designing exhibits for expositions and fairs are not subject to tax where the designs are made to display ideas, the designer retains title thereto, and he subsequently contracts under separate agreements to construct and lease exhibits depicted therein."

In this case, the terms of petitioner's contracts with its customers are reflected in the billing invoices, which also served as bid sheets. These documents show that the service of designing the sets was offered to the customers with the sets as a "package deal". In no case did the customer contract for the design services separately from the lease of the sets. The design services were therefore "part of the sale" of the sets, and the charges for the design services are fully taxable.

3. Finally, petitioner seeks exemption to the extent its lump-sum charges included compensation for transporting the sets to the customer's location, installation, personnel and strike labor.

Transportation. Subdivisions (a)(3) and (c)(7) of Revenue and Taxation Code Section 6011 provide that the sales price includes charges for transporting the property sold or leased, unless certain requirements are satisfied. Among other requirements for exemption, the transportation charges must be "[s]eparately stated". Since petitioner did not separately state transportation charges, it is not entitled to exemption.

Installation. Subdivision (c)(3) of Section 6011 provides that the sales price does not include charges for installation. It has therefore been held that the labor of installing leased exhibits at expositions and fair sites is not subject to tax, even if the installation charges are not separately stated. (Sales and Use Tax Annotation 330.3320 [4/16/70].)

The information which petitioner presented for the [name] commercial does not include any specific calculation of installation expenses. Installation labor is apparently included, along with transportation, in petitioner's category "move to stage". The "move to stage" expenses equal 4.22 percent of labor expenses for the job (\$2,390 divided by \$56,646) and 2.78 percent of total expenses (\$2,390 divided by \$86,990.87). On this basis we are willing to assume, without further evidence, that the installation portion of "move to stage" was at least two percent of total expenses.

We therefore recommend a reaudit to allow exemption for installation charges equal to two percent of the total charges to customers. If petitioner believes that the installation charges were in fact higher than that amount, it may present additional evidence to the audit staff during the reaudit.

Personnel. This includes charges for supervision and direction performed by Mr. L--- on location, as well as for production assistance and prop persons.

In numerous contexts, the Board has concluded that charges for personnel provided with a lease of tangible personal property are not subject to tax if two requirements are satisfied. First, the customer must have the option to lease the property without the personnel, and second, the charges for personnel must be separately stated. (See, e.g., Sales and Use Tax Annotations 330.2080 [1/9/69], 330.3140 [10/5/65], 330.3160 [8/20/65], 330.3460 [5/19/67], 330.3480 [12/19/66] and 330.3560 [10/5/65].)

Charges for a production assistant were listed separately on the invoice for job no. 209-88. However, the production assistant was provided as part of a "package" with the set rental, and the customer was apparently not offered an option to rent the sets without the production assistant. In all other cases, charges for personnel were not separately stated, and the personnel were presumably offered as a mandatory part of set rental. Petitioner is therefore not entitled to any deduction for personnel charges.

Strike Labor. As with charges for personnel, it has previously been concluded that charges for dismantling leased property are nontaxable only if they are separately stated, and the lessee is free to lease the property without having to hire the lessor to do the dismantling. (Sales and Use Tax Annotation 330.3280 [12/28/66].) Petitioner did not separately state charges for strike labor on most jobs, and there is nothing to indicate that the strike labor was optional on any job. Deductions for strike labor are therefore not allowable.

Recommendation

Reaudit in accordance with the view expressed herein.

James E. Mahler, Hearing Officer

4/23/91

Date