STATE OF CALIFORNIA

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
	)	No. REDACTED TEXT
Petitioner	)	

The Appeals conference in the above-referenced matter was held by Paul O. Smith, Staff Counsel on May 5, 1994, at Culver City, California.

Appearing for Petitioner: REDACTED TEXT

Appearing for the Sales and Use Tax Department: Gilbert A. Smith, Supervising Tax Auditor; Albert W. Lai, Senior Tax Auditor

Protested Items

The protested tax liability for the period January 1, 1988 through December 31, 1990, is measured by:

Item	Amount
A. Disallowed claimed professional fees of $10,000 or more billed to California clients.	REDACTED TEXT
B. Disallowed claimed professional fees of less than $10,000 based on a statistical sample that revealed a 10.24 percent of error.	REDACTED TEXT

C. Disallowed claimed reimbursed expenses for $10,000 or more.	REDACTED TEXT
D. Disallowed claimed reimbursed expenses for charges less than $10,000 based on a statistical sample that revealed a 7.03 percent of error.	REDACTED TEXT
Total	REDACTED TEXT

Petitioner's Contentions

1. It is not a graphic designer, it is a design architect, and as such provides a service, not the delivery of a drawing.

2. Its competitors have received opinions from the State Board of Equalization that their work is exempt, though they perform the same service as petitioner.

3. Based on the "Report of Office Discussion" in a prior audit, petitioner got the impression that its procedures were correct.

4. Its work should be considered preliminary art.

Summary

During the period in issue petitioner REDACTED TEXT operated as a design firm. The nature of petitioner's business operations during the period in issue are essentially the same as in prior periods. Petitioner completed the design work for the REDACTED TEXT as well as a comprehensive system of traffic signs for REDACTED TEXT in REDACTED TEXT, Florida, and the REDACTED TEXT logo and REDACTED TEXT directional system. Petitioner also developed the design concept and the color and materials palette for the REDACTED TEXT. In this project petitioner reviewed the client's program and alternative approaches to design the project. It prepared drawings and other documents to illustrate the scale and relationship of the project. Based on approved design documents, petitioner assisted the project's architect in preparing drawings and specifications that detailed project requirements, and in preparing and awarding construction contracts. Petitioner developed the general color and material direction for the project's color palette and materials program. To show its color ideas, petitioner developed drawings, sketches, models or mock-ups. Petitioner considers itself to be a design company that develops conceptual ideas and designs; it is a company that operated somewhere between an architect and graphic designer.

Architectural sign companies such as REDACTED TEXT used petitioner's drawings as guidelines to create their version of construction and shop drawings for use by a fabricator. The fabricator did the actual production and installation of the signs from procedures documented by

petitioner as a signing schedule and design control drawings delivered as blueprints.[1] Petitioner also created sample layouts that the fabricator used as a reference in the production of mechanical artwork for the signs, and observed all stages of the fabrication process. Petitioner does not produce any reproducible art, and employed four licensed architects. Petitioner claims its design drawings closely resemble architectural drawings.

On July 29, 1992, Mr. David J. Slechta, a State Board of Equalization (hereinafter "Board") District Principal Auditor, by letter advised REDACTED TEXT, a company engaged in the same type of sign work as petitioner, that each phase of its contract, other than its creation of mechanical artwork for some signs, was a nontaxable service. He also advised the company that furnishing drawings or mock-ups constituted a taxable transfer of tangible personal property, though the items were evidence of a design or idea. However, on April 5, 1993, Mr. Slechta advised petitioner that its performance of the same activities, other than observing the fabrication process, were taxable.

The Sales and Use Tax Department (Department) has conducted at least three prior audits. Petitioner states that in each of the prior audits the Department examined its architectural and signing contracts and did not find them to be taxable. Petitioner states that all prior audit discussions dealt only with the taxability of print and exhibit contracts where production costs passed through petitioner to the client. The immediately prior audit covered the period April 1, 1985 through December 31, 1987, and at its completion the Department instructed the auditor to:

> "Examine TP claimed exempt labor charges again. Set up tax on any charges for drawings delivered to the engineering firm [fabricator]. Do not set up any tax on drawings delivered to out-of-state engineering firms."

After a hearing with the District Principal Auditor in the immediately prior audit, the Department reduced petitioner's tax assessment. Because the auditor's reexamination resulted in a reduction in taxes, and because the Department made no additional changes or assessed additional taxes, petitioner assumed the Department found its procedures to be correct. The Department disputes this claim.

The Department determined that petitioner's contracts require the performance of: (1) data collection; (2) project analysis and schematic drawings; (3) conceptual design; (4) documentation; and (5) observation of a sign's fabrication and installation. In phases 3 and 4, the Department determined that petitioner produced tangible personal property such as sketches, design drawings, signing layouts, and sometimes mechanical artwork, models and mock-ups. Petitioner billed all clients at an hourly rate plus expenses, and no phase of the contract was separately stated in petitioner's billings. In most transactions petitioner retained title to the visual items it produced. A licensed architect was always involved in the contract (the architect either hired petitioner, or the client hired petitioner to work with the architect). Because the fabricator used petitioner's drawings in constructing its bid, the Department determined that the drawings were the true object of the contracts.

[1] A typical specification required each fabricator to submit a written quotation for all items shown on a bid document (a bid document is identified as two sets of design drawings with specifications, sign message schedules, and a bid breakdown form) . For a fee, the fabricator could obtain the architectural drawings from petitioner. On some occasions petitioner made its designs on a drawing, reproduced it, and gave it to the fabricator. All payments were made directly to the fabricator by the client. The specifications also required a fabricator to submit to petitioner its shop drawings (inclusive of elevations, details of fabrication and erection, including all materials, shapes, etc.), and samples, such as materials, colors, full-size patterns of each sign, and non-returnable lettering samples.

On January 6, 1993, the Department issued its Notice of Determination to petitioner on that basis. On February 3, 1993, petitioner submitted a timely Petition for Redetermination.

In a letter dated June 13, 1994 (Exhibit A), the Department stated it segregated petitioner's disallowed sales into 7 categories depending on the nature of the contract: (1) the sales of sample layouts and technical drawings were considered sales of tangible personal property, though petitioner retained title to the items; (2) the sales of sketches, sample layouts, photographs, slides, mock-ups and models were considered taxable because title passed to the client; (3) the sales of vinyl [leather] and flags were considered taxable because petitioner is the retailer of the items; (4) the delivery of camera ready art for logos and technical drawings were considered taxable sales;[2] (5) the sales of camera ready art for logos, signs, stationery, and brochures or printed materials were considered taxable as regular graphic designer work; (6) sales invoice REDACTED TEXT was disallowed because it related to the sale of taxable artwork and drawings; and (7) sales invoice REDACTED TEXT was disallowed because petitioner could not state what was sold or what service was performed.

On June 29, 1994, petitioner submitted a response (see Exhibit B), and on July 1, 1994, submitted a supplement to this response. (Exhibit C). The responses stated, among other things, that on April 24, 1990, petitioner wrote off $14,124.35 of sales invoice REDACTED TEXT; on April 18, 1991, petitioner issued a credit of $611.39 against sales invoice REDACTED TEXT, and $5,432.94 of the invoice was written off; on April 23, 1991, $10,151.95 of invoice REDACTED TEXT was written off; and on August 7, 1991, $589.93 of sales invoice REDACTED TEXT was written off.[3]

Analysis and Conclusions

Revenue and Taxation Code section 6012 provides in relevant part that the term "gross receipts" means the total amount for which tangible personal property is sold, including any services that are part of the sale. The general standard for classifying transactions involving both services and the transfer of tangible personal property is whether there was a sale of tangible personal property, or whether the transfer of tangible personal property was incidental to the performance of a service. That is, is the true object sought by the buyer the service per se or the property produced by the service. (See Culligan Water Conditioning v. State Bd. of Equalization (1976) 17 Cal.3d 86, 97; Albers v. State Bd. of Equalization (1965) 237 Cal.App.2d 494, 497.) This principle is codified in California Code Regulations, tit. 18, reg. 1501.

Regulation 1501 provides in relevant part that "the basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true objects of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred." The regulation further provides, for example, a firm that does business advisory, record keeping, payroll and tax services, providing forms, binders, and other property to its clients as an incident to the rendition of its services is the consumer and not the retailer of tangible personal property. Here, the true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property.

[2] Petitioner claims it charged sales tax on the fees billed for the logo, but has yet to produce the invoice.
[3] The Department's audit schedule (Exhibit A, schedule D) indicates invoice REDACTED TEXT as $582

An idea may be expressed in the form of tangible personal property and that property may be transferred for a consideration from one person to another; yet, the person transferring the property may still be regarded as the consumer of the property. Thus, the transfer to a publisher of an original manuscript by the author of it for publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of his creation. Tax still would apply to the sale of artistic expressions in the form of paintings and sculptures though the work of art may express an original idea. This is because the purchaser desires the tangible object itself; that is, since the true object of the contract is the work of art in its physical form. (Cal. Code Regs., tit. 18, reg. 1501.)

Petitioner argues that it provides a service, not the delivery of a drawing. The critical point of inquiry is whether the true object of petitioner's contracts is sample layouts, drawings, sketches, models or mock-ups, or the performance of design service.

Similar to the work of an architect or engineer, petitioner's concepts and ideas were depicted in its design drawings. Petitioner and its client clearly contemplated that the production of design drawings would be used by a client as a representation of petitioner's concepts and ideas. For example, the REDACTED TEXT required petitioner to prepare drawings and documents that illustrated the scale and relationship of the project, as well as documents to fix and describe the size and character of the entire project. With the project architect, petitioner also prepared drawings and specifications that detailed the projects requirements, and prepared sketches, drawings, models or mock-ups that demonstrated petitioner's color idea. These drawings and documents, containing petitioner's ideas and concepts, were used by the client to complete the project. Also, architectural sign companies used petitioner's drawings as guidelines to create shop drawings for use by a fabricator. Further, fabricators used petitioner's design control drawings delivered as blueprints, or sample layouts in the fabrication process.

In Albers v. State Bd. of Equalization, *supra*, the court, in distinguishing between the efforts of an architect and a draftsman, treated the latter as a retailer of drawings furnished to customers and the former as a consumer for sales tax purposes. The court reasoned that the sale of the draftsman's drawing of construction plans was taxable because the true object of the transaction was the drawing itself, not the architectural or engineering services. The regulatory and case authorities stand for the proposition that if the purchaser desires concepts and ideas embodied in the form of drawings and artwork (tangible personal property), not merely for conveying the concepts and ideas, but to use the property, the transfer is subject to tax. (See also Culligan Water Conditioning v. State Bd. of Equalization, supra, 17 Cal.3d at 96; Simplicity Pattern Co. v. State Bd. of Equalization (1980) 27 Cal.3d 900,-907.)

From the above, I conclude that in the performance of the contracts in issue, petitioner's primary purpose was to produce drawings and designs for use by its clients, not to conceive or to dictate any of its ideas, concepts, designs, or specifications in those items. In other words, the client purchased the drawings and designs for its own use, not merely just the design or specifications pictured in the item. (Cf. Albers v. State Bd. of Equalization, supra, 237 Cal.App.2d 494.)

When a transaction is a sale of tangible personal property, tax applies to the gross receipts from the transaction, without any deduction on account of the work, labor, skill, thought, time spent, or other expense, of producing the property. Physical objects valued in part for their intangible content are taxed as tangible personal property on their total worth. (See e.g. Rev. & Tax. Code, § 6051; Cal. Code Regs., tit. 18, reg. 1540, subd. (c); Simplicity Pattern Co. v. State Bd. of Equalization, supra 27 Cal.3d at 906.) Thus, petitioner's contracts are taxable as tangible personal property measured by the full amount received by petitioner, without any deduction for amounts paid for any intangible (concept or idea).

Petitioner makes an analogy of its activities to the production of a story board. The distinction, which petitioner misses, is that by giving its clients possession of its drawings, a sale has occurred (see Rev. & Tax. Code, § 6006, subd. (a) which provides in relevant part that a "sale" means and includes any transfer of title or possession of tangible personal property for a consideration.) In the case of a story board, a photocopy (or possibly a sketch) of it is given to the producer free of charge. Petitioner states, without providing any names, that other California firms engaged in the sign design business are not charging sales tax on any aspect of their signing projects. This may be. But this does not make them correct. I do not know what criteria these companies are using to conclude that they are engaged in a nontaxable service. If, however, their signing activities are examined under regulation 1501, as I have here, then their contracts could be nontaxable only if the true object of the contract is the service per se, though some tangible personal property is incidentally transferred.

Petitioner's reliance on Sales and Use Tax Annotations 515.0340 (Aug. 20, 1969); 515.0380 (Dec. 15, 1965; Apr. 25, 1988); and 515.1220 (May 26, 1955), is misplaced. While it is true that petitioner engages in architectural design, none of the contracts in issue required such work by petitioner.[4] In each of the contracts in issue petitioner was either employed by an architect or assisted the architect in the design phase of the contract. Further, as previously stated, architectural sign companies and fabricators connected with a contract used petitioner's drawings as guidelines to perform their phase of the contract. Architectural sign companies, such as REDACTED TEXT used petitioner's drawings as guidelines to create their version of construction and shop drawings for use by a fabricator.

Petitioner also argues that its competitors have received opinions from the State Board of Equalization that their work is exempt, though they did the same service as petitioner. Petitioner further argues that based on the "Report of Office Discussion" in a prior audit, petitioner got the impression that its procedures were correct. Because these arguments are related by statute, I am discussing them both here.

Section 6596 gives authority to the Board to relieve taxpayers of tax, interest, or penalty where the Board finds that the failure to make a timely payment was due to the taxpayer's reasonable reliance on written advice from this Board. However, a condition that must be satisfied, to use this statute, is a request in writing to the Board for advice whether a particular activity or transaction is subject to the sales or use tax. Here, Mr. REDACTED TEXT response to petitioner's written request, advised petitioner that the furnishing of drawings or mock-ups constituted a taxable transfer of tangible personal property, though the items were evidence of a design or idea. Since this advice was correct, petitioner cannot receive relief under this portion of the statute.

[4] On December 16, 1992, the Department prepared a revised audit report excluding receipts for consultation services, color design or service charges for architectural drawings.

I agree with petitioner that Mr. Slechta's letter of July 29, 1992, demonstrates an inconsistent position by the Board. But, petitioner, to obtain relief under the statute can only rely on its own written request and the Board's response to that request. (Rev. & Tax. Code, § 6596, subd. (c) (1); see also State Bd. of Equal., Oper. Memo 1012, p. 3, Aug. 13, 1993.) Petitioner cannot rely on a letter from the Board that was directed to another party, even though petitioner and the other party were engaged in the same type of sign operations.

On September 30, 1992, the Board delegated to the Department authority to relieve taxpayers of tax, interest and penalty, as provided by section 6596, under the following limited circumstance:

"(2) Where the issue in question was clearly discussed in the prior audit and the essence of the advice to the taxpayer is set forth in writing in the working papers. Both staff and the taxpayer must agree that the erroneous advice was provided in the prior audit. In all other cases, claims of reliance on erroneous advice must be ruled upon by Board members." (State Bd. of Equal., Oper. Memo 1012, p. 4, Aug. 13, 1993.)

In the immediate prior audit the Department instructed its auditor to reexamine petitioner's claimed exempt labor charges, and to tax only charges for drawings delivered, to an in-state fabricator. Also during this audit period petitioner generated at least 100 invoices related to signing jobs, but the Department did not disallow the sales from these jobs. Though the Department ultimately reduced the tax assessment and made no additional changes, this is not evidence that the parties specifically discussed the taxability of petitioner's design contracts. I do not dispute petitioner's claim that the nature of its business is essentially unchanged from prior periods. However, the failure of the Department to adjust for the 100 invoices related to signing jobs, while in error, does not constitute written advice to petitioner that its contracts were nontaxable.

Here, there is no evidence that the Department's action was anything other than an oversight. Neither is there any evidence that the auditor reviewed and understood the nature of the transactions. Petitioner must show that the Department examined 100 sign contracts, found them to be nontaxable, and stated as much, in writing, in the audit workpapers. Lastly, there must be an agreement between the parties that erroneous written advice was provided in the prior audit. The Department denies that it gave any erroneous advice to petitioner.

In the alternative, petitioner contends its work should be considered preliminary art.

California Code Regulations, title 18, reg. 1540, subdivision (c) provides in relevant part that tax does not apply to separate charges for preliminary art as defined in subdivision (b) (4) (A). Subdivision (b) (4) (A) provides that "preliminary art" means roughs, visualizations, layouts and comprehensive, title to which does not pass to the client but is prepared by a designer solely to demonstrate an idea or message for acceptance by the client before a contract is entered into. In addition, the charge for preliminary art must be billed separately to the client, or it must be separately listed on a billing, and it must be clearly identified on the billing as preliminary art.

Here, title to petitioner's preliminary art did not pass to its clients. However, there is no indication, as required by regulation 1540, that such art was prepared solely to demonstrate an idea or message for acceptance by the client, before a contract was entered into. Also, there was

no separate charge for preliminary art on petitioner's billings or as a separate billing to a client. Therefore, I must conclude that the Department properly taxed preliminary art sold by petitioner.

With respect to the credit applied against sales invoice REDACTED TEXT (Exhibit B), the term "sales price" does not include the amount refunded to a customer in cash or credit. (Rev. & Tax. Code, § 6012, subd. (c) (2).) Thus, the amount listed for invoice REDACTED TEXT should be reduced by the $611.39 credit, providing the amount was refunded to the customer in cash or credit.

I now discuss petitioner's argument that it is entitled to the bad debt deductions set forth in Exhibit B.

Section 6055 provides that a retailer can be relieved from liability for sales tax represented by accounts that are worthless and charged off for income tax purposes. Regulation 1642, which implements section 6055, provides in relevant part that the deduction should be taken on the return filed for the period in which the amount was found worthless and charged off for income tax purposes. (Cal. Code Regs., tit. 18, reg. 1642, subd. (a).)

Regulation 1642 also provides that in support of deductions or claims for credit for bad debts, retailers must maintain adequate and complete records showing: (1) date of original sale; (2) name and address of purchaser; (3) amount purchaser contracted to pay; (4) amount on which retailer paid tax; (5) all payments or other credits applied to account of purchaser; and (6) evidence that the uncollectible portion of gross receipts on which tax was paid actually has been legally charged off as a bad debt for income tax purposes. (Cal. Code Regs., tit. 18, reg. 1642, subd. (e).)

Here, the only amount written off during the period in issue was the $14,124.35 written off against invoice REDACTED TEXT. This is the only amount that could have been charged off in petitioner's income tax returns in this period. Therefore, this amount is to be allowed as a bad debt deduction, providing petitioner meets the requirements of subdivision (e). If petitioner has evidence that the amount was charged off for income tax purposes, then petitioner can submit it with a timely Request for Reconsideration of the Decision and Recommendation.

Recommendation

Conduct a reaudit to allow a $611.39 credit against invoice REDACTED TEXT, and allow the $14,124.35 written off against invoice REDACTED TEXT, in accordance with the analysis herein. Deny the petition in all other respects.

10/26/94

Paul O. Smith, Staff Counsel — Date

Attachments: Exhibits A and B