STATE OF CALIFORNIA

100.0034.400

STATE BOARD OF EQUALIZATION
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November 19, 1996

Ms. C--- H---, CPA
XXXX --- Ave., Unit ---
---, CA XXXXX

Re: Unidentified Taxpayer
"Media Purchase"

Dear Ms. H---:

This responds to your inquiry dated July 22, 1996 concerning a design and marketing company (D---) which contracts to create and produce three advertisements (a print ad, a radio ad and a video/tv ad) for a client; and to research and recommend the best media placement for each ad. Although you do not say, we assume for purposes of responding to your inquiry that D--- is located in California.

Additionally, in order to give you accurate advice, we have had to make a number of further assumptions, as well as stating our understanding of the meaning of some of your comments, to clarify the information which you provided. If the assumptions which we make or the meanings we attribute to your comments in this letter are incorrect, the advice contained in this letter may be incorrect. Please also be aware that since you do not identify the design and marketing company, this opinion letter does not come within the provisions of Revenue and Taxation Code section 6596.

You indicate that D--- does the following described work in performing its contract. D--- renders numerous conceptual directions for each advertisement. The concepts are shown to the client in the form of visual presentations. The concepts/visual presentations include photographs, illustrations and written advertising headlines. The visual presentations may be physically mounted on boards or may be in the form of "output from the computer." For purposes of this opinion letter, we assume that by the phrase "output from the computer", you

mean text and graphics generated by a computer program and printed out in the form of hard copy so that the client may view it.

In order to solicit comments and direction from the client, D--- meets with the client to present the concepts. For purposes of this opinion letter, we assume that neither title to, nor possession of, the tangible personal property which is used in preparing or displaying the visual presentations passes to the client.

After the client selects a preferred conceptual direction, D--- develops the concept further through a writing and graphic design process. Prior to production D--- prepares a final "mock-up" for the client's review and approval. By the term "mock-up", we assume you mean a model of the advertisement.

You describe the final production (after client approval) of the advertisements:

> "For the print advertisement, this means the production of camera-ready art, created on disk and sent to film that is late shipped to the publication. For the radio this means that is production of the advertisement is recorded in a studio (by and outside agency/vendor), using professional talent (people) and sound. For the tv/video advertisement, this means that the film is actually shot, using a camera crew, stock footage, sound, located, etc.; the "raw" film is then edited into the final version of the advertisement." (Quoted as written.)

In regard to the final production of the print advertisement, we understand the above to mean that D--- produces camera-ready artwork and type matter on a computer which it transmits via a computer disk to be reproduced or duplicated in-house by a photographic process. This photographic reproduction, which you refer to as "film", is then shipped by D--- to the publication which will run the advertisement. For purposes of this opinion letter, we assume that the publication which will run the ad is not a printed sales message as defined by Regulation 1541.5. (Copy enclosed.)

As to the radio advertisement, we understand your language, quoted above, to mean that D--- contracts with a third party to make the "master tape or master record" (as those terms are defined in Regulation 1527) of the advertisement in a recording studio, utilizing professional actors and/or singers, and sound in the recording process. We assume that D--- ships the completed master tape or master record of the radio advertisement to the radio station which will run the advertisement, and that D--- does not transfer possession or title of any other tangible personal property to the client or radio station.

As to the tv/video advertisement, we understand your statement, quoted above, to mean that D---, not a third party, "produces" (as that term is used in Regulation 1529) the advertisement. For purposes of this opinion letter, we assume that D--- utilizes the services of its own employees and/or third parties to produce what you refer to as the "raw film" for the ad. We

further assume that by the term "raw film", you mean a "work print" (as that term is defined and used in Regulation 1529). Included in the services, according to our understanding of your statement, are things such as the shooting of the film by a camera crew, the production of stock shots, and sound and/or music recording. We further assume you to mean that D--- then edits the work print into what becomes the final version of the advertisement. We assume that D--- ships the final version of the advertisement to the television or cable entity which will run it, and that no transfer of possession or title to any other tangible personal property is made by D--- to the client or to the television or cable entity.

You indicate that D--- also researches the best media choices for placement of the advertisements, and recommends these choices to the client. You state that the placement of the advertising is purchased. For purposes of this opinion letter, we assume that in some instances the client may directly purchase the advertising placement from the media chosen, and in some instances D--- may purchase the placement. We also understand that D--- may or may not receive a commission on the placement.

You ask about the taxability of charges made by D--- to its client. Your letter does not include any statement that D--- is acting as an agent on behalf of its client. Therefore, this opinion letter is based upon an assumption that D--- is not acting as an agent on behalf of the client, and that D--- acts as a seller, not as an agent, in its dealings with its client.

Discussion

Revenue and Taxation Code section 6051 imposes a sales tax on all retailers measured by their gross receipts from retail sales of tangible personal property. Although the sales tax is imposed on the retailer, the retailer may collect sales tax reimbursement (usually itemized on the invoice as "sales tax") from the purchaser if the contract of sale so provides. (Civ. Code § 1656.1.) When the sales tax does not apply, Revenue and Taxation Code section 6201 imposes a use tax on the storage, use or other consumption of tangible personal property in this state.

A retail sale means a sale for any purpose other than resale in the regular course of business in the form of tangible personal property. (Rev. & Tax. Code § 6007.) A purchaser who purchases property for resale in its regular course of business may issue the seller a resale certificate. (Reg. 1668; see also Reg. 1540(d).)

1. The Print Advertisement

Regulation 1540 (copy enclosed) applies to advertising agencies, commercial artists and designers, such as D---. To the extent that such a business acts on its own behalf, as D--- does, (as opposed to acting as an agent for its client) in acquiring tangible personal property, it is the purchaser of the property with respect to its supplier. Generally, a business such as D--- is the seller of any of the property so acquired which it delivers to its client or to third parties for the benefit of the client. It is also the seller of any of the property which it retains but title to which

it transfers to its client. (Reg. 1540(a)(1).) A business such as D--- is also the seller of tangible personal property produced or fabricated by its employees and then delivered to the client or to third parties for the benefit of the client. (Reg. 1540(a)(2)(B).)

When such a business bills a client, its charges may include compensation for tangible personal property sold by the business to the client and compensation for expenses and service costs related to the production of the property. In those instances, tax applies to the total amount of the retail sale of the property, whether the property was prepared by employees of the business or acquired from an outside source. (Reg. 1540(b)(1).) As the regulation states:

> "Tax applies to all charges made for such property, including charges for copy written solely for use as a part of such property. Tax applies to charges for services rendered that represent services that are a part of a sale of the property, or a labor or service cost in the production of the property. Charges for such items as supervision, consultation, research, postage, express, telephone and telegraph messages, and travel expenses, if involved in the rendering of such services, are likewise taxable. No deduction may be taken on account of the payment of model fees or talent fees, or for the cost of typography, or for the cost of other services involved in the producing of such items, even though the costs are itemized in the billing rendered to the client." (Reg. 1540(b)(1).)

However, Regulation 1540 makes a significant differentiation between "preliminary art" and "finished art", and how tax applies to charges for each:

> "`Preliminary art' means roughs, visualizations, layouts and comprehensives, title to which does not pass to the client but which is 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 copy for reproduction. If the preliminary art is prepared on data processing equipment, the advertising agency, commercial artist, or designer shall produce a hard copy of each of the roughs, visualizations, layouts or comprehensives presented for client approval and retain such copies in accordance with subdivision (d) of Regulation 1668.
>
> "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.
>
> "`Finished art' means the final art used for actual reproduction by photo-mechanical or other processes; or for display purposes including charts, graphs, and illustrative materials not reproduced. Tax applies to the total charges made by the advertising agencies, commercial artist or designers to their clients for finished art produced by them." (Reg. 1540(b)(4); emphasis added.)

Thus, when D--- produces a print advertisement for a charge, it is the seller of tangible personal property (such as the photographic reproduction of the ad) sold at retail to the client. Tax does not apply to D---'s separately stated charges for preliminary art, such as the visual presentations and/or "mock-up" which D--- shows to the client to obtain final approval for production of the ad. Tax does apply to the total amount of the charges to the client for the production of the finished art and photographic reproduction of the ad following client approval of the preliminary art.

Please note that while D---'s charges to the client may consist of a final bill itemizing the expenses incurred by D--- (such as labor, materials, equipment expenses, etc.) in producing the ad subsequent to client approval of the preliminary art, it is only itemized charges for preliminary art which are not subject to tax. Tax applies to all other charges related to the sale, and expenses to D--- may not be deducted before calculating the sales tax.

2. The Radio Advertisement

Regulation 1527 (copy enclosed) applies to sound recordings such as the radio advertisement which D--- sells to its client. Under the regulation, master tapes or master records include tapes or records which are produced for use as radio commercials. The measure of tax with respect to the retail sale of such master tapes or records is limited to the sale price of the unprocessed recording media. (Reg. 1527(b).) Regulation 1527 further specifies:

> "The measure of tax does not include charges for labor in recording sound, services rendered in producing, fabricating, processing or imprinting the master tapes, any other services or production expenses or amounts paid for the copyrightable, artistic, or intangible elements of master tapes or master records, whether designated as royalties or otherwise." (Reg. 1527(b)(2).)

Thus, the charges by the third party outside vendor to D--- for producing the master tape or record of the radio commercial which are subject to tax are limited to the sale price of the unprocessed recording media. D--- may issue a resale certificate to the third party outside vendor for the purchase since D--- will make a retail sale of the master tape or record to its

client. The measure of tax for D---'s charges to its client for the radio advertisement is limited to the sale price of the unprocessed recording media on which the master tape or record was recorded.

3. The TV/Video Advertisement

Revenue and Taxation Code section 6010.6 and Regulation 1529 (copy enclosed) explain the application of tax to motion pictures. The production of a television or video commercial, such as D---'s production of a tv/video advertisement for its client is the production of a "qualified motion picture" within the meaning of the section and as further defined by Regulation 1529, which implements and explains the section. (Rev. & Tax. Code § 6010.6(b)(3); Reg. 1529(b)(1)(A)1; see Reg. 1540(b)(4)(G).)

Section 6010.6 excludes from the application of sales or use tax, charges for the transfer of all or part of a qualified motion picture, such as the advertisement produced by D---, so long as the motion picture is transferred before the date of its exhibition or broadcast to its general audience. (Rev. & Tax. Code § 6010.6(a)(2); Reg. 1529(b)(1)(C).) Likewise, tax does not apply to charges for any "qualified production services" performed in connection with the production of all or any part of a qualified motion picture (Rev. & Tax. Code § 6010.6(a)(1); Reg. 1529(b)(2)(A).)

"Qualified production services" are defined as:

> "[A]ny fabrication performed by any person in any capacity (including but not limited to, an employee, agent, or independent contractor) on film, tape, or other audiovisual embodiment in connection with the production of all or any part of any qualified motion picture. Qualified production services include, but are not limited to, photography; sound or music recording; creation of special effects or animation on film, tape or other audiovisual embodiment, including animation drawings, inkings, paintings, tracings and celluloid `cells'; technological modifications, including colorizing; adaptation; alteration; computer graphics, including transfers of computer graphics on computer-generated media; sound dubbing or sound mixing; sound or music or effect transferring; film or tape editing or cutting; developing or processing of negatives or positives; timing; coding or encoding; creation of opticals, titles, main or end credits; captioning; and medium transfers (e.g., film to tape, tape to tape).
>
> "The term includes any such fabrication whether performed on the qualified motion picture before or after the release date. The term does not include work to manufacture release prints.
>
> "Qualified production services include processing performed on a qualified motion picture, except for processing to produce release prints.

Processing includes film developing and processing; film to tape transfers; and sound transferring, rerecording, dubbing, and mixing." (Reg. 1529(b)(2).)

A person, such as D--- or a third party, which performs qualified production services is the consumer of, and tax applies to the sale to that person of tangible personal property which that person uses in the performance of the services. (Reg. 1529(b)(2)(B).) Tax does not apply to charges, such as charges to D--- by a third party or charges by D--- to its client, for qualified production services. (Reg. 1527(b)(2)(A).)

Likewise, since the advertisement is a qualified motion picture, tax does not apply to D---'s charges to the client for the single final version of the ad. This final version is the qualified motion picture. We note, however, that any charges for the manufacturing of copies for exhibition to the public are subject to tax. Such copies are defined as "release prints." (Reg. 1529(d)(11).) The application of sales tax to sales of release prints is the same as the application of tax to other sales of tangible personal property; that is, the sale of a release print to a person for exhibition or broadcast is a retail sale subject to sales tax. (Reg. 1527(b)(3)(A).)

Thus, since D---'s contract with its client is to produce a single final version of a qualified motion picture, D---'s charges to its client are not subject to tax. D--- is the consumer of the film transferred to its client, and of any other tangible personal property which it uses in producing the ad. Sales to or use by D--- of such property is subject to tax.

4. Placement of Advertising

The service of placing of advertising (e.g., contracting with a television station to air an ad) is not a service that is part of a sale of tangible personal property by D--- to its client. (Reg. 1540(b)(4)(I).) Therefore, charges for the service of placing the advertising are not subject to tax. Commissions received for placement of the advertising are also not taxable. (Reg. 1540(b)(4)(I).) Thus, neither D--- nor the client are subject to tax on any amounts paid for the placement of the ads nor on any commissions derived from the purchase of the media placement.

In summary, for the print advertisement, only charges to the client for the finished art are subject to tax, so long as any charges for preliminary art are itemized. For the radio advertisement, only charges by D--- to its client for the unprocessed recording media on which the master tape or record was recorded are subject to tax. For the tv/video advertisement, no charges by D--- to the client are subject to tax so long as the only tangible personal property sold to the client is the one final version of the video/tv advertisement (the qualified motion picture).

I hope this information is of assistance. If we may answer any further questions, please write again giving a more detailed description of the work which D--- will perform, and providing copies of any contracts between D--- and its client.

Sincerely,

Sharon Jarvis
Senior Tax Counsel

SJ:rz
Enclosures: Reg. 1527, Reg. 1529, Reg. 1540, Reg. 1541.5

cc: --- District Administrator - --