

STATE OF CALIFORNIA

100.0190

BOARD OF EQUALIZATION

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--- & ---, INC.	)	No. SR -- XX-XXXXXX-020
	)	
	)	
<u>Petitioner</u>	)	

The Appeals Conference in the above-referenced matter was held by Senior Staff Counsel Lucian Khan on January 11, 1995 in Culver City, California.

Appearing for Petitioner:

B--- B---  
Vice President-Finance

P--- L---  
Senior Manager of Taxes  
P--- C---, Inc.

Appearing for the  
Sales and Use Tax Department

George Ito  
Supervising Tax Auditor

Anita Joshi  
Senior Tax Auditor

Protested Items

Tax assessed in audit sample for preliminary art charges for the audit period January 1, 1989 through June 30, 1992. The amount in dispute is undetermined at this time.

Contention

Preliminary art charges are not taxable since title to the art did not pass to clients.

Summary

Petitioner is engaged in business as an advertising agency, and according to the Sales and Use Tax Department (SUTD) acts as both a retailer and an agent. Preliminary art is produced in-house.

In the audit, tax was assessed on petitioner's charges for preliminary art to clients C---, Inc. (C---) and P--- P--- C--- (P---), based on the auditor's conclusion that title had passed to the clients.

A copy of the P--- agreement has been submitted (Exhibit 1 attached), but not for C---. This is because petitioner has concluded that the C--- agreement does not address the issue of title to preliminary art. Both SUTD and petitioner agree that all other requirements under Sales and Use Tax Regulation 1540 to exclude preliminary art charges, have been met. Both SUTD's and petitioner's arguments below, relates to a review of the P--- contract only.

According to SUTD, petitioner is involved in concept creation, writing and designing of advertisements. A review of the P--- agreement indicates title did pass to the client. This is illustrated by paragraph 2 which states as follows:

"All services rendered, including any ideas or advertising or promotion materials are for the use of the client only to advertise and promote client and/or client's products...."

This conforms with paragraph 9 that states:

"All advertisements, copy, layouts, ...prepared for and purchased and used by client shall become client's property, subject to the restrictions contained in paragraph 2, and shall be preserved for delivery to client upon request...."

The second subparagraph of paragraph 7, which makes the client liable for paying all production costs, states:

"In producing any finished product pursuant to this Agreement, it is expressly understood that title to all items and materials purchased by agency to complete the property to be produced passes to client at the time of purchase and prior to any use by Agency."

Petitioner argues title to preliminary art does not pass to the client. Paragraph 7 actually supports this position. The purpose of the first subparagraph of paragraph 7 (page 3 of Exhibit 1) is simply to indemnify petitioner from third-party obligations and to assure reimbursement for cost incurred. The second subparagraph of paragraph 7 merely states that title to any finished product produced on behalf of the client passes to the client prior to any use by petitioner. It therefore only passes title to materials purchased to complete the property to be produced for use by the client. Materials purchased is understood to be those component parts of the finished product used by the client, including materials purchased to produce finished art, mechanicals, typography, and engravings. It does not include comprehensive layouts, or any items that are used solely for the purpose of conveying an idea, concept, etc. Preliminary art is not used by the client, but rather is a means for petitioner to present creative/conceptual ideas for the client's consideration.

As to paragraph 9, petitioner argues the purpose and intent is to protect the client against intellectual property rights claims by third parties for the materials prepared by petitioner on the client's behalf. It specifically states that ownership of "advertising materials" reverts to the client when the materials are: (1) prepared for, (2) purchased and (3) used by the client. The very nature of preliminary art precludes it from being used by the client. Only the extent preliminary art would be incorporated into a finished ad, would ownership rights come into play. Petitioner does not incorporate preliminary art into finished ads.

### Analysis and Conclusions

Eff. 10/3/02, Reg. 1540(b)(4)(A)  
became 1540(a)(11). DR 1/13/05.

The definition of "preliminary art" and application of tax to charges made by advertising agencies to clients, is contained in Sales and Use Tax Regulation 1540(b)(4)(A). It defines "preliminary art" as roughs, visualizations, layout, and comprehensives 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 the preparation of finished art. The regulation provides that tax does not apply to charges for preliminary art providing that:

1. It does not become physically incorporated into the finished art, and
2. It is clearly identified on the billing as preliminary art, and billed separately either on a separate billing or separately charged on the billing for finished art, and
3. Title does not pass to the client.

Here, SUTD agrees that, except for the third requirement, all of the above requirements are met. SUTD contends that under the terms of the contract, title to preliminary art is passed to the client. Based on my review of the P--- contract (Exhibit 1), I agree with SUTD. The first paragraph of paragraph 7 defines "costs" to include items which would be defined as preliminary art, such as comprehensives and layouts. The second paragraph of paragraph 7, in referring to any "finished product", states it is expressly understood that title to all items and materials purchased by petitioner to complete the property to be produced, passes to the client at the time of purchase and prior to any use by petitioner. Although petitioner argues the term "finished product" actually relates to items such as finished art, this term is not defined. Clearly, preliminary art could be defined as a "finished product" providing it was complete, and ready for its intended use. That use is to demonstrate an idea or message for acceptance by the client before preparation of finished art.

The first paragraph of paragraph 9 includes preliminary art items such as all layouts and artwork within the definition of advertising materials and it also provides that the "advertising materials" prepared for and purchased and used by the client shall become the client's property, subject to the restrictions contained in Paragraph 2, and shall be preserved for delivery to the client upon request. Paragraph 2 of the agreement specifically states all services rendered, including any ideas or advertising or promotional materials, are for the use of the client only to advertise and promote the client and/or the client's products.

Interpreting these three paragraphs of the agreement as a whole, title to all advertising materials, including preliminary art, was transferred to the client, and therefore became the client's property. The agreement does not explicitly state that title to only finished art will transfer to the client, nor does it specifically state that title to preliminary art will not transfer. Admittedly, there are some ambiguities here. However, paragraph 18 specifically states that upon the client's request, petitioner will transfer, assign and make available to the client (or their representative) all property and materials in petitioner's possession or control which belongs to, and has been paid for by the client. Because Revenue and Taxation Code Section 6091 creates a presumption that all gross receipts are subject to tax until the contrary is established, I must conclude petitioner has not met its burden of proving that title to preliminary art did not pass to the client.

I do not find petitioner's interpretation of Paragraph 9 persuasive. Petitioner argues that the very nature of preliminary art precludes it from being used by the client; however, some of the mentioned items which become the client's property would in fact be defined as preliminary art. As to the transaction(s) relating to C---, I reach the same conclusion as well. No evidence has been presented to show that title did not transfer.

Recommendation

Redetermine in accordance with reaudit dated October 25, 1993.

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Lucian Khan, Staff Counsel

2-28-95  
Date