

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

295.1678

In the Matter of the Petition)	DECISION AND RECOMMENDATION
for Redetermination Under the)	OF HEARING OFFICER
Sales and Use Tax Law)	
)	
C--- M--- COMPANY)	Account No. SY -- XX XXXXXX
)	
)	
<u>Petitioner</u>)	

This matter came on regularly for hearing on December 14, 1977, in Los Angeles, California.
R. E. Hanna, Hearing Officer.

APPEARANCES

For the Petitioner:

Mr. J. H--- S---
Attorney at Law

Mr. C--- J---, Controller

Mr. S--- H---, former
Controller

For the Board's Staff:

Mr. I. E. Jenkins, Supervising Auditor

SUBJECT OF PROTEST

The petition was filed with respect to an assessment of tax and interest per a notice of determination issued July 27, 1977, pursuant to audit findings for the period 4-1-73 to 9-30-76. the protested tax was assessed with respect to an understatement of reported purchases of catalogs subject to use tax in the amount of \$93,027 (audit report descriptive item I).

PETITIONER'S CONTENTION

The major portion of the amount in question represents payments for services that are exempt from tax.

SUMMARY OF PETITION

Petitioner is a corporation which operates three 'catalog showroom' retail stores in the Los Angeles area. In this merchandising format, most sales are made at the retailer's showroom-store, with delivery from stockroom inventory to purchasers who personally present complete order blanks with descriptive entries taken from listings in the seller's catalog; however, a substantial number of sales are made through "mail order" procedures. Petitioner has been engaged in this business for many years, and was last audited for periods through the year 1972.

Each year petitioner purchases a large number of annual catalogs. Some are mailed to customers on its mailing lists, and some are retained at the business locations for hand-out distribution or for on-premises use by customers and employees. During its early years, petitioner was directly involved in most aspects of its catalog preparation procedures. In general, it: (1) selected the merchandise items proposed for inclusion in the catalog; (2) negotiated merchandise supply arrangements (prices, delivery commitments, returns and allowances agreements, etc.) through contacts between its buyers and the suppliers; (3) secured photographs and/or other illustrative graphics and data depicting and describing the merchandise for use in catalog illustrations and listings; (4) arranged for necessary camera-ready art work, design, layout, etc., by use of its employees and/or outside service firms; and (5) contracted with a commercial printing firm for production of the catalogs.

Later, apparently around 1970 or 1971, petitioner began purchasing its catalogs from C--- M--- and P---, Inc. (C---), a firm located in [city], Minnesota, which had developed a comprehensive program for production of a basic catalog each year which could be used by a member of different catalog-showroom firms with relatively simple and inexpensive customizing as to any particular use. Within this program C--- performs all, or almost all, of the services and actions described in steps (1) through (4) above, and has the catalogs printed by B--- P--- Company (B---), also located in [city]. Petitioner is one of a fairly large number of catalog-showroom retailers (referred to by C--- as "member" firms) whose catalogs are supplied by the C---/B--- team. Typically, petitioner, as does each of the member firms, executes a contract with C--- in the Spring of each year, agreeing to purchase a certain number of copies of C---'s basic Fall catalog. Attached hereto as Exhibit A is a copy of the 1976 contract, showing the details of the controlling purchase agreement for that year, including those concerning customizing the catalog to petitioner's particular identity and preferences. We understand this is a standard contract format used in C---'s agreements with all of its member firms, and that it remains largely unchanged from year to year.

Prior to 1973, billings under the contract (which are usually, but not always, rendered by B---) described the charges billed as being for catalogs. Petitioner did not then report its payments as being subject to use tax, and the previous audit resulted in an assessment of a use tax deficiency with respect to the catalog purchases. In 1973 C--- informed its member customers that the billing method would be changed to one in which the customer would receive three documents: (1) a statement of the basic and extra catalog charges; (2) an invoice for two-thirds of that amount representing a charge for "catalogs only"; and (3) a second invoice for one-third of that amount representing a charge for "buying services and consultation fees". (See copies of the notification bulletin and of petitioner's 1973 billing documents, attached hereto as Exhibit B.) Acting in accordance with the apparent intent of the change in the billing practice, petitioner reported only part of C---'s 1973 total charges as subject to use tax on the premise that one-third of the total amount billed was for exempt services rather than for the purchase of catalogs. This billing and reporting practice has since been followed each year.

In reviewing petitioner's reportings during the audit period, the auditor concluded that the amounts invoiced under the one-third apportionment to services and fees were actually part of the taxable sales price of catalogs. All C---/B--- billings were reviewed, allowances were made for certain nontaxable distributions and for some sales of catalogs, and the remaining costs representing catalogs used in California were deemed to be subject to use tax. Comparison with reported amounts disclosed the protested reporting understatement. Most of the understatement is attributable to petitioner's use of the two-thirds "catalog" invoice amounts as the starting point in compiling its reported amounts; but some portion, not separately identified in the audit analysis, represents other compilation oversights and omissions.

PETITIONER'S ARGUMENTS

The information summarized above was only partially available at the time of the preliminary hearing. Since then, Mr. S--- has been in communication with C---, and has furnished copies of several documents, including those shown in the attached exhibits, along with explanatory comments and statements of his arguments. All material furnished by him is in the petitioner file.

Petitioner's basic premise is, of course, that part of C---'s charges are for services which are not part of the actual production of the catalogs, and such charges should be excluded from the amounts subject to use tax. Mr. S--- describes such services as including but not limited to: (a) selection of merchandise for inclusion in the catalog; (b) negotiating all merchandise purchase terms with suppliers, then organizing this information and supplying it to member firms; (c) acting as a clearing house for merchandise problems of member firms through the services of a full-time staff of merchandise managers who work with suppliers and manufacturers on such problems; (d) providing data processing assistance to members; (e) providing in-store fixture layout assistance to members on request; (f) coordinating buying conferences; (g) maintaining product updates; and (h) handling special purchases for members. As to such services and the one-third apportionment of part of the catalog charges for them, it is said that:

1. A C--- officer has stated that he has figures and would testify that approximately two-thirds of the catalog billing costs are made up of paper, printing costs, art work, and the like; while one-third is made up of time spent by C---'s people at meetings of the member firms to determine what merchandise will be carried in the catalog, and the like.
2. If C--- did not provide such services, petitioner would have to obtain them elsewhere or perform them itself, and then would still have to pay to have the catalog printed, as it did before entering into the arrangement with C---.
3. The fact that the catalog billings are usually rendered by B---, rather than by C---, is not material as the sales of catalogs and services to petitioner are actually made by C---, with B--- billing as assignee and remitting the excess of receipts over its charges to C---.

4. In a similar controversy between another of C---'s member firms and the state of Michigan, Michigan's decision, rendered October 6, 1977 allowed the major portion of C---'s service charge as exempt, ruling that only that percentage of the service charge equal to the percentage of C---'s "production" salaries to total salaries (approximately 20.2%) would be subject to tax. Such production salaries are described as those paid to technical employees who perform design, layout, proofing, and copyrighting work in the preparation of the catalog for printing.

Petitioner's arguments conclude with the suggestion that the issue here be resolved on the same basis as was the Michigan tax matter, i.e., by allowance of some 80% of C---'s one-third service billings as nontaxable service charges.

ANALYSIS AND CONCLUSIONS

The use tax is measured by (computed on) the "sales price" of the property the use of which is subject to the tax (Section 6201 of the Revenue and Taxation Code). Section 6011 of the code defines "sales price" in pertinent part as: "...the total amount for which tangible personal property is sold...without any deduction on account of...the cost of materials used, labor or service cost, interest charged, losses, or any other expenses.... The total amount for which the property is sold...includes...any services that are a part of the sale...."

In the transactions under consideration here C--- and petitioner contracted for the sale/purchase of the catalogs on the basis of a quoted price per basic catalog (see page 2 of Exhibit A), subject to adjustment for additional or nonincluded inserts/sections and/or special charges, such as for handling (see page 2 of Exhibit B). The issue is whether under the above-quoted statutory provision, a part of the price charged for each catalog can be set apart and regarded as a charge for services having no connection with the sale/purchase of the catalog. We believe it cannot be, thus we must affirm the audit finding and recommend denial of the adjustment sought here. The views shaping this decision are summarized below.

First, the contract documents evidencing the agreement between C--- and petitioner show the agreement to be one for the sale/purchase of catalogs only, with the price expressed as a charge for each copy of the catalog. There is no provision showing that the parties were agreeing that C--- was to furnish and petitioner was to pay for special services apart from the furnishing of the catalogs.

Second, the more important of the activities described as services by the petitioner, and the only ones for which we can clearly see an element of reimbursement in the catalog pricing arrangement, are activities C--- performs in a proprietary role or capacity while developing a basic catalog "package" which it sells to many customers each year via contracts for sales of catalogs. We refer here to: "coordinating buying conferences"; "selection of merchandise for inclusion in the catalog"; "negotiating merchandise purchase terms with suppliers" (and therefore furnishing copies of forms containing the resulting information to all member firms who purchase catalogs); and "maintaining product updates".

Each of these activities is necessary or important in varying degree to the development and marketing of the basic catalog. They are conducted by C--- without regard to whether any one firm, such as petitioner, will or will not be purchasing catalogs as a participating member in a coming Fall season; and petitioner benefits from them only if and after it purchases C---'s catalogs in a given year. Seen in this light, the above-mentioned activities are not services that are provided to petitioner's special order for just its need; instead, C--- is selling a prepackaged product, of which such activities are a part, and from which they cannot be separated for purposes of establishing the product's sales price.

Last, even if the contracts had been written in a form giving special mention to the services herein discussed, so as to assign part of the price per catalog to them, we would be unable to recognize exempt status for any of the amounts so assigned. Charges for "services that are a part of the sale" (Section 6011) are not limited to charges for "production" services. Unless otherwise excluded by specific provision of the statute (e.g., delivery charges in certain circumstances and installation charges), charges that are part of the sales price include those for: (a) any services performed or costs incurred by the seller which are connected in any realistic sense with things he must do to complete the sale, and (b) any services or costs for which the purchaser must pay the seller as a condition of being allowed to purchase and/or use the property sold.

To illustrate the first of these principles, we cite the following examples drawn from Sales and Use Tax Regulations and from Tax Counsel rulings in the Business Taxes Law Guide, Sales and Use Tax Annotations: (1) where an advertising agency or commercial artist/designer has contracted to sell tangible personal property (as distinguished from a contract for the performance of services which do not involve a sale of tangible personal property) the sales price of such property includes charges for related costs of consultation, research, supervision, design, copy writing, travel, etc. (Regulation 1540); (2) the sales price of photographs or photocopies includes the photographer's or photocopier's charges for travel time, costs of locating/selecting the subjects to be photographed or copied, costs (such as fees paid) of gaining access to the subject or documents to be photographed or copied, or any other costs or expenses of filling the customer's order, whether or not such charges are itemized when billing the customer (Regulation 1528 and Annotation 515.0190); and (3) charges for research, design, development, engineering, etc., are part of the sales price of property when the contract is for a sale of the end product to which such services relate (Annotations 515.0480, and 515.0720).

To illustrate the second of these principles, we cite the following examples drawn from the regulations: (1) when property is sold subject to mandatory payment by the purchaser or a charge for a maintenance/repair service contract, such charge is included in the sales price whether separately stated or not (Regulation 1546); and (2) where services such as programming, training or maintenance must be purchased on a mandatory basis as an inseparable part of a purchase of data processing equipment, charges for such services are includable in the measure of tax (sales price) whether the charges are separately stated or not (Regulation 1502).

Applying these principles to the facts under consideration here, we can conceive of no services, described or undescribed, for which adjustment could be made when payment therefore is included in the price of the catalogs, or must be made as a condition of purchasing the catalogs.

Our decision cannot be influence by that assertedly reached by the state of Michigan on the same issue with a different taxpayer. We believe the explanations and examples of administrative interpretation and practice offered in the above discussion will fully explain why this is so.

RECOMMENDATION

We recommend that the tax liability be redetermined without adjustment.

R. E. HANNA, HEARING OFFICER

8/16/78

Date