STATE OF CALIFORNIA

100.0033

BOARD OF EQUALIZATION

APPEALS DIVISION

In the Matter of the Claim for Refund Under the Sales and Use Tax Law of:	)	HEARING DECISION AND RECOMMENDATION
N--- C---, INC.	)	No. SR -- XX-XXXXXX-001
Claimant	)	

The above-referenced matter came on regularly for hearing before Hearing Office James E. Mahler on October 10, 1990, in Van Nuys, California.

Appearing for Claimant:

R--- D. M---
President

J--- G---
Vice President

J--- S---
Certified Public Accountant

Appearing for the Sales and Use Tax Department:

Ira Anderson
Supervision Tax Auditor

Gary Weishaup
Senior Tax Auditor

Subject of Claim

Claimant seeks a refund for the period January 1, 1986, through December 31, 1988, measured by:

	Item	State, Local, County & LACT
A.	Taxable portion of overall fees added to total billings	$77,714

Claimant's Contention

The management fees were for services which were not part of the sales of tangible personal property and were not a labor or service cost in the production of such property.

Summary

Claimant corporation is engaged in the advertising business. One of its principal clients during the period in question was A--- M--- Co., Inc. (A---). For sales and use tax purposes, claimant was a seller and retailer of advertising materials to A---, not a true agent. (See Sales and Use Tax Reg. 1540(a)(1).)

The terms of claimant's relationship with A--- were set out in a letter agreement dated July 17, 1986. Claimant agreed to become familiar with A---'s business, to use its best efforts to conduct a successful advertising campaign, and to submit all advertising plans and ideas to A--- for approval. Claimant was to pay all bills incurred in the advertising program (after receiving A---'s approval for such expenditures) and A--- was to reimburse claimant for those costs at the end of each month. A--- also agreed to pay claimant on the first day of each month "the amount of $2,800 which will constitute the monthly guaranteed compensation for the [term] of this Agreement."

Claimant sent billing invoices to A--- for each month of the period in question. (Some of the bills antedate the July 1986 letter agreement, so we assume that the letter agreement was intended to be written confirmation of a prior oral agreement.) The billings included charges for advertising flyers, brochures, photographs, product stickers, sales kits and other items of tangible personal property. Each bill also included the $2,800 guaranteed compensation, which was described on the invoices as a "management fee." There were no other separate charges for commissions, fees or time charges, but according to testimony at the appeal hearing, the amounts billed for property included markups ranging from 17 percent to 30 percent above claimant's cost. Claimant charged tax reimbursement and reported tax on all or substantially all the charges for property, but not on the management fees.

An audit by the Board's staff concluded that claimant had overpaid tax on charges to A--- for printed sales messages and certain other items. The total measure of the overpayment was $105,137. The audit further concluded, however, that claimant was liable for tax on 79.3 percent of the management fees, for a measure of $77,714 (total billings of $98,000 times 79.3 percent). The audit also found a minor underpayment with respect to color separations measured by $1,464. The audit thus found a net overpayment measured by $25,959 (105,137 minus $77,714 minus $1,464 equals $25, 959).

As noted, the audit asserted tax on only 79.3 percent of the management fees. This percentage was derived from a detailed examination of four of the invoices to A---. On these four billings, the total amount charged for tangible personal property (except management fees) was $123,283, of which $97,742 or 79.3 percent was subject to tax. This ratio of taxable to total charges for property was applied to determine the taxable portion of the management fees.

Claimant contends that no part of the management fees were subject to tax. According to testimony at the appeal hearing, the management fees were intended as compensation for the development of general advertising strategies and ideas, and were not related in any way to the creation of specific brochures or other property sold to A---. The strategies and ideas were discussed with A--- at consultation meetings two or three times each month. In support of this testimony, claimant presented a letter from Mr. P--- S---, A---'s Vice President, Marketing, which states:

> "I agree with your position that the management fee should be nontaxable. For the record I would like to state that the monthly management fee that you have charged A--- is for advice and consultation regarding our overall advertising program. Also paid for in the management fee are services such as market research on our behalf. The management fee represents a fee for services that you provide to us that are a non-tangible, and therefore a nontaxable nature. Perhaps the 'Monthly Management Fee' would have better been named 'Monthly Market Research and Advertising Program Fee'. Surely, this would have avoided all of this sales tax confusion."

Analysis and Conclusions

Subdivision (b)(1) of Revenue and Taxation Code Section 6012 defines "gross receipts", which is the measure of sales tax, to include not only charges for the property sold, but also charges for any "services that are a part of the sale." Subdivision (a)(2) of that section further provides that no deduction from gross receipts is allowable for labor or service cost or any other expense.

Sales and Use Tax Regulation 1540 applies these rules in the specific context of advertising agencies. Subdivision (b) (3) of the regulation states:

> "SERVICES AND EXPENSES –WHEN NONTAXABLE. Some charges may represent the price for the performance of services rendered that do not represent services that are a part of a sale of tangible personal property or a labor or service cost in the production of tangible personal 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 nontaxable."

Subdivision (b)(4)(C) further provides:

> "Consultation and Research. Effective January 1, 1975, tax applies to charges for consultation and research if the consultation or research relates solely to tangible personal property as to which the agency is acting as a seller. Tax does not apply to such charges in other circumstances, including those in which the agency is acting as an agent, or where research charges relate to advertising testing even

though the agency may have been the seller of tangible personal property used in conveying the advertising message."

On the other hand, subdivision (b)(4)(K) provides:

"Fee Added to a Total Billing. (Effective January 1, 1975.) The term 'fee' as used herein means a general over-all fee encompassing all agency services performed for the client. Such fees may be fixed or based on agency costs and are generally in lieu of commissions, fees added to purchases, and separate time charges added to jobs or agency project or any combination thereof.

"A fee added by an agency to a total billing encompassing items as to which the agency is a seller and items as to which tax does not apply is taxable in accordance with the ratio between the charges for the items as to which the agency is a seller and the charges for nontaxable items if the agency performed no duties as an agent of its client, within the standards set forth in (a)(2)(A), during the course of its performance under the contract with its client…."

The Board has long recognized the distinction between taxable fees added to a total billing and nontaxable consultation charges. The distinction is explained more fully on pages 6 through 8 of the Board's Pamphlet No. 38, Tax Tips for Advertising Agencies, which provides:

"A fee charged by a taxpayer who produced, fabricated or resold tangible personal property may represent a part of the charge for the property and may be, in fact, all or in part a taxable labor charge attributable to a taxable sale. If the taxpayer charged a general overall fee and all other charges to the consumer during the course of its performance under the contract represented taxable sales, the taxpayer will be liable for tax on all charges including the amount of the fee.

* * *

"If the agency performed no duties as an agent of its client during the course of its performance under the contract with its client, then the fee is taxable in accordance with the ration between the charges for the items as to which the agency is a seller and the charges for nontaxable items.

This viewpoint applies to all taxpayers. It is particularly germane to any taxpayer involved in producing, fabricating or purchasing for resale items that are of a customized nature usable only by a specific consumer. Thus, a custom tailor cannot exclude from sales tax a design fee from the taxable sale price of a garment nor can a custom furniture maker exclude from the taxable charge for furniture a portion of the charge for labor under the guise of a 'fee'.

"Advertising agencies are subject to the application of this concept of the measure of tax in the same manner as any other taxpayer.

"Specifically, if a fee charged by the agency does not represent charges for duties as an agent, as defined by Regulation 1540, all or part of the fee may be taxable by prorating the amount of the fee between taxable and nontaxable billings of the agency.

"Regulation 1540(b)(3) states that tax does not apply to services that are not a part of a sale of tangible personal property nor a labor or service cost in the production of tangible personal property.

"It is therefore of extreme importance that any agency charging a fee identify the fee on the billing to the client as being for services as an agent, if such is the case. Invoices reading: `Retainer Fee for the month of ' or `Service Charge' may be viewed as general overall fees subject to proration between taxable and nontaxable billing if the regulation so provides in a particular case.

"In order to avoid confusing taxable agency fees with fees for nontaxable services, the billing of fees for nontaxable services should be identified as charges for consultation, media planning and placement, marketing counsel or services in the performance of duties as agent not solely related to the furnishing of tangible personal property.

* * *

"If an agency does not perform any duties as agent of a client, tax will apply to the portion of the fee represented by the ration of taxable and nontaxable items in the billing. If the agency performed no duties as agent of its client during the course of its performance under the contract with its client, the prorating of a general overall fee will apply.

"In order to illustrate the meaning of this provision, here is a theoretical example:

> "(1) The agency at no time has acted as agent for the client. That is to say that the agency has always purchased items from outside sources for resale to the client. The agency has charged sales tax on the full amount charged to the client inclusive of all agency charges.
>
> "(2) The agency receives a fee from the client as its sole source of income or as supplemental income in addition to media commissions and amounts added to outside purchases.
>
> "(3) The agency performs a nontaxable service within the meaning of (b)(3) of Regulation 1540 and charges the client for the service in addition to its fee. An example of such a nontaxable service would be a new product market research project.

> "(4) Assume the nontaxable market research project and other nontaxable billings represented 85 percent of both taxable and nontaxable charges to the client. In this example 15 percent of the fee would be taxable." (Emphasis in original.)

This case is indistinguishable from the theoretical example cited in the tax tip pamphlet. Specifically, claimant at no time acted as an agent for A---; claimant received the management fee as a supplement in addition to the markups added to the property sold; claimant also performed nontaxable services such as mailing of printed sales messages; and the ratio of taxable to total charges was 79.3 percent. It follows that 79.3 percent of the management fees were subject to tax.

It is worth noting that claimant did not bill A--- for any identifiable services, such as market research or customer surveys. All or substantially all charges on its invoices were for property sold to A---. Therefore, while the management fees may well have been intended as compensation for monthly consultation meetings, it is reasonable to conclude that the consultation related to the design and creation of the property sold. Such consultation services are part of the sale of the property and are taxable to the extent that the charges for property are taxable.

We would reach the same conclusion even if claimant had labelled the management fees as "consultation fees" on its invoices. Under the portions of Regulation 1540 dealing with persons who are not true agents, any overall fee added to the invoices is taxable in accordance with the ratio of taxable to total charges, without regard to how the fee is labelled. Exemption is allowable only if there are clear records or other direct evidence to show that the fee was charged for specific nontaxable services, such as market research or customer surveys. Claimant has no such records or other evidence and we therefore conclude that tax was properly asserted in the audit.

Recommendation

Deny the claim for refund of tax on management fees.

_____ 4/16/91

James E. Mahler, Hearing Officer Date