

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

100.0036

In the Matter of the Petition)
for Redetermination Under the)
Sales and Use Tax Law)
)
B---, G--- & M--- INC.)
)
)
Petitioner)

REVISED
DECISION AND RECOMMENDATION
No. SR -- XX XXXXXX-010

The above-entitled matter came on regularly for hearing on Friday, November 7, 1980, in West Los Angeles, California before Susan M. Wengel, Hearing Officer.

Appearing for Petitioner:

P--- R. J---
President, J--- & M--- Inc.

J--- F. S---
Business Manager

M--- F. M---
Executive Vice President

Appearing for the Board

Joseph A. Fisher
Senior Tax Auditor

Protested Item

The petitioner has filed a petition for redetermination of a tax deficiency determination issued on May 8, 1980, for the period July 1, 1976 through June 30, 1979. The protest involves tax determined on the following audit item:

Audit Item A

Taxable sales understated	
Preliminar art sold to clients	\$576,291

Contentions of Petitioner

Title to the layouts do not pass to their clients.

Summary of Petition

The petitioner is a corporation engaged in business as an advertising agency for pharmaceutical laboratories. There was a prior audit through January of 1974.

During the audit, the Board's staff found that the petitioners made unreported sales of layouts to its clients and assessed a tax on these sales. The petitioner contends that title to the layouts never passed to their clients and that sales of preliminary art are not taxable.

The liability has been paid in full.

Analysis and Conclusions

Sales and Use Tax Regulation 1540(b)(4)(A) defines preliminary art to mean:

“...roughs, visualizations, layouts and comprehensives, title to which does not pass to the client, but 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 preparation of finished art to be furnished by the agency, commercial artist or designer to its client.”

Samples of the petitioner's contracts with its clients have been submitted to this hearing officer for review. The contracts have been divided into six groups which will be considered individually.

Type 1

The termination clauses in the four contracts which comprise “Type 1” contracts read as follows:

“Upon termination, we agree to transfer and make available to you, or your designated agent, all property and materials in our possession belonging to and paid for by you, and all information regarding your advertising or promotions which you instruct us to divulge.”

“In the event of termination, it is understood that all rejected or unused advertising plans and ideas prepared by us shall remain our property to use as we see fit....”

“Upon termination of this agreement, we shall transfer, assign and make available to you, or your designated representative, all property and materials in our possession or control belonging to and paid for by you, and all information regarding your advertising.”

Applicable Clients

Date

A---, Inc	January 1, 1973
B--- L---	September 1, 1972
R--- C--- Company	August 15, 1974
R--- L---, Inc.	May 1, 1975 – April 30, 1977

The petitioner contends that the terms “all property and materials” in the first paragraph mean reusable tangible property such as photographs, finished art and engraving plates as well as product samples or documents furnished by the client. Neither the agency nor the client has ever considered that preliminary concept layouts are encompassed in this language. The petitioner further contends that the second paragraph denies a client the right to obtain preliminary art upon termination of the agreement.

The first paragraph refers to “all property and materials in our possession belonging to and paid for by” the client. Had the contract meant to restrict the property to finished art it would have so stated. The language should be given its common meaning, which in this case means all property including layouts. The restrictive provisions of the second paragraph only exclude “rejected or unused” plans or ideas. There will be no tax on rejected layouts which are separately billed. The preliminary art of an accepted idea does not fall within this exclusion. Regulation 1540(b)(4)(A) applies only to preliminary art, title to which does not pass to the client. It is concluded that the language of the “Type 1” contracts causes title of the preliminary art to be passed to the petitioner’s customers.

The remaining issue presented by this type of contract is when does title to the property pass to the customer.

Clearly title can pass at the time the customer takes possession of the property. However, the facts appear to support a finding that there is no actual transfer of possession. There are, however, provisions in the contract which state that once the property is approved and paid for the property belongs to the customer. This conclusion is supported by the portion of the contract which states that at the time of termination there is some property in the petitioners possession which belongs to the customer and has been paid for by the customer. This property can only be approved layouts as the contract provides that all rejected or unused plans remain the petitioner’s property. It is concluded that title to the approved layout passes to the customer and the sale takes place once the layouts are approved and paid for.

As title has already passed at the time the contract terminates, this point in time will not be used to determine when the sale takes place.

Type 2

The termination clause of this type of contract provides that:

“Upon termination of this agreement, we shall transfer, assign and make available to you, or your designated representative, all property and materials in our possession or control belonging to and paid for by you, and all information regarding your advertising.”

Applicable Clients

Date

A--- T--- Corp
(Formerly A--- S---
P--- Division)

January 1, 1974

This contract in paragraph B contains the same language as founding the first paragraph of the “Type 1” contracts. The same analysis which applied to the “Type 1” contracts will apply to the “Type 2” contracts.

Type 3

The terms of payment clause and the termination clause of this type of contract provide that:

“All work done by the Agency for the Client shall become the exclusive property of the Client upon payment therefore.

“Following the termination of this Agreement or product withdrawal, to the extent that either the Agency or the Client has ownership rights, the Agency shall transfer to the Client, and the Client shall be entitle to use, without further obligation, all material, films and the like submitted to the Client by the Agency, subject only to the Client’s payment to the Agency therefore of all amounts payable thereon, but unpaid to termination date or date of product withdrawal, under this Agreement, plus media commission or advertising prepared by the Agency and run after the termination or withdrawal date in media, the closing dates for which occurred prior to the termination or withdrawal date.”

Applicable Clients

Date

A--- L--- D---
Division, Texas
A--- U---
A--- P--- Company
B--- Corporation

January 1, 1979
March 30, 1977
August 1, 1977
May 18, 1978

C--- L---, Inc.	December 1, 1978
H--- F--- Corporation	May 15, 1978
M--- M--- Corporation	February 15, 1979
P--- C--- S---, Inc.	August 14, 1978
T--- X, Inc.	January 1, 1979

The petitioner contends that the term “all work” was intended to mean finished work having a future potential use by the client such as reproducible drawings, medical type illustrations, film negatives, medical research reports and reusable property purchased by the client but held by the agency as bailee. The term was never intended to include preliminary layout concepts and is so understood by the clients. This position is fortified by the language “to the extent that either the Agency or the Client has ownership rights...(in) all materials, films and the like.” In the petitioner’s view, the term “materials, films and the like” can only refer to items resulting from completed projects and which may be reused by the client in the future.

Once again the contract by its terms gives the client the right to all work done by the Agency upon payment of the agreed upon price. It does not mean only finished work having a future potential use. The contract also refers to the client’s right to all material and the like submitted to the client by the petitioner. The preliminary layouts were at some point in time submitted to the client for his approval. This supports the conclusion that all work means exactly what is says – all work, including preliminary layouts. It is noted that this contract is even less restrictive than the “Type 1” contracts which limit the client’s right to materials which were actually used or accepted by the client.

No adjustment can be recommended on the Type 3 contracts.

Type 4

The termination clause and the terms of payment clause in this type of contract provide that:

“All work done by the Agency for the Client including without limitation plans, preliminary outlines, sketches and copy, shall become the exclusive property of the Client upon payment therefore.

Following the termination of this Agreement or product withdrawal, to the extent that either the Agency or the Client has ownership rights, the Agency shall transfer to the Client, and the Client shall be entitled to use, without further obligations, all materials, films and the like submitted to the Client by the Agencyetc.”

Applicable Clients

Date

S--- O---, Inc.

May 1, 1978

The petitioner contends that this language:

“...does not stipulate that preliminary layouts for advertisements or literature are to become the property of the client. ‘Preliminary outlines’ refers only to outlines of marketing and sales plans and supporting research, if any. ‘Sketches’ does not include layouts but refers to what are commonly referred to in the advertising agency industry as ‘thumbnail sketches’. Such sketches are small, extremely rough (that is, not fully developed as in the case of layouts) and precede the execution of layouts. Sketches may or may not be done by artists but may be done by writers or account service personnel of the agency. Our charges for layout time do not include time for sketches. Layout time charges are limited to the actual time spent by layout artists in preparing layouts for submission to the client.”

The petitioner further contends that the phrase “all work done by the Agency” refers to reusable finished property and does not include layouts as noted in comments as to other types of agreements.

It is concluded that this contract also passes title of the preliminary art to the petitioner’s clients. First, the phrase “all work done by the Agency” clearly means all work. The same is true for the phrase “all materials”. Finally, this contract refers also to “without limitations, plans, preliminary outlines, sketches and copy”. A layout is preliminary work which could be an outline, a sketch, copy, or a combination of all three. No adjustment is warranted on this type of contract.

Type 5

The terms of payment and termination clauses of this type of contract provide:

“All work done by the Agency for the Client shall become the exclusive property of the Client upon payment therefore.

Following the termination of this Agreement or product withdrawal, to the extent that either the Agency or the Client has ownership rights, the Agency shall transfer to the Client, and the Client shall be entitled to use, without further obligations, all plans, ideas, sketches, copy, layouts, commercial material, films and the like submitted to the Client by the Agency, subject only to the Client’s payment therefore....etc.”

Applicable Clients

A--- D--- Division, California
P--- R--- Inc.

Date

March 1, 1976
May 1, 1977

S--- L---, Inc.

April 1, 1975

The petitioner contends that:

“This paragraph gives the client a conditional right to receive layouts only upon termination of the agreement. Transfer of title to layouts is clearly restricted to the point in time when the agreement is terminated by either party. This type of agreement does not include any provision which may, in our view, be construed to transfer title to layouts at any time during the term of the contract prior to cancellation.

“As of the end of the audit period, there had not been a termination of this type of agreement. If a termination had occurred, or does occur in the future, it would be our intention to give the client only those layouts which were currently under consideration for future advertising which have not been approved as a basis for finished art.

“In the event a termination of this type of agreement does occur and a client exercised this conditional right, we would impose sales tax on our charge for such layouts whether or not billed to the client prior to the date of cancellation. We do not believe a requirement exists to impose sales tax in anticipation that this qualified right will be exercised at some undeterminable future date.

Like the “Type 3” and “Type 4” contracts, the terms of payment clause provide that All work done by the agency...” is to become the exclusive property of the client upon payment. For the reasons discussed in the analysis of the Type 3 contracts, the preliminary art in the Type 5 contracts were properly held to be subject to tax. Title to the preliminary art transferred when the payment was made. The language in the termination clause sections of the contract will not affect when title passes. Regulation 1628 provides that unless explicitly agreed that title is to pass at a prior time, the sales occurs at the time and place at which the retailer completes his performance with reference to physical delivery of the property. In the contract, the parties agreed to pass title at time of payment. This clause is controlling. No adjustment is recommended for this item.

Type 6

The terms of this type of contract provide:

“All plans for advertising, preliminary sketches, lay-outs (sic), copy, ‘commercial’ material, films and transcriptions shall become from time of approval therefor by you in accordance with the terms hereof, your exclusive property. Title to such property, however, shall be contingent upon full payment therefore by you within the time provided in this agreement.

“Upon termination, we agree to transfer and make available to you, or your designated agent, all property and materials in our possession belonging to and paid for by you, and all information regarding your advertising or promotions which you instruct us to divulge.”

Applicable Clients

Date

M---, S--- & D--- O--- Co., Inc.
R--- L---, Inc.

November 1, 1974
May 1, 1977

The petitioner contends that:

“These two agreements clearly transfer title to layouts which are approved by the clients at the time of approval. The transfer of title is limited to layouts which are approved.

“Tax should apply to charges only for those layouts which are approved, title to which is thereby transferred to the client. However, several layouts for the same advertisement or piece of printed matter may be submitted for consideration, one of which is approved. The art department charge is for the rejected layouts as well as the approved layout. Under the terms of these agreements, the agency retains title to the layout(s) not approved. We believe we can develop a formula to determine the taxable portion of layout charges attributable to approved layouts.”

To the extent a layout is approved and paid for, we conclude that a sale has taken place. The sale would be of only the approved layouts. The remaining layouts will be considered sold to the petitioner’s client only upon termination of the contract. If the termination of the contract occurs before a layout is approved and paid for, the termination date will be the date of the sale.

UNWRITTEN AGREEMENTS

The petitioner contends that as to their clients who did not have written agreements, the preliminary art should be tax-exempt. Layout charges to the following clients during the audit period totaled \$20,118:

- C--- S---
- C--- C---
- E---
- G--- A---
- H--- L---
- L--- S---

M--- S---
M.M.A.
U---
X---
X---

The audit staff reviewed these invoices and found that like all the billings for layout labor after June 1, 1978, these layouts were not billed separately. Tax was assessed.

The petitioner, in support of their position that the charges are not taxable, provided the following:

“During the audit period, specifically from June 1, 1978 to June 30, 1979, the form of our billing was changed. The change was instituted by our billing department without realizing it could create possible sales tax problems. They recognized that ‘creative services’ performed by us were not subject to sales tax, with the exception of finished art. They, therefore, concluded that they could identify preliminary creative charges as a single item on the client copy of our invoice, although our file copy detailed the charges separately. Creative charges included layout charges. They reasoned that since each type of charge was tax exempt, the sum of the charges was likewise tax exempt.

“This practice has been pointed out to us as a possible technical error, but, in our view, is not substantive and does not violate the rightful intention of Regulation 1540 to exclude from tax preliminary art which is not used for reproduction or title to which is not passed to clients to be rendered into finished art by the client. These creative charges, including preliminary art, are for strictly personal services. We, therefore, believe the layout charges included therein should be exempt from sales tax.”

Regulation 1540(b)(4)(A) specifically provides that, “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.” “Creative Services” does not clearly identify a charge for preliminary art as those terms could include much more than layouts. If a charge for preliminary art does not meet the specific regulatory requirements for exclusion from tax, the tax must be assessed. Billings of separately stated layout labor to clients without written agreements prior to June 1, 1978 are exempt from tax. The layout labor on all the petitioner’s client’s contracts after June 1, 1978 are subject to tax.

The petitioner has stated that during the audit period their billing clerks erroneously imposed sales tax on such charges as creative supervision, type specifying, photo supervision, model and talent fees, one-time mailing list usage and audio/visual scripts. It is concluded that the model and talent fees, mailing charges including mailing lists and audio/visual and photo supervision,

are allowable as the agency was acting as the agent of their client. (Regulation 1540(b)(4)(F).) As to the type specifying, because the petitioner sells the finished art of which the type specifying is a component, the charges would be taxable. However, as the supervision of style and size of type was purchased tax paid, no additional tax is due.

Recommendation

It is recommended that as to "Type 1" and "Type 2" contracts, the district audit staff should determine at what time the layouts were approved and paid for. This will be the point in time when title passed to the petitioner's customers and the sales took place.

It is further recommended that as to contracts "Type 3", "Type 4", and "Type 5", the liability be redetermined without adjustment. The "Type 6" contracts should be reviewed in accordance with this recommendation. All plans and layouts will be considered to have been sold only if the material has been approved and paid for. Tax will not apply to unapproved materials.

The billings of separately stated layout labor to clients without written agreements prior to June 1, 1978 should be considered to be exempt from tax.

Finally, adjustments should be made to reflect that tax was erroneously reported on the model fees, mailing charges, etc. discussed in this recommendation and decision.

Susan M. Wengel, Hearing Officer

July 8, 1981
Date