STATE BOARD OF EQUALIZATION
LEGAL DIVISION (MIC:82)
450 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0082)
Telephone: (916) 324-2634
FAX: (916) 323-3387

December 20, 1996

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

Re: Unidentified Taxpayer
"Design of Retail Store Interior"

Dear Ms. H---:

This responds to your inquiry dated July 22, 1996 concerning a design and marketing company (DMC). Although you do not say, we assume for purposes of responding to your inquiry that DMC is located in California. Unless stated otherwise (as in your questions 4 and 5), we assume that the client and third party vendors are also located in California. Additionally, in order to give you accurate advice, we have had to make a number of other assumptions, as well as stating our understanding of the meaning of some of your comments, to clarify the limited information which you provided. If the assumptions which we make, or the meanings which we attribute to your comments, 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.

Facts

You write that a retail facility is being designed and constructed by licensed architects and contractors. DMC is "the primary design firm for the interior store fixtures, the interior layout of the store, and the design and development of display fixtures, including Point of Sale Graphics and Interior signage relating to the product that will be sold in the store."

You describe the work which DMC will perform for the client as follows. Step One:
"Client Consultation." DMC attends meetings and verbally presents creative concepts to its client.

Step Two: "Creative Concepts." DMC depicts the concepts in a tangible form as visual presentations mounted on boards. These include "conceptual illustrations, computer-generated

visual materials incorporating typography, photography and illustrations." For purposes of this opinion letter, we assume you mean that the board mounted visual presentations may include hand or mechanically drawn illustrations, as well as computer-generated materials which may include text and graphics, such as illustrations and photographs, and are printed out in the form of hard copy for client review.

You indicate that upon review, some of the designs depicted in the visual presentations may not be accepted by the client. The designs presented to the client are "rough at this junction", and are modified many times before they reach the next step. 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.

Step Three: "Finished Drawings." DMC creates drawings which you describe in the following words. "Renderings are created in various forms, ranging from plans to elevation, perspectives. Frequently, drawings of this nature may also show dimensions, measurements, specifications of materials and other details." We understand from this that what you refer to as the "finished drawings" are final drawings and/or diagrams of the interior layout of the store, and final drawings of interior store display fixtures and other interior fixtures. You indicate that these drawings may also include information such as dimensions, measurements, specifications of materials to be used in fabricating the fixtures, and other details. For purposes of this opinion letter, we assume the "finished drawings" are transferred to or used by the client or its designee as a reference in making the interior fixtures and placing them in the proper locations in the store.

Step Four: "Finished mock-up and final artwork." You describe this in the following words: "Graphics are created for final production. These graphics show dimension, image, typography, color and details to create the standard for future graphics. Examples are `mocked' up, usually to exact size or scale in order to meet client approval. Artwork is provided to the client on computer disk. Production specifications are noted along with representative visual examples."

Since your description, above, refers to graphics and artwork, we assume that the work performed by DMC in Step 4 relates to the *signs*, as opposed to other interior fixtures. Thus, we understand your language, quoted above, to mean that DMC creates final visual representations of the interior *signs*, including dimensions, artwork, typography, color and other details. For purposes of this opinion letter, we assume that these final visual representations serve as a guide during the making of the completed interior signs. DMC also makes example models, usually to exact size and scale, of the interior signage. We assume for purposes of this opinion letter that the models are also used as a guide during the making of the completed interior signs. We also understand from your description of Step 4 that DMC transfers the final artwork, embodied in a computer disk, to the client. For purposes of this opinion letter, we assume that the final artwork will be used for actual reproduction by photo-mechanical or other processes in making the signs.

Step Five: "Coordination and Supervision of Fabrication and Implementation." We understand that after final client approval, third parties are selected to make the fixtures,

including the signs. You indicate that DMC, acting as the client's agent, supervises and reviews the fabrication work performed by these third party vendors. You do not state who purchases the fixtures, DMC or the client. For purposes of this opinion letter, we assume that DMC also acts as the client's agent to purchase the fixtures, including the signs, from the third parties for the client.

Step Six: "Installation." You state, "After all components have been fabricated by outside vendor(s), [DMC] is responsible for installing the pieces produced in their proper location and manner. Components are generally delivered to the store location in groups or pieces and [DMC] needs to direct installation team and others as to how and where components are used, placed and put together." From this we understand that DMC is responsible for placing and, if needed, fastening and adjusting the interior fixtures in the store in the proper locations and configurations. For purposes of this opinion letter, we assume that no fabrication or assembly of the fixtures is performed at the store site, and that the "installation team and others" who assist in the installation are employees of DMC.

Step Seven: "Training." DMC trains employees of the client to properly set up and maintain the interior store system and plan designed by DMC. For purposes of this opinion letter, we assume that the training is not required by DMC, but is an optional element for which the client may or may not chose to contract.

You also indicate that DMC may travel out of town or locally to meet with the client and/or third party vendors concerning the project.

Your letter poses a number of questions in regard to the above-stated facts. However, before turning to your specific questions, we provide the following background information and discussion.

Discussion

California imposes a sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempted or excluded from taxation by statute. (Rev. & Tax. Code § 6051.) 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.

The term "sale" means and includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code § 6006(a).) 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).) A timely resale certificate, taken in good faith from a person who holds a California seller's permit and is engaged in the

business of selling tangible personal property, relieves the seller from liability for sales tax. (Rev. & Tax. Code § 6092; Reg. 1668.)

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.)

The "retailer's gross receipts" which are subject to tax mean the total amount of the sale price of the retail sales without any deduction for cost of the property sold; the cost of the materials used, labor or service cost, interest paid, losses, or any other expenses; and the cost of transportation of the property, unless otherwise excluded. (Rev. & Tax. Code § 6012(a).) The total amount of the sale price includes any services which are a part of the sale; all receipts, cash, credits and property of any kind; and any amount for which credit is allowed by the seller to the purchaser. (Rev. & Tax. Code § 6012(b).) Certain things are excluded from taxable gross receipts as stated in subsection (c) of Revenue and Taxation Code section 6012, including the price received for labor or services used in installing or applying the property. (Rev. & Tax. Code § 6012(c)(3).)

An agent is one who represents another, called the principal, in dealings with third persons. (Civ. Code § 2295.) To the extent that one acts as an agent of its client in acquiring tangible personal property, it is neither the purchaser of the property with respect to the supplier nor the seller of the property with respect to its principal. (Reg. 1540(a)(1).)

Persons engaged in the business of rendering *services* are considered consumers, not retailers, of the tangible personal property they transfer incidental to the performance of the service, or which they use in the performance of the service. (Reg. 1501.) Tax applies to the sale of the property *to* those persons or to their use of that property. (Id.) The distinction between the sale of tangible personal property and the transfer or use of such property incidental to the providing of a service is set forth in Sales and Use Tax Regulation 1501:

> "The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred...."

Since it is only the sale or use of tangible personal property which is subject to tax under the Sales and Use Tax Law, in those instances where there is no transfer of title or possession to tangible personal property, nor services performed which are a part of the sale of tangible personal property, the transaction is not subject to tax. In steps one ("Client Consultation"), and two ("Creative Concepts"), described above, there is no transfer of title or possession of any tangible personal property from DMC to the client. Based upon your descriptions and the

assumptions made in this opinion letter, we also do not consider the services performed in steps one and two to be a part of the sale of tangible personal property by DMC. Rather, we believe those charges by DMC are for professional services for interior decorating. Thus, charges by DMC to the client for the work in steps one and two, including any charges for travel costs, are not subject to tax. However, these charges should be separately stated in DMC's billing to the client.

For your further information, we note that fees for *bona fide* professional services, such as consultation, layout of furnishings, coordination of furnishings and fabrics, selection of color schemes, and supervision or performance of installation are generally considered nontaxable charges for services. However, fees charged in connection with acquiring and providing tangible personal property to the client, such as furniture and fixtures, are generally considered subject to tax as gross receipts from retail sales of tangible personal property. (See enclosed "Tax Tips for Interior Designers and Decorators", Pamphlet No. 35, May 1990; cf. BTLG Annot. 190.0176 (8/30/67), BTLG Annot. 190.0176 (8/30/67), BTLG Annot. 515.0380 (12/15/65 & 4/25/88).)

In step three, the drawings which DMC creates are final drawings of the interior store layout and fixtures. Regulation 1540 (copy enclosed) applies to a designer or commercial artist, such as DMC in this instance. When a designer or commercial artist bills a client, some charges may represent the sale price of tangible personal property sold to the client and compensation for expenses incurred in, and service costs related to, the production of that 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 designer or commercial artist, or acquired from an outside source. (Reg. 1540(b)(1).) The regulation specifies:

> "Tax applies to all charges made for such [tangible personal] 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 does differentiate 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 artists or designers to their clients for finished art produced by them." (Reg. 1540(b)(4); emphasis added.)

Moreover, tax applies to the transfer of items, such as final art or production drawings which are used by the client, or on the client's behalf, to make or fabricate a final product, for example, a sign. (BTLG Annot. 100.0073 (2/13/91); BTLG Annot. 100.0103 (4/14/95); BTLG Annot. 515.0017 (10/26/94).)

Thus, since the final drawings of the fixtures are used as a reference or guide in making the interior fixtures, they are final art or production drawings. Tax applies to the total charges made by DMC to the client for the finished drawings (including any related travel costs). (Rev. & Tax. Code §§ 6006(a), 6051, 6201; Reg. 1540 (a)(1).) Charges for any other final drawings provided to the client, or to a third party for the benefit of the client, are also subject to tax, excluding any separately stated charges for preliminary art, as designs or drawings provided to the client in the form of tangible personal property. (Reg. 1540 (c).)

In step four, the final visual representations and mock-ups/example models are created to serve as a guide during the making of the completed signs by the third party vendors. Likewise, the computer disk containing the final artwork for the signs is fabricated by DMC to be used for actual reproduction in making the signs. Pursuant to Regulation 1540 the designer or commercial artist is the seller of tangible personal property, such as a computer disk or models, 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).) The sale of the final visual representations, mock-ups, and computer disks by DMC to the client are retail sales of finished art which are subject to tax. (Reg. 1540(b)(4).) Tax applies to the total charges made by DMC for that finished art, including any charges for the cost of travel. If any preliminary art is physically incorporated into the finished art, charges for such preliminary art are subject to tax as well. (Reg. 1540(b)(4).)

Please note that the regulation is quite specific in regard to charges for finished art which may take the form of fees or commissions. The regulation states,

> "If an agency [or designer or commercial artist] supplies tangible personal property such as finished artwork to a client and the entire payment for such property is included in some other form of compensation, such as a fee, commissions or a combination thereof, tax applies to the fair retail selling price of such property.
>
> "`Fair retail selling price' is an amount sufficient to cover (i) the net labor costs of employees of the agency [or designer or commercial artist] plus an allowance for overhead and profit of not less than 100 percent of such labor cost, and (ii) the cost of purchased items incorporated into the tangible personal property as to which the agency [or designer or commercial artist] is a seller. If an agency [or designer or commercial artist] has furnished a firm quoted price based on estimated labor costs plus overhead and profit of not less than 100 percent of the labor cost and bills in accordance with such a quoted price, the agency [or designer or commercial artist] will be deemed to have charged the fair retail selling price." (Reg. 1540(b)(1).)

You have concluded that, in step five, DMC acts as the client's agent in supervising and reviewing the work of the third party vendors selected to make the fixtures, including the signs. DMC also purchases the fixtures, including the signs, from the third party vendors as the client's agent. As discussed earlier, a true agent is neither a buyer nor a seller in acquiring tangible personal property on behalf of its principal. Thus, tax does not apply to DMC's charges to the client for its work in step five, including any related travel costs.

Please note, however, that purchases by an agent, such as DMC, are regarded as purchases on its own behalf for resale or use unless the purchaser establishes with respect to any acquisition that it is acting as an agent for the principal or client. (Reg. 1540(a)(2)(A).) As specified in Regulation 1540(a)(2)(A):

> "To establish that a particular acquisition was made as agent for its client (i) the agency [or commercial artist or designer] must clearly disclose to the supplier the name of the client for whom the agency [or commercial artist or designer] is acting as agent, (ii) the agency [or commercial artist or designer] must obtain prior to acquisition, and retain written evidence of agent status with the client, and (iii) the price billed to the client, exclusive of any agency [or commercial artist or designer] fee, must be the same as the

> amount paid to the supplier. The agency [or commercial artist or designer] may make no use of the property for its own account, such as charging the item to the account of more than one client. An advertising agency [or commercial artist or designer] purchasing tangible personal property as an agent on behalf of its client may not issue a resale certificate to the supplier. It will be presumed that an advertising agency [or commercial artist or designer] who issues a resale certificate to its supplier is purchasing the tangible personal property on its own behalf for resale and is not acting as an agent for its client.
>
> "The reimbursement for the property should be separately invoiced, or shown separately on an invoice, to the client." (Emphasis added.)

In step 6, DMC is responsible to install the fixtures after they are delivered to the store location. Charges for the labor or service of installing tangible personal property are not subject to tax. (Rev. & Tax. Code § 6012(c)(3); Reg. 1521(b)(2)(B).) Thus, DMC's charges for installation of the client's fixtures, as well as any charges for travel costs related to the installation, are not subject to tax. However, it is advisable to separately state installation charges in the contract or billing. (See Reg. 1521(c)(1).)

In step seven, DMC trains employees of the client to properly set up and maintain the interior layout and system of fixtures which DMC planned, designed, sold to the client, and installed. Training which is not a mandatory part of a contract to purchase tangible personal property is distinct from any sale of tangible personal property, and is a service, charges for which are not subject to tax. (See, e.g., BTLG Annot. 295.0730 (10/4/76.) The training provided by DMC as a service which is an optional part of the agreement with the client is not a part of any sale of tangible personal property by DMC to the client. Charges for that training, including any charges for travel costs, are not includible in DMC's taxable gross receipts. (Rev. & Tax. Code § 6012(b)(3).) However, the charges for the training should be separately stated in DMC's billing to the client.

Questions

You ask us to respond to the following questions:

Questions 1, 2, and 3

Question 1. "What events described above are `taxable' events with respect to the design firm's services."

Answer: The discussion above responds to the question of what "events" are taxable with respect to DMC.

Question 2. " If the design firm were a licensed architect, would any of the above services be taxable?"

Answer: The application of tax to charges by a licensed architect would depend upon further facts.

Question 3. "Are the out of pocket expenses plus usual markup and fees reimbursed by the client taxable?"

Answer: Please see our response to question 1 in regard to what charges by DMC are subject to tax. Please also recall, as discussed earlier, that if DMC makes a purchase of tangible personal property as an agent of its client, the amount charged to the client for such property must be the same as the amount DMC paid to the supplier of the property.

Questions 4 and 5

Question 4. "If the end client is located out of state, and the work product will be presented and installed out of state, is the work taxable?"

Question 5. "Assuming there is an intermediary company in California who invoices the end client, and passes through payments from the out of state clients to the design firm; the work products will be presented and installed out of state. In this scenario, is the work taxable? If it were in-state, would it be taxable? Or assuming there is an intermediary company in California who invoices the end client, and passes through payments from the out of state client to the design firm, with a mark up on the design firm's services; the work product will be presented and installed out-of-state. In this scenario, is the work taxable? If it were in-state, would it be taxable?" (Quoted as written.)

Answers: Questions 4 and 5 in part hypothesize that the client is located out of state and that the "work product will be presented and installed out of state." There are exempted from California sales and use taxes gross receipts from the sale or use of tangible personal property which, pursuant to the contract of sale, is required to be shipped and is shipped to a point outside this state by the retailer by means of either facilities operated by the retailer, or delivery by the retailer to a carrier, customs broker, or forwarding agent, for shipment out of the state. (Rev. & Tax. Code § 6396.) However, if a use of the property is made in California by the purchaser, or if DMC makes use of property in California on behalf of the purchaser, before the property is shipped out of state, tax applies. (Reg. 1620(a)(3)(A).)

In question 4, we understand you to be asking the following question: If DMC's client is located out of California, if DMC's presentations to the client will be made out of this state, and if the fixtures will be installed out of state, are DMC's charges to the client taxable?

We cannot tell from the wording of your question whether the signs and other fixtures will be made in California or out of state. If DMC's contract with the client requires any tangible personal property to be shipped to the out-of-state client before any use of the property is made in California by or on behalf of the client, and this, in fact, occurs, the charges to the client for the property are not subject to tax. However, if DMC transfers title to property to the

client in this state and uses the property in California on behalf of the client prior to its shipment out of state, tax applies to the charges by DMC to the client for the sale of the property

In question 5, we assume the only function the intermediary company performs for DMC is to invoice DMC's clients. In such case, DMC's employment of the intermediary has no bearing on how tax applies to DMC's charges. However, when DMC's charges are subject to tax, the gross receipts of DMC's sales necessarily include any increased amount the customer pays because of the intermediary's service

We hope this information is of assistance. If the assumptions we have made are incorrect, please write again clarifying the facts and identifying your client. We will then be able to respond with an opinion letter upon which your client may rely.

Sincerely,

Sharon Jarvis
Senior Tax Counsel

SJ:rz

Encl. Reg. 1540; Tax Tip Pamphlet No. 35.

cc: --- District Administrator - --