

**STATE BOARD OF EQUALIZATION**

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April 14, 1995

Mr. D--- G. J---
J---, N---, B--- & Co.
XXXX --- --- Blvd., Suite XXX
--- ---, CA XXXXX

Re: SR -- XX-XXXXXX

Dear Mr. J---:

This is in response to your letter to Assistant Chief Counsel Gary Jugum requesting our opinion on the application of tax to various design operations undertaken by your client, S---/P--- & Company, Inc. ("SPC"). You state:

"S---/P--- & Company, Inc., is a California Corporation This is a graphic design company that specializes in the environmental architectural industry. A majority of their clients do not want finished art in a typical advertising agency scenario. While they go through the preliminary art and finished art stage in sequential order, their finished art may include blueprints and artwork that the client will not reproduce. For lack of a better term, their work can be described as an 'architectural style of graphic design.' While they are not called an architectural firm, they have two employees on staff who are licensed architects.

"The[ir] client is --- ---, the medical care program company, and the project is to provide signs and graphics services required for the campus site signing program at their facility known as P--- C--- Medical Center.

"The total fee will vary depending on the time it takes to complete each phase and they must receive client approval to continue to the next phase. Reimbursable expenses such as printing and permit fees will be paid at cost. The contract reads that all of the above work is to be invoiced in four phases. If there is no approval to finish each phase, S---/P--- can not continue on to the next phase.

"Each phase will have a different invoice submitted to the client. Phase I is to do a review of their current design themes and come up with conceptual ideas. Phase II is to do a 'Preliminary Art' stage where sketches and rough design drawings are rendered.

"No title will pass on any work for Phases I and II. Phase III will be for finished art and will be subject to sales tax. This will include the construction documents which will be finished artwork and final blueprints. Phase IV will be for quality control supervision to observe the installation of the finished art including the construction documents. No design or artwork is provided in this phase. In this project, another company will provide the final blueprints and install the items on the site.

"....

"This project requires not only graphic design but an expertise in engineering, lighting requirements, load calculations, safety considerations and special installation techniques to comply with what the client wants to achieve. S---/P--- must work with the architect and the general contractor and comply with all safety requirements in order to coordinate the project at each phase. Phase IV is a requirement by the client that S---/P--- observe and make sure that the art work and graphic design is installed properly and meets their lighting and artistic standards."

We understand your letter to ask whether the goods and services provided by SPC (especially those in Phase IV) under the master agreement are subject to tax. To facilitate our response, you provided us with copies of the contracts for each phase of the project.

Discussion

Before answering your specific question, a general overview of the application of tax to SPC may be helpful in understanding our response. As you know, 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 exempt from taxation by statute. (Rev. & Tax. Code § 6051.) The term "sale" 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).) Persons engaged in the business of rendering services are consumers, not retailers, of the tangible personal property they transfer incidental to the providing of a 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 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"

We understand that SPC provides both graphic design (artwork) as well as architectural services. Tax applies to the sale of finished artwork (Regs. 1540(b)(4)(B), 1541(f)(5), 1543(b)(1)(B)) while the fees charged by architects or engineers for their ability to design, conceive or dictate ideas, concepts, designs or specifications are generally not subject to tax. (See Business Taxes Law Guide Annots. 515.0380 (12/15/85; 4/25/88) and 515.0040 (2/27/64).) Thus, the application of tax under each phase of the contract (including Phase IV) depends in part on whether SPC is regarded as providing artwork or architectural services to its client.

Master contract #C639 requires SPC to perform only Phase I and II operations consisting of, among other things, the preparation of preliminary drawings, diagrams, and conceptual ideas for its client. This contract specifies that SPC will only prepare "presentation materials" to describe its intentions to its client, that title to these materials shall remain with SPC, and that a separate contract or amendment will be sent for subsequent phases. A separate billing (itemized) for the goods and services provided by SPC is also contained in this agreement. Under these facts, tax applies to SPC's Phase I and II operations as set forth in Regulation 1540(b)(4)(A):

"'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 approved layout is used as camera copy for reproductions. 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 1698. 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."¹

¹ See also Regulation 1543(b)(4).

Thus, we regard SPC as preparing preliminary art on behalf of its client. Tax does not apply to the preliminary art under Phases I and II if these materials did not become physically incorporated into finished art later sold to this client.

Phase III operations are set forth in Addendum #639.01 to Master Contract #639. This addendum generally requires SPC to provide finished artwork of its designs as well as final design drawings for use in construction of finished signs. Under this phase, SPC is providing either finished artwork and/or production drawings. (Regs. 1540(b)(4)(B), 1541(f)(5), 1543(b)(1)(B); Business Taxes Law Guide Annot. 515.0440(3) (2/27/64).) Tax applies to the sale of these materials as the retail sale of tangible personal property inside this state. (Rev. & Tax. Code § 6051.)

Finally, Phase IV (Contract #639.02) requires that SPC will, among other things, review and revise (as necessary) the fabricator's shop drawings and building processes as well as make adjustments to the installation of the signs. We understand that these signs will be built and installed by a third party under a separate contract with SPC's client. If so, we would regard SPC's charges attributable to the supervision and review of installation as excludable from its taxable gross receipts as a charge for installation. (Rev. & Tax. Code § 6012(c)(3); Reg. 1546(a); see also Business Taxes Law Guide Annot. 315.0100 (3/27/53).) SPC's charges under Phase IV which relate to or contribute to the design or production of the finished signage are, however, taxable as part of the cost of producing tangible personal property sold to its client. (Rev. & Tax. Code § 6012(a); Business Taxes Law Guide Annot. 315.0100 (3/27/53).) As such, SPC's review of and revisions to the fabricator's production drawings, sign samples and patterns would constitute charges related to the production of the finished signage and are therefore subject to tax. SPC should separately itemize the amounts which relate to nontaxable installation and those which relate to taxable production costs on its invoice(s) to its client.

If you have any further questions, please write again.

Sincerely,

Warren L. Astleford
Staff Counsel

WLA:plh

cc: C--- C--- District Administrator - --