

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

100.0129

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination and Claim for) DECISION AND RECOMMENDATION
Refund Under the Sales and Use)
Tax Law of:)
)
K--- A---, INC.) Nos. SR -- XX XXXXXX-010
) and -001
)
Petitioner/Claimant)

The Appeals conference in the above-referenced matters was held by Staff Counsel Lucian Khan on August 11, 1993 in Culver City, California.

Appearing for Petitioner/Claimant
(hereinafter "Petitioner):

J--- K---
President

J--- A. V---
Attorney at Law

Appearing for the
Sales and Use Tax Department
(SUTD):

Betti Richter
Supervising Tax Auditor

Albert Lai
Senior Tax Auditor

Protested Item

For both the claim and petition, petitioner protests disallowed agency fees claimed as nontaxable measured by \$61,968, and disallowed preliminary art charges claimed as nontaxable measured by \$331,198. The claim for refund and petition relate to the audit period of January 1, 1987 through December 31, 1989.

Contentions

1. Charges to clients for preliminary art were nontaxable. The contract for finished art was always entered into after the client viewed and accepted the preliminary art.

2. Petitioner does not agree with SUTD's conclusion that title to preliminary art passed to the client in the transaction involving C--- P--- T---
3. Agency fees upon which tax was determined related to nontaxable services.
4. In a prior audit, it was determined that petitioner's charges for preliminary art and agency fees were nontaxable. Based on the auditor's written comments, petitioner is entitled to relief under Revenue and Taxation Code Section 6596.

Summary

Petitioner is an advertising agency with an in-house art department producing preliminary art and camera-ready mechanical assemblies. Materials incorporated into the finished art include typography purchases tax-paid from outside vendors, and photostats produced in-house. Petitioner acts as a true agent.

The audit was completed in approximately August of 1990, and the results were discussed with petitioner's representative, M--- A---. A revised audit was then made, and a determination issued on June 10, 1991. Petitioner paid the amount of tax included in the determination on June 7, 1991, and on June 21, 1993, filed a petition for redetermination, and claim for refund. Details of petitioner's arguments are as follows.

Preliminary Art

Both petitioner and SUTD agree that with the exception of the transaction involving C--- P--- T---, the only issue is whether there is sufficient evidence that a contract for finished art was entered into after the preliminary art was reviewed and accepted by the client(s).

According to the auditor, there were no separate written contracts, purchase orders, work orders, or other records showing preliminary art and finished art were separately negotiated, or approval of preliminary art was prior to contracts for the finished art. Tax was not assessed on preliminary art where petitioner could show evidence that a contract for finished art was entered into after the preliminary art was reviewed by the client. If the records showed a memorandum indicating the client had reviewed the preliminary art, then entered into the contract for finished art, this was accepted. However, the remaining 76.26 percent of the charges were taxed because petitioner could not provide back-up documentation proving when the contract for finished art was entered into. Some documents which petitioner submitted related to preliminary art, but it was not accepted because the test was performed on a statistical random sampling, and the documents either showed approval for finished art on a different job (not in the sample), or some indicated approval to prepare preliminary art instead of finished art.

Petitioner argues that it is rare for a client to enter into a contract for finished art until after having the opportunity to review preliminary art. A separate contract is always entered into for finished art after viewing the preliminary art; however, the contract is rarely reduced to writing. The customer will always inspect the preliminary art first, then ask petitioner to produce the finished art. Sometimes a memo will be prepared to indicate what transpired, and other times not. Petitioner submitted four one-page statements in support of this argument. The statements include a March 8, 1991 statement from Z--- I--- Company, a March 11, 1991 statement from H--- N---, a March 14, 1991 statement from G--- H---, and a March 21, 1991 statement from B--- W--- E---, Inc. The four statements, in substance, read essentially the same. Each statement indicates that preliminary art is first prepared for separate approval and authorization, after which petitioner is then verbally authorized to proceed with the finished art. Many times petitioner follows up with a written acknowledgment, and charges for preliminary and finished art are always billed separately.

C--- P--- T--- Transaction

This contract involves an alleged sale of preliminary art to the client. SUTD determined that title transferred, and assessed tax accordingly.

SUTD argues that the client obtained title to the "original art"; therefore, this transaction does not qualify as a nontaxable sale of preliminary art.

Petitioner argues an apparent distinction between the terms "preliminary art" and "original art". Preliminary art is conceptual roughs or comprehensives (comps) that are used to show a client an idea and are then discarded. The art has no further value. Original art specifically refers to items of tangible personal property including, but not limited to, transparencies, illustrations, final art assemblies (boards), negatives and positives. It is therefore clear that the contract with C--- P--- T--- called for both preliminary art and finished art, and tax may only apply accordingly.

Agency Fee

This issue involves the disallowance of an agency fee claimed by petitioner as nontaxable and determined as taxable by the auditor since the finished art was not billed at fair retail selling price.

SUTD argues that petitioner had three types of contracts during the audit period with regard to how the charges were billed:

Type 1. Taxpayer charged all buyouts at cost plus a production coordination fee computed at a fixed percentage (e.g., 17.65 percent for one client and 20 percent for another) on the cost of buyout.

Type 2. Taxpayer charged all buyouts at cost plus a fixed monthly agency fee.

Type 3. Could work like a Type 1 or Type 2 contract depending on the volume of the buyouts in that month. A fixed monthly fee is set. If the volume of the buyout is large enough that a fixed percentage of the cost of the buyouts is larger than the fixed fee, the fixed percentage will be used for the billing just like a Type 1 contract. Otherwise, the fixed monthly fee will be used for the billing just like a Type 2 contract.

Petitioner produced finished art "in-house"; therefore, it is considered a seller of the typography and photostats incorporated into the finished art. For the Type 1 contracts, and Type 3 contracts that work like a Type 1 contract (when the production coordination was calculated using a percentage), gross receipts should have been calculated as the charges of typography and photostats plus the production coordination added to these charges. Since tax was not reported on production coordination charges, any production coordination related to typography and photostats was disallowed.

For all Type 2 contracts, and the remaining Type 3 contracts that work like a Type 2 contract, typography and photostats were billed at cost without adding a markup as was done in Type 1 contracts; therefore, part of the agency fee was disallowed as not properly allocated to those items of which petitioner was considered a seller (finished art). Had these items been billed at their fair retail selling price, the entire fee would not be taxable.

Petitioner argues that final art consisted of the actual fabrication of materials and typography and photostats which are assembled as part of the finished art product. In no instance did petitioner incorporate finished art charges as part of the monthly service and supervision fees, which were for liaison, marketing council, copyrighting, research, travel time, and overall coordination of the account. High retail value was charged on finished art that included all cost and profits, including supervision. SUTD may only assert the issue of fair retail selling price when a lump-sum charge is made for both preliminary and finished art. The finished art is separately stated and includes all charges for fabrication. Sales and Use Tax Regulation 1540(b)(4)(K) is not applicable because there is no fee added by the agency to a "total billing" encompassing items as to which petitioner is a seller, and items as to which tax does not apply. Whenever any costs were questionable as to whether it was attributable to preliminary or finished art, petitioner always billed the item as finished art; therefore, more than the fair retail selling price was always charged for finished art.

Advice From Prior Audit

The prior audit covered the period January 1, 1983 through December 31, 1985. Petitioner submitted a photocopy of the prior auditor's handwritten comments regarding petitioner's handling of the monthly agency fee, compensation for finished art, and preliminary art. At the conference, petitioner pointed out the auditor's comments which support its position. Those portions are as follows:

"...Taxpayer receives monthly agency fee - a flat amount, a commission on the purchase of materials plus expenses, compensation for the finished art, and compensation for preliminary art....

"For the preliminary art, they were billed as graphic design with the selling price stated separately, which is accepted. Finished art made by the art department was billed at retail price. The materials-stats were tax paid at purchase. Taxpayer receives a monthly fee for liaison, meeting, marketing strategy, media service, account administration....

"Labor claimed in 3-84 and 4-84 were charges for the preliminary art and commission on purchased materials. Generally, these charges were claimed as 'fee, etc.' deduction.... Based on the examination of the transactions, sales tax is properly charged...."

Petitioner argues the above audit comments led it to believe that all taxes were properly paid relating to transactions involving preliminary art, finished art, and the agency fee. During the prior audit period, petitioner did not report tax on preliminary art or agency fees. The auditor made no additional assessment on these items and in fact states that all tax was properly paid.

SUTD argues that petitioner did not submit a written request as required by Revenue and Taxation Code Section 6596. It is their position that prior audits do not constitute a written opinion and therefore they are not bound by them. Furthermore, in examining the prior audit, it is clear that petitioner's procedure has changed. The prior auditor's comments indicate that petitioner charged a commission on the purchase of materials, and in the current audit, purchases were billed at cost.

Analysis and Conclusions

Under Revenue and Taxation Code Section 6006, the term "sale" is defined as any transfer of title or possession, exchange, or barter, condition or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. To determine the application of tax to charges made by advertising agencies, the Board has promulgated Sales and Use Tax Regulation 1540. Unless indicated otherwise, all references following relate to this regulation.

This regulation distinguishes between circumstances where an agency may act as an agent on behalf of its client (subdivision (a)), and those circumstances where it does not (subdivision (b)). The regulation is based on the presumption that advertising agencies are acting as retailers unless the agency specifically establishes that it is an agent. For the

advertising agency to establish that a particular acquisition was made as an agent for its client, subdivision (a)(2)(A) requires the following:

1. It must have written evidence of agency status with the client prior to acquisition of the property.
2. It must disclose to the supplier the name of the client for whom the agency is acting as agent.
3. The price billed to the client exclusive of the agency fee must be the same amount paid to the supplier.
4. No use of the property may be made by the agency, nor may a purchase be billed to more than one client.
5. The charge made by the supplier must have been billed to the client on a separate invoice or shown separately on an invoice encompassing more than one item.

Here, there is no dispute that petitioner complied with the express requirements to be considered a true agent. This is expressly stated by the auditor in the audit workpapers, and has not been disputed by petitioner. Therefore, the following issues will be resolved based on this finding.

Preliminary Art

Subdivision (b)(4)(A) defines "preliminary art" as roughs, visualizations, layouts and comprehensives, title to which does not pass to the client, but which is prepared by the advertising agency 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 the preparation of finished art, to be furnished by the agency to the client. The charge for preliminary art must be billed separately to the client, either on a separate billing, or separately charged on the billing for 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. No other proof shall be required.

It is clear from the above authority that acceptance by the client may be made either before a contract is entered into for the production of finished art, or before the client (with the contract already entered into) approved the preliminary art, then authorized petitioner to prepare the finished art. SUTD has already accepted those transactions in which petitioner could produce evidence in the form of a memorandum that the preliminary art was reviewed prior to preparation of the finished art. The only circumstances under which petitioner's documents were disregarded was either where it showed approval for finished art for a different job which was

not selected in the random sampling, or the document indicated approval for preparation of preliminary art instead of finished art.

The methods described as proof in the regulation are not exclusive. Those methods were added to the regulation for the benefit of the taxpayer but they do not prohibit other proof. Therefore, a taxpayer can prove this requirement by other satisfactory evidence. The Board's Assistant Chief Counsel of Business Taxes has previously so interpreted this regulation in a petition for redetermination case.

I note from a review of pages 3 and 4 of the verification comments of July 19, 1990 that the auditor states the following:

"Taxpayer had internal records showing that the preliminary art was approved by the client (Exhibit c); however, there was no records indicating that the approval of the preliminary art was before the contract of the finished art."

It is noted from a review of various invoices, that in most situations where petitioner billed the client for preliminary art (graphic design), there was no additional or separate charge for finished art. This would seem to indicate that any charges for finished art were invoiced at a later time. In other instances, both preliminary and finished art were billed separately in the same invoice. A review of petitioner's memos to its clients, or memos entitled "Conference Report" reveals notations made either to the client asking for review and approval of the preliminary art, or statements (internal) that the client needed to review and approve the preliminary art. Normally, the memos were dated earlier than the related invoice, where the invoice included both preliminary and finished art charges. Apparently, where the auditor observed these comments, the charges for preliminary art was disallowed.

Based on a review of the evidence, I conclude petitioner has met its burden in order to make the charges for preliminary art nontaxable. It is clear from the auditor's verification comments that petitioner's internal records reveal preliminary art was approved by the clients before commencing with production of finished art. SUTD's argument that there were "no records" indicating approval of preliminary art prior to the contract for finished art, is refuted by the verification comments. SUTD seems to be implying that there must be a separate and distinct contract for finished art, entered into after approval of the preliminary art. The regulation simply requires that approval of preliminary art occur before starting preparation of the finished art. The four one-page statements from petitioner's clients, the comments in the memos relating to the invoices, and the verification comments provide adequate evidence in support of petitioner's argument.

C--- P--- T--- Transaction

The issue in this transaction apparently involves a transfer of title to "original art", which the auditor disallowed as a nontaxable sale of preliminary art. On the other hand, petitioner seems to be arguing that the auditor was of the opinion the term "original art" actually related to finished art, to which title was taken. Petitioner's opinion is apparently based on the distinction between the term "original art" as opposed to "preliminary art". Petitioner concludes by stating the contract called for both preliminary and finished art.

It is noted from a review of item 10 of the September 3, 1987 agreement between petitioner and C--- P--- T---, that the agreement states as follows: "The client shall maintain rights of ownership of all original art prepared for client upon payment to agency."

I see no reason for petitioner's fine point distinction between the terms "original art" and "preliminary art" or whether what in fact was transferred was finished art. Subdivision (b)(4)(A) expressly requires that for the charge made by an advertising agency for preliminary art to be nontaxable, title must not transfer to the client. Subdivision (b)(4)(B) provides that tax applies to the total charges made by advertising agencies for the sale of finished art. Regardless of how this situation is viewed, petitioner does not deny that "original art" was transferred to the client. Because title transferred, the transaction would be taxable whether the charge was for preliminary or finished art.

Agency Fee

Subdivision (b) discusses the application of tax to various charges made by advertising agencies. Under (b)(4)(K), where an agency has acted as an agent with respect to acquiring property for the client from outside sources, and billed those items at their fair retail selling price, then the fee added to the total billing is not taxable. Where the agency fails to bill the items as to which it is a retailer at the fair retail price (as defined in (b)(1)), then the fee added to the billing is taxable in accordance with the ratio between taxable and nontaxable charges.

Subdivision (b)(1) provides that if an agency supplies 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 defined as an amount sufficient to cover: (1) net labor costs of the agency employees plus allowance for overhead and profit of not less than 100 percent of such labor cost; (2) cost of purchase items incorporated into tangible personal property as to which the agency is a seller. If the agency has furnished a firm quoted price based on estimated labor cost plus overhead and profit of not less than 100 percent of labor costs, and bills in accordance with the quoted price, the agency is deemed to have charged a fair retail selling price. Sales and Use Tax Pamphlet No. 38 entitled "Advertising Agencies" provides further detail on page 18 (Exhibit 1 attached) in determining whether an agency is complying with the requirement of charging a fair retail selling price.

After making a review of the audit working papers and other evidence submitted in this matter, it was noted that this issue could not be resolved without further documentation from petitioner showing employee time billed to particular projects, records of time spent on each item of finished art, documentation showing overhead and profit included in all invoices to clients, copies of purchase invoices for property incorporated into finished art, and corresponding sales invoices to those same clients for finished art charges.

In a January 12, 1994 letter, petitioner was requested to submit the above documentation to resolve this issue, and given 30 days in which to do so. In a follow-up letter of March 2, 1994, petitioner was given an extension until March 15, 1994 to provide this documentation. Currently, the documentation has not been provided. Here, petitioner must not only prove that the Department's determination is incorrect, but also produce evidence from which a proper determination may be made on this issue. (Paine v. State Board of Equalization (1982) 137 Cal.App.3d 438, 445.) The Department is not bound to accept a taxpayer's unsupported statements. (Revenue and Taxation Code Section 7053; People v. Schwartz (1947) 31 Cal.2d 59.)

If, in a Request for Reconsideration, petitioner can produce the documentation previously requested, and that documentation reveals that the finished artwork was billed at fair retail selling price, it will be entitled to relief on this issue.

Advice From Prior Audit

Section 6596 provides that if a person's failure to make a timely return or payment is due to the person's reasonable reliance on written advice from the Board, the person may be relieved of the taxes imposed by Sections 6051 and 6201 and any penalty or interest added thereto. The person must have requested in writing that the board advise him or her whether a particular activity or transaction is subject to tax. The specific facts and circumstances of the activity or transaction must be fully described in the request. The Board must have responded in writing, stating whether or not the described activity or transaction is subject to tax, or stating the conditions under which the activity or transaction is subject to tax.

The Board has determined that relief can be allowed under Section 6596 when the issue in question was clearly discussed in a prior audit, and the essence of the advice to the taxpayer is set forth in writing in the working papers.

Any advice from the prior audit as it relates to charges for preliminary art will not be further considered since it has already been determined petitioner is entitled to relief on this issue.

As to whether the advice in the prior audit relating to the agency fee was erroneous, that determination will be based on two factors: (1) whether in the prior and the current audits petitioner did not bill for finished art at fair retail selling price, yet was advised by

the auditor that it did; and (2) this issue was clearly discussed in the prior audit. If petitioner did bill for finished art at fair retail selling price in the prior audit and the audit comments indicated tax on the fee was properly reported, then the advice would not be erroneous.

It is noted from a review of an August 21, 1991 memo addressed to the Petition Unit and authored by District Principal Auditor David Slechta that in comparing both audits, it was determined that in the prior audit, tax was charged on finished art which included a commission on the purchase of materials. In the current audit, the purchases were billed at cost.

Reviewing the written audit comments pointed out by petitioner, it is noted the auditor stated "finished art made by the art department was billed at retail price.... Based on the examination of the transactions, sales tax is properly charged...." This statement expressly indicates that in the prior audit, petitioner charged fair retail selling price for finished art and that petitioner properly handled the application of tax.

Based on a review of the evidence, we conclude petitioner is not entitled to relief. It appears that in the prior audit, charges for finished art were billed at fair retail selling price while in the current audit, it was not. If, in a Request for Reconsideration, petitioner can prove that in the prior audit it did not bill finished art at fair retail selling price, as the auditor so concluded, then the written comments would be proven erroneous and entitle petitioner to relief for tax assessed on a portion of the agency fee. On the other hand, if petitioner can prove that finished art was billed at fair retail selling price in the current audit, then relief under Section 6596 would not be necessary, since a portion of the agency fee would then not be subject to tax. (See agency fee issues and analysis above.)

Recommendation

Conduct a reaudit, deleting from the measure of tax preliminary art charges, with the exception of the transaction involving C--- P--- T---. Otherwise, redetermine without adjustment.

Lucian Khan, Staff Counsel

Date

Attachment: Exhibit A