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February 1, 1994

Mr. M--- K---, Principal  
 M--- K--- and Associates  
 XXX --- Street, Suite XXX  
 --- ---, CA XXXXX

Re: **SR - - XX-XXXXXX**

Dear Mr. K---:

This is in response to your letter of December 14, 1993 in which you request advice as to the application of tax to charges made in connection with the production of marketing materials. Your company provides consulting services and produces marketing materials such as brochures for its clients. Your charges for producing the brochures are itemized.

You ask whether the following itemized charges are subject to sales tax:

"Marketing strategy; i.e., assessing a client's marketing needs and objectives and recommending how to achieve them. This service results in a written report prepared solely for the purpose of recommending a corporate positioning and/or thematic direction for acceptance by a client before approval is given to commence creative services."

Revenue and Taxation Code section 6051 imposes a sales tax on all retailers measured by their gross receipts from retail sales of tangible personal property. If all you provide is the report<sup>1</sup>, we would regard that as the providing of a service with the transfer of any tangible personal property (i.e., paper) as being merely incidental to the service. (Regulation 1501 (copy

<sup>1</sup> We assume that the report consists of text only and contains no photographs or artworks.

enclosed.) Charges and expenses incurred in the rendering of such nontaxable services, such as supervision, consultation, research, telephone and travel expenses, are likewise nontaxable.

However, if you are providing tangible personal property (such as brochures) in addition to the report, then sales tax applies to the sale of that tangible personal property. As stated above, the sales tax is measured by the gross receipts from a sale of tangible personal property. Section 6012 of the Revenue and Taxation Code defines "gross receipts" to include the cost of any services that are a part of the sale of the tangible personal property. "Services that are a part of the sale" are defined in Sales and Use Tax Annotation 295.1690 (8/16/78) which states:

"'Services that are a part of the sale' include any the seller must perform in order to produce and sell the property, or for which the purchaser must pay as a condition of the purchase and/or functional use of the property, even where such services might not appear to directly relate to production or sale costs. Thus, charges described by a seller of catalogs as for preproduction research and consultation services and for postproduction merchandising consultation services are part of the taxable sales price of the catalogs, whether separately stated or not. The first 'service' is a necessary prelude to catalog production; and the second is furnished only to catalog purchasers who are required to pay for the service when they purchase the catalogs, whether or not it is desired or used."

In order to determine your taxable gross receipts from the sale of the brochures, it is first necessary to determine whether the written report you provide is a "service that is a part of the sale" or not. Your letter states that this report is used by the client to decide whether or not to contract with your firm for creative services as well as for the production of marketing items such as brochures. Given the fact that the client may reject the recommendations made in the report, there may not be a transfer of any tangible personal property other than the report itself. This fact situation appears to be analogous to preliminary art. "Preliminary art" is defined in Regulation 1540(b)(4) (copy enclosed) which states:

"'Preliminary art' means 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. Tax does not apply to separate charges for preliminary art except where the preliminary art becomes physically incorporated into the finished art ...."

As noted above, if you contract to provide only the report, your charges would be regarded as nontaxable service charges. Similarly, charges for preliminary art are regarded as nontaxable service charges when the customer does not purchase any tangible personal property.

Further, charges for preliminary art are regarded as nontaxable service charges when meeting the requirements quoted above. By analogy, we believe the same rules apply here. That is, the charges for the written report will not be subject to tax if it was produced prior to any contract or before approval by the client for the production of the final product. The charge for the report must be billed separately to the client, either on a separate billing or separately charged for on the billing.

You also ask whether the following charges are subject to tax:

"Out-of-pocket expenses incurred -

- a) during the marketing strategy phase;
- b) during the preliminary art phase; or
- c) during the copywriting and mechanical art phase:
  - interview transcripts
  - photocopy costs
  - courier services
  - proofreading services
  - design materials
  - automobile parking charges
  - long-distance telephone charges."

Revenue and Taxation Code section 6012 states that "gross receipts" include "the cost of the materials used, labor or service cost, interest paid, losses or any other expense."

During the "marketing strategy" phase, if all you are providing is a non-taxable report, then your charges to your customer for expenses incurred in rendering that service are likewise nontaxable. Your question is unclear as to whether you are providing "preliminary art", as defined above. The application of tax to preliminary art is as discussed above. When you charge your customer for your expenses related to nontaxable preliminary art, your charges are not taxable. If, however, the preliminary art does not qualify as nontaxable as discussed above, all charges related to the preliminary art are likewise subject to tax. Similarly, your charges for expenses related to production of the final marketing product, which is subject to tax, are also included in the measure of tax. If you are making a taxable sale together with providing services which qualify as nontaxable, you should retain documentation to support your treatment of costs passed on to your customer as related to the nontaxable services rather than the taxable sale.

Mr. M--- K---

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February 1, 1994  
295.1536

If you have any further questions, please do not hesitate to write again.

Sincerely,

Sukhwinder K. Dhanda  
Staff Counsel

SKD:plh

Enclosures - Regulations 1501 and 1540

bc: --- --- District Administrator - --