

Audit Manual

Chapter 11

Advertising Agencies, Graphic Artists, Printers, and Related Enterprises



Sales and Use Tax Department
California State
Board of Equalization

This is an advisory publication providing direction to staff administering the Sales and Use Tax Law and Regulations. Although this material is revised periodically, the most current material may be contained in other resources including Operations Memoranda and Policy Memoranda.

Please contact any board office if there are concerns regarding any section of this publication.

Table of Contents

Advertising Agencies, Graphic Artists, Printers, and Related Enterprises	1100.00
INTRODUCTION	1101.00
General	1101.05
General Steps in the Graphic Design and Printing Process	1101.10
Identifying the Nature of Taxpayer's Business and Status as Agent or Retailer	1101.15
TYPES OF RECORDS	1102.00
General	1102.05
Summary Records	1102.10
Source Documents	1102.15
HOW TAX APPLIES TO ADVERTISING AGENCIES AND COMMERCIAL ARTISTS	1103.00
General	1103.05
Preliminary Art — Conceptual Services	1103.10
Finished Art — Tangible and Intangible	1103.15
Sales of Other Tangible Personal Property	1103.20
Intermediate Production Aids	1103.25
Special Printing Aids	1103.30
Specific Nontaxable Service Charges	1103.35
Technology Transfer Agreements	1103.40
Transfers at a Social Gathering	1103.45
SPECIAL PROVISIONS APPLICABLE TO ADVERTISING AGENCIES	1104.00
General	1104.05
Advertising Agency Acting as an Agent for its Client or as a Retailer of Tangible Personal Property	1104.10
SPECIFIC APPLICATIONS	1105.00
Commercial Photographers	1105.05
Creative Art Services for the Motion Picture Industry and Other Motion Picture Producers	1105.10
Digital Pre-Press Instruction	1105.15
Newspapers and Periodicals	1105.20
Printed Sales Messages	1105.25
SPECIAL REPORTING PROCEDURES FOR PRINTERS REGARDING SPECIAL PRINTING AIDS	1106.00
General	1106.05
Percentage of Sales Method	1106.10
Sales of Special Printing Aids for Resale	1106.15
When the Percentage of Sales Method May Not Be Used	1106.20
Verification Procedures	1106.25
GLOSSARY OF TERMS	1107.00

AUDIT MANUAL

**ADVERTISING AGENCIES, GRAPHIC ARTISTS,
PRINTERS, AND RELATED ENTERPRISES 1100.00**

INTRODUCTION 1101.00

GENERAL 1101.05

This chapter is a guide for determining the sales and use tax liability of persons providing graphic art services, finished art, and printed matter. These persons include advertising agencies, commercial artists, printers, and publishers. Commercial artists can include commercial photographers, graphic artists, graphic designers, printers, publishers, and others who provide these types of services. See the Glossary of Terms (Section 1107.00) for definitions of terms that are used throughout this chapter.

A preliminary review of the business operations is essential to understand what and how tangible personal property and services are provided and to whom. This preliminary analysis should include a tour of the premises to understand the taxpayer's graphic arts process, the customer base, the types of output, and the billing methods. In order to make sound recommendations, the auditor must accumulate sufficient data to support a reasonable conclusion or opinion based on acceptable auditing standards as discussed in Chapter 4, General Audit Procedures.

The application of sales and use tax to transactions by advertising agencies, graphic artists, printers, and related enterprises is governed by the following regulations:

- Regulation 1507, Technology Transfer Agreements
- Regulation 1529, Motion Pictures
- Regulation 1540, Advertising Agencies and Commercial Artists
- Regulation 1541, Printers and Related Arts
- Regulation 1541.5, Printed Sales Messages
- Regulation 1543, Publishers
- Regulation 1590, Newspapers and Periodicals

GENERAL STEPS IN THE GRAPHIC DESIGN AND PRINTING PROCESS 1101.10

Understanding the graphic arts process is crucial when determining the correct application of tax to transfers of tangible personal property and related services. The providers of graphic art services include advertising agencies, commercial artists, stock shot houses, sketch artists, illustrators, commercial photographers, copy writers, printers, print brokers, mailing houses, publishers, color separators and photolabs or colorhouses providing scans and transparencies. The consumers of graphic art services include advertising agencies acting as agents of their clients, businesses that use forms or business cards, event producers, and other end users of the tangible personal property.

The steps in the graphic design and printing process may include:

Concept/Design/Preliminary Art — Phase 1

1. Conceptual development, design, ideas, sketches;
2. Obtaining or preparing transparencies, stills, low resolution scans, stock shots, photo shoots, illustrations;
3. Art and idea development, sometimes along several lines of thought presented in roughs or comprehensives (“comps”), involving various approval stages, narrowing to one or more developed ideas;
4. Writing of copy;
5. Client approval of ideas and visualizations that are selected to go forward into the development of finished art;

Preparation of Finished Art — Phase 2

6. Preparation of finished art (generally provided in the form of Quark or PageMaker file). The finished art file is typically sent to a pre-press house or printer who will use the file as input to a pre-press process such as SyQuest. The finished art is accompanied by a laser proof that shows the positioning of the elements and photography and illustrations as needed. The file may be sent either on digital media or by modem;

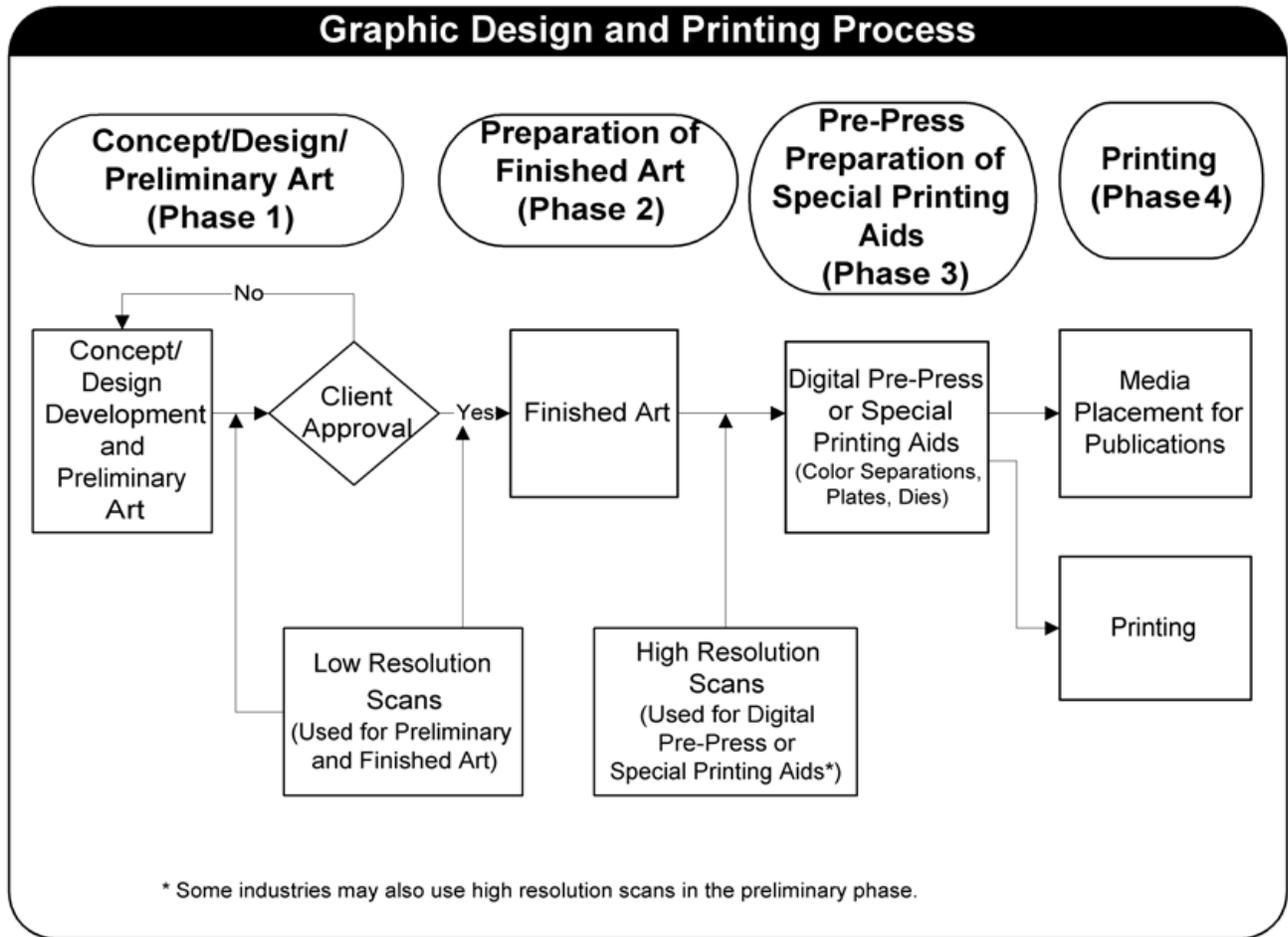
Pre-Press Preparation of Special Printing Aids — Phase 3

7. Preparation of high resolution scans of photographs and/or illustrations for input into pre-press process together with finished art file received from advertising agency or commercial artist;
8. Preparation of color separations, if part of the process (generally with a proof);
9. Preparation of plates (sometimes digital plates are used, for which no separations are required, called “direct-to-plate”);

Printing, Binding, and Finishing — Phase 4

10. Printing (may include such items as brochures, business cards, books, magazines, flyers, catalogs, posters, instructions, forms, containers, banners, shirt silk-screening, etc.);
11. Binding and finishing (may include die-cutting, embossing, foil stamping, punching, etc.); and
12. Distribution.

The steps described above are shown in the following chart. This chart illustrates a general graphic design and printing process, and details may vary.



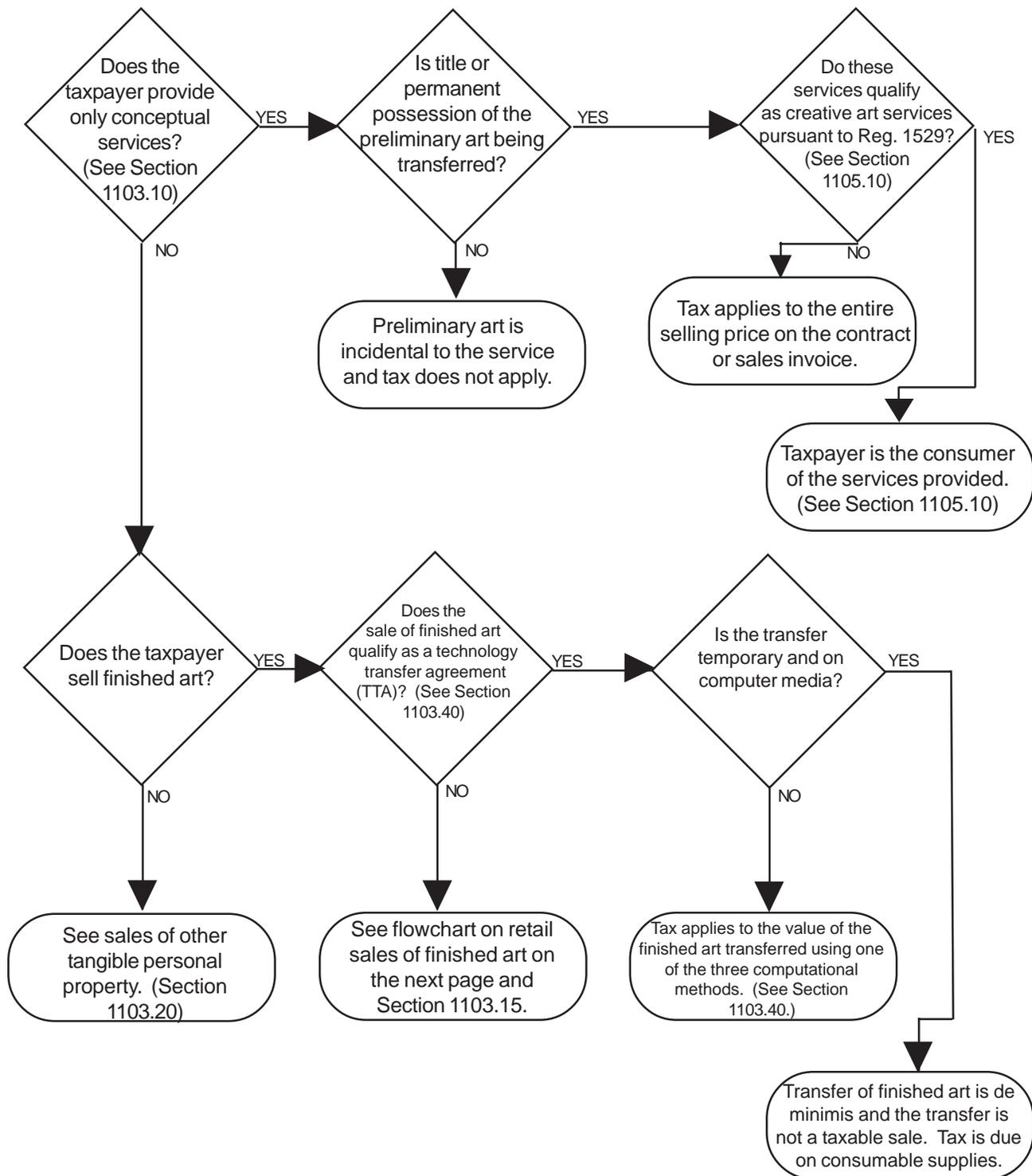
IDENTIFYING THE NATURE OF TAXPAYER’S BUSINESS AND STATUS AS AGENT OR RETAILER

1101.15

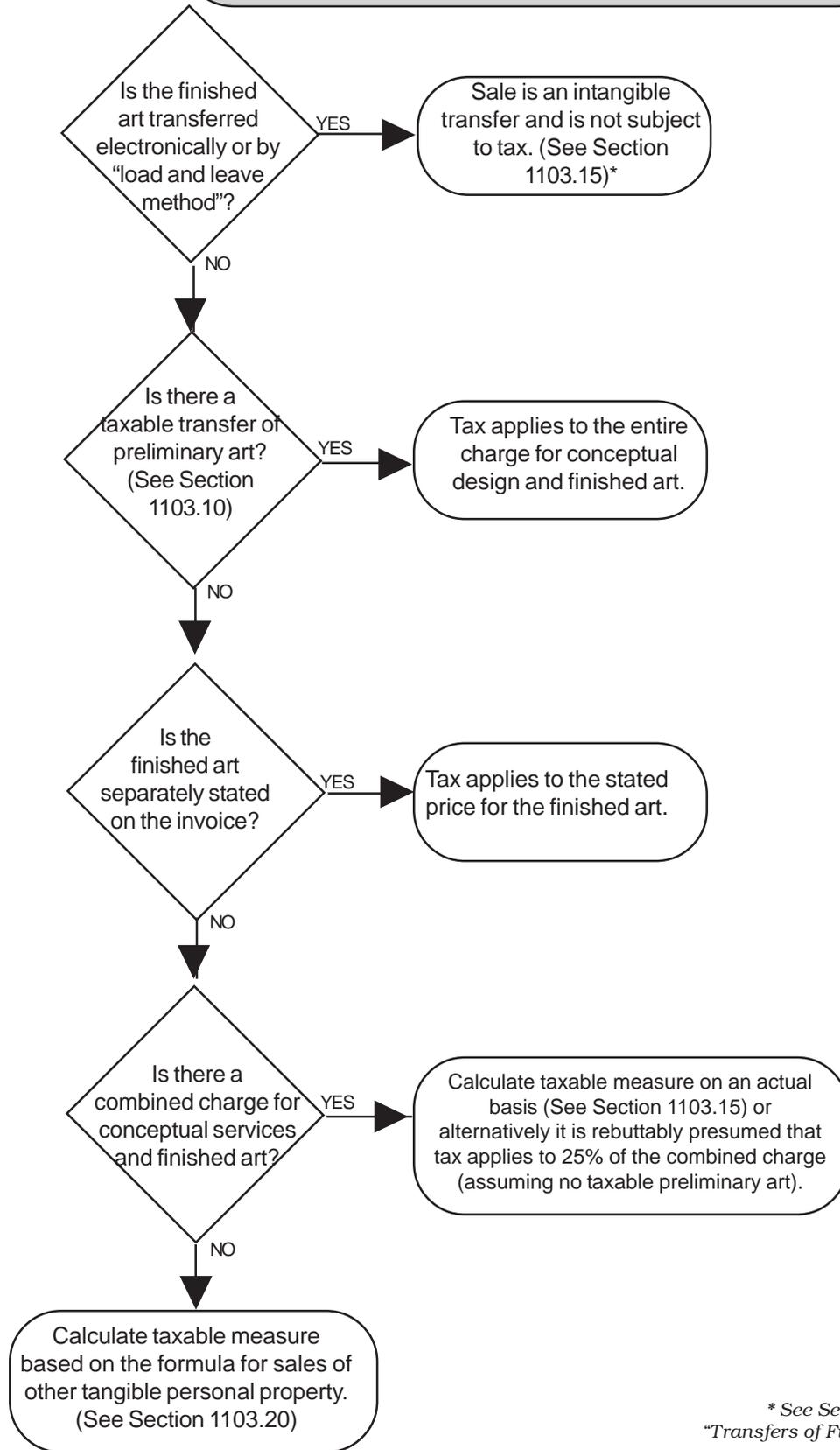
Auditors need to identify the nature of the taxpayer’s business prior to determining the application of tax to the taxpayer’s transactions. Auditors need to determine if advertising agencies and commercial artists are providing design services, preliminary art, finished art, or other tangible personal property. Prior to determining the application of tax to the charges by an advertising agency, it is important to determine if the advertising agency is purchasing as an agent on behalf of its client or if the advertising agency is acting as a retailer and purchasing on its own behalf (see Section 1104.10).

The following flowcharts apply to advertising agencies and commercial artists acting as retailers of tangible personal property.

Identifying the Nature of the Taxpayer's Business When Tangible Personal Property is Transferred



Retail Sales of Finished Art that Do Not Qualify as a Technology Transfer Agreement



* See Section 1103.15 paragraph titled, "Transfers of Finished Art in Intangible Form".

AUDIT MANUAL

TYPES OF RECORDS **1102.00**

GENERAL **1102.05**

The type of records maintained by persons engaged in the graphic arts and printing industries varies depending on the tangible personal property or service provided. Generally, the records include the items described in Sections 1102.10 to 1102.15.

SUMMARY RECORDS **1102.10**

The summary records should include a general ledger with supporting sales and purchase journals. The taxpayer should be able to provide an audit trail from the sales tax worksheets to the summary records. These summary records should also provide an audit trail to the supporting source documents.

SOURCE DOCUMENTS **1102.15**

Depending on the nature of the business, the supporting documentation for the sales journal and purchase journal may include the following items:

1. Job/Customer folders (usually maintained by customer name or job number).
2. Contracts/Master agreements (describe nature of the job, acknowledge any title clauses, indicate items purchased and any applicable fees).
3. Bid sheets (showing estimated costs, vendors, quantities, and profit).
4. Written work orders (define the work to be done, the customer, the intent, and the final product).
5. Written change orders (outside the scope of original contract/agreement).
6. Purchase orders from customers/clients.
7. Purchase orders to vendors; purchase invoices from vendors (for artwork, scans, photographic images, props, and services including independent contractors).
8. Delivery receipts (shipping documentation).
9. Copies of preliminary artwork (comps, sketches, etc.).
10. Copies of finished art.
11. Copies of correspondence (e-mails, letters, etc.).
12. Sales invoices (may be lump-sum billed, itemized, or combination thereof).

AUDIT MANUAL

HOW TAX APPLIES TO ADVERTISING AGENCIES AND COMMERCIAL ARTISTS

1103.00

GENERAL

1103.05

This section applies to advertising agencies, commercial artists, and other persons operating in these capacities. Advertising agencies are persons who design and implement advertising campaigns for purposes of advertising the goods, services, or ideas of their clients. Commercial artists are persons who provide services and tangible personal property to their clients for use in their clients' advertising campaigns or for other commercial purposes. Commercial artists can include commercial photographers, graphic artists, graphic designers, printers, publishers, and others who provide these types of services.

PRELIMINARY ART — CONCEPTUAL SERVICES

1103.10

“Conceptual services” are services performed to convey ideas, concepts, messages, etc., prior to entering into a contract or obtaining approval for finished art, that generally result in the creation and development of preliminary designs (preliminary art). Preliminary art is tangible personal property prepared solely for the purpose of demonstrating an idea, concept, look, or message for acceptance by the client prior to the preparation of finished art. Examples of preliminary art include roughs, visualizations, drawings, sketches, renderings, illustrations, layouts, comprehensives, photographs, negatives, transparencies, prints, copies, chromatics, stats, logotypes, scans, lasergraphics, visual prototypes, and electronic imagery. Preliminary art does not include items used to produce finished art (i.e., intermediate production aids).

Charges for conceptual services should be identified as “design charges,” “preliminary art,” “concept development,” or another designation that clearly indicates that the charges are for the development and creation of preliminary designs, not finished art.

Note: If conceptual services are provided in connection with the production, distribution, or exploitation of a qualified motion picture, see Section 1105.10 pertaining to “creative art services.”

Tax does not apply to charges for conceptual services/preliminary art unless:

- a. The master agreement or other contract provides that the advertising agency or commercial artist will pass title or the right to permanent possession of the preliminary designs (artwork) in tangible form; or
- b. Permanent possession of the artwork in tangible form is actually transferred to the client. Permanent possession does not include temporary transfers to the client for review and approval purposes.

When charges for conceptual services/preliminary art are **not** subject to tax, the taxpayer must pay tax measured by the purchase price of the tangible personal property developed and used to produce the preliminary designs. This includes preliminary production aids used in the creation of the designs such as artwork, illustrations, photographic images, photo engravings, and other similar materials purchased from third parties and used to produce preliminary art. Aids used in the production of preliminary art are not presumed sold to the client prior to use, contrary to the presumption with intermediate production aids. If the advertising agency or commercial artist chooses to sell the preliminary production aids to the client prior to use, the contract or sales agreement must include a specific title transfer clause transferring title to the aids to the client prior to use. When this is the case, the advertising agency or commercial artist should separately itemize the taxable, retail sale of the preliminary production aids from their charges for the nontaxable conceptual services.

PRELIMINARY ART — CONCEPTUAL SERVICES

(CONT. 1) 1103.10

In the event the master agreement or other contract provides that the client is to receive title to or the right to permanent possession of the preliminary designs in tangible form, the entire charge for the conceptual services/preliminary art is subject to tax. Similar language in an agreement or contract that effectively transfers title or the right to permanent possession to the client of all material produced during the term of such agreement or contract will also make any charges for conceptual services/preliminary art subject to tax. The measure of tax is not limited to merely the value of the tangible personal property transferred but also includes the charge for the conceptual services.

It is important to note, however, a contract provision providing that the “concepts” embodied in the preliminary art are not to be used for other clients does not constitute the transfer of title to the preliminary art to the client. Nor does a contract provision that the creator of the preliminary art retains the right to permanent possession of the preliminary art, in tangible form, constitute a sale of the preliminary art. Title to tangible personal property is distinguished from title to the intellectual property (e.g., ideas, concepts, designs) which is embodied in the tangible personal property.

In the case where the agreement or contract is silent as to the transfer of title or the right to permanent possession of preliminary art, but the taxpayer has nevertheless transferred permanent possession of the preliminary art in tangible form, the charge for the preliminary art transferred is subject to tax. Generally, transfers of permanent possession can be evidenced by a subsequent invoice or billing for the preliminary art or other documentation that supports a permanent transfer.

Note: Since numerous conceptual stages can be involved in the creation of preliminary art and various design concepts may be developed, transfers of permanent possession of any of the preliminary designs or enhancements can occur during any stage in the approval process. As such, documentation that details all stages of the preliminary art development process and the designs created should be reviewed by the auditor. This documentation should also provide the date that the client provided final approval of the preliminary art to go forward with finished art.

When numerous preliminary designs are created and only some are transferred to the client in tangible form, and permanently retained (for example 10 out of 20 preliminary designs under one contract) then a portion (i.e., 50%) of the charge for the conceptual services/preliminary design rather than the entire charge, is includable in taxable gross receipts.

Example 1: Preliminary Art — Flat Fee

A commercial artist is hired to provide ideas and designs for a company logo. The preliminary art is not permanently transferred to the client. The commercial artist bills the following based on a flat fee or an hourly basis:

Preliminary Art — 8 concepts and layouts	\$1,000.00
Tax	0.00
Total Invoice	<u>\$1,000.00</u>

This is a charge for conceptual services only. The preliminary art is considered incidental to the service and not subject to tax.

Example 2: Preliminary Art - Itemized Bill

The same commercial artist in Example 1 itemizes the charges as follows:

Design of Company Logo:	
Concept Development Fee	\$ 750.00
Preliminary Art Fee	250.00
Tax	0.00
Total Invoice	<u>\$1,000.00</u>

The commercial artist is providing conceptual services only. Regardless of the type of billing, the preliminary art is considered incidental to the service and not subject to tax.

Example 3: Preliminary Art — Proration of Art Transferred

The same facts as Example 1, except that the commercial artist permanently transfers five of the eight preliminary designs since the client wanted to retain possession of five of the designs. The preliminary designs permanently transferred represent 62.5% (five of eight) of the total preliminary designs provided. In this case, the commercial artist bills the following:

Preliminary Art — 8 concepts and layouts	\$1,000.00
Tax on \$625 @ 7.75% (5 layouts transferred)	<u>48.44</u>
Total Invoice	<u>\$1,048.44</u>

If all the layouts were permanently transferred, the full \$1,000 charge would be subject to tax. On the other hand, if the preliminary art is transferred electronically, the full \$1,000 charge would be nontaxable regardless of the number of designs permanently transferred.

Example 4: Purchase Option for Preliminary Art

The master agreement between the advertising agency and the client stipulates that the advertising agency has title to all drawings, proofs, etc (the tangible personal property) during the term of such agreement. The agreement also provides that the client receives title to the intellectual property (ideas, concepts, designs, etc). The agreement also stipulates that upon termination of the agreement, the client may purchase the tangible personal property for an agreed price. The advertising agency will bill separately for preliminary art and finished art. Upon termination of the agreement, if the client requests the tangible personal property on which the ideas, concepts and designs are embodied, tax on the transaction will be measured by the price agreed upon in the agreement.

FINISHED ART — TANGIBLE AND INTANGIBLE

1103.15

Transfers of Finished Art in Tangible Form. Finished art is the final artwork used for reproduction by photomechanical or other processes, or used for display. It includes electronic artwork, illustrations (e.g., drawings, diagrams, halftones, or color images), photographic images, sculptures, paintings, hand lettering, etc.

Charges for the electronic or manual preparation of finished art transferred in tangible form for reproduction, display, or other such purposes are subject to tax. Except in the case of a sale pursuant to a technology transfer agreement, the measure of tax includes all charges for any rights sold with the finished art (e.g., copyrights or distribution and production rights). (See Section 1103.40 for a discussion of technology transfer agreements.)

The following discussions regarding the value of finished art are based on the assumption that title to or the right to permanent possession of the preliminary designs is **not** transferred to the customer. If title or right to permanent possession of the preliminary designs is transferred to the client, or the services are otherwise subject to tax, see Section 1103.10. The discussions also pertain to advertising agencies and commercial artists as retailers. If the advertising agency is acting as an agent, see Section 1104.10.

- a. Calculating the Value of Finished Art.** When the advertising agency or commercial artist itemizes the charges to its client for both conceptual services and finished art, only the separately stated charges for finished art, verified to be a proper allocation, are subject to tax. The separately stated charges for conceptual services are not subject to tax.

When the advertising agency or commercial artist bills a combined charge for both conceptual services (i.e., preliminary designs) and finished art, the retail value of the finished art may be calculated on an actual basis by adding the following:

- Cost of direct labor (see Glossary, Section 1107.00);
- Cost of purchased items becoming an ingredient or component part of finished art;
- Cost of any intermediate production aids;
- A reasonable markup based on taxpayer's operations; and
- Taxable reproduction rights (rights to reproduce but not sell).

The difference between this amount and the total charge is presumed to be a nontaxable charge for conceptual services.

- b. Lump Sum Billing (Combined Charge) — 75/25 Presumption.** An alternative reporting method is allowed for combined charges that include charges for conceptual services through the steps needed to create finished art. (See phases 1 and 2 of the graphic design and printing process chart in Section 1101.10.) In this case, it is **rebuttably** presumed that 75 percent of the total charge is for nontaxable conceptual services and the remaining 25 percent is the measure of tax on the retail sale of finished art as specified in Regulation 1540 (b)(2)(C)2.

Due to the varying billing methods of advertising agencies and commercial artists, auditors should determine if the billed charges are for services, tangible personal property, or for a combined charge representing both. Auditors should verify that the combined charge does not include charges for other services or tangible personal property that do not relate to the creation of preliminary and finished art (e.g., media placement or printed matter). In addition, auditors should verify if amounts assumed to be included in the combined charge are invoiced separately (e.g., a separate charge for the associated taxable reproduction rights, intermediate production aids, design charges). *If any other charges not related to the creation of preliminary and finished art are included in the lump-sum billing, the taxable measure of the finished art must be computed by using the actual basis method.* (See Section 1103.20, Sales of Other Tangible Personal Property.)

If intermediate production aids or the taxable reproduction rights are separately stated on the invoice along with the combined charge for preliminary art and finished art, the charge for the intermediate productions aids or taxable reproduction rights is subject to tax in addition to 25 percent of the lump-sum charge. On the other hand, if any conceptual services or other nontaxable charges are separately stated in addition to a combined charge that represents preliminary art and finished art, the 75/25 presumption cannot be applied. Instead, the taxable measure should be calculated on an actual basis when there is no longer a combined charge that represents all nontaxable services that are presumed to be included in the 75 percent allocation.

If the sales price paid by the advertising agency or commercial artist for items procured from third parties, such as the finished art (or component parts) and any intermediate production aids or special printing aids sold to the client for that combined charge is more than 25 percent of the combined charge to the client, the measure of tax is the sales price of the tangible personal property to the advertising agency or commercial artist.

Note: Since an advertising agency may act in both capacities as a retailer and an agent on the same job, any costs incurred by the advertising agency acting in the capacity of an agent would not be included in the 75/25 percent calculation and should be separately stated on the invoice. (See Section 1104.00, Special Provisions Applicable to Advertising Agencies.) Also, the 75/25 presumption allows the advertising agencies and commercial artists an alternative to allocating time (services) between preliminary art and finished art. The tax due on the sale of the finished art must be reported for the reporting period in which the sale of the finished art occurs. The sale may be evidenced by the date of the invoice to the client. Generally, the sale of the finished art occurs upon actual delivery of the art to the client or his or her representative unless the contract provides that title passes sooner. If the deliverables (finished art) are transferred in more than one reporting period, tax must be properly allocated and reported for each reporting period in which the sales occur.

Example 1: Itemized Charge for Finished Art

A commercial artist is hired to design and produce a corporate logo for the client’s internal use, which does not qualify as a technology transfer agreement. The client does not receive title to or the right to permanent possession of any preliminary art. The finished art is delivered to the client in tangible form. The commercial artist bills the following:

Design of Corporate Logo:	
Concept Development	\$ 2,000.00
Finished Art	350.00
Tax on \$350 @ 7.75%	<u>27.12</u>
Total Invoice	<u>\$2,377.12</u>

This is an itemized charge to the client for both conceptual services and finished art. The separately stated charge for finished art is subject to tax.

Example 2: 75/25 Presumption — Lump-Sum Charge

An advertising agency, acting as a retailer, is hired to design and produce a corporate logo for the client’s internal use, which does not qualify as a technology transfer agreement. The advertising agency does not transfer title to or the right to permanent possession of the preliminary art.

Concept, design, development of logo	\$ 2,500.00
Tax on \$625 (25% of \$2,500) @ 7.75%	<u>48.44</u>
Total Invoice	<u>\$ 2,548.44</u>

This is a lump-sum billing that includes only charges for conceptual services and finished art (logo). As an alternative to computing the taxable measure on an actual basis, it is rebuttably presumed that 25% of the combined charge is the measure of tax on the retail sale of finished art.

If the advertising agency also transferred title to the preliminary art, the measure of tax would be the full \$2,500 with no deduction for nontaxable conceptual services.

Example 3: 75/25 Presumption — Itemized Charges

An advertising agency, acting as a retailer, or commercial artist designs a corporate logo for the client’s internal use, which does not qualify as a technology transfer agreement, provides the finished art, the business cards, and invoices the following:

Design of Corporate Logo:	
Conceptual development, design, and final art	\$ 2,000.00
Production management	500.00
Business Cards	<u>1,000.00</u>
Total	<u>\$3,500.00</u>

Since the charges for conceptual development and final art along with production management represent combined charges for conceptual services and finished art, the 75/25 presumption would apply to both the \$2,000.00 and \$500.00 charges (\$2,500). The separately stated charge for printed matter of \$1,000.00, which the advertising agency purchased for \$750, is fully taxable. The total measure subject to tax on this transaction is \$1,625.00 (\$1,000 plus 25% of \$2,500). If the separately stated charge for production management represented a charge related to only preliminary art, the 75/25 presumption would not apply since the advertising agency is extracting components of the 75 percent out of the combined charge. The advertising agency would be required to compute the taxable measure on an actual basis.

FINISHED ART — TANGIBLE AND INTANGIBLE

(CONT. 3) 1103.15

If the advertising agency acted as an agent when acquiring the business cards from the printer for \$1,000, which represents cost plus tax, the taxable measure due on the transaction would be \$625 (25% of \$2,500).

Example 4: Advertising Agency Acting as a Retailer and as an Agent

An advertising agency designs a corporate logo for the client’s internal use, which does not qualify as a technology transfer agreement, and the project includes obtaining photography as an intermediate production aid and using an outside supplier to do digital pre-press instruction. The advertising agency invoices the following:

Conceptual development/final art	\$ 6,000.00
Stock Photograph (cost including tax)	1,077.50
Digital pre-press instruction	500.00
Tax on \$1,500 (25% of \$6,000) @ 7.75%	116.25
Total Invoice	\$7,693.75

This is an example of when the advertising agency is acting as both the retailer and the agent on the same job. The advertising agency acts as a retailer with respect to the art, and the 75/25 presumption applies to the combined charge for conceptual services and finished art. The stock photograph (intermediate production aid) is excluded from the presumption since it was acquired with the advertising agency acting as an agent on behalf of the client. If the advertising agency marked-up the amount billed for the stock photograph, the advertising agency would be the retailer of the photography (see Section 1104.00), and the entire charge for the stock photograph would be subject to tax in addition to 25% of the combined charge for the artwork. Tax does not apply to charges for digital pre-press instruction.

Purchasing Tangible Personal Property for Resale. An advertising agency acting as a retailer or commercial artist may purchase tangible personal property for resale when such tangible personal property is a component part of the finished art being sold or leased. Tangible personal property may also be purchased for resale when (1) there is a specific title clause transferring title prior to use by the advertising agency or commercial artist, or (2) the presumption of title passage in Regulation 1541 relating to intermediate productions aids and special printing aids applies to the transaction. All other tangible personal property used to create the finished art and otherwise consumed during the creation of the finished art is subject to tax at the time of purchase. When the applicable tax due on the purchase is use tax, the advertising agency or commercial artist must pay such tax to the retailer or self-report the tax to the Board.

Transfers of Finished Art in Intangible Form. Transfers of finished art by electronic means (such as by modem or over the Internet) are not subject to tax. The taxpayer should retain documentation that transfers were made electronically. Documentation to support the electronic transfer may include language in contracts, purchase orders, or sales invoices. Also, transfers of artwork in a “load and leave” situation are not subject to tax. In a nontaxable “load and leave” transaction, the client does not receive temporary or permanent possession or control of any tangible personal property, such as a CD. The advertising agency or the commercial artist must load the artwork on the client’s computer and leave with the CD, without giving the client control of the CD containing the artwork.

FINISHED ART — TANGIBLE AND INTANGIBLE**(CONT. 4) 1103.15**

For “load and leave” transfers, auditors should verify that the advertising agency or commercial artist has a written statement signed, at the time of loading, by the client and the person who loaded the electronic artwork into the client’s computer. The following or similar language will suffice:

“This electronic artwork was loaded into the computer of [client’s name] by [advertising agency’s or commercial artist’s name], and [advertising agency or commercial artist’s name] did not transfer any tangible personal property containing the artwork, such as electronic media or hard copies, to [client’s name].”

When there is no timely, completed statement, the advertising agency or commercial artist must provide other documentary evidence establishing that control or possession of the artwork, in tangible form, was not transferred to the client or its representative. When artwork is transferred electronically, the advertising agent or commercial artist is considered to be transferring an intangible and, as such, is the consumer of all materials used to create and electronically transfer the finished art.

SALES OF OTHER TANGIBLE PERSONAL PROPERTY**1103.20**

Tax applies to the total charge for the retail sale of tangible personal property by an advertising agency or commercial artist. The 75/25 presumption discussed in Section 1103.15 does not apply when the lump-sum charge includes anything other than finished art and conceptual services. If any other tangible personal property is sold and the charge is included in the lump-sum price (with or without finished art) or any other services are provided for the lump-sum charge (with or without conceptual services), then the actual basis method in Regulation 1540(b)(3) must be applied. Thus, if an advertising agency or commercial artist combines charges for nontaxable services such as media placement with charges for tangible personal property for which the advertising agency or commercial artist is the retailer (e.g., finished art, or printing, or both), the measure of tax on that retail sale of property includes the following:

1. Direct labor (see Glossary, Section 1107.00);
2. Cost of purchased items that become an ingredient or component part of the property;
3. Cost of intermediate production aids and special printing aids (see Glossary); and
4. A reasonable markup based on the taxpayer’s operations.

Other charges such as commissions and fees exclusively related to the production or fabrication of the tangible personal property are part of the direct labor and must be included in the measure of tax. Charges for creative processes such as concept development are nontaxable and are excluded from the taxable measure.

Auditors should examine available records such as work orders and sales invoices to determine which charges are exclusively related to the production of the tangible personal property and include them in the measure of tax.

INTERMEDIATE PRODUCTION AIDS**1103.25**

Intermediate production aids include items such as artwork, illustrations, photographic images, photo engravings, and other similar materials used to produce special printing aids or finished art. Intermediate production aids do not include items used to produce preliminary designs/art. These items are used prior to a contract or approval for the production of finished art and are not presumed sold to the client prior to use.

When an advertising agency acting as a retailer or a commercial artist uses intermediate production aids in the creation of finished art, the provisions of Regulation 1541 applicable to special printing aids apply. (See Section 1103.30, Special Printing Aids.) As provided by Regulation 1541, it is rebuttably presumed that the intermediate production aids are resold to the customer, prior to any use, along with the sale of the finished art. This is true irrespective of whether the advertising agency or commercial artist itemizes the charge for the intermediate production aids. As such, the advertising agency or commercial artist may purchase the intermediate production aids for resale, by issuing a timely resale certificate to its vendors for any intermediate production aids which will be used solely in the production of finished art.

However, when the advertising agency or commercial artist wishes to retain title to the intermediate production aids and not sell them to the client prior to use, the contract or sales invoice must include the following or substantially similar statement:

“Intermediate production aids are not being sold to the customer as part of the sale of the finished artwork or printing, and the selling price of the finished artwork does not include the transfer of title to the intermediate production aids.”

When the advertising agency or commercial artist chooses to retain title to the intermediate production aids, it should not purchase the intermediate production aids for resale. When the applicable tax due on the purchase is use tax, the advertising agency or commercial artist must pay such tax to the retailer or self-report the tax to the Board.

Leases of Intermediate Production Aids. For the title transfer presumption discussed above to apply, however, the advertising agency or commercial artist must obtain title to the intermediate production aids that will be resold. In the case of leases of tangible personal property, such as a photograph, the advertising agency or commercial artist cannot transfer title to the leased property since the advertising agency or commercial artist does not gain title (ownership) to the property as a lessee. Therefore, the title passage presumption does **not** apply and the advertising agency or commercial artist should not issue a resale certificate when leasing intermediate production aids and should instead pay the applicable tax due on the amount of the lease payment. However, if the contract between the advertising agency or commercial artist and its client has an explicit provision stating that the advertising agency or commercial artist will sublease such property to the client prior to any use of the leased property, the property can be purchased (leased) for resale and the sublease to the client will be subject to tax.

SPECIAL PRINTING AIDS**1103.30**

Special printing aids are reusable manufacturing aids used by printers in the printing process and are useful only to a particular customer. Examples of special printing aids include film, screens, cutting dies, color separations, reusable printing plates and intermediate production aids. Intermediate production aids include items such as artwork, illustrations, photographic images, photo engravings, and other similar materials that are used to produce special printing aids.

Sales of Special Printing Aids in General. A printer is regarded as selling special printing aids used to produce printed material along with the printer's sale of the printed matter unless the printer explicitly retains title to the special printing aids by including the following, or substantially similar, statement in the contract or sales invoice:

“Special printing aids are not being sold to the customer as part of the sale of the printed matter, and the selling price of the printed matter does not include the transfer of title to the special printing aids.”

Often, terms and conditions are pre-printed on the back of the sales invoice. Auditors should review the pre-printed terms and conditions to see if a statement retaining title to special printing aids is included on such terms and conditions.

If the contract or sales invoice for the printed matter being sold includes this statement, the printer may not issue a resale certificate when purchasing special printing aids for the job. Tax applies to the sale of the special printing aids to the printer, and there is no deduction for the cost of the special printing aids in determining the correct measure of tax from the sale of the printed matter. Accordingly, if a printer retains title to the special printing aids and makes a fully taxable sale of printed matter, the entire charge to the customer is taxable whether or not the charge for the special printing aids is separately stated.

Absent the title retention statement previously discussed, the printer is considered to be purchasing the special printing aids for resale when it purchases special printing aids for use in producing printed matter which the printer will sell. This is true whether the printer separately states a charge for the special printing aids or not. Accordingly, the printer may issue a resale certificate when purchasing such special printing aids. If the printer pays tax or tax reimbursement when purchasing the special printing aids that will be resold, the printer may take a tax-paid purchases resold deduction in accordance with Regulation 1701. See also Section 1106.00, “Special Reporting Procedures for Printers Regarding Special Printing Aids.”

Taxable Sales of Printed Matter with Special Printing Aids, Including “Split Sales.”

When a printer makes a fully taxable retail sale of printed matter along with special printing aids, the entire charge is taxable, whether the charge for the special printing aids is separately stated or not.

However, the printer may sell special printing aids along with printed matter where a portion of the sale is taxable and a portion is not taxable. These transactions are known as “split sales” and tax applies to the sale of the special printing aids as explained below.

If the charge for the special printing aids is separately stated, tax is due on that stated amount as long as the amount is not less than the sales price of the special printing aids or their components to the printer. If the separately stated amount is less than the printer's cost of the special printing aids, tax is due on that cost.

If the charge for the special printing aids is not separately stated and the taxable portion of the sale of the printed matter is at least equal to the printer's cost of the special printing aids, the taxable portion of the sale of printed matter will be regarded as including the sale of the special printing aids. Tax is due on the taxable portion of the sale of the printed matter, and no further tax is due on account of the sale of the special printing aids. If the taxable portion of the sale of printed matter is less than the printer's cost of the special printing aids, the sale of the special printing aids will be regarded as including the taxable portion of the sale of the printed matter. Tax is due on the cost of the special printing aids to the printer, and no further tax is due on account of the taxable portion of the sale of the printed matter included with the special printing aids.

Sales of Printed Matter and Special Printing Aids to U.S. Government. When the printer makes a sale of printed matter to the U.S. Government, the printer's sale of the printed matter and the printer's sale of the special printing aids are exempt from tax. Tax does not apply to any portion of the charge.

Sales of Special Printing Aids along with Other Nontaxable Sales of Printed Matter. When a printer sells special printing aids along with a nontaxable sale of printed matter, the printer is making a taxable retail sale of the special printing aids unless the special printing aids are sold for resale (as discussed below). For example, a printer makes an exempt sale of printed matter in interstate commerce. The printer's sale of the special printing aids is a taxable retail sale, and not an exempt sale in interstate commerce, because the printer's use of the special printing aids occurs prior to any possible shipment of the special printing aids to the customer.

Likewise, this is true if the sale of the printed matter is a nontaxable sale for resale but the printer's customer does not purchase the special printing aids for resale. For example, a printer makes an exempt sale of printed matter to a manufacturer of an instruction manual to be included with the sale of the product sold by the manufacturer to a retailer for resale. The manual is resold with the product, but the special printing aids are not.

The measure of tax on the printer's sale of the special printing aids is measured by the printer's cost, whether or not the charge for the special printing aids is included in a lump-sum charge that includes the printed matter, or the charge for the special printing aids is separately stated on the invoice (and without regard to the amount of such separately stated charge). If the printer has paid tax or tax reimbursement to the vendor of the special printing aids, no further tax is due. If the printer collects tax reimbursement from its customer in an amount greater than the tax due on the cost of the special printing aids to the printer, the difference is excess tax reimbursement pursuant to Regulation 1700(b).

Sales of Special Printing Aids For Resale. In order for the printer to sell special printing aids for resale prior to the printer's use, two requirements must be satisfied:

1. A timely, valid resale certificate for the special printing aids must be obtained and accepted in good faith, and
2. There must be a separate statement on the invoice for the special printing aids in an amount of at least the cost of the special printing aids to the printer.

The purchaser of printed matter and special printing aids from a printer may not properly issue a resale certificate for the special printing aids unless they will, in fact, be resold prior to any use. *The purchaser cannot purchase special printing aids for resale if the purchaser does not have an existing contract for that resale by the time the printer uses the special printing aids, since the printer will obviously have used the special printing aids, on the purchaser's behalf, prior to any resale.* The purchaser may not purchase special printing aids for resale unless that purchaser will, in fact, resell the special printing aids to someone who obtains the right to exercise "dominion and control" over them. If the printed matter will be resold to more than one purchaser, all the purchasers cannot exercise dominion and control over the special printing aids, and the printer's customer is not, in fact, reselling the special printing aids to the multiple purchasers.

Note: If the printer knows that the special printing aid cannot be resold to the purchaser's customer with the printed material, the printer should not sell the special printing aids for resale. In addition, if the printer separately states a charge for special printing aids in an amount at least equal to the printer's costs, but does not have a timely, valid resale certificate on file for special printing aids, the printer may use the XYZ letter process to verify that the special printing aids were resold prior to the printer's use (see "Resale Verification by Means of XYZ Letter" discussed later in this section).

For example:

A manufacturer contracts to purchase instruction manuals for products to be sold by the manufacturer. The printer cannot accept a resale certificate from the manufacturer for the special printing aids used to produce the instruction manuals because the manufacturer will not be reselling the special printing aids to each purchaser of the instruction manuals.

See Exhibit 1, Special Printing Aid Examples 1 through 5.

Print Brokers. Print brokers are intermediaries who contract for the sale of printed matter but do not perform the printing. A person may be a printer for some jobs (i.e., perform the actual printing) and a print broker for others (i.e., purchase the printing from the printer or another print broker). A print broker may acquire special printing aids from the same person from whom it purchases the printing, or may obtain the special printing aid from another source. The print broker could also produce the special printing aid in-house. When a print broker acquires title to special printing aids, it is regarded as reselling the special printing aids to its customer prior to any use provided that the print broker has an existing contract with the customer for the sale of the printed matter and the print broker does not include a statement in its contract or sales invoice, as discussed above, retaining title to the special printing aids.

Tax applies to a print broker's sale of printed matter along with special printing aids similar to the manner tax applies to sales of printed matter and special printing aids by a printer, as discussed in the prior section titled "Taxable Sales of Printed Matter with Special Printing Aids Including 'Split Sales'."

When a print broker makes a fully taxable retail sale of printed matter along with special printing aids, the entire charge is taxable, whether the charge for the special printing aids is separately stated or not. When the print broker makes a split sale and the charge for the special printing aids is separately stated, tax is due on that stated amount as long as the amount is not less than the sales price of the special printing aids or their components to the print broker (i.e., the separately stated price of the special printing aids to the print broker). If the separately stated amount is less than the print broker's cost of the special printing aids, tax is due on that cost.

If the charge for the special printing aids is not separately stated and the taxable portion of the sale of the printed matter is at least equal to the print broker's cost of the special printing aids, the taxable portion of the sale will be regarded as including the sale of the special printing aids. Tax is due on the taxable portion of the sale of the printed matter, and no further tax is due on account of the sale of the special printing aids. If the taxable portion of the sale of printed matter is less than the print broker's cost of the special printing aids, the sale of the special printing aids will be regarded as including the taxable portion of the sale of the printed matter. Tax is due on the cost of the special printing aids to the print broker, and no further tax is due on account of the taxable portion of the sale of the printed matter included with the special printing aids.

Note: Unlike a printer, when a print broker makes a retail sale of special printing aids with a nontaxable sale of printed matter, the taxable measure for the sale of the special printing aids is the separately stated price to the customer when the separately stated price is at least the cost of the special printing aids to the print broker. If the separately stated price to the customer is less than the cost of the special printing aids to the print broker, tax applies to the print broker's sale of the special printing aids measured by the printer's separately stated sale price to the print broker.

See Exhibit 1, Special Printing Aid Examples 6 through 8.

Leases of Photographs and Illustrations. In order for the automatic title passage rules discussed above to apply, the printer must actually obtain title to the special printing aid. If the printer leases rather than purchases photographs or illustrations, the printer cannot pass title to such property to its customer since it has not acquired title to the property. Therefore, the printer cannot rely on the title passage presumption in the regulation to issue a resale certificate when leasing photographs, illustrations, or other property used as special printing aids. The printer should instead pay any applicable tax on the amount of the lease payment. However, if the contract between the printer and its customer has an explicit provision stating that the printer will sublease such property to the customer prior to any use by the printer, then the property can be purchased (leased) for resale and the sublease to the customer will be subject to tax.

Sales of Artwork as Special Printing Aids. Artwork may be used as finished art that is used to make a special printing aid (e.g., graphic art used to make a printing plate). A separately stated charge for artwork as special printing aids is not a separately stated charge for finished art and conceptual services. Therefore the auditor should not allow any portion of the charge as a nontaxable charge for conceptual services when the charge is identified as "special printing aids." Charges for nontaxable conceptual services will be allowed when they are separately stated or allowed as a percentage when itemized as finished art as explained in Regulation 1541(d)(2) and (d)(3).

Audit Procedure. (See Exhibit 2 for the Printer's Sales of Special Printing Aids Flowchart.)

An important first step is for the auditor to determine if the printer is the retailer of the special printing aids or if the printer retains title to them by a statement on the sales invoice or contract of sale. The auditor needs to determine what is being sold and if the special printing aids are sold with the printed matter.

The auditor should then find out if the printer acquires special printing aids tax-paid or ex-tax, or both. For any special printing aids that the printer purchased tax-paid and then resold prior to any use as discussed above, the printer may take a tax-paid purchases resold deduction. The printer may claim this deduction only on special printing aids purchased for use on sales to the U.S. Government, taxable sales, and sales where a specific resale certificate for special printing aids is provided to the printer by the customer.

If the printer purchases all special printing aids ex-tax, tax measured by the selling price of the special printing aids to the printer should be reported by the printer on special printing aids for use on nontaxable sales where resale certificates on special printing aids are not provided to the printer. Examples of these nontaxable sales are sales in interstate commerce, exempt sales of printed sales messages, exempt sales of containers/labels, and exempt sales of newspapers and periodicals. The reported amount is for a sales tax transaction (where the printer is the retailer of the special printing aids that are deemed to be resold prior to use) and should be reported on line 1 (total sales) of the sales tax return, not on line 2 (purchases subject to use tax).

A printer may claim a tax-paid purchases resold deduction or report special printing aids sold on an actual basis or on an alternative reporting method based on the percentage of sales. (Refer to Section 1106.00 for auditing procedures for Special Reporting Procedures for Printers Regarding Special Printing Aids.)

When a printer uses an actual basis to compute the amount of special printing aids to claim a deduction or to report the amount sold, the auditors must verify the accuracy of the selling price of the special printing aids to the printer. The auditors must examine job files to see if the costs of special printing aids used are recorded on each job and if the printer is using the same information to perform the computation.

Resale Verification by Means of XYZ Letter. In accordance with general audit procedures, the auditor may accept other evidence to support the validity of a claimed resale. Typically, XYZ letters are used to verify resales when the seller does not have a valid resale certificate. Exhibit 3, BOE-504-CPA, Statement Concerning Property Purchased Without Payment of California Sales Tax, should be used in cases where the printer does not have a valid resale card on file. *It is important to note that the XYZ procedure may be used to verify resales of special printing aids only when the printer has a separately stated selling price for the special printing aid.* If there is no separate statement, the aid was not sold for resale and the XYZ process should not be used. See Audit Manual Section 0409.51 for guidelines on using the XYZ procedure.

Separately Stated Charges for Special Printing Aids. When a printer makes a retail sale of special printing aids with a nontaxable sale of printed matter, the taxable measure for the sale of the special printing aids is always the cost of the special printing aids to the printer, and not the separately stated price to the customer, even if that price is higher than cost. When a printer separately states an amount for special printing aids which is greater than the printer's cost, the auditor should confirm that tax has actually been reported on the correct measure of tax, that is, cost. The auditor should also confirm that the printer has **not** collected tax reimbursement on the separately stated price which is greater than the printer's cost. When this occurs, the printer has collected excess tax reimbursement pursuant to Regulation 1700(b), and the auditor should ensure that the printer reported and paid the excess tax reimbursement to the Board. If not, unless the printer establishes that the excess tax reimbursement was refunded to the customers, that excess must be paid to the Board. Whether the printer had already paid the excess tax reimbursement to the Board or it is included in a deficiency assessment, the auditor should instruct the printer to cease collecting the excess tax reimbursement.

Note: When a print broker sells special printing aids with a nontaxable sale of printed matter, the measure of tax is the print broker's separately stated price of the special printing aids, if it is at least equal to the separately stated price of the special printing aids to the print broker. If it is not or if there is no separately stated price, the measure of tax is the separately stated price to the print broker.

Local Tax Considerations. When a tax-paid purchase resold audit adjustment specific to special printing aids results in a refund of \$25,000 or more in measure, an adjustment of local tax must be considered. In these situations, a refund of the local tax must be taken from the jurisdiction that originally received the tax. Typically, this would be the jurisdiction where the vendor is located. Accordingly, in those cases where the tax area code of the vendor is different than that of the printer, a BOE-414-L must be prepared to adjust the local tax. The BOE-414-L should be attached to the audit report when transmitted to Headquarters.

SPECIFIC NONTAXABLE SERVICE CHARGES

1103.35

In general, tax is due on the total charge for tangible personal property sold by an advertising agency acting as a retailer or by a commercial artist. The total charge includes all services and fees related to the sale of the property plus a reasonable markup. However, there are certain fees and commissions that are excluded from the measure of tax when such fees and commissions are separately stated. These include:

1. Media commissions or fees for placement of advertising whether paid by the medium, by another advertising agency, or by the client.
2. Supplier commissions or fees paid to the advertising agency, such as those paid by premium manufacturers or direct mail suppliers.
3. Consultation and concept development fees related to client discussion, development of ideas, and other services. If the advertising agency transfers tangible personal property to the client as a result of these services, the transfer is incidental to the advertising agency's providing of the service and is not a sale of tangible personal property. The advertising agency is the consumer of tangible personal property transferred to the client incidental to the providing of the service. However, when the fees are associated with conceptual services and the transfer of tangible personal property (i.e., preliminary designs), in tangible form, is other than on a temporary basis (i.e., for review and approval purposes), the transfer of the property is not considered incidental to the providing of a service (See Section 1103.10).
4. Research and account coordination fees.
5. Fees for quality control supervision that entails the proofing and review of printing and other products provided by outside suppliers.
6. Charges for the formulation and writing of copy.

Note: Whether separately stated or not, these fees and commissions are **not** included in the calculation of "direct labor" when calculating the measure of tax on an actual basis (see Section 1103.15 and Section 1103.20).

Signage. Environmental graphic design is the planning, design, and documentation of signs and sign systems, including directional signs, architectural and site identification signs, interpretive displays and exhibits, regulation and information signs, maps and directories, and decorative architectural and streetscape graphics. Charges for single copies of the master set of blueprints, diagrams and instruction for signage produced as a result of environmental graphic design services are not taxable. If services are provided for the subsequent revisions of the master set, charges for single copies of the revised master sets are not taxable. Charges for additional copies of the initial or revised master set are taxable.

Billboard art and billboard displays are not considered to be environmental graphic design and charges for such services are taxable.

SPECIFIC NONTAXABLE SERVICE CHARGES

(CONT.) 1103.35

For Example: MegaFun Amusements is developing a new theme park. As part of the process, Megafun contracts with EnviroSign, Inc. to design and determine the type and placement of directional, instructional, and other types of signs required for the facility. Examples of the signs being designed and placed include, but are not limited to, exit signs, designation of fire alarms, identification of men's and ladies' rooms, disabled access signs, ride marquees, and exterior signs directing visitors to parking or delivery areas. After reviewing a site plan and blueprints of the facility, EnviroSign provides MegaFun with blueprints that show designs, fabrication techniques, specifications and the placement of the various types of signs. The sign types are identified by a code that is keyed to a matrix provided along with the blueprint. The matrix includes a description of the sign type and, in some cases, the text that will appear on the sign along with a designation of the font or typeface to be used. Tax does not apply to the charges for the services leading to the creation of the initial blueprints and matrix nor to the charges for the creation of the initial copies of the revised blueprints or matrix. Tax will apply to charges for any additional copies of the blueprints and matrix.

Website Design. An advertising agency or commercial artist who designs, edits or hosts an electronic website is performing a service, the charge for which is not subject to tax provided the advertising agency or commercial artist does not transfer any tangible personal property to the client or other person on the client's behalf. Similarly, the posting of artwork on a website is not subject to tax if the posting does not involve the transfer of tangible personal property.

Website design services may be billed based on an hourly rate or a flat fee. An example of an hourly rate billing where there is no tangible personal property transferred is as follows:

Description	Hrs. Billed	Amount
Concept/Design	35	\$ 6,125.00
HTML Production	5	650.00
Database Management	50	6,300.00
High Level Programming	15	2,500.00
Total		<u>\$15,575.00</u>

If the advertising agency or commercial artist also transferred tangible personal property, such as a backup disk, the provisions of Regulation 1540 for transfers of finished art would apply.

TECHNOLOGY TRANSFER AGREEMENTS

1103.40

Defining a Technology Transfer Agreement. Under federal law, a person generally may not lawfully reproduce copyrighted material without the permission of the holder of the copyright. Under the provisions of subdivision (c)(10) of Revenue and Tax Code sections 6011 and 6012, the Sales and Use Tax Law recognizes certain sales of copyrights in conjunction with sales of the tangible personal property to which the copyrights relate, as made pursuant to technology transfer agreements. The transfer of a copyright interest pursuant to a qualifying technology transfer agreement is treated as the sale of intangible personal property separate from the sale of the tangible personal property. Tax applies only to the selling price of the tangible personal property transferred pursuant to a qualifying technology transfer agreement. This is explained in Regulations 1507 and 1540. (Regulation 1507 is the general regulation on technology transfer agreements while provisions in Regulation 1540 are specific to sales by advertising agencies and commercial artists.)

TECHNOLOGY TRANSFER AGREEMENTS

(CONT. 1) 1103.40

Although sales of patent rights can qualify as technology transfer agreements under the Sales and Use Tax Law, Regulation 1540 refers only to transfers of copyrights, which is the main reason why this chapter does not discuss patents. Since taxpayers may mention it in this context, auditors should be aware of the California Supreme Court case of Preston vs. State Board of Equalization (2001) 25 Cal. 4th 197, in which the court considered technology transfer agreements under subdivision (c)(10) of Revenue and Taxation Code sections 6011 and 6012. However, for technology transfer agreements covered by this chapter, auditors should refer instead to Regulation 1540 since relevant portions of the Preston decision were incorporated into the regulation.

Requirements of a Technology Transfer Agreement. Subdivision 1540(b)(2)(D) defines a technology transfer agreement as follows:

“Any agreement evidenced by a writing (such as a contract, invoice, or purchase order) that assigns or licenses a copyright interest in finished art for the purpose of reproducing and selling other property subject to the copyright interest....”

It should be noted that not every transaction that includes an assignment of a copyright for reproduction qualifies as a technology transfer agreement. To qualify as a technology transfer agreement, an agreement must satisfy three requirements:

1. It must be evidenced by a writing;
2. It must assign a copyright interest in finished art; and
3. The purchaser of the right must intend to reproduce and sell other property subject to the copyright interest in finished art.

If **any** of these three requirements is not satisfied, the agreement is not a technology transfer agreement. (See Audit Procedure later in this section.)

Note: Terminology such as “copyright,” “reproduction right,” “use (for limited time or purpose),” “advance royalty” or “royalty contract” will probably indicate the presence of a copyright assignment (one of the three requirements of a technology transfer agreement).

These concepts are illustrated by the following examples.

Example 1: Intent to Reproduce but Not Sell

Acting as the agent of its client, pursuant to Section 1104.10, an advertising agency retains a commercial artist to create a logo. The agency purchases that logo and the artist notes on the invoice that the client has the right to reproduce the logo on business cards that will be used by the client. The client intends to provide the finished art to a printer who will print the business cards. Even though the transaction meets requirements 1 and 2, that is, there is a writing that transfers a copyright interest, the transaction does not meet the third requirement that the logo be reproduced and sold. The client acquired the logo to reproduce it onto its own business cards that it will use, and not to reproduce the image onto other property subject to the copyright interest that the client will sell. Consequently, the transaction does not qualify as a technology transfer agreement.

Example 2: Intent to Reproduce and Sell

Same as previous example, but the advertising agency acquires the logo and copyright on its own behalf, acting as the retailer, for resale to its client for the purpose of reproducing the image on business cards that it will sell to the client. That is, it will either print the cards itself or purchase them from a printer on the agency’s own behalf and not as the agent of its client.

This transaction between the artist and the agency qualifies as a technology transfer agreement. It meets requirements 1 and 2 because there is a statement on the invoice indicating that the agency will acquire the right to reproduce the logo on business cards that the advertising agency will sell to its client. In addition, the transaction meets requirement 3 because the agency, as the purchaser of the right to reproduce, intends to reproduce and sell property (the business cards) subject to the copyright interest to a third party, its client.

However, the sale by the agency to the client is not pursuant to a technology transfer agreement because the client purchased the logo for self-consumption, and did not purchase the interest in the logo for selling other property subject to the copyright interest.

Example 3: Intent to Reproduce

A manufacturer purchases commercial artwork and reproduction rights for the purpose of copying the image onto merchandise it will sell. This transaction qualifies as a technology transfer agreement provided there is a writing assigning the reproduction rights to the manufacturer.

In contrast, the same manufacturer buys other artwork and all the intangible rights associated with that artwork for the sole purpose of controlling the use of the image. The manufacturer does not intend to reproduce the image, but instead wants to prevent use of the image by other manufacturers. This purchase is not pursuant to a technology transfer agreement.

It should be noted, however, that just because the manufacturer did not reproduce the image and sell the reproductions does not automatically mean that the contract **could not be** a qualifying technology transfer agreement. A purchaser of a right to reproduce a copyrighted image and sell the reproductions who does not actually reproduce the image and sell the reproductions may be able to show that the purchaser's intent when purchasing the copyright interest was to reproduce and sell, but that the purchaser's intent changed thereafter. If the purchaser establishes its intent at the time of purchase was to reproduce and sell, this condition is satisfied even if the purchaser does not actually reproduce the copyrighted image and sell the reproductions.

Example 4: Intent to Reproduce and Sell

A commercial artist provides artwork to a book publisher. The artist indicates on the invoice that reproduction rights are being sold to the publisher. The publisher reproduces the artwork in books printed for resale. The publisher also has a right to use some of the artwork to produce rubber stamps for resale. Some of the artwork is transferred to the publisher in digital files on CDs. Other artwork is transferred on paper or art board. The publisher must return all of the artwork to the artist after downloading or scanning the images into its computer.

All transfers of artwork in this example are being made pursuant to technology transfer agreements. Therefore, no tax is due on the temporary transfers of artwork made by CD and tax is due on the temporary transfers made on paper or art board. The taxable measure must be calculated using the formula in Regulation 1540(b)(2)(D).

Calculating the Value of Finished Art Transferred in Technology Transfer Agreements.

Tax applies to the value of the tangible personal property sold or leased as part of a technology transfer agreement, but does not apply to the value of the intangible copyright interest. The one exception to this basic rule is that no tax applies to the temporary transfer of computer storage media containing finished art, which is transferred as part of a technology transfer agreement. The amount attributable to such storage media is de minimus (having minimal value); accordingly, the transferor is the consumer of such media. For purposes of determining if the transfer is temporary, the computer storage media containing the finished art should be returned to the commercial artist within a 30 day billing cycle or within a reasonable time period in excess of 30 days if additional time is necessary for the client to copy the image.

Subdivision 1540(b)(2)(D)2. sets forth three methods to determine the taxable measure on the sale of finished art transferred by an advertising agency or commercial artist as part of a technology transfer agreement:

- a. The separately stated sales price if the finished art is permanently transferred, or the separately stated lease price if the finished art is temporarily transferred; provided that the separately stated price is reasonable; or
- b. Where there is no such separately stated price, the separate price at which the person holding the copyright interest in the finished art has sold or leased that finished art or like finished art to an unrelated third party where: 1) the finished art was sold or leased without also transferring an interest in the copyright; or 2) the finished art was sold or leased in another transaction at a stated price satisfying the requirements of subdivisions (b)(2)(D)2.a.; or
- c. If there is no such separately stated price under subdivision (b)(2)(D)2.a., nor a separate price under subdivision (b)(2)(D)2.b., 200 percent of the combined cost of materials and labor used to produce or acquire the finished art. "Cost of materials" consists of the costs of those materials used or incorporated into the finished art, or any tangible personal property transferred as part of the technology transfer agreement. "Labor" means any charges for labor used to create such tangible personal property where the advertising agency or commercial artist purchases such labor from a third party, or the work is performed by an employee of the advertising agency or commercial artist.

Note: The 75/25 presumption discussed in Section 1103.15 does not apply to sales of finished art pursuant to technology transfer agreements.

"Materials" under the third method include the following items:

- The cost of materials physically incorporated into the finished artwork:

Finished art on computer media	The cost of the diskette or CD
Finished art transferred on hard copy	The cost of paper, ink, film or other materials used for the physical image
Photograph	The cost of the photographic paper and chemicals
Three dimensional artwork	The cost of the wax, clay, plaster, board stock, or other materials and the cost of any internal framework

- The cost of materials used to create the finished artwork, but not physically incorporated:

Two dimensional artwork	The cost of any artwork or photographs used to create the image (e.g., artwork which is not physically incorporated). For example, scanned photographs.
Photograph	The cost of any film used on a photo shoot whether or not transferred to the client, and the cost of any props or lighting equipment leased or purchased specifically for the photo shoot.
Three dimensional artwork	The cost of molds for production of three-dimensional artwork. The cost of any props or two-dimensional artwork used as models.

Costs of labor include the amounts paid to third parties or employees, but does **not** include the value of labor performed by the commercial artist as a sole proprietor. Third parties include not only persons actually creating the artwork, but also persons who assist in its creation. For example, payments made to a person who acts as a model for a drawing, photograph, or statue, or to persons who assist in the setup and lighting for a photograph are included in the labor factor. Costs of labor do not include travel expenses for such items as airfare, hotels, rental cars, and meals.

The following four examples illustrate how to calculate the value of finished art transferred pursuant to technology transfer agreements.

Example 5: Permanent Transfer of Artwork — Itemized Selling Price

Commercial artist permanently transfers artwork with a separately stated selling price (Regulation 1540(b)(2)(D)2.a.).

A manufacturing company hires a commercial artist to develop illustrations for product packaging. The commercial artist provides conceptual design services with no transfers of preliminary art. The commercial artist permanently transfers the finished artwork to the manufacturer on a CD.

Concept development and preliminary art	\$2,000.00
Finished art	500.00
Reproduction rights	8,000.00
Tax (\$500 x .0775)	38.75
Total	\$10,538.75

This transaction is a technology transfer agreement since there is a statement on the invoice indicating that the artist is selling reproduction rights and the manufacturer will be selling other property (packaging) subject to the copyright interest. Since the finished art is separately stated and is assumed to be a reasonable value, the amount subject to tax is the \$500 separately stated price. The concept development is a nontaxable service and the reproduction rights are nontaxable transfers of the copyright interest in the finished art as part of the technology transfer agreement.

Example 6: Temporary Transfer of Artwork — Itemized Selling Price

Commercial artist temporarily transfers artwork with a separately stated selling price (Regulation 1540(b)(2)(D)2.).

The manufacturer in Example 5 subsequently contracts with the commercial artist to develop product labels that complement the package illustrations. The commercial artist temporarily transfers the finished art to the manufacturer on CD. After the manufacturer downloads the artwork onto its own computer, the CD is returned to the commercial artist within 30 days.

Concept development and preliminary art	\$1,000.00
Finished art	300.00
Reproduction rights	9,000.00
Tax	0.00
Total	<u>\$10,300.00</u>

As in Example 5, this transaction is a technology transfer agreement since there is a statement on the invoice indicating that the artist is selling reproduction rights and the manufacturer will be selling other property (the product labels) subject to the copyright interest. The transfer of the finished art is temporary. Since the temporary transfer is on computer storage media, it is nontaxable. The computer storage media was returned within a reasonable period of time.

Example 7: Lump-Sum Selling Price — Similar Itemized Sales

Commercial artist transfers artwork without separately stated selling price, but has made transfers of similar artwork with a separately stated selling price (Regulation 1540(b)(2)(D)2.b.).

An artist creates lithographs and usually prints 50 copies of each image. The artist generally sells the lithographs for display at a standard price of \$500. A local art museum contracts with the artist to use one of the images, *Birthday Cakes #5*, for fund-raising. The image will be reproduced on coffee mugs that will be sold in the museum store. The artist sells the lithograph to the museum for placement in the museum’s permanent collection. The museum then uses the lithograph to generate the image that is reproduced on the coffee mugs. The artist charges the museum \$1,100 for the lithograph and reproduction rights.

Birthday Cakes #5, No. 45/50 and right to reproduce on coffee mugs	\$1,100.00
Tax (\$500 x .0775)	38.75
Total	<u>\$1,138.75</u>

This transaction is a technology transfer agreement since there is a written transfer of reproduction rights and the museum intends to reproduce and sell the image on property subject to the copyright interest. Even though there is a lump-sum billing for the lithograph and reproduction rights, the selling price of the final artwork can be determined based on prior sales of the lithographs with the same image. That is, since the lithograph has been sold to unrelated third parties for \$500, the \$500 is considered to be the measure of tax for the sale of the lithograph to the art museum. The amount received for the copyright interest (\$600) is not subject to tax as part of a technology transfer agreement.

Example 8: Lump-Sum Selling Price — No Similar Itemized Sales

Commercial artist transfers artwork without a separately stated selling price and has no transfers of similar artwork with a separately stated selling price (1540(b)(2)(D)2.c.).

An advertising agency contracts with a manufacturer to develop a product logo that will be reproduced on the manufacturer’s product and packaging. The contract price is \$40,000. The transaction is a technology transfer agreement because there is a written transfer of the reproduction rights and the manufacturer will reproduce the image on property subject to the copyright interest. The logo will be transferred permanently to the manufacturer. The advertising agency’s records indicate that its in-house art department spent 50 employee hours creating the finished art. The average labor cost for the in-house art department is \$35/hour per employee. The records also indicate that the materials used to transfer both a hard copy and digital copy of the finished art cost approximately \$10. The measure of tax for the sale of the finished art transferred is computed as follows:

Product logo and reproduction	\$40,000.00	* Labor: \$35/hour x 50 hours	\$1,750.00
Tax *	<u>272.80</u>	Material	<u>10.00</u>
Total	<u>\$40,272.80</u>	Total	<u>\$1760.00</u>
		Taxable Total (\$1760 x 200%)	<u>\$3,520.00</u>
		Tax (\$3,520 x .0775)	<u>\$272.80</u>

If the labor was provided by the owner of the advertising agency who is self-employed, the measure of tax for the sale of the finished art would be computed as follows:

Labor: (no purchased labor)	\$ 0.00
Material	<u>10.00</u>
Total	<u>\$10.00</u>
Taxable Total (\$10 x 200%)	<u>\$20.00</u>
Tax (\$20 x .0775)	<u>\$1.55</u>

Purchasing Materials for Resale. An advertising agency or commercial artist may purchase materials for resale when such materials are physically incorporated into the finished art being sold or leased as discussed previously. Materials may also be purchased for resale when there is a specific title clause transferring title prior to use by the advertising agency or commercial artist. All other materials used to create the finished art and otherwise consumed during the creation of the finished art are subject to tax at the time of purchase. When the applicable tax due on the purchase is use tax, the advertising agency or commercial artist must pay such tax to the retailer or self-report the tax to the Board.

Note: In situations where the finished art is purchased by a consumer from out-of-state vendors and the records are not available to compute a value for the finished art on an actual basis, the auditor should use other verification techniques to confirm that the purchaser calculated its use tax measure on a reasonable value for the finished art. This may include a test of other purchases of similar finished art in order to compute a reasonable value or a percentage of a lump-sum billing that represents the finished art subject to use tax.

Audit Procedure. To determine whether or not a transfer of finished art is made pursuant to a technology transfer agreement, the auditor should review job files and other pertinent documents to determine the following:

- Does the transaction include a transfer of the right to reproduce copyrighted finished art and sell the reproductions in other property?
- Is the transfer of the interest in the copyright evidenced by a writing?

A writing can include specific contractual language, statements on a purchase order issued by the purchaser, a statement on a sales invoice, or other documents that clearly state that the seller is transferring to the purchaser the right to reproduce copyrighted material and the right to sell those reproductions. Specific terminology need not be used, but the writing must indicate that the seller is transferring to the purchaser an image, which the purchaser is allowed to copy, and which copy the purchaser is allowed to sell. See the invoice samples below for examples of language that may be used.

- Does the purchaser of the right intend to reproduce the copyrighted image and sell those reproductions in other property?

A contract does not qualify as a technology transfer agreement when the purchaser does not intend to sell or lease the copyrighted image, or when the purchaser is the consumer of the property or image that results from exercise of the copyright.

When the purchaser of the copyright interest actually reproduces the image and sells the reproductions, it should generally be accepted that this is consistent with the purchaser's intent at the time the copyright interest was assigned barring clear evidence to the contrary. However, when the purchaser does not reproduce the copyrighted image and sell those reproductions, the purchaser must establish that the purchaser's intent changed from the time the copyright interest was assigned to the purchaser.

For example: A photographer agrees to transfer a photographic image of Yosemite, in tangible form, to a publisher along with the right to reproduce the image in a planned book on scenic spots in California. The publisher does not publish the book. However, upon audit, the publisher establishes that after acquiring the photograph and the right to reproduce and sell the image, the publisher decided to cancel the project because it had determined that there was an inadequate market for the book. The transfer of the image to the publisher was pursuant to a technology transfer agreement even though the image was not used for the intended purpose.

In contrast, as noted in the examples above, if review indicates that a purchaser purchased an image for its own consumption or for the purpose of controlling the use of the image, the transaction was not made pursuant to a technology transfer agreement and tax would apply to the value of the finished art as discussed in Section 1103.15.

When evaluating a technology transfer agreement that includes a transfer of finished art, the auditor should take the following steps to determine the taxable measure:

- Determine whether tangible personal property was transferred. If no tangible personal property has been transferred (that is, the finished art was transferred electronically) or the transfer of the finished art was a temporary transfer on computer storage media, the transaction is not subject to tax.
- When tangible personal property is transferred, determine the value of the transferred property following the criteria provided in Regulation 1540, as detailed previously. If the transaction has no separately stated selling price and the auditor is unable to find a selling price for similar artwork, the measure of tax must be determined by calculating 200 percent of the combined cost of materials and labor.

Example 9: Sample Invoice

Facts: Joe Whammo owns Whammo Graphics as a sole proprietorship. Whammo supplies finished artwork to advertising agencies and its own clients. Whammo contracts with an advertising agency to develop a logo for food processor Organicks' campaign emphasizing the purity of its product. Whammo provides the logo to the agency on a CD, which the agency will temporarily possess and return after the image is loaded on the agency's computer. Organicks will use the logo on its packaging during a promotional campaign. Whammo and the advertising agency agree that the logo may be reproduced for the projected six-month campaign. If Organicks decides to make additional use of the logo, Whammo and the advertising agency will negotiate additional license fees. This transaction is pursuant to a technology transfer agreement since there is a written transfer of the reproduction rights and Organicks will reproduce and sell the image on property subject to the copyright interest.

Whammo Graphics Art with Impact	2592 Scitex Place Dutch Flat, CA e-mail:whammo@flinger.com	Job No.: 00-186 Client: ValueAdded for Organicks Date: March 23, 2003
Organicks pure food logo - Six months of reproduction		\$5000.00
Tax - [No tax. Transfer of finished art temporarily on CD is de minimis.]		0.00
Total due on billing: Job 00-186		<u>\$5000.00</u>

The transfer of finished art on computer storage media on a temporary basis is not a taxable sale. Tax is due on the consumable supplies used to create the image on the computer storage media.

TRANSFERS AT A SOCIAL GATHERING**1103.45**

Regulation 1540(d) explains that the transfer of original drawings, sketches, illustrations, or paintings intended for entertainment purposes only at a social gathering is not a sale or purchase provided all the following requirements are satisfied:

1. Eighty percent (80%) or more of the drawings, sketches, illustrations, or paintings are delivered by the artist to a person or persons other than the purchaser;
2. Eighty percent (80%) or more of all of the drawings, sketches, illustrations, or paintings are received by a person or persons, other than the purchaser, at no cost to the person or persons who become the owner of the drawings, sketches, illustrations, or paintings;
3. The charge for the drawings, sketches, illustrations, or paintings is based on a preset fee; and
4. The preset fee charged for the drawings, sketches, illustrations, or paintings is contingent upon a minimum number of at least three drawings, sketches, illustrations, or paintings to be produced by the artist at the social gathering.

If all of the above listed requirements are met, the artist's charges are not taxable and the artist is the consumer of any property so transferred.

Example 1:

A family plans a birthday party for their soon-to-be six-year old child. Clowns and a moon-bounce house are rented. In addition an artist is hired to supply the party participants a charcoal rendition of themselves to commemorate the occasion. All partygoers who sit for the 5 minute portrait are given their finished drawing for no charge, as the artist will be paid a preset agreed upon amount by the parents of the birthday child. The artist produces over 20 drawings for the children. Under these circumstances the fee paid to the artist is not subject to sales tax, and the artist is considered the consumer of all property transferred. The artist owes tax on the cost of the paper and the charcoal and any other material used and transferred along with the drawing of the children.

Example 2:

Same situation as in example #1 with the exception that the artist negotiates separately with each parent the price of the portrait depending on whether or not the customer wants it done in color or charcoal, and how much detail will be included. In this example none of the four criteria is met, and the artist is the retailer of the drawings and owes tax on the sales price of all the portraits sold.

AUDIT MANUAL

**SPECIAL PROVISIONS APPLICABLE
TO ADVERTISING AGENCIES**

1104.00

GENERAL

1104.05

An agent is one who represents another, called the principal, in dealings with third parties. When acting as an agent, the advertising agency is neither a purchaser of the property with respect to the vendor, nor a seller of the property with respect to the principal, its client. Rather, the client is purchasing the property directly from the vendor. Unless an advertising agency elects non-agency status or is otherwise the retailer of the property as described in Section 1104.10, it is rebuttably presumed that the advertising agency acts as the agent of its client when acquiring tangible personal property on its client's behalf.

The determination of whether an advertising agency is acting as the agent of its client or as the retailer of property to its client is complicated by the fact that an advertising agency might be acting as the agent with respect to the acquisition of some property and as the retailer of other property **on the same job**.

**ADVERTISING AGENCY ACTING AS AN AGENT FOR ITS CLIENT
OR AS A RETAILER OF TANGIBLE PERSONAL PROPERTY**

1104.10

An advertising agency will be regarded as acquiring tangible personal property as the agent of its client, for sales and use tax purposes, unless any of the following conditions apply:

1. The advertising agency elects non-agent status by written documentation. This written documentation can be in a contract, on a purchase order, or on an invoice to the client. A provision stating that "(advertising agency's name) will not be acting as an agent of (client's name) for the purposes of this transaction," or similar language will establish that the advertising agency has elected non-agent status and is instead the retailer.
2. The advertising agency fabricates the tangible personal property in-house. An advertising agency is not the agent of its client with respect to the acquisition of materials incorporated into items it produces or fabricates; rather, the advertising agency is the retailer of such property.
3. The advertising agency's sales invoice does not separately state the amount paid to the vendor for the property purchased on behalf of its client. For example, the sales invoice might separately state a charge for the property that is marked up from the amount paid to the vendor. Another example is when the charge for the property is combined with charges for other property or services. The advertising agency is the retailer of the property.
4. The advertising agency furnishes a resale certificate to the vendor, in which case the advertising agency is presumed to have purchased the tangible personal property on its own behalf for resale to its client as the retailer. The advertising agency may provide evidence to overcome this presumption, so that it is regarded as purchasing the tangible personal property as the agent of its client, provided the advertising agency has not collected tax or tax reimbursement from its client on that sale. Unless the advertising agency proves that the issuance of the certificate was a mistake, the advertising agency is acting as the retailer.

**ADVERTISING AGENCY ACTING AS AN AGENT FOR ITS CLIENT
OR AS A RETAILER OF TANGIBLE PERSONAL PROPERTY**

(CONT. 1) 1104.10

Note: When an advertising agency issues a resale certificate for tangible personal property but establishes that it did so by mistake, the advertising agency is liable for use tax on the cost of the tangible personal property unless (1) the advertising agency has already paid that tax to the vendor or to the Board, or (2) the client has already self-reported and paid the tax to the Board. *If no tax has been paid, the tax should be assessed against the advertising agency, not the client.* The XYZ letter process may be used to verify this information.

Application of Tax to Sales Made by an Advertising Agency. The measure of tax on the retail sale made by an advertising agency that elects non-agent status or is otherwise the retailer with respect to tangible personal property sold to clients is the separately stated charge for the tangible personal property. If there is no separately stated charge, the measure of tax should be calculated as discussed in Section 1103.00.

If the advertising agency charges the client a monthly agency or retainer fee, and the agreement or contract stipulates that any transfer of tangible personal property will be billed separately, the agency or retainer fee will not be subject to tax. If the monthly agency fee or retainer fee is for both services and the sale of tangible personal property, the agency or retainer fee will be prorated and subject to tax based on the portion of the agency or retainer fee related to the sale of tangible personal property.

Intermediate Production Aids and Special Printing Aids. Under the provisions in subdivision 1541(c)(1)(A), a person acquiring intermediate production aids or special printing aids to produce printed matter for sale is regarded as purchasing such aids for resale along with the printed matter unless that person specifically retains title to the aids as a consumer. (See Section 1103.30.) However, these provisions are not applicable to an advertising agency that is acting as an agent of its client when acquiring intermediate production aids or special printing aids. As an agent, the advertising agency never obtains title to the aids, and thus can neither be the seller nor the consumer of the aids since the aids are sold by the vendor directly to the client.

Tax Application to Vendor's Sales to Advertising Agency. A vendor is presumed to have made a retail sale of tangible personal property when selling to an advertising agency unless the vendor takes a timely and valid resale certificate. A vendor should not assume that an advertising agency is purchasing tangible personal property for resale since the advertising agency may be purchasing the property as the agent of its client.

If the vendor does not obtain a timely and valid resale certificate from the advertising agency, the vendor should regard the advertising agency as purchasing the tangible personal property as the agent of its client. As an agent, the advertising agency is neither the buyer nor seller of the property. Rather, the vendor is making the sale directly to the client of the advertising agency, and unless the vendor takes a timely and valid resale certificate in good faith **from the client of the advertising agency**, the vendor's sale is a taxable retail sale. In such circumstances, the vendor should report sales or use tax on the sale.

**ADVERTISING AGENCY ACTING AS AN AGENT FOR ITS CLIENT
OR AS A RETAILER OF TANGIBLE PERSONAL PROPERTY**

(CONT. 2) 1104.10

If the vendor fails to take a resale certificate, the vendor is liable for sales or use tax, as applicable, unless it overcomes the presumption that its sale is at retail. The vendor has the burden of establishing that the advertising agency elected non-agent status and resold the property, that the advertising agency otherwise resold the property as the retailer, or that the advertising agency's client purchased directly from the vendor for resale. In order to show that the advertising agency purchased the property for resale, the vendor would have to establish that the advertising agency was not the agent with respect to the purchase of the property, but instead purchased the property on its own behalf for resale to its client prior to use. This information can be obtained by using the XYZ letter process.

During an audit of the advertising agency, if the auditor determines that the advertising agency acted as the retailer with respect to the specified property, it is not necessary to contact the vendors to determine if they have resale certificates on file with respect to the advertising agency's purchases of that tangible personal property for which it acts as the retailer. The vendors are not liable for tax with respect to sales of property for which the advertising agency is the retailer.

Example 1: Acting as a Retailer

An advertising agency charges its client for a brochure that consisted of finished art created in house and photography and printing, purchased from a third party, as follows:

Concept and Design of Brochure	\$ 1,000.00
Stock Photography (Cost \$300)	350.00
Finished Art	500.00
Printing of Brochure (Cost \$7,200)	8,000.00
Print Supervision	200.00
Tax on \$8,850 @7.75%	685.87
Total	<u>\$10,735.87</u>

Since the advertising agency is acting as a retailer making sales to its client (because the advertising agency sold the photography and brochures for more than its cost), all itemized charges except the concept and design and print supervision are subject to tax. The concept and design is a nontaxable service and the print supervision is a nontaxable service provided with a third party transaction. If the printing is produced in-house, the print supervision would be subject to tax.

Example 2: Acting as an Agent

An advertising agency acquires property on behalf of its client on a contract to provide printed brochures. The contract does not qualify as a technology transfer agreement. The advertising agency bills the following:

Agency Fee	\$ 2,000.00
Finished Art (Cost \$350 plus tax)	377.12
Printing of Brochure (Cost \$7,200 plus tax)	7,758.00
Print Supervision	200.00
Stock Photography (Cost \$300 plus tax)	323.25
Tax	0.00
Total	<u>\$10,658.37</u>

Since the advertising agency acted on behalf of its client when acquiring the tangible personal property and billed its client for cost plus tax reimbursement, no additional tax is due on this transaction. The agency fee and print supervision are also nontaxable services.

ADVERTISING AGENCY ACTING AS AN AGENT FOR ITS CLIENT
OR AS A RETAILER OF TANGIBLE PERSONAL PROPERTY

(CONT. 3) 1104.10

Purchases from Out-of-State Vendors Who Do Not Collect Use Tax. An advertising agency may purchase tangible personal property from out-of-state vendors who are not registered with the Board and who do not collect California use tax. It may also purchase property from registered out-of-state retailers who, for whatever reason, failed to collect use tax on sales to the advertising agency.

- Purchases on advertising agency's own behalf: When the advertising agency purchases tangible personal property on its own behalf for its own use, the advertising agency is liable for use tax on its purchase price. When the advertising agency purchases tangible personal property on its own behalf for resale to its client prior to use, no use tax is due on the advertising agency's purchase; rather, the advertising agency owes tax on its resale of the property.
- Purchases by advertising agency as the agent of its client: When the advertising agency purchases tangible personal property as the agent of its client, the vendor is regarded as making the sale directly to the client. As such, the client would generally be liable for the applicable use tax. However, because of the unique circumstances involved in these transactions, Regulation 1540(c)(1)(B) provides that it is the advertising agency who is liable for any use tax due on transactions where it purchased property as the agent of its client. This liability is not extinguished unless the client has, **in fact**, already self-reported and paid the tax to the Board.

SPECIFIC APPLICATIONS**1105.00****COMMERCIAL PHOTOGRAPHERS****1105.05**

Commercial photographers are considered commercial artists for purposes of Regulation 1540, when they provide services, licenses, and/or tangible personal property to their clients for use in their clients' advertising, marketing or merchandising activities, or for their clients' other commercial endeavors such as where the clients will sell reproductions of the finished art (photographic images). Commercial photographers create and sell or license the use of photographs to commercial entities such as advertising agencies and graphic design firms and directly to client companies for their commercial use. "Commercial use" refers to reproduction or display for commercial purposes such as promotion, publicity, marketing, publishing, advertising, corporate communications, packaging, creation of products, merchandising, and other similar commercial uses. For guidelines on other photographers, see the non-commercial photographer section below.

Creation of Preliminary Art. Commercial photographers may provide preliminary art, as discussed in Section 1103.10, when providing services to convey their ideas, concepts, looks or messages to clients. The tangible personal property temporarily transferred when providing preliminary art might include contact sheets, photographic images produced from a digital camera, direct positive prints, or photographic images processed from film. A commercial photographer may be providing preliminary art for an advertising agency, another commercial artist, or another commercial entity.

In order for a commercial photographer's charges for preliminary art to be nontaxable, the presence of two critical factors must be established. Charges will be deemed to be for nontaxable services only when they represent services performed to convey ideas, concepts, or messages to a client. The parties must intend that the commercial photographer will produce preliminary art that demonstrates an idea or message developed by the commercial photographer. So the first element is that it must have been the commercial photographer's idea, concept, look, or message that is being presented to the client.

The second factor is the expectation of the parties that the client will be considering its acceptance or approval of the idea, concept, look, or message, as set forth in the preliminary art. If the client gives the commercial photographer a generalized idea for the scope of the project, such as, "We need photographs of full moons over urban landscapes for next year's calendar," clearly the preliminary photographs presented will represent ideas and concepts of the commercial photographer, submitted for the client's approval. On the other hand, if the assignment is, "Take a daytime photograph of my building, from this spot across the street," or, "We need a photograph of our new cereal package, with nothing in the background," then the idea, concept, look, or message was that of the client, and any charges for work to present the photographs, for the client's selection, will not receive nontaxable status as preliminary art.

Examples of these concepts follow, at the end of this commercial photographer section.

Transfers of Finished Art. As with any other commercial artist, a commercial photographer might provide conceptual services along with the finished art. Tax applies to the activities of a commercial photographer in the same manner as tax applies to the activities of any other commercial artist. For example, if the commercial photographer transfers a photograph in tangible form (e.g., "finished art"), tax will apply to all or a portion of the charges for finished art as explained in Regulation 1540. On the other hand, if a commercial photographer transfers no tangible personal property to the client whatsoever, no tax applies to its charges.

The finished art of a commercial photographer, that is, a photographic image, is usually delivered to the client in one of the following forms:

1. As a tangible printed image — The print is scanned or otherwise duplicated by the client and then is generally returned to the photographer, in which case the print remains the photographer's property and is only held by the client for the period necessitated by the scanning process. The print may also be permanently transferred to the client, in which case the client becomes the owner of that print.
2. As a tangible original piece of film ("transparency," "slide," or "negative") — The film is scanned or otherwise duplicated by the client and then is generally returned to the photographer, in which case the film remains the photographer's property and is only held by the client for the period necessary to scan or otherwise duplicate the film. The film may also be permanently transferred to the client, in which case the client becomes the owner of the film.
3. As a digital file, electronically transmitted to the client — The file is sent to the client electronically or downloaded by the client via the Internet, or the photographer physically visits the client's business location, uploads the file from electronic media (e.g., CD) without the client ever taking possession of the tangible media, then the photographer leaves with the tangible media.
4. As a tangible digital media — The file is recorded onto electronic media and transferred to the client. The client may return the media after using it or may be entitled to retain permanent possession of it.

License to Use Finished Art. A commercial photographer sells or leases photographs along with a right to reproduce those photographs (sometimes called a "license to use" the photograph). This is almost always in the context of the transfer of some or all of the commercial photographer's copyright interest in the photographic image. The right to reproduce transferred to the client may be broad or may be limited and very specific. Some typical specifications/limitations may include:

- The type of usage media (consumer magazines, brochures, billboards, etc.)
- The frequency or quantity of use (how many magazines or billboards or brochures, etc.)
- Exclusive or non-exclusive use (if "exclusive use," the photographer cannot license the photograph to anyone else as specified in the exclusive use agreement)
- Period of use (time period during which the photograph may be reproduced)
- Region of use (geographic)
- Reproduced size of the image
- Language of the text to accompany the photograph when reproduced

In a common situation, a commercial photographer transfers to the client the right to reproduce the photographic image for a specified purpose or period. Ownership of the copyright and all rights to the photographic image remain with the commercial photographer at all times, including the period during which the license to the client is active. The photographer is generally free to license that photographic image to other clients at any time. Although a common practice in this industry is that the transfer is with restrictions, a photographer can transfer all rights to the image to the client, without restriction and without the photographer's retaining any rights to use the image or to license it to anyone else.

When a commercial photographer makes a sale of a photographic image, and also transfers the entire copyright interest to the buyer, the transaction may qualify as a technology transfer agreement provided all three requirements specified in Section 1103.40 are satisfied.

When the transfer of the photograph is in tangible form, tax applies to the charge for the tangible transfer of the finished art. (See Sections 1103.15 and 1103.40.) This is true whether the tangible personal property is transferred to the client permanently, or is a temporary transfer (lease) of the tangible personal property to the client. (The exception to this rule is for the temporary transfer of computer storage media containing finished art, which is transferred as part of a technology transfer agreement as discussed in Section 1103.40.)

Sales tax applies to the sale or license of the finished art and taxable reproduction rights transferred to the client. (See Section 1103.15.) In a transaction that does not qualify as a technology transfer agreement (as discussed in Section 1103.40) and when the value of the finished art is not separately stated on the invoice, the commercial photographer may either calculate the value of the finished art on an actual basis or apply the 75/25 presumption if the charge for finished art, along with any taxable reproduction rights, is combined with conceptual services.

Auditors need to determine what is being transferred (preliminary art, finished art, reproduction rights, other tangible personal property, etc.) and to whom it is being transferred (advertising agency acting as an agent or retailer, printer, client that is the consumer, etc.) in order to determine the application of tax to each transaction. Commercial photographers may sell or license photographic images to various clients that may have different applications of tax when determining the gross receipts subject to tax.

Charges by a Commercial Photographer/Artist. Auditors may find that commercial photographers bill in a variety of ways for their services rendered. Some commercial photographers charge their client a fee for the time involved in creating the photographic image, in addition to charging a license fee for the reproduction rights. Some commercial photographers charge the client a licensing fee that is appropriate for the usage requirements of the client, without billing a fee for services rendered. Reimbursable expenses may also be billed to the client, either "at cost" or with markup. Other commercial photographers may only invoice the client for a flat fee, which includes the license fee and expenses, without itemization. Examples of itemized charges may be:

- a. **Finished Art.** Charge for finished art (photographic images). A separately itemized charge for the finished art is 100% taxable. If preliminary art is included in a combined charge with finished art, 25% of the combined charge is taxable unless the records indicate otherwise or the transfer qualifies as a technology transfer agreement.
- b. **License/Re-license fees.** Charge for the right to reproduce finished art. May be taxable if the transfer is not made pursuant to a technology transfer agreement or nontaxable if the transfer of the finished art is made pursuant to a technology transfer agreement.
- c. **Intermediate Production Aids.** The piece of film that contains the photographic image for reproduction. The entire roll of film is not an intermediate production aid for purposes of computing the value of finished art transferred with taxable reproduction rights or in a transfer that does not qualify as a technology transfer agreement.

COMMERCIAL PHOTOGRAPHERS

(CONT. 3) 1105.05

- d. Labor/Crew Time. Charge for labor to create finished art, and in some situations, also preliminary art. The labor charges associated with the creation of the finished art are included in the taxable measure for the sale of finished art.
- e. Travel Expenses. Separately stated travel expenses for items such as airfare, hotels, rental cars, and meals that are billed by a commercial photographer, are included for purposes of calculating the value of the finished art transferred. (Travel expenses are not considered costs of labor or materials for purposes of the 200% calculation in a TTA transaction. Additionally, travel expenses are not considered direct labor for purposes of valuing finished art if there is a combined charge in a non-TTA transaction.)
- f. Production Expenses. Sometimes a commercial photographer will purchase or rent supplies, equipment, props, and other items that are necessary to create the photographic image. Again, depending on the type of transfer, the charges for materials that are included in the calculation of the taxable measure will vary.
 - 1. When Tangible Personal Property is not Sold Pursuant to a Technology Transfer Agreement (TTA) — only those materials that become a component part of the finished art or are intermediate production aids or special printing aids are included in cost of materials when calculating the measure of tax for the finished art.
 - 2. When Sold Pursuant to a TTA — all materials used or incorporated into the finished art are considered cost of materials for purposes of calculating the measure of tax for the finished art.

Example 1. Not a TTA — 75/25 Presumption

A commercial photographer is hired to create a photographic image for an upcoming sales campaign that is not pursuant to a technology transfer agreement. The client gives the product to the commercial photographer in various packages, with a generalized statement that the product will be marketed to a given demographic of consumers. The commercial photographer takes several photographs of the various packages, using a variety of props, models, etc. in order to demonstrate different ideas. The commercial photographer meets with the client to provide the photographs taken in hopes that one or more of the photographs captured the type of image the client wants for its sales campaign.

After reviewing several contact sheets, the client selects and approves one of the photographic images demonstrating the idea for the sales campaign. The client may or may not request some enhancements to the selected photographic image, which the photographer will accomplish digitally when producing the finished art. The photographer then creates the final photographic image, which will be transferred in tangible form to the client. The charges for the preparation of the finished art are subject to tax. If the photographer makes a combined charge for both the preliminary art and the finished art, the 75/25 presumption would apply.

In this example, the commercial photographer temporarily transfers various photographs to its client solely to convey an idea, concept, look or message in response to the client's request. The concepts or ideas are presented for the purpose of obtaining the client's approval or acceptance, of the concepts or ideas. The commercial photographer has provided a service for its client — developing concepts and ideas for use in marketing the product. Additionally, the client is not given title to or the right to permanent possession of the preliminary images. As such, the commercial photographer's charges related to this conceptual phase, including any direct or indirect reimbursement of costs for any props, models, lighting, etc. used, are not subject to tax as long as the commercial photographer does not subsequently transfer title to or the right to permanent possession in tangible form of the preliminary photographic images to its client. Tax does apply, however, to the commercial photographer's purchases of any tangible personal property used in the creation and production of preliminary photographic images (e.g., models, props, film, etc.).

Example 2. Not a TTA — 100% Taxable

A commercial photographer is hired to take a photograph of the Sacramento Capital to be included in its client's advertising campaign that is not pursuant to a TTA. In this case, the commercial photographer is asked to provide a specific photograph of a specific object for its client's campaign. The client selected and approved one of the 20 photographic images presented on contact sheets. The commercial photographer then produced the final photograph for the client.

In this case, the client is not hiring the commercial photographer to develop a concept or look that the client may or may not use for its campaign. The client has an in-house design department that developed the concepts and ideas for the campaign. As such, the commercial photographer has a contract and/or approval to provide finished art; i.e., the photographic image of the building. Although shooting the image of the building requires the commercial photographer to utilize his or her expertise in determining the proper lighting and angles to capture the best picture, the commercial photographer is not considered to be providing services to its client under the provisions of Regulation 1540. Accordingly, all charges related to this photo shoot would generally be subject to tax.

On the other hand, if the commercial photographer was hired by a graphic artist, designer or an advertising agency, acting as a retailer, who would be copying and selling the photographic image to its client pursuant to a TTA, the taxable measure would be calculated based on one of the three valuation methods described in Section 1103.40.

Example 3. TTA — 200% Calculation

A commercial photographer is hired to provide photographs for a book that is planned for distribution and sale to the public about the winners of the Academy Awards. This transaction qualifies as a TTA since the commercial photographer will assign in writing the copyright interest in the photographic images to the publisher who will copy and sell the photographic images in the books.

The photographer is paid an advance against royalties of \$40,000 (50% paid on signing and 50% paid on delivery) to cover all expenses and fees. In performing the contract, the commercial photographer hires two assistants, a hair and make-up artist, and a fashion consultant to travel with the photographer around the world to photograph the living recipients of the Academy Awards.

COMMERCIAL PHOTOGRAPHERS

(CONT. 5) 1105.05

The commercial photographer edits 3,000 images and delivers 300 transparencies (all of which will be returned to the commercial photographer after scanning) to the publisher for consideration as to which 30 images will actually be chosen for publication in the book. The expenses for the finished photographs are as follows:

Film and processing	\$ 3,000
Airfare, hotels, rental cars, and meals	10,000
Clothing for the subjects and props	5,000
Labor for everyone except the photographer	12,000
Total	<u>\$30,000</u>

Since the commercial photographer does not separately state the value of the 30 photographic images transferred nor has had similar sales of photographic images, the value of the finished art transferred to the publisher must be calculated using the 200% calculation as specified in Regulation 1540 (b)(2)(D)2. (see Section 1103.40).

The total cost of materials and labor used to create the finished art that is transferred in tangible form to the publisher is \$20,000 (\$30,000–\$10,000) since the costs for airfare, hotels, rental cars, and meals are not considered direct material or labor costs used to create the finished photographs. Tax would apply to \$40,000, which represents 200% of the cost of labor and materials (200% x \$20,000).

On the other hand, if the material and labor costs totaled \$25,000, resulting in a marked-up cost of \$50,000, which is higher than the \$40,000 royalties received upon delivery, tax would apply to the \$40,000 advance, and the excess of \$10,000 would carry over to future payments received in subsequent periods until the entire computed measure is reported. If no additional payments are received, no additional tax is due on the transaction.

Example 4. TTA — Similar Sale Valuation

A commercial photographer delivers 300 images as 8x10 black and white prints of celebrities for a similar book as in Example 3. The commercial photographer has provided similar photographic images (without reproduction rights) of celebrities for \$25 each and has licensed the reproduction rights for the same images for an average of \$500. Assuming that all three requirements for a TTA are met, the taxable measure would be \$7,500 (300 x \$25), since the value of photographic images has been determined by a previous sale of similar photographic images.

If these photographic images are delivered on a CD that is to be returned once the photographic images are copied onto the client's computer, the transfer of photographic images would not be subject to tax since the transfer qualifies as a temporary transfer on a CD and considered incidental to the service. Tax would be due on the commercial photographer's purchase of materials used to produce the photographic image on the CD.

In addition, if the same photographic images were transmitted electronically to the client instead of on a CD or as prints, there would not be a sale of tangible personal property subject to tax.

Example 5. Not a TTA — 100% Taxable

A commercial photographer is hired by the Motion Picture Academy to provide photographic prints of the headshots of the nominees for the Oscar ceremonies handbook. This handbook will be given away to all the attendees of the ceremony. This transfer is not made pursuant to a TTA since the purchaser does not intend to reproduce and sell the handbook. The commercial photographer is liable for sales tax measured by the total charge to produce the photographic images that are selected for the handbook since the commercial photographer was hired to photograph subjects and not to produce an idea or concept for the handbook. The 75/25 presumption would not apply to this sale of photographic images.

If these photographic images were sold to be incorporated into a handbook that was sold to the attendees, then the transfer would qualify as a TTA with tax measured by one of the three valuation methods discussed previously.

Example 6. TTA - 200% Valuation — Stock Photograph

A commercial photographer has a written contract with an advertising agency to provide a photograph from the commercial photographer's inventory of stock photographs. The photograph is transferred in tangible form as a print. The advertising agency has informed the commercial photographer that it is acting as a retailer, and will not be acting as an agent on behalf of its client. The advertising agency is going to reproduce the photographic image in producing brochures that it will sell to its client. The commercial photographer charges the advertising agency \$5,000 for the transfer of the photograph.

Analysis of Transaction: The transaction between the commercial photographer and the advertising agency is a TTA (there is a written agreement, there is an assignment of a copyright interest, and the buyer is reproducing the photographic image and selling other tangible personal property subject to the copyright interest). The transfer of the photograph is a lease. Since there is not a separately stated price for the finished art (the print), and assuming there is no "like finished art" which was sold by the commercial photographer for a separately stated price, the measure of tax must be established using the 200% calculation set forth in Regulation 1540(b)(2)(D)2.c. The commercial photographer needs to calculate the value of the finished art by combining 200% of the costs of materials and labor used or incorporated into the finished art. The cost of materials and labor would include costs for any film, props, leased equipment, models, and other purchased labor.

Example 7. Not a TTA — 100% Taxable — Stock Photograph

Same facts as Example 6, except that the purchaser requesting the stock photograph is the end buyer, who will use it to create brochures in house, which will be given away as part of an advertising campaign.

Analysis of Transaction: This transaction is not a TTA (there is a written agreement, there is an assignment of a copyright interest, but the buyer is not going to sell other tangible personal property subject to the copyright interest — the buyer here is going to make the brochures in house, and give them away). The transfer of the photograph is a lease. The charge for the lease of the photograph is \$5,000. The question is whether the entire charge of \$5,000 is taxable, or whether a portion of it is nontaxable, for any creative services that the photographer had in the photograph. The client selected the photograph from the photographer's inventory of photographs. The commercial photographer did not perform any creative services for this client, within the meaning of Regulation 1540. While the commercial photographer was no doubt creative in taking the photograph, the taking of the photograph did not involve any services to convey ideas, concepts, looks or messages to this client. Nor did the commercial photographer need to get this client's approval of any preliminary art, prior to producing the finished art. The client simply selected the photograph it desired, from the inventory of stock photographs. Therefore, tax applies to the entire charge of \$5,000, including the reproduction rights, with no deduction for preliminary art.

Example 8. TTA — Relicense Fee

A commercial photographer had a written contract with an advertising agency by which the commercial photographer took many photographs, the advertising agency selected the photograph that best suited the needs of its client, and after making edits to the image pursuant to the advertising agency's directions, a photographic image was transferred. The advertising agency had informed the commercial photographer that it was acting as a retailer and would not be acting as an agent on behalf of its client. The advertising agency reproduced the photographic image in producing brochures that it sold to its client. The commercial photographer charged the advertising agency \$5,000 for the lease of the photo, and the parties agreed to a one-year license for the use of the photograph. That transfer was pursuant to a TTA.

Now, a year later, the advertising agency returns to the commercial photographer, and requests that the license to use the photographic image be extended for an additional year to produce more brochures. The commercial photographer agrees to extend the license, for a payment of \$5,000 with no additional tangible personal property transferred.

Analysis of Transaction: The \$5,000 for the additional one-year license is not taxable since the original transaction was made pursuant to a TTA. Tax does not apply to the charges for re-licensing the copyright interest.

Example 9. Not a TTA — Relicensing Fee

Same facts as Example 8, except that the original purchaser who is now requesting the license extension is the end user, who will use it to continue to create brochures in house, which will be given away as part of an advertising campaign.

Analysis of the Transaction: The original transaction was not pursuant to a TTA, nor is this re-licensing agreement pursuant to a TTA. The taxability of the \$5,000 payment for the extension of the license pursuant to a non-TTA agreement depends on how the original photographic image was transferred. If the image was originally transferred electronically (such as through the Internet or e-mail transmission), then that original transaction was not subject to tax, and the subsequent fee for extending the license will not be subject to tax.

COMMERCIAL PHOTOGRAPHERS**(CONT. 8) 1105.05**

However, if the original photograph was transferred in tangible form, such as a print, then tax will apply to the \$5,000 paid for the extension of the license. This is the case, even if some portion of the original \$5,000 was not taxable because there were conceptual services provided. Thus, even if the 75/25 presumption was applied by the photographer at the time of the original transaction, thereby reducing the taxable measure to \$1,250, the full \$5,000 is taxable for the extension of the reproduction rights. Regulation 1540(b)(2)(C) explains that tax applies to all charges for finished art, including for any rights sold with the finished art, such as reproduction rights. Since this transaction is not pursuant to a TTA, the \$5,000 charge for additional reproduction rights of the copyrighted image are taxable.

Non-Commercial Photographers

Regulation 1528, Photographers, Photocopiers, Photo Finishers and X-Ray Laboratories, governs the application of tax to photographers who sell photography for non-commercial use. "Non commercial use" refers to categories such as wedding and portrait photography, and prints sold as fine art.

Tax applies to sales of photographs, whether or not produced to the special order of the customer. Tax applies to charges for the making of photographs out of materials furnished by the customer or others. No deduction is allowable on account of expenses such as travel time, telephone calls, rental of equipment, or salaries or wages paid to assistants, whether or not such expenses are itemized in billings to customers.

**CREATIVE ART SERVICES FOR THE MOTION PICTURE INDUSTRY
AND OTHER MOTION PICTURE PRODUCERS****1105.10**

"Creative art services" are defined in Regulation 1529(d)(15) as services performed by advertising agencies, commercial artists, designers, commercial photographers, color separators, and other such persons to convey ideas, concepts, looks or messages in connection with the production, distribution or exploitation of a "qualified motion picture," as defined in Regulation 1529(b)(1). As in the case of conceptual services (discussed in Section 1103.10), creative art services may result in the transfer, enhancement, or revision on any medium, including roughs, visualizations, drawings, sketches, renderings, illustrations, layouts, comprehensives, photographs, negatives, transparencies, prints, copies, chromatics, stats, logo types, scans, laser graphics, visual prototypes and electronic imagery. Creative art services do not include the services for the preparation of finished art for use in reproduction by photomechanical processes.

Unlike conceptual services under Regulation 1540 where the provider is regarded as selling tangible personal property, if the preliminary art demonstrating the ideas, concepts, etc., is permanently transferred to the client, a provider of qualifying creative art services is regarded as providing nontaxable services rather than the sale of tangible personal property. This is true even if title to or permanent possession of the preliminary art demonstrating such creative art services is transferred to the client.

**CREATIVE ART SERVICES FOR THE MOTION PICTURE
INDUSTRY AND OTHER MOTION PICTURE PRODUCERS****(CONT 1) 1105.10**

A provider of creative art services under Regulation 1529 should retain documentation or records, including invoices, or other written evidence of the charges made to a client, for creative art services. Creative art services can be provided during the production, distribution or exploitation of a qualified motion picture, which may involve several markets for exploitation (e.g., home video). As long as the creative art services are performed in accordance with the provisions of Regulation 1529, the service is not taxable. The provisions in Regulation 1529 for creative art services do not override or alter the taxability of the charges associated with the production of finished art even though the purchaser is a motion picture studio. The production and sale of finished art is a taxable sale of tangible personal property. As set forth above, creative art services do not include the services for the preparation of finished art by photomechanical processes.

In the event a person who is performing creative art services subcontracts to others part of the work, those persons also become creative art service providers. When a contract includes both creative art services and the preparation of finished art, the seller should segregate the charges for the creative art services from those related to the production of finished art.

Note: If a recipient subsequently uses the property for reproduction or display, that person would owe use tax based on its purchase price.

In performing audits of motion picture studios and similar other purchasers, the auditor should verify whether the purchaser has reported and paid the tax due on the seller's charge for any tangible personal property acquired ex-tax as discussed above where the purchaser has made use of the property for reproduction or display.

Creative Art Services — Advertising Agencies and Commercial Artists. Regardless of the provisions of Regulation 1540, an advertising agency or commercial artist who provides creative art services within the meaning of Regulation 1529(d)(15) is the consumer of the tangible personal property used to provide the creative art services rather than the retailer, even when permanent possession or title to the preliminary art is transferred to the purchaser. For example: a commercial photographer contracts with a movie studio to take photographs during location or on the set of the shooting of a qualified motion picture, and as part of that contract, the photographer provides its client with either the rolls of film or developed photographs. If the contract is for "creative art services" in connection with the production, distribution, or exploitation of a qualified motion picture, the provisions of Regulation 1529 apply to the commercial photographer's charges and not the provisions of Regulation 1540. Although the photographs may be of the quality of a finished photographs, the contract is for "creative art services" provided the photographs are transferred solely to convey ideas, concepts, looks or messages and the movie studio will make no use of them for reproduction or display. When such is the case, the transfer of permanent possession of the photographs is not subject to tax. The commercial photographer is the consumer of any items that become an ingredient or component of the photographs, rather than the retailer. The important thing to determine is whether the contract is actually for qualified creative art services under Regulation 1529.

**CREATIVE ART SERVICES FOR THE MOTION PICTURE
INDUSTRY AND OTHER MOTION PICTURE PRODUCERS**

(CONT 2) 1105.10

Creative Art Services — Printers & Print Brokers. It would be unusual for a printer or print broker to have a contract to provide creative arts services since they generally enter the process after there is a contract or approval for finished art. If a printer or print broker does, in fact, enter into a contract to provide “creative art services” under Regulation 1529(d)(15) in connection with the production, distribution, or exploitation of a qualified motion picture, the provisions of Regulation 1529 apply to the charges for such services rather than the provisions of Regulation 1541. Under Regulation 1529, a person providing creative art services is the consumer of the property used in the performance of such services. Consequently, the printer or print broker should not transfer title, prior to use, to any production aids that may be used in the creation or development of all preliminary designs. Nor should it issue a resale certificate when purchasing items used in the production of preliminary art or in the performance of creative art services.

Creative Art Services — Color Separators. When a color separator or a printer acting in the role of a color separator has a contract to provide “creative art services” in connection with the production, distribution, or exploitation of a qualified motion picture, the provisions of Regulation 1529 apply to the charges for such services rather than the provisions of Regulation 1541. Accordingly, the provisions of Regulation 1541 regarding passage of title to the color separator’s “working products” are inapplicable when the color separator has a contract to provide creative art services in connection with the production, distribution, or exploitation of a qualified motion picture. Regardless of any title clauses that may exist between the color separator and the service recipient, the color separator is the consumer of the working products used in the performance of creative art services and may not issue a resale certificate when purchasing his or her working products.

DIGITAL PRE-PRESS INSTRUCTION

1105.15

Digital pre-press instruction is the creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output to film, plate, or direct to press, which is then transferred on electronic media such as CD. Digital pre-press instruction is a custom computer program the sale of which is not subject to tax, provided it is prepared to the special order of the customer.

Digital pre-press instruction involves the following processes:

1. **Image Capture** — This is the process of capturing in digital form, the images needed to produce the job. Often the customer provides these components (e.g., electronic design files, hand artwork, and photos) to the printer or service provider. Artwork provided in hard copy is scanned to capture the image.

Programs used to perform this step are usually tied to the hardware used in capturing the image. Examples may include Agfa Fotolook, Epson LaserSoft Silverfast Ai, Heidelberg LinoColor, or Creo’s EverSmart oXYgen.

2. **Image Manipulation** — Once the image is captured, it must be reviewed and adjusted for the desired results when output. With photographs, the process of image manipulation is accomplished with software termed as paint software because of its ability to alter the pixels in a photo. Adobe’s PhotoShop is a standard program used for image manipulation. Although many things can be altered with this software, the main objective that printers or service providers accomplish is matching the color desired by the client.

Drawing programs such as Adobe's Illustrator and Macromedia's FreeHand can manipulate graphic files, which are also known as vector files. These are not photos, but mathematically defined drawings of lines and curves anchored by control points.

3. Page Layout — Text, graphics and photos are combined into a single file and positioned for output. Page layout software allows these elements to be imported and positioned for output. This is what is commonly called the mechanical, mechanical assembly, or finished art. Examples of layout programs include QuarkXpress, PageMaker, InDesign, FrameMaker, Ventura Publishing, and Corel Draw.
4. Output — The page layout file is sent to "print" to a specific high-resolution device through a postscript driver. The postscript driver converts the page layout program along with the graphics and photos to postscript code. Postscript code is a page description language developed by Adobe to describe an image for printing.

The code is then sent to a Raster Imaging Processor (RIP)¹ that interprets the postscript into the device specific language. An object or display list is created in the RIP's memory, including screening algorithms, separations, trapping, imposition, and other functions that control certain options of the printing device. The display list is converted (rasterized) to a single file using the parameters of the destination printer that is used to image the information.

This resulting electronic file is digital pre-press instruction. The file has limited uses as it is generated from proprietary software for digital output for the purpose of printing. The printer or service provider will then use the file to prepare film or plates, or send the file directly to press for printing. As provided in Regulation 1541(g), a specific charge for digital pre-press instruction is not taxable.

Some printers, advertising agencies and commercial artists have the ability to perform all four steps, but often perform the first three as corrections to customer supplied files. If the fourth step is not performed, digital pre-press instruction has not been sold and the printer's, advertising agency's, or commercial artist's charges are considered fabrication labor.

The sale of canned or prewritten digital pre-press instruction in tangible form is a sale of tangible personal property which is subject to tax.

Charges Not Considered Digital Pre-Press Instruction. The first three steps described in section 1105.10 by themselves do not qualify as digital pre-press instruction. Charges for scanning artwork or photographs, creating original artwork by computer, or manipulating scanned images are subject to tax if the artwork is transferred to the client in tangible form as described in Regulation 1540.

Proofs. Proofs are generally provided to the customer during the digital pre-press process. Proof art is not digital pre-press instruction. Charges for proof art delivered to a California consumer are taxable.

Film and Plates. Charges for film and/or plates are not digital pre-press instruction (even though the film or plates are prepared from the electronic digital pre-press file). Tax applies to these charges as provided in Regulation 1541(c) Special Printing Aids.

¹The RIP is the control device for raster-based output. Raster means line. For each line (there could be from 300 to 3,000 lines to an inch) the laser is either on or off for each possible position. Since almost all output today is based on dots, a RIP is required. The RIP is connected to a marking engine that uses lasers to put dots that create images on film, plate, or directly to press. The end product of the RIP is a bit map of zeros and ones that describes where every dot is located. The marking engine to turn the laser on or off to place the dots in position uses this data.

NEWSPAPERS AND PERIODICALS**1105.20**

The sale of newspapers and periodicals is generally subject to tax. (The terms “newspaper” and “periodical” are defined in Regulation 1590, Newspapers and Periodicals.) Printers selling these publications for resale should obtain a timely, valid resale or exemption certificate from their customer. The preferred form of the exemption certificate is provided in Regulation 1590 — Certificate A.

Free Newspapers and Periodicals. Tax does not apply to the sale or use of property which becomes an ingredient or component part of a newspaper or periodical regularly issued at average intervals not exceeding three months when that newspaper or periodical is distributed without charge, nor does tax apply to such distribution. Printers selling such publications should obtain a timely, valid exemption certificate from their customer. The preferred form of the certificate is provided in Regulation 1590 — Certificate B.

Subscriptions. The sale of a newspaper or periodical is not subject to tax if (1) it is sold by subscription; (2) it appears at least four, but not more than 60 times each year; and (3) it is delivered by mail or common carrier. Printers selling these publications for resale should obtain a timely, valid resale or exemption certificate from their customer. The preferred form of the exemption certificate is provided in Regulation 1590 — Certificate A.

Nonprofit Organizations. The sale or distribution of newspapers and periodicals by a nonprofit organization may not be subject to tax.

a. Organizations qualifying for tax-exempt status under Internal Revenue Code Section 501(c)(3) — tax does not apply to the sale or use of a newspaper or other periodical, or its component parts, if either of the following apply:

- Issues of the publication are distributed to the organization’s members in consideration of their membership dues, or
- The publication does not receive revenue from, or accept, commercial advertising.

To qualify for the exemption, the newspaper or periodical must be regularly published, averaging at least four issues a year. Printers selling such publications should obtain a timely, completed exemption certificate from their customer. The preferred form of the certificate is provided in Regulation 1590 — Certificate C.

b. Other nonprofit organizations [organizations not qualifying under IRC Section 501(c)(3)] — tax does not apply to the sale or use of a newspaper or periodical if both of the following conditions are met:

- The publication is distributed to the organizations’ members in consideration of their membership dues, and
- The cost for printing the publication is less than ten percent of the membership fee for the period in which the publication is distributed. (See Regulation 1590(b)(5)(B) for calculating printing costs.)

Printers selling such publications should obtain a timely, completed exemption certificate from their customer. The preferred form of the certificate is provided in Regulation 1590 — Certificate D.

Ingredient or Component Part. Tax does not apply to the sale or use of materials that are physically incorporated into the newspaper or periodical. For example, paper and ink are ingredients of a newspaper; however, a photograph does not become an ingredient or component part of a newspaper or periodical merely because the image of the photograph is reproduced in the publication (see special printing aids below). Fliers, circulars, handbills, order forms, reply envelopes, and similar items are considered component parts when inserted in or attached to a newspaper or periodical. Printers may sell these items for resale even if the purchaser of the printed matter is not the seller of the newspaper or periodical.

Special Printing Aids. Regulation 1541(c)(2)(B)1., “Sales of printed matter to multiple purchasers,” provides that a person is not purchasing special printing aids for resale when title to the special printing aids does not pass to that person’s customer prior to any use. A person does not purchase special printing aids for resale when the printed matter produced with those special printing aids is sold to several purchasers. Consequently, a person purchasing newspapers or periodicals for individual sale cannot purchase special printing aids for resale because the individual purchasers of the newspapers and periodicals are not also purchasing the special printing aids.

Example 1: A furniture store purchases 1 million advertising flyers to be inserted in and sold with a local newspaper. The store may purchase the printed matter for resale because the inserts will be resold with the newspapers. The store may not purchase the special printing aids for resale, however, because the purchasers of the newspapers are not purchasing the special printing aids.

Example 2: A furniture store purchases 1,100,000 advertising flyers — 1 million to be inserted in and sold with a local newspaper, and 100,000 to be delivered to the individual store locations (to give free to walk-in customers). The store may purchase 1 million flyers for resale, but tax applies to the sale to the store of the 100,000 that will be used at the stores.

With respect to the special printing aids, the printer should report tax based on the split sales rule described in Regulation 1541(c)(2)(C). If the printer separately states a charge for the special printing aids in an amount not less than the printer’s cost of the special printing aids or their components, tax applies to that separate charge. In the absence of a separate charge, the taxable portion of the sale of the flyers will be regarded as including the sale of the special printing aids provided that the measure of tax on the flyers is at least equal to the printer’s cost of the special printing aids or their components. If the measure of tax on the sale of the flyers is less than the printer’s cost of the special printing aids or their components, the printer owes tax on the difference.

PRINTED SALES MESSAGES**1105.25**

The application of tax to sales of printed sales messages is governed by Regulation 1541.5, Printed Sales Messages. Printed sales messages are materials printed for the principal purpose of advertising or promoting goods or services. Printed sales messages include brochures, catalogs, circulars, coupon books, letters, and pamphlets, including three-dimensional items such as standees and danglers. In order for sales of printed messages to be exempt from tax, they need to satisfy the following conditions:

1. Printed to the special order or specific request of the purchaser;
2. Mailed or delivered by the seller, the seller's agent or mailing house acting as the agent for the purchaser, through the U.S. Postal Service or by common carrier; and
3. Received by a person who becomes the owner of the printed sales messages at no cost to that person.

If all of the above conditions are not met, tax applies to the charges for the printed sales messages to the same extent as sales of other printed matter. Printed sales messages do not include campaign literature and other fund-raising materials, stationery, sales invoices, containers for sample merchandise, newspapers or periodicals, calendars, notepads, cash register tapes, or directories unless they meet the principal purpose of advertising or promoting goods or services. Printed sales messages also do not include reply envelopes and order forms unless these items are inserted in, stapled, glued, or otherwise affixed to the printed sales messages to become a component or integral part **and** are sold together with the printed sales messages.

Printed sales messages are generally encountered in the audits of printers and publishers. When testing claimed deductions for printed sales messages, auditors need to examine:

1. Sales invoices;
2. Samples of the printed sales messages;
3. Exemption certificates issued for the printed sales message; and
4. Shipping documents (U.S. postal receipts or bills of lading) to determine who received the printed sales messages.
5. Any agency agreement for the purchase of envelopes and other printed matter as described in Regulation 1541.5(b)(10).

If any portion of the printed sales messages is shipped to the California address of the purchaser or delivered to sales representatives of the purchaser, that portion of the selling price of the printed sales messages is includable in gross receipts and subject to tax. (See Exhibit 4 — Printed Sales Messages Flowchart.)

Auditors should review the job/customer folders to examine a sample of the printed material and the exemption certificate issued for that job. When reviewing the sample of the printed sales message, auditors should verify that the printed matter is in fact advertising or promoting a good or service. If the printed material contains both promotional and informational material, more than 50% of the printed material must be promotional in order to be considered a printed sales message. If the promotional material is less than 50%, the printed material will not qualify as a printed sales message even when there is a timely exemption certificate on file that identifies the printed material as a printed sales message. Purchase orders containing the information required on exemption certificates will be considered adequate documentation in place of the exemption certificate. Refer to Regulation 1541.5 for examples of exemption certificates for printed sales messages.

When reviewing the sales invoices, auditors should review the items sold with the printed sales message, since not all items will qualify for the exemption. Auditors should review the delivery receipts to verify that the printed sales messages were delivered by common carrier or by the seller to someone other than the owner of the printed sales messages. The seller should maintain the necessary documentation to support the type of delivery and the destination of the printed sales messages. If necessary, the common carriers can be contacted to verify delivery destinations. Quite often the purchaser directs common carriers to have some of the printed sales messages delivered to its business location for its own use to distribute to its customers. The portion of the charge for printed sales messages diverted to the purchaser is subject to tax.

Agency Relationship — Envelopes & Other Printed Matter. As provided by Regulation 1541.5, the purchaser of printed sales messages may enter into an agency agreement with the seller of printed sales messages to purchase envelopes and other printed matter, generally in bulk, as an agent of the seller of the printed sales messages. In turn, the seller will incorporate the envelopes or other printed matter into the printed sales messages and sell the envelopes or other printed matter with the printed sales messages. The sale by the third-party supplier is a sale for resale to the seller of the printed sales messages. As such, the purchaser, as the agent, should provide the third party supplier with a resale certificate, purchase order, or other such document containing the seller's permit number, the seller's name, and the seller's address. The resale certificate or other such document must also contain a statement that the property is purchased "for resale" and be signed and dated. Unless the resale certificate or other such document is given on behalf of the seller of the printed sales messages, pursuant to the agency agreement, the purchaser of the printed sales messages will be presumed to be acting on its own behalf. In this case, the envelopes or other printed matter will **not** be considered sold with the printed sales messages and the purchase of the envelopes and other printed matter will be subject to tax.

When auditing the books and records of the parties involved, the auditor should verify that the seller and purchaser of the printed sales messages entered into an agreement, prior to the acquisition of the envelopes or other printed matter, that the purchaser would act as an agent of the seller with respect to the purchase of envelopes or other printed matter which become incorporated by the seller into the printed sales messages sold. The inclusion of a statement in a letter of agreement or other such document similar to that provided in Regulation 1541.5(c)(6) will suffice.

Although Regulation 1540 provides a presumption that an advertising agency is acting as an agent of its client unless it elects a non-agent status, the presumption does not apply under the conditions discussed above. If an advertising agency is the purchaser of printed sales messages and enters into an agency agreement with the seller of printed sales messages for the purchase of envelopes or other printed matter that will be sold by the seller along with the printed sales messages, the advertising agency and seller must adhere to the requirements of Regulation 1541.5 for the treatment discussed above to apply.

Note: The purchaser of printed sales messages cannot act as an agent of the seller with respect to the delivery of the printed sales messages. If the printed sales messages are delivered to the purchaser for any purpose, the exemption does not apply.

**SPECIAL REPORTING PROCEDURES
FOR PRINTERS REGARDING SPECIAL PRINTING AIDS**

1106.00

GENERAL

1106.05

Unless a printer includes a statement in the contract or sales invoice retaining title to the special printing aids, the printer shall be regarded as having resold the special printing aids purchased or produced by the printer for use on the customer's job, prior to any use, along with the printed matter. Printers keeping detailed job cost records may use actual basis reporting to calculate their tax liability on purchases and sales of special printing aids. Actual basis reporting traces the specific printing aid from its purchase to its sale.

Note: a printer who will retain title to special printing aids for a particular job should not use a resale certificate when purchasing those special printing aids even if the printer usually purchases all its special printing aids under resale certificates.

PERCENTAGE OF SALES METHOD

1106.10

As an alternative to reporting their tax liability on purchases and sales of special printing aids on an actual basis, printers may use the "percentage of sales method." This method allows printers to determine their tax liability on special printing aid purchases by using a formula that compares sales of printed matter. (See Exhibit 5 for an illustration of the percentage of sales method calculation.) For purposes of the formula, "printed material" includes only those transactions that included the sale of special printing aids. Printed material that did not include the sale of special printing aids should not be included in the calculation (e.g., stock forms, blank envelopes, reprint orders that used an old special printing aid). Printers using this method **must perform the calculations for each reporting period**. Printers cannot use a sales ratio from a prior period for future reporting. See Section 1106.20 for situations when printers must report their tax liability for purchases and sales of special printing aids on an actual basis.

Special Printing Aids (SPA's) Purchased Tax-Paid. Printers purchasing all of their special printing aids tax paid may claim a tax-paid purchases resold deduction for special printing aids that were resold as part of taxable and U.S. Government sales of printed material, and for sales of special printing aids where the special printing aids themselves were actually sold for resale. (See Section 1106.15 for an explanation of when sales of special printing aids qualify as sales for resale.) Using the percentage of sales method, the tax-paid purchases resold deduction would be calculated using the following formula:

$$\frac{\text{Taxable and U.S. Govt sales of printed matter} + \text{resales of printed matter and SPA's}}{\text{Total sales of printed matter}} \times \text{Tax paid purchases of SPA's}$$

Special Printing Aids Purchased Ex-Tax. Printers purchasing all of their special printing aids ex-tax will need to report sales tax on their cost of those special printing aids that were sold as part of nontaxable jobs other than U.S. Government, unless the special printing aids themselves were actually sold for resale. Using the percentage of sales method, the sales of special printing aids subject to sales tax would be calculated using the following formula:

$$\frac{\text{Nontaxable sales of printed matter} - \text{Sales of printed matter to U.S. Govt.} + \text{resales of printed matter and SPA's}}{\text{Total sales of printed matter}} \times \text{SPA's purchased ex-tax}$$

Mixed Purchases of Special Printing Aids. Printers purchasing some of their special printing aids ex-tax and some tax-paid will need to perform additional calculations to determine if they owe sales tax on their sales of special printing aids or are entitled to a tax-paid purchases resold deduction.

Step 1: Calculate as if all the special printing aids were purchased ex-tax:

$$\frac{\text{Nontaxable sales of printed matter} - \left| \begin{array}{l} \text{Sales of printed matter to U.S. Govt.} \\ \text{+ resales of printed matter and SPA's} \end{array} \right|}{\text{Total sales of printed matter}} \times \text{Total purchases of SPA's} = \text{Total special printing aids subject to tax}$$

Step 2: Subtract the amount of tax-paid purchases of special printing aids:

Total special printing aids subject to tax – Tax-paid purchases of special printing aids = Sales of special printing aids to be reported (positive amount) or Tax-paid purchases resold deduction (negative amount*)

* The amount of the tax-paid purchases resold deduction should be claimed on the return as a positive number.

SALES OF SPECIAL PRINTING AIDS FOR RESALE

A person who sells special printing aids along with printed matter does not necessarily sell the special printing aids for resale just because the printed matter is sold for resale. Rather, even when the printed matter is sold for resale, the usual presumption applies that the special printing aids are sold at retail. However, a person purchasing printed matter for resale may also purchase the special printing aids used to produce the printed matter for resale if that person will, in fact, resell the special printing aids prior to any use. The most common example is a print broker who purchases both printed matter and special printing aids for resale to its client. In such circumstances, tax then applies to that person’s sale of the special printing aids unless that person’s sale of the special printing aids is for resale. Except for situations where the seller of the printed matter is the printer or print broker, it would be unusual for the purchaser to be purchasing special printing aids for resale.

As explained in Regulation 1541(c)(2)(B), a printer is regarded as selling special printing aids for resale only where:

1. The printer separately states the sale price of the special printing aids in an amount not less than the sale price of the special printing aids, or their components, to the printer; and
2. The printer accepts a timely resale certificate from the printer’s customer stating that the special printing aids are purchased for resale.

As explained in Regulation 1541(c)(2)(B)1., a purchaser of printed matter is never regarded as purchasing special printing aids for resale along with the printed matter when the printed matter will be sold to multiple purchasers (e.g., sales of newspapers or printed boxes as containers for products). As explained in Regulation 1541(c)(2)(B)2., a purchaser of printed matter is never regarded as purchasing special printing aids for resale if that person’s contract for the sale of the printed matter is not in existence prior to the printer’s use of the special printing aids. As previously mentioned, unless the purchaser of the special printing aids is a printer or a print broker for that transaction, the special printing aids are not being purchased for resale.

WHEN THE PERCENTAGE OF SALES METHOD MAY NOT BE USED**1106.20**

The percentage of sales method calculates taxable measure for the purchase and sales of special printing aids based on the cost of the special printing aids, and therefore may not be used by print brokers since print brokers are regarded as selling special printing aids at retail and are generally liable for sales tax on the separately stated price of the special printing aids, assuming that the stated price is greater than the cost of the special printing aids to the print broker.

The percentage of sales method works on the assumption that the relationship between the printed matter sales price and the special printing aid cost is essentially a consistent relationship between the cost and selling price for all the printer's transactions. For example, if the cost of special printing aids for the printer represents 5–10% of sales, without regard to whether the sale is taxable or not, a customer whose transactions had a higher ratio may not be consistent. The auditor will need to determine which customers, if any, do not have a consistent relationship for purposes of applying the percentage of sales method.

If a customer is not similar to other customers as to printing aid purchases, the sales and purchases related to that customer should be pulled out of the percentage of sales method calculation and handled on an actual basis. If an auditor discovers such a customer has not been pulled out of the calculation, the auditor should treat the matter on a prospective basis. This means that the auditor should not pull out the customer and recalculate the percentage in the audit. However, for reporting periods subsequent to the audit report, the customer should be removed from the calculation. The auditor should make specific audit comments in the audit working papers to provide the taxpayer written notice that sales to that customer should be handled on an actual basis.

VERIFICATION PROCEDURES**1106.25**

If a printer uses the percentage of sales method to report its tax liability with respect to special printing aids, the auditor will audit the printer using the same method. As explained below, the auditor will audit the components of the formula in order to verify that tax has been reported correctly.

Sales of Printed Matter. The auditor should verify that the amounts included in the numerator of the formula do not include sales where a special printing aid was not sold. The auditor must also verify that the taxpayer correctly segregated sales of printed matter into taxable sales, U.S. Government sales, sales of printed matter for resale where the special printing aids are also resold, and other nontaxable sales of printed matter. In particular, the auditor should verify that sales of printed matter for resale where the special printing aids are also resold (see Section 1106.15) are correctly segregated from other sales of printed matter for resale. Other sales for resale, sales delivered out of state, exempt sales of printed sales messages, exempt sales of containers and labels, and exempt sales of newspapers are all considered "other nontaxable sales." That is, this category includes any nontaxable sale of printed matter except: 1) sales to the U.S.; and 2) sales of printed matter for resale where the special printing aids are, in fact, also sold for resale.

Total Sales. The auditor should include in the denominator of the formula all sales (taxable and nontaxable) of printed matter that were sold along with the special printing aids. Special attention should be taken to not include any sales where a special printing aid was not also sold.

Purchases of Special Printing Aids. The auditor should verify that the amount used for purchases represents the tax-paid or ex-tax status used in the formula. In other words, if the taxpayer represents that all special printing aids are purchased tax paid, the auditor should test to verify that assertion is true. If the taxpayer purchases special printing aids ex-tax and tax-paid, the auditor should verify that purchases are properly segregated.

Verifying Sales of Printing Aids for Resale. In verifying special printing aids for resale, the auditor must first examine the contract of sale (the written documentation of which may consist solely of the sales invoice). The contract of sale must have a separately stated sales price for the special printing aid and that price must be at least as much as or greater than the sales price of the special printing aids (or, when self-manufactured, the cost of the components) to the printer.

Once the auditor has determined that the printer has made a separate statement for the sale of the special printing aids, he or she must determine whether the printer has taken a timely and valid resale certificate. The term "special printing aids" on a resale certificate shall be sufficient to cover all special printing aids.

If the printer has a valid resale certificate on hand for both printed material and special printing aids, the auditor should accept the certificate unless good faith acceptance is questioned.

Good faith acceptance of a resale certificate for a special printing aid depends upon the appearance of two factors:

1. Does the customer of the person issuing the resale certificate obtain the right to exercise dominion and control over the special printing aid? and
2. Does the person issuing the resale certificate have an existing obligation to sell the special printing aid to the customer when the certificate is issued?

If the printer has no reason to question whether the answer to both of these questions is yes, then the resale certificate can be accepted in good faith. For example, if the printer knows that the purchaser will be reselling the printed matter to multiple purchasers, then the resale certificate is not accepted in good faith.

When it is necessary to determine whether an existing obligation was present at the time of use, the auditor should examine the relative purchase order, invoice, or other existing agreement. If the existing obligation is an oral agreement, the person purchasing the special printing aids for resale must have some means to establish that the agreement was in existence no later than the time the special printing aids were used in the printing process. Note that this inquiry will most commonly be required in the audit of the purchaser who issued the resale certificate, not in the audit of the printer who accepted that certificate, unless the auditor has first determined that the printer did not accept the certificate in good faith.

GLOSSARY OF TERMS**1107.00**

ADVERTISING. Advertising is commercial communication utilizing one or more forms of media (such as television, print, billboards, or the Internet) from or on behalf of an identified person to an intended target audience.

ADVERTISING AGENCIES. Advertising agencies design and implement advertising campaigns for purposes of advertising the goods, services, or ideas of their clients. As part of that primary function, advertising agencies provide their clients with services (such as consultation, consumer research, media planning and placement, public relations, and other marketing activities), and may also provide tangible personal property (such as print advertisements, finished art, and video and audio productions).

CLIP ART. Clip art is prepackaged art (including photographic images) which is not produced to the special order of the customer and which is commercially available on CD, other electronic media, or by computer program for use in digital page layout. Images that are enlarged, reduced, or rotated are not considered “produced to the special order of the customer.”

COLOR SEPARATOR. A color separator is a person who engages in the process of color separation. The process of color separation divides a full color photographic image into four separate components, corresponding to the four primary colors used in process color printing. The color separator may accomplish this photographically or electronically, and the products of this process may be either a negative or positive film separation or a separated printing plate.

COLOR SEPARATION WORKING PRODUCTS. Color separation working products consist of property such as photographic film for making transparencies, masks, internegatives, interpositives, halftone negatives, composite color separation negatives, goldenrod paper and mylar plastic used in making flats, tape used in stripping negatives into flats, developing chemicals which become a component part of negatives and positives, proofing material and ink used in making final proofs, progressive proofs, and similar items, which are similar in function to special printing aids.

COMMERCIAL ARTISTS. Commercial artists, who may characterize themselves as commercial artists, commercial photographers, or designers, provide services and tangible personal property to their clients for use in their clients’ advertising campaigns, or for their clients’ other commercial endeavors such as sales of copies of finished art (e.g., photographic images) provided by a commercial artist. Services they provide to their clients include the creation and development of ideas, concepts, looks, or messages. Electronic artwork they provide may be transferred through remote telecommunications such as by modem or over the Internet, or by tangible means through electronic media such as CD. Tangible personal property they provide may include electronic media on which electronic artwork is transferred to the client, hard copies of the electronic artwork, and hard copies of finished art (which may consist of photographic images).

COMPREHENSIVE (COMP). Ideas presented as preliminary art to demonstrate concepts in the initial phase of art design.

CONTRACT OF SALE. An agreement to transfer tangible personal property for consideration is a contract of sale. The client may, for example, issue a purchase order for the purchase of tangible personal property. The contract of sale for that tangible personal property consists of the terms of the purchase order together with the relevant terms of the master agreement.

CREATIVE ART SERVICES. Creative art services are services performed by persons such as advertising agencies and commercial artists to convey ideas, concepts, looks, or messages in connection with the production, distribution, or exploitation of a “qualified motion picture,” as defined in Regulation 1529(b)(1)(A). Creative art services do not include services for the preparation of finished art for use in reproduction by photomechanical processes.

DANGLERS. Printed advertising similar to standees (see below), except they are not generally three-dimensional and hang on a string instead of standing upright.

DESIGNER. A designer plans and prepares a general layout of typographical and illustrative elements for printed literature.

DIGITAL PRE-PRESS INSTRUCTION. Digital pre-press instruction is the creation of original information in electronic form by combining more than one computer program into specific instructions or information necessary to prepare and link files for electronic transmission for output to film, plate, or direct to press, which is then transferred on electronic media such as tape or CD.

DIRECT LABOR. Direct labor includes the charge for any labor to create tangible personal property sold by an advertising agency or commercial artist, whether the advertising agency or commercial artist performs the labor itself as a sole proprietor or pays someone else to perform the labor, such as an employee or sub-contractor. Direct labor does not include travel expenses for such items as airfare, hotels, rental cars, and meals. (See “Labor” for technology transfer agreements.)

ELECTRONIC ARTWORK. Electronic artwork is artwork created through the use of computer hardware and software processes which results in artwork in a digital format that can be transmitted to others via electronic means (that is, transmitted through remote telecommunications such as by modem or over the Internet, or by electronic media such as CD). Elements of the process include the creation of original artwork or photographic images, scanning of artwork or photographic images, composition and design of text, insertion and manipulation of scanned and original electronic artwork, photographic images, and text. Electronic artwork does not include artwork that is transferred to clients in a tangible form, other than on electronic media, even where such artwork may have been manufactured or produced in whole or in part by computer hardware and software processes.

FINISHED ART. Finished art is the final artwork used for actual reproduction by photomechanical or other processes, or used for display. It includes electronic artwork, illustrations (e.g. drawings, diagrams, halftones, or color images), photographic images, sculptures, paintings, and handlettering. Blueprints, diagrams, and instructions for signage furnished to a client as the result of environmental graphic design services are not finished art.

HARD COPIES. An item is transferred on hard copy when it is transferred on any tangible personal property other than in digital format on electronic media. For example, finished art transferred on canvas or paper is transferred on hard copy while a transfer of finished art solely in digital format on a CD is not regarded as a transfer on hard copy.

ILLUSTRATOR. An illustrator creates an illustration, which is an original artwork (including cartoons and comic strips) licensed for the purpose of publication.

INTERMEDIATE PRODUCTION AIDS. Intermediate production aids include items such as artwork, illustrations, photograph images, photo engravings, and other similar materials which are used to produce special printing aids or finished art.

LABOR. For purpose of determining the cost of labor for the calculation of the measure of tax on the sale of tangible personal property as part of a qualifying technology transfer agreement, “labor” means any charges for labor used to create such tangible personal property where the advertising agency or commercial artist purchases such labor from a third party, or the work is performed by an employee or the advertising agency or commercial artist.

The difference for purposes of determining the value of “labor” under Regulation 1540(b)(2)(D)2.c. for sales of tangible personal property with qualifying technology transfer agreements and “direct labor” for other sales of tangible personal property covered by Regulation 1540(b)(3) is that in the former, the value of a sole proprietor’s **own** labor is excluded from the calculation (for technology transfer agreements) while the value of a sole proprietor’s own labor is **included** in the calculation for other sales of tangible personal property. If the seller is not a sole proprietor, this distinction is inapplicable.

MAILING HOUSE. A business providing the services of stamping, addressing, sealing, or otherwise preparing property for mailing for compensation.

MASTER AGREEMENT. A master agreement is a contract, however characterized (such as “agency-client agreement”), entered into between an advertising agency or commercial artist and its client which specifies the obligations of each party to the master agreement with respect to their relationship, whether for a specified time or advertising campaign or until one of the parties terminates the agreement. A master agreement between an advertising agency and its client may specify the obligations of each with respect to the design of an advertising campaign for the client, the placement of the advertising with print and television media, and for the sale and purchase of tangible personal property related to the advertising campaign. There may then be additional terms for the purchase of specific tangible personal property during the advertising campaign, such as in a purchase order, which identifies the specific property that will be purchased and sold and the sales price for that property.

MECHANICAL OR PASTE-UP. A mechanical or paste-up (also called camera-ready art or camera-ready copy) is produced by preparing copy to make it camera-ready with all type and design elements, and then pasting the prepared copy on artboard or illustration board in exact position along with instructions, either in the margins or on an overlay, for the platemaker. This technology has been generally replaced with computerized layout processes.

MEDIA COMMISSIONS. Compensation for the placement of advertising.

PHOTO ENGRAVINGS. The process of preparing letterpress plates from illustrations.

PHOTOGRAPHER. A photographer creates an original photographic image through the use of a camera or similar device.

PHOTOSTAT. A photostat (also called a “stat”) is a copy produced by photographic means, often used in layout, dummy work, or “for position only” on camera-ready art.

PRELIMINARY ART. Preliminary art is tangible personal property which is prepared 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 provided neither title to, nor permanent possession of, such tangible personal property passes to the client. Examples of preliminary art include roughs, visualizations, layouts, comprehensives, and instant photos.

PRELIMINARY PRODUCTION AIDS. Aids used in the production of preliminary art.

PRINT BROKER. A print broker is a person who contracts to sell printed matter, but who does not actually engage in the printing process to produce the printed matter to be sold, instead purchasing the printed matter from a printer or from another print broker for resale to the print broker's customer. A person who sells printed matter for which that person did not engage in the printing process is acting as a print broker even if that person engages in the print process for other contracts.

PRINTER. A printer is a person engaged in the printing process.

PRINTING PROCESS. The printing process involves activities related to the production of printed matter such as letterpress, flexography, gravure, offset lithography, reprography, screen printing, steel-die engraving, thermography, laser printing, inkjet printing, and photocopying.

PRODUCTION FUNCTION. A production function is a segment of the process of producing camera-ready art or camera-ready copy, and includes the following:

- a. Alterations, which are changes made to typeset copy or camera-ready copy.
- b. Dummy, which is a mock-up or layout of a page showing position and overall form, used for approval. A dummy can be assembled manually or generated by a computer program. A dummy is never physically incorporated into a mechanical or paste-up.
- c. Formatting, which is a manuscript markup, when done electronically.
- d. Manuscript markup, which is the application of type specifications to a manuscript for typesetting, when done manually.
- e. Mechanical or paste-up (also called camera-ready art or camera-ready copy), which is produced by preparing copy to make it camera-ready with all type and design elements, and then pasting the prepared copy on artboard or illustration board in exact position along with instructions, either in the margins or on an overlay, for the platemaker.
- f. Production Coordination, Traffic Coordination, or Production Direction, which is the coordination and scheduling of the various components of a project.
- g. Production Editing, which is editing that maintains editorial integrity of the author's work during the production process.
- h. Proofreading, which is a reading of typeset copy for correctness in comparison with the original manuscript.
- i. Typesetting, typography, or composition, which is the fabrication or production of composed type, or reproduction proofs thereof, for use in the preparation of printed matter. Typesetting, typography, or composition does not include the fabrication or production of a paste-up, mechanical, or assembly of which a reproduction proof is a component part.

PUBLISHER. A publisher owns, outright or by license, the rights to reproduce, market, and distribute printed literature.

REPRODUCTION PROOF. A reproduction proof is used exclusively for reproduction. It consists of either a direct impression of composed type forms containing type matter only or type matter combined with clip art, or a copy of that direct impression made by any method, including the diffusion transfer method.

SCANNING. Scanning is the process using a computer and a computer peripheral (a scanner) whereby a hardcopy of artwork, such as a photograph or illustration, or other hardcopy, is digitized into computer-readable format which can then be manipulated, if necessary or desirable, by computer software.

SPECIAL PRINTING AIDS. Special printing aids are reusable manufacturing aids which are used by a printer during the printing process and are of unique utility to a particular client or customer. Special printing aids include electrotypes, stereotypes, photoengravings, silk screens, steel dies, cutting dies, lithographic plates, film, single color or multicolor separation negatives, and flats. For purposes of Regulation 1541, special printing aids includes items defined as intermediate production aids.

SPLIT SALES. A split sale is when a printer or print broker sells printed matter along with the retail sale of a special printing aid (or aids) used to produce that printed matter where the sale of a portion of the printed matter is subject to tax and the sale of a portion is exempt or otherwise nontaxable. Sales to the United States are never split sales; the sale of the printed matter as well as the sale of the special printing aids is entirely exempt from tax.

STOCK SHOT HOUSES. A business that maintains a library of photographs for sale or lease. The photographs may be owned by the stock shot house, or the photographs may be owned by others (e.g., photographers) and marketed on the owners' behalf by the stock shot house.

STANDEES. Printed advertising that is freestanding and three-dimensional. Often used as cut-outs to promote movies by being displayed movie theater lobbies.

TANGIBLE FORM. Tangible form means in the form of tangible personal property.

TRANSPARENCIES. Transparent positive film that is used as the basis for creating color separations or other types of film used in the printing process.

WEBSITE DESIGN. The design, editing, or hosting of an electronic website.

Table of Exhibits

Special Printing Aid Examples	Exhibit 1
Printer's Sales of Special Printing Aids (SPA's) Flowchart	Exhibit 2
XYZ Forms for Special Printing Aids	Exhibit 3
Printed Sales Messages Flowchart – Regulation 1541.5	Exhibit 4
Percentage of Sales Method Example	Exhibit 5

SPECIAL PRINTING AID EXAMPLES

EXAMPLE 1. Printer makes a taxable sale of printed matter and bills in lump-sum.

A California printer contracts to design and print flyers for a customer. The contract is silent with respect to ownership of special printing aids. The printer hires a commercial artist to design a character and then produce it as an illustration for the flyer. The commercial artist sells and transfers the final art to the printer, but retains title to and permanent possession of any preliminary art. The printer issues a resale certificate to the commercial artist, and the commercial artist bills a lump-sum charge of \$1,000 for the conceptual services and the illustration.

The printer contracts with a color separator and furnishes a resale certificate. The printer scans the illustration into its computer and creates finished art for use by the color separator, who provides the color separation for \$2,000. The printer prints the flyers and invoices the customer as follows:

Printing Today!	Invoice : 9876
Design and print 100,000 flyers	\$10,000.00
Tax on \$10,000 @ 7.75%	<u>775.00</u>
Total	<u>\$10,775.00</u>

Analysis of Transaction.

This is a taxable sale and the printer’s entire charge is subject to tax. Since the printer owns final art (illustration) and the printer’s contract did not retain title to the special printing aids (illustration and color separation), the printer is the retailer of them. Thus, the printer properly purchased them for resale. The printer’s lump sum charge includes the sale of the flyers and the sale of the special printing aids. Since that charge is fully taxable and includes the charge for the special printing aids, no further tax is due with respect to them.

Note: The analysis would be different if the artist gave the printer only temporary possession of the final artwork. A temporary transfer constitutes a lease to the printer. The printer generally could not sub-lease artwork to the customer. Consequently, the printer could not issue a resale certificate to the artist and would be required to pay sales or use tax on the value of the transferred final artwork. Since the sale from the artist to the printer qualifies as a technology transfer agreement, the value of the final artwork would need to be determined using the criteria detailed in Section 1103.40.

EXAMPLE 2. Printer makes an exempt sale of printed matter in interstate commerce and bills in lump-sum.

Same facts as Example 1, except the printer delivers the flyers out of state pursuant to the contract of sale, and invoices the customer as follows:

Printing Today!	Invoice : 9877
Design and print 100,000 flyers	\$10,000.00
Tax (shipped out of state - no tax)	0.00
Total	\$10,000.00

Analysis of Transaction.

Since the printer’s contract did not retain title to the special printing aids, the printer is the retailer of them, and the printer’s retail sale of those special printing aids occurs in California prior to the printer’s use (without regard to whether the special printing aids may, thereafter, be shipped outside the state). Thus, the printer’s charge for the special printing aids is taxable, but the printer’s charge for the flyers is not taxable since the sale of the flyers is an exempt sale in interstate commerce. The printer’s taxable retail selling price of the special printing aids is the printer’s cost.

The \$1,000 charged by the commercial artist is for conceptual services and tangible personal property (the illustration). The charge for the conceptual services is not taxable. Since the charge is in lump sum and assuming the transaction is not a technology transfer agreement, the 75/25 presumption of Regulation 1540(b)(2)(C)2. applies. Since the printer has no information with respect to a higher or lower figure, the printer’s cost for the tangible personal property is presumed to be \$250 (\$1,000 x 25%). The printer’s cost for the color separation is \$2,000, so the printer’s total cost for special printing aids is \$2,250, which is the printer’s measure of tax on its sale of the special printing aids.

The tax owed by the printer on \$2,250 is sales tax. The invoice is thus okay as is, or the printer could have collected tax reimbursement on the \$2,250 if permitted by the contract of sale. In either event, the printer must report and pay sales tax on the \$2,250.

In contrast, if the transfer of the final artwork from the artist to the printer qualifies as a technology transfer agreement, valuation of the taxable cost of the final artwork would need to be calculated as detailed in Section 1103.40.

EXAMPLE 3. Printer makes an exempt sale of printed matter in interstate commerce and separately itemizes charges for special printing aids.

Same facts as Example 2 except that the printer separately itemizes charges for the special printing aids (the illustration and the color separation). The printer invoices the customer as follows:

Printing Today!	Invoice : 9878
Design and print 100,000 flyers	
Printing	\$6,100.00
Illustration	1,300.00
Color Separation	2,600.00
Tax (shipped out of state - no tax)	0.00
Total	\$10,000.00

Analysis of Transaction

As in the previous example, the printer is making an exempt sale of the flyers and a taxable retail sale of the special printing aids. Although the printer itemized a marked up charge for the special printing aids, under Regulation 1541(c)(2)(A)2. the printer’s taxable selling price is the printer’s cost of the special printing aids. That is, the application of tax is the same as the lump sum billing in the previous example, meaning that the printer owes sales tax measured by the printer’s \$2,250 cost of the special printing aids as explained in the previous example.

As noted in the previous example, if the sale of the illustration qualifies as a technology transfer agreement, the final art would be valued using the criteria in Section 1103.40.

EXAMPLE 4. Printer sells printed matter to an advertising agency as agent for its client and separately itemizes charges.

Same facts as in Example 1 except that the printer separately itemizes charges for special printing aids, and the purchaser is an advertising agency who does not issue a resale certificate to the printer. The printer invoices the advertising agency as follows:

Printing Today!	Invoice : 9879
Design and print 100,000 flyers	
Printing	\$6,100.00
Illustration	1,300.00
Color Separation	2,600.00
Tax on \$9,025* @ 7.75%	699.44
Total	\$10,699.44

*Consists of printing, color separation and taxable artwork (illustration \$1,300 x 25%)

Analysis of Transaction

An advertising agency is presumed to act as the agent of its client. Since the advertising agency did not issue a resale certificate to the printer, under Regulation 1540(c)(1)(A) the printer is presumed to have made a retail sale. To overcome that presumption the printer would have to establish that the advertising agency elected non-agent status under Regulation 1540(c)(2)(A) and -resold the property or that the advertising agency resold the property as the retailer under Regulation 1540(c)(2)(B) or (c)(2)(C). Since the printer has no information to overcome the presumption, the printer properly treated the sale as subject to tax.

The illustration is finished art; however, artwork (e.g., finished art) is regarded as an intermediate production aid under Regulation 1541(a)(6) which in turn is regarded as a special printing aid under Regulation 1541(a)(12). The basic rule under Regulation 1541(c)(2)(A)3. is that when a printer makes a retail sale of a special printing aid (such as the illustration) along with a taxable retail sale of printed matter, the entire charge is taxable, without regard to itemization. Under this basic rule, the measure of tax in this example would be the entire charge of \$10,000. However, Regulation 1541(d) explains when the printer can deduct a portion of its charge for nontaxable conceptual services.

As applicable to this example, Regulation 1541(d)(3) provides that when a printer separately itemizes a charge for finished art that also includes a charge for conceptual services, it is rebuttably presumed that 75 percent of that charge is for nontaxable conceptual services. On the other hand, Regulation 1541(d)(3) also provides that there will be no deduction for conceptual services, and the entire charge will be taxable, if the printer itemizes the charge as a “special printing aid”.

Note: Regulation 1541(d) applies **only** when the sale of the printed matter is taxable. To the extent there may be any inconsistency, this specific provision is controlling over the general rule of Regulation 1541(c)(2)(A)3.

The printer here separately itemized a charge of \$1,300 for the illustration. This qualifies as an itemized charge for finished art, and it includes the conceptual services performed by the commercial artist. Thus, it is presumed that 75% of the charge, or \$975, is for nontaxable conceptual services. The remainder of the printer’s charge for the illustration (\$325) and all other charges (\$6,100 for the flyers and \$2,600 for the color separation) are taxable for a total taxable measure of \$9,025.

Note: As in Example 1, the analysis would be different if the artist gave the printer only temporary possession of the final artwork. A temporary transfer constitutes a lease to the printer. The printer generally could not sub-lease artwork to the customer. Consequently, the printer could not issue a resale certificate to the artist and would be required to pay sales or use tax on the value of the transferred final artwork. Since the sale from the artist to the printer qualifies as a technology transfer agreement, the value of the final artwork would need to be determined using the criteria detailed in Section 1103.40.

EXAMPLE 5. Printer sells printed matter to an advertising agency for resale, and separately itemizes charges.

Same facts as Example 4 except that the advertising agency furnishes a resale certificate to the printer for the printed matter only. The printer invoices the advertising agency as follows:

Printing Today!	Invoice : 9880
Design and print 100,000 flyers	
Printing	\$6,100.00
Illustration	1,300.00
Color Separation	2,600.00
Tax (resale - no tax)	0.00
Total	\$10,000.00

Analysis of Transaction

Since the resale certificate is for the printed matter and not the special printing aids, the printer is responsible for tax on the selling price of the special printing aids. Under Regulation 1541(c)(2)(A)2, the printer’s taxable selling price of the special printing aids (the illustration and the color separation) is deemed to be the printer’s cost, without regard to whether the printer separately itemizes a separate charge. As explained in Example 2, the cost to the printer for the special printing aids is \$2,250, and this is the measure of tax owed by the printer.

Note: As noted in Example 2, if the transfer of the final artwork from the artist to the printer qualifies as a technology transfer agreement, valuation of the taxable cost of the final artwork would need to be calculated as detailed in Section 1103.40.

EXAMPLE 6. Print broker makes a taxable sale of printed matter and bills in lump-sum.

A print broker contracts to design and print flyers for a customer. The print broker hires a commercial artist to design a character and then produce it as an illustration for the flyer and issues a resale certificate. The print broker hires a California printer to do the remaining preliminary work and print the flyers, and issues a resale certificate for the flyers only (not for the special printing aids).

The commercial artist mails the illustration to the printer as instructed, retaining title to and permanent possession of any preliminary art, and bills the print broker a lump-sum charge of \$1,000. The printer contracts with a color separator and furnishes a resale certificate. The printer scans the illustration into its computer and creates finished art for use by the color separator, who provides the color separation for \$2,000. The printer prints the flyers and invoices the print broker a lump-sum charge of \$8,700. The print broker in turn invoices its customer as follows:

Printing Today!	Invoice : 9881
Design and print 100,000 flyers	\$11,000.00
Tax on \$11,000 @ 7.75%	852.50
Total	<u>\$11,852.50</u>

Analysis of the Transaction

This is a taxable sale and the entire amount is subject to tax. Note: The print broker has no tax liability for the color separation because it did not give a resale certificate to the printer for special printing aids. Even though the broker made a taxable sale, the printer still has a tax liability for the color separation measured by its cost of \$2,000. In order for the printer to shift the tax liability for the special printing aids to the print broker, the printer must have a timely, valid resale certificate for the special printing aids AND separately state the charge for the special printing aids on the customer's invoice.

EXAMPLE 7. Print broker makes an exempt sale of printed matter in interstate commerce and bills in lump sum.

Same facts as Example 6, except the flyers are shipped out of state pursuant to the contract of sale. The print broker invoices its customer as follows:

Printing Today!	Invoice : 9882
Design and print 100,000 flyers	\$11,000.00
Tax (shipped out of state - no tax)	0.00
Total	<u>\$10,000.00</u>

Analysis of the Transaction

The sale of the flyers is an exempt sale in interstate commerce; therefore, there is no tax due on the sale of the flyers. Since the print broker did not furnish a resale certificate to the printer and the printer did not separately itemize its charge for the special printing aid, the print broker does not have any tax liability with respect to the special printing aid (the color separation) acquired by the printer.

The print broker is the retailer of the illustration the print broker acquired from the commercial artist. The print broker owes tax on its selling price of the illustration, which is deemed to be its cost. Since the charge by the commercial artist was a lump sum charge for the illustration and conceptual services, the 75/25 presumption of Regulation 1540(b)(2)(C)2. applies, and since the print broker has no information with respect to a higher or lower figure, the print broker's cost for the tangible personal property is presumed to be \$250 (\$1,000 x 25%).

EXAMPLE 8. Print broker receives resale certificate for printed matter, and issues resale certificate for printed matter and special printing aids.

Same facts as Example 6 except: 1) the print broker issues a resale certificate to the printer for the printed matter and for the special printing aid; 2) the printer separately itemizes its charges, invoicing the print broker \$6,100 for the flyers and \$2,300 for the color separation; and 3) the print broker's customer issues the print broker a resale certificate for the flyers but not for the special printing aids. The print broker invoices its customer as follows:

Printing Today!	Invoice : 9883
Design and print 100,000 flyers	
Printing	\$7,100.00
Illustration	1,300.00
Color Separation	2,600.00
Tax \$3,900* @ 7.75%	226.69
Total	\$11,226.69

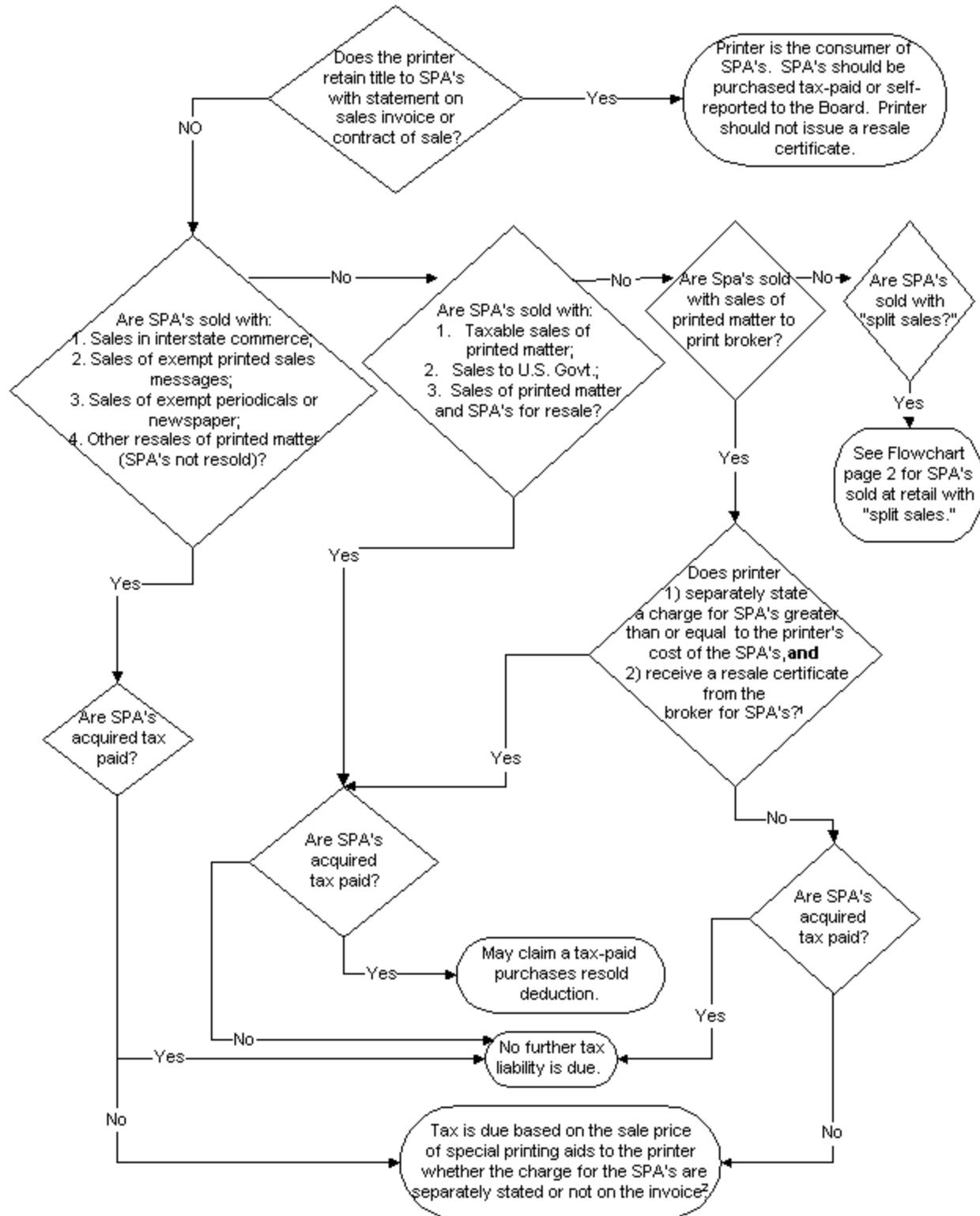
*Consists of color separation and illustration

Analysis of the Transaction

The printer's sale of the printed matter is a nontaxable sale for resale. Since the print broker issued the printer a resale certificate for the special printing aid (the color separation) and the printer separately itemized a charge for it, the printer's sale of the special printing aid is also for resale. Thus, the printer has no tax liability on the sale.

The print broker's sale of the flyers is a nontaxable sale for resale. The print broker's sale of the special printing aids (the illustration and the color separation) is a taxable retail sale. Unlike printers, print brokers owe tax based on their separately itemized charge for special printing aids. (Regulation 1541(c)(3)(C)2.) The measure of tax here is the print broker's separately stated selling price of \$3,900 for the special printing aids (\$1,300 + \$2,600).

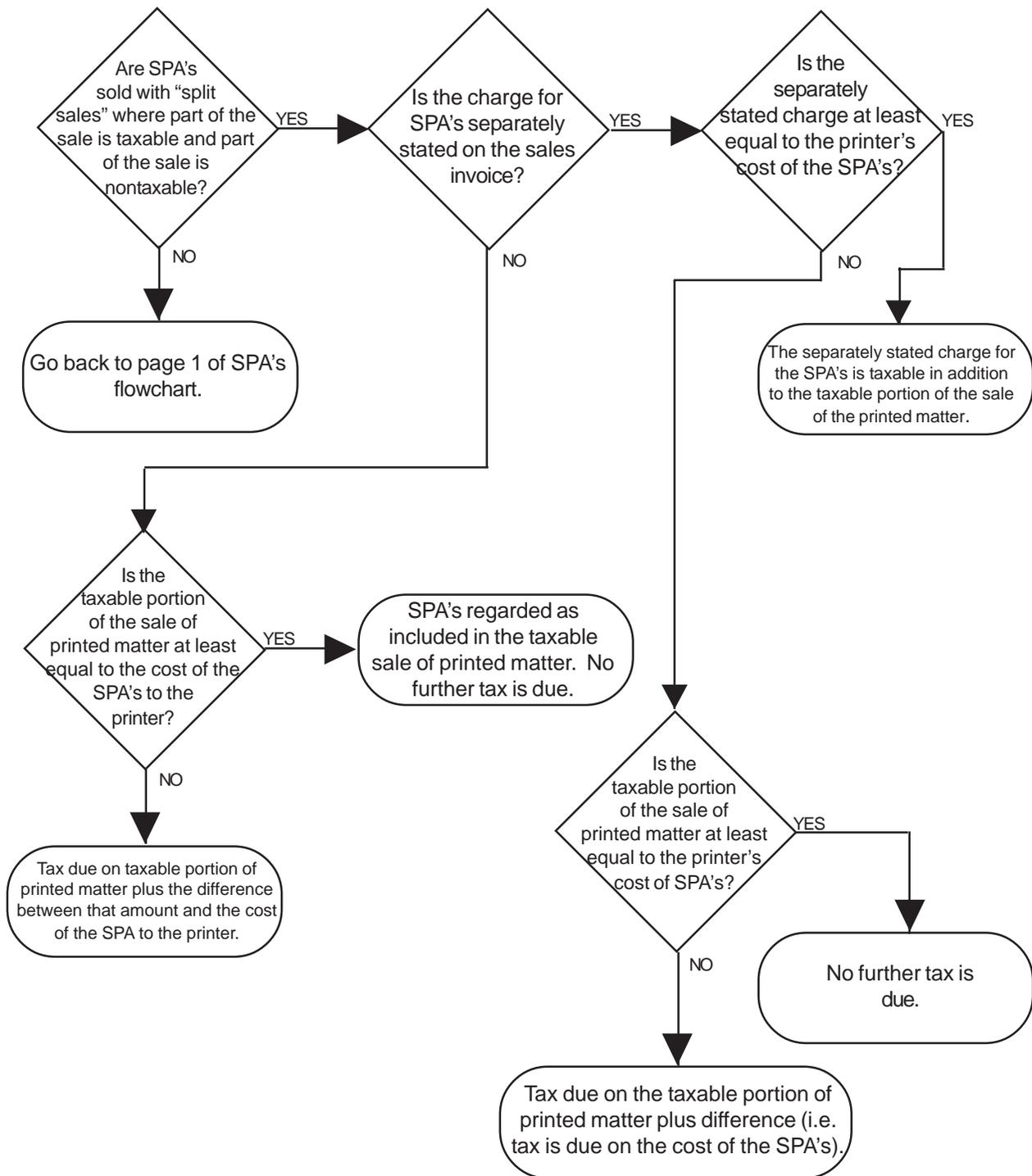
PRINTER'S SALES OF SPECIAL PRINTING AIDS (SPA'S) FLOWCHART



¹ If the charge for SPA's is separately stated in an amount at least equal to the printer's cost but a valid resale certificate is not on file, an XYZ form (BOE-504-CPA) may be used to verify that the sale of the SPA was for resale.

² If the printer has collected tax reimbursement on the separately stated price that is an amount greater than the printer's cost, the printer has collected excess tax reimbursement and must either refund it back to the customer or pay it to the Board.

SPA's Sold at Retail in "Split Sales"



XYZ FORMS FOR SPECIAL PRINTING AIDS

EXHIBIT 3

PAGE 1 OF 2

BOE-504-BPA (11-02)

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

SAMPLE LETTER FOR SPECIAL PRINTING AIDS
Requesting Purchaser's Statement

XYZ Company
1234 5th Street
Los Angeles, California 90013

The California State Board of Equalization is currently examining our records for compliance with the California Sales and Use Tax Law. They have questioned certain nontaxed sales of special printing aids made to you as indicated on the invoices listed on the attached sheet. These nontaxed sales are not supported by a valid resale certificate.

Please indicate the disposition of these special printing aids by placing the applicable letter in the corresponding response column for each invoice listed.

Unless printers specifically state that they are retaining title to the special printing aids on their customer's contract or sales invoice, printers are considered the retailers of the special printing aids and may purchase special printing aids for resale. However, special printing aids are considered purchased for the purchaser's own use and not for resale if the purchaser:

- Only resells printed material and not special printing aids. For example, book/newspaper publishers or manufacturers purchasing product labels or packaging for resale with the product. The printed material is resold, but the publisher or manufacturer is the end user of the special printing aids
- Buys the printed matter for their own use
- Is a print broker who resells the printed material but maintains ownership of the special printing aids

Your prompt response is necessary to support any claims for exemption. The board will **not** accept the statement if it is not filled out completely and signed by an authorized representative. Please return the inquiry statement within 10 days using the enclosed envelope or fax to (_____) _____.

Sincerely,

Encl:

BOE-504-CPA REV. 2 (11-02)

**STATEMENT CONCERNING PROPERTY PURCHASED
WITHOUT PAYMENT OF CALIFORNIA SALES TAX – SPECIAL PRINTING AIDS**

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

DMA _____
Auditor's Initials _____

Please complete this inquiry statement to indicate the disposition of certain non-taxed purchases you made from the seller listed below. Please fill out the form completely and sign as your company's authorized representative. The form should be returned within 10 days.

NAME OF SELLER FROM WHOM YOU PURCHASED ITEMS WITHOUT SALES TAX	SELLER'S PERMIT NO.
--	---------------------

DATE	INVOICE NUMBER	PURCHASE ORDER NUMBER	AMOUNT	DESCRIPTION	RESPONSE <i>List boxes (a) through (i) that apply</i>

Please check the appropriate boxes below and list in Response area above. If none of these apply, please explain in Comments below.

Note: Manufacturers purchasing product labels or packaging for resale with a product are considered end users of special printing aids and should select either D or E even though the printed material is resold. (See the cover letter accompanying this form for more information.)

- A. A special printing aid **was purchased for resale** and resold in a sale subject to California tax.
- B. The special printing aid **was purchased for resale** and resold to the US government.
- C. The special printing aid **was purchased for resale** and sold with a nontaxable sale of printed material other than US Government (ie. Interstate commerce, newspaper, printed sales message). **Our sale of the special printing aids was:**
 - C1. a sale for resale. We separately stated the sale price of the special printing aids and obtained a resale certificate for the special printing aids from our customer. The separately stated sales price was at least the amount of the sales price we paid for the special printing aids of their components.
 - C2. subject to tax. Tax was paid to the Board with our sales tax return. *Indicate amount of tax and period reported under Response above.*
 - C3. subject to tax. Tax was paid to the Board as a result of an audit that included the above purchases either on an actual basis or as a result of a percentage of error based upon a test. The purchases sampled in the audit were similar in nature to the above transaction, we believe tax on the above transaction has been paid to the Board as a result of the audit. *Indicate amount of tax and audit period under Response above.*
 - C4. subject to tax. However, we did not pay tax with our sales tax return or through an audit.
- D. The special printing aid **was not purchased for resale**. However, tax was paid directly to the Board with our sales tax return. *Indicate amount of tax and period reported under Response above.*
- E. The special printing aid **was not purchased for resale** and tax is applicable.

COMMENTS _____

NATURE OF BUSINESS _____

PURCHASER'S SALES TAX PERMIT NUMBER	PURCHASER'S NAME
-------------------------------------	------------------

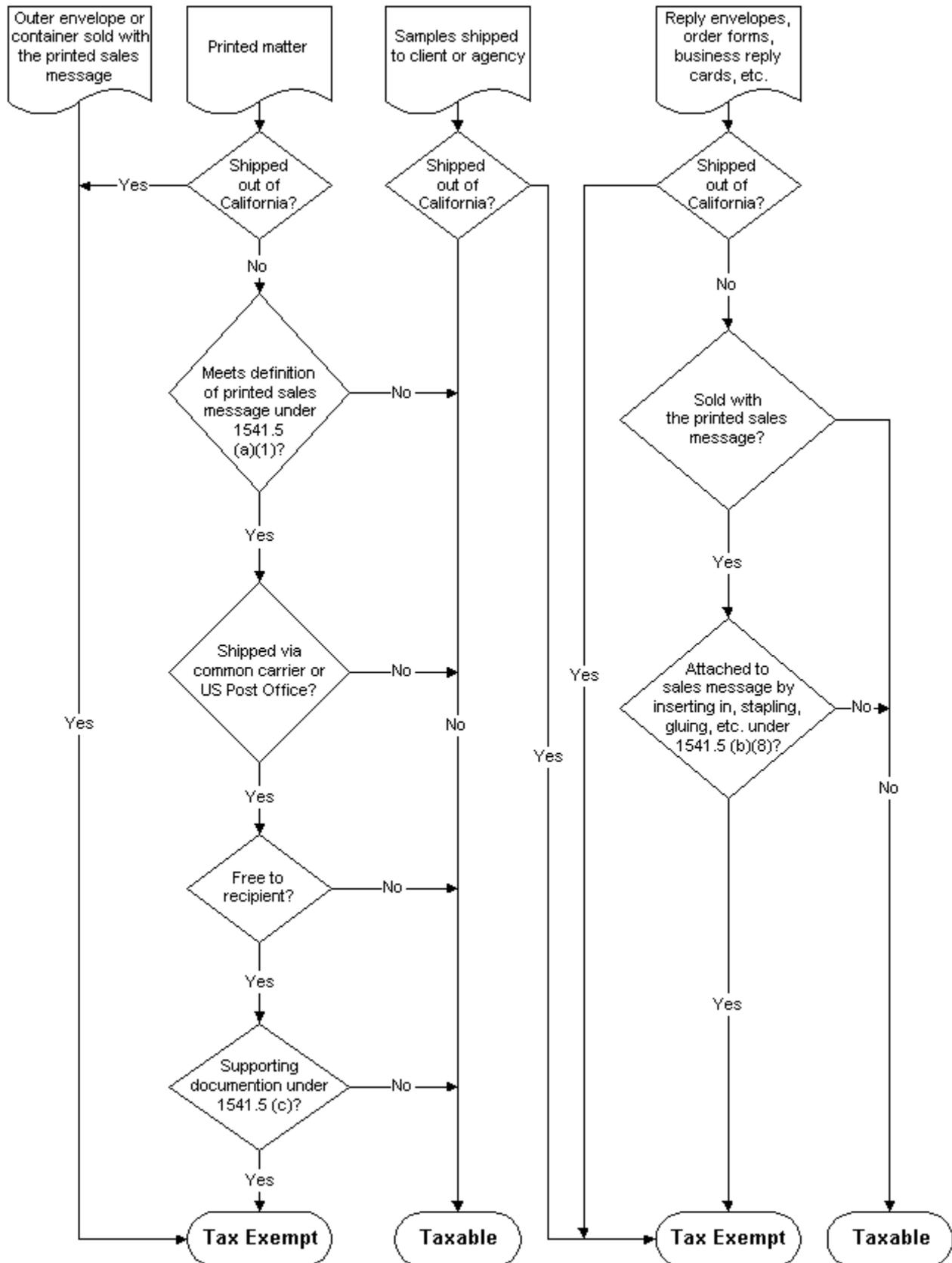
SIGNATURE	TITLE
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DATE	PHONE	CITY
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The information provided above is subject to verification by the State Board of Equalization.

PRINTED SALES MESSAGES FLOWCHART – REGULATION 1541.5

EXHIBIT 4



PERCENTAGE OF SALES METHOD EXAMPLE

XYZ PRINTING
Sales Journal

Invoice Date	Invoice Number	Customer	Taxable Printing (ex-tax)	US Govt	Resales of Printing and SPA's	Other Resales	Printed Sales Messages	Out of State	Total
04/02/01	01-658	Little Guy Inc.	6,796.96						6,796.96
04/03/01	01-659	Printing R Us			2,786.00				2,786.00
04/08/01	01-660	USA Stores	4,988.00					5,623.50	10,611.50
04/12/01	01-661	Big Business Inc.	7,078.00						7,078.00
04/16/01	01-662	Big Business Inc.	1,486.00						1,486.00
04/19/01	01-663	Forms 4 U			1,494.00				1,494.00
04/22/01	01-664	US Postal Service		488.50					488.50
04/29/01	01-665	Big Business Inc.	2,551.00						2,551.00
05/03/01	01-666	USA Stores						2,997.00	2,997.00
05/09/01	01-667	USA Stores	3,369.50						3,369.50
05/12/01	01-668	Advertising Services Co.	7,788.00						7,788.00
05/12/01	01-669	Little Guy Inc.				3,871.00			3,871.00
05/15/01	01-670	Big Business Inc.	2,562.00						2,562.00
05/19/01	01-671	Mail Sales Co.					8,465.00		8,465.00
05/22/01	01-672	Big Business Inc.	5,348.40						5,348.40
05/25/01	01-673	Advertising Services Co.	2,167.00						2,167.00
05/28/01	01-674	Printing R Us			1,700.00				1,700.00
06/05/01	01-675	USA Stores	759.00					5,500.00	6,259.00
06/06/01	01-676	Graphic Traffic	1,733.00						1,733.00
06/07/01	01-677	Advertising Services Co.	1,812.00						1,812.00
06/10/01	01-678	Forms 4 U			5,597.50				5,597.50
06/11/01	01-679	Big Business Inc.	2,530.71						2,530.71
06/12/01	01-680	USA Stores	3,844.99						3,844.99
06/13/01	01-681	Graphic Traffic	146.50						146.50
06/16/01	01-682	Little Guy Inc.				3,792.00			3,792.00
06/18/01	01-683	Advertising Services Co.	1,365.00						1,365.00
06/19/01	01-684	Big Business Inc.	1,512.00						1,512.00
06/20/01	01-685	Printing R Us				1,773.66			1,773.66
06/21/01	01-686	Advertising Services Co.	7,914.65						7,914.65
06/22/01	01-687	Forms 4 U			4,080.50				4,080.50
06/23/01	01-688	Graphic Traffic	2,321.00						2,321.00
06/25/01	01-689	USA Stores	1,480.00						1,480.00
06/26/01	01-690	Big Business Inc.	11,395.00						11,395.00
Total 2Q01			80,948.71	488.50	15,658.00	9,436.66	8,465.00	14,120.50	129,117.37

Percentage of Sales Calculation:

$$\frac{\text{Other Resales} + \text{PSM} + \text{Out of State}}{\text{Total Sales}} = \frac{9,436.66 + 8,465.00 + 14,120.50}{129,117.37} = \frac{32,022.16}{129,117.37} = 24.80\%$$

Total special printing aids subject to tax:

Purchases of special printing aids (ex-tax) subject to tax	15,628 x 24.80% =	3,875.74
Less: Tax-paid purchases of special printing aids (ex-tax)		<u>1,340.00</u>
Sales of special printing aids to be reported on Line 1:		<u>2,535.74</u>

Information regarding XYZ Printing:

XYZ Printing contracts and invoices on a lump-sum basis for all sales except resales of printing and special printing aids. XYZ Printing separately states the sales price of special printing aids (at cost or above) on the resales of printing and special printing aids. There is no collection of sales tax reimbursement on special printing aids sold with nontaxable sales of printed matter. Invoiced items consist only of printed matter that required the use of a special printing aid (sold with the print job). Other merchandise is rung up on a cash register and not invoiced. All customers and jobs are essentially homogenous with respect to special printing aids; jobs are bid so that the cost of special printing aids comprises 4-7% of the total sales price of the job.

Purchase journal shows total second quarter 2001 special printing aids purchases of \$15,722.15. XYZ Printing generally purchases special printing aids for resale, however, they did not provide a resale certificate to one vendor. Purchases from that vendor in second quarter 2001 were \$1,437.15 or \$1,340 ex-tax (\$97.15 tax). Total purchases ex-tax equal \$15,628.00 (\$15,722.15 - \$97.15).