

# Memorandum

**To** : Mr. Ramon J. Hirsig  
Executive Director (MIC 73)

**Date:** August 3, 2004

**From** :   
Freda Orendt, Acting Deputy Director  
Sales and Use Tax Department (MIC 43)

**Subject** : Proposed revisions to Audit Manual Chapter 11

In accordance with the established procedures for audit and compliance manual revisions, I am submitting the following proposed revisions to Audit Manual Chapter 11, *Advertising Agencies, Graphic Artists, Printers and Related Enterprises*, for your approval to forward to the Board Proceedings Division. These changes have been reviewed and approved by SUTD management, provided to Board Members, and posted on the website for two months at <http://www.boe.ca.gov/sutax/staxmanuals.htm> to solicit comments from interested parties.

A typographical error in section 1103.15, example 3, was corrected based on comments from Board Member staff. On July 22, 2004, we sent a memo advising Board Members of this correction and our intention to place these revisions on the August 24, 2004 Administrative Agenda.

## Summary of Revisions

- **AM Section 1101.15, *Identifying the Nature of Taxpayer's Business and Status as Agent or Retailer***. Corrects typographical errors in both flowcharts.
- **AM Sections 1103.10, 1103.15, 1103.40, 1104.10, 1105.05**. Added labels to example headings to make referencing easier.
- **AM Section 1103.15, *Finished Art – Tangible and Intangible, Example 3***. Revises dollar amounts in example for clarity. Prior amounts showed a taxable sale of \$1,500 (\$1,000 business cards plus 25% of \$2,000 concept development, design, final art and production management). That same dollar amount (\$1,500) was also the itemized charge for concept development, design and final art. Reviewers felt that the dollar amount similarity might confuse readers.
- **AM Section 1103.40, *Technology Transfer Agreements, Example 7***. Corrects calculation error in total.
- **AM Section 1103.40, *Technology Transfer Agreements, Example 8***. Corrects typographical errors.
- **AM Section 1105.05, *Commercial Photographers, Example 1***. Replaces acronym "TTA" with "technology transfer agreement" for clarity.

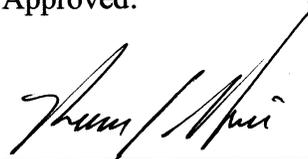
- **AM Section 1105.05, *Commercial Photographers*, Example 3.** Clarifies that tax applies to 200% of the cost of labor and materials. Corrects typographical error in the last sentence so the sentence reads that no additional tax is due on the transaction.
- **AM Section 1105.05, *Commercial Photographers*, Example 5.** Clarifies why transaction is not a technology transfer agreement (TTA); example now correlates to the second paragraph which explains that the transaction would be a TTA if the books were sold.

Attached are copies of these proposed revisions.

We request your approval to forward these proposed changes to the Board Proceedings Division for placement on the next Administrative Agenda as a consent item.

If you have any questions, please let me know or contact Mr. Jeff McGuire at 323-8690.

Approved:



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Ramon J. Hirsig  
Executive Director

Attachment

cc: (all without attachments)  
Ms. Freda Orendt (MIC 47)  
Mr. Stephen Rudd (MIC 46)  
Mr. Jeff McGuire (MIC 92)

BOARD APPROVED  
At the Month Day, Year Board Meeting

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Deborah Pellegrini, Chief  
Board Proceedings Division

bc: Lynn Whitaker (MIC 44)  
AIS Files – AM Revisions

**PROPOSED AUDIT MANUAL REVISIONS**

**PRELIMINARY ART — CONCEPTUAL SERVICES**

**(CONT. 1) 1103.10**

**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	<u>0.00</u>
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.

**PROPOSED AUDIT MANUAL REVISIONS**

**PRELIMINARY ART — CONCEPTUAL SERVICES**

**(CONT. 2) 1103.10**

**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	<u>0.00</u>
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.

PROPOSED AUDIT MANUAL REVISIONS

FINISHED ART — TANGIBLE AND INTANGIBLE

(CONT. 2) 1103.15

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:	
Concept development, design and final art	<del>\$1,500.00</del> <u>2,000.00</u>
Production management	500.00
Business Cards	<u>1,000.00</u>
Total	<del>\$3,000.00</del> <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 ~~\$1,500.00~~ 2,000.00 and \$500.00 charges (~~\$2,000~~ 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 ~~\$1,500.00~~ 1,625.00 (\$1,000 plus 25% of ~~\$2000~~ 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.

## PROPOSED AUDIT MANUAL REVISIONS

### 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 ~~\$500~~ 625 (25% of ~~\$2,000~~ \$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%	<u>116.25</u>
Total Invoice	<u>\$7,693.75</u>

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.

## PROPOSED AUDIT MANUAL REVISIONS

### TECHNOLOGY TRANSFER AGREEMENTS

(CONT. 1) 1103.40

#### **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.

## PROPOSED AUDIT MANUAL REVISIONS

### TECHNOLOGY TRANSFER AGREEMENTS

(CONT. 2) 1103.40

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).

PROPOSED AUDIT MANUAL REVISIONS

TECHNOLOGY TRANSFER AGREEMENTS

(CONT. 4) 1103.40

**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.

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

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.

**PROPOSED AUDIT MANUAL REVISIONS**

**TECHNOLOGY TRANSFER AGREEMENTS**

**(CONT. 5) 1103.40**

**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.

Conceptual development and preliminary art	\$1,000.00
Finished art	300.00
Reproduction rights	9,000.00
Tax	<u>0.00</u>
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)	<u>38.75</u>
Total	<u><del>\$1,300.00</del>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.

**PROPOSED AUDIT MANUAL REVISIONS**

**TECHNOLOGY TRANSFER AGREEMENTS**

**(CONT. 6) 1103.40**

**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>\$1,760.00</u>
		Taxable Total (\$1,760 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>

## PROPOSED AUDIT MANUAL REVISIONS

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

(CONT. 2) 1104.10

#### **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.%	<u>685.87</u>
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	<u>0.00</u>
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.

## PROPOSED AUDIT MANUAL REVISIONS

COMMERCIAL PHOTOGRAPHERS

(CONT. 3) 1105.05

### **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 TTA 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.

## PROPOSED AUDIT MANUAL REVISIONS

### COMMERCIAL PHOTOGRAPHERS

(CONT. 4) 1105.05

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.

## PROPOSED AUDIT MANUAL REVISIONS

### 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	\$ 3,000.00
Airfare, hotels, rental cars, and meals	10,000.00
Clothing for the subjects and props	5,000.00
Labor for everyone except the photographer	<u>12,000.00</u>
Total	<u>\$30,000.00</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-times the 200% markup).

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, the 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.

## PROPOSED AUDIT MANUAL REVISIONS

### COMMERCIAL PHOTOGRAPHERS

(CONT. 6) 1105.05

#### **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 ~~copyright interest in the photographic images is not being transferred to the Motion Picture Academy 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.

## PROPOSED AUDIT MANUAL REVISIONS

### COMMERCIAL PHOTOGRAPHERS

(CONT. 7) 1105.05

**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.