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**STATE BOARD OF EQUALIZATION**

In the Matter of the Petition	)	
for Redetermination Under the	)	DECISION AND RECOMMENDATION
Sales and Use Tax Law	)	OF HEARING OFFICER
	)	
	)	
Petitioner_____	)	Account No. : _____

The above-entitled matter case on regularly for hearing on Tuesday, July 31, 1979, in Sacramento, California. James E. Mahler, Hearing Officer.

Appearing for Petitioner:

Appearing for the Board:

Mr. Robert Hocking  
District Principal Auditor

Mr. David W. McKillip  
Auditor

PROTEST

Petitioner protests a determination of sales and use tax deficiency for the period January 1, 1971 through December 31, 1978. The protested taxes are measured by:

<u>Audit Item</u>	<u>State, Local and County</u>
A. Fabrication labor on television commercials.	\$263,808
B. Purchases subject to use tax	231,684
C. Tax-paid supplies and materials used to fabricate commercials	<u>(16,896)</u>
	\$478,596

Petitioner also protests the imposition of a penalty in the amount of \$2,759.14 for failure to file returns.

## CONTENTIONS

1. Petitioner is a producer or coproducer of the television commercials.
2. The audit overstates the measure of tax on one of the purchases in audit Item B.

## SUMMARY

Petitioner is a corporation which operates a commercial television station in Sacramento, California. It did not hold a seller's permit or file sales and use tax returns during the period in question.

Audit Items A and C concern the commercials broadcast by petitioner. Although merely broadcasting a commercial is of course exempt from sales tax, petitioner also produces or fabricates many of the commercials and charges its clients separately for such work. The audit classified these charges into two categories, those where petitioner produced the entire commercial and those where petitioner did only a portion of the work. Charges in the former category were considered exempt from sales tax on the ground that petitioner was the "producer" of the commercials under Sales and Use Tax Regulation 1529. However, tax was asserted on the charges in the latter category on the theory that petitioner made taxable "fabrication" sales of the commercials under Revenue and Taxation Code section 6006(b). A tax-paid purchases resold credit was allowed for materials used in the fabrication.

The charges which the audit considered taxable involve various types of transactions. In the majority of cases, petitioner's client supplied petitioner with a semi-complete commercial which was not a "production" as that term is defined in Regulation 1529. Petitioner performed any work needed to complete the production, such as recording a sound track or appending logos which were referred to in the body of the commercial. Since such commercials were almost always on film, petitioner also transferred them to video tape prior to broadcasting.

In some cases, however, the client supplied petitioner with a commercial which qualified as a production but which needed additional work prior to broadcasting. Such additional work might include adding logos not referred to in the commercial, editing or adding to the commercial to make it fit the available broadcasting time, or converting the commercial from film to video tape.

Finally, in a few cases petitioner would produce or acquire a complete commercial ready for broadcasting. Some time later, however, circumstances required a change in the commercial. For example, if the client opened a new store or held a special sale of the advertised product, petitioner would add a logo to the commercial to reflect those facts.

Under the rules of the Federal Communications Commission, petitioner is responsible for the content of everything it broadcasts. For all commercials, therefore, petitioner retains broad rights to review and approve the script, to require retakes of scenes, or to cut and edit the commercial to conform to the federal standards.

Once the commercial was complete, petitioner kept the video tape in its library for periodic broadcasting. Petitioner states that copies of the commercial were never transferred directly to its clients, and that the video tape was simply erased or discarded when the commercial was no longer needed. There is some suggestion in the petition file that petitioner may occasionally have transferred copies of the commercials to other television stations on behalf of its clients, but it does not appear that any such transfers were included in the audit measure of tax.

Audit Item B, purchases subject to use tax, includes the purchase of a minicomputer from --- --- - --- a company which is not registered as a retailer with the Board. Petitioner recorded \$159,000 as the cost of the minicomputer on its books, and the audit asserted tax on that amount. However, petitioner has submitted a billing invoice showing that the total sales price was actually \$150,000. The extra \$9,000 which petitioner recorded on its books was apparently intended to reflect the tax on the sale.

The minicomputer was defective and did not perform up to specifications, so petitioner unilaterally deducted \$15,000 "damages" from the sales price. I sent --- a check for \$135,000 in December 1976, and --- informed that that would be its final payment. --- never formally agreed to the reduction of the sales price, but it has also never attempted to collect the remainder. Petitioner's accounts payable records show that it and --- have done a good deal of business with each other since that time.

#### ANALYSIS AND CONCLUSIONS

Audit Items A and C: Subdivision (c)(1)(A) of Regulation 1529 provides that no sales tax liability arises from the fabrication or processing of a production by a producer or coproducer. The term "coproducer" is defined in subdivision (b)(2)(B) of the regulation to include persons who contribute to the production, share in the profits from the production, and share significantly in the responsibility of producing the production.

Most of the audit transactions here are cases where petitioner receives an incomplete production from its clients and performs the work necessary to complete the production. Petitioner shares in the profits of the production through its broadcasting revenues and possibly by sales of copies. It shares significantly in the responsibility for the production because it retains the right to review and approve the scripts and to cut or edit the production. Petitioner qualifies as a coproducer of such productions.

The remaining transactions are exempt from sales tax without regard to whether petitioner is a coproducer. Petitioner's principal business is broadcasting, and the true object of the contracts between petitioner and its clients is to have the commercials televised. Although the work which petitioner does to prepare the commercials for broadcast might be taxable fabrication if done by another, when done by petitioner it is incidental to the broadcasting services and therefore exempt from sales tax.

Audit Items A and C should therefore be deleted from the measure of tax on reaudit. The reaudit should also determine whether petitioner in fact made sales of copies of the commercials. If it did, petitioner may be liable for tax on such sales in accordance with subdivision (c)(1)(B) of Regulation 1529.

Audit Item B: subdivision. (b) of Regulation 1655 provides that amounts credited by sellers to consumers on account of defective merchandise may be excluded from the measure of tax. Normally the seller must formally agree to the credit before the consumer can deduct it from the measure of use tax. There has been no such formal agreement in this case. However, petitioner made its final payment on this transaction almost three years ago. Since then --- has made no attempt to collect the balance due, and has even continued to do business with petitioner on an ongoing basis. From these facts it is reasonable to presume that --- has agreed to a reduction of the selling price. Therefore petitioner is entitled to a defective merchandise credit and the measure of tax on this purchase should be reduced to \$135,000.

Penalty: Petitioner has submitted a statement under penalty of perjury from its Treasurer explaining the reasons for failing to file returns. It is recommended that the penalty be deleted on reaudit.

RECOMNENDATION

Sacramento District is to initiate a reaudit in accordance with the views expressed herein.

\_\_\_\_\_  
James E. Mahler, Hearing Officer

\_\_\_\_\_  
Date