

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING #96-35**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.

SUBJECT

The application of the sales and use tax to a graphic design business.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

The Taxpayer is a graphic design business. The Taxpayer first meets with a client to discuss a new project. This may result in a design consultation fee, which the Taxpayer views as a fee for creative labor. The client and the Taxpayer then agree on a budget for

the project to be done. The next step is to present the client various initial layouts, which might be in the form of sketches or drawings or computer printouts. The initial layouts must usually be revised. After the client approves a specified design, the Taxpayer proceeds to final art. Final art usually consists of camera ready mechanicals (film negatives/ photographic stats) or a computer disc in the form of digital art.

The Taxpayer might also charge the client for buyouts, which are the services of an outside photographer or illustrator. The Taxpayer will charge for printing a particular job if the client requests the project be handled by the Taxpayer in its entirety.

The invoice provided to the client separates the charges for items such as design/production, materials costs, illustration, color outputs, film separations, printing, scans, tax, and shipping.

QUESTIONS

1. Whether charges for design consultation are taxable.
2. Whether the initial layouts given to the client are taxable.
3. Whether charges to the client for materials used in layouts are taxable.
4. Whether the revisions of the initial layouts are taxable.
5. Whether charges to the client for camera-ready mechanicals are taxable.
6. Whether the designer's production time/labor is taxable.
7. Whether the computer discs containing the final art are taxable.
8. Whether the buyouts are taxable.
9. Whether the final printed piece is taxable.
10. Whether items sold for resale are taxable.
11. Whether sales to clients located out-of-state are taxable.
12. Whether sales to non-profit companies are taxable.

RULINGS

1. Charges to the client for design consultation are taxable if the consultation leads to the sale of tangible personal property.

2. The initial layouts given to the client are taxable as part of the sales price of the tangible personal property sold.
3. Charges for materials used in layouts are taxable as part of the sales price of the tangible personal property sold.
4. Revisions of the layouts are taxable as part of the sales price of the tangible personal property sold.
5. Charges for camera-ready mechanicals consisting of film negatives or photographic stats are taxable as part of the sales price of the tangible personal property sold.
6. The designer's production time/labor is taxable if it leads to the sale of tangible personal property.
7. Computer discs containing the final art are taxable as the sale of tangible personal property.
8. Buyouts are taxable as part of the sales price of the tangible personal property sold.
9. The final printed piece is taxable as the sale of tangible personal property.
10. Items sold for resale are not taxable if the sale for resale is supported by a valid resale certificate.
11. Sales to clients located out-of-state are not taxable in Tennessee if there is no transfer of title or possession of the tangible personal property in this state.
12. Sales to non-profit companies are not taxable if supported by a valid exemption certificate or, if the non-profit company is domiciled outside Tennessee, an exemption from federal taxation under 26 U.S.C. § 501(c)(3).

ANALYSIS

Design/Production

The sale of tangible personal property is subject to sales tax. T.C.A. Section 67-6-202(a). Tangible personal property is defined to include "personal property, which may be seen, weighed, measured, felt, or touched, or is in any other manner perceptible to the senses." T.C.A. Section 67-6-102(28). Items such as layouts, paper, color copies, photographs, computer discs, brochures, videos, tee-shirts, and any final printed piece are all tangible personal property under this definition.

In a case similar to the instant ruling request, the Tennessee Supreme Court rejected the argument that advertising design models are incidental to advertising ideas and thus not taxable tangible personal property. *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621 (Tenn. 1987). The Court recognized that the purpose of the transaction was the exchange of creative ideas. *Id.* at 622. The Court made a finding, however, that the design models “were the *only* method by which [the customer] could review the ideas of the ad agency” and thus concluded that

these models were more than merely incidental by-products to the purchase of intangible intellectual property. Rather these models were a crucial, *i.e.* necessary, element in the editing process that was structured so as to create promotional materials that acceptably publicized [the customer’s] product to consumers.

Id. at 624. Under the *Thomas Nelson* analysis, the various items produced by the Taxpayer are crucial elements in the graphic designing process and thus taxable tangible personal property. This is true when the item is a final product, such as a video or color copy, and when the item is the means by which the customer reviews the Taxpayer’s ideas, as with layouts.

The tax base on the sale of tangible personal property is the sales price. T.C.A. Section 67-6-202(a). Sales price is defined to mean

the total amount for which a taxable service or tangible personal property is sold, including any services that are a part of the sale of tangible personal property, valued in money, whether paid in money or otherwise, and includes any amount for which credit is given to the purchaser by the seller, without any deduction therefrom on account of the cost of the property sold, the cost of the materials used, labor or service costs, losses, or any other expense whatsoever.

T.C.A. Section 67-6-102(25). Under this provision, charges for design service and production labor are taxable when a part of the sale of tangible personal property. This is in accord with *Thomas Nelson*, which held that the entire costs of the transactions between the advertising agency and the customer are subject to the tax. *Id.* at 622.

If the Taxpayer makes a charge for design consultation that does not lead to the sale of tangible personal property, no taxable incident occurs. The sales tax law does not provide for the taxation of this intangible service unless such service is rendered as part of the sale of tangible personal property. T.C.A. Section 67-6-102(25).

Sales for resale

Any sale for resale in compliance with rules and regulations promulgated by the Commissioner is not subject to sales tax. T.C.A. Section 67-6-102(23)(A). The Taxpayer may sell tangible personal property free of sales or use tax when provided with a Tennessee certificate of resale. Sales and Use Tax Rule 1320-5-1-.68(4). Certificates of resale may not be accepted, however, when the Taxpayer knows, or should know in the use of ordinary care, that the tangible personal property is not for resale by the purchaser, but rather for the purchaser's own use or consumption. *Id.* Graphic design products purchased by a client to be incorporated in a different product are deemed to be used by the client rather than resold. The Taxpayer will be deemed the dealer and held liable for the tax on all sales not supported by a valid resale certificate. Sales and Use Tax Rule 1320-5-1-.68(2).

Sales made out-of-state

Tangible personal property must be sold in this state in order to be subject to Tennessee sales tax. T.C.A. Section 67-6-202(a). A sale is a transfer of title or possession or both of tangible personal property for a consideration. T.C.A. Section 67-6-102(24)(A). Where the transfer of title and possession takes place outside Tennessee, no sales taxable incident occurs in Tennessee.

Sales to non-profit organizations

Sales to a variety of types of entities are exempt from sales and use tax. *See*, T.C.A. Section 67-6-322. Included among the tax-exempt entities are

such other institutions and organizations which have received a determination of exemption from the internal revenue service under § 501(c)(3), (c)(5) labor organizations, and (c)(19) (26 U.S.C. § 501(c)(3), (c)(5), and (c)(19)) of the Internal Revenue Code and are currently operating under it, and any war-time era veteran's organization which has received a determination of exemption from the internal revenue service under § 501(c)(4) (26 U.S.C. § 501(c)(4)) of the Internal Revenue Code and which is chartered by the United States Congress.

T.C.A. Section 67-6-322(b). Many non-profit organizations are exempt under this provision.

Sales to exempt organizations must be supported by a valid exemption certificate. Sales and Use Tax Rule 1320-5-1-.51. If the sale is not supported by an exemption certificate, the dealer will be held liable for the sales and use tax. Sales and Use Tax Rule 1320-5-1-.78. An exemption certificate issued by the Commissioner is not required in the case of a sale to a customer who is not a resident or domiciliary of Tennessee if the customer provides the Taxpayer "a copy of a current and valid exemption from federal taxation under 26 U.S.C. § 501(c)(3). The Taxpayer shall maintain a copy of such exemption in

his records to document that the purchaser was entitled to the exemption.” 1996 Tenn. Pub. Acts 1001.

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