



**House
Legislative
Analysis
Section**

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SALES TAX: ADVERTISING, ETC.

**House Bill 4452 with committee
amendment**

Sponsor: Rep. Willis Bullard, Jr.

**House Bill 4453 with committee
amendment**

Sponsor: Rep. Kirk A. Profit

Revised First Analysis (4-25-95)

Committee: Tax Policy

THE APPARENT PROBLEM:

A recently issued Department of Treasury revenue administration bulletin (RAB-95-1) has fanned the flames of a longstanding dispute between the department and the advertising industry over the application of the sales tax. The dispute is over whether certain items produced during the creative ad-producing process (e.g., videotapes, photographs, artwork) should be taxed as tangible personal property (as they would be if purchased for home use) or exempt from sales tax as services (like the work of an attorney or beautician). Also at issue is whether, as the advertising industry alleges, the department has overstepped its authority in recent years by attempting to tax items that had previously been explicitly exempt.

The revenue administrative bulletin, approved February 14, 1995, establishes guidelines for using the "real object test" as a methodology for distinguishing between the sale of a service (which is not taxable) and the sale of tangible personal property (which is taxable). The "real object test", as summarized in the bulletin, involves answering the question: "From the perspective of an impartial third party, what is the purchaser seeking? A tangible end product produced by a service, or merely the service itself?" The bulletin goes on to provide some general standards and a series of examples for applying the test in differentiating between the sale of tangible property and several kinds of services; namely, creative services, intellectual services, personal services, and services on the property of others.

For example, the statement of standard in the RAB for applying the "real object" test to creative services is as follows:

"Where the object of the transaction is predominantly to obtain services of a special creative nature, the transaction will be characterized as a service. Where the object of the transaction is predominantly to obtain a tangible product which may require services of a special technical nature, the transaction will be characterized as a sale of tangible personal property subject to tax. In these situations, the entire gross proceeds of the transaction would be subject to tax."

Two examples are used in the bulletin to illustrate this standard. In one case, Company A hires Company B to produce a videotape. Company A provides the set, script, actors, and other creative aspects. Company B does the videotaping and provides post-film editing functions, such as color correcting and music dubbing to the specifications of Company A. Company A is to use the videotape "to illustrate a concept for a television commercial to its customer." In this case, the sale of the videotape by company B would be taxable; the "real object" of the transaction is the sale of tangible personal property, the videotape. The creative aspects of the videotape were provided by the customer (Company A). The second example focuses on the hiring of Company A to design an advertising campaign by Company X. Company A, as before, hires Company B to produce a videotape (just as described above). Company A then uses the videotape to illustrate to Company X a concept for a commercial. The "real object" of the transaction between Company X and Company A is that of a service; the videotape "merely represents a medium for conveying this concept" from Company A to Company X. This same

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methodology would be applied, under the bulletin, to products produced in creating an advertisement by illustrators, photographers, designers, and others.

The examples intend to demonstrate that what is at issue is not the nature of the physical item involved (the videotape) but the "real object" of the transaction: what is the purchaser seeking? Other examples provided as illustrations in the bulletin compare the hiring of an attorney to prepare a will (the document would not be taxable) versus purchasing a packaged set of preprinted documents and instructions that allow a person to prepare a customized will (the set of documents and instructions would be taxable as tangible personal property); the hiring of an accountant to prepare a tax return (not taxable) versus purchasing a book on how to prepare your taxes (taxable); hiring a company to formulate a product evaluation questionnaire for a blender, mail it to purchasers, compile the results and prepare a customer profile report (not a taxable transaction) versus hiring a company to have a product questionnaire printed and, under a separate contract, to mail it to customers for return to the manufacturer (the questionnaire would be taxable as tangible personal property).

The department's stated aim in issuing the bulletin, and in adopting the "real object" test, is to "clarify the taxability of complex transactions." (In fact, the department intends to issue separate bulletins on how the "real object" test will affect various kinds of transactions in individual industries, including the advertising industry.) To representatives of the state's advertising industry trade association, the Michigan Advertising Industry Alliance, however, the bulletin represents another attempt by the treasury department to impose a tax on creative services that were once specifically exempt. The alliance and other department critics allege that through its tax audits and its revenue administrative bulletin, the department is in essence changing state tax policy without legislative approval. Advertisers say they have relied on a 1977 letter to industry representatives from a deputy revenue commissioner detailing when transactions involving drawings, paintings, or other art works and photographs would constitute sale of a service. Throughout the 1990s, according to the alliance, the advertising industry has been trying to fend off treasury department efforts to apply the sales tax to "service implements" (e.g., photographs and videotapes) produced in the creative process in contravention of the 1977 letter.

Legislation has been introduced to address this controversy.

THE CONTENT OF THE BILL:

The bills would provide exemptions from the sales and use tax for "service implements" produced by a person providing a service whose fee is based on the service provided, rather than a tangible product of that service.

A "service implement" would be defined as "a tangible object that is unique, of no intrinsic value, of no literary or artistic value, and of no value to anyone other than the person who commissioned the service." A service implement would include (but not be limited to) an annual report or financial audit prepared by an accountant; an audiotape or videotape master for an advertisement prepared by a postproduction service; an original design or plan prepared by an architect; a will, contract, deed, or other legal document prepared by an attorney; a layout or artwork for an advertisement prepared by a commercial artist; a tax return prepared by an income tax service; a photograph for reproduction in an advertisement created by a photographer; a mounted fish, animal, bird, or other trophy prepared by a taxidermist; or an electrocardiogram or prescription ordered by a physician.

Broadcasting exemption. The bill also would rewrite the existing exemption from the sales and use taxes for broadcasting equipment. Currently, the sale of property to a person licensed to operate a commercial radio or television station is exempt from the sales and use tax, if the property is used in the origination or integration of the various sources of program material for radio or television transmission. The exemption does not apply to vehicles or to satellite transmission equipment. Under the bills, this provision would be rewritten so that the exemption would apply to property "predominantly stored, used or consumed" in the origination, integration, or broadcast of radio or television program material. Further, the bills would apply the exemption to educational (as well as to commercial) stations, and would delete the specific language regarding vehicles and satellite equipment.

House Bill 4452 would amend the General Sales Tax Act (MCL 205.51 and 205.54a), and House Bill 4453 would amend the Use Tax Act (MCL 205.92 and 205.94).

FISCAL IMPLICATIONS:

The House Fiscal Agency points out in an analysis dated 4-21-95 that there is controversy over the fiscal impact of the bills. Proponents say the bills would have minimal impact because they simply codify a longstanding exemption. The Department of Treasury, however, argues that the bills would expand the exemptions from the sales and use taxes to include transactions currently taxable. (The department also believes some companies that now qualify for the industrial processing exemption would pay more in taxes.) The HFA says that if one assumes the treasury department is correct, the estimated revenue loss would be \$33.7 million in fiscal year 1994-95 (partial year impact) and \$72.2 million in 1995-96.

ARGUMENTS:

For:

The bills would protect certain kinds of creative work from being unfairly and arbitrarily subjected to the sales and use taxes by statutory interpretations of the Department of Treasury. Tax policy ought to be established in statute by the legislature (or, at least, by rule, with legislative oversight). Tax policy ought not to be changed by administrative fiat. The bills say that "service implements", products produced as part of the creative process in providing a service, should not be taxed as tangible personal property. If a person buys a photograph from a studio to hang on a wall, it is taxable. The person is paying for a product. If an advertising agency hires a photographer to produce an image that will be used as an element in an advertisement, the payment to the photographer should not include sales tax. The payment is for a service; the product will likely be destroyed after use. This should also be the case with other kinds of art work and with videotape masters. These are like services provided to a client by such professionals as lawyers, accountants, and architects, not like products purchased for general use, such as automobiles, stoves, and books.

The advertising trade association asserts that the efforts in recent years by the Department of Treasury to tax certain kinds of products used in providing creative services contravenes the stated policy provided by the department in 1977. Prior to August of 1976, the work of advertising, illustrative, and commercial artists as part of creative advertising, and the making of photographs as part

of advertising, were exempted by rule. A 1977 department letter, following the removal of the provisions from the rules, provided advertisers similar protection. Industry officials say they have been using the 1977 letter as a guide, but claim the treasury department in the 1990s has rejected the letter and has audited ad-related businesses for back taxes, interest and penalties. To assess a six percent tax on creative services can only be harmful to the state's economy and help the advertising industry elsewhere -- notably, Chicago, which does not tax such services and is already the second largest ad community in the country.

The adoption of the "real object" test poses problems. Does a customer want a service or the tangible product that is the manifestation of the service? The customer clearly wants both. How is one to decide tax cases using this test? Some critics have said it comes down to the gut reaction of the judge. These bills provide some clarity in one specific area, that of creative services. It clearly exempts transactions that those in the profession have long considered exempt. This is preferable to adopting standards with little history of case law in the state.

Against:

This is an area of tax law that needs clarifying, but these bills are not the way to do it. Critics of the "real object" test say that test will lead to litigation, but the exemption provided here will also lead to lawsuits. The "real object" test is in use in other states, including neighboring Ohio, and has a long legal history. The standard used in these bills does not make the law any clearer and does not get at the overall problem. It simply targets a few specific exemptions, and at the same time provides a general exemption for "service implements", the definition of which will require future interpretation. It should be noted that many of the itemized transactions on the list of exemptions are already exempt under the "real object" test, such as the items produced by attorneys, accountants, architects, income tax services, and physicians. The other exemptions, for audiotapes and videotapes, layouts and artwork, and photographs, are not now exempt and are at the heart of the controversy these bills are intended to address. They do not meet the "real object" test in all cases. The treasury department has had discussions with taxidermists over how their services and products should be treated under the "real object" test; it is premature to provide them an exemption.

It is not fair to say that the department is creating law when it issues revenue bulletins clarifying how the law is to be interpreted. That is part of its responsibility in enforcing the tax laws. The department does not set out to write bulletins that conflict with statute. Unless the legislature wants to spell out in great detail how the sales and use tax laws apply, the department has to provide interpretations and create methodologies in order to categorize transactions and provide taxpayers with information on how to comply with the law. In this case, the department has adopted a well established test and is in the process of developing revenue administrative bulletins on an industry-by-industry basis to guide taxpayers in applying the test to a variety of transactions.

Treasury department officials have also said that some businesses engaged in producing what the bill refers to as service implements would prefer that these be taxed at retail so that they can qualify for the industrial processing exemption under the sales tax. That exemption permits a sales tax exemption for the purchase of property used or consumed in industrial processing. (The term "industrial processor" refers to a business that transforms, alters, or modifies tangible personal property by changing the form, composition, or character of the property for ultimate sale at retail or sale to another industrial processor to be further processed for ultimate sale at retail.)

POSITIONS:

The Michigan Advertising Industry Alliance supports the bill. (3-27-95)

The Department of Treasury is opposed to the bill. (3-27-95)