

06-0709
SALES AND USE
TAX YEARS: 2003, 2004, 2005
SIGNED: 12-04-2007
COMMISSIONERS: P. HENDRICKSON, R. JOHNSON, D. DIXON
ABSENT: M. JOHNSON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,

Petitioner,

v.

AUDITING DIVISION
OF THE UTAH STATE
TAX COMMISSION,

Respondent.

ORDER

Appeal No. 06-0709

Account No. #####

Tax Type: Sales and Use

Audit Period: 01/01/03 – 09/30/05

Judge: Chapman

Presiding:

Kerry Chapman, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REP. 1
PETITIONER REP. 2

For Respondent: RESPONDENT REP. 1, Utah Assistant Attorney General
RESPONDENT REP. 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing on August 8, 2007.

On March 17, 2006, Auditing Division (“Division”) issued a Preliminary Notice - Sales and Use Tax (“Preliminary Notice”) to the Petitioner for the audit period January 1, 2003 through November 30, 2005. The Preliminary Notice indicated that the Petitioner owed \$\$\$\$ in additional sales and use tax, plus interest, for the audit period. No penalties were imposed. On April 28, 2006, the Division issued a Statutory Notice to the Petitioner, informing it that the additional tax and interest previously identified in the

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Preliminary Notice was being assessed.

In the Preliminary Notice, the Division determined that sales and use tax was due on transactions identified in four separate audit schedules. The amounts of the transactions identified in the schedules are as follows:

Schedule	Amount of Transactions
Schedule 1	\$\$\$\$\$
Schedule 2	\$\$\$\$\$
Schedule 3	\$\$\$\$\$
Schedule 4	<u>\$\$\$\$\$</u>
Total	<u>\$\$\$\$\$</u>

The Petitioner is only contesting the Division's imposition of sales and use tax on the transactions identified in Schedule 3, which concern the Petitioner's purchases of photographs, illustrations, or artwork (collectively referred to as "artwork"). The Petitioner asks the Commission to rule that the Schedule 3 transactions are not subject to sales and use tax, while the Division asks the Commission to sustain its imposition of tax on these transactions.

APPLICABLE LAW

Utah Code Ann. §59-12-103(1) provides for the imposition of sales and use tax on certain transactions, as follows in pertinent part:

A tax is imposed on the purchaser as provided in this part for amounts paid or charged for the following transactions:

(a) retail sales of tangible personal property made within the state;

....

(k) amounts paid or charged for leases or rentals of tangible personal property if within this state the tangible personal property is:

(i) stored;

(ii) used; or

(iii) otherwise consumed;

(l) amounts paid or charged for tangible personal property if within this state the tangible personal property is: (i) stored; (ii) used; or (iii) consumed;

....

Utah Code Ann. §59-12-102 provides definitions for purposes of Utah’s sales and use tax , as follows in pertinent part:

....
(43)(a) “Lease” or “rental” means a transfer of possession or control of tangible personal property for:

- (i) (A) a fixed term; or
- (B) an indeterminate term; and
- (ii) consideration.

....
(82) (a) “Sale” means any transfer of title, exchange, or barter, conditional or otherwise, in any manner, of tangible personal property or any other taxable transaction under Subsection 59-12-103(1), for consideration.

(b) “Sale” includes:

-
(v) any transaction under which right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made.

....
(96)(a) “Tangible personal property” means personal property that:

- (i) may be:
 - (A) seen;
 - (B) weighed;
 - (C) measured;
 - (D) felt; or
 - (E) touched; or
- (ii) is in any manner perceptible to the senses.

....
(108)(a) “Use” means the exercise of any right or power over tangible personal property under Subsection 59-12-103(1), incident to the ownership or the leasing of that property, item, or service.

....

UCA §59-12-104(25) provides for an exemption from sales and use tax for “property purchased for resale in this state, in the regular course of business, either in its original form or as an ingredient or component part of a manufactured or compounded product[.]”

Utah Admin. Rule R865-19S-75 (“Rule 75”) provides guidance concerning the taxability of products sold by photographers, as follows in pertinent part:

A. Photographers, photofinishers, and photostat producers are engaged in selling tangible personal property and rendering services such as developing, retouching, tinting, or coloring photographs belonging to others.

1. Persons described in this rule must collect tax on all of the above services and on all sales of tangible personal property, such as films, frames, cameras, prints, etc.

....

Utah Admin. Rule R865-19S-81 provides guidance concerning the taxability of art, as

follows:

A. Art dealers and artists selling paintings, drawings, etchings, statues, figurines, etc., to final consumers must collect tax, whether an object is sold from an inventory or is created upon special order. The value or worth of the services to produce the art object are an integral part of the value of the tangible personal property upon completion and no deduction for such services may be made in determining the amount which is subject to tax.

B. Paints, canvases, frames, sculpture ingredients, and items becoming part of the finished product may be purchased tax-free if used in a painting or other work of art for resale.

1. Brushes, easels, tools, and similar items are consumed by the artist, and tax must be paid on the purchase of these items.

Utah Admin. Rule R865-19S-110 ("Rule 110") provides guidance concerning the taxability

of advertisers' purchases and sales, as follows in pertinent part:

A. "Advertiser" means a person that places advertisements in a publication, broadcast, or electronic medium, regardless of the name by which that person is designated.

1. A person is an advertiser only with respect to items actually placed in a publication, broadcast, or electronic medium.

B. All purchases of tangible personal property by an advertiser are subject to sales and use tax as property used or consumed by the advertiser.

C. The tax treatment of an advertiser's purchase of graphic design services shall be determined in accordance with rule R865-19S-111.

....

Utah Admin. Rule R865-19S-111 ("Rule 111") provides guidance concerning the taxability

of graphic design services, as follows in pertinent part:

A. Graphic design services are not subject to sales and use tax:

1. if the graphic design is the object of the transaction; and
 2. even though a representation of the design is incorporated into a sample or template that is itself tangible personal property.
- B. Except as provided in C., if a vendor provides both graphic design services and tangible personal property that incorporates the graphic design:
1. there is a rebuttable presumption that the tangible personal property is the object of the transaction; and
 2. the vendor must collect sales and use tax on the graphic design services and the tangible personal property.
- C. A vendor that provides both graphic design services and tangible personal property that incorporates the graphic design is not required to collect sales tax on the graphic design services if the vendor subcontracts the production of the tangible personal property to an independent third party.
- D. A vendor that provides nontaxable graphic design services and taxable tangible personal property under C. must separately state the nontaxable graphic design services or the entire sale is subject to sales and use tax.

ANALYSIS

The Petitioner **SERVICES** to the public. For purposes of this appeal, the Petitioner's customers are interested in obtaining (**PRODUCTS**) or other similar items (the "final products"). Before a final product is produced, the Petitioner produces a "master product," which is used in the process of (**X**) the required number of copies of a final product.

Once the Petitioner produces the master product, the Petitioner claims that its transactions with its clients take one of three forms:

1) The Petitioner uses the master product itself to print the final product requested by the customer, after which the Petitioner sells the final product (i.e., **PRODUCTS**) to the customer. The Petitioner proffers that this type of transaction occurs for "smaller jobs";

2) The Petitioner subcontracts out the (**X**) job to another firm, after which the Petitioner sells the final product to the customer; and

3) The Petitioner sells the master product to its customer, after which the customer either prints the final product itself or subcontracts out the (**X**) job to another firm.

At issue in this appeal are those instances in which the Petitioner obtains a license or right to replicate the artwork not only in the final product, but also in its master product in preparation for the (X). Examples of Invoice and License Agreements for such artwork are included in Exhibit B of the Division's Prehearing Memorandum. The October 5, 2005 Invoice and License Agreement in Exhibit B illustrates a transaction that is at issue. In this transaction, the Petitioner paid \$\$\$\$ to obtain a one-time, non-exclusive right to use an image in magazine advertising with a distribution quantity of (#). The Petitioner did not pay sales tax on the transaction, while the Division taxed the transaction in Schedule 3 of its assessment.

In this situation, the Division argues that the Petitioner's purchase of a license or right to use artwork is taxable because the Petitioner "consumes" the artwork in producing the master product. The Division admits, however, that this matter may be one of first impression for the Commission to consider.

The Petitioner argues, however, that the Commission should find that its purchase to obtain a license or right to use artwork is not subject to taxation, under any one of four arguments, specifically: 1) the Petitioner's purchase of a license to use the artwork is a transaction for a nontaxable, intangible right; 2) its purchase of a license to use artwork is exempt from sales and use tax under Section 59-12-104(25) because the artwork is purchased for resale either in its original form or as an ingredient or component part of a manufactured or compounded product; 3) its purchase of a license to use artwork should be deemed nontaxable because it is made in order to provide nontaxable design services; or 4) it would be inequitable to impose tax on the Petitioner's purchases because the Petitioner is not convinced that other, similar firms are taxed on their purchases of licenses to use artwork.

I. A License of Artwork - Nontaxable Intangible or Taxable Tangible Personal Property?

The Petitioner contends that any purchase of a license to use artwork transfers an intangible right, not tangible personal property, and, as a result, is not subject to sales and use tax. The Petitioner argues that such a transaction is similar to the nontaxable purchase of a manuscript. However, the sale of a

manuscript is nontaxable because the primary object of the transaction is considered to be the services required to create the manuscript, not the incidental tangible personal property associated with delivering the manuscript. On the other hand, a photograph or piece of art is subject to taxation because the taxable tangible personal property itself, not the services required to create it, is considered the primary object of the transaction. *See* Rule 75(A) and Rule 81(A).

Furthermore, courts generally apply a different analysis in determining whether *licenses* to use tangible personal property such as photographs, illustrations, or other artwork are taxable. Although a few courts have found otherwise, many courts in other states have sustained sales tax on licenses to use motion picture films, tapes and records, in addition to licenses to reproduce photographs and commercial illustrations in advertising catalogs and brochures.¹ These courts have found that the right to use property cannot be separated from the property itself. Because the items of tangible personal property are produced for broadcast or reproduction, the courts have found that the transfer of possession with a license to broadcast or reproduce constitutes a taxable transfer for the consumption of the tangible personal property.

Such a result appears consistent with Utah law, as well. Section 59-12-102(82)(b)(v) provides that a “sale” includes “any transaction under which the right to possession, operation, or use of any article of tangible personal property is granted under a lease or contract and the transfer of possession would be taxable if an outright sale were made.” The sale of a photograph or other artwork at issue would be subject to taxation in Utah, if an outright sale were made. Furthermore, the Petitioner enters into contracts to obtain the right to use the artwork. As a result, the Commission finds that the Petitioner’s transaction to obtain a

¹ Jerome R. Hellerstein & Walter Hellerstein, *State Taxation*, P 13.07(4) (3rd ed. 2000), citing *American Television Co. v. Hervey*, 490 S.W.2d 796 (Ark. 1973); *Mount Mansfield Television, Inc. v. Vermont Comm’r of Taxes*, 336 A.2d 193 (Vt. 1975); *Pagano & Andersen v. City of NY*, 30 N.Y.S.2d 302 (Sup. Ct. 1939), aff’d, 48 N.Y.S.2d 693 (1st Dep’t 1944), aff’d, 66 N.E.2d 298 (1946); *Hillman Periodicals, Inc. v. Gerosa*, 137 N.Y.S.2d 863 (1st Dep’t), aff’d, 127 N.E.2d 842 (1955).

license to use artwork qualifies as a “sale” of tangible personal property under Utah law.²

In addition, amounts paid to “use” an item of tangible personal property are subject to taxation pursuant to Section 59-12-103(1)(l). “Use” is defined in Section 59-12-102(108)(a) to mean “the exercise of **any** right or power over tangible personal property. . .” (emphasis added). With the licenses it purchases, the Petitioner obtains a right or power over the items of artwork. Accordingly, the Petitioner is deemed to “use” the artwork at issue, and the transactions for licenses to obtain such use are subject to taxation.

For these reasons, the Commission finds that the non-exclusive license or right to use artwork is subject to Utah sales and use tax unless an exemption applies. The Commission also notes that the license to use artwork is taxable, even if the artwork is delivered from the supplier in an electronic format. *See South Central Utah Telephone Association, Inc. v. Auditing Div.*, 951 P.2d 218 (Utah 1997),

II. Section 59-12-104(25) Exemption – Purchase for Resale or as Component Part.

The Commission has rejected the Petitioner’s argument that the licenses at issue are nontaxable intangibles. Accordingly, the transactions found in Schedule 3 of the assessment are taxable, unless an exemption applies. The Petitioner argues that the exemption provided in Section 59-12-104(25) applies, while the Division argues that the exemption is inappropriate because the Petitioner did not receive title to the artwork to pass on to its customers.

Section 59-12-104(25) provides an exemption for transactions involving “property purchased for resale in this state, in the regular course of business, either in its original form or as an ingredient or component part of a manufactured or compounded product.” The Petitioner argues that the artwork at issue becomes part of the final product and, as such, should qualify for exemption as property purchased for resale.

² Given this conclusion, the Commission finds the Petitioner’s argument that a “license” is not “tangible personal property,” as defined in Section 59-12-102(91), to be unpersuasive.

The Commission does not find the Division's argument concerning title to the artwork to be entirely on point. Earlier, the Commission determined that a license to use artwork is subject to tax because the tangible personal property associated with the license may not be segregated for taxation purposes. Accordingly, regardless of whether the license to use artwork passes title to that artwork, the Commission's decision is dependent on whether the tangible personal property the Petitioner receives with the license is resold to its customers.

Regardless, the Commission is not convinced that the artwork for which the Petitioner purchases a license to use is actually resold to its customers in its original form or as an ingredient or component part of the master product or the final product. When the Petitioner produces the master product, the Commission is not convinced that the actual artwork provided by the supplier is incorporated into it. Similarly, the actual artwork is not incorporated into the final product. Although reproduced images may appear in the master product or the finished product, the items of artwork (i.e., the photographs, illustration, and other artwork) actually received by the Petitioner are not incorporated into these products. As a result, the Commission finds that the Petitioner is "using" the artwork, not reselling the artwork or the license to use the artwork, in the course of providing its own services.

The Commission believes that this conclusion is supported by the Utah Supreme Court's interpretation of the resale exemption in other cases.³ The Commission also believes the situation is similar to cutting dies purchased for use in the graphic design industry. In a New York case where dies were cut to a

³ See *Gull Lab, Inc. v. Utah State Tax Comm'n*, 936 P.2d 1082, 1084 (Utah Ct. App. 1997), in which the Court found that in order "[t]o determine whether [an item] was indeed "purchased for resale," we must evaluate Gull's purpose for buying the [item] and its use of the [item], citing *Nucor Corp. v. Utah State Tax Comm'n*, 832 P.2d at 1294 (Utah 1992). The Court further explained that [t]he essential consideration in determining whether the purchased-for-resale exemption applies is the 'primary purpose of the purchase, not who eventually ended up with the items.'"

customer's specifications, become the customer's property, and were used in the purchaser's cutting presses, the court found that the purchaser used the dies in its production process so that the primary utility of the dies was exhausted prior to any transfer to the customer. *See Cut-Outs, Inc. v. State Tax Comm'n*, 85 A.D.2d 838, 446 N.Y.S.2d 436 (N.Y. 3d Dep't 1981).

In conclusion, the Commission finds that the Petitioner's transactions to purchase licenses to use artwork are not eligible for the resale exemption provided in Section 59-12-104(25).

III. Nontaxable Design Services.

Nor does the Commission find the Petitioner's argument concerning nontaxable design services to be convincing. In the previous section, the Commission found that the Petitioner consumes the artwork associated with the licenses at issue. Accordingly, even if some or all of the Petitioner's services are considered nontaxable design services in accordance with Rule 111, any items the Petitioner consumes to provide these services are still subject to taxation.

IV. Inequity – Petitioner's Claim that Other Taxpayers Not Taxed on Similar Transactions.

The Petitioner claims that it is not convinced that the Tax Commission requires other firms in the same business as the Petitioner to pay sales and use tax on their purchases of licenses to use artwork. The Division, on the other hand, assures the Commission that it taxes other firms of which it is aware similarly to the way it taxed the Petitioner in Schedule 3 of the assessment. However, the Division stated that it is not aware on any previous assessment of the license to use artwork in this context and that the matter may be one of first impression.

Nevertheless, the Petitioner has provided no evidence that the Commission's taxation of licenses to use artwork is a departure from its prior practice, that the Commission has ruled otherwise in regards to other taxpayers, or that the Commission has audited other, similar firms in the past without

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imposing sales and use tax on such transactions. Without evidence to support the Petitioner's claim on inequity, the Commission does not consider the argument persuasive.

ORDER

Based upon the foregoing, the Commission sustains the Division's imposition of additional sales and use tax on the transaction concerning licenses to use artwork, as imposed in Schedule 3 of the Division's assessment. Accordingly, the Petitioner's appeal is denied. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2007.

Kerry Chapman
Administrative Law Judge

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BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this _____ day of _____, 2007.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.

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