

May 6, 2005

NAME
ADDRESS

RE: Private Letter Ruling – Film Industry Sales Tax Exemption

Dear NAME,

Over the last several months since the 2004 Utah Legislature enacted Senate Bill 190 (“S.B. 190”), the Tax Commission has undertaken considerable discussion with you and members of the film industry in an attempt to reach a mutual understanding of which property is exempt. That bill, enacted as Utah Code Ann. §59-12-104(60), provides an exemption from sales and use tax on “purchases, leases, or rentals of machinery or equipment by [certain establishments] if the machinery is primarily used in production or postproduction of [certain] media for commercial distribution[.]” As nothing has been formalized as of yet, the Commission has determined that it would be appropriate to issue a Private Letter Ruling that was first drafted last summer.

We thank you again for the information you have provided concerning the film industry practices in general. The list of items exempt from taxation in New Mexico and the two lists of items used by Utah film production companies have provided a perspective in determining what constitutes “machinery or equipment” for purposes of the exemption.

Because the exemption does not apply to all purchases or leases made by a film production company, we understand the need for additional clarity concerning the scope of the exemption. Upon studying the lists of items that have been provided to us, and comparing them to the language of the bill, we have made some initial determinations that should narrow what constitutes “machinery or equipment” for purposes of the exemption. We will provide a general guideline for applying the film industry exemption, along with a few specific examples, rather than a detailed list of which items are exempt. This is for two reasons. First, there was a lack of descriptions for the items listed. Second, and more importantly, we do not typically itemize lists such as yours in the context of a letter ruling.

Another problem in identifying precise exemptions results from the overall complexity of the sales tax statutes. Please bear in mind that this ruling must be read in conjunction with the sales tax statutes. A complete explanation of the Utah sales and use tax laws, itemizing all

taxable and nontaxable transactions, is impractical given this complexity and the scope of the topic. This can be seen by simply looking at the transactions subject to Utah sales and use tax that are listed in Utah Code Ann. §59-12-103(1). It is also important to understand that many transactions are not listed in the statute, and, accordingly, are not taxable in the first place. For example, even though a transaction may not be specifically exempted, such as interstate air travel, it is still not taxable in the first place. This distinction is important to keep in mind so that a company does not accrue use tax on a non-taxable transaction because it was not specifically identified as exempt.

We are limiting our ruling to address only two of the elements necessary for an item to qualify for exemption under Section 59-12-104(60): 1) what items generally constitute “machinery or equipment” for purposes of the exemption, and 2) when are such items “primarily used in production or postproduction.” We are not addressing other issues that could affect the taxability of items that would otherwise qualify for exemption, including which establishments qualify for the exemption, what constitutes “commercial distribution” for purpose of the exemption, and whether the media produced is the type for which the exemption applies.

Business Affected

Before defining machinery and equipment, we believe it would be helpful to distinguish the types of businesses involved in the film industry that would be affected by the exemption. We understand there are basically two types of companies; leasing and production.

Leasing Companies

A leasing company is considered to be the seller. As such, under Utah Code Ann. §59-12-107, it is required to collect sales tax on all leases or sales of property to a production company unless the property is exempt. In accordance with Section 59-12-106(2) and Administrative Rule R865-19S-23 a seller is required to have an exemption certificate on file to document the nontaxable status of the sale. Once the purchaser provides the seller with an exemption certificate, the seller no longer is obligated to collect sales tax on the transaction, other than for equipment specifically identified by the purchaser or lessee as taxable. However, a seller should have some knowledge of the exemption, and should be generally aware of taxable, non-taxable, and exempt items to the extent that they are specified in statute, rule, or other forms such as this letter.

If the production company does not provide an exemption certificate, the leasing company is required to collect sales tax on all sales or leases of tangible personal property. If there is no exemption certificate and no sales tax is collected, the leasing company may be held liable for any taxes that should have been collected.

In general, if a production company provides an exemption certificate, the leasing company will not be held responsible for any uncollected taxes for property that is not exempt. Rather, the production company will be liable for the unpaid sales tax. A leasing company, however, may still be held liable, under certain circumstances, if it failed to collect tax on specific taxable transactions identified in this letter, any future rules or statutes, or any bulletin

issued by the Tax Commission. This liability would occur only if the leasing company acts fraudulently in either collecting the tax or soliciting a purchaser to use an exemption certificate improperly.

A copy of the exemption certificate is attached, and is available on our Website at <http://tax.utah.gov/forms/current/tc-721.pdf>.

Production Companies

Unfortunately, the problem for the production company is not so easy. These companies are considered the consumer, and as such, are the entities required to actually pay the tax. Even with an exemption certificate, a production company must still pay taxes on property that is not exempt. In such a circumstance, the production company must specify the non-exempt property at the time of purchase or lease, at which time the vendor or leasing company would collect the appropriate taxes. The main portion of our letter, then, is to provide general guidance to production companies.

Application of the Exemption

Section 59-12-104(60) provides the Utah film industry a sales and use tax exemption on certain purchases or leases of “machinery or equipment” used in the “production or postproduction” process. First, we must determine what the Legislature intended by limiting the exemption only to “machinery or equipment.” To help clarify our position regarding the exemption with respect to our sales tax statutes, we will discuss three broad categories or types of transactions: 1) tangible personal property, 2) services, and 3) other transactions. The Commission finds that the exemption applies only to a subset of the first category.

In describing what is exempt or what is taxable, however, we must caution you that we have no more than the most basic understanding of how the film industry operates. Therefore, some of the examples we describe may not actually correspond to real situations the production process.

Tangible Personal Property

We believe that the exemption only applies to sales of a particular subset of tangible property identified as “machinery or equipment.” However, those terms are not defined for purposes of the exemption. Without legislative guidance concerning the scope of these terms, the Commission first looks to the ordinary meaning of the terms and then tries to apply these meanings in the context in which they were used. In Webster’s Ninth New Collegiate Dictionary (1988), as well as Webster’s On-line (<http://webstersonline.com>), the word “machine” is defined a number of ways, including “a constructed thing . . .,” “an assemblage of parts that transmit forces, motion and energy one to another in a predetermined manner,” and “a mechanically, electrically, or electronically operated device for performing a task[.]” “Equipment” is also defined a number of ways to include “the set of articles or physical resources serving to equip a person or thing [, including] the implements used in an operation or activity,” and “all the fixed assets other than land and buildings of a business enterprise[.]” It appears that some standard

definitions are essentially synonymous with “tangible (personal) property.” However, the legislature has defined all tangible personal property to be subject to taxation, but did not apply the same term when exempting sales to the film industry. Accordingly, we find that “machinery or equipment” must mean a smaller category or a subset of “tangible personal property.”

Two areas closely associated with taxation are finance and accounting. Therefore we will look to these areas for clarification. Most, if not all, accounting and financial texts describe machinery and equipment in general to be subcategories of fixed assets. This concept conforms with one of Webster’s definitions – “all the fixed assets other than land and buildings”

Machinery or Equipment

Given these definitions and the legal requirement that tax exemptions be narrowly construed, the Commission believes that “machinery or equipment,” for purposes of the exemption, means “all fixed assets, other than land and buildings,” that are eligible for capitalization under accounting standards. Under these standards, the property must be depreciable, having a useful economic life of more than one year, which is a standard applied under generally accepted accounting principles (GAAP). Accordingly, any such assets purchased or leased by a film company (or other qualifying entity) in its production or postproduction of a film (or other qualifying media) would meet the criteria for exemption from sales and use tax under Section 59-12-104(60).

We understand that most firms apply varying standards for capitalizing acquisitions of tangible personal property. In some cases, 2-3 year useful life thresholds are used, and in some cases the threshold is a minimum dollar amount. Another problem associated with the last scenario is that a business’ financial records might show an individual item as being expensed, but a bulk acquisition of identical property would be capitalized, depending on the invoiced purchase price. Consequently, for administrative purposes, we must qualify our guidelines in this respect. First, if an article of tangible personal property is not shown on a fixed asset ledger, balance sheet, or other financial record as a capital asset (i.e., it has been expensed on an income statement), there is a rebuttable presumption that the item is not eligible for capitalization and, therefore, would not be exempt from sales tax. Under this circumstance, a taxpayer would have to offer proof that the item could have been capitalized, even though the taxpayer chose not to do so, before the exemption would be allowed. Conversely, items with economic lives of one year or less, but are capitalized on a firm’s financial records solely because they were purchased in bulk, would not qualify for the exemption. Consequently, the film industry in general, and production companies in particular, will have to look to general accounting principles, as well as industry and their own internal practices in determining whether or not to claim the exemption.

Exempt Property. Under this standard, items that qualify for the exemption would include vehicles (purchased or leased without drivers or operators); trailers, wardrobe; sets and set furniture; computers; lighting, sound, electric, and editing equipment, and cameras (including lens and filters if the economic or useful life is greater than one year).

Taxable Property. Raw materials and supplies, on the other hand, are not capitalized fixed assets at the time of purchase and, accordingly, do not qualify as “machinery or

equipment” exempt from sales and use tax. Film would probably not qualify for two reasons. First, it appears to be raw material. While a camera may be used to transmit images onto film, the film itself is a distinct item, not a part of the camera itself. Secondly, even if it is not a raw material, we believe film typically does not have an economic life of more than one year in its original state, and thus would be classified under supplies.

Even if they serve a complimentary function for machinery or equipment, supplies would still not receive the exemption. For example, while leasing a desk and other office furniture may be exempt (unless used for administrative rather than production purposes), purchases of paper, pens, and office supplies would not.

Parts

The Commission would also disqualify certain replacement or repair parts from the exemption. Section 59-12-104(60) does not mention these items, whereas replacements are specifically exempted in Section 59-12-104(15), which deals with the aerospace industry. There are exemptions for “replacements” in subsection 104(14)(a), which at least implies repairs and parts for manufacturers. Consequently, we believe that parts in general are not granted a blanket exemption. Nonetheless, the Commission believes that replacement or repair parts, although not specifically mentioned in statute, qualify for the exemption if the parts meet the definition of machinery or equipment -- that is, they are eligible for capitalization. As we discuss later, if labor charges are associated with the installation of the part, they must be broken out or invoiced separately. Otherwise the entire transaction is subject to tax even if the specific item of equipment is eligible for capitalization and would be exempt if purchased alone.

Bundled Transactions

An exception to the distinction between exempt machinery and equipment and taxable property might occur when individual products are sold or leased in a package or “bundled transaction.” A bundled transaction is a transaction, for a single price, which includes multiple items of personal property whose individual prices are not negotiated separately. For example, a “grip truck” leased to a production company may include both capitalized fixed assets as well as supplies with an economic life one year or less. The Commission would consider this to be a single transaction, exempt from sales tax, as long as any individual supplies (not eligible for capitalization) are incidental to the transaction.

We understand that a grip truck might also provide raw materials that are purchased and consumed, rather than leased, by a production company. We also understand that the raw materials are billed separately from the initial lease. As a result, while the lease on the truck and equipment would be exempt from sales tax, the purchase of the raw materials would be subject to sales tax. Accordingly, the production company leasing the grip truck would be required to pay the sales tax on the raw materials. However, if the purchase of the raw materials is included under a single invoice with the lease of a grip truck, the taxability would be determined under a different set of considerations. If the purchase of raw materials is incidental relative to the leased equipment, no tax would be incurred. If, on the other hand, the primary transaction were the

purchase of raw materials, and the equipment rental were incidental, the entire transaction would be taxable.

Another example of a combined transaction might be lighting fixtures. Even if the transaction included light bulbs, cable, batteries, etc., which are not exempt if purchased separately, the entire sale or lease would be exempt as long as they were grouped in a package and the fixtures themselves were capitalized. However, the exemption would not apply if the items were purchased and itemized individually, even if they were acquired at the same time.

Services

Section 59-12-104(60) only exempts certain purchases and leases of “machinery or equipment.” The exemption language is silent concerning purchases of “services.” Although many services are not taxable under Utah law to begin with, some are specifically designated as taxable in Section 59-12-103. However, because sales tax exemptions are narrowly construed, we are required to find, as we indicated previously, that the new exemption does not extend to the purchase of taxable services, even if the services, such as labor for repairs, are performed on machinery or equipment that is itself exempt. Thus the repair of a camera, a trailer, or a set would be taxable.

Examples of transactions that have been, and remain, nontaxable include make-up artist and hair stylist services. Even if a makeup artist bills the use or sale of the makeup on a separately stated invoice, we deem the makeup artist to be the ultimate consumer of the makeup, not the production company. Thus the entire transaction, the application of the makeup and the separate billing for the makeup itself, would be non-taxable. The makeup artist, however, is responsible to pay tax on his or her purchase of the makeup. However, if the film company purchases its own makeup from an establishment other than the makeup artist directly, the film company would be responsible to pay sales tax, since we would deem the makeup to be supplies rather than equipment.

Among the services taxable in Utah are cleaning or washing tangible personal property. On the other hand, the same services with respect to real property are not taxable. The attachment of an item of tangible personal property to another item of tangible personal property is taxable, while the installation of such an item to real property is not. Although Section 59-12-104(60) does not exempt any taxable service, we add this comment to help illustrate which types of services remain taxable and which ones remain nontaxable.

Attaching personal property to other personal property is also taxable under Utah law. In your case, setting up a stage set might involve more than just the purchase of the equipment and materials. There could be labor charges as well, which would be taxable if the labor were contracted with, and performed by a third party, other than an employee of the production company. Unless the labor charges and equipment charges are separately stated on an invoice, the entire transaction could be subject to tax, regardless of whether the individual pieces of equipment were exempt or not. This situation is analogous to the bundled transactions scenarios

we discussed previously. In this case you might have an exempt purchase or lease, say lighting fixtures, combined or bundled with a taxable service, attaching the fixtures to a moveable set. In this case, the lease of the fixtures would have to be invoiced separately from the labor to attach them; otherwise the entire transaction would be taxable.

Other Transactions

Section 59-12-104(60) does not apply to most other types of sales that are taxable under Section 59-12-103(1). Qualifying film companies would remain liable for sales and use tax on many of these transactions (some of which were identified in the lists you provided), including the following: transportation; gas, electricity and other fuels; meals; admissions to various events; and accommodations. On the other hand, film companies have never been required to pay sales tax on the purchase of story rights or other intangible property, even before the passage of S.B. 190.

Summary

We will offer one final group of transactions, not just as a specific guideline, but more as a summary to show how the complexity of the tax laws prohibits a detailed list of exempt transactions. This group of scenarios involves food or meal related transactions. Sales or rentals of ovens, microwaves, etc. would be exempt from sales tax; food purchases would not. Leasing a food cart or catering vehicle (equipment) would be exempt Section 59-12-104(60); purchases of disposable or short-lived plates and utensils (supplies) would not. However, if plates and utensils were included with a catering truck lease, they would probably be incidental to the lease of the truck and, thus, included with the exemption. In this case the rental has the characteristics of a bundled transaction. Charges to hire an entire catering service, which may include items that might otherwise be taxable, would not only be subject to the sales tax but to any tourism tax under Utah Code Ann. §59-12-603.

Primarily Used in Production or Postproduction

In addition to being classified as “machinery or equipment,” an item must be used **primarily** in the production or post-production process before it qualifies for exemption under Section 59-12-104(60). Accordingly, items purchased or leased for use in pre-production activities or for a production company’s administrative purposes would not qualify for the exemption.

There may even be identical items that would either qualify or not qualify for the exemption, depending on how or when they are used. For example, a computer used in an office for administrative purposes, such as accounting or word processing, would not receive the exemption, even if used occasionally in the production or post-production process. However, an identical computer used only or primarily for film editing and processing or as a prop on a film set would be exempt. If the same item were used both in the production process and for administrative purposes, the exemption would apply only if the primary use were in the production process. Primary use would be a use greater than 50%.

Conclusion

With respect to specific types of equipment, most individuals in the various divisions of the Tax Commission have no familiarity or understanding of what any particular piece of equipment is. While the film industry works with it every day, we have never or, at most, rarely seen the equipment. Thus it is difficult at best to say yes or no as to the exemption for any specific piece of equipment. The question is whether it is eligible for capitalization or not.

To date, all that the Commission has seen is lists of equipment ranging from grip trucks to cameras to story rights. What is lacking are definitions and descriptions of the equipment, along with an explanation as to how this equipment is handled according to general accounting principles. There is simply no easy way of identifying whether or not any specific piece of equipment is exempt under that statute. We have been, and continue to be willing to listen to any proposals the film industry has to offer.

We trust, however, that the general guidelines and examples provided in this letter will provide the production companies with sufficient guidance to determine which specific types of equipment are exempt and which are taxable. We suggest the place to begin is in both the production and leasing companies' own accounting records.

We also remind you that even after the equipment has been defined, and its use relative to the production or postproduction process has been determined, it still needs to meet other statutory requirements in order to receive the exemption. These criteria include the specific establishments that qualify, a determination of what constitutes "commercial distribution," and whether the media produced is eligible for the exemption.

Please feel free to forward the ruling to any production, leasing or other companies in the film industry that may benefit from it. In addition to this letter, the Commission is in the process of drafting another administrative rule, which may address other aspects of the exemption as well.

Please contact us if you have any other questions.

For the Commission,

NAME
Commissioner

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