Sales Tax

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Sales Tax

This review of sales tax practices in New York and California was commissioned by AIGA based on success in clarifying the issue in these bellwether states through legal and administrative proceedings. The intention of this brochure is to provide information to all AIGA members and to allow members in other states to use the New York and California examples as support in clarifying their sales tax liability in their own states.

As tax agencies more aggressively enforce the sales tax laws, more are eager to audit for possibly overlooked revenue. Designers can best protect themselves from unexpected tax liability by learning when they are and are not required to collect sales tax on the work they provide for clients.

Sales tax is a state—and occasionally a local—matter, which prevents AIGA from pursuing a single national clarification of the issue. Statutes and the practice of the taxing authority will vary somewhat from jurisdiction to jurisdiction. In addition, design services are seldom addressed explicitly in state sales tax laws. The many things that graphic design embraces—design services, illustration, printing specifications and delivery of printed matter—are viewed as different forms of property and are treated and grouped differently for tax purposes from state to state. While AIGA offers a general guide to sales tax principles, dealing with sales tax should be worked out in consultation with an accountant.

You should be aware, however, that many accountants, even those "familiar with sales tax issues," may have no idea whatsoever what the sales tax issues are with regard to this poorly defined area of the design profession, and may suggest the safest course (but most costly to designers): to charge tax on everything. A better course will be for designers to contact an accountant, and armed with this document, raise their consciousness on this issue, and then get their advice on how this affects your personal situation.

Current cases that help to narrow the liability of designers for sales tax will be posted on www.aiga.org.

A key distinction: Is your work tangible or intangible?

The basic divide that determines what is subject to sales tax is the sometimes-blurry line between the tangible and the intangible. Transfers of tangible goods are generally taxed, unless specifically exempted by statutes or regulations; services and intangible property are generally exempt from tax, unless statutes or regulations specifically render them taxable. Designers typically provide services that are in most cases nontaxable, and grant or license to clients the right to reproduce their work. Licenses are considered intangible personal property, and transfers of such are generally not subject to tax. Designers may, however, also provide their clients with tangible personal property such as finished printed matter or a disk that contains the intangible personal property—a reproduction rights transfer—that is the substance of the contract. Tangible personal property is generally subject to tax. While tangible printed matter should be presumed taxable, treatment of disks or other layout transfers may vary widely from jurisdiction to jurisdiction.

The designer, then, must consider what is being *done*, and what is being *transferred*, in the various elements of each client contract, and separate out a job's taxable elements from its nontaxable elements as precisely as possible in all contracts or invoices, according to the laws of the home jurisdiction.

Services

Services, as noted above, are usually not subject to tax unless specifically included in a statute or regulation. This is the general category under which to group charges for time and labor; billable time for producing concepts and designs, scanning and manipulation, time spent on press, time spent building and encoding a website and similar billables should be calculated as services and so noted in all contracts and invoice terms.

Intangible property

Copyright licenses are intangible *property*, as opposed to the intangible *services* of time and labor. Designers, unlike illustrators, tend not to treat their client commissions as copyright licensing transactions. The images that a designer creates, however—whether the logo, which is clearly a free-standing image, or the larger images created by arranging type, illustrations and photographs in a brochure or package or poster design—are copyrightable works of graphic art that the designer licenses to the client. This is not the place for a lengthy examination of the copyrightability of graphic design. But the designer who registers designs when appropriate and who, with or

without registration, makes clear to the client that he or she is acquiring a *license*, not purchasing *ownership* of either the original design itself or the boards or disks on which the design is embodied, is better able to retain control of the design and its integrity. Regarding sales tax, a clear paper trail that indicates the design is a copyright property being licensed to the client makes clear to a taxing authority that the portion of a job not tax-exempt as "services" is a nontaxable transfer of intangible property.

Tangible property

Printed matter, such as brochures, stationery or posters, is taxable as tangible property if the designer sells them to the client. If, however, the designer simply acts as the client's agent in dealing with the printer, with the client paying the printer directly, the transfer to the client will still be subject to tax; in this instance the printer, not the designer, will have to collect the tax. The issue that arises when the designer transfers tangible personal property to the client in addition to performing services and licensing the design is how, and where, the line will be drawn between the intangible, nontaxable portion of the transaction and the tangible, taxable portion. Taxing authorities are typically concerned that in a transaction of this nature the bulk of the value will be loaded into the nontaxable portion of the transaction as an exercise in tax evasion, which is why a clear paper trail—differentiating the *value* of the intangible services (however calculated) and the licenses granted, from the taxable *costs* of the tangible printing and production, is essential to avoid unnecessary tax liability.

What is less clear: Is graphic design tangible?

While most states do not tax intangible services or copyright transfers, the state laws and regulations may not be clear as to whether or not "design" falls within provision of services and copyright license transfers, or is merely a production adjunct of the printing trade. Many state laws are woefully out of date—having been drafted long before the adoption of the current copyright law, in the era of engraving houses, hot type and keylining—and do not even recognize the existence of the graphic designer independent from a printing or typesetting establishment. As an auditor's knowledge of the industry may well consist entirely of regulations that describe the industry as of 20 or more years ago, it falls entirely on the designer to provide clarification *within* the relevant laws and regulations, no matter how out of date, to explain why graphic design should be exempt from collection of tax in the event of an audit.

The New York example

Nowhere in these classifications does the graphic designer, as such, clearly appear. Under New York tax law, then, a designer's services and licenses are potentially exempt from tax, but the designer must know in which category to classify different jobs.

New York exempts grants of the right to reproduce an "original image" from sales tax and also exempts "the services of an advertising agency or other persons acting in a representative capacity." Thus creation of an original work, such as a logo or creative services of a consulting nature, appears to be excluded.

New York does not, however, extend that exemption to what it terms a "license to use." Licensing of "original work"—i.e. created by the licensor—is a transfer of reproduction rights under New York law, and not subject to tax, if it is used as is. If, however, one is merely licensing the use of another's work, that is a "license to use" and subject to tax. It is also considered a taxable "license to use" if the licensee retouches or alters the work. The taxable "license to use" may apply to the designer who licenses an image from an archive or stock house, where the archive or stock house is not the creator of the work. If the designer manipulates the image in the sense of retouching it, the license paid by the designer is also a taxable "license to use" rather than a license of "reproduction rights."

Nonetheless, designers generally license original work to the client. Even if the original work of an annual report, book jacket design or brochure design incorporates illustrations or photography which are someone else's original work, the end result which the designer licenses to the client is an original work in itself, in the form of a collective work which arranges the type, images, colors, paper, etc., into a different whole. The designer may have to pay tax on a "license to use" a stock image that he or she manipulates to create the original design licensed to the end client, but the designer's end design, if reproduced as is, is a license of reproduction rights and not taxable. If the client, rather than the designer, adapts it and manipulates it, then it would appear the end client is licensing to "use" rather than to "reproduce," and must pay tax.

This would seem to be a strong incentive for designers and clients, both, to not have the client "adapt and apply" a design, but rather license it for straight reproduction. Not only does the client avoid paying tax, as does the designer avoid having to collect it, but the designer retains a greater level of control over his or her work.

"Original work," even that incorporating the licensed work of others, is the property of the designer whether the designer is a sole proprietor, or whether the designer is a commercial entity such as a partnership or corporation. In the latter instance, the original work of authorship—"the design"—is a work-for-hire work of authorship owned by the commercial entity. True, the term, "work-for-hire" raises the hackles on every creator, but if a work of authorship is created by several creatives in a company, and the end result is licensed by the company rather than an individual, the work is a "work for hire" owned by the company, and the company is the author.

In New York, design fees are not taxable, but transfers of tangible personal property such as layouts, printing plates, catalogs and promotional handouts are. If you actually hand over design in a tangible form, rather than allowing the client to transfer design electronically for specified uses (without leaving a disk or tangible product), you are less likely to be liable for tax on a tangible product.

The designer may sometimes act as an advertising agency, or as an "other person acting in a representative capacity," avoiding tax on fees charged in both cases. A designer may also, however, grant a license to reproduce an original image—as in the case of a logo—or may license, or sub-license, images that the designer has retouched or otherwise manipulated. In the case of the logo, the designer's grant of reproduction rights is clearly not subject to tax; in the case of manipulated images, to avoid tax liability under a "license to use," it would be necessary for the designer to be able either to classify the job as being done in the role of an "advertising agency or other person acting in a representative capacity," or as the grantor of rights in the original *derivative* image, of which the designer is in fact the author.

Explanations in New York sales and use tax law

¶165-018 (f) "Reproduction rights" (1) The granting of a right to reproduce an original painting, illustration, photograph, sculpture, manuscript or other similar work is not a license to use or a sale, and is not taxable, where the payment made for such right is in the nature of a royalty to the grantor under the laws relating to artistic and literary property.

(2) Mere temporary possession or custody for the purpose of making the reproduction is not deemed to be a transfer of possession which would convert the reproduction right into a license

to use. See Howitt v. Street and Smith Publications, Inc., 276 NY 345 and Frissell v. McGoldrick, 300 NY 370.

(3) Where some use other than reproduction is made of the original work such as retouching or exhibiting a photograph, the transaction is a license to use, which is taxable.

Example 1: A person contracts with an artist for a right to reproduce one of the artist's paintings on a book cover. No other right is given by the artist for the use of his or her painting. The person who obtains the reproduction right to the painting may have copies made and returns the painting to the artist without alteration, change or correction, and without having destroyed or publicly exhibited the painting. The transfer is not held to be a transaction subject to the sales tax, as a rental, lease or license to use.

Example 2: A photographer takes photographs and furnishes the same to a magazine publisher for the purpose of reproduction. In the course of reproduction, the publisher retouches the photograph. After reproduction, the photograph is returned to the photographer. The receipts from such a transaction are subject to the tax as a license to use.

Example 3: A dealer collects photographs and photographic prints. He or she furnishes the prints to a magazine publisher for the purpose of further reproduction. After reproduction the prints are returned to the dealer. The prints may or may not be changed or altered. The receipts from such transactions are subject to the tax. Since the dealer merely collects the photographic prints and does not have the right to grant the right to reproduce the original, the transaction is deemed a license to use tangible personal property.

¶ 165-033 (b)(5) "Exclusions" Fees for the services of advertising agencies or other persons acting in a representative capacity are excluded from the tax. Advertising services consist of consultation and development of advertising campaigns, and placement of advertisements with the media without the transfer of tangible personal property. The furnishing of a personal report containing information derived from information services, by an advertising agency to its client for a fee, is not a taxable information service. However, if an advertising agency is engaged only for the purpose of conducting a survey or if a survey is separately authorized and billed to the customer, the taxability of such survey is determined in accordance with the provisions of subdivision (a) of this section

and the other provisions of this subdivision. Sales of tangible personal property such as layouts, printing plates, catalogs, mailing devices or promotional handouts, tapes or films by an advertising agency for its own account are taxable sales of tangible personal property.

Example 4: An advertising agency is hired to design an advertising program and to furnish artwork and layouts to the media. The fee charged by the agency to its clients for this service is not subject to the tax. However, if the layout and artwork are sold by the advertising agency to the customer for his or her use, the advertising agency is making a sale of tangible personal property which is subject to the sales tax.

The California example

Unlike New York, California does directly refer to designers in its regulations, but the understanding of the design industry reflected there has traditionally rendered most finished work liable to tax. California in the past has exempted what it calls "preliminary art"—conceptual work, sketches and preliminary layouts—but subjected "total charges for finished art"—used for actual reproduction—to sales tax. Until recently, California's sales tax authority consistently refused to recognize the concept of licensing or reproduction rights as applied to images, though it did recognize these rights with regard to written works of authorship.

In the recent decision of Preston v. State Board of Equalization, the California Supreme Court rejected the state's traditional application of sales tax to image-based transfers of rights. In that case, an illustrator successfully sued the board for applying tax to payments for the copyright licenses she transferred to various publishers, and to the royalties she was subsequently paid. As a result of this favorable decision, brought about largely through an amicus brief filed by the Graphic Artists Guild and strongly supported by AIGA, the California sales tax regulations have been extensively redrafted. The redrafted regulations discuss rights transfers in

terms of "technology transfer agreements," a California concept which evolved during the development of Silicon Valley, and which exempts transfers of intangible rights to images but does impose a minimal sales tax when such rights are transferred even temporarily in a tangible medium. The regulations affected include California sales and use tax regulations 1528, 1540, 1541 and 1543, and new regulation 1507; the most important for designers are regulations 1507, which discusses the technology transfer concept, and 1540, which applies that concept to design, but most designers will at some time or other have to familiarize themselves with regulations 1528 (photography), 1541 (printing) and 1543 (publishing).

In brief, images transferred in intangible form—e.g., by modem—are wholly exempt from tax, but when the rights to an image are transferred using tangible means, such as flat art, boards or disks, the rights transfer itself is exempt from tax, but the transfer of the tangible medium remains taxable, even if the transfer is temporary. Calculation of the amount subject to tax begins with a rebuttable presumption. If payment is received in a lump sum without distinguishing between "conceptual services" (which include all preliminary sketches and presentation pieces) and "finished art" (the final used for reproduction), it is presumed that 75 percent of the job fee is for conceptual services, leaving only 25 percent of the fee subject to tax.

This presumption of a taxable 25 percent can be reduced in three ways. If the designer's contract or invoice states the fee for the copyright license separately from the sale price for permanent transfer of the tangible material, or the lease price for temporary transfer of the tangible material, the copyright license is nontaxable and the sale or lease price is the amount on which tax is due. If the contract or invoice does not separately state the charge for transferring the tangible work, the designer can calculate this taxable amount by referencing the taxable amounts of similar work done in the past. The third option is to calculate the taxable amount at 200 percent of the costs of materials and third-party labor. Under this last option, if a designer has no third-party labor costs (e.g., is a sole proprietor without employees or other assistance) and does the work on a computer, the sole taxable amount would be 200 percent of the cost of materials (i.e., of the disk or CD on which the final files are recorded and turned over to the client). Thus, with good record keeping, the actual tax burden can be calculated so as to be reduced to almost nothing.

Sales tax venue

Sales tax applies only to business conducted within the designer's home state, with two exceptions. A few contiguous states, usually adjoining, have reciprocal agreements; the designer living in a state that has one of these agreements should consult an accountant to determine if tax is due on transactions with clients in the reciprocal state. Also, if an out-of-state client has a substantial business nexus such as a store or branch office in the designer's home state, tax will apply if due. If the designer is having printing done out of state for an in-state client, the shipping of the completed printed matter from out of state will still be subject to tax if the designer, not the printer, bills the client.

The designer's role in collecting sales tax

Clients, understandably, do not want to pay tax if they can avoid doing so, and frequently attempt to evade sales tax by the simple expedient of refusing to pay or ignoring the line item on the invoice. The designer, however, is liable to the state for the tax owed, whether or not the client pays—and so should stress to the client that sales tax is "charged" by the state, not the designer, who merely *collects* it on behalf of the state, as mandated under state law.

Contract language that clarifies the tax status

The contract or proposal should contain language permitting the designer to pass through to the client any sales tax he or she must pay on a project and protecting the designer in the event that any taxing authority assesses sales tax on audit. The following wording should be in all contracts for *nontaxable* transactions and grants of rights for one-time reproduction of designs only: "Client is liable for sales tax paid by [the designer] to vendors or freelancers for services rendered or materials purchased relating to the execution of this project. The client shall also pay any sales, use or other transfer taxes that may be applicable to the services provided, including any tax that may be assessed on subsequent audit of [the designer's] books of accounts."

On projects where the client is being provided the grant of a right for one-time reproduction of the designs only, all mechanicals and disks sent to the client must be marked with a stamp or label that provides the following message to avoid appearing to be a taxable transaction: "Ownership and title of all drawings, artwork, electronic files and other visual presentations at all times remains the property of [the designer]. Temporary transfer of possession is granted only for the purpose of reproduction after which all materials must be returned,

unaltered and unretouched to [the name and address of the designer]."

The following wording should be in all contracts for taxable projects: "This estimate does not include sales tax. Sales tax will be charged for that portion of the job delivered in New York [State] when the job is invoiced."

Recommendations to minimize sales tax liability

Most states fall somewhere between New York and California in their application of sales tax to designers. The statutes and regulations may or may not recognize designers as such, or the existence and intangibility of reproduction rights, but most states—including California, once the regulatory revisions are complete—exempt most aspects of design transactions except for the delivery of tangible printed matter. The designer who wishes to avoid needlessly collecting tax, and to avoid unnecessary liability for sales tax if audited, must be aware of how his or her home state statutes and regulations are configured, and adjust contracts and billing to clearly distinguish tangibles from intangibles, and taxable transfers from nontaxable, in a manner that conforms to them. Initial consultation with an accountant familiar with sales tax can provide the designer with a template for design transactions that will enable the designer to avoid unpleasant surprises.

To minimize your sales tax liability, you should consider the following practices:

- Differentiate on your invoices the fees for design services (consulting), intangible products (use licenses) and tangible products (boards and disks, which should be treated as a commodity rather than as a specialized product to which all of the value of your creativity accrues). This may not be sufficient. An even more explicit approach would be to execute separate contracts for tangible and intangible products and services.
- Clarify in your written agreement with the client that you are providing the rights to use your work, but not the ownership of the work itself.
- Specify on your boards or disks that they are the property of your studio and should be returned.
- Have clients pay directly for tangible products, such as printing, so that you do not have to assume the sales tax collection role.

If you need to make use of official clarifications from New York or California authorities to advocate your case in these or other states, they are contained in the preceding highlighted pages and on the web at www.aiga.org.

About AIGA

AIGA, the professional association for design, is the oldest and largest membership association for design professionals engaged in the discipline, practice and culture of designing. Its mission is to advance designing as a professional craft, strategic tool and vital cultural force.

The organization was founded as the American Institute of Graphic Arts in 1914. Since then, it has become the preeminent professional association for communication designers, broadly defined. In the past decade, designers have increasingly been involved in creating value for clients (whether public or business) through applying design thinking to complex problems, even when the outcomes may be more strategic, multidimensional and conceptual than what most would consider traditional communication design. AIGA now represents more than 19,000 designers of all disciplines through national activities and local programs developed by more than 55 chapters and 200 student groups.

AIGA supports the interests of professionals, educators and students who are engaged in the process of designing. The association is committed to stimulating thinking about design, demonstrating the value of design, and empowering success for designers throughout the arc of their careers.

Through conferences, competitions, exhibitions, publications and websites, AIGA inspires, educates and informs designers, helping them to realize their talents and to advocate the value of design among the media, the business community, governments and the public.

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Together with AIGA, Adobe is creating innovative programs that give members a voice, nurture young designers and actively engage the creative community in dialogues about the important issues in the fields of design and technology.

The alliance between AIGA and Adobe is a long-term partnership dedicated to advancing design and the use of technology across creative industries as well as understanding and highlighting the impact of design on the economy and society.

Adobe has been an active participant in the design community over the past 25 years and looks forward to an ongoing conversation and dialogue – listening closely to designers and their needs.

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"Sales Tax" is one topic in the AIGA Design Business and Ethics series, a range of publications dealing with ethical standards and practices for designers and their clients. New topics will be added to the series periodically. Additional copies can be downloaded from www.aiga.org. For more information on solving communications design problems or hiring a professional designer, visit www.aiga.org.

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