



Guide to Utah's Taxation on Creative Services

The information provided below is meant to clarify whether or not graphic design services are subject to sales taxes. The American Advertising Federation of Utah encourages all individuals and businesses to consult an attorney with specific questions pertaining to their own individual accounting and business practices.

HISTORY OF AAF-UTAH PROJECT

In the mid-90's, State Tax Commission auditors audited a number of creative service firms (advertising agencies, graphic design firms, public relations firms, etc.). Tax assessments were made against these businesses on the basis that if a creative service firm engaged in the production of a tangible product, sales tax should apply not only to production costs but also to the associated creative services charges.

Some of these businesses approached the American Advertising Federation of Utah, expressing concern that this interpretation of the Utah tax code was not only an expensive surprise, but was also inconsistent with prior professional advice and previous Tax Commission positions. Furthermore, there was also a strong view that this new position advocating taxation was inconsistent with Utah law.

The question of how best to proceed presented a challenge. Litigation on behalf of an individual business did not seem an adequate remedy for an industry-wide solution. As such, it was decided that a broad-based industry effort would be undertaken with the goal of working with the Utah State Tax Commission to develop a more clearly understood policy.

The American Advertising Federation of Utah spearheaded this effort and formed an industry coalition to approach the Tax Commission. This coalition included the American Advertising Federation of Utah (AAF-Utah), the Salt Lake City Chapter of the American Institute of Graphic Arts (AIGA), the Greater Salt Lake Chapter of the Public Relations Society of America (PRSA) and the Utah Broadcaster's Association (UBA).

A number of meetings and work sessions took place over several years. Members of the Utah State Tax Commission and their staff were very cooperative and willing to learn more about the industry. Eventually, the commissioners chose to develop a new rule dealing specifically with graphic design services. The focus of the rule was to more clearly state that creative services are a nontaxable service. The development of the rule also facilitated the resolution of a number of outstanding audits.

With generous contributions of both time and money, the AAF-Utah was able to obtain the legal services that were critical to the resolution of the issue. The information below contains the text of the new taxation rule as well as commentary and advice from Roger O. Tew, who acted as legal counsel for this project.

BACKGROUND

Utah tax laws require that sales tax be applied to the purchase of all tangible personal property. When a client seeks the services of an advertising agency, graphic design firm or public relations firm, they are primarily purchasing the talent and experience of the firm. In general these services are not subject to sales tax. In many cases the client's final product may be a tangible representation such as a logo or mockup. In other cases, the firm may not only be hired to develop a publication or brochure, but may also be responsible for actual printing or production. The questions center on when sales tax is applicable and if applicable, how the tax should be determined.

TAX COMMISSION RULE ON GRAPHIC DESIGN SERVICES

The Utah State Tax Commission rule references graphic design services. However, the rule is actually applicable to all enterprises that engage in creative service activities, ad agencies, public relations firms, etc. The rule acknowledges that it is possible to separate the nontaxable creative activities from the taxable production of a product. However, the responsibility for this separation falls upon the business and its accounting practices.

DESIGN SERVICES ONLY

Although there have been few tax problems where a firm was engaged only for design work, the rule clarifies that these activities are nontaxable services – even if the final product is a physical representation of the design efforts. For example, a firm is engaged to develop a logo. The fact that the logo is actually a tangible product does not change that the nature of the activity is that of a nontaxable service. That same logic would apply to mockups, prototypes, etc.

DESIGN AND PRODUCTION

Problems have arisen where creative development and responsibility for production have been undertaken by the same firm. An example is a client that engages a firm to prepare an annual report. The contract is for a flat amount to cover all design, printing and production costs. The question is what items are taxable and if taxable, at what amount? Under the new rule, the creative services may be separated from the production component for tax purposes, if the subsequent production is undertaken by a third party. In other words, the rule does not apply to firms that operate their own production facilities.

The critical requirement is that of separately accounting for design and other creative services. Some have asked whether this requirement mandates separate invoices or merely separate accounting. The rule states that creative services must be “separately stated.” The degree of separation is left to the design firm. However, failure to provide a clear delineation will result in the entire amount being taxable.

Example: XYZ Company engages ZZZ Graphic Design to prepare its 2007 annual report. Company XYZ agrees to pay \$100,000 for 5,000 copies. Under what circumstances are various aspects taxable or nontaxable?

SCENARIO 1: If ZZZ Graphic Design simply completes the project and invoices XYZ Company for \$100,000 then sales tax applies to the entire \$100,000. This outcome would result regardless of who did the actual printing.

SCENARIO 2: ZZZ Graphic Design accepts the job. They complete their internal design efforts at a cost of \$40,000. They then subcontract with ABC Printing to actually print the reports. ZZZ Graphic invoices XYZ Company for the entire \$100,000, but separately accounts for the design activities and the printing. Sales tax would apply only to the \$60,000 printing costs. The design costs are considered nontaxable services.

QUESTIONS

After the adoption of the rule, we actively solicited questions and areas of clarification that might be needed. Candidly, we were pleasantly surprised at how few there were. Undoubtedly, over time, others will arise. However, the following items address those few that were presented:

Question 1: Are such items as supervision fees, print markups and commissions considered taxable or not?

Answer: Much of tax law is proper labeling and invoicing. The answer is not meant to be evasive or technical. Rather, it is an acknowledgment that how you do things is important. Monitoring fees and associated commissions can present such a challenge. It is important to emphasize that eligibility for tax exemption assumes that there will be two separate categories of charges: Those for non-taxable services and those for taxable production charges. If fees, mark-ups, or commissions are included with printing or production charges and are shown as such on an invoice, then they are taxable. In other words, any charge from or payment to a printer or manufacturer will most likely be subject to sales tax. That situation is particularly true if the associated charge is really simply a case of directing part of the production or printing payment to the design firm.

On the other hand, if the fee or charge is directly associated with a particular service provided by the design firm and is accounted for with other services provided by the firm, then there is a strong argument for non-taxability. For example, if part of the design firm's responsibilities are to over-see or supervise printing or production and charges for these services are included within the service component of the invoice, then the charges are non-taxable.

This general statement does not mean that you can call any activity or expense anything you want solely for tax purposes. Clear production expenses cannot suddenly become service charges simply by changing the labeling. Potential problems may be avoided by clearly delineating those areas that fall within the production and the service areas as part of the initial contract with the client.

QUESTION 2: How do I treat materials and equipment for tax purposes?

ANSWER: Nothing has changed here. The design firm is considered the final consumer of materials and equipment. As such, tax is paid on these items at the time of purchase. It is important to remember the use tax on material and equipment purchased out-of-state. In short, material and equipment, except in limited circumstances, is always subject to sales tax.

QUESTION 3: Are photographs and photographic rights subject to sales tax?

ANSWER: The current law dealing with photographs is governed by tax commission rule R865-19S-75. Essentially, that rule states that all sales or leases of photographs are considered taxable. The tax should be collected by the photographer at the time of purchase. Obviously, there have been changes in the world of commercial photography since the adoption of this rule. Nonetheless, the current law states that purchases of photographs and photographic rights are subject to taxation.

QUESTION 4: There may still be sales tax areas that are unclear. How should I proceed?

ANSWER: As frustrating as this may be, I would always say when in doubt pay the tax, or better stated, have your client pay the tax. By imposing and collecting the tax, there is a potential profitability impact – the cost is pay by the client. However, if the tax is not collection and it is ultimately deemed to be owed, the tax cost will be paid entirely by you – the creative service business. This bottom line hit can be catastrophic in some cases.

CONCLUSION

The Creative Services Taxation Project had two primary goals: (1) The successful disposition of outstanding audits; and (2) The development of an official policy or rule on sales by graphic artists, advertising agencies and public relation firms. We have been successful on both fronts. All the outstanding audits that triggered the project have been favorably resolved. The development of the tax commission rule has provided important guidance. Lastly, there is now a more level playing field in this highly competitive business.

This does not mean that all questions have been answered. It is important to note that in many cases, questions must be analyzed in the context of individual business operations. To that end, it is suggested that you seek guidance and additional clarification from your legal counsel.

R865-19S-111

Graphic Design Services Pursuant to Utah Code Ann. Section 59-12-103

Graphic Design services are not subject to sales and use tax: if the graphic design is the object of the transaction; and even though a representation of the design is incorporated into a sample or template that is itself tangible personal property. Except as provided in C., if a vendor provides both graphic design services and tangible personal property that incorporates the graphic design: there is a rebuttable presumption that the tangible personal property is the object of the transaction; and the vendor must collect sales and use tax on the graphic design services and the tangible personal property. 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. 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.