



**House  
Legislative  
Analysis  
Section**

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**SALES TAX: ADVERTISING, ETC.**

**House Bill 4452 as enrolled  
Public Act 209 of 1995  
Sponsor: Rep. Willis Bullard, Jr.**

**House Bill 4453 as enrolled  
Public Act 208 of 1995  
Sponsor: Rep. Kirk A. Profit**

**Second Analysis (8-30-96)  
House Committee: Tax Policy  
Senate Committee: Finance**

***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 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

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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 says it 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 advertising industry trade association, however, the Michigan Advertising Industry Alliance, the bulletin represents another attempt by the treasury department to impose a tax on creative services that were once specifically exempt. 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, which followed the removal of the exemptions from the rules, provided advertisers similar protection, say industry representatives. 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 advertising-related businesses for back taxes, interest and penalties. Legislation has been introduced to address this controversy.

### ***THE CONTENT OF THE BILL:***

The bills would provide exemptions from the sales and use taxes for a commercial advertising element if it was used to create or develop a print, radio, television, or other advertisement; was discarded or returned to the provider after the advertising message was completed; and was custom developed by the provider for the purchaser. The term "commercial advertising element" would refer to a negative or positive photographic image, an audiotape or videotape master, a layout, a manuscript, writing of copy, a design, artwork, an illustration, retouching, and mechanical or keyline instructions. The exemptions would not apply to black and white or full color process separation elements, an audiotape reproduction, or a videotape reproduction. House Bill 4452 would amend the General Sales Tax Act (MCL 205.51) and House Bill 4453 would amend the Use Tax Act (MCL 205.92).

### ***FISCAL IMPLICATIONS:***

According to the Senate Fiscal Agency, the bills would reduce sales and use tax revenue by about \$3.5 million in fiscal year 1995-96, based on information from the Department of Treasury. Almost all of the impact would be on sales tax revenues, says the SFA, and thus, the School Aid Fund would lose \$2.5 million; General Fund/General Purpose revenues would decrease by 0.6 million; and revenue sharing payments to cities, villages, and townships would be reduced by 0.4 million. (SFA summary dated 11-7-96)

### ***ARGUMENTS:***

#### ***For:***

The bills would exempt certain kinds of creative work from being unfairly and arbitrarily subjected to the sales and use taxes. The bills say that commercial advertising elements, 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 bill aims at clarifying what is taxable and what is not.

#### ***Response:***

Regardless of the merits of this bill, 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.

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