STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
ZAGOREN GROUP, INC. AND GLENN ZAGOREN, OFFICER OF ZAGOREN GROUP, INC.	:	DETERMINATION DTA NOS. 808189 AND 808190
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period September 1, 1983 through May 31, 1987.	:	

Petitioners, Zagoren Group, Inc. and Glenn Zagoren, officer of Zagoren Group, Inc., 19 Orchard Street, Manhasset, New York 11030, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1983 through May 31, 1987.

A consolidated hearing was commenced before Marilyn Mann Faulkner, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on November 19, 1991 at 9:15 A.M., and continued before Jean Corigliano, Administrative Law Judge, at the same offices on June 25, 1992 at 9:15 A.M., with all briefs due by January 1, 1993. Petitioners, appearing by Edmund J. Mendrala, Esq., filed a brief on October 2, 1992. The Division of Taxation, appearing by William F. Collins, Esq. (Robert J. Jarvis, Esq., of counsel), did not file a brief.

ISSUE

Whether the corporation's charges for its consulting and design work should be subject to sales tax when such work resulted in the production of tangible personal property.

FINDINGS OF FACT

Petitioner Glenn Zagoren is president and founder of the Zagoren Group, Inc. ("Zagoren Group") which commenced operation in 1975. Mr. Zagoren describes the nature of the

business, in contrast to an advertising agency, as a design and consulting production group concerned with creating an image for a company that may result in advertising or other means to promote that image.

The Division of Taxation ("Division") commenced a field audit of the Zagoren Group for the period September 1, 1983 through May 31, 1987.

On October 5, 1987, Mr. Zagoren signed a consent extending the period of limitation for assessment of sales tax until December 20, 1988 for the taxable period September 1, 1983 through August 31, 1985. After the Division determined that the records of the Zagoren Group were adequate and sufficient to warrant a full audit for the period, Mr. Zagoren and the Division's auditor, Allan Korenstein, signed a test period audit method agreement on September 2, 1988.

Mr. Korenstein reviewed all the sales invoices for the two quarters ending August 30, 1986 and November 30, 1986. Based on the information contained on the sales invoices and responses to inquiries by Mr. Korenstein to petitioners' accountant for clarification of the information contained on the invoices, Mr. Korenstein differentiated the sales into three categories -- a sale of tangible personal property, a sale of an advertisement placed in a publication for sale, and a sale of an advertisement placed in a publication not for sale. Of the three categories, Mr. Korenstein determined that only the first category of sales was subject to tax. At hearing, Mr. Korenstein testified as follows:

> "The way you determine whether the charges are taxable is what the entire invoice or sale resulted in. If it resulted in an advertising service then these services might be deemed exempt. If the whole sale results in a sale of tangible personal property, all the expenses of the sales are taxable." (Tr., p. 178.)

In his testimony, the auditor determined that the tangible personal property which petitioners produced were items such as brochures, decals, posters and calendars that were delivered to petitioners' clients.

The auditor determined an error rate of 1.2237% for the test period taking into account credit for the taxes paid. He then projected that error rate over the entire audit period to determine the amount of additional tax due.

The Division issued three notices of determination and demands for payment of sales and use taxes due, dated October 12, 1988, to Zagoren Group, Inc. and three notices of determination, dated October 12, 1988, to Glenn Zagoren, as officer, for the same amounts. The first notice indicated tax due for the period September 1, 1983 through February 28, 1987 in the amount of $70,835.97, plus a $19,337.66 penalty and $34,904.17 in interest, for the total amount of $125,077.80. The second notice stated the tax due for the period March 1, 1987 through May 31, 1987 in the amount of $3,541.03, plus a $885.26 penalty and $605.19 in interest, for the total amount of $5,031.48. The third notice stated a $3,753.05 penalty for the period June 1, 1985 through May 31, 1987.

After a conciliation conference, the conferee issued a Conciliation Order, dated February 23, 1990, recomputing the amounts contained in the statutory notices by cancelling all penalties.

Petitioners filed two separate petitions, dated May 18, 1990, challenging the amount of tax due. Petitioners alleged, inter alia, that the Division failed to consider the effect of Tax Law § 1105 and the exclusion from tax for advertising services consisting of consultation and development of advertising campaigns; that 20 NYCRR 527.3 specifically exempts consultation and development services by advertising agencies; that the Division's audit procedures failed to properly segregate Zagoren Group's sales of tangible personal property and sales of advertising consultation and development services; and that petitioners properly charged and paid over sales tax due and owing on the delivery of tangible personal property.

The Division filed two answers, dated September 3, 1991, alleging, inter alia, that Zagoren Group engaged in sales of tangible personal property and services that were subject to tax, and that Glenn Zagoren was personally liable for the tax deficiencies asserted against the corporation.[1]

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[1]In his petition, Glenn Zagoren did not challenge the assessment against him on the ground that he was not responsible for the collection and payment of sales tax. At hearing, he affirmatively stated that he was president and founder of the corporation and that there was no challenge to the Division's allegation that Glenn Zagoren, as an officer of the corporation, was

At the hearing held on November 19, 1991, petitioner Glenn Zagoren testified and presented evidence as to the nature of the Zagoren Group's business in general. Using specific examples of services rendered within and without the audit period, Mr. Zagoren described his billing procedures. He also submitted a printed document outlining five phases of his billing procedure.[2] The five phases were described in the document as follows:

> "**Phase 1, Programming:** This phase is concerned with gathering information and establishing design criteria, and often requires spending a great deal of time with the client to define the needs and problems that are to be solved.
>
> "**Phase 2, Concept Development:** After the designer and client have reached an agreement concerning the basic program, visual solutions are pursued that solve the stated problems. Much of this phase results in a presentation showing only those ideas that the design team feels are viable, appropriate and meet the prescribed criteria.
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> "**Phase 3, Design development:** At this stage, the design team refines the accepted design, which may include the grid, selected typefaces and other elements, and the assignment of illustration and/or photography. A final presentation will be made explaining the applications. Once the client and designer have chosen a definite direction, any changes in budget and/or schedules are agreed upon.
>
> "**Phase 4, Design implementation:** Decisions on all related art direction including commissioned illustrations and photography; typography; copywriting; mechanicals; and all other elements are final at this point. Any changes made by the client after this point are billable as 'authors alterations' (AA's), although designer errors or printer errors (PE's) are not.
>
> "**Phase 5, Production:** This phase will include going on press and supervising the fabrication of the job. Supervision is the key to this phase since so much depends on the precision and quality achieved in this final step."

In his testimony at hearing, Mr. Zagoren drew a distinction between the work performed by the Zagoren Group and an advertising agency noting that an advertising agency is primarily concerned with media placement whereas the Zagoren Group is a design and consulting group

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personally liable for any sales tax ultimately determined to be due.

[2]Mr. Zagoren testified that this document was derived from the Graphic Artists Guild Handbook on Ethical Practices and that he has used the document, since the beginning of the corporation, in his presentation to clients to explain his phased billing program.

whose services may be terminated at the end of any phase in the billing procedure.[3] Petitioner[4] submitted into evidence examples of

work performed by it for various accounts to demonstrate projects that had been billed at the completion of different billing phases. For example, on one account the Zagoren Group only billed the client, a small dessert shop, for a consulting fee after it drafted on tissue paper several rough sketches of different designs for an ad that could be placed in a magazine or handed out on leaflets. As part of its brainstorming session with the client, petitioner also provided the client with information concerning the cost of implementing the sketched ideas. In this case, the client decided not to proceed to the next phase; therefore, petitioner did not charge the client sales tax for its "phase one" work.

Petitioner presented as evidence a job folder containing design work for a client who was billed through phase two or concept development. At this phase, petitioner produced three "comps" or sketches of ideas to be used for advertising. Again, because the client decided not to proceed to the next phase, petitioner did not charge the client any sales tax.[5]

As an example of a project that had proceeded through the production phase, petitioner presented a job folder containing various sketches, the final brochure actually produced and the invoices. In this case, there were two invoices for the client, one dated August 31, 1986 and another dated October 5, 1986, both of which were examined by the Division's

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[3]Mr. Zagoren noted that the corporation was a member of the Graphic Artists Guild but not a member of the American Association of Advertising Agencies.

[4]Petitioner, when used in the singular form, will refer to the Zagoren Group.

[5]Petitioner also produced the invoice, dated August 31, 1986, for its services. In cross-checking this invoice number against the auditor's workpapers, it is clear that the Division's auditor determined that no tax was owing on this invoice as well.

auditor because they fell within the test period. On the invoice dated August 31, 1986, the client was billed as follows:

		Current Billing
Stats		$ 28.00
Messenger		10.00
Typography		233.88
Zagoren typography	90.00	
Mercadante typography	36.00	
Mercadante typography	12.00	
Mercadante typography	24.00	
Mercadante typography	36.00	
Mercadante typography	5.88	
Di Typeset correx	6.00	
Di Typeset correx	24.00	
23.25 Hours Agency Service		1,665.00
4.00 hrs. copywriting		
5.25 hrs. creative/layout/design		
3.75 hrs. production supervision		
10.25 hrs. mechanical/paste-up		
Sub-total		$1,936.88
Sales tax		20.95
	Total	$1,957.83[6]

Mr. Zagoren testified that the corporation was originally retained to design a mailer to promote the sale of two buildings and that the client terminated the job at the design stage prior to production because it believed it had obtained a buyer for the real estate project. Therefore, in the August bill petitioner charged sales tax on outside purchases only. However, when the anticipated sale did not materialize, the client requested that the designs proceed to printing. Thus, the October 5, 1986 invoice contained the following production charges:

		Current Billing
Express shipping		$ 17.00
Blueline to Craftsmen	17.00	

[6]Petitioner charged sales tax on the typography and stats only. In the auditor's workpapers, he recalculated the tax by charging sales tax on the 23.25 hours of agency services for the total sales tax of $154.15 ($20.95 + $133.20).

Printing		1,625.00
3M mailers	1,625.00	
2.25 hours agency service		135.00
2.25 hrs. production supervision		
Sub-total		$1,777.00
Sales tax		130.00
Total		$1,907.00[7]

Mr. Zagoren testified that the corporation always retained the rights to all artwork and designs even when the design project proceeded to the actual production phase. He noted that at times the clients would decide to print the designs themselves or by another printer, in which case petitioner would provide the clients with the mechanicals[8] for printing. Mr. Zagoren explained that no sales tax was charged on these mechanicals, unless outside purchases were involved, and the mechanicals would be returned to the corporation because it retained the rights to all artwork. Petitioner claimed that the corporation sold only the right to use the design created but not the right to the designs or layouts themselves which instead remained the property of the corporation. Mr. Zagoren further explained that because the corporation retained the rights to all art designs it could provide to a subsequent customer at a reduced price designs similar to designs created for a previous customer by using photos or techniques developed in the former project. (Tr., pp. 44-48.)

[7]Petitioner charged sales tax on printing costs only, whereas the auditor determined that $142.16 in sales tax was owed on the entire bill ($130.00 + $12.16).

[8]Mr. Zagoren described mechanicals as similar to blueprints because they contain instructions for printing, including specifications for color breakouts.

SUMMARY OF THE PARTIES' POSITIONS

At the conclusion of the June 25, 1992 hearing, the Division's counsel, Robert J. Jarvis, set forth the Division's position as follows:[9]

> "What we have in this case is a situation where it has to be determined whether the invoices which were examined were for the sale of advertising services or whether they were for the sale of tangible personal property. It's the state's position that, in the instances which were assessed as being taxable sales by the auditor, sales themselves were indeed for the sale of some form of tangible personal property. There may have been some 'services' included in the amounts and by the way of overhead, the usual things that go into producing an item. Any time a piece of tangible personal property is made in some fashion whether that be something like an artist's layout or whether it be something as big as a car or other big machine, there are certain categories of the charge that get included that one could deem to be 'services' in some fashion. However, from the sales tax standpoint, what we look at is overall charge in what is being sold to the customer. It's the state's position in this case all the items that were assessed as being taxable were for sales of TPP [tangible personal property] and the fact there may have been some other charges incidental to the delivery of that piece of TPP is not the determinate factor but rather what was being sold." (Tr., pp. 195-196.)

In brief, petitioners argue that the Division's auditor based his determination solely on a review of the corporation's invoices without an understanding of the business's type of operations or manner of doing business; that the corporation was not an advertising agency; that the corporation's income was generated by the sale of ideas and not the sale of tangible personal property; that the design elements of the corporation's operations were separate from the delivery of tangible personal property; and that the corporation's operations were similar to a "stock photo house" and that in a recent advisory opinion it was held that the use of materials from a "stock photo house" does not constitute a sale of tangible personal property subject to sales and use tax.

CONCLUSIONS OF LAW

A. Tax Law § 1105(c)(1) imposes a sales tax on receipts from every sale, except for

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[9]Despite the granting of two requests by Mr. Jarvis for an extension of his brief date, the Division did not submit a brief.

resale, for the:

> "furnishing of information by printed, mimeographed or multigraphed matter by duplicating written or printed matter in any other manner, including the services of collecting, compiling or analyzing information of any kind or nature and furnishing reports thereof to other persons, but excluding . . . the services of advertising or other agents, or other persons acting in a representative capacity . . . ."

Relying on the advertising exclusion, the Appellate Division in Matter of Laux Advertising v. Tully (67 AD2d 1066, 414 NYS2d 53) held that purchases of materials to prepare mechanicals were not exempt from sales tax as sales for resale because the primary purpose of the mechanicals was to produce advertisements in publications and not to resell them to customers. The court noted that any resale of the mechanicals to customers was merely incidental to the purchaser's primary business of advertising.

Here, petitioners repeatedly emphasized that the corporation is not an advertising agency but instead a design or image-building agency. However, petitioners have not clearly articulated what significance this distinction has in their legal theory. In any event, this distinction appears to be irrelevant because this case involves the imposition of sales tax on tangible personal property transferred to a client and not services resulting in the transfer of mechanicals to an advertiser (see, Finding of Fact "4").

B. Tax Law § 1105(a) imposes sales tax upon receipts from every retail sale of tangible personal property. Petitioners argue that the Zagoren Group's design services are separate and distinct from its production services; that is, each phase in the billing process should be considered separately in determining whether sales tax should be imposed. Petitioners also argue that the corporation's business is similar to that described in the Division's Advisory Opinion (TSB-A-91[79]S), where the Division opined that a licensing fee paid to a taxpayer by its customer for the right to reproduce movie footage was not subject to sales and use tax. Petitioners' arguments have no merit.

Here, petitioners agreed to a test period audit. The auditor reasonably calculated an error rate based on the information petitioners' accountant provided during the course of the field audit (see, Finding of Fact "4"). Therefore, petitioners have the burden of demonstrating by

"clear and convincing" evidence that the method of audit or amount of tax assessed was erroneous (see, Matter of Surface Line Operators Fraternal Org. v. Tully, 85 AD2d 858, 446 NYS2d 451, 453 [and cases cited therein]). Despite the numerous exhibits petitioners presented in support of their case, only two fell within the test period within which the percentage of error was computed. One exhibit represented a project where the corporation billed the client through phase two (see, Finding of Fact "11") and, therefore, no sales tax was charged because no tangible personal property was produced or transferred to the client. A cross-check of that invoice with the auditor's workpapers revealed that the auditor also did not consider petitioners' services subject to sales tax with respect to this particular job (see, Finding of Fact "11", footnote 5). Therefore, the only evidence relevant to petitioners' legal arguments are the two invoices concerning one account where the client terminated the project prior to the production phase and thereafter revived the project for the production of brochures (see, Finding of Fact "12"). On those invoices, the corporation charged sales tax on the actual printing and typography costs but excluded from sales tax all other services performed by the agency such as production supervision, design and layout, etc. Petitioner, therefore, appears to theorize that its charges with respect to design services are distinct from any charges involved in the actual printing of the tangible personal property (brochures) transferred to the client; and that because it retains the rights to the actual art work, such services are not subject to sales tax.

There is no authority in the statute, regulations or case law that would support petitioner's theory that only the printing costs involved in the production of the tangible personal property are taxable. The receipts from the sale of the tangible personal property cannot be broken down into the taxable and nontaxable services involved in the production of the tangible personal property. Here, the clients' purchase of the tangible personal property included the corporation's creative input because absent the corporation's creative input, the tangible personal property would have no value to the client. To read the statute as urged by petitioner, a taxpayer could separate all the customer charges associated with the various stages in the production of tangible personal property into taxable and nontaxable services. Clearly, such a reading of the

statute was not intended by the lawmakers[10] and would result in endless schemes to avoid the payment of sales tax.

Furthermore, petitioner's reliance on the cited Advisory Opinion is misplaced. First, advisory opinions do not constitute binding authority inasmuch as they are restricted to the specific facts that are addressed (Tax Law § 171 [24]). Secondly, the Advisory Opinion does not support petitioner's position in any event. Petitioner claims that its operations are similar to the operations of a "stock film house" that was addressed by the Advisory Opinion. In the Advisory Opinion, it was determined that a licensing fee to reproduce film footage was not subject to sales tax because there was no permanent transfer of tangible personal property but only a temporary transfer for the purpose of reproducing the film footage. In petitioner's case, the invoices concerned the actual production of tangible personal property (brochures) for a particular client that was permanently transferred to that client. Despite the fact that petitioner retained the right to reuse all design work in subsequent projects, petitioner's customers were not charged a licensing fee but were charged for the actual time spent on each project. To the extent that tangible personal property resulted from its design efforts and such property was transferred to the customer, all receipts from the customer, no matter how broken down into separate charges, were subject to sales tax. Indeed, in that Advisory Opinion, the Division stated that the separate sale of "scratched" workprints to the customer did constitute the transfer of tangible personal property subject to sales tax.[11]

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[10]Tax Law § 1105(c)(2) further indicates that the Legislature intended taxable receipts to include all charges associated with the production of tangible personal property that are passed on to the customer. Section 1105(c)(2) imposes sales tax on the sale of services performed on tangible personal property furnished by, or on behalf of, the person for whom the services are performed if such services involve production, fabricating, processing, printing or imprinting (see, 20 NYCRR 527.4[b], [c], [d], [e]; Matter of Harrison Services v. State Tax Commn., 124 AD2d 251, 508 NYS2d 63). Moreover, the regulations specifically provide that costs incurred by a vendor in making the sale of tangible personal property are not deductible from the "receipts" provided by a purchaser (see, 20 NYCRR 526.5[e]).

[11]A "scratched" print literally has scratches on the film rendering it unusable for reproduction purposes but usable for viewing by a client for decision-making purposes with respect to

C. The petitions of Zagoren Group, Inc. and Glenn Zagoren are denied, and the six notices of determination and demands for payment of sales and use taxes due, dated October 12, 1988, as modified by the two conciliation orders, are sustained.

DATED: Troy, New York
May 27, 1993

/s/ Marilyn Mann Faulkner
ADMINISTRATIVE LAW JUDGE

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selecting the film footage the client seeks to reproduce.