



## **Proposed Sales Tax Regs For The Advertising Industry**

By: James B. Astrachan

A sales tax audit scares an ad agency as much as anything. The auditors will select one month from the last forty-eight months for a comprehensive audit, determine how much sales and use tax should have been paid if the rules were followed and extrapolate that result over the forty-eight month period. An audit can ruin an agency.

Maryland sales and use taxes are five percent of the purchase price of goods. The buyer is obligated to pay the sales tax; but if the buyer does not, the seller must. An agency can be a buyer and a seller. A use tax is a tax imposed on the privilege of using in Maryland goods bought in another state, such as audio-visual equipment bought by internet from a New York vendor.

The advertising community is concerned about sales tax issues primarily because no agency is comfortable with how the sales and use tax is applied. Many agencies felt, rightfully or wrongfully, that the same circumstances in two different shops would often produce two different results.

The Maryland Comptroller of the Treasury recently proposed sales and use tax regulations intended to govern the advertising industry to "clarify the applicability of

sales and use taxes to advertising agencies." If adopted, these regulations will become effective on July 1, 2002.

The Sales Tax Division asked for written comments to the regs, but the press of work did not make it possible to meet the July 31 deadline. Nevertheless, it would be very helpful to the Division and the ad community to meet to discuss each other's concerns.

Parts of the proposed regs are straightforward and adopt principles that have been communicated by Division auditors by word of mouth. Other parts are far afield of existing practice.

#### Non-Taxable Services.

Generally, personal services such as legal and accounting are not taxed. The regs name five categories of ad services not subject to tax. First is *preparation and placement of advertising* in print or broadcast media. Historically, the Division has attempted to tax the client for purchases made by the agency used to produce print. Conversely, the Division has attempted to tax the agency, as the end user, for purchases made to produce broadcast ads. This exclusion would appear to pertain only to the personal services applied by an agency to prepare and place these ads - not to purchase of materials such as photographs, illustrations and even the final broadcast master. But the exclusion may be extremely limited as the regs also tax charges for "preliminary property" (defined as art, mock-ups, layouts or models) produced for a client's approval, even if the charges for the personal services are separately stated.

Only when the charges are for initial consultations and preliminary art created before a contract is entered into will the charge not be taxed. This added caveat would appear to eliminate any exclusion for personal services for the "preparation. . . of advertising in print or broadcast media". Nevertheless, this reg might echo sentiments of the Division, spoken over a decade ago, that if an agency had one contract for preliminary work, terminable by the client at will, and a second contract for execution of the work speced in the first contract, the work performed under the first contract was not taxable if title did not pass to the client.

Next, *public relations and setting up press conferences* are excluded. Fourth, *conducting marketing research* is excluded. Finally, *creative concept development* is excluded but this clashes with the requirement that preliminary property, such as mock-ups, be taxed. With print advertising, creative concept development flows into mechanical production.

#### Production Tapes.

The proposed regs define taxable personal property as "property that the client uses in its business (such as signage, letterhead. . .annual reports, or audio or video tapes). . .". The inclusion of video tapes is troubling, as much broadcast production is delivered on video tape. Does this mean that if a commercial that cost \$1 million to produce is delivered to the agency on tape, a tax is imposed on \$1 million? It might. In the past, if the agency's creative efforts were responsible for the product, it was not taxed; if the agency hired an outside producer and director to create the ad, it was taxed. This needs clarification, especially in light of the Noble Steed holding whereby

the cost of producing music delivered on tape was taxed because the tape was "tangible personal property".

#### Agent for a Disclosed Principal.

Once, if an agency acted as an agent for a disclosed principal the state would impose the tax directly on the client (principal) and not the agency. The problem was the factual determination of whether the agency was really an agent.

The Division insisted that the appointment be in writing, although that formality is not required under the laws of agency. It also wanted purchase agreements between agency and vendor to state that the agency was an agent for a named principal. These requirements are in the proposed regs.

Also in the regs is a requirement that the vendor price billed to the agency be passed on to the client, and that mark-up be separately stated. Many agencies will gag over this requirement as it interferes with the agency's ability to charge its client.

Finally, the agency cannot use the purchased property to prepare ads. This, in effect, eviscerates the agent-principal exclusion now relied upon because most material purchased by an agency will be used to prepare ads.

If the agency is determined to be an agent, the agency must pay the sales tax, even though "[T]he client, as buyer, is ultimately responsible for payment. . .". This would appear to be exactly the state of the law without a determination that the agency is an agent.

Regs for the ad industry are a good idea. Likely, they would work better after a face-to-face meeting between the Division and the ad community.

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