

**TENNESSEE DEPARTMENT OF REVENUE
LETTER RULING # 12-33**

WARNING

Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This ruling is based on the particular facts and circumstances presented, and is an interpretation of the law at a specific point in time. The law may have changed since this ruling was issued, possibly rendering it obsolete. The presentation of this ruling in a redacted form is provided solely for informational purposes, and is not intended as a statement of Departmental policy. Taxpayers should consult with a tax professional before relying on any aspect of this ruling.

SUBJECT

The application of the exemption found under TENN. CODE ANN. § 67-6-312 (2011) to an advertising agency's creation of brochures.

SCOPE

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department, and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time. Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling; and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

FACTS

[TAXPAYER] (the "Taxpayer") is [ENTITY TYPE] with its principal place of business located in [TENNESSEE]. The Taxpayer is engaged in the business of providing advertising services, including the development of advertising brochures. When an advertising strategy involves the creation of a brochure, the Taxpayer will produce the brochure in several phases.

When the Taxpayer is hired by a customer, it spends a substantial amount of time during the “consultation phase” consulting with the customer in order to develop a general advertising strategy. The Taxpayer also provides account planning services, such as budgeting. Such consultation usually starts at the beginning of a client project, but oftentimes carries forward throughout the client relationship.

Next, the Taxpayer engages in the “research and development” phase, whereby it conducts research and develops a concept (or multiple concepts) for the brochure.

After developing one or more potential concepts, the Taxpayer next engages in the “design phase” whereby it produces brochure mock-ups for the customer’s review. This phase involves art direction, design, and drafting of copy text. The Taxpayer also creates or purchases necessary photographs, graphic designs, artwork, or other images (collectively referred to as the “artwork or images”) needed to develop the mock-up or mock-ups. It is not known at the time a mock-up is created whether any copy text, artwork, or other images included in such mock-up will be included in a final brochure proof.

After the customer approves an initial mock-up, the Taxpayer begins the “production phase” of brochure development. During this phase, based on customer comments or critique, the Taxpayer makes necessary modifications to the design, copy text, or artwork or images and will often prepare additional preliminary proofs for customer review. Once all customer critiques are incorporated, the Taxpayer produces a final proof. The customer will either take the final proof and have it printed elsewhere, or contract with the Taxpayer to have it printed. When the customer chooses to have the Taxpayer handle the printing, the Taxpayer contracts with a third-party printer to perform the printing. The Taxpayer passes the printing charge through to the customer, along with a charge for the Taxpayer’s print coordination and management services.

Less than five percent of the time, clients provide artwork or images to the Taxpayer for use in creating a brochure. The rest of the time, the Taxpayer purchases artwork and images from third parties.

RULINGS

1. When customers choose to have the Taxpayer coordinate the printing of brochures, do the brochures printed utilizing the final proof produced by the Taxpayer constitute “advertising materials” for purposes of TENN. CODE ANN. § 67-6-312 (2011)?

Ruling: Yes. The brochures printed utilizing the final proof produced by the Taxpayer constitute “advertising materials” for purposes of TENN. CODE ANN. § 67-6-312 (2011).

2. When customers choose to have the Taxpayer coordinate the printing of brochures, do the printing charges that the Taxpayer passes through to its customers constitute taxable charges?

Ruling: Yes. When customers choose to have the Taxpayer coordinate the printing of brochures, the printing charges that the Taxpayer passes through to its customers are subject to the Tennessee sales and use tax.

3. When customers choose to have the Taxpayer coordinate the printing of brochures, are the charges levied by the Taxpayer for its service of coordinating and managing the brochure printing process subject to the Tennessee sales and use tax?

Ruling: Yes. When customers choose to have the Taxpayer coordinate the printing of brochures, the charges levied by the Taxpayer for its service of coordinating and managing the brochure printing process are subject to the Tennessee sales and use tax as part of the sales price of the brochures.

4. Does the final proof created by the Taxpayer during the production phase constitute “final artwork” for purposes of TENN. CODE ANN. § 67-6-312 (2011)?

Ruling: Yes. As described in the Facts section, the final proof created by the Taxpayer during the production phase constitutes “final artwork” for purposes of TENN. CODE ANN. § 67-6-312 (2011).

5. Does the sales price of final artwork include only costs attributable to the preparation of a final proof after receiving customer critique from any additional preliminary proofs provided by the Taxpayer to its clients?

Ruling: The sales price of final artwork includes all costs directly allocable to the production of final artwork, excluding advertising services. There could be costs incurred prior to the customer critiquing the final proof that are not advertising services and are directly allocable to the production of final artwork.

6. May the Taxpayer use a resale certificate to purchase artwork and images that are incorporated into final artwork?

Ruling: No. The Taxpayer may not use a resale certificate to purchase artwork and images that are incorporated into final artwork.

7. Do the brochure mock-ups and preliminary proofs produced by the Taxpayer, including artwork or images created or purchased by the Taxpayer and incorporated therein, constitute “preliminary artwork” for purposes of TENN. CODE ANN. § 67-6-312 (2011)?

Ruling: The brochure mock-ups and the preliminary proofs produced by the Taxpayer constitute “preliminary artwork” for purposes of TENN. CODE ANN. § 67-6-312 (2011). Artwork or images purchased by the Taxpayer are not “preliminary artwork,” and the Taxpayer must pay Tennessee sales or use tax on its purchase of those items.

8. Do the Taxpayer’s services provided during the creation of the brochure mock-ups and preliminary proofs constitute nontaxable “advertising services” for purposes of TENN. CODE ANN. § 67-6-312 (2011)?

Ruling: The Taxpayer’s services provided during the creation of the brochure mock-ups and preliminary proofs constitute “advertising services” for purposes of TENN. CODE ANN. § 67-6-312 (2011). Such services are not taxable at the time they are rendered, but they are

included in the sales price of any “advertising materials” ultimately created and sold in the course of providing such services.

ANALYSIS

Under the Retailers’ Sales Tax Act,¹ the retail sale in Tennessee of tangible personal property and specifically enumerated items and services is subject to the sales and use tax, unless an exemption applies. The sales tax is levied on the “sales price”² of tangible personal property or taxable services, while the use tax is levied on the “purchase price”³ of tangible personal property not sold within Tennessee but “used, consumed, distributed, or stored for use or consumption” in Tennessee.⁴

TENN. CODE ANN. § 67-6-102(78) (2011) defines the term “retail sale” as “any sale, lease, or rental for any purpose other than for resale, sublease, or subrent.” Moreover, TENN. CODE ANN. § 67-6-102(80)(A) defines the term “sale” in pertinent part to mean “any transfer of title or possession, or both, exchange, barter, lease or rental, conditional or otherwise, in any manner or by any means whatsoever of tangible personal property for a consideration.”⁵

Tangible personal property, as defined in the Retailers’ Sales Tax Act, means “personal property that can be seen, weighed, measured, felt, or touched, or that is in any other manner perceptible to the senses.”⁶

Services are also taxable under the Retailers’ Sales Tax Act.⁷ But the sales tax does not apply to all services; rather, it only applies to retail sales of those services specifically enumerated by the Retailers’ Sales Tax Act.⁸

There are two ways that even non-enumerated services may, however, be included in the sales price of a given transaction, despite not being directly subject to tax. First, a nontaxable service or item may be subject to taxation when charges for the nontaxable service or item are combined

¹ Tennessee Retailers’ Sales Tax Act, ch. 3, §§ 1-18, 1947 Tenn. Pub. Acts 22, 22-54 (codified as amended at TENN. CODE ANN. §§ 67-6-101 to -907 (2011)).

² The “sales price” generally means “the total amount of consideration . . . for which personal property or services are sold, leased, or rented.” TENN. CODE ANN. § 67-6-102(81)(A) (2011).

³ Although appearing to apply a different measure in the use tax context, “[p]urchase price” has the same meaning as sales price.” TENN. CODE ANN. § 67-6-102(74).

⁴ TENN. CODE ANN. § 67-6-203 (2011).

⁵ *Accord Nashville Clubhouse Inn v. Johnson*, 27 S.W.3d 542, 544 (Tenn. Ct. App. 2000) (“[T]here are three elements necessary to constitute a taxable sale: (1) the transfer of title or possession or both, (2) of tangible personal property, and (3) for a consideration.”).

⁶ TENN. CODE ANN. § 67-6-102(91)(A).

⁷ TENN. CODE ANN. § 67-6-201(a)(3) (2011); *see also* TENN. CODE ANN. § 67-6-102(80)(C).

⁸ *See Covington Pike Toyota, Inc. v. Cardwell*, 829 S.W.2d 132, 135 (Tenn. 1992); *Ryder Truck Rental, Inc. v. Huddleston*, No. 91-3382-III, 1994 WL 420911, at *3 (Tenn. Ct. App. Aug. 12, 1994); *see also* TENN. CODE ANN. § 67-6-205(c) (enumerated services) (2011); TENN. CODE ANN. §§ 67-6-226 to -227 (tax on cable and satellite television services) (2011).

with charges for a taxable good or service into a single price. Specifically, TENN. CODE ANN. § 67-6-102(81)(A) provides that the sales price of a good or service equals the “total amount of consideration . . . for which personal property or services are sold.” Thus, if taxable goods or services and nontaxable goods or services are sold together for a single charge, the entire charge is generally subject to taxation, with the bundled sales price as the measure of the tax.⁹

The second manner in which a non-enumerated service will be included in the sales price of a transaction is where the service is intertwined with the sale of taxable tangible personal property. The definition of “sales price” provides in pertinent part that there will be no deductions for “labor or service” cost by the seller, and also includes “[c]harges by the seller for any services necessary to complete the sale, other than delivery and installation charges.”¹⁰

A line of cases, beginning with *Crescent Amusement Co. v. Carson*, 213 S.W.2d 27 (Tenn. 1948), expand this concept, establishing that 1) where a sale of a non-enumerated service is accompanied by tangible personal property that is a “crucial,” “essential,” or “integral” element of the transaction, the sales price will include the entire cost of the transaction, including the value of the non-enumerated service,¹¹ and conversely, 2) where a sale of tangible personal property is accompanied by non-enumerated services that are a “crucial,” “essential,” or “integral” element of the transaction, the sales price will include the entire cost of the transaction, including the value of the non-enumerated services.¹²

In contrast, where a transfer of tangible personal property is “merely incidental” to a sale of a non-enumerated service, the transaction would not be subject to sales tax.¹³

In 2009, the Tennessee General Assembly created limited exemptions for certain transactions involving property transferred during an advertising agency’s provision of advertising services.¹⁴ The new exemptions are codified in a trifurcated statute that is heavily dependent on new

⁹ See *Tomkats Catering, Inc. v. Johnson*, No. M2000-03107-COA-R3-CV, 2001 WL 1090516, at *2 (Tenn. Ct. App. Sept. 19, 2001); cf. TENN. CODE ANN. § 67-6-102(81)(A)(vi) (“Sales price” includes “[t]he value of exempt personal property given to the purchaser where taxable and exempt personal property have been bundled together and sold by the seller as a single product or piece of merchandise.”).

¹⁰ TENN. CODE ANN. § 67-6-102(81)(A)(ii).

¹¹ See, e.g., *Thomas Nelson, Inc. v. Olsen*, 723 S.W.2d 621, 625 (Tenn. 1987).

¹² See, e.g., *AT&T Corp. v. Johnson*, No. M2000-01407-COA-R3-CV, 2002 WL 31247083, at *7-9 (Tenn. Ct. App. Oct. 8, 2002); see also *Rivergate Toyota, Inc. v. Huddleston*, No. 01A01-9602-CH-00053, 1998 WL 83720, at *4 (Tenn. Ct. App. Feb. 27, 1998).

For convenience, the four (4) cases cited in this paragraph will be referred to as the “*Crescent* line of cases.”

¹³ See *Commerce Union Bank v. Tidwell*, 538 S.W.2d 405, 407 (Tenn. 1976) (citing *Washington Times-Herald, Inc. v. District of Columbia*, 213 F.2d 23 (1954)); cf. *Nashville Mobilphone Co. v. Woods*, 655 S.W.2d 934, 935-37 (Tenn. 1983) (holding that the renting out of radio equipment was merely incidental to the taxpayer’s principal business of “furnishing services as a ‘radio common carrier system,’” and therefore the taxpayer’s purchase of the radio equipment was subject to sales or use tax).

¹⁴ See Act of June 17, 2009, ch. 530, § 55, 2009 Tenn. Pub. Acts 780, 799 (codified at TENN. CODE ANN. § 67-6-312 (2011)).

terminology, also defined within the legislation.¹⁵ The particular nuances of this legislation will be addressed in the responses to the Taxpayer's questions below.

Tax Treatment of Brochures and Associated Printing Charges.

The 2009 legislation did not change the application of prior Tennessee jurisprudence as to the final products of advertising that are actually sold or used, with TENN. CODE ANN. § 67-6-312(c) (2011) declaring that "[t]he sale or use of advertising materials" is subject to the Tennessee sales and use tax.

"Advertising materials" is a term of art incorporated into the 2009 legislation, statutorily defined in TENN. CODE ANN. § 67-6-102(2) as "tangible personal property or its digital equivalent *produced to advertise* a product, service, idea, concept, issue, place or thing, including, but not limited to, *brochures*, catalogs and point-of-purchase materials, but not including preliminary artwork"¹⁶ and not including certain original sound recordings or video recordings.

Accordingly, for the Taxpayer's brochures to constitute "advertising materials," the following requirements must be met: 1) the brochures must be tangible personal property or its digital equivalent; 2) the brochures must be produced to advertise a product, service, idea, concept, issue, place or thing; and 3) the brochures must not be preliminary artwork.¹⁷

First, the facts indicate that the brochures are tangible personal property because the Taxpayer has stated that its clients will have either the Taxpayer, or another firm, print the brochures. Printed brochures can be "seen, weighed, measured, felt, or touched," and are consequently tangible personal property.¹⁸

Second, the brochures are produced to advertise a product, service, idea, concept, issue, place or thing. Brochures are in fact expressly included in the examples of "advertising materials" listed in TENN. CODE ANN. § 67-6-102(2).

Third, the brochures are not preliminary artwork. Although the characteristics of "preliminary artwork," another term of art in the 2009 legislation, will be discussed below, the primary distinction between preliminary artwork and advertising materials is that preliminary artwork is created to convey ideas to the client of an advertising agency, while advertising materials are created to sell products and services to the client's potential customers.¹⁹ The brochures here are

¹⁵ See Act of June 17, 2009, ch. 530, § 56, 2009 Tenn. Pub. Acts at 799-800 (codified at TENN. CODE ANN. § 67-6-102(1)-(3), (40), (65) (2011)).

¹⁶ (Emphases added).

¹⁷ The brochures are clearly not sound or video recordings, so this ruling does not explore that aspect of the TENN. CODE ANN. § 67-6-102(2) definition of "advertising materials."

¹⁸ See TENN. CODE ANN. § 67-6-102(91)(A). Note also that, under TENN. CODE ANN. § 67-6-102(2), even if the Taxpayer's clients do not physically print the brochures but instead create a digital brochure, that would be the digital equivalent to a printed brochure. Cf. TENN. CODE ANN. § 67-6-102(31) (treating, for purposes of the TENN. CODE ANN. § 67-6-233 tax on "specified digital products," a "digital book" as "works that are generally recognized in the ordinary and usual sense 'books' that are transferred electronically.").

¹⁹ Compare TENN. CODE ANN. § 67-6-102(65) (defining "preliminary artwork"), with TENN. CODE ANN. § 67-6-102(2) (defining "advertising materials").

produced to advertise the Taxpayer's client's product or service to potential customers, and thus cannot be properly characterized as preliminary artwork.

Accordingly, brochures printed utilizing the final proof produced by the Taxpayer constitute "advertising materials" for purposes of TENN. CODE ANN. § 67-6-312.

The calculation of the sales price of advertising materials was not altered by the General Assembly's enactment of the 2009 legislation.²⁰ The sales price of such advertising materials consequently includes the total amount of consideration given for the advertising materials,²¹ without any deduction for the "*cost of materials used, labor or service cost, interest, losses, all costs of transportation to the seller, all taxes imposed on the seller, and any other expense of the seller.*"²² Consequently, the sales price of such advertising materials would include the "entire cost of the transaction," including charges for final artwork and all advertising services provided during the entire process of designing and developing the advertising materials.²³

In addition, if the client chooses to have the Taxpayer coordinate the printing of the client's brochures, any fees the Taxpayer charges for such services, though not an enumerated service under TENN. CODE ANN. § 67-6-205(c) (2011), would also be included in the sales price of the brochures for the reasons just discussed.

Finally, the Taxpayer has indicated that it contracts with a third-party printer to perform the printing of the brochures and then passes the printing charges through to its client. The printing of brochures is generally subject to sales and use tax, unless such printing is "part of a manufacturing process for resale."²⁴

Here, the third-party printer is fabricating the brochures so that the Taxpayer may resell them to its client.²⁵ Because the fabrication is for resale, the Taxpayer will not be subject to sales and use tax on its purchase of the brochures, provided that it presents a valid resale certificate to the third-party printer.²⁶

The charges that are passed along to the Taxpayer's client for the printing of the brochures will be subject to sales and use tax as a component of the sales price of the brochures. This is the

²⁰ Cf. TENN. CODE ANN. § 67-6-312(c).

²¹ See TENN. CODE ANN. §§ 67-6-102(81)(A), -202(a).

²² TENN. CODE ANN. § 67-6-102(81)(A)(ii) (emphases added).

²³ See generally *Thomas Nelson, Inc.*, 723 S.W.2d at 622-24; *AT&T Corp.*, 2002 WL 31247083, at *8-9; *Rivergate Toyota, Inc.*, 1998 WL 83720, at *4 (advertising brochures taxable based on the "'entire cost of the transaction'"). Note that advertising services would also be included in the sales price because advertising services are a "crucial" or "integral" element of the transaction, without which no advertising materials could be developed.

²⁴ See TENN. COMP. R. & REGS. 1320-5-1-.67(2) (2008) (The "printing and binding of paper, books, forms, letters, and the like is a fabrication thereof, and is subject to the Sales or Use Tax unless the fabrication is a part of a manufacturing process for resale.").

²⁵ See generally TENN. CODE ANN. § 67-6-102(77)(A) ("Resale" means a subsequent, bona fide sale of the property, services, or taxable item by the purchaser."). Observe that all "sales for resale" must be in "strict compliance with [the] rules and regulations promulgated by the [Commissioner of Revenue]." TENN. CODE ANN. § 67-6-102(77)(A).

²⁶ See TENN. COMP. R. & REGS. 1320-5-1-.68 (2008) (resale certificates).

case, regardless of whether the Taxpayer chooses to mark up the printing costs.²⁷ Additionally, such charges are part of the sales price of the brochures, regardless of any separate itemization on the invoice given to the client.

In summary, the brochures produced by the Taxpayer from the final proof constitute “advertising materials” for the purposes of TENN. CODE ANN. § 67-6-312. The sales price of the brochures, both under Tennessee law prior to and following the 2009 legislation, is comprised of all the costs incurred in developing the brochures, including any materials or services necessary to produce the brochures throughout the entire advertising design process, and including any printing fees or print coordination fees charged by the Taxpayer to its client, regardless of whether the Taxpayer marks up the fees.

Note, however, that even though all of the costs involved in creating the brochures are included in the sales price of the brochures, the Tennessee sales and use tax still only applies to those brochures where “title or possession” transfers to the Taxpayer’s client in Tennessee.²⁸ As a general example, if a client hires the Taxpayer to produce brochures of which 25% are for use in Tennessee and the remaining 75% are shipped outside of Tennessee without the client taking title or possession in Tennessee, the Tennessee sales and use tax only applies to the 25% of the brochures sold or used in Tennessee.²⁹

Tax Treatment of Final Proof and Associated Services

Although the taxation of advertising materials under TENN. CODE ANN. § 67-6-312(c) is identical to their taxation prior to the 2009 legislation, the same is not true for final artwork. Before discussing how final artwork is treated differently under the law enacted in 2009, it is first necessary to explain why the final proof created by the Taxpayer constitutes “final artwork” within the meaning of TENN. CODE ANN. § 67-6-102(40).

“Final artwork” means “tangible personal property or its digital equivalent that is suitable for use in producing advertising materials and includes, but is not limited to, photographs, illustrations, drawings, paintings, calligraphy, models and similar works that are used to produce advertising

²⁷ Cf. TENN. COMP. R. & REGS. 1320-5-1-.99(2) (1974) (“In the event an advertising agency . . . obtains tangible personal property for a client and charges the client more for the property than the agency pays for the property[,] the agency shall collect, report and pay the Sales or Use Tax on the amount actually charged or received for the tangible personal property.”).

²⁸ See TENN. CODE ANN. § 67-6-102(80)(A) (defining “sale” in part as “any transfer of title or possession, or both . . . of tangible personal property for a consideration”).

²⁹ Although the result would be the same prior to 2009 regarding advertising materials, a different result would have been reached for preliminary or final artwork prior to 2009. If, for example, a company based in Tennessee had an advertising campaign designed entirely out of state but concept models were sent into Tennessee for approval, the company would owe sales or use tax on the entire cost of creating the concept models, even if none of the advertising materials ultimately created from those models were ever used in Tennessee. Cf. *Thomas Nelson, Inc.*, 723 S.W.2d at 622. After the 2009 legislation, however, such a transfer would either be exempt, if falling under TENN. CODE ANN. § 67-6-312(a), or subject to a smaller base, if falling under TENN. CODE ANN. § 67-6-312(b).

materials, but does not include preliminary artwork” or certain original sound recordings or video recordings.³⁰

Hence to be considered “final artwork” for purposes of TENN. CODE ANN. § 67-6-312(b), the final proof: 1) must be tangible personal property or its digital equivalent; 2) must be suitable for use in producing advertising materials; 3) must not be preliminary artwork; and finally 4) the brochures produced from the final proof must constitute “advertising materials.”

First, although the Taxpayer has not indicated whether the final proof is provided to its client in physical or digital form, the final proof would nevertheless constitute either tangible personal property if given in physical form or a digital equivalent if, for example, “delivered electronically” as a PDF file.³¹

Second, the Taxpayer’s final proof is suitable for use in producing advertising materials. The Taxpayer has stated that once all customer critiques are incorporated, the Taxpayer produces a final proof that is used to print the brochure. The final proof is necessarily suitable for use in producing the brochure since that is what is actually used to print the brochure.

Third, the final proof is not preliminary artwork. As will be discussed in more detail below, to be considered preliminary artwork, an item has to satisfy three requirements: 1) it must be tangible personal property or digital equivalents; 2) it must be produced by an advertising agency in the course of providing advertising services; and 3) it must be produced solely for the purpose of conveying concepts or ideas or demonstrating an idea or message to a client.³²

Here, the final proof is not produced solely for the purpose of conveying concepts or ideas or demonstrating an idea or message to a client. Instead, the final proof is produced for the purpose of printing the brochures, and is meant to convey ideas to potential customers of the client rather than to the client itself. The final proof therefore cannot be characterized as preliminary artwork.

Fourth, the brochures produced from the final proof constitute “advertising materials,” for reasons that were explained above.

Accordingly, the final proof created by the Taxpayer constitutes “final artwork” for purposes of TENN. CODE ANN. § 67-6-312(b).

As final artwork, the sales price of the final proof is determined in accordance with TENN. CODE ANN. § 67-6-312(b). In enacting TENN. CODE ANN. § 67-6-312(b), the General Assembly established that while final artwork is subject to the sales and use tax, the tax base is limited to

³⁰ TENN. CODE ANN. § 67-6-102(40). Materials used to make a printed brochure do not likely include any sound or video recordings, so that aspect of the definition of “final artwork” is not discussed further within this ruling.

³¹ See generally TENN. CODE ANN. § 67-6-102(26).

³² See TENN. CODE ANN. § 67-6-102(65).

“only the charges made by the advertising agency that are directly allocable to the production of final artwork,” not including “any fees paid for advertising services.”³³

This statute supersedes the principles set out in the *Crescent* line of cases. Previously, advertising services were clearly an essential and crucial element of creating a final proof ready for printing. The final proof would therefore be taxed based on the entire cost of the transaction.³⁴ Following the enactment of TENN. CODE ANN. § 67-6-312(b), however, the sales price of final artwork is limited to those charges that are “directly allocable to the production of [the] final artwork.”

“Directly allocable” is a unique phrase in Title 67 of the Tennessee Code Annotated, lacking a statutory definition. When a word or phrase is not defined, the Tennessee Supreme Court has looked to its “usual and accepted meaning” to determine the Legislature’s intent.³⁵

“Directly” means “in a direct way.”³⁶ BLACK’S LAW DICTIONARY 88 (9th ed. 2009) defines “allocable” as “capable of being allocated,” with “allocation” being defined as “[a] designation or apportion for a specific purpose; esp., the crediting of a receipt or the charging of a disbursement to an account.”³⁷

“Production” is also not defined in the statute, but means “the action of producing something or the process of being produced.”³⁸ To “produce” something means to “make, manufacture, or create something.”³⁹

Consequently, the sales price of the final proof will only include those costs directly designated for the specific purpose of creating or making the final proof. These costs would typically include any printing costs, the costs of paper and ink, the costs of purchasing stock or custom photography that is used in the final artwork, any fees paid to models who are photographed, etc.

³³ See TENN. CODE ANN. § 67-6-102(3)(B) (“‘Advertising services’ does not include the production of final artwork.”).

Note that the final artwork must be “provided by an advertising agency to its client pursuant to an agreement for providing advertising services” in order for advertising services to be excluded from the sales price of any final artwork. See TENN. CODE ANN. § 67-6-312(b). The Taxpayer has represented that it meets the statutory definition of advertising agency contained in TENN. CODE ANN. § 67-6-102(1) (An “advertising agency” is “a business, more than eighty percent (80%) of whose gross receipts in the previous taxable year were, or in the first taxable year are reasonably projected to be, from charges for advertising services.”). The Tennessee Code Annotated does not explain what “an agreement for providing advertising services” is. The Department will assume in this ruling that the Taxpayer’s agreements with its clients are for advertising services because the facts as presented do not indicate otherwise.

³⁴ Cf. *Thomas Nelson, Inc.*, 723 S.W.2d at 622.

³⁵ See *Byrant v. Genco Stamping & Mfg. Co.*, 33 S.W.3d 761, 765 (Tenn. 2000).

³⁶ COMPACT OXFORD ENGLISH DICTIONARY OF CURRENT ENGLISH 279 (3d rev. ed. 2008).

³⁷ See also COMPACT OXFORD ENGLISH DICTIONARY OF CURRENT ENGLISH 23 (3d rev. ed. 2008) (defining “allocation” as the “amount of a resource given to someone”).

³⁸ COMPACT OXFORD ENGLISH DICTIONARY OF CURRENT ENGLISH 812 (3d rev. ed. 2008).

³⁹ *Id.*

Some of these costs may have been incurred during what the Taxpayer has coined as earlier “phases” of the advertising process. For example, while creating a preliminary proof, the Taxpayer may hire a photographer to take a picture for the background image in the preliminary proof. It is true, as the Taxpayer has stated in the Facts section, that at the time such picture is created, the Taxpayer will not know whether that picture will be incorporated into the final artwork. But at the time when the Taxpayer’s client decides on all of the elements to include in the final proof, the Taxpayer will know which elements ultimately will be incorporated into the final artwork. The Taxpayer should then include all of the costs for each of those elements into the sales price of the final artwork, as these costs would be directly allocable.

As stated above, TENN. CODE ANN. § 67-6-312(b) excludes fees paid for advertising services from the sales tax base of final artwork. “Advertising services” are “services provided by an advertising agency to promote a product, service, idea, concept, issue, place or thing.”⁴⁰ These services include providing marketing and advertising advice and counseling, strategic planning, consumer research, design and layout services, and development of preliminary artwork.⁴¹ Thus any fees falling within the aforementioned categories will be excluded from the sales price of the final proof.

The final proof created by the Taxpayer is properly considered “final artwork” for purposes of TENN. CODE ANN. § 67-6-312(b), and the sales price of the final proof includes all costs directly allocable to the production of such proof, but excludes any fees paid for advertising services.

Resale Certificates

The Taxpayer has also raised a corollary issue relating to the final proof but not affected by the 2009 legislation, which is whether it may use a resale certificate to purchase artwork and images that are incorporated into final artwork. The Taxpayer may not.

The retail sale in Tennessee of tangible personal property is generally subject to sales and use taxation.⁴² The term “retail sale” means “any sale, lease, or rental for any purpose other than for *resale*, sublease, or subrent.”⁴³ Moreover, a “sale for resale” is “the sale of the property, services, or taxable item intended for subsequent resale by the purchaser,” and a “resale” is “a subsequent, bona fide sale of the property, services, or taxable item by the purchaser.”⁴⁴

TENN. CODE ANN. § 67-6-102(77)(A) requires that all “sales for resale” be in strict compliance with the rules and regulations promulgated by the Commissioner of Revenue. TENN. COMP. R. & REGS. 1320-5-1-.68(1) (2008) provides that for Tennessee sales and use tax purposes, a dealer must receive a resale certificate from a purchaser in order to make an exempt sale for resale of tangible personal property or taxable services in Tennessee.

⁴⁰ TENN. CODE ANN. § 67-6-102(3).

⁴¹ See TENN. CODE ANN. § 67-6-102(3)(i)-(xiv).

⁴² See TENN. CODE ANN. § 67-6-202(a) (2011).

⁴³ TENN. CODE ANN. § 67-6-102(78) (emphasis added).

⁴⁴ TENN. CODE ANN. § 67-6-102(77)(A).

The Tennessee Supreme Court has held that artwork, graphic designs, and other items that are to be incorporated in a finished product by means of being copied, rather than being directly incorporated, do not become component parts of a finished product but rather are purchased for use and consumption.⁴⁵ It follows that these items, when used by an advertising agency, cannot also be resold.

TENN. COMP. R. & REGS. 1320-5-1-.68(3) provides that “[c]ertificates of resale may not be used to obtain tangible personal property or taxable services to be used by the purchaser, and not for resale.”⁴⁶ The artwork and images incorporated into final artwork are thus purchased for use and not for resale, and the Taxpayer may not use a resale certificate to purchase such artwork and images.

Brochure Mock-Ups, Preliminary Proofs, and Associated Services

TENN. CODE ANN. § 67-6-312(a) is the final statutory addition resulting from the 2009 legislation and represents a complete departure from the *Crescent* line of cases. TENN. CODE ANN. § 67-6-312(a) operates to exempt from the Tennessee sales and use tax both “the transfer of preliminary artwork by an advertising agency to its client” and “[t]he use by an advertising agency of preliminary artwork created by the advertising agency to provide advertising services.”

TENN. CODE ANN. § 67-6-102(65) defines the term “preliminary artwork” to mean “tangible personal property and digital equivalents that are produced by an advertising agency in the course of providing advertising services *solely for the purpose of conveying concepts or ideas or demonstrating an idea or message to a client* and includes, but is not limited to concept sketches, illustrations, drawings, paintings, models, photographs, storyboards or similar materials.”⁴⁷

In order to be considered “preliminary artwork” for purposes of TENN. CODE ANN. § 67-6-312(a), the following requirements must be satisfied: 1) the item must be tangible personal property or digital equivalents; 2) the item must be produced by an advertising agency in the course of providing advertising services; and 3) the item must be produced solely for the purpose of conveying concepts or ideas or demonstrating an idea or message to a client.

The Taxpayer has described its activities in “phases,” which ultimately result in the creation of brochure mock-ups that its clients use to choose which advertising concept they wish to move forward with, and preliminary proofs that its clients use to refine the brochure mock-up idea into a suitable piece of final artwork. Both brochure mock-ups and preliminary proofs qualify as preliminary artwork.

The process of creating a brochure mock-up involves art direction, design, and drafting of copy text. The Taxpayer also creates or purchases the necessary photographs, graphic designs,

⁴⁵ *Kingsport Publ’g Corp. v. Olsen*, 667 S.W.2d 745, 746-47 (Tenn. 1984).

⁴⁶ Such use shall be grounds for the revocation of the registration certificate of the dealer wrongfully making use of the resale certificate. TENN. COMP. R. & REGS. 1320-5-1-.68(3). In addition, it is a misdemeanor to misuse a resale certificate for the purpose of obtaining tangible personal property or taxable services without the payment of the sales or use tax when it is due. *Id.*

⁴⁷ (Emphasis added).

artwork, or other images needed to develop a mock-up.⁴⁸ It is not known at the time a mock-up is created whether any copy text, artwork, or other images included in such mock-up will be included in a final brochure proof.

First, although the Taxpayer has not indicated whether the brochure mock-ups and preliminary proofs are provided to its customers in physical or digital form, they would nevertheless constitute either tangible personal property if given in physical form or a digital equivalent if, for example, “delivered electronically” as a PDF file.⁴⁹

Second, the brochure mock-ups and preliminary proofs are produced by an advertising agency in the course of providing advertising services. The Taxpayer has represented that it meets the requirements to be an “advertising agency” under TENN. CODE ANN. § 67-6-102(1). Moreover, as will be explained in more detail below, the Taxpayer’s services provided during the process of creating brochure mock-ups and preliminary proofs constitute “advertising services” under TENN. CODE ANN. § 67-6-102(3).

Finally, both the brochure mock-ups and the preliminary proofs are produced “solely for the purpose of conveying concepts or ideas or demonstrating an idea or message” to a client. The Taxpayer has indicated that the brochure mock-ups created during the “design phase” are the culmination of the research and consultation it had already performed in earlier “phases.” As such, the brochure mock-ups are intended to memorialize and convey the Taxpayer’s concepts and ideas to its customer for review and approval. These brochure mock-ups therefore qualify as “preliminary artwork” for the purposes of TENN. CODE ANN. § 67-6-312.

Similarly, the preliminary proofs are also produced “solely for the purpose of conveying concepts or ideas or demonstrating an idea or message” to the Taxpayer’s client. The Taxpayer has indicated that the preliminary proofs are used to solicit customer comments and critiques, with the end goal of producing a final proof for printing. Thus the preliminary proofs are used to hone and refine the different aspects of the advertising concept selected by the customer into final artwork suitable for printing and distribution, and each preliminary proof is produced solely to convey an idea or concept related to the overall goal of the advertising project.

Accordingly, the brochure mock-ups and preliminary proofs created by the Taxpayer constitute “preliminary artwork” for purposes of TENN. CODE ANN. § 67-6-312.

⁴⁸ Note that, under TENN. CODE ANN. § 67-6-102(65), “preliminary artwork” must be “produced” by an advertising agency. To “produce” something means to “make, manufacture, or create” it. COMPACT OXFORD ENGLISH DICTIONARY OF CURRENT ENGLISH 812 (3d rev. ed. 2008). Any photographs, graphic designs, artwork, or other images purchased rather than created by the advertising agency would not constitute preliminary artwork because it is not produced by the advertising agency. The Taxpayer is responsible for paying the sales or use tax on those purchases, and as explained above, the Taxpayer cannot use a resale certificate for those purchases. *Cf. Kingsport Publ’g Corp.*, 667 S.W.2d at 746-47.

The same reasoning applies to exclude any photographs, graphic designs, artwork, or other images provided by the Taxpayer’s client to the Taxpayer. Since the Taxpayer did not produce such materials, they would not constitute preliminary artwork and the Taxpayer must remit use tax for those items.

⁴⁹ See generally TENN. CODE ANN. § 67-6-102(26).

In addition, the Taxpayer's services rendered to create the brochure mock-ups and the preliminary proofs are properly considered "advertising services."

As stated above, "advertising services" are "services provided by an advertising agency to promote a product, service, idea, concept, issue, place or thing."⁵⁰ These services include providing marketing and advertising advice and counseling, strategic planning, consumer research, design and layout services, and development of preliminary artwork.⁵¹

During the initial consultation, the Taxpayer consults with the client and lays the foundation for the general advertising strategy, in addition to creating a budget and additional account planning. These activities are enumerated examples of advertising services under TENN. CODE ANN. § 67-6-102(3)(A)(i), (ii), (iv).

The Taxpayer next engages in the "research and development phase," where the Taxpayer conducts market research and begins developing concepts for its client's brochure. These activities are also enumerated advertising services.⁵²

During the "design phase," the Taxpayer produces brochure mock-ups for its client's review. The Taxpayer usually oversees the creation of any necessary photographs, graphic design, and artwork, as well as any drafting of copy text in its development of brochure mock-ups. Many of these activities are enumerated advertising services.⁵³

Finally, during the "production phase," the Taxpayer makes necessary modifications to the design,⁵⁴ the copy text (editing the wording),⁵⁵ and prepares additional preliminary proofs for customer review.⁵⁶

As a result of the services provided by the Taxpayer during the creation of brochure mock-ups and preliminary proofs being enumerated in the statute, these services are properly considered "advertising services."

Standing alone, the provision of these advertising services is not subject to Tennessee sales and use tax because advertising is not an enumerated service under TENN. CODE ANN. § 67-6-205(c). Even though the transfer of preliminary artwork used to be taxable, under TENN. CODE ANN. § 67-6-312(a), such a transfer is now exempt from the Tennessee sales and use tax. Consequently, the *Crescent* analysis is inapplicable because both the transfer of preliminary artwork and the provision of advertising services are not taxable, regardless of whether either the preliminary artwork or the advertising services are a "crucial," "essential," or "integral" element of the

⁵⁰ TENN. CODE ANN. § 67-6-102(3).

⁵¹ See TENN. CODE ANN. § 67-6-102(3)(i)-(xiv).

⁵² See TENN. CODE ANN. § 67-6-102(3)(A)(iii); cf. TENN. CODE ANN. § 67-6-102(3)(A)(vi)-(xi).

⁵³ See TENN. CODE ANN. § 67-6-102(3)(A)(vi)-(xi).

⁵⁴ See TENN. CODE ANN. § 67-6-102(3)(A)(vi)-(vii).

⁵⁵ See TENN. CODE ANN. § 67-6-102(3)(A)(x)-(xi).

⁵⁶ See TENN. CODE ANN. § 67-6-102(3)(A)(viii).

transaction. Likewise, bundling principles are inapplicable because bundling two independently non-taxable items or services together results in a single charge that remains non-taxable.

Thus these advertising services are not subject to the Tennessee sales and use tax at the time rendered, but they do become a component of the sales price of any “advertising materials” used or distributed within Tennessee, in accordance with Tennessee’s longstanding jurisprudence.⁵⁷

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Commissioner of Revenue

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⁵⁷ See TENN. CODE ANN. §§ 67-6-102(81)(A), -202(a), -312(c); *Thomas Nelson, Inc.*, 723 S.W.2d at 622-24; *AT&T Corp.*, 2002 WL 31247083, at *8-9; *Rivergate Toyota, Inc.*, 1998 WL 83720, at *4.