

New York State Department of Taxation and Finance
Taxpayer Services Division
Technical Services Bureau

TSB-A-98(75)S
Sales Tax
November 5, 1998

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. S980211A

On, February 11, 1998, the Department of Taxation and Finance received a Petition for Advisory Opinion from Simplicity Pattern Co., Inc., 2 Park Avenue, 12th Floor, New York, New York 10016.

The issues raised by Petitioner, Simplicity Pattern Co., Inc., are:

1. Whether Petitioner's Counterbooks are purchased for resale, or produced for sale, by Petitioner.
2. Whether the production costs related to pattern products which are also utilized for pages in the Counterbooks represent costs for items used directly and predominantly in the production of tangible personal property for sale.
3. What categories of Petitioner's production costs qualify for the production exemption?

Petitioner submits the following facts as the basis for this Advisory Opinion.

Petitioner produces home sewing patterns. A sewing pattern enables a consumer to construct a garment by placing the pattern on fabric to properly guide the cutting of the fabric pieces and then, using the instructions provided, to sew the appropriate pieces together.

The three key components of a pattern are the printed tissue paper containing the outline of the garment's shape (the "Pattern"), the written instructions printed on newsprint quality paper (the "Instructions") and an envelope (the "Envelope") that either includes an artist's illustration or photo of the finished product and a description of fabric and notion materials required to complete the sewing project. The consumer will refer to the artist's illustration or photo on the Envelope as he or she is sewing the garment. The Pattern and the Instructions are packaged in the Envelope. The Pattern, Instructions and Envelope constitute the main product that Petitioner offers for sale to retailers (the "Pattern Product").

Consumers purchase the Pattern Products at various retail outlets such as specialty fabric chains, discount stores and chains and independent fabric and craft stores. At the retail location, the Pattern Products are contained in cabinets. A typical assortment of Pattern Products will include approximately 3,500 different items. Due to the large number of Pattern Products offered, the only effective way for a consumer to purchase a Pattern Product is with the aid of a counterbook (the "Counterbook"), which the retailer purchases from Petitioner. The Counterbook shows one or more pictures of all pattern designs available and is organized into sections based on the merchandising category/theme.

A consumer will page through the Counterbook and, after viewing either the photo or artist's illustration of a particular Pattern Product, will decide which pattern he or she wishes to purchase. Pattern Products are housed in cabinets in order of design number. Once the design number has been obtained from the

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Counterbook, a particular pattern can be located in the pattern cabinet for purchase either by going directly to the cabinet where the Pattern Products are housed or by asking a sales clerk to obtain the Pattern Product from a secured area. The only way for a consumer to relate an actual garment pattern (based on the photo or artist's illustration of the finished garment) to the location of the Pattern Product in the cabinet is via the use of a design number, which is obtained from the Counterbook.

In producing the Pattern Products, Petitioner must purchase services from the following categories of individuals: 1. designers who come up with the ideas for a particular garment for a particular season or theme; 2. artists who do artwork depicting a person wearing a particular garment which will appear on the Envelope; 3. photographers who take pictures of persons wearing the garments which photos will appear on the Envelope; 4. illustrators who draw the outlines of human figures that appear on the Instructions; and 5. technical writers who write the instructions about how to construct the particular garment, which appears on the Instructions. (Services enumerated 1.-5. are collectively referred to as "Pattern Product Costs") The same artwork or photography that appears on an Envelope will also appear in the Counterbook. For example, the illustration or artwork that appears on the Envelopes is also shown in the Counterbook. Each Counterbook page is a "by-product" of the Envelope component of the Pattern Product.

Petitioner also produces a great number of specialty booklets and books (the "Specialty Products"), such as the "Egg Instruction" booklet, "Simply the Best Book of Sewing," "Simply the Best Book of Home Decorating," and the "Lampshade" booklet. Produced for sale to retailers, the Specialty Products are designed to appeal to consumers who do arts and crafts as hobbies in their homes and who sew or do home decorating. In producing the Specialty Products, Petitioner must purchase services from the following categories of individuals: 1. crafts people who come up with ideas for a Specialty Product; 2. writers who write and edit the text contained in the Specialty Products; 3. artists who draw illustrations and artwork that appear in the Specialty Products; 4. technical writers who write the instructions to make the particular craft that is the subject of the Specialty Product; 5. photographers who take pictures that are reproduced in the Specialty Product; and 6. color separators and printers who print the Specialty Products (Services enumerated 1.-6. are collectively referred to as the "Specialty Product Costs"). The Specialty Product Costs are totally separate from any costs associated with the production of the Counterbooks and are produced by outside publishers.

Petitioner did and does the early production of the Pattern Products in New York City through and including the development of the Envelope, the Instructions and the Pattern. Petitioner then encodes the production instructions for each of these components on disks and sends the disks to its production plant in Niles, Michigan (the "Niles Plant"). The Niles Plant then mass produces the Pattern Products. During the period through December, 1995, the Niles Plant also produced the Counterbooks. After December, 1995, Petitioner outsourced the production of the Counterbooks to an unrelated third party printer. The Niles Plant continued to produce the Pattern Products.

Petitioner sold the Counterbooks to its retailers for between \$13.50 and \$16 per book. Petitioner indicates that prior to outsourcing the production of the Counterbooks, its cost of producing a Counterbook was approximately \$9.50 per book. Its costs consisted of variable production costs and variable overhead. The costs excluded allocated fixed overhead because most of the fixed costs were not directly related to the Counterbook. The fixed overhead allocation consists of costs of plant service and administrative departments such as Maintenance, Industrial Engineering, Warehousing, Scheduling, Human Resources, Plant Accounting

and includes such expenses in these departments as salaries, fringes, supplies, parts, general insurances, real estate taxes, utilities, depreciation, and retirees benefits. The Niles Plant continues to incur a significant amount of these expenses even though the production of the Counterbooks was outsourced in December, 1995.

After outsourcing in 1995, Petitioner's costs in paying the third party printer were approximately \$12.50 per Counterbook, which included a profit margin for the printer and still left the cost to Petitioner at less than the selling costs of the Counterbook.

Applicable Law & Regulations

Section 1101(b)(4) of the Tax Law, in part, defines retail sale:

(i) A sale of tangible personal property to any person for any purpose, other than (A) for resale as such or as a physical component part of tangible personal property . . .

Section 1115(a)(12) of the Tax Law, in part, provides an exemption for:

Machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale, by manufacturing, processing, generating, assembling, refining, mining or extracting, or telephone central office equipment or station apparatus or comparable telegraph equipment for use directly and predominantly in receiving at destination or initiating and switching telephone or telegraph communication, but not including parts with a useful life of one year or less or tools or supplies used in connection with such machinery, equipment or apparatus

Section 526.6(c) of the Sales and Use Tax Regulations further explains the resale exclusion.

(c) *Resale exclusion.* (1) Where a person, in the course of his business operations, purchases tangible personal property or services which he intends to sell, either in the form in which purchased, or as a component part of other property or services, the property or services which he has purchased will be considered as purchased for resale, and therefore not subject to tax until he has transferred the property to his customer.

* * *

(4) (i) Tangible personal property which is purchased and given away without charge, for promotion or advertising purposes is not purchased for resale. It is a retail sale to the purchaser thereof, and is not a sale to the recipient of the property.

(ii) Tangible personal property which is purchased for promotional or advertising purposes and sold for a minimal charge which does not reflect its true costs, or which is not ordinarily sold by that person in the operation of his business, is a retail sale to the purchaser thereof, and not a sale to the recipient of the property.

Section 528.13(c) of the Sales and Use Tax Regulations provides, in part:

(c) *Directly and predominantly.* (1) Directly means the machinery or equipment must, during the production phase of a process,

(i) act upon or effect a change in material to form the product to be sold, or

(ii) have an active causal relationship in the production of the product to be sold, or

(iii) be used in the handling, storage, or conveyance of materials or the product to be sold, or

(iv) be used to place the product to be sold in the package in which it will enter the stream of commerce.

* * *

(4) Machinery or equipment is used predominantly in production, if over 50 percent of its use is directly in the production phase of a process.

Opinion

Issues

1) Section 526.6(c)(4)(ii) of the Sales and Use Tax Regulations indicates that tangible personal property purchased for promotional or advertising purposes and sold for a minimal charge which does not reflect its true costs does not qualify for the resale provision. That is not the case here. The Counterbooks qualify for the resale exclusion under Section 526.6(c) of the Sales and Use Tax Regulations when purchased from outside printers. Prior to December 1995, they were produced for sale when printed in-house by Petitioner. It should be noted that Petitioner is making retail sales of the Counterbooks to its dealers.

2) Since the Counterbooks, as well as Petitioner's Pattern Products, are sold by Petitioner to retail outlets, machinery and equipment that are used directly and predominantly to produce the Pattern Products and the Counterbooks are exempt from sales and use tax as provided under Section 1115(a)(12) of the Tax Law.

3) Design services and the services of technical writers are not among the services subject to tax under Section 1105(c) of the Tax Law. Photographs, artwork and illustrations and color separations qualify as equipment for purposes of section 1115 (a) (12) of the Tax Law when used directly and predominantly to produce tangible personal property for sale. See New York State Department of Taxation and Finance Publication 842 (12/93), New York State and Local Sales Tax Information for Printers, at page 27. Before September 1, 1996, the services of installing, repairing, maintaining or servicing production equipment were exempt from Statewide sales tax but subject to the local New York City sales tax and local sales taxes outside of New York City. Since September 1, 1996, these services performed on production equipment have been exempt from local New York

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City sales tax, as well as the Statewide tax, but continue to be subject to local sales taxes outside New York City. See Section 1105-B of the Tax Law.

DATED: November 5, 1998

/s/
John W. Bartlett
Deputy Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions are limited to the facts set forth therein.