

ST 07-17
Tax Type: Sales Tax
Issue: Graphic Arts Exemption

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS

v.

ABC STUDIOS, INC.,

Taxpayer

No. 00-ST-0000
IBT# 0000-0000
NTL# 00 0000000000000000
000000000000000000
000000000000000000

Ted Sherrod
Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Special Assistant Attorney General John Alshuler on behalf of the Illinois Department of Revenue; Alan Segal of Alan Segal & Associates, P.C. on behalf of ABC Studios, Inc.

Synopsis:

This matter comes on for hearing pursuant to the timely protest of ABC Studios, Inc. to Notice of Tax Liability (“NTL”) number 00 0000000000000, NTL number 00 0000000000000 and NTL number 0000000000000000 issued on November 16, 2005 covering the period January, 1998 through June, 2003. The issue in this matter is whether computers, software and other equipment and supplies used by the taxpayer in its website design and design related website technology business qualifies for the graphic

arts machinery and equipment exemption from Illinois sales and use tax provided at 35 ILCS 120/2-5(4) and by 35 ILCS 105/3-5(6). A hearing to consider this matter was held on April 27, 2007 at which John Doe, the founder and Chief Executive Officer of the taxpayer appeared and testified. After considering the evidence adduced at hearing, it is recommended that this matter be resolved in favor of the Department of Revenue. In support of this determination, I make the following findings of fact and conclusions of law.

Findings of Fact:

1. As a result of a Department of Revenue (“Department”) audit, three Notices of Tax Liability were issued to the taxpayer, ABC Studios, Inc. (“ABC” or “Taxpayer”) on November 16, 2005: Notice of Tax Liability (“NTL”) number 00 0000000000000 for Retailers’ Occupation and related taxes (“ROT”), penalty and interest in the amount of \$49,894.70 covering 1/98 through 11/00, NTL number 00 0000000000000 for ROT, penalty and interest in the amount of \$26,848.48 covering 12/00 through 6/02, and NTL number 00 0000000000000 for ROT, penalty and interest in the amount of \$9,792 covering 7/02 through 6/03. Department (“Dept.”) Exhibit (“Ex.”) 1.
2. The Department’s *prima facie* case, inclusive of all jurisdictional elements, was established by the admission into evidence of the SC-10-K Audit Correction and/or Determination of Tax Due prepared by the Department’s auditor in this case, and the aforementioned NTLs issued to ABC. *Id.*
3. The NTL assessments are based upon the Taxpayer’s purchase of various assets and supplies for which no sales tax or use tax was paid. *Id.*; Tr. pp. 5-7.

4. ABC Studios, Inc., a/k/a ABC Media Group, Inc., is an Illinois domiciled multinational corporation which was founded in 1994, having its principal place of business in the United States in Chicago, Illinois. Taxpayer's Ex. 1. ABC is engaged in the business of providing website design services and related internet technology services to companies wishing to advertise and market products or services using the internet and the "worldwide web." Tr. pp. 7, 8, 18, 22-24. ABC's website design business constitutes 90% of its total business activities. Tr. pp. 38, 39.
5. John Doe is the founder, president and Chief Executive Officer of ABC. Tr. pp. 5, 16, 18; Taxpayer's Ex. 1. He holds a degree in aeronautical engineering from the University of Illinois, and has been engaged in the internet technology and website design business for over 11 years. Tr. pp. 17, 18.
6. The website design business in which ABC is engaged involves transforming images, text and other material into a form suitable for publication electronically through display on the internet's world wide web. Tr. pp. 8, 9, 19-27, 30, 31. This process begins when ABC prepares images, text and other material it proposes to incorporate into the customer's proposed website and posts them on large sheets of paper glued upon a "story board" which is a board or other surface. Tr. pp. 8, 9, 19, 20. Computers, software and other items are used in this process. Tr. pp. 19, 20.
7. Once the "story board" is completed by the Taxpayer, it is submitted to the Taxpayer's customer for review. Tr. pp. 8, 9, 20, 25. The customer reviews the "story board" and specifies to the Taxpayer exactly how any text, graphics, images or other components of the website or webpage are to appear on it. *Id.* Once final modifications to the proposed website design included on the "story board" have been

approved, computers, software and other items are employed by the Taxpayer to reproduce, copy or otherwise manipulate the images and concepts indicated on the “story board” into a digital format appropriate to a website format. Tr. pp. 21, 24, 25. MacIntosh computers, and Silicon Graphics, “Adobe Photoshop”, and “Illustrator” software are used in this process. Tr. pp. 24, 25, 29. The record does not indicate the precise manner in which computers, software and other items are utilized in this function.

8. The website designed by the Taxpayer is delivered to the customer in the form of a “digital file”. Tr. pp. 7-10, 19-22, 25, 27, 32. While this “digital file” can be sent directly to the customer through the computer, the Taxpayer ordinarily transfers possession of the “digital file” using a tangible medium such as a CD or DVD disc. Tr. p. 26.
9. The Taxpayer uses processes similar to those described above to produce its own brochures, business cards, advertising and other materials. Tr. pp. 29, 30. The record does not indicate whether equipment and other items used to produce advertising in-house are the same as, or different from the computers, software and other items used in the Taxpayer’s core retail website design business.
10. The Taxpayer’s final work product is a website. Tr. pp. 7, 8, 10, 26, 39, 43. Upon delivery of this work product in the form a “digital file”, the Taxpayer’s website design function is completed. *Id.* After the delivery of the “digital file”, the Taxpayer can also be retained to display the customer’s website on the Taxpayer’s server. Tr. p. 8.

11. Should the customer desire to reproduce website designs contained in the “digital file” delivered by the Taxpayer as brochures or other print advertising, a third-party printer must be employed for this purpose. Tr. pp. 41-43. The Taxpayer does not have the capacity to perform print production of its website designs and must outsource this function if requested by its customer. *Id.*

Conclusions of Law:

Pursuant to 35 ILCS 120/4, the SC-10-K Audit Correction of Returns submitted as Department of Revenue (“Department”) Exhibit (“Ex.”) 1 is *prima facie* correct and constitutes *prima facie* evidence of the correctness of the amount of tax due as shown therein. See also A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826 (1st Dist. 1988). The Department having established the *prima facie* correctness of the amount of tax due through the admission into evidence of the Correction of Returns, the burden shifted to the taxpayer to show that its determination was incorrect. Copilevitz v. Department of Revenue, 41 Ill. 2d 154 (1968). In order to overcome the presumption of validity attached to the Department’s corrected returns a taxpayer must produce competent evidence, identified with its books and records, showing that the Department’s returns are incorrect. *Id.*

ABC Studios, Inc. (“ABC” or “Taxpayer”) has been assessed sales and use tax for failure to pay these taxes on its purchase of various assets and supplies used in its business. The Taxpayer contests this assessment, claiming that no tax is due on these items because they are exempt pursuant to the graphic arts exemption enumerated at section 35 ILCS 120/2-5(4) (“section 2-5(4)”) of the Retailers’ Occupation Tax (35 ILCS 120/1 *et seq.*) and at 35 ILCS 105/3-5(6) (“section 3-5(6)”) of the Use Tax Act (35

ILCS 105/1 et seq.) On examination of the record in this case, I find that the Taxpayer has not presented competent evidence to prove that the graphic arts exemption is applicable to computers, software and other items purchased for use in its website design and related activities as enumerated in the above findings of fact. Accordingly, under the reasoning given below, this matter should be resolved in favor of the Department.

Section 3-5(6) of the Use Tax Act and section 2-5(4) of the Retailers' Occupation Tax Act exempt machinery and equipment used primarily for "graphic arts production" from Illinois sales and use taxes. "Graphic arts production" is defined as "printing, including ink jet printing, by one or more of the common processes described in Groups 323110 through 323122 of Subsector 323, Groups 511110 through 511199 of Subsector 511 and Group 512230 of Subsector 512 of the North American Industry Classification System published by the U.S. Office of Management and Budget, 1997 edition. Graphic arts production does not include (i) the transfer of images onto paper or other tangible personal property by means of photocopying or (ii) final printed products in electronic or audio form, including the production of software or audio-books." 35 **ILCS 105/3-30**; 35 **ILCS 120/2-30**.

The Department has promulgated a regulation concerning the graphic arts exemption. This regulation, 86 Ill. Admin. Code, ch. I, section 130.325(b), states as follows:

- (1) Graphic arts production has the following meanings and applications:
 - A) Graphic arts production means printing, including ink jet printing, by one or more of the processes described in Groups 323110 through 323122 of Subsector 323, Groups

511110 through 511199 of Subsector 511, and Group 512 of the North American Industry Classification System (“NAICS”) published by the U.S. Office of Management and Budget, 1997 edition (no subsequent amendments or editions are included). Graphic arts production does not include the transfer of images onto paper or other tangible personal property by means of photocopying or final printed products in electronic or audio form, including the production of software or audiobooks. (Section 2-30 of the Act) Groups 323110 through 323122 of Subsector 323, Groups 511110 through 511199 of Subsector 511, and Group 512230 of Subsector 512 include printing upon apparel and textile products, paper, metal, glass, plastics, and other materials except fabric (grey goods). Printing upon grey goods is part of the process of finishing fabric and is included in the NAICS Textile Mills subsector in Industry 31331, Textile and Fabric Mills.

- B) ...
- C) The exemption applies to machinery and equipment used in graphic arts production processes, as those processes are described in the NAICS. While the NAICS subsectors referenced in subsection (b)(1)(A) describe types of graphic arts production, the exemption is not limited to qualifying machinery and equipment used by the establishments described in the NAICS, but rather, to qualifying machinery and equipment used in the printing processes described in the NAICS (for example, lithography, gravure, flexography, screen printing, quick printing, digital printing and trade services such as prepress and binding and finishing services). The tangible personal property produced by graphic arts production need not be sold at retail in order for the exemption to apply. For instance, a company’s purchase of qualifying graphic arts equipment used to produce its own printed materials qualifies for exemption, even though the company is not in the business of selling printed materials at retail.
- D) The exemption includes printing by methods of engraving, letterpress, lithography, gravure, flexography, screen, quick, and digital printing. It also includes the printing of manifold business forms, blankbooks, looseleaf binders, periodicals

and newspapers. Included in the exemption are prepress services described in Subsector 323122 of the NAICS (e.g., the creation and preparation of negative or positive film from which plates are produced, plate production, cylinder engraving, typesetting and image setting). The exemption also includes trade binding and related printing support activities set forth in Subsector 323121 of the NAICS (e.g., tradebinding, sample mounting and postpress services, such as book or paper bronzing, edging, embossing, folding, gliding, gluing, die cutting, finishing, tabbing and indexing).

- E) “Digital printing and quick printing” mean the printing of graphical text or images by a process utilizing digital technology, as provided in subsection (b)(4) of this Section. It also includes the printing of what is commonly known as “digital photography” (e.g., use of a qualifying integrated computer and printer system to print a digital image). The exemption extends only to machinery and equipment, including repair and replacement parts, used in the act of production. Accordingly, no other type or kind of tangible personal property will qualify for the exemption, even though it may be used primarily in the graphic arts business.¹

The record indicates that ABC is primarily a website graphic design firm, and that designing websites constitutes 90% of its business. Tr. pp. 38, 39; Taxpayer’s Ex. 1. Pursuant to its claim of exemption under section 3-5(6) of the Use Tax Act and section 2-5(4) of the Retailers’ Occupation Tax Act, the Taxpayer in effect argues that its website graphic design activities constitute “graphic arts production” since both the Illinois statutes and the applicable regulation makes engaging in “graphic arts production” a condition precedent to qualification for the graphic arts exemption. For a majority of the

¹ 86 Ill. Admin. Code, ch. I, section 130.325(b)(4)(B) provides in part as follows: “(4) By way of illustration and not limitation, the following activities will generally be considered graphic arts production ... (B) The transfer of images or text from computers, plates, cylinders or blankets to paper or other stock to be printed. This process begins when paper is introduced on the press. Examples of qualifying equipment used in this activity include printing plates, printing presses, blankets and rollers, automatic blanket washers, scorers and dies, folders, punches, stackers, strappers used in the pressroom for signatures, dryers, chillers and cooling towers. Laser or ink jet printers used to print on paper or other stock are also included in this exemption.”

period 1/98 through 6/03 at issue in this case, both the Illinois statutes and the Department's regulations expressly confine "graphic arts production" to printing using one of the processes or methods enumerated in Groups 323110 through 323122 of Subsector 323, Groups 511110 through 511199 of Subsector 511, and Group 512230 of Subsector 512 of the North American Industry Classification System published by the U.S. Office of Management and Budget, 1997 edition. (For the portion of the period at issue preceding August 13, 1999, "graphic arts production" is confined to "printing by one or more of the common processes or graphic arts production services as those processes and services are defined in Major Group 27 of the U.S. Standard Industrial Classification Manual" pursuant to 86 Ill. Admin. Code, ch. I, section 130.325).

The record in this case indicates that the Taxpayer prepares a "digital file" but does not engage in printing of any kind as part of its retail web site design and related activities.² The NAICS classifications enumerated in the statute and regulations pertaining to the "graphic arts" exemption, on their face, cover only various methods of printing and print production, and services directly related to these activities. Section 130.325(b)(1)(C) underscores this limitation, stating that "[t]he exemption applies to machinery and equipment used in graphic arts production processes, as those processes are described in the NAICS [.] While the NAICS subsectors referenced in subsection (b)(1)(A) describe types of graphic arts establishments that typically engage in graphic

² The record indicates that the Taxpayer uses its equipment to produce in-house advertising. While 86 Ill. Admin. Code, ch. I, section 130.325(C) states that "a company's purchase of ... graphic arts equipment used to produce its own printed materials qualifies for .. exemption", the exemption only applies to equipment that is used primarily for graphic arts production. Since the record does not indicate whether any of the Taxpayer's equipment is used exclusively or primarily to produce in-house advertising, it has not shown that this exemption is applicable as a consequence of its in-house production activities.

arts production, the exemption is not limited to qualifying machinery and equipment used by the establishments described in the NAICS, but rather, to qualifying machinery and equipment used in the printing processes described in the NAICS (for example, lithography, gravure, flexography, screen printing, quick printing, digital printing and trade services such as prepress and binding and finishing services).”

The Taxpayer has provided this forum with no guidance regarding exactly under which NAICS classification it believes that its activities fall.³ However, the facts enumerated in the record suggest that some its activities are among those described in NAICS Group 323115. The summary of Group 323115 provides that “[t]his U.S. industry comprises establishments that primarily engaged in printing graphical materials using digital printing equipment[.] Establishments known as digital printers typically provide sophisticated prepress services including using scanners to input images and computers to manipulate and format the graphic images prior to printing.” While the Taxpayer engages in the graphic design activities the summary of this NAICS industry describes, the summary indicates that establishments engaging in these activities fall within this category only if they also print the graphic designs they produce. Accordingly, this category does not fit the narrower scope of activity in which the Taxpayer is engaged.

³ The Taxpayer has provided this forum with no indication of why it believes any NAICS classifications apply to its activities. The provision of such information to this forum is the responsibility of the Taxpayer, not the administrative law judge. Obert v. Saville, 253 Ill. App. 3d 677, 682 (2d Dist. 1993).

Since the Taxpayer has failed to show that any of its production activities encompass print production methods or related activities described in the NAICS classifications set forth in section 3-5(6) of the Use Tax Act and section 2-5(4) of the Retailers' Occupation Tax Act, and regulation 86 Ill. Admin. Code, ch. I, section 130.325, the Taxpayer has failed to rebut the Department's *prima facie* case. This is true because a showing that the Taxpayer is engaged in "graphic arts production" is a statutory and regulatory prerequisite to establishing that the Taxpayer's computers, software and other items qualify for the graphic arts exemption. For this reason, I find that the Taxpayer has failed to establish its claim for relief from the NTLs at issue in this case.

Despite the absence of any ascertainable activities falling within any category of "graphic arts production" covered by the graphic arts exemption, the Taxpayer nevertheless argues that the statutory graphic arts exemption should be broadly construed to encompass the Taxpayer's activities evident from the record presented in this case. Specifically, the Taxpayer argues as follows:

[W]e believe that ...the exemption for graphic arts should apply. Perhaps the – the regulations need to be expanded to show that this is indeed the case, but I believe that we are sufficiently within the graphic arts exemption.
Tr. pp. 55, 56.

The Taxpayer's proposal is directly at odds with Illinois case law which provides that tax exemptions are to be strictly construed against the taxpayer and in favor of the taxing body. Medcat Leasing v. Whitley, 253 Ill. App. 3d 801, 803 (4th Dist. 1983); Telco Leasing, Inc. v. Allphin, 63 Ill. 2d 305 (1976). The Taxpayer clearly has the burden to

prove entitlement to the exemption with all doubts being resolved in favor of taxation. United Airlines, Inc. v. Johnson, 84 Ill. 2d 446 (1981); Folett's Illinois Book & Supply Store, Inc. v. Isaacs, 27 Ill. 2d 600 (1963).

The gravamen of the Taxpayer's exemption claim is that its final work product, a "digital file" containing the product of its graphic arts design services is tangible personal property for Illinois sales and use tax purposes and therefore similar to a printed product. Tr. pp. 7-11. While this argument is not clearly articulated (see Tr. pp. 31-34), it appears to be premised upon the Taxpayer's claim that the "digital file" is ordinarily delivered to the Taxpayer using a tangible medium such as a CD or DVD. Tr. p. 26. At first blush, this argument is undermined by the Taxpayer's own apparent compliance procedures. Specifically, the record does not indicate that the Taxpayer collected any tax on any of its sales of "digital files" containing its final work product. Were the "digital file" deemed the sale of tangible personal property by the Taxpayer, it would have been required to collect and remit tax on the sale of such items pursuant to 35 **ILCS** 120/3.⁴ Moreover, the Taxpayer's contention that the "digital file" is tangible personal property is wholly at odds with the Illinois case law.

The Taxpayer's production of "digital files" transferred by CD or DVD is analogous to the special order production of other types of property governed by 86 Ill. Admin. Code, ch. I, section 130.2115. In construing this regulation, the Illinois Supreme Court, in J.H. Walters & Co. v. Department of Revenue, 44 Ill. 2d 95 (1969), has ruled

⁴ The Taxpayer does not contend that its "website design" product constitutes non-taxable "software" pursuant to 86 Ill. Admin. Code, ch. I, section 130.1935. This regulation provides for an exception to the general rule that "software" constitutes non-taxable intangible personal property (First National Bank of Springfield v. Department of Revenue, 85 Ill. 2d 84 (1981)) for "canned software" which the regulation defines to exclude software that is "prepared to the special order of the customer."

that a fabricator and designer of products pursuant to special order is engaged in a service occupation rather than the sale of tangible personal property subject to the retailers' occupation tax. Pursuant to the aforementioned administrative rule, a product is exempt from retailers' occupation tax if (a) the purchaser has engaged the seller on the basis of the seller's substantial skill in designing the product to fit the purchaser's unique requirements; (b) the value of the product lies only in the specific purpose for which it was made; and (c) the product's value is specific to the purchaser.

In evaluating whether the taxpayer satisfied the tests stated in the Department's administrative rule, the court, in Walters, listed several factors extracted from the body of Illinois case law which it deemed generally helpful to its determination. Among the cited factors were the ratio of the cost of materials to ultimate purchase price; the buyer's objective in choosing the particular seller; the "special order" character of the item; and the "most basic and probative inquiry" of "whether the business sought to be taxed is selling personal property at retail, in which service is incidental, or selling services in which supplying materials or making retail sales is but incidental' ". Walters at 102. While the record contains insufficient information to apply all of the criteria enumerated in Walters to the facts at issue in this case, there is sufficient evidence to conclude that the Taxpayer has failed to establish that the production of the "digital file" it delivers to its customers is the production of "tangible personal property" for retail sale under the Walters criteria.

In discussing the nature of its business activities, John Doe, the Taxpayer's founder, president and chief executive officer, stated the following during his testimony at the hearing in this case:

Legally by law we have to give all of our clients a copy of their web design, their graphic design on digital media such as DVD, CD..

Q When you say legally by law –

A Well, because the – the client pays us x-amount of dollars – to design to– a web site for them to come up with a creative – creative design. So we had to – one of the deliveries we provide to them in addition to the web site itself is a hard copy of the files that they can take and they can store within their office and – keep on record.

Q And you believe this is a legal requirement?

A Well, for us it is –

Q Okay.

A – because we’re – we’re getting paid to deliver a creative design –

Q Okay.

A – to the client. So the client is paying us x-amount of dollars. In return they get – we delivery a “digital file”.

Q Now, when you deliver that “digital file” to them, can they then on their own modify or do they have to come back to you if they want to – if they decide they want to update their web page –

A. It depends.

Q – if they want – go ahead?

A If they have staff on board, talented graphic designers, then they could go ahead and modify their own files. If not, then they can call us.

This testimony indicates that the principal value of the Taxpayer’s finished product, the website design, and the principal input for which the Taxpayer is being compensated, lies in the services rendered by the Taxpayer rather than in the tangible medium used to deliver the result of these services. Moreover, the nature of the product at issue, a website graphically designed to meet the unique nature of each customer’s business,

renders the Taxpayer's product of little value to anyone other than the specific customer for whom the website is designed. These facts are sufficient to support a finding that the Taxpayer's preparation and delivery of a "digital file" to its customer constitutes the delivery of a service rather than the retail sale of tangible personal property under the tests enumerated in Walters. Accordingly, the Taxpayer's claim that the Taxpayer's transfer of the "digital file" constituted the retail sale of tangible personal property must be rejected.

WHEREFORE, for the reasons stated above, it is my recommendation that the Department's Notices of Tax Liability at issue in this case be finalized and affirmed in their entirety.

Ted Sherrod
Administrative Law Judge

Date: August 8, 2007