

PRIVATE TAXPAYER RULING LR95-003

April 28, 1995

The following private taxpayer ruling is in response to your letter dated February 14, 1995 requesting a private taxpayer ruling on the Arizona transaction privilege tax with regard to the

The following is a restatement of the facts in your letter.

Statement of facts:

... is the parent company of ... ("..."), a film producer and distributor. ... is the parent company of ... ("..."), a video cassette distributor. All three entities are headquartered in

... has formed a new subsidiary, ..., as a production company to produce will perform production-related activities on more than one film at any given time. Each film takes approximately ... months to complete.

Special equipment has been and will be purchased by ... for the ..., including computer graphics equipment and related software, which will

... will produce its films pursuant to an ... with ...; i.e., every ... film will be transferred to ... for ... to exploit (distribute).

Films get "green lighted" (approved for production) by After the story development process, a decision must be made as to whether to invest the large sums of money necessary to make a film. Such a decision is made by ..., which then instructs ... to proceed with production.

The copyright to the film is initially held by

... takes the following steps in producing the film:

..;

...;

...; and,

....

Upon completion of the film, ... will transfer the film (...) and the underlying copyright to

... will be compensated by ... on a ... basis, where all of its

... will use the master film negative to make film prints. Film prints will be leased to the theaters by

The ownership of the film prints remains with

... will license to ... the right to distribute video cassettes. A video master (which is made from the ... film ...) is used in the manufacture of video cassettes.

... subcontracts out the manufacture of video cassettes. Video cassettes are then sold for resale to wholesalers and retailers.

Your position/questions:

A. The transfer of the completed ... film ... outside Arizona ... is nontaxable due to one or more of the following theories:

1. The production activity is a personal service with an inconsequential transfer of tangible personal property;
2. The transfer is made in interstate commerce;
3. The transfer is a sale for subsequent lease;
4. The transfer is a sale for resale; or
5. The production of a film is like that of custom software and thus exempt.

B. Would the transfer of the ... film ... be exempt if ... film ... were not completed at the date of transfer (i.e., what if some post-production work were performed in ...)?

C. Is the purchase of raw film stock ... exempt?

D. Are special ... equipment used in the ... process tax exempt?

Applicable statutory provision:

Arizona Revised Statutes (A.R.S.) § 42-1310.01 levies the transaction privilege tax on the business of selling tangible personal property at retail.

A.R.S. § 42-1310.01.A.1 excludes from the retail classification professional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements.

A.R.S. § 42-1310.01.B.1 exempts from the retail classification sales of machinery or equipment used directly in manufacturing or processing operations.

Arizona Administrative Code (A.A.C.) R15-5-104 addresses the concepts of inconsequentiality and purchases made by service businesses.

A.A.C. R15-5-120 addresses exempt sales of machinery or equipment.

Discussion:

Arizona imposes a transaction privilege tax which differs from the sales tax imposed by most states. The Arizona transaction privilege (sales) tax is a tax imposed on the privilege of conducting business in the State of Arizona. This tax is levied on the vendor, not the purchaser. The vendor may pass the burden of the tax on to the purchaser; however, the vendor is ultimately liable to Arizona for the tax.

Arizona Revised Statutes (A.R.S.) § 42-1310.01 levies the transaction privilege tax on the business of selling tangible personal property at retail. "Selling at retail" is defined as a sale for any purpose other than for resale. All retail sales of tangible personal property are subject to tax unless specifically exempted by statute.

A.R.S. § 42-1310.01.A.1 provides an exclusion from tax for professional or personal service occupations or businesses which involve sales or transfers of tangible personal property only as inconsequential elements.

A.A.C. R15-5-104.B provides that gross receipts from the sale of tangible personal property by a person engaged in a professional or personal service occupation or business, shall not be taxable if the property is sold only as an inconsequential element of the nontaxable service. Subsection C provides that sales of tangible personal property shall be considered inconsequential elements of the service if:

1. The purchase price of the tangible personal property to the person rendering the service represents less than 15% of the charge, billing, or statement rendered to the purchaser in connection with the transaction;

2. At the time of the sale, the tangible personal property transferred is not in a form which is subject to retail sale; and

3. The charge for the tangible personal property is not separately stated on the invoice.

Generally, video production is considered to be a professional service activity which involves transfers of tangible personal property as an inconsequential element of the transaction.

The professional service provider is considered to be the end user of the raw material used in the providing of the nontaxable service. (A.A.C. R15-5-104.A) Therefore, the video tape or film used in the production, editing, dubbing, and mastering of video or film is subject to tax under the retail classification when purchased. Items of tangible personal property such as props and equipment used in video production are also subject to tax under the retail classification when purchased. These items are being used or consumed in performing the professional service activity of video production.

A.R.S. § 42-1310.01.B.1 provides an exemption for machinery or equipment used directly in manufacturing, processing, job printing, and fabricating.

Arizona Administrative Code (A.A.C.) rule R15-5-120 defines the term "machinery and equipment used in processing" as including machinery or equipment that constitutes

the entire primary manufacturing or processing operation from the initial state of where actual processing begins through the completion of the finished end product.

The rule goes on to define "manufacturing" as the performance of an integrated series of operations which place tangible personal property in a form, composition, or character different from that in which it was acquired and transforms it into a different product with a distinctive name, character, or use.

In general, machinery and equipment used directly in manufacturing or processing are exempt from transaction privilege tax. However, it is the specific use of the machinery and equipment in a given situation which will determine taxability or exemption in each case. The machinery and equipment must be directly connected to a manufacturing or processing operation.

In order to qualify for the exemption, machinery or equipment must be used in a business engaged in a manufacturing, processing, or refining operation as those terms are commonly understood within their ordinary meaning. Additionally, the tangible personal property must be transformed within the manufacturing, processing, or refining environment from one distinct form into another distinct form in order for it to be marketable.

In summary, video production is generally considered to be a professional service activity. Machinery or equipment used in performing the video production activity is not used directly in a manufacturing or processing operation. Therefore, video production equipment does not qualify for the machinery or equipment exemption under the retail classification.

The department has issued a transaction privilege tax ruling on the taxability or exemption of video production activities and the associated sale of videotapes, TPR 92-2. A copy is enclosed for your reference.

Conclusion and ruling:

The following ruling is given based on the facts presented in your request.

The department rules that the transfer by ... of the completed ... film ... to ... is exempt as an inconsequential element of a service business. The ruling does not change if the ... film ... were not completed at the time of transfer. The exemption for professional or personal service does not require the transfer of a completed product.

The department also rules that the purchase of the raw film stock is subject to tax.

In addition, the department rules that ... equipment used in the ... process are subject to tax when purchased.

The conclusions in this private taxpayer ruling do not extend beyond the facts as presented in your letter of February 14, 1995 in this request for a private taxpayer ruling.

This response is a private taxpayer ruling and the determination herein is based solely on the facts provided in your request. The determination in this taxpayer ruling is the present position of the department and is valid for a period of four years from the date of issuance except as set out herein. This determination is subject to change should the facts prove to be different on audit. If it is determined that undisclosed facts were substantial or material to the department's making of an accurate determination, this taxpayer ruling shall be null and void. Further, the determination is subject to future change depending on changes in statutes, administrative rules, case law or notification of a different department position.