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REVENUE ADMINISTRATIVE BULLETIN 1995 - 1

Approved: February 14, 1995

SALES AND USE TAX GUIDELINES FOR DISTINGUISHING BETWEEN THE SALE OF A SERVICE AND THE SALE OF TANGIBLE PERSONAL PROPERTY

RAB-95-1. This Bulletin establishes the "real object test" guidelines adopted by the Department of Treasury. The real object test will be used to differentiate between the sale of a service and the sale of tangible personal property.

Analyzing sales transactions using the real object test will clarify the taxability of complex transactions. This bulletin will discuss the real object test through use of several standards. Among these standards are: creative service or sale of tangible personal property, intellectual service or sale of tangible personal property, and personal service or sale of tangible personal property.

Background

The Michigan Sales Tax Act does not allow a specific deduction from the "gross proceeds" of taxable sales of tangible personal property for costs of services. Michigan's sales and use taxes are imposed on activities related to retail sale of tangible personal property and the use or consumption of very specific services. Services taxed according to the Use Tax Act, MCL 205.93(a); MSA 7.555(3a) are:

- (a) "Intrastate telephone, telegraph, leased wire and other similar communications"
 - (b) "Rooms or lodging furnished by hotel-keepers, motel operators and other persons furnishing accommodations that are available to the public"
- "Interstate telephone communications that either originate or terminate in this state and for which the charge for the service is billed to a Michigan service address or phone number"

NO OTHER SERVICES ARE SUBJECT TO MICHIGAN SALES AND USE TAXES.

The true nature of the activity taking place within the transaction must be determined to distinguish whether a transaction is a sale of tangible personal property or a performance of a service. The analysis must view the entire transaction as a whole, rather than the individual components of the transaction.

Real Object Test

The Michigan Tax Tribunal in *Shelby Graphics Inc v Michigan Department of Treasury*, 5 MTTR 63, 69, (Docket No. 83611 October 7, 1986) stated:

"By far the most pervasive test adhered to by courts confronted with the sales/services question is that commonly referred to as the **'real object' test**; . . . this standard calls upon the trier of fact to discern whether, from the perspective of the purchaser, the purpose of the transaction lies in the transfer of an end product or in the acquisition of services." (Emphasis added).

The Tribunal quoted an earlier Ohio case by the Ohio Supreme Court *Federated Department Stores v Kosydar*, 45 Ohio St 2d 1; 340 NE2d 840 (1976):

"the real object sought by the buyer, i.e., the service per se or the property produced by the service . . . [to] determine if it was the buyer's object to obtain an act done personally by an individual as an economic service involving either the intellectual or manual personal effort of an individual, or if it was the buyer's object to obtain only the saleable end product of some individual's skill." (Emphasis in text).

In *Emery Industries, Inc v Limbach*, 43 Ohio St 3d 134,139; 539 NE2d 608,613 (1989), the Ohio Supreme Court characterized the real object test in the following manner: "The true object test seeks the essential reason the buyer enters the transaction--either to obtain the service or the property produced by the service."

Statement of Test

From the perspective of an impartial third party, what is the purchaser seeking? A tangible end product produced by a service, or merely the service itself?

Discussion

It is the intent of the Department to provide some general standards to aid in "real object" determinations. The standards provided are not intended to be exclusive or all-inclusive; however, they are intended to provide guidance to the taxpayer.

Department Rejects Custom/Special Order as a Viable Standard

The Michigan Tax Tribunal rejected some standards of other jurisdictions in its opinion in *Shelby, supra*, at 69, 70, by stating:

STATEMENT OF STANDARD

"For example, those criteria which premise a finding of a service transaction upon the existence of unique requirements on the part of the buyer, or upon any 'special order' relationship between buyer and seller, illegitimately create a distinction between customized goods and goods produced for mass purchase."

The Department accepts this reasoning and thereby rejects a custom or special order criteria as a standard. In 1940 the California Supreme Court in *Bigsby v Johnson*, 99 P2d 268,270 (Cal, 1940) quoted from an earlier Kentucky case, *Cusick v Commonwealth*, 260 Ky 204; 84 SW 2d 14 (1935):

"Coming to the argument that a photographer is engaged in selling service, and that service is not taxable, it must not be overlooked that the chief value of many articles consists in the cost of the

service and skill by which they are produced, rather than the cost of materials out of which they are made. Moreover, the situation is not the same as if the patron took an article to another to be repaired and paid only for the service rendered. One who desires a photograph of himself or his family does not contract simply for service. He desires the finished article, and that is what he buys and what the photographer sells." (Emphasis added).

Continued support for this position can be found in the Ohio Supreme Court decision in *Emery, supra*, at 139, with the statement:

"Even though a prospective purchaser may seek an accomplished photographer, he wants a photograph. He is seeking property The overriding purpose of the purchaser in hiring the photographer is to obtain a picture to depict something."

Creative Service or Sale of Tangible Personal Property

A criteria to be used when applying the "real object" test for Michigan will be as follows:

STATEMENT OF STANDARD

Where the object of the transaction is predominantly to obtain services of a special creative nature, the transaction will be characterized as a service.

Where the object of the transaction is predominantly to obtain a tangible product which may require services of a special technical nature, the transaction will be characterized as a sale of tangible personal property subject to tax. In these situations, the entire gross proceeds of the transaction would be subject to tax.

The Ohio Supreme Court and the Rhode Island Supreme Court have decided cases distinguishing sales of creative services from sales of the tangible end products of those creative services.

In *Federated, supra*, 340 NE2d 845, the Ohio Supreme Court stated:

"The testimony also definitely establishes the appellant's real object in hiring the artists is to acquire the sketches, themselves, so that the sketches may be turned over to the advertising department to be used in newspaper or magazine compositions. The record clearly establishes an objective to acquire tangible personal property"

The Rhode Island Supreme Court addressed the issue in *Hasbro Industries, Inc v Norberg*, 487 A2d 124, (1985) in the following terms:

"Hasbro relies on the 'real object' test expounded upon in *Statewide Multiple Listing Service, Inc v Norberg*, 120 RI 937; 392 A2d 371 (1978), to support its argument that its payments to the design firm were for nontaxable services. In *Statewide Multiple Listing Service*, we noted that 'where the real object of the transaction is the product of the service, it is a taxable transfer', but "[w]here the real object of the transaction is the service rendered and the transfer of personal property is merely incidental to the service, the transaction is not taxable.' [*Id.* at 942; 392 A2d at 374.]

"It is undisputed that considerable expertise and effort went into producing the mechanical artwork and that the value of the expertise and effort exceeded the component value of the resultant tangible personal property. However, this does not mean that the transfer of personal property was merely incidental to the service rendered. The fact that property the subject of a

sale is custom made and that labor is the principal cost factor does not establish the contract as one for rendition of services rather than sale'." [*Community Telecasting Service v Johnson*, 220 A2d 500, 503 (Me 1966); see also *Voss v Gray*, 70 ND 727, 734; 298 NW 1,4 (1941).]

"The critical test is the 'real object' of the transaction. Since the 'real object' of Hasbro's transaction with the design firm was to obtain as an end product the mechanical artwork from which its packaging could be fabricated in a finished form for ultimate sale, the transaction is not established as a nontaxable 'service' transaction."

Example 1:

Addy, Ltd. hires VCR, Inc. to videotape a staged enactment. The set, script, actors and other creative aspects are provided by Addy. VCR will provide post-film editing functions such as color correction and music dubbing to Addy's specifications. Addy will use the resulting videotape to illustrate a concept for a television commercial to its customer.

Determination 1:

The real object of this transaction is the sale of tangible personal property. VCR has contributed only its technical expertise to produce the videotape. The videotape is the tangible personal property that is sought, and will be used, by Addy. VCR's sale to Addy is taxable. Addy's service to its customer is not taxable. All creative aspects of the videotape were provided by the customer.

Example 2:

Maker Corp. hires Addy, Ltd. to design an advertising campaign for its new product line. VCR, Inc. is hired by Addy to videotape a staged enactment. Addy developed and provided the set, script, actors and other creative aspects. VCR will provide post-film editing functions such as color correction and music dubbing to Addy's specifications. Addy will use the resulting videotape to illustrate a concept for a television commercial to Maker.

Determination 2:

The real object of the sales transaction between Addy and Maker is that of a service. Maker seeks advertising concept, which includes a concept for a television commercial. From Maker's perspective, the videotape merely represents a medium for conveying this concept from Addy to Maker. (Note: The sales transaction between Addy and VCR remains identical to that in Example 1.)

Intellectual Service or Sale of Tangible Personal Property

Another criteria to be utilized in analyzing transactions under a real object test will be:

STATEMENT OF STANDARD

When the object of the transaction is to obtain the special intellectual ability or knowledge of the "seller," the sale will be judged to be a nontaxable service transaction.

When the object of the transaction, what the purchaser seeks, is to obtain the tangible manifestation of knowledge, the sale will be judged to be a sale of tangible personal property subject to tax.

The Ohio Supreme Court, in *Emery, supra*, at 613, distinguished service transactions involving professional or intellectual services. The court concluded that:

"Accordingly, we hold that in a professional, insurance or personal service transaction in which

the charge for the services is not separated from the charge for the property, if the overriding purpose of the purchaser is to obtain tangible personal property produced by the service, the transfer of the property is a consequential element of the transaction and the entire transaction is taxable. If the purchaser's overriding purpose is to receive the service, the transfer of the personal property is an inconsequential element of the transaction, and the entire transaction is not taxable."

Example 3:

John Doe hires attorney Joe Legal to prepare his will.

Determination 3:

When John Doe hired attorney Joe Legal, he sought the distribution of his estate at his death. The court will not accept Joe Legal's word; the court must see the documentary proof of John Doe's desired distribution of his estate. The overriding purpose of John Doe hiring Joe Legal to prepare his will is the service of the attorney to accomplish the distribution of the client's estate at death. John Doe has purchased a nontaxable service in which the tangible personal property is only an inconsequential element of the transaction.

Example 4:

John Doe purchases a packaged set of preprinted documents and instructions titled "Legal Eagle." John Doe prepares a customized will by reading the instructions, making choices and filling in the blanks on the preprinted documents.

Determination 4:

John Doe sought tangible personal property in the purchase of the packaged set of preprinted documents and instructions. He has purchased a taxable tangible manifestation of intellectual expertise of a general nature. The transfer of the property is a consequential element of the transaction. Intellectual expertise of an individualized or customized nature has not been purchased.

Example 5:

Jenny Taxpayer visits Susan B. Accountant, CPA, to have her 1991 Michigan Individual Income Tax Return (MI 1040) prepared.

Determination 5:

Jenny Taxpayer seeks the specialized intellectual knowledge of Susan B. Accountant. Accountant reviews Taxpayer's finances and prepares a report of her tax status. Taxpayer has purchased a nontaxable service. The transfer of the tangible personal property is an inconsequential element of the transaction. The paper (MI-1040) document represents documentary evidence of the individualized service performed by Accountant. It is the service, not the tax return, that is the real object of the transaction.

Example 6:

Jenny Taxpayer purchases a book titled "Your 1991 Michigan Individual Income Tax Return (MI 1040)" written by Susan B. Accountant, CPA. Jenny uses this book to prepare her 1991 MI 1040.

Determination 6:

Taxpayer seeks the tangible property represented by the book. In this instance, the transfer of the property is a consequential element of the transaction. The book is a taxable item of tangible personal property containing knowledge of a general nature and, for that reason, it is subject to sales tax.

Personal Service or Sale of Tangible Personal Property

An additional criteria to be used in analyzing transactions under the real object test will be:

STATEMENT OF STANDARD

When the object of the transaction is to obtain an economic service involving either the intellectual or personal effort of an individual, the transaction will be characterized as a nontaxable personal service.

When the object of the transaction is to obtain the property produced by the service, i.e., the saleable end product of some individual's skill, the transaction will be characterized as a sale of tangible personal property subject to tax.

Example 7:

ABC Company, a manufacturer of small kitchen appliances, contracts with XYZ Corporation to formulate a product evaluation questionnaire form for ABC's new blender. Additionally, XYZ will mail the questionnaire to all registered blender purchasers, receive the replies, compile the results, and prepare a customer profile report. The report will be the only item of tangible personal property transferred from XYZ to ABC.

Determination 7:

The true object of this sales transaction is a service. ABC sought from XYZ the services necessary to compile the desired information. The report itself is unique, and the fee charged is clearly for a service. ABC Company did not seek to obtain the questionnaire, but rather the information provided in response to the questionnaire. The report represents an inconsequential medium used to transmit the information sought.

Example 8:

ABC Company, a manufacturer of small kitchen appliances, engages XYZ Corporation to have a product evaluation questionnaire form printed for ABC's new blender. XYZ Corporation is also engaged, under a separate contract, to mail the questionnaire to all registered blender purchasers. The completed questionnaires will be returned to ABC Company by the registered purchasers.

Determination 8:

There are two separate and distinct sales transactions in this example. First, ABC seeks the tangible personal property of a questionnaire, which is subject to tax. As stated in Federated Department Stores, ABC sought the "saleable end product". Second, under a separate contract, ABC seeks a mailing service, separate and distinct from the taxable questionnaire, which is not subject to tax. This example is contrasted to the preceding example in that there is no report or other medium transmitting a unique service to XYZ Corporation.

Service on Property of Others or Sale of Tangible Personal Property

The need for a real object transaction analysis arises when the transaction includes services performed on the property of others. Michigan's sales tax is structured as a transactional tax. A single transaction cannot be segmented for tax purposes except as provided by law.

Sales tax is imposed on the "gross proceeds" of a "sale at retail" as ". . . a transaction by which the ownership of tangible personal property is transferred for consideration . . ." MCL 205.51(h) defines "gross proceeds" as the total amount received for a sale at retail ". . . without a deduction for the cost of the property sold, the cost of material used, the cost of labor or service purchased . . ."

The General Sales Tax Act provides in MCL 205.55a that only under the following circumstances can transaction be divided not segments for tax purposes:

Notwithstanding the provisions of section 2, labor or service charges involved in maintenance and repair work on tangible property of others shall be separately itemized and the tax applied only to the amount charged for the tangible personal property sold.

The following discussion shows the interaction of the provisions of MCL 205.55a with real object single transaction analysis:

STATEMENT OF STANDARD

When the purchaser's object is to seek a service performed on his or her property, and tangible personal property is transferred from the seller to the purchaser, this transfer of property is inconsequential to the service. The entire transaction will be considered a nontaxable service.

When the purchaser's object is to seek an item of tangible personal property, in addition to a service performed on his or her property, it will be determined that separate transactions have occurred. Both a sale of tangible personal property subject to tax and a sale of a nontaxable service have occurred.

Note: Transactions can combine several elements. Some of these elements can be determined to be services, while others can be determined to be sales of tangible personal property. In situations like this, several distinct elements are combined into one transaction. In all instances, one should always revert to an analysis of the real object of the transaction as a whole. A danger exists when the analysis reverts to a separation of a transaction by its elements. This could easily result in improper taxation and should be avoided.

Example 9:

Shipco hires Weldco to repair and reinforce the split corner seams of metal shipping containers. By making these repairs, Weldco consumes welding equipment, welding gases, and welding rod.

Determination 9:

The real object of the transaction is the repair of Shipco's containers, not the purchase of welding rod. In this instance Weldco is a consumer. Weldco, by consuming the equipment, gases and rod, has a sales and use tax liability on its purchases. No taxable sale of tangible personal property takes place between Weldco and Shipco.

Example 10:

JAW, Inc. hires CSF Company to cut a shipping container to size, and fabricate and attach a new metal top to it. The shipping container is owned by JAW, Inc., and the new top is supplied by CSF Company.

Determination 10:

The real object of the transaction of cutting the container to size is a service performed on an item owned by another. The charges for the service would be non-taxable provided they are separately stated on the invoice. The real object of the transaction of fabricating and attaching a new metal top is a sale of tangible personal property, the entire amount charged for the new metal top in the absence of a valid claim for exemption from JAW, Inc. would be subject to sales tax as gross proceeds. However, if a separate charge is made for labor to attach the top, the labor would not be subject to tax.

Example 11:

Patty Purchaser takes her automobile to Car Dealer Company complaining that it does not run properly and the door squeaks. The Car Dealer Company mechanic performs diagnostic tests on the automobile and determines that a new water pump is needed. The mechanic informs Patty Purchaser that she needs a new water pump and provides her with an estimate of costs for parts and labor. She approves the repair work and is billed for parts and labor. There is an added labor charge on the invoice for the door repair. A small quantity of grease and a small rubber seal are used to repair the door.

The real object of the water pump transaction is twofold: (1) it is the installation of a new water pump, and (2) it is a sale of taxable tangible personal property. The parts component of the billing is subject to sales tax. The labor component of the billing for the water pump installation is not subject to sales tax. Patty Purchaser originally sought to have her automobile repaired; the repair required a decision to purchase a new part and pay labor to have it installed. The labor costs to diagnose the problem are incorporated into the labor costs of the water pump installation and, therefore, are properly treated as a nontaxable service. The real object of this transaction is the installation of a new water pump.

The real object of the door repair transaction is a nontaxable service. Patty Purchaser sought to have her door repaired and did not make any subsequent decisions of a different nature. By repairing the door, Car Dealer Company consumed incidental materials, i.e., the grease and rubber seal. Car Dealer Company has a use tax liability for those consumed items.