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Sales Taxation of Mixed Transactions in Ohio: A Proposal to End the Turmoil

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SALES TAXATION OF MIXED TRANSACTIONS IN OHIO:
A PROPOSAL TO END THE TURMOIL

The statutory scheme of the Ohio sales tax statute is to tax all transfers and exchanges between two or more parties unless the transaction or exchange fits under a category of specific statutory exemptions. The application of the various exceptions has in recent years been the subject of considerable controversy. One particular exemption, the personal service exemption, has been especially difficult to delineate.

Positions taken by the Ohio Tax Commissioner in strictly construing the personal service exemption virtually repeal the exemption when a transfer of printed material is included in the transaction. As a result, many professionals must ponder whether or not to charge their clients sales tax and, if they do, whether to base the tax upon the entire consideration paid to them or just upon the value of the printed material given to the client. For example, a design firm creating a "logo," a doctor writing a diagnostic report, and an attorney drafting a will, all include a transfer of printed tangible personal property. Either the inclusion of the printed material makes the entire transaction subject to sales taxation, or it makes the transaction subject to sales taxation only to the value of the printed material, or it does not affect the tax-exempt status of the transaction. The third possibility has been the one usually accepted by professionals. However, if either of the other two are applied by the courts, then the professionals would be in substantial peril. Most professionals have not charged any sales tax for transactions which included printed material; as a result, there exists a

3 E.g., Credit Bureau v. Collins, 50 Ohio St. 2d 270, 364 N.E.2d 27 (1977); Federated Dept Stores, Inc. v. Kosydar, 45 Ohio St. 2d 1, 340 N.E.2d 840 (1976); Accountants' Computer Servs., Inc. v. Kosydar, 35 Ohio St. 2d 120, 298 N.E.2d 519 (1973).
6 The effect of White Motor Corp. v. Kosydar, 50 Ohio St. 2d 290, 364 N.E.2d 252 (1977), and Federated Dept Stores, Inc. v. Kosydar, 45 Ohio St. 2d 1, 340 N.E.2d 840 (1976), which were the result of a suit by the Commissioner for sales taxes due, was to eliminate the personal service exemption if the client would not have paid the total consideration unless the transaction included the printed material.
7 E.g., 50 Ohio St. 2d 290, 364 N.E.2d 252; 41 Ohio St. 2d 68, 322 N.E.2d 668.
failure to file a sales tax return\(^8\) or the filing of an incomplete return.\(^9\) The latter constitutes fraud for which there is no statute of limitations.\(^10\) Furthermore, the professional is charged with the legal duty of collecting the sales tax\(^11\) and is made personally liable for the amount of the tax that he fails to collect.\(^12\) Thus, the professional may be faced with a staggering assessment for all the years in which he failed to remit to the state the amount of sales tax which was required, even though it was not believed that sales tax was applicable to transactions that were primarily personal services.

This note will examine Ohio's statutory framework for the exemption of personal service transactions from sales taxation in light of judicial developments and the Tax Commissioner's interpretations. The analysis begins with whether a mixed transaction, one involving personal service and tangible personal property, is subject in its entirety to sales taxation only because a small amount of personal property was included. Then the advantages and disadvantages of separating personal service and personal property expenses will be examined. There the taxpayer would charge the client sales tax for the personal property portion of the transaction, but not for the personal service portion. Thereafter, the focus will be upon resolving the turmoil that has developed around Section 5739.01(B) by construing the "real object test."

Ohio levies a sales tax on "each sale made within [the] state."\(^13\) However, the mere fact that printed material is transferred as part of a personal service transaction should not, in itself, taint the entire transaction, making the transaction completely subject to sales taxation. In fact, personal service transactions which involve the transfer of an inconsequential amount of personal property are exempted from sales taxation.\(^14\) In order for a transaction to be in the personal service category, it must be an "act done personally

\(^9\) Id.
\(^10\) Id. § 5739.16.
\(^11\) Id. §§ 5739.12-13.
\(^12\) Id. § 5739.13. The Code states: "If any vendor fails to collect the [sales] tax on any consumer fails to pay the tax imposed by or pursuant to section 5739.02 . . . on any transaction . . . such vendor or consumer shall be personally liable . . . ." See also Mannen & Roth Co. v. Peck, 161 Ohio St. 153, 118 N.E.2d 134 (1953); Bowyz v. Commissioner, 135 Ohio St. 278, 20 N.E.2d 528 (1939).
\(^14\) The Code states: "Other than as provided in this section, 'sale' and 'selling' do not include professional, insurance, or personal service transactions which involve the transfer of tangible personal property as an inconsequential element, for which no separate charges are made." Id.
by a particular individual; it is, in effect, an economic service involving either
the intellectual or manual personal effort of an individual, not the saleable
product of skill."\(^{15}\) In effect, it is the skill for which the client pays in a per-
sonal service transaction.\(^{16}\) The trouble is that in most transactions, at least
to a limited extent, there is a mixed degree of personal services and the
transfer of tangible personal property.\(^{17}\) The question to be decided in these
mixed transactions is whether the transfer of tangible personal property is
a consequential element of the transaction, thereby subjecting the entire
transaction to sales taxation.

Notwithstanding the express wording of Section 5739.01(B) that,
"[o]ther than as provided in this section, 'sale' and 'selling' do not include
... personal service transactions which involve the transfer of tangible per-
sonal property as an inconsequential element,"\(^{18}\) it has been argued that sales
tax liability is to be imposed on all transactions that involve printed or drawn
materials, regardless of whether or not a substantial personal service is in-
volved.\(^{19}\) That is, the personal service portion of the transaction is tainted by
the mere inclusion of personal property. Since the personal service trans-
action exemption is prefaced by the "[o]ther than as provided" phrase, this
exemption would not apply to cases where printed matter is given to the
client, because the transfer of printed materials is defined as a "rule" by
another portion of the Code.\(^{20}\) This rationale is based on the statutory inter-
pretation that, "[w]ith the general application that a special statute covering
a particular subject matter must be read as an exception to a statute covering
the same and other subjects in general terms."\(^{21}\)

The theory upon which the taint argument was formulated is accurate.
However, the theory is not applicable to this situation since there exists no
problem of reconciling two separate statutes, one general and the other
specific. The real problem involves the harmonizing of several phrases of
Section 5739.01(B). Furthermore, the taint argument fails under the spe-
cific rule of judicial construction of tax statutes: "[a] statute which author-
izes the levying of a tax will be construed strictly against the taxing authori-

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\(^{15}\) Recording Devices v. Porterfield, 30 Ohio St. 2d 208, 213, 283 N.E.2d 626, 629 (1972).
\(^{16}\) Pla-Mor, Inc. v. Glander, 149 Ohio St. 295, 297, 78 N.E.2d 725, 726 (1948).
\(^{17}\) Koch v. Kosydar, 32 Ohio St. 2d 74, 77, 290 N.E.2d 847, 850 (1972).
\(^{18}\) OHIO REV. CODE ANN. § 5739.01(B) (Page Supp. 1977).
\(^{19}\) E.g., 35 Ohio St. 2d 120, 298 N.E.2d 519; 32 Ohio St. 2d 74, 290 N.E.2d 847.
\(^{20}\) Id.
\(^{21}\) Porter v. Kosydar, No. 28881 (Ohio Bd. of Tax Appeals 1978).
The intention to tax must clearly be expressed and any doubt as to such intention will be resolved in the favor of the taxpayer.\textsuperscript{22}

The “real object” test demonstrates the internal weakness of the taint argument. The real object test, borrowed from California,\textsuperscript{22} has been explained by the Ohio Supreme Court as follows:

[I]n determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service a distinction must be made as to the true object of the transaction contract... that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible property is transferred.\textsuperscript{24}

Under the real object test, the only question to be determined is whether the personal service element was the dominant feature of the transaction.\textsuperscript{25} If personal service was the real reason for the transaction, then the entire transaction is sales tax-exempt;\textsuperscript{26} however, if the transfer of personal property is the real reason for the transaction, then the entire transaction is subject to sales taxation.\textsuperscript{27} “To [decide the real purpose], the Tax Commissioner ... must examine the real object sought by the buyer, i.e., the service per se or the property produced by the service. . . .”\textsuperscript{28}

The taxpayer should be able to rely upon the real object test to overcome the taint argument that all mixed transactions including a more than inconsequential amount of tangible personal property are necessarily subject to sales

\textsuperscript{22} McNally v. Evatt, 146 Ohio St. 443, 448, 66 N.E.2d 633, 636 (1946) (emphasis added). Additional citations to decisions applying this rule are found in B.F. Goodrich Co. v. Peck, 161 Ohio St. 202, 118 N.E.2d 525 (1954). Section 5739.01(B) must be construed also by the rule that:

In enacting a statute, it is presumed that: . . .
(B) The entire statute is enacted to be effective;
(C) A just and reasonable result is intended;
(D) A result feasible of execution is intended.


Additionally, the statute states:

If a statute is ambiguous, the court, in determining the intention of the legislature, may consider among other matters:

(A) The object sought to be attended; . . .
(E) The consequences of a particular construction . . . .

\textit{Id.} at § 1.49.

\textsuperscript{23} 35 Ohio St. 2d at 124, 298 N.E.2d at 525.

\textsuperscript{24} \textit{Id.} at 129, 298 N.E.2d at 525.

\textsuperscript{25} \textit{Id.}

\textsuperscript{26} \textit{Id.} at 132, 298 N.E.2d at 527.

\textsuperscript{27} \textit{Id.}

\textsuperscript{28} \textit{Id.}

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taxation. However, in utilizing the real object test the taxpayer places himself in a potentially dangerous position, since there is great discretion for determining the real purpose of a transaction.

The seller of a service that involves both personal services and the transfer of tangible personal property may attempt to separate the cost of the two in order to retain the personal service exception.\(^{29}\) The primary intent for separating the two costs would be to benefit by:

1. not being subject to personal liability for not collecting sales tax;
2. not increasing the costs charged to the customer (assuming that sales tax must be charged, this approach would attempt to limit the tax to the smallest portion of the total cost) and
3. starting the statute of limitations running.

However, the disadvantages of following this approach would probably outweigh the advantages.

First, there are statutory implications which must be considered in order to determine the feasibility of separating expenses for the purpose of retaining the exemption for the personal service portion of the transaction. There is no language in Section 5739.01(B) that provides for a bisection of the total transaction into component parts.\(^{30}\) However, there is specific reference in Section 5739.01(H) to the fact that, “[p]rice [which is taxable] does not include the consideration received for labor or services used in installing or applying the property sold if the consideration for such services is separately stated . . . .”\(^{31}\) The statute specifically says that personal service is separable when the total transaction involves the installing or applying of property sold. That would seem to include only situations analogous to car repairs or house painting.\(^{32}\) Anyone engaged in the usual professional services would probably not fit into the category covered by Section 5729.01(H) since the transfer of personal property is the transfer of the end product of the professional’s work and not the installation or application of the tangible personal property.

Furthermore, the argument *expressio unius est exclusio alterius*\(^{33}\) could be made. Under that construction, the legislature permitted the separation

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\(^{29}\) This is the second of the three alternatives considered in the introduction. For example, a $1000.00 fee might be divided as $950.00 for personal services and $50.00 for printed material. As a result, a sales tax of $2.00 would be placed on the $50.00 of tangible personal property.

\(^{30}\) See generally OHIO REV. CODE ANN. § 5739.01(B) (Page Supp. 1977).

\(^{31}\) Id. at § 5739.01(H).

\(^{32}\) See Spray Wax Car Wash, Inc. v. Collins, 46 Ohio St. 2d 164, 167, 346 N.E.2d 696, 698 (1976); Cogen v. Glander, 156 Ohio St. 263, 266, 102 N.E.2d 1, 3 (1951).

\(^{33}\) The phrase argues that the expression of one thing is the exclusion of the other. See Sas-law v. Weis, 133 Ohio St. 496, 498, 14 N.E.2d 930, 932 (1938).
of personal property costs from personal service costs under Section 5739.01(H) in order to allow such businesses as car repair garages to retain part of the personal service exemption. Its failure to do the same under Section 5739.01(B) for other businesses is construed as an intentional exclusion of other types of businesses from doing the same.

Notwithstanding the lack of statutory support for a separation of personal property from personal service expenses, there are also potential problems in the making of an admission that part of the transaction should be subject to sales taxation. In Accountants' Computer Services, Inc. v. Kosydar, the Ohio Supreme Court said that:

If the Ohio taxation scheme is to be recognized, the cases we have ... must be decided by application of the same tests as have heretofore been used. Having concluded that a sale has occurred, it must then be determined whether a consequential professional, insurance, or personal service is involved. If not, then the exception cannot be available and the entire transaction is taxable. If, however, such a consequential service is rendered, then it must be further ascertained whether the transfer of the tangible personal property is an inconsequential element of the transaction. If so, then the “exception” provides that none of the consideration paid is taxable.

The tactical mistake would be that the professional would be giving away an exemption that he already has, which is, as the court stated, if “the tangible personal property is an inconsequential element of the transaction,” then the entire transaction is sales tax-exempt.

If that portion of the exemption was given away, one could conclude that the tangible personal property was not an “inconsequential element of the entire transaction.” Thus, the professional could be construed as having admitted that the printed matter was a significant element in the entire transaction. The result of such an admission could be that, “we, [the State of Ohio, would] also tax the entire consideration paid in transactions which, of necessity, involved some insignificant and inconsequential amount of personal service, without deducting from the total consideration paid the amount attributed to the inconsequential personal service provided.” Even if the tangible personal property was not construed to be the significant portion of the transaction, it could be construed as evidence that the whole transaction

34 35 Ohio St. 2d 120, 298 N.E.2d 519.
35 Id. at 131-32, 298 N.E.2d at 527 (emphasis added).
36 Id.
37 Id.
38 Id. at 129, 298 N.E.2d at 526 (emphasis added).
was tainted under the real object test. The basis of such an argument would be that:

Taxpayers paid . . . a substantial consideration for their services, and it is unlikely that this would have occurred without receipt of the [personal property]. It was their intention to acquire materials . . . . [T]he personal property purchased was the “real object” sought by the buyers.39

It is argued that since the taxpayer admits there is more than an insignificant amount of tangible personal property in the transaction, the client’s real object in paying the consideration for the transaction was receipt of the personal property.40 Hence, the whole transaction would necessarily be subject to sales taxation.41 As the final word against separating the personal service from the tangible personal property expense, the most recent Ohio Supreme Court decision in this area stated, “[t]his court must determine whether the transaction involved an inconsequential transfer of personal property; otherwise, the exception is not available and the entire transaction is taxable.”42

As discussed previously,43 the real object test has been used by the Ohio Supreme Court in determining whether a mixed transaction qualifies for the personal service exemption under Section 5739.01(B). The question to be answered is whether the service or the printed matter is the reason for a transfer of consideration. Or, stated practically, does a client pay his attorney for a will in expectation of receipt of a personal service or personal property? The real object test is subject to expansion44 which would have the effect of taxing every mixed transaction, no matter how inconsequential the part that the tangible personal property played in the transaction.

In United States Shoe Corp. v. Kosydar,45 the court said that the taxpayer had “paid the [professional advertising] agencies a substantial consideration for their services, and it is unlikely this would have occurred without receipt of the [folders and advertisement tapes].”46 As a result the court

39 United States Shoe Corp. v. Kosydar, 41 Ohio St. 2d 68, 72, 322 N.E.2d 668, 672 (1975).
40 Id.
41 The result is the same as if the taint argument had not been defeated. See notes 13-17 and accompanying text supra. The real object test only appeared to protect the taxpayer from having to charge sales tax on the entire consideration for all mixed transactions.
42 53 Ohio St. 2d at 66, 372 N.E.2d at 353 (1978) citing 50 Ohio St. 2d at 272, 364 N.E.2d at 29 (emphasis added).
43 See notes 23-28 and accompanying text supra.
44 Id.
45 41 Ohio St. 2d 68, 322 N.E.2d 668.
46 Id. at 71, 322 N.E.2d at 672.
concluded that the entire transaction was subject to sales taxation. This is because under the real object test, if tangible personal property was the real reason for the purchase, then there is no exemption from sales taxation for either the personal service or the personal property portion of the transaction.

As the Ohio Supreme Court stated in Accountants' Computer Services:

When a transaction is regarded as a sale of tangible personal property, [under the real object test] tax applies to the gross receipts from the furnishing thereof, without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property.

Therefore, if a personal service involves the preparation of tangible personal property as the end product of the professional skills involved, and it is unlikely that the taxpayer would have paid for such services without receipt of the property, then the entire transaction is subject to sales taxation.

This decision has been affirmed by recent cases. In United States Shoe, the Commissioner assessed sales tax on expenditures to advertising agencies for services and promotional aids. The court held that such purchases were subject to sales taxation because the personal property purchased was the real object sought by the taxpayer. The court simply stated that the taxpayer would not have paid the agency for its services without the receipt of the personal property; therefore, the payment was for personal property, not for services.

The Commissioner also assessed sales taxes against a taxpayer for the purchase of advertising materials in Federated Department Stores v. Kosydar. The state supreme court agreed with the Commissioner that the taxpayer was liable for the sales tax due on items of tangible personal property purchased from an advertising agency. The court said that the services rendered by the agency were inconsequential since the taxpayer would not have paid for the services without receipt of the personal property.

47 35 Ohio St. 2d 120, 298 N.E.2d 519.
48 Id. at 129, 298 N.E.2d at 525-26.
49 41 Ohio St. 2d 68, 322 N.E.2d 668.
50 Id. at 71, 322 N.E.2d at 672.
51 Id.
52 Id.
53 45 Ohio St. 2d 1, 340 N.E.2d 840.
54 Id. at 7, 340 N.E.2d at 845.
55 Id. The court stated: "The testimony also definitely establishes the appellant's real object in hiring the artists is to acquire the sketches, themselves . . . and . . . the personal service rendered is an inconsequential element in the transaction."
A third case, *White Motors Corp. v. Kosydar*, involved the purchase of designs and drawings which were used in ordering custom-made production equipment. The court agreed with the Commissioner that the taxpayer was subject to sales taxation for such purchases since the real object was to acquire the designs and drawings themselves. The court’s rationale for this conclusion was that the taxpayer would not have paid for the services without receipt of the drawings and designs which were items of personal property.

If the real object test were literally accepted in its absolute form, that the purchaser in a mixed transaction would not have paid full consideration but for the inclusion of the tangible personal property, the result would be nothing less than the elimination or repeal by implication of the professional and personal service exemption in the Code.

The scope of such an outcome would have devastating and nonsensical results. For example, if an average citizen hired an architect to design a home, common sense would say that the true object of the transaction was the translation of the individual’s desire, by means of the architect’s skills, into drawings from which the house could be constructed. The true object of the individual was the home itself; plans and drawings were incidental to that object. Yet, when the architect’s skills are placed on paper, in order to transfer his mental product to workable orders for the builders, sales tax would be applicable since the purchaser would not have paid for the transaction without receipt of the tangible personal property.

What of the attorney who prepares a will? Common sense would suggest that the reason the individual retained an attorney was for the application of the attorney’s skills to the solution of his problem, in this example with regard to the disposition of his property at death. When the attorney applies his skills and drafts a will, there has been an element of tangible personal property included in the transaction. In order to determine whether the entire transaction is sales tax-exempt, the real object of the transaction, the personal service or tangible personal property, must be determined. Since the test under the trilogy referred to previously is whether the customer would have paid the consideration for the service without the written

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50 Ohio St. 2d 290, 364 N.E.2d 252.
51 Id. at 300, 364 N.E.2d at 257.
52 Id.
53 The results would be the same as if the taint argument were applied so that all mixed transactions were subject to sales taxation. See notes 13-28 and accompanying text supra.
54 See 41 Ohio St. 2d at 72, 322 N.E.2d at 672.
reports, the entire transaction would be subject to sales taxation since the individual would not have paid the attorney unless the written document, the will, was transferred.

The Ohio Supreme Court seems to have recognized the risks of applying the real object test too broadly. In *Avco Broadcasting Corporation v. Lindley*, the court held that purchases of news services and television rating services were not subject to sales taxation. In *Avco*, written reports of ratings and written news stories were transferred to the buyer. The Commissioner said that the transaction was not exempt from sales taxation because the real object sought by the buyer was the printed rating reports and the printed news stories. The Board of Tax Appeals affirmed the Commissioner's decision. However, the Ohio Supreme Court reversed the Board and held that both types of transactions were exempt from sales taxation. Under the broad interpretation of the real object test which was followed by the Board, the buyer probably would not have paid for the transaction without receipt of tangible personal property. However, the court said that the way to determine the real object of the transaction is 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 the saleable end product of some individual's skill." The object of the transaction was the receipt of marketing and advertising information which required substantial personal service. The transaction involving the wire news stories was tax-exempt because the "gathering of news involves intellectual and manual personal effort on the part of those providing the service and it is the service *per se* which is the real object sought ... ." A 1977 decision can also be interpreted as departing from the broad application of the real object test. In *Credit Bureau of Miami County, Inc. v. Collins*, the court reversed the Board of Tax Appeals which had held that the transfer of written reports containing credit information was subject

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61 See 50 Ohio St. 2d at 294-95, 364 N.E.2d at 257.
63 Id. at 64-65, 372 N.E.2d at 351-52.
64 Id.
65 Id. No. E-174 (Ohio Bd. of Tax Appeals 1977).
66 53 Ohio St. 2d at 67, 372 N.E.2d at 353.
67 Id.
68 Id.
69 See text describing the broad interpretation accompanying notes 45-59 supra.
70 50 Ohio St. 2d 270, 364 N.E.2d 27 (1977).
to sales taxation." The state supreme court accepted the real object test, but found that the *sine qua non* was the information requested and not the tangible personal property."

The real object test has not been directly modified since the *United States Shoe* case. *Avco* was a one page opinion which merely said the object of the transaction was not to obtain the saleable end product of the seller's skill. *Avco* did not delineate as to how the real object test was applied, nor did it modify the test from its earlier application.

The distinction between *Avco* and the previous cases appears to be one of transactions involving advertising and those not involving advertising. In the earlier trilogy of cases, the court was using the real object test against transactions among advertising agencies and their clients. In those transactions, personal service was involved in developing and planning the advertising campaign, but since the advertising agencies prepared the television and radio tapes that were to be used, the court seemed to be saying that the real object was the saleable end product, the tapes themselves rather than the information they communicated. The buyer in such instances did nothing with the tapes except to distribute them to radio and television stations. In *Avco* and *Credit Bureau*, the reports contained information to be used by the purchaser. Under this interpretation, it is admitted that the buyer would not have paid the seller for a mixed transaction without the transfer of tangible personal property. However, the information communicated by the report was the real object of the transaction. As a matter of convenience or necessity, a written or drawn document may be supplied with the information, which necessarily constitutes the *sine qua non* of the transaction. The pieces of paper conveying individualized material have no intrinsic value as items of property beyond the information contained thereon by the words or symbols supplying the skill. Such an interpretation avoids the absurd result of subjecting every mixed transaction to sales taxation. A mixed transaction under this interpretation is examined concerning the actual item conveyed, to determine if it is the information or the tangible personal property that is the *sine qua non* of that transaction.

The court's present movement away from those interpretations of the exception which impose taxes on the professional's work, promises some relief from the confusion and uncertainty that have surrounded Section 5739.01(B). The application of the taint test would have resulted in the implied repeal of the personal service exception since the transfer of even

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11 *Id.* at 273, 364 N.E.2d at 30.

12 *Id.* at 272, 364 N.E.2d at 29.

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the smallest amount of tangible personal property subjected the entire trans-
action to sales tax. The literal interpretation of the real object test would
also have resulted in the implied repeal of the personal service exception
since the customer probably would not have paid for a mixed transaction if
the personal property was not also transferred. The court’s hesitancy to
repeal the exception or even to modify it is evidenced by its opinion in
Avco. It appears that the court will now examine the facts of each case
to determine if the real object of the buyer is to obtain the “thoughts” and
“analysis” of the seller and not some amount of tangible personal property.
If such mental processes are the real object of the buyer, the entire transaction
is exempt from sales taxation. Under this interpretation, it appears that
the court is at last applying the statute as the legislature originally intended
and providing professionals with a fair and workable system of taxation.

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