STATE OF CALIFORNIA

477.0775

BOARD OF EQUALIZATION

APPEALS SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
S--- C---, INC.	)	No. SY -- XX-XXXXXX-010
Petitioner	)	

The Appeals conference in the above-referenced matter was held by Tax Counsel III Lucian Khan on March 6, 1996 in San Jose, California.

Appearing for Petitioner:

P--- B---
Corporate Controller

D--- B---
Operations Controller

D--- F---
Corporate Accounting Supervisor

J--- C---
Representative

Appearing for the Sales and Use Tax Department:

Garth Keel
Supervising Tax Auditor

Shirley Smith
Senior Tax Auditor

Type of Business: Manufacturer of printed circuit boards

Protested Items

Claimed exempt sales disallowed (item A) based on .6504 percent error factor developed by statistical sample, measured by $XXX,XXX. The audit period covers April 1, 1989 through June 30, 1992.

Contentions

1. For certain invoices contained in the audit sample, title to tooling did not pass to customers.

2. The auditor erroneously determined that certain separately billed engineering charges were related to the production of tooling, when in fact they did not.

3. In the prior audit, it was determined that title to the tooling never passed to customers, and that separately billed engineering charges related only to production of printed circuit boards which were sold for resale.

4. The auditor erroneously projected two errors found for petitioner's Costa Mesa location. These errors should have been assessed on an actual basis (i.e., removed from sample).

Summary

During the audit period, petitioner produced photoplots from raw film it purchased tax paid from suppliers. Photoplots are manufacturing aids (tooling) which are used to produce printed circuit boards (PCBs). To create the photoplots, petitioner used its computers and computer-aided design (CAD) software to design and layout the electronic components on printed circuit boards, from paperwork and schematics provided by its customers. The CAD software was used to manipulate data, and generate the optimum design for the boards. Petitioner's photo lab then used the CAD program to create the photoplots.

The auditor reviewed various invoices and related customer purchase orders of a selected block sample. Many of the purchase orders contained clauses stating that the customers obtained title to all tooling (photoplots) which were paid for. On its invoices, petitioner made separate charges for the photoplots as well. The auditor also noted invoices containing separate "NRSU" charges. She concluded these charges related to production of the photoplots. Petitioner explained that "NRSU" stands for non-recurring set-up charges. The auditor considered these charges to represent taxable transfers of the photoplots, and assessed tax on 76.5 percent of the photoplot charges (the remaining 23.5 percent was attributable to petitioner's tax-paid cost).

Petitioner's arguments are summarized in a March 17, 1993 letter from attorney I--- S--- (pp. 22-27 petition file), and March 6, 1996 and April 16, 1996 letters from representative J--- C--- (pp.

28-36 and 41-43 petition file.) The Sales and Use Tax Department's (SUTD) arguments are summarized in its Report of Office Discussion dated July 20, 1993 (see p. S3-S10, petition file) and memos dated March 7, 1996 (p. 37, petition file) and June 12, 1996, which is attached to the audit workpapers. To simply the matters at issue, each will be discussed separately, including my analysis and conclusion before proceeding to the next.

1. Title Transfer/NRSU Charges

Petitioner argues that simply because it made separate charges on its invoices for the photoplots, this does not mean that title transferred to its customers. Petitioner does not agree with SUTD that it is required to have documentation specifically stating that title did not transfer.[1] Petitioner maintains there must be specific evidence that title transferred, not just the auditor's showing that these items were separately billed in petitioner's invoices.

In support of its position, petitioner has submitted an undated memorandum (see pp. 18-19 petition file). Petitioner maintains this memorandum was provided by the auditor when the audit was first scheduled. The last paragraph of this memo states that:

> "Merely because a taxpayer bills its customer for mechanical tooling and adds sales tax reimbursement, it does not follow that the taxpayer has necessarily sold the tooling to the customer. All the terms of the contract must be examined, including purchase orders and invoices.... There is no basis for concluding that the tooling is sold to the purchaser where the tooling is not delivered to the purchaser and where no accounting of the tooling in the possession of the seller is made to the purchaser."

The four invoices which petitioner considers at issue are numbers 3668, 3778, 4130 and 4438. (See Schedule R12A-1a, pp. 2 and 3.) In each instance, the auditor noted NRSU charges only, and either that there was no title clause on the purchase order, or a copy of the purchase order could not be found in petitioner's records.

Petitioner further maintains that the NRSU charge encompasses more than the production of the photoplots. It also includes the engineering cost for evaluating customer-furnished material for design flaws. This involves time spent with the customer to correct any flaws found. It also includes time spent to develop the specific programs needed to run S---'s drilling, routing and other machines in order to produce the PCBs. If the order is not expected to be ongoing, the costs are partially recovered by the NRSU charge. However, this charge does not solely represent a charge for photoplots that may become the property of S---'s customers. It also relates to the PCBs which were sold for resale as well. The pricing of these charges does not have a direct relationship to the specific cost which petitioner incurs. Rather, the charge is based on what the market will bear. Only

[1]SUTD made this suggestion in an earlier letter to petitioner.

30 percent of this charge relates to the selling price of the photoplots (tooling). This amounts to a 20 percent markup on the cost of the film sold.[2]

Based on its review of the evidence submitted, SUTD now concludes (in a June 12, 1996 memo), that the NRSU charge consists of "many elements" and therefore a portion of petitioner's CAD design charges might qualify as exempt under Annotation 515.0600 (Exhibit 1 attached). This annotation provides that tax does not apply to CAD design charges even where some tangible representation of the design, such as drawings or data, is transferred to the customer, although tax does apply to manufacturing aids such as photoplots. However, SUTD points out the annotation does not address whether the CAD design charges must be separately stated to be considered exempt. SUTD considers petitioner's 30 percent figure acceptable since this would mean a 28 percent markup, if the design charges need not be separately stated, to be exempt.

Conclusion

The arguments here are somewhat confusing. Petitioner maintains that in no instances did title to the tooling (photoplots) transfer to its customers, yet petitioner only considers four invoices (3668, 3778, 4130 and 4438) to be in dispute. For the four invoices in question, the only charge which the auditor taxed was for NRSU. (See R12A-1a, pp. 2 and 3.) In the alternative, petitioner argues that if title to the tooling did transfer, the NRSU charge should be considered only partially (30 percent) taxable, since the remainder of this charge relates to items other than the production of tooling. However, I note that tax was assessed on NRSU charges for more than the four invoices which are in dispute. Therefore, we will first discuss the facts and circumstances under which title to the photoplots (i.e., tooling) did pass to petitioner's customers, then whether the NRSU charges would be considered taxable.

According to my review of the audit workpapers, for most of the transactions upon which the auditor assessed sales tax, the customers' purchase orders either stated that title to tooling transferred to the customers, or the tooling became the customers' property, once the customers paid for it. Clearly, this type of contract language means that title did transfer, and thus a sale occurred (Revenue and Taxation Code Section 6006). Therefore, the auditor properly assessed tax on tooling on these transactions.[3]

An additional matter that should also be considered in the recommended reaudit (see below) is the fact that some of the purchase orders in the audit workpapers contain clauses which only pass title to the customer after a use of the tooling is already made. Therefore, a taxable use (if no tax paid on cost) of the tooling occurred before title transferred, in addition to tax due on the later transfer of title. Accordingly, for those instances in which tax was assessed on the invoiced price to the customer, tax would also be due on petitioner's cost. If petitioner already paid tax on cost,

[2]To support its argument, petitioner has submitted cost figures for SUTD's review.
[3]Petitioner has not contended that the audit staff included in the measure of tax charges for photoplots for transactions in which the purchase orders did not contain a title clause.

petitioner would not be entitled to a tax-paid purchases resold deduction on its subsequent sale of tooling. (See Memo 9 purchase orders of Digital Transmissions, Inc. [Item 13], and HRB Systems [Item A8], both of which state tooling becomes the property of the buyer "upon completion of this order", e.g., after a use of the tooling was already made.)

This brings us to the issue of the NRSU charges which in the alternative petitioner argues should only be partially taxable, and the Department seems to agree with this, except for the fact that the portion allegedly attributable to the design of the photoplots was not separately stated. The Department bases its conclusion on a review of Annotation 515.0600 (Exhibit 1). The substance of this annotation is that computer-assisted design charges are not subject to tax, while charges for photoplots (tooling) are. We believe that the annotation is incorrect.

Regulation 1501.1(b)(5) specifically provides that production tooling is a custom-made item, and tax applies as outlined in (b)(3) of the regulation. Subdivision (b)(3) provides that tax applies to the entire contract price without regard to the fact that the research, design and development charges may be separately stated. In other words, the full costs of producing the tooling must be considered. Separately stating the design charge does not change this. The annotation is inconsistent with the new regulation. However, the annotation was published before the regulation was promulgated. We note that the design charges were combined with a nontaxable charge and not included in the charge for the photoplot. I conclude that, based on this annotation, all NRSU charges should be deleted from the audit. (See Rev. & Tax. Code § 6596 regarding incorrect written advice.) Petitioner is now on notice that tooling design charges are fully taxable.

Although I have recommended that the NSRU charges be deleted, I question the allocation for photoplot charges (30 percent) accepted by the Department. A copy of the photoplot is in the audit workpapers. It is a mirror image of the PCBs which it produces. Therefore, unlike tooling such as a robot on an automobile assembly line which requires separate engineering from the automobile it produces, it appears that all necessary engineering for the PCB's would have already occurred at the point in time when the photoplot was produced. In other words, I do not see what additional engineering would be necessary separate and apart from the photoplot, to produce the PCBs. I am also concerned that the charges for photoplot design were unreasonably low because, according to petitioner, they did not necessarily reflect the true cost that petitioner incurred. Therefore, the 30 percent allocation should not be relied upon by petitioner for future quarters unless petitioner's records can clearly substantiate that this is the correct amount.

2. Prior Audit Advice

Petitioner maintains that during the period covered by the prior audit, tooling and NRSU charges were separately stated in its invoices to customers, as was done in the current audit under petition. Despite this, the previous auditor concluded that title to the tooling did not transfer, and that petitioner was the consumer. The auditor also concluded the NRSU charges were not taxable, and apparently that these charges were part of the selling price to the PCBs, which were sold for resale, rather than the tooling. In support of this argument, petitioner has submitted a copy of the prior audit comments and certain invoices relating to sales during that period. (See pp. 28-33 petition file.)

Conclusion

Revenue and Taxation Code Section 6596 provides for relief of any tax, penalty or interest which is the result of written misinformation from a Board employee, in response to a written inquiry from the taxpayer. The Board has previously determined relief may be extended to advice given in prior audits. The written evidence must demonstrate that the issue in question was examined either in a sample or actual review, as set forth in the audit workpapers.

The relevant prior audit comments on this issue are as follows:

> "The auditor found that TP had purchased a substantial amount of raw film for resale and the raw film was used as mfg aids in the process of mfg printed circuit boards. Per reg. 1525.1., TP cannot show where title to mfg aids passes to the customer prior to use and therefore auditor is considering TP to be the consumer of raw films.... The exposed or finished film is sometime known as 'tooling'. Generally, the customers do not get the tooling but is kept at the TP's plant in case of future orders. The TP state that it's the customers' property if they wanted it. Some films are not given to customers when it involves confidential product method used."

The submitted invoices which relate to the prior audit clearly show separate charges for tooling and NRSU. Since it is already recommended that NRSU charges be deleted, we will only discuss the alleged prior audit advice relative to tooling.

Although the evidence shows petitioner billed tooling charges to its customers the same way in the prior audit as the current, it is not the bills that we are relying upon to determine if title passed. In any event, I do not find that the audit comments contain erroneous advice regarding the application of tax. A taxpayer may be both the consumer and the retailer of tooling if the taxpayer uses the tooling prior to selling it to the customer. Thus, the fact that the prior audit workpapers stated that petitioner was the consumer of the tooling does not mean that petitioner could not also have been the seller of the tooling. Regarding passage of title to the tooling, it is not clear from the above-quoted comments whether the auditor (1) determined that title did not pass at all or (2)

determined that title passed but not prior to use, i.e., the auditor determined that title passed after use. Nor is there any indication that the auditor reviewed purchase orders from the customers and determined that they did not contain title clauses. Thus, I conclude that these comments do not form a basis for relief from tax on the tooling charges.

3. Erroneous Error Projection

Petitioner argues the test period used for its Costa Mesa location is invalid. There was only two errors; therefore, the errors should have been assessed on an actual basis, rather than projected. In its March 7, 1996 memo, SUTD agrees with petitioner. SUTD states that all projected errors will be from the northern California portion of the sample only (i.e., take Costa Mesa errors out of sample). I agree with this conclusion.

Recommendation

Conduct a reaudit using the following guidelines:

1. Delete all NRSU charges.

2. Determine any additional measure of tax due for instances where the customer's purchase orders transferred title to tooling after petitioner has already made a taxable use.

3. Delete the Costa Mesa errors from the audit sample and audit on an actual basis. Recompute the remaining measure from the remaining sample.

_____ February 26, 1997
Lucian J. Khan, Tax Counsel III Date