

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

495.0610

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)
)
V--- T---, INC.) No. SY -- XX XXXXXX-020
)
)
Petitioner)

The Appeals Conference in the above-referenced matter was scheduled by Senior Staff Counsel James E. Mahler for March 28, 1991, in Sacramento, California.

Appearing for Petitioner: J--- F. M---
Consultant

Appearing for the Sales and Use Tax Department: Randy P. Pace
Senior Tax Auditor

Protested Item

The protested tax liability for the period January 1, 1985, through December 31, 1987, is measured by:

<u>Item</u>	<u>State, Local, County & SCCT</u>	<u>SCTA</u>
A. Disallowed [claimed] exempt Sales (net reaudit adjustment)	\$214,525	\$258,887

Contentions

1. Petitioner did not sell the artwork to its customers.
2. The artwork was exempt custom computer programming
3. If sales tax is due on the artwork, the measure should be two to six percent of the charge to the customer.
4. Credit should be allowed for tax erroneously reported on sales of artwork.
5. Sales to two certain customers qualify as nontaxable sales for resale.

6. Sales to those two customers should be deleted from the audit test as unrepresentative.

Summary

Petitioner is a corporation which designs, manufactures and sells "Burn-In Boards" (BIBs). BIBs are used to test the components of electronic equipment.

According to petitioner's representative, petitioner designs the BIBs in accordance with specifications provided by each customer. This normally takes seven or eight hours, but may take up to 24 hours for a complex job. When the design is complete, petitioner makes a "photoplot" of the design on paper or mylar, and the photoplot is shown to the customer for approval. Upon approval, petitioner's computer "reads" the photoplot and fabricates a "drill tape" for use as a template in manufacturing the BIBs. Fabrication of the drill tape requires only about one-half hour. Petitioner does not transfer possession of the photoplots or drill tapes to its customers.

Petitioner's invoices to its customers during the audit period included separately stated charges labeled "artwork - blue line" which were intended as charges for the design and fabrication of the photoplot and drill tape. Petitioner charged tax reimbursement and reported tax to the Board on the charges for BIBs and artwork on sales to California customers, except for some transactions claimed as sales for resale. When the BIBs were delivered to customers outside California, however, petitioner did not charge tax reimbursement or report tax.

The auditor examined job folders which typically included the customer's purchase order, design drawings and miscellaneous production documents, shipping documents and sales invoices. The purchaser order in most cases specifically mentioned artwork. (See, e.g., audit workpapers Schedule 12A3, page 1, line 21.) Based on these records, the auditor concluded that petitioner had sold the photoplots and drill tapes to its customers and, further, that the sales occurred in California prior to use of the photoplots and drill tapes in manufacturing the BIBs. Since petitioner had not reported or paid tax on sales to out-of-state customers, the auditor determined that additional tax was due.

The auditor originally decided that the additional tax should be measured by the entire charge for artwork. After the audit was completed, however, the auditor received a copy of a memo from the Board's Principal Tax Auditor regarding computer-aided design. (This memo was later annotated as Sales and Use Tax Annotation 515.0600 [undated].) Based on this memo, the auditor decided that tax would apply only to the portion of the charge for artwork which was for the photoplot and drill tape, and not to the portion for design services. A reaudit was therefore initiated.

The reaudit regarded only ten percent of the artwork charges on each invoice as taxable. That was the auditor's estimate of the portion of the artwork charge attributable to the photoplot and drill tape. The record does not reveal the basis for that estimate.

The audit measure of tax was calculated on a test basis. The test sample includes 337 invoices totaling \$2,109,605, from a universe of 3,622 invoices. The test sample was originally intended to be ten percent of the population, and 361 invoices were selected, but duplicate numbers reduced the final sample size to 337 invoices.

After reaudit adjustment, 43 of the 337 sample invoices were found to include unreported taxable charges. Of these 43, 38 invoices charged out-of-state customers for artwork in the manner described above. The artwork charges totaled \$33,650, of which ten percent or \$3,365 was found taxable, an average of \$88.55 per invoice.

One of the other test transactions was a \$136.50 sale of ten "P.O. sockets". Petitioner had claimed this transaction as a nontaxable sale for resale, but did not have a resale certificate on file and the customer did not respond to an XYZ inquiry.

One of the other test transactions was a sale to R--- W--- (RW) of [city], California. The invoices charged \$950 for artwork, plus \$8,112 for BIBs, for a total of \$9,062. Petitioner had claimed the entire amount as a nontaxable sale for resale, but did not have a resale certificate on file. It appears that petitioner attempted to send an XYZ inquiry to RW, but RW had gone out of business and its former owners could not be located. The auditor found that the sale of BIBs was a taxable retail sale. (Through oversight, the reaudit asserted tax on the entire \$9,062, and did not allow partial exemption for the \$950 artwork charge.

The final three test invoices were sales of BIBs to N--- S--- C--- (NSC) of [city], California (in amounts of \$1,070, \$4,464 and \$1,862, with no associated artwork charges). Again, petitioner had claimed these transactions as sales for resale but did not have a resale certificate on file. Petitioner sent an XYZ inquiry to NSC but NSC refused to return it.

The total amount found taxable in the test sample was \$19,959.50. Of that amount, \$16,485 or 82.59 percent is from the four sales to RW and NSC.

Petitioner was previously audited for periods through September 30, 1984. The prior audit also tested claimed exempt sales, and sales of BIBs to RW and NSC were questioned in the test sample. Those sales were ultimately found nontaxable, however, on the basis if XYZ letters returned to petitioner by RW and NSC.

The prior audit test sample also included sales to A--- M--- D---, Inc. (AMD). Those sales were found taxable based in part on AMD's response to an XYZ letter that it had purchased the property for use. Petitioner appealed, contending inter alia that AMD had in fact purchased the property for resale and only later decided to use it. The reviewing officer concluded that the sale to AMD was taxable, but recommended that it be deleted from the audit test and that all claimed exempt sales to AMD be examined on an actual basis.

Analysis and Conclusions

1. Revenue and Taxation Code Section 6006 defined "sale" to include the transfer of title or possession of tangible personal property for a consideration. Petitioner alleges, and the audit staff appears to agree, that petitioner does not transfer possession of the photoplots or drill tapes to its customers. Petitioner can therefore be classified as a seller of these items only if title is transferred.

The auditor classified petitioner as a seller of photoplots and drill tapes after reviewing the sale documents in petitioner's job folders. By necessary implication, the auditor must have found that title in this property passed to the customers pursuant to the contracts of sale. The auditor's finding was apparently based in part on the fact that many customer purchase orders specifically mentioned the artwork. (See Sales Tax General Bulletin 50-24 [7/10/50]; see also Sales and Use Tax Regulation 1525.1.)

Petitioner contends that the auditor's finding is erroneous, but has not presented any sale documents for our review. Based on the present record, we have no reason to disturb the auditor's conclusions, and therefore find that petitioner was selling the photoplots and drill tapes. If petitioner wishes further review on this point, it should file a Request for Reconsideration, including copies of the job folder for each protested transaction.

2. Transfers of certain "custom computer programs" are excluded from "sale" and "purchase" by Revenue and Taxation Code Section 6010.9. Subparagraph (b) of that section provides that "computer" does not include "tape-controlled automatic drilling, milling, or other manufacturing machinery or equipment." The audit in this case has asserted tax on sales of photoplots and drill tapes, and there is nothing in the record to suggest that such property could be classified as custom computer programming.

3. The auditor estimated the taxable portion of the artwork charge to be ten percent. The basis for this estimate is not revealed in the record.

Petitioner estimates that the taxable portion should be somewhere between two percent and six percent. This estimate is based on taxpayer's allegations regarding the amount of time necessary to design and fabricate the photoplots and drill tapes. According to petitioner, fabricating the drill tape takes only about one-half hour, while designing the photoplot takes seven or eight hours up to 24 hours. One-half hour divided by eight hours is approximately six percent; one-half hour divided by 24 hours is approximately two percent.

Petitioner's calculations are intriguing but insufficiently supported. No time and motion studies or other supporting evidence has been presented. Furthermore, we see no reason why the allocation should be based on a time ration rather than a ration of relative costs or some other factor. On the basis of the present record, therefore, we see no basis for adjustment to the audit.

4. Petitioner contends that if it was selling the artwork to its out-of-state customers, as found in the audit, it must also have been selling the artwork to its in-state customers. Petitioner points out that it reported and paid tax on all charges for artwork to in-state customers (except for those transactions claimed as sales for resale). Petitioner concludes that it is entitled to refund or credit for taxes paid on the portion of the artwork charges attributable to design services. Petitioner concedes that any such refund or credit would be conditioned upon refund of excess tax reimbursement to its customers.

The staff appears to agree that overpayments were made, but points out that petitioner failed to file a timely claim for refund. The staff argues that credits would therefore be allowable only up to the amount of the determined taxes, and that any further refund would be barred by the statute of limitations.

We agree with the staff. Revenue and Taxation Code Section 6902 prohibits the Board from granting a refund or credit unless a timely claim for refund has been filed. Section 6905 provides that failure to file a timely claim “constitutes a waiver of any demand against the State on account of overpayment.” Under section 6483, however, the Board may offset overpayments against underpayments when “making a determination....”

Under Section 6902, a claim for refund of Board-assessed taxes may be filed within six months from the date the determination became final. For self-assessed taxes, however, a refund claim must be filed within three years from the due date of the return for the period for which the overpayment was made.

The determination in question has not as yet become final, and the statute of limitations is therefore still open for the Board-assessed items. Overpayments by petitioner can be used to offset the determination. However, more than three years has passed since the due dates of the returns for all reporting periods in question. Any additional refund of self-assessed taxes is therefore barred.

5. Petitioner next contends that the sales of BIBs to NSC and RW should be allowed as nontaxable sales for resale. We disagree.

Under Sections 6091 through 6093 of the Revenue and Taxation Code, all gross receipts are presumed subject to tax unless the seller takes a timely resale certificate from the customer in good faith. Subdivision (c) of Sales and Use Tax Regulation 1668 provides that, absent such a certificate, a seller claiming that the property was sold for resale can prevail only upon submission of satisfactory evidence: (1) that the purchaser resold the property prior to use; (2) that the purchaser is still holding the property for resale prior to use; or that (3) the purchaser paid tax directly to the state.

Petitioner did not have a resale certificate from either NSC or RW (even though petitioner had been advised by the prior audit of the need for resale certificates). No evidence of the type specified by Regulation 1668 has been presented. It follows that petitioner is liable for sales tax. (However, the measure of tax on the sale to RW should be adjusted to account for the artwork charges.)

Petitioner points out that both NSC and RW executed XYZ letters in the prior audit stating that they purchased BIBs for resale. Those XYZ letters dealt with certain specific purchases during the prior audit period, however. The admissions by NSC and RW that those specific purchases were for resale do not prove that subsequent purchases during this audit period were also for resale.

Petitioner also alleges that NSC, as a matter of business practice, booked all BIBs purchased from petitioner into resale inventory accounts. We agree with petitioner that such an accounting practice, if it in fact existed, would be evidence that NSC bought the BIBs for resale. However, petitioner has presented no evidence to support its allegation that NSC had such a practice.

6. The sales to NSC and RW were considered taxable in the audit test because of the lack of evidence to support a resale exclusion. All the other test transactions, save one, were questioned because of the auditor's conclusion that sales of artwork occurred in California on claimed interstate commerce transactions. Petitioner contends that the sales to NSC and RW were so different from the other transactions that they should be deleted from the audit test and taxed on an actual basis.

We understand that all exemptions and exclusions claimed by petitioner were lumped together as a single line item on its returns. That is, claimed interstate commerce sales were not listed separately from claimed resales. Board policy therefore allows auditing both types of transactions as part of a single test. (See the Board's Audit Manual, Section 0405.20, subparagraph (b).)

For reasons unique to this particular case, however, we agree with petitioner that the two types of transactions should be segregated. The audit test was designed to evaluate the charges for artwork on claimed interstate commerce sales; the questioned resales were discovered almost by accident. The disallowance on the 38 artwork sales averages only \$88.55 per transaction; the four disallowed sales to NSC and RW average \$4,114,50 and account for over 80 percent of the total disallowance. Furthermore, a transaction similar to the sales to NSC and RW was deleted from the prior audit test.

Accordingly, we recommend a reaudit to segregate the sales to NSC and RW from the artwork sales. In the audit staff's discretion, the sales to NSC and RW might be incorporated into a new test of claimed resales; or the sales to those two customers might be audited on an actual basis.

Recommendation

Reaudit in accordance with the views expressed herein.

James E. Mahler, Senior Staff Counsel

11/7/91

Date