



STATE BOARD OF EQUALIZATION

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TELEPHONE (916) 445-6450

August 21, 1990

RE: XX

Dear Mr. ---:

This is in response to your letter dated July 13, 1990. You ask whether under the facts set forth in your letter, your client, On XX, is leasing property in substantially the same form as acquired with the right to make an election to pay tax measured by purchase price.

XX will lease a system for viewing videocassettes in a hotel. The system will consist of a central unit comprised of 80 video cassette players (VCP's), switching and modulation equipment, character generators which produce menus on the television screens, and a microcomputer which controls the system. A printed circuit board will be installed inside each hotel television, which allows the guest to access the system via the television remote controller. XX recognizes that it is selling this printed circuit board to the hotel and that its sale price for the printed circuit board is subject to sales tax.

XX installs and maintains the system in the hotel. The hotel charges its guests certain fees for movies accessed via the system by the guests. The hotel retains 10 percent of the revenue it collects from the guests who use the system and remits the other 90 percent to XX. The contract between the hotel and XX is for a five-year period.

You describe construction of the system and its installation as follows:

“XX purchases all of its system components, including VCPs, switching devices, modulators, character generators, and a micro computer from outside suppliers and assembles them, primarily by wiring or cabling them together, in a central unit cabinet, which is air conditioned to protect the equipment. XX also tests each system before installing it in the hotel. The cost of the components for a typical system, exclusive of the circuit boards installed in the televisions, is approximately \$95,000 to \$100,000 and assembly labor is approximately \$4,500 to \$5,500 for a typical system. In

addition, labor for testing the system prior to installation is approximately \$2,00 to \$2,500 for a typical system.

“The XX system is installed by wiring the central control unit to a hotel’s existing cable network. XX uses local independent private cable television companies to modify the existing hotel cable system to accommodate the XX system by breaking the hotel cabling into multiple loops, with each loop connected to sixteen television sets. These installation charges are approximately \$10,000. The systems are visited either monthly or as required for maintenance and changing of tapes by field service engineers who are employees of XX.

“The printed interface circuit boards are custom manufactured to XX’s design by independent subcontractors at a cost of approximately \$5,000. The circuit boards are usually installed directly by the subcontractor, at a cost of approximately \$2,500, in the hotel’s television sets, preferably ones newly purchased by the hotel. It is possible that in the future some hotels may have the circuit boards installed in already existing or in-place television sets, in which case XX may use its own employees or other third party contractors to install the printed circuit boards in the hotel’s televisions on sit.”

You ask the following questions:

“1) Is the service provided by XX considered a non taxable service for sales and use tax purposes or, with the exception of the circuit boards installed in the hotel’s televisions, is it considered a lease of property, in substantially the same form, such that XX has the option under Revenue and Taxation Code section 6094.1 of paying tax measured by the purchase price of the component equipment?”

“2) Are the installation charges from the independent cable television companies exempt from tax?”

“3) Must XX pay sales tax upon installation of the circuit boards in the hotel’s television sets?”

You believe that no sales or use tax is applicable to the transaction between the hotel guest and the hotel because no tangible personal property is transferred to the guest. We agree that the hotel is providing the guest nontaxable video service and is not selling any tangible personal property since the tangible personal property remains in the possession and control of the hotel.

You also believe that XX is leasing the system to the hotel because the hotel has physical possession of the system for a five-year period and XX has only a limited right of removal. We agree. You further believe that the taxable consideration for the lease of the system is the 90 percent share of the revenue that the hotel pays to XX, less the portion attributable to the circuit boards which are sold to the hotel. We agree.

You believe that XX should be allowed to elect to pay sales tax at the time of its purchase of the various components of this system under an election provided by Revenue and Taxation Code section 6094.1. Section 6094.1 does not apply. By its very terms, it applies only to property acquired in transactions described by either subdivision (a) or subdivision (b) of section 6006.5. Rather, the election about which you inquire is available by virtue of the definition of "sale" and "purchase" under the Sales and Use Tax Law. A lease of tangible personal property is a continuing sale and purchase for purposes of the Sales and Use Tax Law unless the property is leased in substantially the same form as acquired by the lessor and the lessor has paid sales tax reimbursement or timely paid use tax measured by purchase price of the property. (Rev. & Tax. Code §§ 6006(g)(5), 6006.1, 6010(e)(5), 6010.1.) This is explained in Regulation 1660, a copy of which is enclosed.

You cite Business Taxes Law Guide Annotation 330.3980 (11/1/67) for the proposition that a change involving fabrication labor or 12 percent constitutes a substantial change in form while fabrication labor consisting of 5 percent fabrication labor does not. Since in this case there is assembly labor of 5 percent and testing labor of 2 percent, you believe that there is not a substantial change in form for purposes of electing to pay tax on purchase price. We disagree. The annotation you cite discusses changes in irrigation pipes. A change that involved welding a coupler onto one end of the pipe and a latch on the other, with a sprinkler also attached, was deemed not to be a substantial change in form. That the fabrication labor was but 5 percent was not determinative, but rather was an additional fact included in the annotation.

A review of the annotations on this subject shows that the determination of whether there is a substantial change in form is made on a case-by-case basis and the percentage of fabrication labor is a fact to be considered but is not determinative. The general rule is that if the value of the leased property is substantially in excess of the purchase price of the property used in preparing the leased item, the item is not leased in substantially the same form as acquired. (BTLG Annot. 330.3900 (2/17/67).) In Annotation 330.3970 (9/26/86), we considered whether fences were leased in substantially the same form as acquired. A fence leased by embedding posts into the ground and unrolling chain link fencing and attaching that to the post was considered to be leased in substantially the same form as acquired. On the other hand, a panel fence in which the taxpayer manufactured panels out of tubing, chain link fencing, and perhaps barbed wire, was considered to not be leased in substantially the same form as acquired. No consideration was made with respect to the percentage of the fabrication labor involved.

We do not consider your alternative to be a close question. XX is creating an entirely new product. Rather than a number of VCPs, each controlled individually, XX manufactures an entirely new product consisting of 80 VCPs all responding to central command, which in turn is

accessed by a number of remote control units in hotel rooms. This is clearly a substantial change in form, and XX has no election to pay tax on purchase price. Rather, its leases of the system are continuing sales and purchases and are subject to use tax measured by rentals payable, which XX must collect from the lessee and pay to the state. (Rev. & Tax. Code § 6203, Reg. 1660(c)(1).) XX may purchase the items incorporated into the system ex-tax for resale assuming it makes no use of those items prior to the sale (lease) of the system to the hotel.

We agree that the installation charges from the independent cable television companies are excludable from sales or use tax as charges for labor rendered installing property. (Rev. & Tax. Code §6203, Reg. 1660(c)(1).) XX may purchase the items incorporated into the system ex-tax for resale assuming it makes no use of those items prior to the sale (lease) of the system to the hotel.

We agree that the installation charges from the independent cable television companies are excludable from sales or use tax as charges for labor rendered installing property. (Rev. & Tax. Code §§ 6011(c)(3), 6012(c)(3).)

We agree that XX is selling the circuit boards to the hotel. When these circuit boards are installed into new televisions, we consider the installation to be fabrication labor as a step in the fabrication of a new television suitable for the hotel's purposes. Charges for that fabrication may not be deducted from XX's taxable gross receipts. On the other hand, the installation of circuit boards into used televisions would be regarded as repair labor since the alteration is not so extensive as to be regarded as the fabrication of an item different from that existing prior to the installation. Charges for such repair labor would not be subject to sales tax and may be deducted from XX's taxable gross receipts. (See Reg. 1546.)

My understanding is that XX does not separately state its sales price to the hotel for the circuit boards and installation. Therefore, XX must fairly apportion the amounts due from the hotel attributable to the hotel's purchase of the circuit boards plus fabrication labor, as discussed above. As you note, this tax, which is a sales tax, is due when the sale occurs, that is, when possession of the boards is transferred to the hotel. You ask further whether XX can recoup the amount of this tax on a ratable basis as it receives revenue from the hotel. Although the tax is a sales tax and is therefore owed by XX, XX may collect reimbursement for that tax from its purchaser if pursuant to their contract. (Rev. & Tax. Code § 6051, Civ. Code § 1656.1.) Assuming the contract between XX and the hotel so provides, XX may collect the reimbursement as it receives the revenue from the hotel. However, it may not collect more reimbursement with respect to these sales than it owes to the state as sales tax.

If you have further question, feel free to write again.

Sincerely,

David H. Levine

Senior Tax Counsel

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Enclosure

bc: San Jose District Office
Mr. John Abbott – I recommend deleting the references to percent of fabrication labor in
Annotation 330.3980. As discussed above, this reference has little meaning.