

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

435.0144

In the Matter of the Petition)	
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)	
)	
)	
N--- S--- CORP.)	No. SR -- XX XXXXXXX-020
)	
<u>Taxpayer</u>)	

The preliminary hearing on the above taxpayer's petition for Redetermination was held on October 28, 19XX, in San Jose, California.

Hearing Officer:	H. L. Cohen
Appearing for Petitioner:	Mr. A. L--- Senior Tax Analyst
Appearing for the Board:	Ms. B. McCrory Supervising Auditor San Jose District
	Mr. P. Nathan Tax Auditor San Jose District

Protested Items

A petition for Redetermination was filed by letter dated August 11, 1987. The letter contained arguments and authority supporting petitioner's position. The protested tax liability for the period July 1, 1980 through December 12, 1983, is measured by:

<u>Item</u>	<u>State, Local and County</u>	<u>District</u>
F. Self-consumed property purchased ex-tax, actual	\$2,223,354	\$2,223,354

G. Self-consumed property purchased ex-tax, estimated	<u>1,250,106</u>	<u>1,510,040</u>
TOTALS	\$3,473,460	\$3,733,358

Contention

Petitioner contends that the property in question consists of manufacturing waste and is in fact properly purchased for resale. If tax applies, it applies only to the charge for converting this manufacturing waste into test units.

Summary

Petitioner is a corporation which is engaged in the manufacture and sale of integrated circuits (IC's). The last prior audit was for the period through June 30, 1980.

Subsequent to the issuing of the deficiency determination, a reaudit was conducted. The total amount subject to tax was reduced in an audit report dated December 7, 1987. The reduction did not affect the protested audit items.

Petitioner purchases silicon wafers for resale, paying no tax or tax reimbursement. The average cost of a new wafer is about \$10. Petitioner etches the wafers with micro-circuitry to produce IC's for sale. Each batch of wafers is tested to assure proper manufacturing by withdrawing a sample wafer and testing it. Some percentage of wafers fail to meet quality control standards and are rejected. Most rejected wafers are scrapped. Some are shipped to vendors who back-lap them. Petitioner also performs some back-lapping itself. Back-lapping consists of cleaning and coating. Back-lapped wafers do not meet petitioner's quality standards for manufacturing IC's for resale. Petitioner uses the back-lapped wafers to test various manufacturing processes. These test wafers are processed through the individual manufacturing processes separately from production wafers as a verification that the process is operating properly. If the process is operating properly, new production wafers are fed through the process as part of the normal manufacturing operation.

The auditor concluded that the back-lapping was a repair operation which is not subject to tax, but that the use of the "repaired" wafers for testing purposes constituted self-consumption of property purchased for resale. Tax was asserted on the original cost of the wafers used as test wafers.

Petitioner states that many IC manufacturers scrap rejected wafers, since their sole value is the precious metal content. Petitioner contends in essence that it is furnishing materials to a vendor who processes the materials into manufacturing aids. Tax should apply only to the charge for fabrication labor which petitioner purchases under purchase orders marked for resale.

Petitioner states that all wafers are purchased with the intention of manufacturing IC's from them. The wafers rejected during the manufacturing process are manufacturing losses which are not taxable. Petitioner cites Business Taxes Law guide (BTLG) Annotations 440.1880 (May 26, 1952), 570.1400 (June 4, 1964), and 570.1340 (December 15, 1952), as support for this position. The back-lapping does not constitute repair; it consists of fabricating manufacturing aids from materials furnished by petitioner. Repair consists of returning property to an original condition. Wafers which have been back-lapped are not suitable for incorporation into the manufactured item which is resold. Accordingly, tax should apply only to the charge for fabrication labor.

Analysis and Conclusions

Section 6094 of the Revenue and Taxation Code provides that if a person who purchases property for resale makes any use of the property other than retention, demonstration, or display while holding it for sale in the regular course of business, the use is taxable to that person. Sales and Use Tax Regulation 1525 provides in subdivision (g) that tax does not apply to property purchased for the purpose of incorporating it into the manufactured article to be sold. If the statute and the regulation are read together, it is clear that tax does not apply to raw materials, such as wafers, which are intended to be resold without intervening use in the form of the manufactured article unless the raw materials are withdrawn from inventory for use other than in an manufactured product which will be resold without intervening use.

The BTLG Annotations cited by petitioner restate the Board's view that if some of the raw materials purchased for resale are lost during the manufacturing process, either through waste or defective products, that will not cause tax to be applied to the portion of the raw materials which does not actually appear in the end product. On the other hand, property used in research and development is regarded as self-consumed. If such property was purchased for resale and is withdrawn from the resale inventory for research and development use, tax will apply to the cost of the property at the time it is withdrawn from resale inventory.

The auditor relies on a letter from the Legal Staff of the Board stating that if repaired property is withdrawn from resale inventory for use in research and development, tax will apply to the original cost of that property. We see a clear distinction between that fact pattern and the facts here. The back-lapped wafers here are not returned to petitioner's resale inventory. Petitioner state that the quality level of these wafers is not acceptable for use in the manufactured products which are resold. Secondly the back-lapped wafers are not used in research and development. In petitioner's case, the rejected wafers are treated as scrap and should be regarded as having been purchased for resale. Tax does not apply to the \$10 average cost.

The next question is whether tax applies to the \$2.50 charge for back-lapping. If the \$2.50 charge is an inter-departmental book entry, no tax would apply since an entity does not pay tax on its own labor costs because we do not treat transactions between branches of the same

entity as sales. If the \$2.50 is a charge by a different entity, whether related or not, there may be a different result.

In order for an activity to be regarded as the performance of repairs, the product must be returned to its original condition or function. If a transaction consists solely of furnishing repair labor, it is regarded as a service activity which is not subject to tax. Here, since the back-lapped wafers are not regarded by petitioner as acceptable for use in its manufactured product, the back-lapped wafers are not being repaired. Petitioner's vendors are producing a product which petitioner uses to test its manufacturing process. This product, the back-lapped wafers, is not resold by petitioner, although petitioner apparently issues purchase orders which qualify as resale certificates. Section 6006(b) defines sale to include the processing of property furnished by another for a consideration. That is what occurs here. Accordingly, tax applies to the amount charged to petitioner by back-lap vendors.

This conclusion is not inconsistent with the letter upon which the auditor relied because the fact differ.

Recommendation

San Jose District to delete the purchase price of all wafers back-lapped in petitioner's own shop from the amount subject to tax and to reduce the amount subject to tax on wafers back-lapped by vendors from the purchase price of the wafers to the charges for back-lapping. Redetermine otherwise in accordance with the audit report dated December 7, 1987.

H. L. Cohen, Hearing Officer

12/20/88

Date

REVIEWED FOR AUDIT:

Principal Tax Auditor

Date