

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

440.0735

APPEALS UNIT

In the Matter of the Petition)
for Redetermination Under the) HEARING
Sales and Use Tax Law of:) DECISION AND RECOMMENDATION
)
)
L--- I--- OF) No. SR -- XX XXXXXX-020
C---)
)
Petitioner)

The above-referenced matter came on regularly for hearing before Hearing Officer Janice M. Fallman on December 20, 1989 in Torrance, California.

Appearing for Petitioner:

W--- W---
Attorney at Law

A--- L---, President

Appearing for the Department
of Business Taxes:

Robert Imig
District Principal Auditor

Chang Noh
Senior Tax Auditor

Observer:

John B. Adamo
Supervising Hearing Officer

Protested Items

The protested tax liability for the period October 1, 1983 through September 30, 1986 is measured by:

<u>Item</u>	<u>State, Local County & LACT</u>
B. Unreported ex-tax purchase of consumable screens purchased from out-of-state vendors on actual basis	809,912

D. Ex-tax purchases of consumable transfer papers on an actual basis not reported	554,450
F. Disallowed claimed sales for resale based on a test result of .21% error	<u>175,102</u>
Total	<u>\$1,539,464</u>

Petitioner also disputes imposition of a 10% penalty for negligence.

Petitioner's Contentions

1. The screens are not subject to tax since they were purchased for resale, and the true object sought by petitioner's clients is the artistic design incorporated therein.

2. The transfer paper purchased from Holland used in fabric manufacturing was acquired because the chemical bonded to the paper would be physically incorporated into the manufactured product. Therefore, it was not a manufacturing aid.

3. Disallowed sales for resale used to calculate the percent of error represent smaller dollar amounts and smaller volume sales. These sales are not representative and were erroneously projected against total sales for resale, the majority of which were large volume exempt sales for resale. Numerous transactions in the sampling were valid sales for resale.

4. The negligence penalty was improperly asserted because petitioner had been allowed ex-tax purchases of the screens in prior audits in which the Department of Business Taxes had concurred that the cylinder was not a manufacturing aid because petitioner's customers really sought and paid for its enhanced value from artistic design.

Summary

Since February 1973, petitioner has operated under a seller's permit obtained from the State Board of Equalization in the name of L--- I--- of C---. Petitioner has been audited on four occasions prior to the reporting periods now in dispute.

Petitioner is a textile manufacturer. It also prints patterns on fabric it produces by tow methods, the wet process and the paper transfer process. The principal issues in dispute involve ex-tax purchases of silk screens and transfer paper used by petitioner in the paper transfer process.

Petitioner maintains a staff of designers who are continuously creating new patterns and colors. According to its brochure, petitioner exercises "a complete and rigid control of patterns, assuring a steady, uninterrupted flow. Artwork can be rapidly transformed to actual production with no delays.

Petitioner's designers used the artwork to create a film which bears the design to be printed on the fabric. They then affix the film onto a metal cylinder with epoxy to make the silk screen. The image that appears on the silk screen is a negative image. The silk screen is then used to print the negative image on transfer paper. Finally, the transfer paper is aligned with the fabric, heat and pressure are applied, and a positive image is transposed on the fabric.

Petitioner buys the metal cylinders used to create the silk screens ex-tax. The life expectancy of a metal cylinder is approximately 20,000 yards of printed cloth, after which it is treated as fully consumed. Petitioner amortizes the cost of the cylinder into the cost of the fabric. For example, a yard of unprinted cloth costs approximately 70¢, but after having the design applied, it wholesales for \$2.75. That wholesale price per yard includes a portion of the amortized cylinder expense. Occasionally, petitioner charges outright for the silk screen, including the cylinder, although the tax auditor noticed no such billings in which the cost of the screen was separately stated.

Petitioner maintains an open line of pattern designs which it has registered and copyrighted. Petitioner generally owns the copyrights to its designs and can sell them to whomever it wishes. However, a purchaser can have an open line design committed to its exclusive use based upon a specific pattern design or a specific combination of colors. Likewise, clients can commission petitioner to create a print or to prepare the film of a print designed by the client. The resultant screen will be used solely for the licensee or owner of that design.

If a client bought from an open line design, the screen was amortized into the price of the printed yardage. If the client wished to acquire the right to exclusively use a particular copyrighted screen or combination of colors for an open line pattern, petitioner billed separately for the screen and deducted from the price of the printed fabric what would have been the amortized cost of the dedicated screen.

After the screen was either fully or partially used, petitioner retained the cylinder at the factory for a period of 6-12 months. If no further orders were forthcoming, the cylinders were cut into strips and sold as scrap metal because they were not reusable. As long as petitioner retained the film, it could recreate the screen on a new cylinder which required only an hour of time at a cost of about \$60. According to petitioner, the cost of the cylinder was only about \$10, and the remaining \$40-\$50 cost was attributable to the value of the artwork. The full value of the screen, including the value of the artistic design, was amortized into the price per yard of the cloth. Petitioner also retained and disposed of cylinders for clients who had been granted exclusive use of its copyrighted designs or who had ordered a custom design.

According to petitioner's attorney, the real value sought by a client of petitioner was artistic work and design, not the screen itself. The blank cylinders were perforated with holes and manufactured in one piece. It was the film that was created from the artwork and the design that was applied to the cylinder which enhanced its value.

Petitioner purchased transfer paper from C---, B--- in Holland. According to petitioner, this paper was made from a wood pulp which provided a more even surface when made into transfer paper. The paper was also purportedly treated with a special chemical. Petitioner was unable to obtain the name of the chemical and a letter from the Dutch supplier analyzes the chemical's role as purely a catalyst or transfer agent (Exhibit A). Petitioner's president stated that he had previously used uncoated transfer paper purchased in the United States which was not as good a quality as the Dutch paper and which did not prevent snagging. Tax Auditor Noh stated that the uncoated paper was not included in the disputed measure of tax presumably because it was purchased tax-paid.

The Department of Business Taxes contends that the chemical on the paper is a releasing agent or catalyst, which constitutes a manufacturing aid under Sales and Use Tax Regulation 1525.1, and that any transfer of the chemical into the fabric is only incidental to its function as a releasing agent (See Exhibit A).

At the hearing, petitioner's attorney stated that the transfer paper consisted of two components – the paper and the thin chemical coating. He likened the paper to a container and apportioned approximately 3-5¢ per yard of its purchase price to the value of the paper. The remaining 13-15¢ per yard was allegedly paid for the value of the unidentified chemical on the coated paper. Petitioner stated it consumed approximately 250,000 to 300,000 yards of transfer paper per year and paid the increased price for this imported transfer paper due to the value of the unnamed chemical. Petitioner initially contended that the chemical fully transferred to the printed fabric and that the remaining paper constituted waste. Petitioner subsequently admitted that some of the chemical may remain in the paper. The paper is not reusable.

According to petitioner, use of the transfer paper for printing changes the texture of the fabric. Petitioner produced a printed sample of the transfer paper and a sample of cloth that had been printed from that paper by the heat transfer method. There does appear to be a definite change in the cloth's texture: the unprinted portion of the cloth has a flat or dull surface, while the printed portion has a sheen. The paper sample provided also retains a higher sheen on the portion that was not used to print the fabric sample.

The District Principal Auditor stated that a previous sample of the paper and printed cloth provided by petitioner did not reveal a variation in sheen between the printed and non-printed areas. He admitted that the prior sample may have been fully printed over the entire surface of the cloth, so there was no chance to distinguish between the quality of the fabric prior to printing and its texture after application of heat to the transfer paper, print, fabric and chemical.

Petitioner contends that the gloss on the printed fabric arose from the presence of the unnamed chemical. Petitioner also alleges that the presence of the chemical in certain sheer polyester fabrics helped prevent snagging. Exhibit A does not discuss any anti-snag protection resulting from use of the Dutch transfer paper.

The tax auditor also examined petitioner's claimed sales for resale on a test basis. The tax auditor and a Mr. F---, employed by petitioner, agreed that a sampling of 750 invoices based upon random number selection was appropriate to determine a percent of error for unreported taxable sales. As a result of that sampling, the tax auditor discovered numerous sales in dollar amounts of approximately \$250 or less for which no resale certificate was issued. These sales were disallowed, thus yielding an error factor of 0.21%.

The disallowed sales were described by petitioner as strike-offs. A strike-off is a limited run of a printed fabric. It is sold to a clothing or other manufacturer who uses it to determine if the proposed fabric is appropriate for draping, or if the proposed pattern and colors are appropriate for a newly created dress design. Strikeoffs used to create clothing samples are allegedly all resold.

According to petitioner's president, everything petitioner sells is made into a garment and resold. Approximately 90 percent of its total sales are bulk sales to clothing manufacturers from whom resale certificates have been obtained. Strikeoffs constitute less than one percent of petitioner's total sales.

Petitioner has a general policy of accepting only orders of 2,000 yards or more, although courtesy runs in lesser amounts are occasionally sold. Petitioner's attorney contends that it is unfair to apply the 21/100 of one percent margin of error to total sales since the bulk of petitioner's sales are patently for resale. Based upon the 750-invoice sampling having been narrowed to one category of sale, i.e., strikeoffs, and the insignificance of strikeoffs to total sales, petitioner alleges the Department of Business Taxes' projection of a percent of error against total sales is flawed.

At the hearing, petitioner also provided copies of XYZ letters for many of the sales disallowed in the test. The Department of Business Taxes has not had an opportunity to review these XYZ letters. Exhibit B is a list of each entity submitting an XYZ letter and the amount previously included in the sampling. If these XYZ letters are accepted, \$2626 of the disputed \$4,796 questioned sales would be verified.

Regarding the negligence penalty, petitioner's attorney argues that prior auditors reviewed the ex-tax purchases of the screens and the tracing paper without making any adjustment. Thus, he concludes, it is unfair in this subsequent audit to assert the penalty.

Analysis and Conclusions

Audit Item B – Ex-tax Purchases of Silk Screens From Out-of-State Vendors.

Sales and Use Tax Regulation 1525.1 provides:

“Tax applies to the sale of manufacturing aids such as dies, patterns, jigs, and tooling used in the manufacturing process notwithstanding the fact that the property used in manufacturing may subsequently be delivered to or held as

property of the person to whom the manufactured product is sold. If the contract of sale between the manufacturer and the customer provides that title to the manufacturing aid passes to the purchaser prior to physical use of the property in the manufacturing process, then the manufacturing aid or its raw materials, if the manufacturing aid is fabricated by the manufacturer, may be purchased for resale. Tax then applies, unless otherwise exempt, to the sale of the manufacturing aid by the manufacturer to the customer, and not also with respect to the sale to the manufacturer.”

Petitioner acquired the cylinders and used them to create silk screen prints. No documentation has been provided to demonstrate that petitioner and any of its clients had a written agreement in which title to the cylinders, or any other materials used to prepare the silk screens, passed to the client prior to use by petitioner. Therefore, petitioner is the consumer of these materials. Since petitioner purchased these items ex-tax by issuance of resale certificates, petitioner owes use tax on the purchase price. (Revenue and Taxation Code Section 6244(a); see also Mercedes Benz v. State Board of Equalization, (1982) 127 Cal.App.3d 871.)

Petitioner contends it was entitled to purchase the cylinders ex-tax since it did resell them to its customers prior to use. However, the admissions of petitioner’s president at the hearing demonstrate that petitioner exercised absolute and exclusive dominion and control of each cylinder from the time it was acquired until it was disposed of as scrap metal. Petitioner claimed a legal or equitable interest in the copyrighted artistic work that created the design placed upon film even after it was affixed to the screen. Printed fabric in petitioner’s copyrighted patterns could only be obtained if petitioner retained the resultant screen, and only if its clients purchased the printed yardage manufactured by the screen from petitioner.

Petitioner’s admission that it amortized the screens as part of the sale price of printed yardage further demonstrates it considered itself, and not its clients, to be the owner of the cylinder and the design. Even for those designs which petitioner created to the custom order of a client, physical possession and control of the resulting film and cylinders were retained by petitioner until the cylinder was ultimately sold for scrap. Each screen was used by petitioner as a manufacturing aid. There is no evidence that any screen having a remaining useful life was ever delivered to any client if no future orders were forthcoming.

Petitioner also contends that its clients actually sought the artistic value and design of the silk screen. We conclude that this issue is foreclosed by the decision of the California Supreme Court in Simplicity Pattern Company v. State Board of Equalization (1980) 27 Cal.3d 900.

In Simplicity, supra, plaintiffs contended that direct costs related to the preparation of a master film strip, including raw film, tape, supplies, outside technical consultants, research, models, artwork and similar services, were not taxable as manufacturing aids. The true object of their client’s purchase, they alleged, was not the resultant tangible personal property in the form of a master film strip negative or master tape but the intellectual property embodied therein. In analyzing the issue, the court looked to Sales and Use Tax Regulation 1501, which states, in pertinent part:

“...when a transaction is regarded as a sale of tangible personal property, 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 in producing the property.”

Analogous to the situation presented in this dispute, that court found that while there may be an intellectual value to the artwork and artistic creativity involved in producing tangible personal property, the true object sought by the client is the tangible personal property itself. The creation of a printed fabric designed by silkscreen printing is no different from any other creation of artistic tangible personal property, e.g., paintings or sculpture. The work of art (fabric) is predicated on an original idea and part of its value may be the aesthetic beauty embodied in the resultant product. Nevertheless, the true object of petitioner’s clients was the finished product into which the artwork was incorporated, not the pure mental creative process of the designer. (Sales and Use Tax Regulation 1501.)

Petitioner’s primary purpose in acquiring the cylinders and other related supplies necessary to make silk screens was to further its manufacturing of yard goods. There is no evidence that at the time petitioner acquired any of these items incorporated into the screens that the acquisitions were identified to a specific client or contract. The true object of its agreements with clients was the sale of tangible personal property, not artwork. Petitioner is therefore liable for use tax on its purchases of the cylinders.

Audit Item D – Ex-Tax Purchase of Transfer Paper from
Holland

Petitioner bears the burden of showing that it is exempt from use tax on the acquisition of transfer paper from its supplier in Holland. Standard Oil Company v. State Board of Equalization (1974) 39 Cal.App.3d 765. In Kaiser Steel v. State Board of Equalization (1979) 24 Cal.3d 188, 192-193, the court explained that “[i]n determining whether a sale is taxable as a retail sale or exempt as a sale for resale, the California courts have consistently looked to the primary intent of the purchaser or the primary purpose of the purchase.” The court explained that:

“...if property is purchased as an aid in the manufacturing process, it is taxable despite the fact that some portion remains in the finished product or that an incidental waste or by-product results. Conversely, if the property is purchased for incorporation as a component of the finished product, it is not taxable despite the fact that some portion may be lost or otherwise dissipated in the manufacturing process.” (24 Cal.3d at 193.)

The court also analyzed two recurrent problems in this area, the problem of “dual purposes” and the problem of “simultaneous uses”. With respect to the former, the court stated:

“When the purchaser buys a quantity of materials and has two purposes in mind (within the meaning of § 6007), the Board permits apportionment of the tax if the purchaser can establish what portion he is using for the exempt purpose and what portion for the nonexempt purpose. This is so even though the portions will be utilized at the same time.” (24 Cal.3d at 196.)

With respect to the problem of simultaneous uses, the court stated:

“Where there are simultaneous uses but only one or primary purpose for the purchaser, the entire unit of material is taxed or not taxed, depending on that purpose: ‘If the primary purpose of purchasing chromic acid is to supply the chrome which is applied through a plating process to articles to be sold, the chromic acid is purchased for resale, even though the acid contains ingredients which aid in the application of the chrome to the articles.’ [Citation omitted.] Conversely, use of forged steel balls to grind silica sand to a desired fineness determines the taxability of the purchase of the balls as a retail sale, even though in the course of grinding the balls wear out and all of the steel from the balls eventually becomes a part of the product. [Citation omitted.] Similarly, when the entire unit is first utilized as an aid in processing or manufacturing and subsequently incorporated into a manufactured product to be sold, the entire unit is taxable.” (24 Cal.3d at 195-196.)

Petitioner contends that the unidentified chemical remains in the finished product to be resold and therefore the Dutch transfer paper can be purchased ex-tax. Under the ruling in Kaiser, however, mere physical presence in the finished product is an insufficient basis for exemption. Materials purchased for utilization in the manufacturing process are exempt from the tax only to the extent they are purchased for the primary purpose of incorporation into the finished product. Materials purchased for the primary purpose of use as manufacturing aids are taxable even though some of the materials may remain in the finished product.

Petitioner concedes that it primarily bought Dutch transfer paper because the quality of the wood pulp provided less flaws than its American competition and it facilitated transfer of prints of a finer quality onto fabric. It was impossible to complete the heat transfer process without use of some type of transfer paper. C---, B---’s response to petitioner’s inquiry about the chemical demonstrates that seller considered the chemical to be a releasing agent or catalyst that facilitated and enhanced the printing of fabric. (Exhibit A).

Petitioner’s inability to identify the chemical bonded to the Dutch transfer paper because of restrictive trade secrets of his supplier is unfortunate. However, petitioner has made no attempt whatsoever to have an independent analysis of the paper performed to determine what chemicals in what percentage were present in the paper before application of the heat transfer process and after. Nor did petitioner have a similar test run on the fabric sample provided. Based on petitioner’s failure to produce this highly relevant evidence, it is impossible to discern if an unknown chemical is present in any significant quantity in either the paper or the fabric. It is also impossible to discern if the chemical was merely a catalyst in the heat transfer process and if any of the chemical remains in the transfer paper after use.

The alleged presence of the unknown chemical in the printed fabric as an anti-snagging agent is likewise not established by adequate evidence. Petitioner's president alluded to the chemical benefiting sheer fabric in this manner but did not discuss its benefit, if any, in other man-made fabrics. Conspicuously absent from C---, B---'s description of its transfer paper is any discussion of the chemical as an anti-snagging agent in printed fabric. (Exhibit A). However, assuming some of the unknown chemical did provide this benefit as a result of the heat transfer process, without a chemical analysis it appears to be incidental to the fact that the paper was a necessary element to the heat transfer process.

The chemical on the paper admittedly facilitated the transfer of the ink to print fabric and produced a finer result due to the quality of the wood pulp used in the paper. (Exhibit A). The value of the wood pulp contained in the paper as a manufacturing aid is totally independent of the chemical's value. The chemical clearly served as a catalyst in the heat-printing process which, according to petitioner's literature, has allowed them an edge in the fabric-printing industry by permitting them to transfer as many as 12 different colors onto a fabric.

If petitioner wishes to submit a chemical analysis of both the transfer paper and of a fabric sample printed from it, the analysis should encompass the fabric and transfer paper contents both before and after use in the heat transfer process. Petitioner is invited to file a Request for Reconsideration based on new evidence within 30 days of this Decision and Recommendation is issued if it wishes to pursue the chemical analysis. This analysis should identify and quantify which chemicals and what percentage of those chemicals are present in the paper before application of the heat transfer product and after. It should also identify and quantify which chemicals are integrated into the fabric after printing.

If no such analysis is undertaken, petitioner has not proved that its purchases of transfer paper are exempt from taxation under the provisions of Standard Oil.

Audit Item F – Results of test sampling of sales for resale.

As noted above, the Department of Business Taxes did not have the opportunity to review the XYZ letters presented at the hearing. (Exhibit B). Petitioner's argument that the sampling used in the percent-of-error calculation should have been stratified is self-defeating.

Attached as Exhibit C is an analysis applying petitioner's proposed method of stratifying the sampling based upon exclusion of 90 percent of total sales being exempt sales for resale. According to Exhibit C, the percent of error would be larger when applied against this smaller 10 percent universe of sales. This results in an increase, not a decrease, in the measure of tax by \$2,158. The 90 percent estimate of sales for resale was provided by petitioner's president during the hearing without any verification of its accuracy by reference to the taxpayer's books and records. However, for purposes of the recalculation, it was used without further proof. To accept petitioner's request for stratification would result in an increase, not a decrease, in tax, which presumably petitioner does not truly wish to pursue.

Copies of the XYZ letters presented have been transmitted under separate cover with the audit workpapers to the Department of Business Taxes. If after review any of the responses are disputed, the Department of Business Taxes should file a Motion for Reconsideration. Otherwise, these responses will be accepted to reduce the sampling used to calculate the percent of error. While numerically this further reduction appears to result in a de minimus percent of error, it demonstrates that there were still at least 30 unsupported sales in the test period. Therefore, their volume and frequency are not de minimus.

Imposition of the Negligence Penalty

Revenue and Taxation Code Section 6484 provides for imposition of a 10 percent penalty for negligence or intentional disregard of authorized rules and regulations. The test for negligence is whether petitioner's conduct met the standard of care that a reasonably prudent businessperson would exercise under attendant circumstances. (Southwestern Finance Company v. Commissioner, 153 F.2d 205 (1946).)

This is not the first time petitioner has been audited on the issue of ex-tax purchases of silk screens and manufacturing aids. Petitioner was audited for the reporting periods July 1, 1977 through June 30, 1980 and was found to owe use tax on \$465,983 of consumable supplies. The negligence penalty was not asserted because petitioner concurred in the resulting tax but alleged it lacked proper information on the taxability of ex-tax purchases of silkscreens. (Exhibit E). Petitioner still purchased the screens ex-tax in this reporting period even though it was on notice not to do so from a prior audit.

Imposition of the negligence penalty is merited where errors are continued from one audit period into another after the taxpayer has been put on notice of its mistake. (Independent Iron Works, Inc. v. State Board of Equalization, (1959) 167 Cal.App.2d 318.)

Recommendation

Defer action for 30 days to permit petitioner to seek a chemical analysis of the Dutch transfer paper and a sample of fabric printed from it by the heat transfer process. Petitioner may file a Request for Reconsideration based upon new evidence prior to obtaining the test results if it undertakes to have these analyses performed. The Department of Business Taxes shall be allowed this same 30-day period to review the XYZ letters presented by petitioner at the hearing. If no Requests for Reconsideration are filed within 30 days hence, reaudit to accept the XYZ letters to reduce the percent-of-error calculation.

Janice M. Fallman, Hearing Officer

April 30, 1990

Date