



STATE BOARD OF EQUALIZATION

1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-6411

February 5, 1979

C--- F. K---
R---
XXXX --- Street
---, CA XXXXX

SR -- XX-XXXXXX-010

Dear Mr. K---:

Enclosed is a copy of the Decision and Recommendation of Hearing Officer pertaining to the Petition for Redetermination pending on this account.

If you wish an oral hearing before the Board in this matter, a written request should be mailed immediately to Mr. H. K. Lackmann of this office. If such a request is not received within twenty days, the hearing officer's recommendation will be presented to the Board for final consideration and action. Official notice of that action will be mailed to you in due course.

Very truly yours,

Richard H. Ochsner
Tax Counsel

RHO:rt

Enclosure

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

440.1595

In the Matter of the Petition)
for Redetermination Under the) DECISION AND RECOMMENDATION
Sales and Use Tax Law)
)
)
)
R---) No. SR -- XX XXXXXXX-010
)
)
Petitioner)

This matter came on regularly for hearing before Richard H. Ochsner, Hearing Officer, in Long Beach, California on December 12, 1978.

Appearing for Petitioner:

Mr. C--- F. K---, President

Appearing for the Board:

Mr. Robert Sayles, Auditor
Mr. Don Farness, Supervising Auditor

Protested Item

The petitioner has protested a sales and use tax deficiency determination issued after audit for the period 1/1/75 to 9/30/77. The protest involves the following audit item:

- 1. Use tax on cost of negatives, drawings, etc.,
Developed in connection with the production
of printed circuit boards which were purchased
ex-tax under a resale certificate. \$XX,208

Contentions of Petitioner

- (1) The measure of tax relates to charges for drafting services rather than tangible personal property.
- (2) Such charges were part of the cost of the circuit boards which were resold.

Summary

The petitioner is a corporation engaged in the business of designing and constructing customer electronic alarm and pollution control systems. The petitioner utilizes printed electrical circuit boards to which are affixed various electrical or electronic components.

When it purchases circuit boards from another manufacturer, the petitioner normally provides all the engineering and design work, together with necessary art work and schematics to the manufacturer. The art work or negative showing the actual circuit which is to be imprinted is used by the manufacturer in the production of the circuit boards. When the manufacturer has completed his job, the negative is returned to, and retained by, the petitioner for use in future manufacturing of the same circuit. Assembly drawings are also produced showing the location of the various components which are to be added or mounted on the circuit board. These drawings are utilized in the petitioner's production process after receiving the printed circuit boards from the manufacturer. An electrical schematic drawing of the circuit and system is also produced for use in servicing the finished product.

The proposed determination arose from a change in the petitioner's usual procedure of providing art work, etc., to the manufacturer. The petitioner contracted with the manufacturer to not only produce circuit boards but also to prepare the negative, assembly drawings and schematics. These items were produced from engineering data supplied by the petitioner. The manufacturer produced the negative and then used it to produce the circuit board to the petitioner's order. Under the contract, the petitioner received not only the circuit boards but also the negatives, drawings and schematics. The charge to the petitioner greatly exceeded the charge which would usually be made where the petitioner furnished the manufacturer the negatives for the circuit board. Based upon the estimated normal cost of the circuit boards, excess charges in the amount of \$XX,208 were capitalized on the petitioner's books of account.

The petitioner treated the total cost of the circuit boards, including the amount capitalized, as cost of goods purchased for resale. Since the circuit boards were purchased from the manufacturer under resale certificates, no sales or use tax was reported or paid. The Board's auditor determined that the negative, drawings and schematics were purchased for the purpose of using them in the manufacture of the petitioner's electronic systems and not for the purpose of physically incorporating them into such systems. He determined, therefore, that such items were not purchased for resale and were subject to use tax.

On March 8, 1978, the petitioner paid the entire amount of the determination but protested the inclusion of the amount of tax allocable to the audit items discussed above. This protest was treated as a Petitioner for Redetermination.

Analysis and Conclusions

The Sales and Use Tax Law provides that a sale includes the transfer for a consideration of title or possession of tangible personal property which has been produced, fabricated, or printed to the special order of the customer. (Revenue and Taxation Code Section 6006, subdivision (f).) Further, subdivision (a) of Regulation 1525 provides that tax applies to the sale of tangible personal property to persons who purchase it for the purpose of use in manufacturing, producing or processing tangible personal property and not for the purpose of physically incorporating it into the manufactured article to be sold. These provisions make it clear that the transfer of the tangible personal property, that is the negatives, drawings and schematics, to the petitioner was a taxable transaction since these items were not physically incorporated into the electronic systems the petitioner was producing for sale. Further, there can be no question regarding the appropriateness of the measure allocated to the negatives and drawings or whether such costs should be included in the cost attributed to the circuit boards which were resold, since this determination is based upon the independent business judgment exercised by the petitioner when it capitalized this amount and extracted it from current operating expenses.

The petitioner suggests, however, that what is involved here is not a sale of tangible personal property but rather the sale of intangible drafting services and that the transfer of the negatives and drawings was only incidental thereto. The petitioner argues that this was essentially a job involving labor, pointing to the fact that had it chosen to perform the work itself, no tax would have been involved.

In determining whether an arrangement involves the sale of tangible personal property or the performance of a service, the California courts have looked at the true object of the transaction. (Albers v. State Board of Equalization (1965), 237 Cal. App. 2d 494; People v. Grazer (1956), 138 Cal. App. 2d 274.) That is, is the real object sought the service per se or the property produced by that service?. Applying this test to the facts presented, we conclude that the true object of the petitioner's contract was to secure the negatives, drawings and schematics. It was clear that these items were essential to the petitioner's manufacturing process and that they had on-going value.

It was recognized in both the Albers and Grazer cases that the fact that the priced charged for a taxable transaction is largely a charge for services rendered in connection with the tangible object transferred is not a bar to the application of tax. The court recognized that quite frequently the expense of a producer of tangible property is largely the cost of the skilled services of technicians or draftsmen and the use of expensive equipment rather than the cost of the raw materials included in the final article. Thus, the fact that the cost of the negatives and drawings involved here was largely attributable to the labor involved in producing them rather than the cost of the materials included does not prevent the application of tax.

Our conclusion is supported by a prior ruling of Sales Tax Counsel dated October 27, 1969, holding taxable a transaction in which the taxpayer designed and created circuit board documents from schematics supplied by the customer. The taxpayer designed a printed circuit and the layout was then placed on transparent Mylar which was delivered to the customer. This ruling demonstrates the long-standing interpretation by the Board that transactions similar to those described herein are taxable transfers of tangible personal property.

Recommendation

It is recommended that the determination be redetermined without adjustment.

Richard H. Ochsner, Hearing Officer

1/18/79
Date