



(916) 445-3723

June 25, 1991

REDACTED TEXT,

Dear REDACTED TEXT,

This is in response to your letter of May 4, 1991, addressed to Mr. O. A. McCarty. We are also in receipt of your letter of June 11, 1991, which was addressed to me and which clarifies activities related to your January and February 1991 sales and use tax returns.

First, with respect to your January 1991 return, it is our opinion that you have reported the tax correctly. You undertook to design and engineer a case to hold collectible baseball cards, so it could be injection molded. The actual tasks performed were in three categories:

Concept configuration, billed at \$500.

Component engineering, billed at \$975.

Making blueprints, billed at \$25.

You describe "concept configuration" as evaluating the problem, gathering data, and solving problems imposed by constraints of the situation such as size, appearance, cost, manufacturability, novelty, etc. The result of this phase is rough sketches and calculations in your engineering book. This information may or may not be furnished to your client. In the case in question, you believe that the documentation was not furnished to your client.

"Concept engineering" involves selecting materials, discussions with toolmakers, calculations, and the production of a master blueprint to allow transmittal of the design to your client, so that the client knows precisely what has been engineered.

The third phase, making blueprints, involves producing copies of the original blueprint, so the client has copies for his toolmaker and whoever in his organization needs information. In the case in question, three sets were made at the client's request.

It is our opinion that the contract in question is basically a service contract. Tax does not apply to concept configuration charges or to component engineering charges. Tax does apply to the charge for duplicate blueprints.

Second, with respect to your February 1991 return, you describe the work as being composed of repairing and re-engineering a radio-controlled toy. You describe the actual tasks performed as falling into two categories:

Concept configuration billed at \$950.

Repair and construction billed at \$500.

You describe “concept configuration” as evaluating the problem, gathering data, and solving problems imposed by the constraints of the situation, such as size, appearance, cost, manufacturability, novelty, etc. In the case in question, an extra operating feature was added. This phase resulted in rough sketches and calculations in your engineering notebook. The documentation was not furnished to your client.

The second phase involved selecting materials and building a rough prototype to allow transmittal of the design to your client so that the client has a working model to show to its clients. In the case in question, you also did extensive repair, because the model received from the client was worn and broken. The hand-built model was made of brass parts, and not of molded plastic as would be a production model. A mold to produce a molded plastic part would be prohibitively expensive—it is cheaper to hand build the prototype from other materials. The model illustrates the idea and will never be sold as a production item.

The principles acceptable here are as follows:

(1) Prototype only. If the only item delivered is a model or prototype, tax applies to the entire contract price, even though the item delivered may be informational only.

(2) Research and development only. A contract to perform research and development services, under which the only items delivered are engineering notes, parts lists, master drawings, etc., is nontaxable. These are service contracts. The entire contract price is nontaxable.

(3) Research and development, with informational prototype. If engineering documentation is delivered, together with a prototype transferred for informational purposes, the charge attributable to the prototype is taxable, but not the engineering charges.

(4) Research and development, with prototype for use. If engineering documentation is delivered, together with a prototype to be used by the client for the purpose for which it was designed, the entire contract price is taxable. Contracts of this type are regarded as contracts for the custom manufacture of machinery and equipment and no part of the contract price may be excluded from tax.

Applying these principles to the work done by you with respect to the radio-controlled toy, our conclusion is that, except for repair charges, tax would apply to your entire contract price, including the amount billed for concept configuration. This is because the contract cannot be classified as a research and development contract, since you did not furnish engineering documentation in the form of notes or drawings to your client.

If, in fact, you had delivered documentation with respect to your research and development activities to your client, and you had delivered the prototype in question, the engineering charges would have been nontaxable.

Further comment is necessary with respect to "repair". Charges made for repairing or refurbishing worn or broken items are generally nontaxable. See our Regulation 1546, "Installing, Repairing, Reconditioning In General," copy enclosed for your reference. However, "rework" is not "repair" under the Sales and Use Tax Law. "Rework" is work performed to bring property to original or revised specification. Basically, under the Sales and Use Tax Law, charges for fabrication, or producing, or reworking tangible personal property are subject to tax.

Very truly yours,

Gary J. Jugum
Assistant Chief Counsel

GJJ:sr

cc: Mr. O. A. McCarty
Return Review Section

Ms. Jean McNeil
Return Review Section

bc: REDACTED TEXT District Administrator