

**STATE BOARD OF EQUALIZATION**

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June 14, 1995

BURTON W. OLIVER
Executive Director

Mr. E--- M. L---
E.M. L--- ENGINEERING & MFG. CO.
XX --- Street, Bay XX
--- ---, CA XXXXX

Re: SR --- XX-XXXXXX

Dr. Mr. L---:

This is in response to your letter dated April 11, 1995, in which you ask for guidance regarding the sales tax consequences of modifying a machine to operate in the manner for which it was designed.

In your letter you describe the machine you will be modifying as a "pick and place machine" for offset type printing. You state that the machine malfunctioned from the day your customer received it. Your company has been retained to perfect the logic of the pick and place system. In order to accomplish this your company will need to spend considerable time learning the functions the machine was designed to perform and then determine how to correct the machine so that it will operate as originally intended. You summarize this task as "to make an existing machine that never functioned as it was supposed to work correctly."

You specifically inquire:

- "1) Question: Is our labor to be taxed or not?
- "2) Question: If we purchase individual items to replace items that were on the machine but did do its function correctly, and we pay the tax on the purchase of the replacement parts, do we consider the whole job as a rework and non-taxable because we are not changing the design but making it work as it was intended to do so, but never did?

- "3) Question: Do we use a 'stop-watch' to keep track of our time that is considered development time, or even design time to separate it from the time spent to align and unfreeze components that are bound and seized at present."

You indicate that costs to repair this machine will be approximately one third of the cost of the machine itself. You also state that 80 to 90 percent of the labor will involve reworking the existing hardware. You anticipate approximately \$10,000 will be spent on this project, with \$1,000, or approximately 10 percent of the repair, attributable to replacement parts.

The underlying question that must first be answered is whether the work performed on this machine will be considered fabrication or repair. Regulation 1526, which I have enclosed for your review, generally provides that tax applies to charges for production or fabrication of tangible personal property which is furnished directly or indirectly by the ultimate consumer. However, the term production or fabrication of tangible personal property which is furnished by the ultimate consumer does not include operations which constitute the repair or reconditioning of tangible personal property to refit it for the use for which it was originally produced. An example of this regulation's application is found in Business Taxes Law Guide (BTLG) Annotation 315.0055 (4/13/92):

"A computer company receives a computer, which was bought elsewhere, from a customer. The company produces and installs into the computer an amplifier. If the computer is a new computer, sales tax applies to the entire charge for the installation of the amplifier. If the computer is a used computer, and the amplifier simply amplified the audio output of the computer and does not refit the computer for a use different from which it was originally produced, the charge for the amplifier and parts furnished to the customer is taxable. Tax does not apply to the charge for labor to install the amplifier."

Based on the information you have provided, it appears that any fabrication or manufacture relative to the printer you received from your customer is to refit a used piece of equipment for the use for which it was originally intended. Accordingly, the operations you perform will be considered repair or reconditioning of personal property. Regulation 1546, which explains the tax consequences of labor and services associated with repair, is also enclosed for your review.

Your next question concerns the sales tax obligations and consequences of the purchase of components used in the repair of the printer. As is explained in Regulation 1546, you are regarded as the retailer of the parts and materials you furnish in connection with your repairs if the retail value of that property is more than 10 percent of your total charge, or if you separately state the charge for that property. When you are a retailer of the parts, tax applies to your separately itemized charge for the parts. If you do not separately itemize the charge, tax applies to the fair retail selling price of the parts as determined by the Board based on information available to it.

When the retail value of the parts and materials furnished in connection with the repairs is 10 percent or less of your total charge and you do not separately state a charge for that property, you are regarded as the consumer of the parts and materials. If you are regarded as consuming the parts in California, tax applies to the sale to you or to your use of such property in this state.

Thus, if you are a consumer, as discussed above, and you pay California tax or tax reimbursement when purchasing the materials, no further tax is due. If you are the retailer of parts under the rules discussed above and have paid California tax or tax reimbursement to your vendor, you may take a tax-paid purchases resold deduction as explained in Regulation 1701 (copy enclosed) with respect to the materials you resell.

Your last inquiry pertains to what you describe as "development" or "design" time. As discussed above, your charges for repair labor are not taxable. However, if you are the retailer of parts furnished in connection with the repairs, your charges for any fabrication of parts is taxable.

If you have any further questions please feel free to write again.

Sincerely,

Patricia Hart Jorgensen
Senior Staff Counsel

PHJ:cl

Enclosures (3)

cc: --- --- District Office