



STATE BOARD OF EQUALIZATION

916-445-6450

September 22, 1986

X-----

Gentlemen:

Your August.8, 1986.followup letter regarding your December 26, 1985 letter has been referred to the legal staff for reply. We are unable to locate a record of having received the original of the December 26 letter.

Your letter requested the application of charges by X----- for converting to color, by computer/video technology, motion pictures originally photographed in black and white. Your specific questions and explanations follow:

“1. IS THE SERVICE PROVIDED BY X----- SUBJECT TO SALES TAX?

Typically, a customer (Owner of a black and white motion picture) provides X----- with a black and white master on one-inch video tap. X-----’s personnel list all scenes and contents thereof; determine overall and scene by scene color strategy; research for photographs, contemporary colored motion pictures, etc. in order to find materials for reference during the color conversion process; electronically color converts the black and white video tape in accordance with the reference materials; and provides the customer with a color master or one-inch video tape.

This process has been completed only for one full length theatrical motion picture, X-----, and took over three months to complete. X----- is color converting the prologue and epilogue of the X----- series X----- and, most recently, X-----is color converting two episodes of the television series X-----. Projected work for 1986 includes theatrical motion pictures, television episodes, and short sequences (e.g. the work on X-----)

X----- requests a formal determination from the State Board of Equalization whether the services provided by X----- are subject to sales tax and, if so, under which laws, regulations, etc.”

It is our opinion that X----- charge for converting the black and white videotape to a color videotape is subject to sales tax. As a sale of tangible personal property (Section 6006, Rev. and Tax. Code), we disagree that the work X----- performs is a “service” rather than a sale of tangible personal property. Although a certain amount of thought, skill and labor must go into X-----’s conversion process, we believe that it is clear that the true object of the contract between X----- and its client is the color master videotape. The “true object of the contract” concept appears in Sales and Use Tax Regulation 1501, Service Enterprises Generally:

“The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred.”

Since X-----’s clients desire the tangible object itself, the color master, the transaction is a sale of tangible personal property, and tax applies to the total gross receipts from the sale without any deduction on account of the work, labor, skill, thought, time spent, or other expense of producing the property (Rev. & Tax. Code § 6012; Reg. 1501.)

“2. IS REGULATION 1529 APPLICABLE?

If Regulation 1529 is applicable, X----- is not a ‘Fabricator-Retailer’ in that, either the product is a completed product prior to the services rendered by X----- or, in the case of a complete theatrical motion picture or a complete television episodic motion picture, X----- is the producer and the fee received by X----- for its service is exempt by this regulation. As outlined above, all work in connection with the color conversion is performed by X-----.

If Regulation 1529 is applicable, X----- requests a formal determination from the State Board of Equalization as to its status as a producer.”

To the extent that Regulation 1529 excludes from, "sale" the outright transfer of a motion picture production by the producer prior to the release date, the regulation is not applicable to X-----’s sale of the color master.

X----- is not precluded from being a "fabricator-retailer" merely because the black and white videotapes which X----- color converts may be complete

productions. Sales and Use Tax Regulation 1529(c) provides that, "receipts from sales of incomplete productions are subject to tax. The seller is a fabricator-retailer in such instances." However, Regulation 1529(d) does not provide the exclusive definition of "Fabricator-retailer". A "fabricator-retailer" is a person who performs fabrication or processing labor, either himself, or in conjunction with his employees, for another. (Reg. 1529(b)(5).) Further, Regulation 1526(b) provides that producing, fabricating, and processing include any operation which results in the creation or production of tangible personal property or which is a step in a process or series of operations resulting in the creation or production of tangible personal property. X----- clearly fabricates or processes the videotape which it sells to its clients.

"3. TIMING OF SALES FOR REPORTING TO THE STATE BOARD OF EQUALIZATION

Typically X----- receives a down payment on commencement of work, progress payments during the conversion process (weekly or monthly), and a final payment following completion of work. Depending on circumstances, X----- may negotiate a participation (or royalty) from the distribution of the motion picture.

X----- has collected \$28,758.82 in the quarter ended June 30, 1985 and \$14,1750 in the quarter ended September 30, 1985 as fees for color conversation (sic). Maximum sales tax due to the State of California for these two periods is \$2,828.07. this amount has not been remitted as of December 26, 1985.

X----- has remitted \$146.25 in November and \$6,506.91 in December 1985 based upon October 1985 and November 1985 receipts.

X----- requests a formal determination from the State Board of Equalization as to when, if ever, the fees for its service is reportable and subject to sales tax."

We note that X----- is on a quarterly reporting basis. In such case, the sales tax for sales which X----- makes during a quarterly period are due on or before the last day of the month following each quarterly period of three months. (Rev. & Tax. Code § 6452.) Generally, unless otherwise explicitly agreed, a sale occurs at the time that the seller completes his performance with reference to the physical delivery of goods. (Cal. U. Com. Code, § 2401.) Accordingly, although X----- may receive progress payments, the sales tax is not due on its sale until such time as X----- completes its performance as to physically delivering the color videotape to its client. The royalty charges X----- receives from the distribution of motion pictures are part of the sales price of the color master and includable in the gross receipts of the sale. (See Bus. Tax. Law Guide, annot. 295.0540.) X----- should report the tax on the royalties for the quarterly period in which they are received; that is, for the quarter in which the amount is made definite. (BTLG, annot. 295.0570.)

“4. ARE SALES TAXES PAID DEDUCTABLE FROM SALES TAXES OWED?

X----- purchases video tape and other supplies used during the conversion process. X----- has paid sales tax on these purchases.

X----- leases certain of its computer and video equipment and pays sales and use tax on its monthly payments.

X----- requests a formal determination from the State Board of Equalization as to whether these taxes are deductible from sales taxes owed or whether the principal amount upon which these taxes are assessed is deductible from sales subject to sales tax.”

Tax applies to the sale to X----- of tangible personal property which X----- purchases for the purpose of manufacturing the color master which X----- sells to its client. The computer, video equipment, and intermediate working products which X----- consumes in the manufacturing process are examples of such property. (Reg. 1525(a).) X----- may not deduct from the gross receipts of its sales the sales tax reimbursement or use tax which X----- pays on the purchase or lease of such items.

Tax does not apply to the sale to X----- of the videotape which X----- sells as a color master to its client with no intervening use. (Reg. 1525(b).)

We hope this answers your questions; however, if you need further information, feel free to write again.

Very truly yours,

R. L. Dick
Tax Counsel

RLD:sr

Bc: Culver City – District Administrator