

**477.1000**

## Memorandum

**To:** Ms. Wanda G. Littles MIC:35  
Return Analysis Section

**Date:** January 3, 1996

**From:** Sharon Jarvis  
Staff Counsel

**Subject:** A--- C--- T---  
Account No. SR -- XX-XXXXXX

This responds to your memorandum dated September 29, 1995 to the Legal Division concerning the above account. You ask whether A--- C--- T--- (A---) can exclude certain "design" charges of \$150,000 from its taxable measure.

By a letter dated October 1, 1994, A--- wrote, in pertinent part, to your section:

"Enclosed is the A--- proposal and resulting service contract from R--- Corporation. The project is to design and develop a custom test instrument for installation of fiber optic equipment. Prototypes were delivered to prove the design.

"The total project cost is \$200,000. \$150,000 was done in 1993. The final design and development is to be completed by November 1994 (7 months later).

"The contract for the first production units is due by the end of October, 1994. In addition, R---'s customer in Germany will purchase 20-30 units early next year. The future for this instrument is hundred's of units as fiber equipment is installed in the world." (10/1/94 letter from A---'s President, J--- F. A---.)

The letter included a copy of the bid proposal submitted by A--- to R--- (dated July 26, 1993), and of R---'s purchase order to A--- which indicates that it is for the "attached

proposal - agreement dated July 26, 1993 for O--- - --- 2300.” For purposes of responding to your inquiry, we understand that the purchase order with the attached proposal was the contract agreed to by R--- and A---.

The proposal provides for the design and development of the O--- Field Test Instrument for R--- in two parts:

“1.1) Design and development of the O--- Test Instrument for L--- X- ---. This includes delivery of a Portable Instrument Unit, Optical Module plug-in, VF Module plug-in and Instrument firmware.

“1.2) Design and development of the L--- X- --- Optical Module plug-in and Instrument firmware for use in the Portable Instrument Unit developed for L-- - X- --- in 1.1.” (Proposal, Part I.)

The proposal calls for initial delivery by A--- of two of the items designed and developed pursuant to section 1.1 and one of the items designed and developed pursuant to section 1.2 (all of the items initially deliverable are referred to as “First Article Units”) to “be used for primary evaluation and may consist of PCB jumpers and some mechanical flaws.” (Proposal, Part II, section 2.1.)

At later dates seven of the section 1.1 units and four of the section 1.2 units (all referred to as “Final Units”) were to be delivered consisting “of changes and improvements as a result of the evaluation of the First Article Unit[s].” The Final Units delivery was to “include all documentation to manufacture and/or repair the units.” (Proposal, Part II, sections 2.2.1 & 2.2.2.) The Final Units also were required to meet specifications of “‘O--- A--- Requirements’ by G--- O---, July 20, 1993.” In addition, the Final Units were required to “meet the data format and optical requirements of L--- X- ---.” (Proposal, Part II, section 2.2.)

According to the proposal, the breakdown of the project cost of \$200,000 is as follows:

“Mechanical Design and Development	- \$20,000
Electrical Design and Development	- \$79,000
Firmware Design and Development	- \$78,000
Project Parts and Manual	- \$23,000.”

(Proposal, Part III, section 3.2.)

The proposal calls for payment for the project by R--- to A--- in eight increments. The last five increments are linked to the dates when the First Article Units and Final Units are delivered. (Proposal, Part III.)

Other provisions of the proposal include a right by R--- to terminate the contract at will. (Proposal, Part V, section 5.1.) A--- also agrees not to sell the O--- Field Tester to a

non-R--- company without written permission of R---, which permission may be unilaterally withheld. (Proposal, Part V, section 5.3.)

As to “intellectual property”, the proposal provides:

“R--- shall exclusively own all intellectual property conceived or reduced to practice and which is developed under this Agreement by A--- and which relates to any one of the O--- Tester software or firmware, Optical Module, and/or VF Module. All other intellectual property conceived or reduced to practice and developed under this Agreement by A--- shall be jointly owned by R--- and A---, such intellectual property to include no software developed under this Agreement. Each party shall have the right to sell the ‘Portable Instrument Unit’ without O--- Tester firmware, Optical Module and VF Module without having to pay a royalty to the other party, and R--- shall also have the right to sell any Portable Unit with the O--- Tester firmware, Optical Module, and/or VF Module without having to obtain written permission from A--- and without having to pay any royalties to A---.” (Proposal, Part V, section 5.4.)

The proposal also includes a provision concerning “tangible materials” as follows:

“All tangible materials including but not limited to records, drawings, models, apparatus, samples and the like conceived or produced in the design and development of the O--- Field Tester by A---, including all documentation required to manufacture and/or repair the O--- Field Tester, shall be delivered to R--- no later than upon delivery of the Final Units. A--- shall keep such records at all times in A---’s custody subject to A---’s control, and shall surrender the same to R--- immediately upon request of R--- upon termination of this Agreement. A copy of such records may be kept by A--- if A--- is supplying additional units after the Final Units.” (Proposal, Part V, section 5.8.)

### **Discussion**

Sales tax applies to the retail sale of tangible personal property in this state. (Rev. & Tax. Code § 6051.) A sale is any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (Rev. & Tax. Code § 6006(a).) If a person produces a custom-made item for a customer, the retail sale of the item is subject to sales tax. However, not all transactions which result in the transfer of tangible personal property are sales. For example, a bookkeeper or accountant provides a service to his or her client but makes an incidental transfer of accounting papers. Sales tax does not apply to such a charge. As provided in Regulation 1501:

“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....”

In analyzing the contract between A--- and R---, a distinction must be made between a contract to manufacture a custom-made item (a sale) and a contract to provide research and development (a service). That distinction is discussed in Proposed Regulation 1501.1 “Research and Development Contracts” which the Board has adopted, but which has not yet been approved by the Office of Administrative Law. (The proposed regulation must be approved by the Office of Administrative Law before it becomes part of the official Sales and Use Tax Regulations. However, the standards of the proposed regulation are being administratively applied at this time.) A copy of the final proposed regulation which has been submitted to the Office of Administrative Law is attached for your information.

Proposed Regulation 1501.1 distinguishes between qualified research and development contracts, and contracts for custom-made items, in pertinent part, as follows:

“(a) DEFINITIONS.

“(1) QUALIFIED RESEARCH AND DEVELOPMENT CONTRACT.

A qualified research and development contract is a contract for a service where:

“a. the service provided under the contract is undertaken for the purpose of discovering information which is technological in nature, the results of which are intended to be useful in the development of a new or improved product, process, technique, or invention, and

“b. the contract calls for the delivery of a report detailing information developed by the contractor or other tangible personal property incidental to the true object of the contract, as defined in Regulation 1501 (18 CCR 1501).

“.... A qualified research and development contract shall ... not include a contract for research for the design and production of a custom-made item as defined in subdivision (a)(5).”

“....

“(5) CUSTOM-MADE ITEMS. A custom-made item includes but is not limited to the following:

“a. Property the purchaser wants for its intrinsic value as an item, and for which the purchaser is not interested in the data developed in the course of the manufacture of the custom-made item.

“b. Property the purchaser will use for purposes other than informational and testing purposes as defined in subdivision (a)(7).

“c. Property purchased for use by the purchaser or for resale.

“d. Production tooling - tooling produced and used for the manufacture of final production units.”

Under Proposed Regulation 1501.1, transfers of prototypes to customers for informational and testing purposes are not subject to tax. (Proposed Reg. 1501.1(b)(2).) The proposed regulation defines prototype as follows:

“Prototype model - an operating model of a design the purpose of which includes:

“1. validating design concepts,

“2. validating design specifications,

“3. demonstrating design integrity, or

“4. demonstrating manufacturability of the design.” (Proposed Reg. 1501.1(a)(4)(b).)

Informational and testing use is defined in the proposed regulation as:

“Use by either the contractor or its customers including, but not limited to:

“1. Testing for verification of a design to specifications.

“2. Developing data, algorithms, ideas and/or knowledge to improve or perfect a design.

“3. Determining alternative design features and implementations.

“4. Validating testing of software and firmware embodied within a design.

“5. Demonstrating operation of a design for approval by a customer.

“6. Quality assurance and performance testing to determine limitations and failure modes of the design.

“7. Determining or improving interfaces to other equipment during the design process.

“8. Determining or improving the processes for manufacture of the design.

“9. Testing to design failure.

“10. Evaluating numerous prototypes for the acceptability of the design and the manufacturability of such design. Qualifying evaluation does not include any functional use of the property in a normal business operations capacity.

“11. Testing prototypes to assure that the design works to the specifications desired.” (Proposed Reg. 1501.1(a)(7).)

Transfers of additional prototypes in connection with a qualified research and development contract for purposes other than informational and testing use, where a functional use occurs, are sales subject to tax. The measure of that tax is the stated value for such property in the contract, or if none is stated, the computed fair market value as determined by applying a factor of three to the cost of direct materials used in the production of the prototype. (Proposed Regulation 1501.1(b)(2).)

From the language of the R--- - A--- contract, it is apparent that R--- wanted the O--- Field Test Instrument designed and developed so that R--- would have the option to manufacture and sell the instruments. In other words, R--- was not merely interested in the production of a custom-made item(s) for its own consumption or resale, but wanted to obtain all the information necessary to itself both manufacture and repair the test instrument. The contract also requires delivery to R--- of all documentation to manufacture and repair the test instrument. Thus, the contract is a qualified research and development contract as defined in proposed Regulation 1501.1(a)(1), undertaken to discover technological information useful in developing a new or improved product, process, technique, or invention for R---, and requiring delivery in writing of the information developed by A---.

Under the contract, A--- is to deliver the First Article Units to R--- for “primary evaluation.” Proposed Regulation 1501.1 provides that transfers of prototypes under a qualified research and development contract for informational and testing purposes are not subject to tax. Our understanding is that the “primary evaluation” of the First Article Units is testing for verification of a design to specifications, and also, presumably, testing to determine if alternative design features are necessary. (See Proposed Reg. 1501.1(a)(7)1. & 2.) Thus, the “primary evaluation” of the First Article Units is an informational and testing use of prototypes within the meaning of Proposed Regulation 1501.1(a)(7). As such, charges related

to the research and development of the First Article Units and to their transfer to R--- for “primary evaluation” are not subject to tax. (Proposed Regulation 1501.1(b)(1) & (2).)

However, it is unclear from the information which you have provided whether the Final Units deliverable by A--- are, or are not, also prototypes transferred for informational and testing purposes. It is possible that the Final Units may be prototypes for informational and testing use pursuant to Proposed Regulation 1501.1(a)(7). However, another possibility is that the Final Units may be “[s]ales of additional prototypes transferred in a qualified research and development contract for purposes other than informational and testing use, where a functional use occurs...” such as actual functional use by R--- of the Final Units to try out its installation of fiber optic equipment, i.e., the use for which the test instrument was designed. (Proposed Reg. 1501.1(b)(2).)

In other words, if R---’s object in receiving the Final Units is for functional use (use for which the property is designed) which occurs after completion of the research and development, the transfer of the Final Units is a sale subject to tax. (Proposed Reg. 1501.1(a)(6) & (b)(2).) . In order to determine whether this is so, you may need to obtain additional information from the taxpayer.

Under Proposed Regulation 1501.1, if the Final Units are transferred for functional use by R---, since the contract does not state a value for the Final Units, the measure of tax is the computed fair market value as determined by applying a factor of three to the cost of the direct materials used in the production of the Final Units. (Proposed Reg. 1501.1(b)(2)).

Finally, we note that it is our understanding that there is no transfer of tooling involved in the R--- - A--- contract. However, if a transfer of prototype tooling were involved, tax would apply as discussed in Proposed Regulation 1501.1(b)(2).

I hope this information is of assistance. Please let us know if we may answer any further questions.

SJ:rz

Attachment: Proposed Regulation 1501.1

cc: --- --- District Administrator - --