

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

495.0035

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition )  
for Redetermination Under the ) DECISION AND RECOMMENDATION  
Sales and Use Tax Law of: )  
)  
C--- V--- I--- L---. ) No. SR -- XX-XXXXXX-020  
)  
)  
Petitioner )

The above-referenced matter came on regularly before Anthony I. Picciano on December 11, 1991 in Van Nuys, California.

Appearing for Petitioner:

P--- C. R---  
Attorney at Law

M--- L. M---  
Attorney at Law

Appearing for the Sales  
and Use Tax Department:

Alan J. Stagner  
District Administrator

Ira C. Anderson  
Supervising Tax Auditor

William J. Faiola  
Supervising Tax Auditor

Steven J. Brouwer  
Tax Auditor

Protested Items

The protested tax liability for the period April 1, 1986 through March 31, 1989 is measured by:

<u>Item</u>	<u>State, Local and County</u>	<u>LATC</u>
A. Ex-tax purchases of supplies and overhead items.	\$ 61,864	61,864
C. Unsupported purchases of master tapes	\$ 268,905	268,905

A ten percent negligence penalty has been added in the amount of \$2,180.71.

#### Petitioner's Contentions

A. Petitioner contends that the materials in question are used to produce movie masters that are resold out of the country which sales are sales in interstate/foreign commerce, therefore, the ex-tax purchased materials are exempt from the imposition of use tax.

C. Petitioner contends that it purchases an intangible asset, that is, the rights to a motion picture and the receipt of an accompanying master tape is incidental to that purchase of an intangible.

#### Summary

The petitioner is a corporation that has been in business since August 1971. Petitioner offers x-rated motion pictures for release outside the United States. It also sells related items overseas such as posters, press books and release trailers. All of petitioner's sales take place outside the state.

There have been two prior audits of the petitioner. The penultimate audit encompassed the period April 1, 1979 through September 30, 1979 and resulted in the application of a taxable measure for ex-tax purchases used by petitioner, however, no penalty was imposed. The prior audit for the period January 1, 1983 through December 31, 1985 also resulted in the application of a taxable measure for ex-tax purchases used by petitioner and included the imposition of a ten percent penalty for negligence. A report of field audit was issued by the Board dated January 25, 1991. A Notice of Determination dated April 5, 1991 was issued by the Board.

The taxable measure of audit item A was derived on an actual basis by the examination of petitioner's paid bills. The purchases that were questioned were scheduled. See Schedule 2A-1. The blank tape conversion charges included in that audit item are only those that were paid up to September 22, 1988. On that date, Revenue and Taxation Code Section 6010.6 became effective which resulted in a change in Sales and Use Tax Regulation 1529 that made such charges non-taxable. The taxable measure of audit item C was derived from petitioner's amortization schedule for its federal income tax returns (FITR) based on the assumption that those motion pictures were received after their original release date. See schedule 2C.

Petitioner purchases supplies and fabrication services ex-tax through the use of resale certificates. Petitioner, in some instances, acts as a producer of motion pictures. In other instances, either it buys from other producers the rights to exploit the motion pictures or it buys the motion pictures outright. In any case, the petitioner receives a master tape copy of the motion picture.

Petitioner contracts with foreign distributors for the distribution of the motion pictures it either produces or buys. The foreign distributors receive a master tape in European (PAL) format for each of the motion pictures for which they contract. They receive, in addition to the master tape, the right to exploit the images thereon in a certain geographical area for a period of time (7 years). The contract uses the terms "license", "licensee", and "licensor". Petitioner issues invoices that show the charges for master video tapes of each motion picture at a price substantially lower than the contract price of the package. The agreement provides that at the expiration of the agreed time-period, the master tape of the motion picture must either be returned to petitioner, or disposed of at the direction of petitioner.

The Sales and Use Tax Department's (Department) position is twofold. The staff asserted the imposition of use tax on the petitioner for its use of supplies that include blank master tapes as well as production services after purchasing them ex-tax through the use of resale certificates. That assertion is based on the fact that petitioner uses the supplies in the process of producing qualified motion pictures. The petitioner as a producer, according to the Department, is the consumer of such items. In addition, the staff argues that purchases of supplies ex-tax for resale is not appropriate because petitioner does not resell the motion pictures.

The staff argues that a sale of the master video tape of a motion picture is not made by petitioner because it grants only a license to the foreign distributors for the motion picture's exploitation. The basis for the Department's argument that the contract entered into by petitioner is a licensing agreement is that the document uses the terms "license", "licensee", "licensor", and the term "license agreement". In the Department's view, petitioner is not selling the master video tapes to foreign distributors because the licensee does not receive a "full bundle of rights". It argues that the distributor obtains only the right to exploit the movie in a particular geographic area for a specific period of time. Petitioner retains title to the master tape and has control of its ultimate disposition. According to the Department, the granting of a license is not a sale by petitioner. Therefore, the petitioner cannot purchase the supplies and fabrication services for resale. This being the case, use tax is owed by petitioner on its use of those items bought ex-tax.

The staff argues that in the absence of information as to the motion picture's release date, the masters that the petitioner amortized on its federal income tax returns in audit item C are taxable. However, subsequent to the conference on this matter and at the request of the staff counsel, the petitioner provided to the staff information to support its contention that some of the masters for the motion pictures amortized were received prior to their release.

The staff reviewed the information provided by the petitioner and has agreed that the cost of certain motion pictures should be removed from the taxable measure of audit item C. The staff stated that Revenue and Taxation Code Section 6010.6 provides an exclusion for transfer before its release, of all or any part of a qualified motion picture. The information received, according to the staff, supports the conclusion that certain motion pictures were received by the petitioner prior to their release and those purchases are not subject to tax. The staff accepted the documents associated with the following motion pictures to allow them to come within the purview of that Code Section: "[movie #1]" (\$20,000), "[movie #2]" (\$20,000), "[movie #3]" (\$20,000), "and "[movie #4]" (\$26,059). The petitioner, according to the Department, was the

producer of the following motion pictures and is considered the consumer of the materials necessary to produce the motion picture: “[movie #5]” (\$20,161), “[movie #6]” (\$3,468), “[movie #7]” (\$6,099, “[movie #7]” (\$7,118) and “[movie #8]” (\$13,510). The petitioner provided a contract for the motion picture “[movie #9]” that shows that it was purchased from a California seller. The Department suggested that there is no evidence that the petitioner issued a resale certificate for that transaction. Therefore, the incidence of tax would fall on the seller and the amount of \$10,000 should be removed from the taxable measure of audit item C. The payment of \$4,200 by the petitioner for S--- script should be removed, according to the Department, because this amount represents payment for an original script and is not taxable. The Department indicated that the motion picture “[movie #11]” should be removed from the taxable measure because the petitioner only received a license to show the motion picture and did not purchase the master video tape. “[movie #12]”, according to the Department is taxable because it was purchased from an out-of-state vendor after its release. The Department indicated that insufficient data was received on the remaining two motion pictures (“[movie #13]” and “[movie #14]”) to determine a status other than taxable.

In regard to the negligence penalty, the Department’s representative argued that the negligence penalty was appropriately imposed because this is the third time petitioner had ex-tax purchases of supplies that were then used in one fashion or another or were sold at retail.

The petitioner’s representative’s stated position is that there were sales by petitioner to foreign distributors and those sales were sales in interstate/foreign commerce that are exempt. Therefore, the cost of supplies and fabrication services purchased by the petitioner should not be included in the taxable measure. The petitioner’s representative indicated the agreement between it and foreign distributors that is included in the file is an old agreement and does not really represent the understanding of the parties. The language in that agreement, according to Mr. Richards, was held over from prior agreements that concerned themselves with the transfer of motion pictures on 35 mm film and not on video tapes. The pre-printed contract was used for the purpose of defining the display rights that the foreign distributor acquired. He argued that the facts here are analogous to those in Simplicity Pattern Co. Inc v. State Board of Equalization (1980) 27 Cal.3d 900 to support his contention that a sale was completed by petitioner. He also said that the parties to those agreements (petitioner and the distributor) act differently than provided for in the agreement. Specifically, the foreign distributors always keep the master tapes. The only limitation is that which is placed upon their right to exploit the movie. He argued that the written contract’s provisions may be altered by oral agreement in accordance with Civil Code Section 1698. He noted that there is a separate charge for the master tape as is evidenced by the invoices. Petitioner’s representative pointed to the invoices that are issued by it as proof of the fact that petitioner sold the tapes and did not just license their exploitation.

The petitioner’s representative argued that the purchases of master tapes that are included in audit item C were motion pictures produced for or sponsored by the petitioner and were transferred to it prior to their release. In the alternative, petitioner receives only a license to exploit the motion pictures. Subsequent to the conference, the petitioner offered various documents to support that position. The petitioner’s representative argued that in accordance with Sales and Use Tax Regulation 1529(c)(1)(C) a transfer of a motion picture prior to its

release date is not a sale for sales tax purposes. In addition, as to certain motion pictures, the payment made is not for tangible personal property but represents the cost of intangible distribution rights.

In regard to the negligence penalty, the petitioner's representative argued that the petitioner's transactions with distributors were reviewed in a prior audit and there was no tax applied. Apparently, according to him, the prior audit viewed petitioner's transactions with distributors as leases/sales, therefore, sales exempt in interstate/foreign commerce. The petitioner's representative relied upon Sales and Use Tax Annotation 320.0140 that provides that where sales are not reported because of a belief in the application of an exemption as export sales, and a bona fide difference of opinion as to taxability exists, the negligence penalty should not apply. He also argued that the negligence penalty, if imposed, should be imposed on an item-by-item basis and that audit item A should not have the negligence penalty imposed.

#### Analysis and Conclusions

An excise tax has been imposed on the storage, use, or other consumption in this state of tangible personal property. See Revenue and Taxation Code Section 6201. Every person storing, using, or otherwise consuming in this state tangible personal property purchased from a retailer is liable for the tax. See Revenue and Taxation Code Section 6202. The supplies purchased by petitioner were admittedly used by petitioner prior to their transfer to distributors. Therefore, that use of the property made by petitioner supports the imposition of use tax on those ex-tax purchases barring the application of an exemption.

The petitioner argued that it sold the master tapes of motion pictures to foreign distributors. We do not agree. The document presented as a copy of the agreements entered into between petitioner and the foreign distributors is clearly a licensing agreement. The argument that it was modified by the parties by oral agreement is not borne out by the facts. The agreement was used for a considerable period of time and it appears that it is still being used in the same form. In any case, we believe that if the agreement did not represent the understanding of the parties, it would have been modified in writing in some fashion over the years that it was used. We find, be it an old or pre-printed agreement, it is the contract entered into between those parties. The fact that an invoice is issued by petitioner when it transfers the master video tape of the motion picture does not alter the provisions of that agreement. The agreement is for the exploitation of specific motion pictures for a specific period of time in a restricted area. In addition to the obvious references to a license within the agreement, the most compelling provisions of the agreement that cause it to be a license are those that cause petitioner to maintain title and control as to the ultimate disposition of the master video tape of the motion picture. The fact that the petitioner in practice may not exercise that right is inconsequential.

We do not agree that the facts in this case are analogous to those presented in Simplicity Pattern Co. Inc v. State Board of Equalization (1980) Cal.3d 900. In that case, there was a sale of audio visual components for medical training. There was no sale of a motion picture. The appellant in that case argued that the sales in question should receive the same tax treatment afforded the sales of motion pictures and was unsuccessful. In our case, we are dealing with

motion pictures. The state had enacted laws and regulations specifically designed for transactions involving motion pictures and it is those particular laws that we must apply.

A sale is defined by Revenue and Taxation Code Section 6006(g)(1) to mean and include any lease of tangible personal property in any manner or by any means whatsoever, for a consideration except, among other things, a lease of motion pictures including television films and tapes. The term lease includes license. See Sales and Use Tax Regulation 1660(a)(1). Therefore, petitioner in the granting of a license/lease is not selling the property in question. Finding that there is no sale of the property by petitioner leaves us with the conclusion that all purchases of supplies and fabrication services are not purchases for resale and the use of those supplies is subject to the imposition of use tax. In that there are no sales in foreign commerce that use is not exempt.

Sales and Use Tax Regulation 1529(c)(1)(C) in effect from November 17, 1983 to January 1, 1988 provided for an exclusion from tax for the outright transfer of all or any part of a motion picture production by the producer when this transfer occurs prior to the original release date. We have reviewed the documentation offered by the petitioner and agree with the Department that “[movie #1]” (\$20,000), “[movie #2]” (\$20,000), “[movie #3]” (\$20,000) and “[movie #4]” (\$26,059) should be removed from the taxable measure of audit item C because they were purchased before their release date and are not taxable in accordance with the requirements of the authority cited above.

Under Revenue and Taxation Code Section 6010.6 which became effective September 22, 1988, a person who produces a motion picture or performs qualified production services is the consumer of and tax applies to sales to that person of supplies used in that production. Tax does not apply to amounts charged for the right to exploit a qualified motion picture nor does it apply to charges for qualified motion picture services performed by any person in any capacity in connection with the production of any part of a qualified motion picture. See Sales and Use Tax Regulation 1529(a)(1), (2), and (3). Therefore, as to the motion pictures where the petitioner is the producer the incidence of tax falls on the vendors of those supplies and services and the petitioner is the consumer of those items. The petitioner has provided documentation such as listings of production expenses paid by it that support the conclusion that petitioner is the producer of the following motion pictures: “[movie #5]” (\$20,161), “[movie #6]” (\$3,468), “[movie #7]” (\$6,099), “[movie #8]” (\$7,118) and “[movie #9]” (\$12,510). Therefore, the sum of \$49,356 should be removed from the taxable measure of audit item C.

Taxes do not apply to charges for services by persons who do not fabricate tangible personal property. See Sales and Use Tax Regulation 1529(a)(4). The transfer of an original manuscript is not taxable when the transfer is for the purpose of publication. See Sales and Use Tax Regulation 1501. The petitioner purchased an original script referred to as the “S--- Script”. We find petitioner’s payment was for the purchase of an original script/manuscript for publication or in this case for use in the production of a motion picture. In that this is a service that was not a fabrication of tangible property and in that the transfer was for the purpose of use

in a qualified motion picture, that transaction is not taxable to the petitioner and the sum of \$4,200 should be removed from the taxable measure of audit item C.

“[movie #11]” was a motion picture for which the petitioner purchased exploitation rights in this country as is evidenced by the agreement provided by petitioner for that license. The purchase of an exploitation right is not taxable. See Sales and Use Tax Regulation 1529(a)(2). In view of that authority, the sum of \$7,762 should be removed from the taxable measure of audit item C.

The documents provided by the petitioner for the motion picture “[movie #12]” support the conclusion that this was a direct purchase of all rights to that motion picture after its release date. According to the documents presented there are no limitations placed on the exploitation of the motion picture nor are there any requirements to return the master tape upon the expiration of a period of time. The use of this motion picture after its release is taxable in accordance with Revenue and Taxation Code Section 6201 above cited.

The petitioner has not provided any evidence to support the contention that its purchases and use of “[movie #13]” and “[movie #14]” and the other motion pictures listed on schedule 2c of the audit working papers should not remain in the taxable measure of audit item C. The burden of providing evidence establishing error in the audit staff’s computations rests with petitioner. (See, e.g., Rathjen Bros. v. Collins (1942) 50 Cal.App.2d 765; Maganini v. Quinn (1950) 99 Cal.App.2d 1; Riley B’s, Inc v. State Board of Equalization (1976) 61 Cal.App.3d 610; Sales and Use Tax Regulation 1698.) Where the Board establishes a deficiency through the use of recognized and standard accounting practices, the burden is upon the taxpayer to explain any disparity between his books and records and the results of the Board’s audit. (See Riley B’s, Inc. v. State Board of Equalization (1976) 61 Cal.App.3d 610.) The petitioner has amortized the purchase of these motion pictures on its FITRs. We find that the petitioner has not carried its burden of proof to show that the remaining taxable measure of audit item C is non-taxable.

Revenue and Taxation Code Section 6484 provides for the imposition of a ten percent penalty if any part of the deficiency for which a determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations. In determining whether petitioner is negligent, the test is whether or not the petitioner’s conduct met the standard of care of a reasonably prudent businessman in the attendant circumstances. (Southwestern Finance Co. v. Commissioner, 115 F.2d 205 (1946).) A substandard degree of care is not to be imputed in a case based solely upon a reasonable error in interpreting the applicable law. The petitioner asked that Sales and Use Tax Annotation 320.0140 be considered as controlling in the imposition of the negligence penalty on the taxable measure associated with the purchases of its supplies. The petitioner asked that the penalty be allocated between the various audit items. As above noted, the law provides that if any part of a deficiency is due to negligence, the penalty will apply to the whole of the determination. Therefore, that request should be denied.

In mitigation of the charge of negligence, petitioner stated that it has been audited on prior occasions and that it has based its actions on the prior audit results believing that it was properly reporting taxable receipts. The Department pointed out, however, that the prior audits established an understatement in the measure of tax in the area of ex-tax purchases used that resulted in additional tax liability as well as the imposition of the negligence penalty. Petitioner's consistency in understating the measure of tax over two successive audit periods justifies imposition of the negligence penalty. (See, generally, Independent Iron Works. v. State Board of Equalization (1959) 167 Cal.App.2d 318, 323.)

Recommendation

Reduce the taxable measure of audit item C to \$111,528 and the penalty accordingly. Deny the petition in all other respects.

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Anthony I Picciano, Staff Counsel

March 22, 1992

\_\_\_\_\_  
Date

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

495.0035

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition  
for Redetermination Under the  
Sales and Use Tax Law of:

DECISION AND RECOMMENDATION

C--- V--- V--- L---

No. SR -- XX-XXXXXX-020

Petitioner \_\_\_\_\_

The above-referenced matter came on regularly before Anthony I. Picciano on December 11, 1991 in Van Nuys, California.

Appearing for Petitioner:

P--- C. R---  
Attorney at Law

M--- L. M---  
Attorney at Law

Appearing for the Sales  
and Use Tax Department:

Alan J. Stagner  
District Administrator

Ira C. Anderson  
Supervising Tax Auditor

William J. Faiola  
Supervising Tax Auditor

Steven J. Brouwer  
Tax Auditor

Protested Item

The protested tax liability for the period January 1, 1986 through December 31, 1988 is measured by:

<u>Item</u>	<u>State, Local and County</u>	<u>LATC</u>
D. Ex-tax purchases of supplies and overhead items subject to use tax.	\$106,994	\$107,074

A ten percent negligence penalty has been added in the amount of \$1,081.71.

#### Petitioner's Contentions

D. The petitioner is protesting only that portion of audit item D that is derived from its ex-tax purchases of video tape and tape conversion charges properly allocated to C--- V--- I--- L--- (I---). The petitioner contends that the protested ex-tax purchases of blank video tapes and conversion charges to PAL format are purchases for resale and are resold to I--- that in turn sells them in interstate/foreign commerce which sales are exempt.

The petitioner contends that it should not be liable for the negligence penalty in view of the fact that it relied upon the findings of an earlier audit that allowed the transactions involved as sales in interstate/foreign commerce.

#### Summary

The petitioner is a corporation that has been in business since June 1, 1979. It is a wholesaler and occasionally a retailer of sexually explicit (x-rated) motion pictures. There have been two prior audits of the petitioner. The penultimate audit encompassed the period June 1, 1979 through September 30, 1979 and resulted in the application of a taxable measure for ex-tax purchases used by petitioner, however, no penalty was imposed. The prior audit for the period January 1, 1983 through December 31, 1985 also resulted in the application of a taxable measure for ex-tax purchases sued by petitioner and included the imposition of a ten percent penalty for negligence. A Report of Field Audit was issued by the Board dated January 25, 1991. A Notice of Determination dated April 4, 1991 was issued by the Board. The taxable measure of audit item D was derived on an actual basis by the examination of petitioner's paid bills. The purchases that were questioned were scheduled. See Schedule 12D-2a.

There is a company related to the petitioner known as C--- V--- I--- L--- (I---), account number SR -- XX-XXXXXX-020. An audit was conducted on I--- contemporaneously with this audit on petitioner. I--- offers x-rated motion pictures for release outside the United States. The two companies are separate entities.

Petitioner purchases blank master video tapes ex-tax sufficient in quantity to satisfy both its needs and that of I---. This procedure allows it to obtain quantity discounts. In some instances it has the blank tape converted to the PAL (European) format which it sells to I--- at the same price it pays. In other cases it sells blank master video tape to I--- in its original state at the same price paid. I--- contracts with foreign distributors for the distribution of motion pictures embodied on the master video tape that it acquires from petitioner. The distributor receives a master tape in PAL format of each of the motion pictures for which they contract. They receive, in addition to the master tape of the motion picture, the right to exploit the images thereon in a certain geographical area for a period of time (7 years). The contract uses the terms "license", "licensee" and "licensor". It also includes a provision for a PAL master tape of the motion picture for a set sum. I--- issues invoices that show the charges for masters of each motion picture at a price substantially lower than the contract price for the package. The agreement

provides that at the expiration of the time period, the master tape must either be returned to I---, or disposed of at the direction of I---.

The Sales and Use Tax Department's (Department) position is twofold. The staff is asserting use tax on the petitioner for its use of master tapes after purchasing them ex-tax. That assertion is based on the assumption that petitioner was using the master tapes in the process of converting them into PAL format. The staff asserted tax on the ex-tax purchases of supplies used in the production of motion pictures in PAL by I--- initially believing that the two entities should be treated as one. In addition, the staff argues that the purchases of blank master video tapes ex-tax for resale is not appropriate because I--- does not resell the master video tapes. The staff argues a sale of the master video tape is not made by I--- because I--- grants only a license to foreign distributors for the motion picture's exploitation. The basis for the Department's argument that the contract entered into by I--- is a licensing agreement is that the document uses the terms "license", "licensee", "licensor" and the term "license agreement." In the Department's view, I--- is not selling the master tapes to foreign distributors because the licensee does not receive a "full bundle of rights". It argues that the distributor obtains only the right to exploit the movie in a particular geographic area for a specific period of time. I--- retains title to the master tape and has control over its ultimate disposition. According to the Department, the granting of a license is not a sale by I---. Therefore, the petitioner cannot purchase the master video tapes for resale. This being the case, sales tax is owed by petitioner on its sales of master video tape to I---.

In regard to the negligence penalty, the Department's representative argued that the negligence penalty was appropriately imposed because this is the third time petitioner had ex-tax purchases of supplies that were then used in one fashion or another or were not sold for resale as claimed.

The petitioner's representative's stated position is that there were sales made by I--- to foreign distributors and those sales were sales in interstate/foreign commerce that are exempt. Therefore, the charges for tape conversion allocated to I--- should not be included in the taxable measure. The petitioner's representative indicated the agreement between I--- and foreign distributors that is included in the file is an old agreement and does not really represent the understanding of the parties. The language in that agreement, according to Mr. R---, was held over from prior agreements that concerned themselves with the transfer of motion pictures on 35 MM film and not on video tape. The pre-printed contract, he said, was used for the purpose of defining the display rights that the foreign distributor acquired. He argues that the facts here are analogous to those in Simplicity Pattern Co. Inc v. State Board of Equalization (1980) 27 Cal.3d 900 to support his contention that a sale was completed by I---. He also said that the parties to those agreements act differently than provided for in the agreement. Specifically, the foreign distributors always keep the master tapes. The only limitation is that which is placed upon their right to exploit the movie. There is a separate charge for the master tape as is evidenced by the invoices. Petitioner's representative pointed to the invoices that are issued by I--- as proof of the fact that I--- was selling the tapes and not just licensing their exploitation.

In regard to the negligence penalty, the petitioner's representative argued that the transactions with I--- were reviewed in a prior audit and there was no tax applied. Apparently, according to him, the prior audit viewed the transactions between I--- and the foreign distributors as leases, therefore, sales exempt in interstate/foreign commerce. The petitioner's representative relied upon Sales and Use Tax Annotation 320.0140 that provides that where sales are not reported because of a belief in the application of an exemption as export sales, and a bona fide difference of opinion as to taxability exists, the negligence penalty should not apply. He also argued that the negligence penalty, if imposed, should be imposed on an item-by-item basis and that the protested portion of audit item D should not have the negligence penalty imposed.

#### Analysis and Conclusions

An excise tax has been imposed on the storage, use, or other consumption in this state of tangible personal property. See Revenue and Taxation Code Section 6201. Every person storing, using, or otherwise consuming in this state tangible personal property purchased from a retailer is liable for the tax. See Revenue and Taxation Code Section 6202. The video masters purchased by petitioner according to the information presented are not used by petitioner prior to their sale to I---. The causing of the tapes to be converted to PAL format is not a use because it is considered to be a step in the preparation of that tape for sale. Therefore, in that no use of the property is made by petitioner, the imposition of use tax on these ex-tax purchases is inappropriate.

The Department also raised the argument that the sale of the blank video masters and associated conversion charges to I--- are sales at retail and should be subject to sales tax. Section 6091 of the Revenue and Taxation Code provides that it shall be presumed that all gross receipts are subject to the tax until the contrary is established. That section also establishes that the burden of proving that sales of tangible personal property are not sales at retail rests upon the person who makes the sales unless he takes from the purchaser a certificate to the effect that the property was purchased for resale. The petitioner argued that there was a sale of the masters for resale to I--- because I--- sold the tapes to foreign distributors. We do not agree. It appears that I--- did not issue a resale certificate to petitioner to allow petitioner to be relieved of its sales tax obligation. In addition, the document presented as a copy of the agreements entered into between I--- and the foreign distributors is clearly a licensing agreement. We find, be it an old or pre-printed agreement, it is the contract entered into between those parties. The fact that an invoice is issued by I--- when it transfers master video tapes of the motion pictures does not alter the provisions of that agreement. The agreement is for the exploitation of specific motion pictures for a specific period of time in a restricted area. In addition to the obvious references to a license within the agreement, the most compelling provisions of the agreement are those that cause I--- to maintain title and control as to the ultimate disposition of the master video tape of the motion picture following the period of the license.

We do not agree that the facts in this case are analogous to those presented in Simplicity Pattern Co. Inc v. State Board of Equalization (1980) Cal.3d 900. In that case, there was a sale of audio visual components for medical training. There was no sale of a motion picture. The appellant in that case argued that the sales in question should receive the same tax treatment afforded the sales of motion pictures and was unsuccessful. In our case, we are dealing with motion pictures. The State has enacted laws and regulations specifically designed for transactions involving motion pictures and it is those particular laws that we must apply.

A sale is defined by Revenue and Taxation Code Section 6006(g)(1) to mean and include any lease of tangible personal property in any manner or by any means whatsoever, for a consideration except, among other things, a lease of motion pictures including television films and tapes. The term lease includes license. See Sales and Use Tax Regulation 1660(a)(1). Therefore, I--- in the granting of a license/lease is not selling the property in question. Finding that there is no sale of the property by I--- leaves us with the conclusion that all sales of the master video tapes and associated conversion charges by the petitioner to I--- are sales at retail and are subject to the imposition of sales tax. Considering that finding, neither the master motion picture tapes nor the conversion fees associated with I---'s business are associated with sales in foreign commerce and are not exempt. In that audit item D is denominated as a use tax, a new audit item E should be established only for the sales tax to be imposed on the sales of master video tapes and conversion charges to I---.

Revenue and Taxation Code Section 6484 provides for the imposition of a ten percent penalty if any part of the deficiency for which a determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations. In determining whether petitioner is negligent, the test is whether or not the petitioner's conduct met the standard of care of a reasonably prudent businessman in the attendant circumstances. (Southeastern Finance Co. v. Commissioner, 115 F.2d 205 (1946).) A substandard degree of care is not to be imputed in a case based solely upon a reasonable error in interpreting the applicable law. The petitioner asked that Sales and Use Tax Annotation 320.0140 be considered as controlling in the imposition of the negligence penalty on the taxable measure associated with the sale of the master video tapes to I---. The petitioner asked that the penalty be imposed only on certain audit items. As above noted, the law provides that if any part of a deficiency is due to negligence, the penalty will apply to the whole of the determination. Therefore, that request should be denied.

In mitigation of the charge of negligence, petitioner stated that it has been audited on prior occasions and that it has based its actions on the prior audit results believing that it was properly reporting taxable receipts. The Department pointed out, however, that the prior audits established an understatement in the measure of tax in the area of ex-tax purchases used that resulted in additional tax liability as well as the imposition of the negligence penalty. Petitioner's consistency in understating the measure of tax over two successive audit periods justifies imposition of the negligence penalty. (See, generally, Independent Iron Works. v. State Board of Equalization (1959) 167 Cal.App.2d 318, 323.)

#### Recommendation

Delete from the taxable measure of audit item D those sums associated with the purchase of the blank master tapes and conversion charges that were sold to I---. Establish a new audit item E as sales understated, comprised of the taxable measure of the sales made to I--- by petitioner of the blank master tapes and associated conversion charges bought by petitioner ex-tax. Deny the petition in all other respects.

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Anthony I Picciano, Staff Counsel

March 22, 1992

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Date