

**STATE BOARD OF EQUALIZATION**PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001
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August 8, 1990

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& P--- D---
XXX --- --- Dr., Ste. XXX
---, California XXXXX

Now see Reg. 1501.1.
SPJarvis 10/3/03

Attention: Mr. N--- F. T---

SR -- XX-XXXXXX

Dear Mr. T---:

This is in reply to your May 1, 1990 letter regarding the application of sales tax to your industrial and product design charges. You provided a list of functions and asked for our opinion as to whether sales tax applies to the charge.

Before turning to the specific functions you listed, we will provide an overview of the application of tax to engineering charges. 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 you produce a custom-made item for a customer, your retail sale of the item is subject to sales tax. Of course, 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 Sales and Use Tax Regulation 15801, Service Enterprises Generally, “[t]he 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 your transactions, 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). Business Taxes Law Guide Annotation 515.0660, Research Contracts, discusses that distinction:

“A research and development contract must be distinguished from a contract for the manufacture of a ‘custom made’ item. In the latter, the research, design, etc., although necessary to the manufacture of the item, is incidental to the primary purpose of the contract. Generally, ‘custom made’ items are for consumption or resale. The buyer wants the item for its intrinsic value as an item, and is not interested in the data developed in the course of its manufacture. In such contracts, the entire contract price is subject to tax if the tax applies. A person contracting for research and development is primarily contracting for information which is intangible. Generally, the person contracting for information is going to use it to manufacture and sell some item of tangible personal property.

“The development of the information in a research and development contract is not a sale of tangible personal property. It is a service. Since the information such as plans, design, parts lists, etc., cannot ordinarily be conveyed orally, the information is conveyed on paper. The transfer of the information on paper is not a sale of tangible personal property, and the transfer is incidental to the service of developing the information. In a few rare instances, the information cannot be conveyed without the transfer of a prototype. In these cases the transfer of the prototype is incidental to the transfer of the information and is not a sale of the prototype. In most instances the information cannot be developed without the production of a prototype, but the information can be conveyed without it. In these instances, if the prototype is also transferred, it is a sale of the prototype along with a sale of intangible information.

“In a true research and development contract, where a prototype is manufactured, the researcher (taxpayer) owes use tax on the materials used to construct the prototype since it was used to compile the data, design, drawings, etc. The measure of the tax is the cost of the materials going into the manufacture of the prototype as well as all other materials consumed.

“Thus, if the true research and development contract calls for the researcher to furnish a prototype along with the engineering data, parts lists, design blueprints, operating instructions, etc., the transfer of the prototype (previously used to develop the data called for in the nontaxable service portion of the contract) is a sale of it without any credit for the use tax paid on the materials. The measure is not the full contract price since the primary purpose of the contract was one for the service of developing information.”

Business Taxes Law Guide Annotation 515.0600, Computer Assisted Design (C.A.D), discusses the application of tax to charges when a person uses computers and C.A.D. software to design the layout of electronic components on printed circuit boards from schematic diagrams provided by the person’s customers. Under those facts, the Board’s legal staff took the position that the design charges were not subject to tax when the taxpayer contributed its independent knowledge and judgment in determining the appropriate layout of electronic components on the

PCBs. The staff believes that the activities are in the nature of engineering or design services under Regulation 1501. Tax does not apply to the charges even though some tangible representation of the design, such as original drawings or date, whether transferred on paper or magnetic media, is transferred in the process. However, tax does apply to charges for drawings suitable for use as camera ready art and for manufacturing aids used in the production of the PCB, such as a "photoplot" or a drill tape used on a tape controlled automatic drill machine.

We will apply these criteria to the different functions you described. We assume that you perform these functions in connection with the contract to design the client's product. We make this assumption, because our answer would be different if, for example, in function 4 below, someone else designed the product and you merely performed the drafting work. In such case, your charge would be subject to sales tax. See Business Taxes Law Guide Annotation 515.0020, citing the case Albers v. State Board of Equalization, 237 Cal.App.2d 494; Sales and Use Tax Regulation 1502, subd. (c)(4).

"1) Counsel our clients in the organization of mechanical and electronic components into a producible product. DELIVERABLES: verbal advice, CAD computer plots, cardboard block models.

We view this function as a research and development function. You have not provided a description of what tangible personal property you transfer in connection with the "CAD computer plots"; therefore, we are unable to give you a specific answer. Assuming the computer plots are merely a tangible representation of C.A.D., tax does not apply to the charges for the verbal advice and the C.A.D. computer plots. Assuming also that, as we understand is usually the case, you could convey the information to the client without the cardboard block models, tax applies to your charge for the models.

"2) Help our clients define the methods of manufacture best suited to their needs. DELIVERABLE: verbal advice."

Since you do not transfer any tangible personal property in this function, sales tax does not apply to your charge.

"3) Source the various manufacturers and components for our clients devices. DELIVERABLE: written reports."

Sales tax does not apply to charges for written reports in manuscript form. (Cf. Sales and Use Tax Reg. 1501.)

"4) Prepare for our client the plans, specifications, documentation, and detail part drawings which enable the various parts to be fabricated. DELIVERABLE: plans with dimensions and notes, written specifications computer plotted on paper and/or floppy data."

We believe that your transfer of plans with dimensions and notes, written specifications computer plotted on paper, and floppy data is an incidental transfer of tangible personal property in connection with your engineering services. Sales tax does not apply to the charge.

“5) Prepare the mechanical layout(s) which show how the device’s major and minor assemblies, sub assemblies and parts relate to each other. DELIVERABLES: plans without dimensions showing all parts computer plotted on paper and/or floppy media.”

The charge is nontaxable as an incidental transfer of tangible personal property in connection with the engineering services.

“6) Prepare assembly drawings used internally in the client’s assembly process to show the various steps in the assembly of the device. DELIVERABLES: CAD drawings computer plotted on paper and/or floppy media.”

Again, we believe the transfer of the assembly drawings is incidental to the engineering services.

“7) Prepare assembly drawings and technical drawings to be used as illustrations in brochures, instruction manuals and sales literature. DELIVERABLES: CAD drawings computer plotted on paper and/or floppy media.”

We believe there is another distinction to be drawn at this point. Although charges for design in the architectural or engineering sense are nontaxable, other charges for design, such as a design in the aesthetic sense, are taxable. Sales and Use Tax Regulation 1540, Advertising Agencies, Commercial Artists and Designers, provides at subdivision (c):

“The tax applies to the entire amount charged by commercial artists or designers for items of tangible personal property such as drawings, paintings, designs or sketches transferred to the client, whether or not the property is suitable for display or is useful for actual reproduction by photo-mechanical or other processes.

“Tax does not apply to separately stated charges for preliminary art as defined in (b)(4)(A).”

Since you prepare these drawings for use in brochures, manuals, and sales literature, the transfer is not a conveyance of information incidental to the engineering services. Tax applies to the charge.

“8) Prepare sketches, renderings and illustrations to convey to our clients our various styling approaches for their devices. DELIVERABLES: pencil sketches, CAD drawings computer plotted on paper and/or floppy media.”

Although charges for this type of design would normally be taxable, since it is our assumption that you are performing the research and development of the client's product, we believe that you may consider the styling of the product as incidental to the engineering function. Tax, accordingly, does not apply to your charge for the pencil sketches, C.A.D. drawings plotted on paper, and floppy media.

“9) Construct cardboard and foam study models to show our clients in three dimensions the various proposed volume and styling approaches for their devices. DELIVERABLE: unpainted, preliminary cardboard models.”

We believe that you could transfer the styling information on paper, and your charge for the cardboard models is subject to tax as a sale of a prototype. See Business Taxes Law Guide Annotation 315.0660, quoted above.

“10) Prepare exterior control drawings (model drawings) and perform liaison support which enable subcontracted fabricator(s) to produce an exact exterior replica of the look and style of the device to show to our client's in order to obtain our client's approval of our styling approach and our color selection for their device. DELIVERABLE: painted realistic model representation, which is non-working. In some cases we retain ownership of this model and loan it to the client as he needs it.”

Tax applies to your charge for the prototype which you transfer to your client. Since you charge the client for your production of the prototype, we do not view your temporary transfer to the client as a loan. Rather, we believe that, when you retain ownership of the model and transfer temporary possession to your client for a charge, your transfer is a lease of the model. Tax applies to your charge for the lease.

On the other hand, if you prepare the replica solely for the purpose of demonstrating an idea or message for acceptance by the client before the client give approval for your preparation of the final design and you retain title to the replica, tax does not apply to your separately stated charge to the client for the temporary transfer of the replica for approval purposes only. You must retain for audit purposes proof of the client's ordering, or your producing the replica, prior to the date of the client's giving approval for the finished design. (Cf. Sales and Use Tax Reg. 1540, subd. (b)(4)(A).)

“11) Hire fabricators and supply them with plans and perform liaison support which enable these fabricators to produce the various parts which when assembled, demonstrate the actual assembly sequence and complexity of the device as well as show the form and demonstrate the function of the device. DELIVERABLE: unpainted machined parts which, when assembled, and, in some cases, when combined with client supplied electronics function exactly as

the actual device would function. In some cases we retain ownership of this prototype and [sic] loan it to the client as he needs it.”

Assuming that you could convey the information to your client without transferring the prototype, your transfer of the prototype to your client is subject to tax as a sale of the prototype. Unless you transfer the prototype to your client prior to use, tax also applies to the sale by the fabricators to you. (Cf. Sales and Use Tax Reg. 1525.) Again, tax would apply to your lease of the prototype to your client.

“12) Perform drawing changes and modifications to the part drawings at the request of the client for the client own reason. DELIVERABLE: CAD drawings, computer plotted on paper and/or floppy media.”

We assume that your drawing changes and modification to the part drawings pertain to your engineering of the product. Tax does not apply to this charge.

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

Very truly yours,

Ron L. Dick
Senior Tax Counsel

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