STATE OF CALIFORNIA

210.0450

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
D--- S---, INC.	)	No. SR -- XX-XXXXXX-010
Petitioner	)	

The Appeals conference in the above-referenced matter was held by Staff Counsel Elizabeth Abreu on May 2, 1994 in ---, California.

Appearing for Petitioner: R--- E. D---
Certified Tax Preparer

Appearing for the
Sales and Use Tax Department: Peter R. Elash
Supervising Tax Auditor

Protested Item

The protested tax liability for the period April 1, 1989 through March 31, 1992 is measured by:

Item	State, Local and County
Ex-tax purchases acquired out-of-state or through the issuance of resale certificates subject to use tax based on a percentage of error	$ 391,518

Petitioner's Contentions

Petitioner purchased the hardware in issue for resale. Petitioner frequently demonstrated the hardware and, therefore, is only liable for use tax measured by the fair rental value of the hardware while it was used to test and refine software.

Summary

Petitioner is a corporation which provides consulting services for computer systems and which sells the D--- System, a software program developed by petitioner to link computers together. The bulk of petitioner's sales are sales of software because most of its clients already have the hardware. Occasionally, however, petitioner sells a complete system which includes hardware and software. Petitioner does not have a showroom, but potential customers can come to its premises for software demonstrations. In some transactions, petitioner will bring the hardware and software to the potential customer's place of business.

The property in issue is hardware which petitioner purchased either ex-tax from out-of-state vendors or ex-tax with resale certificates from California vendors. The hardware includes personal computers and some minicomputers. The Sales and Use Tax Department (Department) determined that petitioner is liable for use tax measured by the purchase price of the hardware because petitioner made a use of this hardware other than retention, demonstration, or display. The Department asserts that petitioner made a taxable use of the hardware by developing software on it and by using the hardware to test the software and demonstrate the software to potential customers. In addition, petitioner capitalized the hardware on its books and records and claimed depreciation deductions for the hardware on its state and federal income tax returns. Although petitioner made a few sales of the same type of hardware to some customers, the sales were not sales of the hardware in issue. As of the time of the exit conference on February 23, 1993, petitioner had not sold any of the hardware in issue. Most of petitioner's revenues come from consulting and sales of software. Only a small amount comes from sales of hardware which it sells if requested by a customer.

Petitioner asserts that the hardware was used to demonstrate itself. Petitioner agrees that the hardware was also used to test software but contends that the tax liability should be limited to the fair rental value for the time its engineers used the equipment to test and refine the software system. Petitioner estimates that the equipment was used about 20 percent or less for testing and refining.

Petitioner stated that the software was developed on a mainframe on which petitioner rented time and also on a mainframe on petitioner's premises. Petitioner was given free time on this latter mainframe by the manufacturer.

Petitioner contends that it promoted sales of hardware in newspaper advertisements. Petitioner, however, has not submitted copies of these advertisements as requested.

Petitioner stated that it is common in the industry to use hardware for demonstration but not sell the hardware until it becomes obsolete because it is too expensive to disengage a particular piece of hardware and set up a new demonstration model. Some of petitioner's hardware, however, has been maintained for a long time because it has been upgraded with new chips.

Petitioner indicated at the Appeals conference that some of the hardware has been sold and argued that the Board does not require a particular time period for an item to be sold. Petitioner promised to provide copies of documents relating to these sales, but we have not received them.

Petitioner contends that it claimed depreciation deductions on the hardware in error, and that it amended its returns with the Internal Revenue Service and Franchise Tax Board at the beginning of this year to correct this mistake. Petitioner promised to provide copies of the amended returns, but to date, we have not received copies of these returns.

According to the Report of Audit Discussion, petitioner agreed with $211,269 of the measure of tax as ex-tax purchases of supplies and software that were not purchased for resale. Petitioner's representative was not sure that he agreed with this figure in its entirety, especially with respect to the software. We have not, however, received a letter, as requested, explaining whether any of this amount is in dispute.

Analysis and Conclusions

In California, property purchased for resale is not subject to sales or use tax while the property is being held for resale. (Rev. & Tax. Code § 6052, 6201, 6008, and 6009.) However, a use tax liability accrues if the purchaser makes a taxable use of the property while holding it for resale. Specifically, Revenue and Taxation Code section 6094(a) provides:

> "If a purchaser who gives a resale certificate makes any use of the property other than retention, demonstration, or display while holding it for sale in the regular course of business, the use shall be taxable to the purchaser under Chapter 3 (commencing with Section 6201) of this part as of the time the property is first used by him, and, except as provided in subdivisions (b), (c), and (d) of this section, the sales price of the property to him shall be the measure of the tax."

Section 6244(a) has a similar provision for property purchaed for resale. If property purchased for resale is used frequently for purposes of demonstration or display while holding it for sale in the regular course of business and is used partly for other purposes, the measure of tax is the fair rental value of the property for the period of such other use or uses. (Rev. & Tax. Code §§ 6094(c) and 6244(c).)

Removing computers off production lines to test other equipment is a taxable, intervening use. (Sales and Use Tax Annotation 570.0405.) Depreciating property on income tax returns is inconsistent with a claim that property is being held as resale inventory. (See McConville v. State Board of Equalization ((1978) 85 Cal.App.3d 156.) However, if a taxpayer claims the depreciation deduction in error and amends the income tax returns, no use tax will be due if the taxpayer does not make any other taxable use of the property. (See Sales and Use Tax Annotation 210.0560.)

In the present case, petitioner made a taxable use of the hardware by using it to test and refine its software and by demonstrating its software to potential customers. Thus, assuming petitioner purchased the hardware for resale, the issue is whether petitioner's liability is measured by the full purchase price of each piece of hardware or by the fair rental value of the hardware for the periods during which it was being used for testing and demonstrating the software.

Unless petitioner frequently demonstrated the hardware itself, the measure of tax is the full purchase price of the hardware, not the fair rental value of the hardware. We conclude that a taxpayer may be regarded as frequently demonstrating property purchased for resale even though the same use has a dual purpose, e.g., demonstration of the property itself and demonstration of other property (in this case software). In the present case, however, most of petitioner's customers already owned the hardware necessary to run petitioner's software programs. Accordingly, most of petitioner's demonstrations were for the sole purpose of demonstrating the software and not for the purpose of demonstrating the hardware in an effort to make a sale of the hardware. We therefore conclude that the hardware was not frequently demonstrated and that the measure of tax should be the full purchase price of each piece of hardware.[1]

Recommendation

It is recommended that the petition be denied.

9/19/94

Elizabeth Abreu, Staff Counsel Date

[1] In addition, petitioner did not submit evidence, as requested, to show that the hardware was purchased for resale in the first place. Nor did petitioner submit evidence that it had amended its income tax returns. In light of our conclusion that the hardware was not frequently demonstrated, however, it is not necessary to decide if petitioner purchased the hardware for resale.