STATE BOARD OF EQUALIZATION
1020 N STREET, SACRAMENTO, CALIFORNIA
(P.O. BOX 942879, SACRAMENTO, CALIFORNIA 94279-0001)
(916) 445-6557

July 19, 1990

P--- L---
Senior Manager of Taxes
P--- P--- Corporation
XXXX --- Avenue
--- ---, CA XXXXX

Dear Mr. L---:

Re: SR – XX XXXXXX-010

Enclosed is a copy of the Decision and Recommendation pertaining to the petition for redetermination in the above-referenced matter.

I have recommended that the Board staff perform a reaudit in accordance with the views expressed in the Decision and Recommendation. No action is required of you at this time, except that you are requested to cooperate with the audit staff during the course of the reaudit.

The audit staff will provide you with a copy of the reaudit report. A copy of that report will also be sent to me. At that time, I will write to you informing you of your options for appeal in the event that you disagree with the reaudit results.

Very truly yours,

James E. Mahler
Hearing Officer

JEM:ct
Enc.

cc: Ms. Janice Masterton
Assistant to the Executive Director (w/enclosure)

Mr. Glenn Bystrom
Principal Tax Auditor (file attached)

--- – District Administrator (w/enclosure)

STATE OF CALIFORNIA

330.2314

BOARD OF EQUALIZATION

APPEALS UNIT

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: P--- P--- CORPORATION. Petitioner	))))))))	HEARING DECISION AND RECOMMENDATION No. SR – XX XXXXXX-010

The above-referenced matter came on regularly for hearing before Hearing Officer James E. Mahler on March 27, 1990 in Hollywood, California.

Appearing for Petitioner: P--- L---
Senior Manager of Taxes

Appearing for the Department
Of Business Taxes: Joseph J. Cohen
District Principal Auditor

Protested Items

The protested tax liability for the period July 1, 19XX through September 30, 19XX is measured by:

	Item	State, Local and County	LACT
L.	Ex-tax purchases of movie video Cassettes (airline version)	$668,661	$ 250.845
M.	Special effects purchased from L--- Films	-0-	17,993,818
		$668,661	$18,244,663

Petitioner's Contentions

Audit Item L. Use tax does not apply to the purchases of movie video cassettes because they were not purchased for use or functionally used in California. Also, any applicable tax would be a sales tax on the vendor rather than a use tax on petitioner.

Audit Item M. The acquisitions of special effects were not taxable purchases.

Summary

Petitioner is a corporation engaged in business as a motion picture studio. It has some offices in California, but all studio facilities and most offices are located in New York. (several related entities operate studio facilities in California under separate permits.) The last prior audit of this account was through June 30, 19XX.

Audit Item L. As part of its business, petitioner distributes specially edited versions of its motion pictures to airlines for showing as passenger entertainment on commercial flights. These pictures are distributed on video cassette tapes. Petitioner has the tapes made by a company called C--- M--- V--- & F--- Laboratories (CM).

CM makes the tapes at a laboratory in M---, New York. According to petitioner, CM also has facilities and is engaged in business in California, but the Department of Business Taxes (DBT) has been unable to find any evidence that CM holds or ever has held a California seller's permit. CM's California facilities, if indeed there are any, are not involved in any way in the transactions at issue here.

Petitioner distributes the tapes through either of two independent companies, T--- C--- Systems of --- ---, California (T---) and A--- I--- of --- ---, California (A---). Both these companies (hereinafter sometimes referred to as "the booking companies") are apparently engaged in the business of leasing projectors, screens and other video equipment to airlines for use in showing in-flight movies. According to petitioner, both companies participate in the distribution of petitioner's pictures solely as an accommodation to their customers (so the airlines can pick up the video equipment and the tapes at one place) and not for profit.

The relationship between petitioner and A--- is spelled out in an agreement dated September 9, 1983. Section 1 of the agreement grants a license to A--- and to "customers of" A--- to exhibit petitioner's motion pictures in video tape format. The license is limited to showing the motion pictures during commercial airline flights, with a special provision that the pictures will not be exhibited "in or over" the states of New York or California except for purposes of "screening" them to potential customers.

Section 4 of the license agreement states that the video cassettes will "at all times remain the property of" petitioner. Section 5 requires A--- to pay a license fee to petitioner based on the number of flights upon which the picture is exhibited. Section 5 also provides that A--- will prepare a "booking schedule" each time a picture is licensed to an airline, and will return the video cassettes to petitioner at an address in California at the expiration of each booking period. In Section 7, A--- agrees to pay all sales or use taxes resulting from the licensing or exhibitions of a picture. Section 17 provides:

> "AGENCY: Nothing in this Agreement shall be construed to create any agency, partnership or joint venture between the parties, nor shall any similar relationship be deemed to exist between them. Neither party shall represent itself to third parties as the agent, partner or joint venturer of the other."

At the appeal hearing, petitioner's representative indicated that the terms of petitioner's agreement with T--- are similar to the terms of the agreement with A---. However, no written agreement between petitioner and T--- has been presented in evidence.

Petitioner's representative also offered the following description of the process for distributing tapes to airlines. Petitioner first informs the major airlines when a particular motion picture will be available in video tape format and what the license fee will be. Interested airlines are directed to contact one of the two booking companies to negotiate specific terms such as length of the license, the size and format of the tapes, and the number of tapes needed.

The booking company notifies petitioner whenever a license is granted to an airline. A--- notifies petitioner by means of a document entitled "Booking Schedule". The booking schedule sets forth the particular terms negotiated with the airline and states that the license to that airline "is hereby brought within the scope of operation of the Agreement dated September 9, 1983…." The booking schedule is signed by A--- and by petitioner, but not by the airline.

T--- notifies petitioner by means of a form letter. This letter also sets out the specific details negotiated with the airline and states: "This letter serves to confirm the license granted by [petitioner] to the below listed airline(s)…." The letter is signed by petitioner and by T--- , but not by the airline.

After receiving notice from the booking company, petitioner prepares a document entitled "Airline Deal Memo" for internal record-keeping purposes. The deal memo describes the terms of the license and identifies A--- or T--- as the "vendor".

Petitioner then sends a purchase order to CM. Sometimes the order is for "straight dubs", that is, copies of pictures that have previously been edited for airlines. Other times, CM may be requested to do the editing work.

The purchase order directs CM to deliver the tapes to the California office of the booking company. No particular method of delivery is required, but it appears that all deliveries during the audit period were made by common carrier such as Federal Express. Neither the purchase orders, nor CM's billing invoices, nor any other documents mention when title in the tapes will pass from CM to petitioner.

The airline picks up the tapes at the California office of the booking company. At that time or perhaps at some later time, the airline pays the license fee to the booking company. According to petitioner, the booking company transfers the entire license fee to petitioner and does not retain any portion as its own profit.

The airline places the tapes on board its aircraft for use in-flight. Petitioner apparently does not keep records to show the physical location of any tape, but each tape presumably leaves and returns to California several times in accordance with the aircraft's schedule.

When the license period expires, the airline returns the tapes to the California office of the booking company. The booking company transfers the tapes to an office of petitioner in California. Since these tapes deteriorate rapidly (they can be shown only about 25 times before they become too "grainy" to be shown on a large screen), petitioner destroys all the returned tapes and does not attempt to re-use them.

DBT and petitioner agree that petitioner is licensing these tapes and that the licenses are leases for sales and use tax purposes. (See Rev. & tax. Code § 6006.3.) They disagree over the identity of petitioner's customers, however. DBT contends that petitioner leases the tapes to the booking companies, who in turn lease the tapes to the airlines. Petitioner, on the other hand, contends that it leases the tapes directly to the airlines.

Petitioner's representative at the appeal hearing explained somewhat vaguely that the booking companies are involved in these transactions solely to create a "paper trail" for internal record-keeping purchases. Petitioner's motion picture production contracts require petitioner to pay royalties to various persons every time a picture is "exploited". There is some legal question as to whether an in-flight showing of a picture on video tape is an "exploitation" under the production contracts. The arrangements with the booking companies were set up to avoid such questions.

DBT and petitioner also agree that a lease of motion picture productions is not a sale for sales and use tax purposes. (See Rev. & Tax. Code § 6006(g)(1).) DBT argues that petitioner's lease of the tapes is therefore a use and that use tax applies. Petitioner contends that its lease of the tapes is excluded from "use" under Revenue and Taxation Code Section 6009.1, since the tapes are intended to be shown on flights outside California. Petitioner also contends that use tax should not apply because the tapes are not intended to be "functionally used" in this state. Petitioner concludes that if any tax is due, it should be a sales tax on CM and not a use tax on petitioner.

Audit Item M. Petitioner acquired special effects for various motion pictures from L--- Films. DBT concluded that the acquisitions were taxable sales and purchases. State, local and county taxes were assessed against L--- Films, but the one-half percent transit tax was asserted against petitioner.

Analysis and Conclusions

Audit Item L. Revenue and Taxation Code Section 6201 imposes use tax when tangible personal property is purchased from a retailer for storage, use or other consumption in California, and is actually stored, used or otherwise consumed in this state. The issues with respect to this audit item are: (1) did petitioner "use" the tapes in this state; (2) did petitioner purchase the tapes "for use" here; and (3) if both these questions are answered in the affirmative, is petitioner entitled to an exemption from use tax on the ground that sales tax is due from the seller of the tapes?

Before turning to these issues, however, there is a preliminary matter which must be addressed. DBT argues that petitioner leased the tapes to the booking companies, who in turn leased them to the airlines. Petitioner contends that it leased the tapes directly to the airlines.

We believe that DBT has the better of this argument. Petitioner had no direct contractual relationship with any of the airlines. There were no purchase orders, invoices, contracts or other documents reflecting any agreement between petitioner and the airlines. To accept petitioner's argument, we would have to assume that the booking companies were acting as agents on petitioner's behalf for the purpose of entering the leases with the airlines. Such an agency relationship is not only unsupported by any evidence, but is directly contrary to Section 17 of the license agreement with A---.

In the final analysis, however, the identity of petitioner's customers is not relevant to petitioner's liability for the tax. For the following reasons, we conclude that petitioner is liable for use tax because it purchased the tapes for use in California and actually used them here, regardless of whether petitioner was leasing the tapes to the booking companies or directly to the airlines.

(1) Use in California

In relevant part, Revenue and Taxation Code Section 6009 defines "use" to include "the exercise of any right or power over tangible personal property incident to the ownership of that property…." Section 6008 of the code defines "storage" to include "any keeping or retention in this state for any purpose except sale in the regular course of business or subsequent use solely outside this State…." However, Section 6009.1 provides that "storage" and "use" exclude:

> "…the keeping, retaining, or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state, or for the purpose of being processed, fabricated, or manufactured into, other tangible personal property to be transported outside the state and thereafter used solely outside the state."

Petitioner exercised a right or power over the tapes in California by leasing them, and also by destroying them at the expiration of the lease terms. The section 6009.1 exclusion does not apply because the tapes were returned to California for destruction (and also because they were returned to California between flights while in the possession of the airlines.) Accordingly, petitioner both "stored" and "used" the tapes in California as those terms are defined in the Sales and Use Tax Law.

Petitioner appears to contend that the Section 6009.1 exclusion should apply on the ground that the "functional use" of the tapes occurred entirely outside this state. As explained more fully below, we do not agree that the "functional use" was entirely outside California. For present purposes, however, it is sufficient to note that Section 6009.1 does not use the term "functional use". The exclusion applies only to utilization of property "for use thereafter solely outside the state." (Emphasis added.) any return of the property to California after out-of-state use, for purposes of storage or for any other type of use in this state, therefore precludes the exclusion.

(2) Purchase for use in California.

Subdivision (b) (3) of Sales and Use Tax Regulation 1620 provides:

> "Property purchased outside of California which is brought into California is regarded as having been purchased for use in this state if the first functional use of the property is in California. When the property is first functionally used outside of California, the property will nevertheless be presumed to have been purchased for use in this state if it is brought into California within 90 days after its purchase, unless the property is used or stored outside of California one-half or more of the time during the six-month period immediately following its entry into this state….
>
> "For purposes of this subparagraph 'functional use' means use for the purposes for which the property was designed."

Petitioner purchased these tapes from an out-of-state vendor and the tapes were shipped into California by common carrier. Since the Sale contracts between petitioner and CM did not include any agreement regarding passage of title, title to the tapes passed to petitioner at the time and place of shipment. (Uniform Commercial Code section 2401.) The tapes were therefore purchased outside California for purposes of Regulation 1620, and if the first functional use of the tapes was in California, the regulation requires us to conclude that petitioner purchased them for use in this state.

Petitioner contends that the only "functional use" of these tapes was showing them on airlines during commercial flights. Since these showings occurred only outside California, petitioner concludes not only that the first functional use occurred outside the state, but also that the tapes were principally used outside California during the entire lease period.

This argument is not consistent with the facts. Petitioner's license agreement with A--- (and, inferentially, its license agreement with T---) authorized the use of the tapes in California for "screening" to the airlines. Any such screening would be a "functional use" and would have occurred in California prior to the time the tapes were shown on the aircraft. (We also note that the "screening" would not be demonstration or display under Revenue and Taxation Code Sections 6094 and 6244, since the tapes were not held for sale in the regular course of business.)

More importantly, we do not believe that screening or in-flight showing is the only functional use of the tapes. The issue is whether petitioner purchased the tapes for use in California, not whether the airlines intended to use them here. This issue must therefore be resolved by examining the use to which petitioner put the tapes, not by examining how the booking companies or the airlines used them. Petitioner purchased the tapes for the express purpose of leasing them to the airlines (either directly or indirectly through the booking companies) and from petitioner's point of view, the act of leasing the tapes was itself a functional use in this state.

The first functional use of these tapes therefore occurred when petitioner transferred them or had them transferred to the booking companies for leasing purposes. Since the first functional use was in California, we conclude that petitioner purchased the tapes for use in this state.

(3) Exemption from use tax.

Revenue and Taxation Code Section 6401 authorizes an exemption from use tax if the purchaser can establish to the satisfaction of the Board that the gross receipts from the sale of the property were included in the measure of the sales tax. Petitioner contends that it qualifies for this exemption on the ground that the applicable tax on its purchases of the tapes was a sales tax on CM. We disagree.

When property is purchased outside California and brought or transported into this state, the application of sales tax is explained in Sales and Use Tax Regulation 1620(a)(2) which provides, in relevant part:

> "(A) From Other States - - When Sales Tax Applies. Sales tax applies when the order for the property is sent by the purchaser to, or delivery of the property is made by, any local branch, office, outlet or other place of business of the retailer in this state, or agent or representative operating out of or having any connection with, such local branch, office, outlet or other place of business and the sale occurs in this state….
>
> "(B) From Other States - - When Sales Tax Does Not Apply. Sales tax does not apply when the order is sent by the purchaser directly to the retailer at a point outside this state, or to an agent of the retailer in this state, and the property is shipped to the purchaser, pursuant to the contract of sale, from a point outside this state directly to the purchaser in this state, provided there is no participation whatever in the transaction by any local branch, office, outlet, or other place of business of the retailer or by any agent of the retailer having any connection with such branch, office, outlet, or place of business."

Thus, sales tax applies only when two requirements are satisfied: the sale occurs in California, and there is local participation by the seller. In this case, title in the tapes passed to petitioner at the time and place of shipment in New York. The sales therefore occurred in New York, not in California. (Rev. & Tax. Code § 6010.5.) Furthermore, there was no participation in the sales by any local branch, office or outlet of CM. Accordingly, sales tax does not apply, and petitioner is not entitled to exemption from the use tax.

* * *

To sum up, petitioner purchased tapes for storage, use or other consumption in California and actually stored, used or otherwise consumed them in this state. There is no applicable exemption from the use tax. Accordingly, we find no basis for adjustment to this audit item.

Audit Item M. After the appeal hearing in this matter, DBT and L--- Films reached agreement as to the taxability of these special effects. We understand that petitioner's liability for transit tax was included in the agreement, with petitioner's consent. Accordingly, we recommend a reaudit to adjust Audit Item M in accordance with the agreement.

Recommendation

Reaudit to adjust Audit Item M in accordance with the agreement reached between DBT and L--- Films. Redetermine in accordance with the reaudit and without other adjustment to the tax.

_____ 6/21/90

James E. Mahler, Hearing Officer Date
6-25-90