STATE OF CALIFORNIA

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April 3, 2003

Mr. A--- D. F---
Partner
State and Local Tax
P---
XXXX --- Street, Suite XXXX
P.O. Box XXXXX
---, CA XXXXX-XXXX

Re: D--- S--- Corp.
SR -- XX-XXXXXX

Dear Mr. F---:

This is in response to your correspondence via telecopier, dated February 28, 2003. You have asked for reconsideration of the opinion set forth in my letter dated January 20, 2003, which analyzes the application of the Sales and Use Tax Law to certain transactions of D--- Sales Corp (D---) that involve non-recurring set up (NRSU) charges and test fixture charges. In particular, you disagree with my legal conclusion that an "exclusive use clause," which you allege is present in D---'s contracts with its customers, can function as a de facto title passage clause that transfers equitable title to a purchaser holding the right of exclusive use. For legal authority in support of this conclusion I relied primarily on *Northrop Corp. v. State Bd. of Equalization* (1980) 110 Cal.App.3d 132 [hereafter *Northrop*], which holds that, even if legal title to and possession of tangible personal property is retained by the seller, a taxable retail sale of the property has occurred if the seller receives consideration from the purchaser for the transfer of ownership rights in the property that are sufficient to pass equitable title to the property to the purchaser.

In your February 28, 2003, correspondence you state, in pertinent part, the following:

> "We do not believe that the issue of exclusive use of the subject property is a controlling factor as suggested in your letter. . . . I have enclosed for your review a copy of the full text of [Sales and Use Tax] annotation 440.0050 . . . [i.e., the "back-up letter" to the annotation], which states in part[:] 'We are of the opinion that seller retains title to the tooling and that the nonrecurring engineering charge

> is nontaxable. This charge is part of the charge for the parts and the parts are resale items. It is immaterial[1] that the tooling may be dedicated to the exclusive use of the customer. This fact alone would not support a conclusion that title to the property passes to the customer.'" (Citation omitted.)

You also assert that my reliance on *Northrop* is misplaced with respect to the transactions at issue. Specifically, you appear to contend that, under *Northrop*, a finding of equitable title passage is only warranted if the purchaser claims deductions or credits related to the property on its income tax returns and has an absolute right to possess the property. You allege that D---'s customers "will not be entitled to depreciation or expense deductions of the [NRSU] charges and test fixture charges" and that these customers "do not have the right to possess or remove the film or test fixtures at issue," but "are granted inspection rights only."

DISCUSSION

Under the facts you set forth in your initial letter dated November 20, 2002, my legal opinion dated January 20, 2003, is not in conflict with the legal opinion on which Annotation 440.0050 is based (hereafter the back-up letter). I concur with your observation that the back-up letter opines that the mere existence of exclusive dedicated use, by itself, is not conclusive evidence that equitable title to a special manufacturing aid has passed to the purchaser of items produced by use of the aid. However, it is clear, from the passage quoted above, that the author of the back-up letter is only analyzing the weight that should be given to the "fact" of dedicated exclusive use, not the legal effect of an exclusive use clause. Moreover, the second and penultimate paragraphs of the back-up letter, when read together, also imply that exclusive dedicated use coupled with multiple orders for items produced by the subject aid could suffice to establish that title to the aid has passed to the purchaser.[2]

In your letter dated November 20, 2002, you refer to D---'s customers placing "subsequent orders" for items produced by use of the film and test fixtures at issue. Moreover, these customers' bargained-for right of access to the film and test fixtures for the purpose of inspection, which you allege is contained in the relevant contracts, corroborates the notion that the subject property will be used more than once at the direction of D---'s customers. In other words, the reasoning of the back-up letter appears to support the conclusion that D--- passes title to the film and test fixtures in question to its customers. In any case, no change to the legal conclusion expressed in my letter dated January 20, 2003, is warranted.

I further note that the back-up letter states that "[t]he question as to whether manufacturing aids were sold to the customer when the manufacturer retains possession is a question of fact in every instance dependent upon the terms of the contract between the manufacturer and the individual customer." Although my letter dated January 20, 2003, informed you that additional documentation was necessary for purposes of issuing a proper legal

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[1] Given the following and last sentence of this quoted passage, it is apparent that the author misused the term "immaterial." The author apparently meant "not dispositive" or "not conclusive" instead of "immaterial."

[2] It should be further noted that the third paragraph of the back-up letter indicates that the seller in question did not have customers who typically placed multiple orders that used the subject special manufacturing aids.

opinion, such documentation did not accompany your request for reconsideration. An examination of the relevant documentation may provide other bases for concluding that D--- passes title to the property in question to its customers.

As to your *Northrop* contention, I find your apparent view of the opinion's holding to be unreasonably narrow. A purchaser's failure to claim a right of ownership on income tax returns (e.g., depreciation or expense deductions) does not conclusively establish that the purchaser does not hold equitable title to the subject property. Moreover, the rules set forth by the Internal Revenue Service for determining when holders of equitable title may take deductions related to the subject property are peculiar to income tax law and are not dispositive for purposes of analyzing title passage under the Sales and Use Tax Law. Finally, an exclusive use clause coupled with the right to repeated use constitutes the practical equivalent of a right to possession and, in any event, establishes that sufficient ownership rights have been transferred for purposes of concluding that equitable title has passed. The right to exclusive and repeated use is tantamount to a right to control, a compelling indication that equitable title has passed. (See *Northop*, 110 Cal.App.3d at pp. 142-143.) In short, I remain convinced that my discussion of the *Northrop* opinion is faithful to the holding of that case, which provides the necessary authority for the conclusion that ---, under the facts alleged, passes equitable title to the property in dispute to its customers.

Finally, your correspondence on this issue has helpfully pointed out the confusing reasoning and potentially misleading ambiguities contained in the back-up letter. Accordingly, to promote greater clarity in this area of the Sales and Use Tax Law, I am recommending that the Department delete Annotation 440.0050 from the Business Taxes Law Guide and annotate this letter instead.

To that end, the first two paragraphs of Annotation 440.0050 are completely consistent with this letter and are incorporated herein by reference in their entireties. Thus, I propose that the recommended annotation of this letter begin with the first two paragraphs of current Annotation 440.0050. Following those two paragraphs, I further propose that a third, and final, paragraph of the recommended annotation state as follows:

> "However, the contract between the parties must be examined. Generally, if the contract specifically provides that the manufacturer retains title, then it is rebuttably presumed that no sale of the manufacturing aid occurred, regardless of the existence of any of the factors set forth in the previous paragraph. However, this presumption is rebutted by, among other things, the inclusion of an exclusive use clause (i.e., a clause providing that the manufacturer's customer has the right to exclusive use of the manufacturing aid), if the manufacturing aid is used to fill multiple orders for items produced by the manufacturing aid."

I trust that the forgoing sufficiently clarifies the legal opinion expressed in my letter dated January 20, 2003. If any questions or concerns remain, please do not hesitate to contact me.

Sincerely,

Randy M. Ferris
Senior Tax Counsel

RMF/ef
cc: --- --- District Administrator (--)
Annotations Coordinator (MIC:50)