

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

440.0058

APPEALS UNIT

In the Matter of the Late)	HEARING
Protest Under the Sales and)	DECISION AND RECOMMENDATION
Use Tax Law of:)	
)	
T--- S--- C--- COMPANY)	No. SR -- XX XXXXXX-010
)	
)	
<u>Protestant</u>)	

The above-referenced matter came on regularly for hearing before Hearing Officer James E. Mahler on January 23, 1989, in Arcadia, California.

Appearing for Protestant:	None
Appearing for Interested Party:	R---t B. K--- CFO/General Counsel P--- P--- M---, Inc.
Appearing for the Department of Business Taxes:	Christopher C. Lu Auditor

Protested Items

The protested tax liability for the period January 1, 1983, through December 31, 1985, is measured by:

<u>Item</u>	<u>State, Local and County</u>
A. Portion of tooling selling price Claimed as exempt, disallowed	\$348,332
B. Tax-paid materials credits not Claimed on tooling sold	- <u>74,049</u>
	\$274,289

Protestant's Contentions

1. Legal title to the tooling did not pass to the buyers as claimed in the audit report.
2. Relief from the finality penalty should be granted.

Summary

Protestant (hereinafter referred to as petitioner) is a division of the V--- Corporation, a subsidiary of F--- I---, Inc. Its business is the design and manufacture of door knobs. Its major customers are lock manufacturers who apparently incorporate the knobs into lock sets for sale under their own brand names.

Each time a customer orders a new style of door knob, petitioner must design and fabricate the tooling to be purchased in the manufacturing process. The customer purchase orders typically include language to the effect that the customer has both title and a right to possession in the tooling, but that petitioner shall retain possession for use in performing the job. (the relevant portions of the purchase orders are set out in Appendix A.)

We understand that the customers insist on these provisions to ensure that the designs will not become available for use by their competitors. According to testimony at the preliminary hearing, however, the tooling may contain clues to petitioner's manufacturing process, which petitioner considers a trade secret and does not want to reveal to its customers. Therefore, petitioner has never transferred possession of the tooling to any customer, and would never do so even if the customer demanded possession.

Petitioner bills the customers for tooling in tow distinct ways. First, a lump-sum charge for the material cost of the tooling is billed immediately, and is labeled a "gage charge" or "tooling charge". Second, the charge for design and fabrication of the tooling is billed under the label "knob development charges" or "developmental service charge". The development charge is sometimes billed as a lump sum, or sometimes amortized over the life the contract.

During the audit period, petitioner charged tax reimbursement to its customers and reported and paid tax to the Board measured by the charges for the material costs of the tooling. However, petitioner did not charge reimbursement or report tax on the development charges. Tax was asserted in an audit, with a partially offsetting deduction for tax-paid purchases resold.

Petitioner originally contended that the development charges had not been taxed in prior audits and that petitioner had not been instructed to charge tax in any of the prior audits. However, examination of the workpapers for the most recent prior audit revealed that tax indeed had been asserted on the development charges. (See Schedule 12L, page 4, of the prior audit workpapers, attached to Schedule 12C, page 3 of the current audit workpapers.)

Petitioner also contended that the development charges represent "engineering services" which should not be taxable. The auditor cited petitioner to Sales and Use Tax Annotations 515.0660 (3/11/66) and 515.0720 (1/22/58), and petitioner has abandoned this contention.

Petitioner now contends only that its does not sell the tooling to the customers at all. At the hearing, we asked whether petitioner intended to file a claim for refund of the tax it reported and paid on tooling sales. The answer was noncommittal.

Petitioner attempted to file a petition for redetermination on December 7, 1986. No determination had as yet been issued against petitioner, however. The Board's Headquarters staff advised petitioner that a petition for redetermination cannot be filed until after the determination has been issued.

The petition was ultimately issued on March 11, 1987. A petition for redetermination was not received within 30 days, so the determination became final and a ten percent finality penalty was added. A representative of F--- has submitted a statement under penalty of perjury stating that petitioner never received the March 11, 1987 determination. (See petition file page S-6.)

In September 1987 (that is, almost two years after the close of the current audit period), V--- and F--- sold petitioner's assets to P--- P--- M--- (PPM). Exhibit C to the sale contract provided that \$X,000,000 of the price would be allocated to "tools & dies". The complete sale contract was apparently quite lengthy and only selected portions have been presented for our review. The selected portions contain no further breakdown of the charge for tooling, nor any indication of a distinction between customer-owned tooling and tooling owned by petitioner itself.

About two weeks after this sale, PPM prepared a breakdown of the tooling in its possession at that time, apparently for internal record-keeping purposes. Some of the tooling at issue here is included on this list and some is not. The book value of tooling which is both included in this audit and included in PPM's tooling list is \$198,038.

When the Board's staff learned of the sale to PPM, a close-out audit asserted tax on the final sale of assets, and that the measure of tax included the entire \$X,000,000 charge for tooling. The determination resulting from the close-out audit has gone final and has not as yet been paid.

Analysis and Conclusions

1. Revenue and Taxation Code Section 6006 provides, in relevant part:

"Sale" means and includes: (a) any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any

means whatsoever, of tangible personal property for a consideration. 'Transfer of possession' includes only transactions found by the board to be in lieu of a transfer of title, exchange, or barter."

The staff contends that petitioner's contracts with each customer, as reflected in the purchase orders, expressly provide that title in tooling will pass to the customer. The staff also notes that petitioner charged tax reimbursement and reported sales tax on a portion of the charge for tooling. The staff concludes that petitioner sold the tooling to its customers and is therefore liable for tax on the entire charge.

Petitioner contends that, despite any contrary language in the sale documents, it did not intend to pass title in the tooling to its customers. As evidence of its intent, petitioner alleges that the tooling included trade secrets and that possession was never transferred to any customer.

Petitioner also points out that the subsequent close-out audit asserted tax on a sale of tooling to PPM. If we understand the argument correctly, petitioner believes that the sale to PPM is significant for two reasons: first, a transfer of title in the tooling to PPM would be inconsistent with a prior transfer of title to the customers, and would be evidence that title in fact did not pass to the customers; and second, it is inconsistent for the Board to tax a sale of tooling to the customers and then tax a second sale of the same tooling to PPM.

For the following reasons, we agree with the staff and conclude that tax was properly asserted in this audit.

In all of the transactions where legible evidence is available, the sale documents expressly provided that title in tooling would pass to the customers. A deliberately executed contract is presumed to express the intentions of the parties correctly. (Kayser v. Gorman, 3 Cal.2d 478.) If the agreement is not ambiguous on its fact, the intent of the parties must be ascertained by reference to the language itself. (Pendleton v. Ferguson, 15 Cal.2d 219.) Only when the terms of the contract are uncertain and ambiguous is it proper to look at extrinsic evidence to ascertain the parties' intent. (Crestview Cemetery Association v. Dieden, 54 Cal.2d 744.) Since the contracts in question here expressly provided that title in tooling would pass to the customers, we find that title did pass and that tax was properly asserted.

As for the remaining transactions, the relevant portions of the purchase orders are either missing or illegible. We therefore find no basis for disturbing the auditor's conclusion that title in the tooling passed to the customers, particularly since petitioner charged tax reimbursement and reported sales tax on a portion of the charge to the customer.

We find nothing to the contrary in the subsequent close-out sale to PPM. Although possession of some customer-owned tooling was transferred to PPM, there is no evidence to suggest that petitioner attempted to transfer title in such tooling. Since petitioner had a right to possession but did not have title, it presumably intended only to transfer the right to possession. The \$X,000,000 price charged for "tooling and dies" was apparently calculated to cover the tooling owned by petitioner itself, with at best a small allocation for the right to possession of customer-owned tooling.

We emphasize that the close-out audit is not before us at this time, and we express no opinion as to whether the measure of tax found therein is or is not correct. If petitioner believes that the close-out audit is incorrect, it should pay the audited liability and file a claim for refund of the disputed amounts.

2. With respect to the finality penalty in this audit, petitioner attempted to file a petition for redetermination before the determination was issued. According to a statement under penalty of perjury signed by a representative of F---, petitioner did not receive the determination when it was subsequently issued. Under these circumstances, we would normally be inclined to recommend that relief from penalty be granted.

However, it is the Board's policy to grant relief from finality penalties only after the tax determination has been paid in full. Accordingly, action on the finality penalty should be deferred pending payment of this determination. Any further delays in payment will influence our decision as to whether relief from the penalty should be granted.

Recommendation

Redetermine without adjustment to the tax. Defer action on the finality penalty until the taxes are paid in full.

James E. Mahler, Hearing Officer

4/4/89

Date