

STATE OF CALIFORNIA
BOARD OF EQUALIZATION
BUSINESS TAXES APPEAL REVIEW SECTION

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|-----------------------------------|---|-----------------------------|
| In the Matter of the Petition for |) | |
| Redetermination Under the Sales |) | DECISION AND RECOMMENDATION |
| and Use Tax Law of: |) | |
| |) | No. |
| |) | |
| |) | |

The Appeals conference in the above-referenced matter was held on December 11, 1991 by Staff Counsel Susan M. Wengel in San Jose, California.

Appearing for Petitioner:

Appearing for the Sales and
Use Tax Department:

Protested Item

The protested tax liability for the period November 11, 1989 through December 31, 1989 is measured by:

| <u>Item</u> | <u>State, Local and County</u> |
|---|------------------------------------|
| C. Final sale of technical library and drawings/designs not reported. | REDACTED TEXT |

Contention of Petitioner

1. The "technical library" was not tangible personal property but was technical know-how of REDACTED TEXT employees and as such should not be subject to tax.
2. The stated value of the assets was not \$175,500 but substantially less.
3. The value of the assets should be reduced by the interest charges included in the \$200,000 paid out over six years.

Summary of Petition

Petitioner was a corporation which manufactured and sold microwave components used in radar systems. Since beginning its operations in 1983, petitioner's major customers were U.S. Department of Defense Contractors.

During an audit by the Sales and Use Tax Department (Department), it was found that on November 22, 1989, petitioner agreed to sell certain assets to REDACTED TEXT. Petitioner agreed to transfer assets which were essential to business such as hardware, equipment, inventory, parts, work in process, technology, designs, patents, processes, finished goods, furniture, goodwill and the right to use the name REDACTED TEXT. The assets did not include cash, receivables and certain consigned inventory. At the time of the sale, REDACTED TEXT was to pay petitioner \$514,000 in cash. Additional consideration was to be made every year for six years equal to four percent of gross receipts from sales of all suspended substrate products sold. The maximum obligation of for this six-year period was to be \$1,400,000 and its minimum obligation was to be \$200,000. (See Exhibit A attached.)

The contract of sale in section 1.4.1 set out the fair market value of the assets sold:

“1.4.1. Fair Market Value of Assets Sold. REDACTED TEXT and REDACTED TEXT hereby agree pursuant to this Agreement that the fair market value of the Assets is summarized [sic] as follows:

| <u>Asset Description</u> | <u>Negotiated Fair Market Value</u> |
|------------------------------|---|
| Inventory: | |
| Raw Material | \$75,000 |
| Finished Goods | 40,000 |
| Work-in-Process | 143,000 |
| Other | 10,000 |
| Inventory Subtotal | \$268,500 |
| Fixed Assets | \$175,500 |
| Contracts in Backlog | 173,000 |
| Existing Programs | 115,000 |
| Technical Library | 100,000 |
| Drawings & Designs | 175,000 |
| Agreement not to Compete | 250,000 |
| Goodwill | <u>43,000</u> |
| TOTAL | <u>\$1,300,000</u> |

“Each of the parties to this Agreement agrees to report this transaction for federal tax purposes in accordance with the negotiated fair market values reflected above.”

When the Department reviewed this valuation information, it concluded that the fixed assets valued at \$175,500 were subject to tax. It also ascertained that the technical library valued at \$100,000 and the drawings and designs valued at \$175,000 were likewise subject to tax. During the course of the audit, the auditor asked REDACTED TEXT, president of petitioner, to describe the technical library. Auditor REDACTED TEXT's notes indicate that the technical library was described as the hard copy written to paper, bound in binders of petitioner's product. It was a description in written and rough drawings of the technology and techniques used to produce petitioner's "widget". The drawings and designs included the pre-drawn or scientific diagrams, blueprints, detailed drawings and schematics of petitioner's products. They included tolerances, dimensions, inputs and outputs.

The audit staff ascertained that because petitioner sold these pre-existing documents and drawings, both the value of the technical library and the value of the drawings and designs were properly included in the measure of tax.

Petitioner asserts that the technical library refers to nothing more than "know-how" that is not embodied in any tangible personal property. In support of this position, a statement from REDACTED TEXT was submitted which refutes the auditor's notes and provides that the technical library was only a description of petitioner's know-how which was not embodied in any tangible personal property. He further states that this was put into the contract because REDACTED TEXT's counsel wanted it so stated for federal income tax purposes. (See Exhibit B attached.) A statement by REDACTED TEXT further provides that the technical library was to represent the intangible skill value of petitioner's employees. Mr. REDACTED TEXT has testified that nearly all petitioner's employees were hired by REDACTED TEXT. Only petitioner's president and the controller were not retained.

Secondly, petitioner asserts that the fair market value of \$175,500 stated in the contract of sale is not the correct value of the fixed assets. In support of this position, petitioner's counsel asserts that the amount taken for federal income tax purposes (\$130,308) more accurately reflects the actual value. Counsel further asserts that this amount may even be too high as this amount represents the value on August 31, 1989. If two more months of depreciation were allowed, the value would arguably be approximately \$110,000. Petitioner paid tax on the \$175,500 measure in its final return for the period October 1, 1989 through November 10, 1989. A claim for refund has been filed for \$6,096.

Finally, petitioner asserts that pursuant to Revenue and Taxation Code Section 24726 (which relates to Bank and Corporation Taxes), a portion of the \$200,000 purchase price which was paid out over six years, should be attributed to interest. The Department contends that pursuant to Sales and Use Tax Regulation 1641(a), if tangible personal property is sold on credit, the whole amount of the contract is taxable unless the retailer keeps adequate and complete records to show separately the sales price of the tangible personal property and the interest. If such records are kept by the retailer, interest charges may be excluded from the measure of tax.

Analysis and Conclusions

1. The first issue is whether the "technical library" is tangible personal property which is subject to tax. When the auditor was reviewing petitioner's records, he asked

REDACTED TEXT, then president of petitioner, what comprised the technical library. The auditor's notes indicate that the technical library was described by as writings and drawings of petitioner's technology and techniques used to produce its product. Petitioner now refutes this finding with a statement from REDACTED TEXT stating that all the written documents were classified and included in the amount charged for "drawings and designs". The auditor notes that the "drawings and designs" had earlier been described by REDACTED TEXT as the scientific diagrams, blueprints, detailed drawings and schematics of petitioner's products. All the drawings, designs, binders and the like were in existence prior to the sale.

Petitioner contends that the \$100,000 value placed on the technical library was only the value placed on the employee's know-how and that nothing tangible was transferred. It is recognized that the retention of petitioner's trained employees had a definite value to REDACTED TEXT and that this value could be reflected in the \$100,000 selling price. The item sold, however, was not called "know-how" but was called a "technical library". There is evidence, although disputed, that binders were transferred which documented the techniques used by petitioner's personnel to produce the finished product. As the later evidence was provided after the fact and can be viewed as self-serving, it must be concluded that the better evidence indicates that tangible personal property, such as binders, writings and drawings, which recorded petitioner's production techniques and practices, was transferred at the sale and are subject to tax.

This finding is consistent with the Department's position in Navistar International Transportation Corp., et al. v. State Board of Equalization (Sup. Ct. San Francisco County, 1990, No. 885174). In this case, data, drawings, concepts, know-how and the like were transferred and were held to be subject to tax based on the price set by the parties to the sale. We find the facts of Navistar indistinguishable from the facts in this case. As binders and drawings were transferred with the know-how, the entire \$100,000 selling price is subject to tax. It follows that the \$175,000 allocated to drawings and designs is likewise subject to tax.

2. The second issue is whether the value of the assets was \$175,500 as stated in the contract of sale. We must conclude that \$175,500 is the appropriate measure of tax. Quite clearly, this is the amount that both parties to the contract agreed was the amount which most accurately reflected the value of the tangible personal property sold. The court in Hawley v. Johnson (1943) 58 Cal.App.2d 232, dealt with a similar issue and found that the automobile dealer and the individual purchaser of a new car fixed by their agreement the valuation of the consideration received by the dealer at the time each sale was made. The automobile dealer argued that market value, not the agreed value, should be used. The court, however, ruled that to make the market value rather than the agreed value the measure would create almost insuperable administrative difficulties, as the taxing agency would be compelled in every transaction to look behind the agreed value and ascertain the actual market value of the property traded. The court went on to state that in the give and take of the market place, the value arrived at by free negotiation of the parties may safely be relied upon to furnish a reasonable measure of the value of property exchanged. As the same principles apply to this appeal, we must conclude that the amount agreed upon by the parties in the contract of sale is the appropriate measure of tax.

3. The final issue presented is whether the value of the assets sold should be reduced by any alleged interest charges which may be included in the \$200,000 paid out over the six

years after the sale. Sales and Use Tax Regulation 1641 provides that if tangible personal property is sold on credit, the whole amount of the contract is taxable unless the retailer keeps adequate records to show a separate sales price and a separate amount for interest. Pursuant to this regulation, if petitioner can produce the documents which will support a separate charge for interest, an adjustment can be recommended. Petitioner is given 30 days to submit this evidence. If no records are received, no adjustment can be recommended.

Recommendation

It is recommended that petitioner be given 30 days to submit the evidence required by Sales and Use Tax Regulation 1641 relating to interest. If no evidence is submitted, it is recommended that the liability be redetermined without adjustment.

Susan M. Wengel, Staff Counsel

May 6, 1992
Date