M e m o r a n d u m

515.0660

To: San Diego – Auditing Date: March 11, 1966

From: Tax Counsel (RHA) - Headquarters

See Regulation 1501.1
SPJarvis 10/6/03

Subject: --- --- ---

I was asked to analyze the merits of the proposed determination in light of petitioner's contentions, request for hearing, audit contentions and the petitioner's contract with "B" Aircraft Co.

The following are some general guidelines relating to the application of tax on purported research and development contracts:

A research and development contract must be distinguished from a contract for the manufacture of a "custom made" item.

In the latter, the research, design, etc., although necessary to the manufacture of the item, is incidental to the primary purpose of the contract.

Generally, "custom made" items are for consumption or resale. The buyer wants the item for its intrinsic value as an item, and is not interested in the data developed in the course of its manufacture. In such contracts, the entire contract price is subject to tax if the tax applies.

A person contracting for research and development is primarily contracting for information which is intangible.

Generally, the person contracting for information is going to use it to manufacture and sell some item of tangible personal property.

The development of the information in a research and development contract is not a sale of tangible personal property. It is a service. Since the information such as plans, design, parts lists, etc., cannot ordinarily be conveyed orally, the information is conveyed on paper. The transfer of the information on paper is not a sale of tangible personal property, and the transfer is incidental to the service of developing the information.

In a few rare instances the information cannot be conveyed without the transfer of a prototype. In these cases the transfer of the prototype is incidental to the transfer of the information and is not a sale of the prototype.

In most instances the information cannot be developed without the production of a protytype, but the information can be conveyed without it. In these instances, if the prototype is also transferred, it is a sale of the prototype along with a sale of intangible information.

In a true research and development contract, where a prototype is manufactured, the researcher (taxpayer) owes use tax on the materials used to construct the prototype since it was used to compile the data, design, drawings, etc. The measure of the tax is the cost of the materials going into the manufacture of the prototype as well as all other materials consumed.

Thus, if the true research and development contract calls for the researcher to furnish a prototype along with the engineering data, parts lists, design blueprints, operating instructions, etc., the transfer of the prototype (previously used to develop the data called for in the nontaxable service portion of the contract) is a sale of it without any credit for the use tax paid on the materials. The measure is not the full contract price since the primary prupose fo the contract was one for the service of developing information.

The question of tax liability on materials purchased ex-tax for resale and fabricated into a prototype and tested in experiments was answered by the Attorney General See 1 AG Ops. 266.

In that opinion it was held that materials used for experimental purposes in the process of developing an airplane are subject to tax in contrast with materials used solely for the purpose of constructing a plane in accordance with some established standard, as a plane for sale. Materials in the latter example are not subject to tax.

Obviously, in the latter example testing the plane is not experimental testing. Instead it amounts to production testing to determine if the manufactured plane meets the established standards.

In a custom made article the standard is constructively established since the purchaser knows what he wants. Thus, testing in the course of manufacture of a custom made item is not research or experiment testing in the sense that it is under a true research and development contract.

I have observed that field interpretations of similar contracts have varied considerably and in most every instance the interpretations disregard the substance of the contracts.

Contracts for the “custom” manufacture of a specific item have been considered true research and development contracts <u>if</u> the customer is out-of-state and the sale of the custom made item is an exempt interstate commerce transaction. In this way, use tax is assessed on the materials used to manufacture the custom made item on the theory that the testing for standards is experimental and taxable.

On the other hand, the same type of contract has been considered as one for the “custom” manufacture of a specific item if the sale can be taxed as an in-state transaction. In this way the entire gross receipts from the transaction have been set up as taxable. Some auditors have gone so far as to assert use tax liability on the materials <u>plus</u> sales tax on the entire gross receipts on the theory that the testing was taxable and was a use before the sale was made.

The purchase order in the "A" – "B" Aircraft contract appears to be one for the purchase of a specific prototype as well as one for research and development of the AC to DC Converter unit.

The "Additional General Provisions" seem to be more like those in a research and development contract.

This appears to be a contract wherein the primary purpose is the research and development of an AC-DC converter. "B" Aircraft does not appear to want the specific prototype for its intrinsic value as a piece of machinery.

In other words, the contract does not appear to be primarily for the fabrication of a custom made AC-DC Converter wherein the purpose for buying it is one for self-consumption or resale.

Before the contract was let there were no doubt unknowns relating to the feasibility, performance, materials, design, materials costs, etc. These were to be developed in the course of performance of the contract by "A" and "B" wanted the answers. "B" also wanted the assurance that the converter would perform. This necessitated the manufacture of the prototype. The transfer of title to "B" probably was not necessary to the transfer of the research and development data desired.

The Additional General Provisions indicate that "B" intended to go into production of the converter.

Summarily, this is a research and development contract calling for the production of one prototype along with the related development data.

The development of the data necessitated the manufacture of the prototype even if the contract had not called for one to be delivered to "B". Therefore, "A" is liable for use tax on all materials consumed under the contract including those used in the manufacture of the prototype. Inasmuch as the prototype was first used to develop data called for under the contract, "A" cannot enjoy a tax paid purchase credit on the sale of the prototype to "B".

Sales tax applies to the sale of the prototype, but the selling price is not the total contract price. It should be measured by the cost of fabricating a simialr AC-DC Converter under conditions where no research is involved, and the converter is manufactured to an already established standard.

The net tax may come close to what the taxpayer has suggested in the way of a compromise. However, we have no compromise powers and it should be made clear to the taxpayer that the tax ultimately arrived at is not a compromise, but an application of tax to materials used in a research and development contract plus receipts from the sale of a prototype measured by costs that do not include research costs.

RHA:dse

cc: Mr. Jack D. Paulson
Mr. Clifton H. Alsop – Petition Unit