

(916) 445-3723

December 19, 1988

REDACTED TEXT

Re: REDACTED TEXT

Dear REDACTED TEXT,

This is to advise you of our position with respect to the petition for redetermination of California sales and use tax filed by you on November 23, 1988, on behalf of your client, REDACTED TEXT (hereinafter "REDACTED TEXT"), with respect to the period January 1, 1980 through December 31, 1986.

We are also in receipt of your letter of October 11, 1988, addressed to Chief Counsel James J. Delaney, and your letter of March 4, 1988, addressed to Supervising Auditor Michael G. Fontana of our New York Office. We have the letter of March 4, 1988 addressed to REDACTED TEXT, Executive Director, Finance and Business Administration, REDACTED TEXT. We have your letter to us of December 9, 1988. Finally, we have your letter of December 13, 1988.

We understand that REDACTED TEXT is a District of Columbia nonprofit corporation which is exempt from federal income tax as a charitable and educational organization under section 501(c)(3) of the Internal Revenue Code. Founded in REDACTED TEXT with federal government start-up funds, REDACTED TEXT's charitable and educational purpose is to create closed captions for television programs for the benefit of hearing-impaired viewers nationwide, and to promote further use of captioning through means such as legislative activity, development of technological advances, and assistance to the low income hearing-impaired population. The targeted beneficiaries of REDACTED TEXT services are the 21 million Americans with impaired hearing. For the hearing-impaired population, REDACTED TEXT captioning has been a major breakthrough in enriching comprehension of television programming, and of the world reflected in that programming.

REDACTED TEXT maintains captioning facilities in REDACTED TEXT, New York City; and Hollywood, California. Each facility employs a trained staff of caption editors who review programs and create appropriate captions for them. REDACTED TEXT captions programs owned by various organizations, including the major networks, independent producers, government agencies, home video companies, syndicators, and advertisers.

REDACTED TEXT captions may be created for its clients in either of two ways. The first is "real-time captioning." In this process, a "real-time captioner" enters captions into a computer simultaneously with the broadcast. These captions are sent from the computer through telephone lines to the broadcaster's studio, and immediately send over the air from the studio. This type of transmission is used for news broadcasts and other "live" programming such as

interviews and sporting events. REDACTED TEXT does not assert that real-time captioning services are subject to sales tax.

The second method is used when REDACTED TEXT receives a videotape of a client's program in advance of the program broadcast. A caption editor is assigned to the program and creates the captions, working to transform the program's sound track into language meaningful to the hearing-impaired audience.

Creation of captions is a complex process. Caption editors receive five weeks of full-time classroom training sessions followed by six months of supervised on-the-job training. At the simple technical level, caption editors are taught to communicate music or other nonverbal sounds and to "synchronize" their captions with the action onscreen. (Synchronization involves making judgments in the timing and in the placing of the captions so as not to obscure the action.) But captioning is far more than a rote transcribing of a program's soundtrack performed by following a few simple rules. A caption editor is required to use his or her language skills to address the language needs of the hearing-impaired while considering the nature of the program being captioned and preserving its substance. The hearing-impaired audience – by no means homogeneous – poses a number of special problems. Those viewers who rely heavily on American Sign Language are accustomed to a syntax and vocabulary far different from those used in standard English. Additionally, on the average, hearing-impaired viewers have more difficulty with reading comprehension than the hearing audience. REDACTED TEXT School Achievement Scores of Hearing-Impaired Children: National Data on Achievement Status and Growth Patterns, 122 American Annals of the Deaf 62-69 (1977). Finally, the captioning for each program must be refined in light of the particular needs of the program's target audience. Clearly, approaches used for children's programs, such as Sesame Street, must be different from those used for business programs aimed at technically trained professionals, such as IBM's Data Systems Division Report.

Caption editors must struggle to preserve not only the meaning but also the character, beauty, and flow of the language they are communicating. For example, slang, ethnic dialect, and Biblical language pose special challenges. Caption editors also must convey the rhythm and harmony of songs through their choice of words and placement of captions. Essentially, caption editors are translating for an audience whose first language is not English as the hearing world knows it. Their task is made more difficult by the need to significantly reduce the number of words used in order to keep the captions at a comprehensible length. It is not surprising that even an experienced caption editor must spend thirty hours to produce one hour of captioned programming.

After developing the captioning information, consisting of the captions themselves (an adaptation of the dialogue, special effects notations, etc.) as well as their placement and timing, the caption editor uses a minicomputer-based caption editing console to "write" the information onto a "caption disk."

The final task is to send the captioning information to the client. This transfer may be accomplished in several ways.

First, the captions can be integrated into a program's master tape through a process known as "encoding." The encoding process begins with the creation of an "encoding disk"

from the caption disk. The encoding disk contains the same data as the caption disk but in a format compatible with a "simple encoder."

At the client's request, REDACTED TEXT can create an encoding disk and send it to the client, or to an encoding house selected by the client, so that the captions on the encoding disk may be encoded onto the master tape of the program. The encoding disk is then disposed of, and, where the encoding is done by encoding house, the captioned master tape is sent to the client. The physical byproduct of REDACTED TEXT caption creation services, the caption disk, is retained at all times by REDACTED TEXT.

Alternatively, if the client prefers, REDACTED TEXT can transmit the information on the caption disk to the client or the client's encoding house over telephone lines. The captioning information is then used by the client to create its own encoding disk. With this method of transfer, the client never receives an encoding disk or any other tangible property from REDACTED TEXT, but simply the intangible captioning information created by REDACTED TEXT's services.

The last method of transfer is closely related to the "real-time" captioning discussed above. When a caption disk is completed but there is not enough time for the client to arrange for encoding onto the program's master tape, the captions can be sent by REDACTED TEXT to the client over the telephone lines while the program is being aired, and are broadcast together with the program.

Thus, it is readily apparent that several alternative methods are available to transfer to clients the result of REDACTED TEXT's caption creation services. The client simply chooses the most convenient method of delivery.

REDACTED TEXT clients do not caption their programs for commercial reasons. That is, the cost of captioning is greater than any financial return that may result from an increased audience. As a public service, REDACTED TEXT's clients establish captioning budgets, but these amounts are not sufficient to caption more than a fraction of all television programming. Thus, REDACTED TEXT subsidize its caption creation services, relying heavily on grants from the federal government, gifts from corporations and foundations, and charitable contributions from individuals, many of whom are faithful viewers of REDACTED TEXT captioned programming. Over the past three years, REDACTED TEXT average annual revenues from fees paid by clients for caption creation services and from charitable contributions and grants have been about \$6 million.

The principal assessment relates to the captioning activities described. However, assessments have also been made with respect to additional items captioned as "Reformatting," "Encoding - Outside," and "Non-captioning Services."

Reformatting

After a program has been captioned by REDACTED TEXT. REDACTED TEXT's client may need to edit or otherwise alter the program for a different use. For example, if the program is syndicated, it must be shortened to allow for additional advertisements to be included. Whenever a captioned program is edited, it is necessary to view the edited program and to change the content, placement, and timing of the captions as needed to match the new version of

the program. This work, referred to as "Reformatting," is performed by REDACTED TEXT's trained caption editors and is simply another form of captioning services provided by REDACTED TEXT. It is thus your position that charges related to reformatting should be treated in the same manner as charges relating to captioning activities.

Encoding – Outside

Encoding is the process of integrating REDACTED TEXT's captions with the program owner's master tape, as described above. The encoding transactions proposed to be taxed arose as follows. At its client's request, during the years at issue, REDACTED TEXT would send its captioned disk directly to the client's encoding house, rather than to the client. The client could also request that REDACTED TEXT pay the encoding house and pass the cost through to the client in one unified bill. The amounts proposed to be taxed reflect the reimbursement from the client for encoding costs paid to REDACTED TEXT. It appears that on such occasions the encoding house charged sales tax reimbursement, which REDACTED TEXT paid on behalf of the client and for which REDACTED TEXT was reimbursed by the client. You have furnished us, with your letter of December 9, 1988, a representative sample of matched invoices from both the encoding house and REDACTED TEXT documenting that the cost to REDACTED TEXT on these transactions was passed through to the client on a dollar-for-dollar basis, inclusive of California sales tax reimbursement.

You suggest that REDACTED TEXT was acting as the client's agent for the purpose of dealing with the encoding house, and you suggest that this conclusion is supported by REDACTED TEXT standard client contract. That contract provided with respect to encoding as follows:

"Encoding of Programs: It is understood by the parties that encoding services are not included in this Agreement. It is further understood that Owner will separately contract for encoding services for the Programs. REDACTED TEXT will cooperate with the encoding entity selected by Owner with respect to the encoding of any captions produced by REDACTED TEXT for Owner." (Emphasis added).

REDACTED TEXT took no markup on the cost of encoding passed through to the client, and showed encoding costs separately from captioning costs on the bill sent to the client. You suggest that REDACTED TEXT's role in the transaction was merely to act on behalf of the client, for the client's convenience, and at the client's request.

Non-captioning Services

This category contains four different items:

<u>Item</u>	<u>Income</u>
Encoding – Outside	\$29,363
Translators	10,037
Tape Dubbing	3,952

Sale of tape stock	_____ 665
	\$44,017

The “Encoding – Outside” item is identical to that described above. It was reported in this category for 1983 and broken out as a separate category thereafter.

The “Translators” item represents payment received by REDACTED TEXT from clients for translators retained by REDACTED TEXT to translate into a different language client programs to be captioned. The translators did not charge tax to REDACTED TEXT with respect to their translation activities, since language translation is a service. REDACTED TEXT did not report sales tax on charges made to clients for translation, both because the charge was apparently passed through dollar-for-dollar and because of REDACTED TEXT’s view that the translation agreements between it and its client constituted service agreements.

REDACTED TEXT concedes that charges for tape dubbing are subject to tax. In addition, REDACTED TEXT concedes that amounts received from sales of tape stock are subject to tax.

REDACTED TEXT has previously conceded that use tax was properly asserted with respect to certain equipment purchased outside California for use within California. This amount is not in dispute.

Finally, the assessment includes a 10 percent penalty under Revenue and Taxation Code section 6511 for failure to file sales and use tax returns for the years 1980 through 1984. REDACTED TEXT has sought relief from the penalty pursuant to section 6592, on the grounds that failure to file was due to reasonable cause and occurred notwithstanding the exercise of ordinary care and the absence of willful neglect.

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Captioning and Applied Grants

As you are aware, the State Board of Equalization uses its Regulation 1501, “Service Enterprises Generally,” to distinguish between transactions which are taxable as sales of tangible personal property and transactions which are nontaxable as service transactions. The regulation provides that the basic distinction in determining whether a paid transaction involves a sale of tangible personal property, or the transfer of tangible personal property incidental to the performance of a service, is one of the true object of the contract; that is, is the real object sought by the buyer the service per se, or the property produced by the service? There can be no doubt that the captioning activities performed by your client are service activities when the captioning is done on a real time basis. Likewise, where information on a caption disk is transferred to the client or the client’s encoding house over telephone lines, it is clear that there is no sale of tangible personal property. The problem of analysis arises where the product of the captioning activity is transferred to the client or the encoding house on a “caption disk” or an “encoding disk.” There is clearly a transfer of tangible personal property, but the question remains as to what the true object of the contract may be.

For many years, the State Board of Equalization focused on the medium of transfer and concluded that a transaction which would otherwise be regarded as a service transaction would

be taxed as a sale transaction if the manifestation of the service were transferred in machine-readable form, as upon a magnetic disk.

Under compulsion of the decision of the court in General Business Systems v. State Board of Equalization, 162 Cal.App.3d 50, and following an independent reconsideration of this approach judged against a standard of reasonableness and common sense, the Board has moved away from this narrow interpretation. It is now the position of the Board that a transaction which might otherwise be regarded as a service transaction will remain a service transaction, even though the results of the service activity may be reported in a machine-readable form. In part, this is merely a recognition of modern world realities. The fact that a manuscript or caption may be transferred on disk does not negate the essential character of the transaction as a service transaction. What is paid for is not putting the words or symbols on the disk, but the service of creating the words and symbols. Applying this concept to the captioning activities in question, we conclude that the captioning activities constitute the performance of a service under Regulation 1501, and that the charges in question are not taxable – notwithstanding the fact that a captioning disk or an encoding disk may be transferred to the client or to an encoding house for the benefit of the client.

Reformatting

We agree with your suggestion that the analysis applicable to captioning is equally applicable to reformatting. Reformatting is captioning anew, under different constraints, material previously captioned, and is an independent service activity not subject to tax.

Encoding – Outside

During the audit years in question, charges for encoding captions onto the client's master tape were subject to tax. It is apparent that the encoding houses regarded their charges as subject to tax, and it is apparent that all charges were passed on by REDACTED TEXT to its clients on a dollar for dollar basis. The question here is whether REDACTED TEXT was purchasing for resale and reselling to its clients, or whether REDACTED TEXT was purchasing as agent for its clients, such that the sales made by the encoding houses were the retail sales.

The invoicing is consistent with the alleged accommodation nature of the transactions and inconsistent with a subcontract analysis. If REDACTED TEXT were acting as a contractor on its own behalf, then presumably the billing to the client would have contained a markup. We note that even if REDACTED TEXT were to be regarded as a subcontractor, no additional tax would be due from REDACTED TEXT because the disks would have been sold at cost, and a tax-paid purchases resold deduction would have been available to REDACTED TEXT. See our Regulation 1701, "Tax-paid Purchases Resold." The net additional tax due would have been zero. Our recommendation will be that amounts identified as "Encoding – Outside" be deleted from the measure of tax. We note that after September 22, 1988, charges for encoding captions onto master tapes became nontaxable. See Statutes of 1988, Chapter 1157 (SB 1405).

Non-captioning Services

As indicated, charges for "Encoding – Outside" should be deleted from the measure of tax.

Charges made by REDACTED TEXT to its clients for translators would be taxable as charges for service as part of the sale of tangible personal property were REDACTED TEXT furnished encoding disks to its client, or to encoding houses, if those transactions were properly classified as sale transactions. As previously concluded, however, even though coding disks may have been transferred, the transactions were properly service transactions, and thus all charges related to the performance of the service were nontaxable. This item should be deleted from the measure of tax.

Three items thus remain subject to tax: tape dubbing (nontaxable after September 22, 1988), sales of tape stock, and use of certain equipment in this state.

As to the penalty, it will be our recommendation to the Board that relief from the penalty be granted, since REDACTED TEXT had every reason to believe that its business activities were of a service nature only.

This matter will be referred to the Board for its action at the earliest date available – probably in February 1989. You will be advised of the Board's action in due course. We would understand that you would not waive your right to an oral hearing before the Board, should the Board reject all or any part of our recommendation.

Very truly yours,

Gary J. Jugum
Assistant Chief Counsel

GJJ:sr

bc: Out-of-State District Administrator
Mr. William D. Dunn
Petition Unit (Please process this matter for action by the Board. This letter serves as the preliminary hearing recommendation in this case.)