

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Administrative Protest)
 4 Under the Sales and Use Tax Law of:)
 5 QED AUTOMATION LLC) Account Number SR DF 100-622747
 6 Taxpayer) Case ID 506559
) Fresno, Fresno County

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 8 Type of Business: Manufacturer of custom machinery

9 Audit period: 05/01/05 – 12/31/07

10 Item Disputed Amount

11 Disallowed claimed deductions \$303,934
 12 Finality penalty \$ 2,552

| | <u>Tax</u> | <u>Penalty</u> |
|--|--------------------|-------------------|
| 13 As determined and proposed to be redetermined | \$25,515.14 | |
| 14 Finality penalty | | \$2,551.51 |
| 15 Less concurred | - 1,295.10 | 00.00 |
| Balance, protested | <u>\$24,220.04</u> | <u>\$2,551.51</u> |
| 16 Proposed tax redetermination | \$25,515.14 | |
| 17 Interest through 12/31/12 | 11,521.81 | |
| Finality penalty | <u>2,551.51</u> | |
| 18 Total tax, interest, and penalty | <u>\$39,588.46</u> | |
| 19 Monthly interest beginning 01/01/13 | <u>\$ 127.58</u> | |

20 UNRESOLVED ISSUES

21 **Issue 1:** Whether the transactions in dispute qualify as nontaxable research and development
 22 contracts. We conclude that they do not qualify.

23 Taxpayer manufactured custom machinery, and performed related engineering and design
 24 consulting services, from May 2005 through June 2010. During the audit period, taxpayer entered into
 25 contracts for the design and fabrication of machines and machine alterations. The contracts included a
 26 “General Terms and Conditions” section, which included provisions covering shipping, warranty,
 27 limitation of damages, attorney fees, and taxpayer’s retention of proprietary rights. Taxpayer included
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1 the contract price in its reported total sales and claimed deductions for the total amount as either
2 nontaxable labor or nontaxable sales for resale.

3 Taxpayer provided records that were reasonably complete, and the Sales and Use Tax
4 Department (Department) examined taxpayer's claimed deductions for nontaxable sales on an actual
5 basis. The Department found that \$303,934 of the claimed amounts (\$126,315 claimed as nontaxable
6 labor and \$177,619 claimed as nontaxable sales for resale) were related to transactions in which
7 taxpayer designed and fabricated tangible personal property at the request of its customers. Taxpayer
8 regarded those transactions as nontaxable contracts for research and development, but the Department
9 determined that the tangible personal property was purchased for its intended use and not for research
10 and development. As a result, the Department regarded the transactions as taxable sales of custom
11 machinery which were not qualifying nontaxable research and development contracts, and it
12 disallowed the claimed deductions.

13 Taxpayer disputes the Department's findings and claims that the disallowed claimed deductions
14 represent qualified nontaxable research and development contracts. Taxpayer asserts that it provided
15 prototypes of machinery for the sole purpose of testing and validating new ideas, and, if the machinery
16 proved successful, a different entity was retained to manufacture the machinery.

17 Taxpayer provided no evidence that its customers purchased the machinery for any purpose
18 other than for functional use of that machinery, and the available evidence shows that is what occurred.
19 Taxpayer marketed itself as a company that could provide machinery to accomplish various tasks,
20 based on specifications provided by customers. That is, as a seller of machine. Consistent with this,
21 taxpayer demonstrated the machinery to its purchasers prior to delivery to show that the machinery met
22 the requisite specifications. Moreover, the sale contracts provided for a 12-month warranty for the
23 machinery, which is inconsistent with a contract for services related to research and development.
24 Accordingly, we conclude that taxpayer's customers sought to purchase tangible personal property for
25 use. Accordingly, we find that the transactions were not qualifying nontaxable research and
26 development contracts under California Code of Regulations, title 18, section 1501.1.

27 **Issue 2:** Whether relief of the finality penalty is warranted. We find relief is not warranted.
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1 Taxpayer has requested relief of the finality penalty that was added because it did not timely
2 pay the determination before it became final. Taxpayer asserts that the Notice of Determination was
3 mailed to an old address, after taxpayer had moved. However, taxpayer has provided no
4 documentation to show that it had moved from the “old” address before the date the Notice of
5 Determination was mailed. Further, we have reviewed the lease agreement for the location to which
6 taxpayer moved, and that agreement indicates taxpayer did not take possession of the property until
7 November 15, 2009, approximately six months after the Notice of Determination was issued on May 1,
8 2009. Accordingly, we find that relief of the finality penalty is not warranted.

9 **OTHER MATTERS**

10 None.

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12 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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