

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)
ULTIMODULE, INC.) Account Number SR GH 100-399409
Petitioner) Case ID 473612
Santa Rosa, Sonoma County

Type of Business: Sales of display systems and hardware embedded with programmable software

Audit period: 06/15/04 – 09/30/07

<u>Item</u>	<u>Disputed Amount</u>
Disallowed claimed exempt sale in interstate commerce	\$15,000
Unreported cost of items purchased ex-tax and consumed	\$56,906
Tax as determined and protested	\$5,932.25
Interest through 03/31/13	<u>3,524.56</u>
Total tax and interest	\$9,456.81
Payments	<u>- 0.14</u>
Balance Due	<u>\$9,456.67</u>
Monthly interest beginning 04/01/13	<u>\$ 29.66</u>

UNRESOLVED ISSUES

Issue 1: Whether one specific claimed exempt sale in interstate commerce was disallowed in error. We find that the claimed amount was properly disallowed.

Petitioner designed, manufactured, and sold embedded display systems and hardware embedded with programmable software from June 2004 through September 2007. Petitioner claimed all of its reported sales as nontaxable, and it reported purchases subject to use tax of \$56,966 for the audit period. For audit, petitioner provided records that were reasonably complete.

The Sales and Use Tax Department (Department) examined petitioner's claimed exempt sales in interstate commerce and questioned six transactions. Based on further review, the Department concluded that three of those sales qualified as exempt sales in interstate commerce and two were nontaxable sales for resale. Thus, the Department disallowed only one claimed exempt sale in interstate commerce, a sale for \$15,000 of three Xylon Demonstration Platforms to Xilinx, Inc. The

1 Department found that the sale of those platforms took place in California, and it disallowed the
2 amount claimed as an exempt sale in interstate commerce.

3 At the appeals conference, petitioner conceded that the sale of platforms took place in
4 California, but it contended that the sale is exempt from tax because the three platforms were
5 prototypes, products related to a Research and Development (R&D) contract with Xilinx, and the
6 platforms were incidental to petitioner's provision of nontaxable R&D services. Petitioner asserts that
7 it was required to build three demonstration units only if the prototype worked. Further, petitioner
8 states that its contract with Xilinx had three phases, and the transaction at issue was part of the first
9 phase of the contract, during which the initial prototype was to be created for informational and testing
10 purposes. On that basis, petitioner asserts that the true object of the contract was not the demonstration
11 units (prototypes) but petitioner's services to determine whether the concept worked, and thus
12 petitioner argues that its transfer of the demonstration units to Xilinx was only incidental to the R&D
13 services petitioner provided. Further, petitioner states that the contract price of \$15,000 is only
14 sufficient to cover the amount charged for a proof of concept, arguing that the end product would have
15 cost Xilinx tens of thousands more. In support, petitioner has provided a proposal dated June 25, 2004,
16 the first page of a contract dated July 14, 2004, a copy of a purchase order issued by Xilinx, and a copy
17 of a sales invoice issued to Xilinx by petitioner.

18 There is no dispute that petitioner manufactured and then transferred to Xilinx three
19 demonstration platforms for consideration of \$15,000, and that such transfer of tangible personal
20 property is subject to tax absent an applicable exemption or exclusion. Thus the initial issue is whether
21 petitioner's contract with Xilinx qualifies as an R&D contract within the meaning of California Code
22 of Regulations, title 18, section (Regulation) 1501.1, subdivision (a)(1). If so, the next issue is whether
23 any tangible personal property was transferred that was not incidental to the true object of that service
24 (R&D) contract.

25 As for the July 14, 2004 contract between petitioner and Xilinx, which is at the heart of this
26 dispute, the parties have provided a copy of only the first page, despite our requests for a copy of the
27 remainder of the contract. Unfortunately, the first page does not describe the parties' contractual
28 duties and instead states only that those duties are outlined in Exhibit A to the contract, which neither

1 party has provided. However, the other documents provided shed some light on the nature of the
2 agreement between petitioner and Xilinx. Petitioner's proposal indicates that petitioner agreed to
3 manufacture and provide a demonstration system, according to specific guidelines. The proposal also
4 included a photograph to demonstrate how the final product would look. Xilinx's purchase order has a
5 single line item for "3 Xylon Demo Platforms," and it indicates with notations on the form that the
6 purchase is subject to tax. Similarly, petitioner's invoice to Xilinx has a single line item for the
7 property sold. We do not find any indication in those documents that petitioner was to perform
8 research for Xilinx, such that petitioner was required to conduct a planned search or critical
9 investigation to discover new knowledge. Further, Xilinx stated to the Department that it had
10 purchased the demonstration systems from petitioner for use as display units at trade shows (in other
11 words, for marketing purposes). We find nothing in the available documents to support petitioner's
12 assertion that the agreement had three phases or that petitioner was contracted to develop a prototype
13 for Xilinx. In any event, whether or not the contract was to be performed in three phases, petitioner
14 has not carried its burden of proving that the \$15,000 charge at issue was for tangible personal property
15 transferred incidentally in the performance of a qualified R&D contract. We find the available
16 evidence indicates that petitioner agreed to design, develop, and manufacture three custom-made
17 demonstration platforms for Xilinx's use at trade shows, for marketing purposes. Thus, the transaction
18 was a taxable sale of tangible personal property.

19 **Issue 2:** Whether any adjustments are warranted to the unreported cost of tangible personal
20 property purchased ex-tax and consumed by petitioner. We find no adjustment is warranted.

21 The Department found that petitioner had a joint development agreement with Sitek, an
22 electronics manufacturing company located in Italy, which involved the sharing of technology, the
23 sharing of costs to develop products, and a joint effort to enter into the automotive industry market in
24 the United States to promote the use of their technologies in automobiles. The Department found that
25 petitioner and Sitek shipped numerous items back and forth and, at the end of each month, the parties
26 "netted out" what the other owed.

27 The Department found that Sitek sometimes sent items to petitioner as samples, which
28 petitioner charged to its sample expense account and did not return to Sitek. The Department found

1 that petitioner had received many out-of-state shipments on which it did not pay tax, but it was unable
2 to determine whether petitioner had used the items or shipped them back to Sitek. Accordingly, the
3 Department concluded that most of the questioned items were not subject to tax. However, it found
4 petitioner had paid \$42,271, via two bank wire transfer payments, for several of the shipments, and it
5 had recorded its expenses for those transactions to the sample expense account in its general ledger.

6 The Department also found that petitioner issued several non-financial commercial sales
7 invoices to Sitek that showed a selling price of \$0.00. The Department concluded that the majority of
8 those invoices did not represent a sale or a taxable use of tangible personal property. However, it
9 found that petitioner had shipped four items of tangible personal property to Sitek, with a total stated
10 value of \$14,635, for which Sitek had not paid any amount to petitioner. The Department concluded
11 that petitioner had withdrawn the items from inventory to give to Sitek. Further, since there was no
12 evidence that petitioner had paid tax or tax reimbursement when it acquired the items, the Department
13 concluded that petitioner's consumption of the items was subject to use tax.

14 Thus, the audit includes unreported cost of samples acquired from Sitek without payment of
15 use tax totaling \$42,271 and unreported cost of tangible personal property purchased ex tax and
16 consumed in California when the items were taken from inventory to be sent to Sitek without charge,
17 totaling \$14,635. Petitioner contends that it does not owe use tax with respect to the items it received
18 from Sitek because the items were demonstration units purchased for resale that were mistakenly
19 identified as samples by the bookkeeper. Regarding the items petitioner sent to Sitek, it contends that
20 none of the items were shipped free of charge (in other words, petitioner argues that it sold the items)
21 and that the items shipped were the transfer of prototypes for informational and testing purposes.

22 With respect to the items received from Sitek, there is no dispute that petitioner made ex tax
23 purchases from Sitek that it recorded in its sample expense account, an account used for recording
24 taxable purchases of samples. The Department found no evidence that petitioner returned the items to
25 Sitek or that petitioner sold or otherwise transferred the items to a third party. Further, we find that
26 none of the items appear to be demonstration units. Moreover, petitioner has not shown that it
27 transferred these items out of the sample expense account into retail inventory or an R&D expense
28 account.

1 With respect to the items shipped to Sitek, there is no dispute that petitioner purchased the
2 items ex-tax, that it transferred the items to Sitek, or that the measure of tax is incorrect. Instead,
3 petitioner argues that the items were prototypes transferred incidentally in accordance with an R&D
4 contract. We first note that petitioner has not provided a copy of its contract with Sitek. Further,
5 petitioner maintained the invoices in question in its non-financial commercial sales invoice file, which
6 consisted of invoices for items petitioner shipped to companies free of charge, and there is no evidence
7 that Sitek submitted a purchase order for the items or paid petitioner any amount for them. Thus, we
8 find, based on petitioner's records, that petitioner made a gift of the items to Sitek and thus owes use
9 tax measured by its purchase price of the items. We further find that the declared value on the
10 shipping documents is the best available evidence of the measure of tax, and petitioner does not argue
11 otherwise.

12 Thus, we find that no adjustment is warranted to the unreported cost of tangible personal
13 property received from Sitek and recorded as samples or to the unreported cost of items purchased
14 extax and provided to Sitek without charge.

15 **OTHER MATTERS**

16 None.

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