

## 1 CALIFORNIA STATE BOARD OF EQUALIZATION

## 2 APPEALS DIVISION BOARD HEARING SUMMARY

3 In the Matter of the Petition for Redetermination )  
 4 Under the Sales and Use Tax Law of: )  
 5 ZOBA INTERNATIONAL CORP., ) Account Number: SR EH 97-245160  
 dba CD Digital ) Case ID 434591  
 6 Petitioner )  
 7 Rancho Cucamonga, San Bernardino County

8 Type of Business: CD/DVD manufacturer and wholesaler

9 Audit period: 10/01/03 - 09/30/06

10 <u>Item</u>	<u>Disputed Measure</u>
11 Partial exemption per RTC section 6378	\$870,000
Credit for partial exemption per RTC 6378	\$ 94,887
12 Arbitration adjustment	\$ 11,248
13 Unreported supply purchases	\$ 11,291
Tax as determined	\$80,265.31
14 Post-D&R adjustment	<u>-16,417.96</u>
15 Proposed redetermination	\$63,847.35
Less concurred	<u>-19,472.19</u>
16 Balance, protested	<u>\$44,375.16</u>
17 Proposed tax redetermination	\$63,847.35
Interest through 04/30/12	<u>28,993.67</u>
18 Total tax and interest	\$92,841.02
Payments	<u>- 27,611.79</u>
19 Balance Due	<u>\$65,229.23</u>
20 Monthly interest beginning 05/01/12	<u>\$ 211.37</u>

21 This matter was scheduled for Board hearing on October 27, 2011, but was postponed because the  
 22 afternoon session of that meeting was cancelled. It was then scheduled for hearing on January 31,  
 23 2012, but was rescheduled by the Board Proceedings Division.

24 **UNRESOLVED ISSUES**

25 **Issue 1:** Whether three of petitioner's purchases qualify for the partial exemption for  
 26 teleproduction or other postproduction services pursuant to Revenue and Taxation Code section 6378  
 27 We find that the partial exemption is inapplicable.

1 As relevant to this issue, which includes the first two items listed above, petitioner made three  
2 purchases of equipment. With respect to two of the purchases, from M2 America Corp. and Hanky &  
3 Partners, totaling \$870,000, petitioner paid tax at the rate of 2.75 percent based on its belief that the  
4 purchases qualified for the partial exemption under section 6378. With respect to the third purchase,  
5 from Dometek, Inc. for \$94,887, petitioner paid tax at the full rate. The Sales and Use Tax Department  
6 (Department) asserts tax at the full rate on the first two purchases, less a credit for the partial tax paid  
7 (since tax was paid in full on the purchase from Dometek, that measure has been removed from the  
8 deficiency). Petitioner does not dispute that the purchases are taxable, but contends that each qualifies  
9 for the section 6378 partial exemption, so that it does not owe any further tax with respect to the two  
10 purchases totaling \$870,000, and claims it is entitled to a credit for the tax of 5 percent it paid above  
11 the 2.75 percent tax rate it contends was applicable to its purchase of \$94,887 from Dometek.

12 Petitioner manufactures compact discs and digital video discs. It mass produced the subject  
13 recorded discs from master recordings its customers supplied, using optical disc glass master stampers.  
14 Petitioner sometimes added security information to protect against unauthorized copying or a separate  
15 computer program to help play the disc. The master recording remained unchanged in this process.

16 Petitioner asserts it used the subject equipment to alter or add to the master recordings by  
17 adding security protections and a program that makes the CD or DVD run automatically after it is  
18 inserted. The partial exemption provided by section 6378 applies to the sale and use of tangible  
19 personal property purchased for use by a qualified person to be used primarily in “teleproduction or  
20 other postproduction services,” which is defined to mean services for film, video or digital multimedia  
21 formats (audio or visual) that include editing, film and video transfers, transcoding, dubbing, subtitling,  
22 credits, closed captioning, audio production, special effects (visual or sound), graphics, or animation.  
23 (Rev. & Tax. Code, § 6378, subd. (c)(3); Cal. Code Regs., tit. 18, § 1532, subd. (c)(4).) A qualified  
24 person for these purposes is one who is primarily engaged in teleproduction or other postproduction  
25 activities that are described in Code 512191 of the North American Industry Classification System  
26 (NAICS) Manual published by the United States Office of Management and Budget, 1997 edition.  
27 (Rev. & Tax. Code, § 6378, subd. (c)(2).) That provision of the NAICS describes such businesses as  
28 “establishments primarily engaged in providing specialized motion picture or video postproduction

1 services, such as editing, film/tape transfers, subtitling, credits, closed captioning, and animation and  
2 special effects.” The Board lists petitioner’s NAICS code as 424300, and the NAICS has additional  
3 codes (334612 and 3346130) that may also be applicable to petitioner’s CD/DVD manufacturing and  
4 duplication business. Not only is NAICS Code 512191 not included in the codes applicable or  
5 possibly applicable to petitioner’s business, but also the nature of petitioner’s business does not come  
6 within the description of NAICS Code 512191: when petitioner copies its clients’ content to discs, it  
7 does not change the content of its clients’ recordings nor does it edit or add to the substance (i.e.,  
8 subtitling, credits, closed captioning, or animation and special effects). We therefore find that the  
9 partial exemption is inapplicable.

10 **Issue 2:** Whether an adjustment is warranted for an arbitration allowance awarded to  
11 petitioner. We find that no adjustment is warranted.

12 With respect to its purchase of \$94,887 from Dometek, arbitration of a dispute resulted in an  
13 award to petitioner of \$11,248, and it seeks a credit for the tax it paid on this portion of its purchase  
14 price. This award was essentially damages from litigation. There is no adjustment to the taxable  
15 purchase price for such awards. (See, e.g., *Southern California Edison Co. v. State Bd. of Equalization*  
16 (1972) 7 Cal.3d 652, 655 (damages obtained through litigation do not readjust the initial sales or use  
17 tax liability).) Accordingly, we find no credit is warranted.

18 **Issue 3:** Whether further reductions are warranted to the measure of unreported ex-tax  
19 purchases of consumable supplies. We find no further adjustments are warranted.

20 The Department examined petitioner’s paid bills for 2004 and 2005 and developed a ratio of  
21 error for each year applying the 2004 ratio to the fourth quarter 2003 and the 2005 ratio to the first  
22 three quarters of 2006. Petitioner contends that the stampers and related manufacturing aids  
23 (developer and pellets) were resold with the discs. Further, petitioner contends that the stampers were  
24 “special printing aids” and were therefore resold, pursuant to California Code of Regulations, title 18,  
25 section 1541, subdivision (b)(2)(c).

26 A manufacturer may purchase manufacturing aids such as tooling for resale only if title to that  
27 tooling will pass to the manufacturer’s customer prior to any physical use of the tooling by the  
28 manufacturer. If title does not pass prior to use, the sale of the tooling to, or the use of the tooling by,

1 the manufacturer is taxable even if the tooling is thereafter delivered to the manufacturer's customer.  
2 Here, petitioner has provided no evidence that title to the stampers passed to its customer prior to use  
3 in manufacturing, or that the developer and pellets were incorporated into the discs it manufactured  
4 and sold. As to petitioner's contention that the stampers are special printing aids, we find that that they  
5 do not qualify because special printing aids must be used in the process of creating printed matter,  
6 which is not the case here. Therefore, we find that petitioner's purchase of the stampers, developer,  
7 and pellets are subject to tax and no further adjustments are warranted.

8 **OTHER MATTERS**

9 None.

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