

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION FINAL ACTION 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 09/30/12	<u>29,959.95</u>
18 Total tax and interest	\$93,807.30
Payments	<u>- 27,611.79</u>
19 Balance Due	<u>\$66,195.51</u>
20 Monthly interest beginning 10/01/12	<u>\$ 181.18</u>

21 The Board held a hearing regarding this matter on April 26, 2012, granting petitioners 30 days
 22 to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond.
 23 Based on petitioner's submissions and the Department's response, we do not recommend adjustments,
 24 as discussed below under Post Hearing Developments.

25 **UNRESOLVED ISSUES**

26 **Issue 1:** Whether three of petitioner's purchases qualify for the partial exemption for
 27 teleproduction or other postproduction services pursuant to Revenue and Taxation Code section 6378
 28 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 Department asserts tax at the
6 full rate on the first two purchases, less a credit for the partial tax paid (since tax was paid in full on the
7 purchase from Dometek, that measure has been removed from the deficiency). Petitioner does not
8 dispute that the purchases are taxable, but contends that each qualifies for the section 6378 partial
9 exemption, so that it does not owe any further tax with respect to the two purchases totaling \$870,000,
10 and claims it is entitled to a credit for the tax of 5 percent it paid above the 2.75 percent tax rate it
11 contends was applicable to its purchase of \$94,887 from Dometek.

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

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

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

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

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

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

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

27 A manufacturer may purchase manufacturing aids such as tooling for resale only if title to that
28 tooling will pass to the manufacturer’s customer prior to any physical use of the tooling by the

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

9 POST HEARING DEVELOPMENTS

10 After the Board hearing, to support its contention that title to the stampers transferred to
11 petitioner's customers prior to use in production, petitioner provided copies of four quotes, four sales
12 invoices (one of which was a duplicate), and an example of its terms and conditions of sale. The
13 quotes and invoices do not include a separate charge for the stampers but do include an entry
14 indicating that the price of the stamper is included in the selling price per CD or DVD. With respect to
15 the terms and conditions of sale, petitioner refers to paragraph 7 of the agreement, which provides that,
16 after petitioner has stored customer's duplication material, packaging material, and labeling material
17 for a maximum of six months, petitioner may return, store, or destroy those materials. Petitioner
18 asserts that this paragraph is evidence the stampers belong to its customers, rather than petitioner. The
19 Department has concluded that the evidence is insufficient to support any adjustments.

20 The selling price of stampers is not separately stated on the quotes or sales invoices. Paragraph
21 7 of the terms and conditions is not relevant because it does not address the passage of title to the
22 stampers, nor is there any other clause that provides that title to the stampers passed to the purchaser
23 prior to petitioner's physical use of the stampers. Thus, the evidence does not show that the stampers
24 were sold to petitioner's customers before petitioner used them. We find that petitioner owes tax on
25 the cost of the stampers and that no further adjustment is warranted.

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