STATE OF CALIFORNIA

BOARD OF EQUALIZATION

120.1165

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
G--- CORPORATION	)	No. S- -- XX XXXXXX-010
Petitioner	)	

The preliminary hearing on the above taxpayer's petition for redetermination was held on October 29, 1986, in Fresno, California.

Hearing Officer — James E. Mahler

Appearing for Petitioner:

D--- M. A---
Attorney at Law

A--- E---
Attorney at Law

B--- L---
Vice President – Finance

S--- P---
Senior Accountant

T--- R---
Finance Supervisor

Appearing for the Board:

Edward Shortland
Supervising Auditor

Orton Bergeland
Tax Auditor

Protested Item

The protested tax liability for the period October 1, 1977, through June 30, 1983, is measured by:

	Item	State, Local and County
A.	Paper report copies ($4,148,515 less reaudit adjustment)	$ 459,995

B.	Microfische report copies	$3,040,318
C.	Index and collection cards	40,502
		$3,540,815

Taxpayer's Contentions

Audit Item A. The distinction between carbon copies and other types of copies is arbitrary and capricious. If tax applies, the audit measure of tax is overstated.

Audit Item B. Tax does not apply to the original (master) microfiche copy of the reports.

Audit Item C. Tax does not apply to the cards and labels.

Summary

Petitioner is a corporation engaged in the data processing business, primarily for financial institutions. During the audit period, it performed a number of financial and record-keeping services, including maintenance of records regarding bank deposits, loans and automatic teller transactions. The audit found that petitioner performed "processing of customer-furnished information" as that term is defined in subdivision (d)(5) of Sales and Use Tax Regulation 1502.

Petitioner received information from its customers on a daily basis and processed it overnight. The results were transferred to the customer on the next business day in the form of human-readable reports. At the customer's option, the reports were recorded on paper, on microfische, or on some combination of the two. Petitioner charged its customers a monthly fee for the data processing and the reports.

Audit Item A. When the customers elected to receive the reports on paper, petitioner provided up to five copies of each report without further charge (hereinafter referred to as the "original copies"). If the customer ordered additional copies, the extras were billed at a rate of $7 each. We understand that petitioner used a laser printer to make all copies and that none of the copies were carbon copies.

For each transaction, the auditor found that one of the five original copies was transferred to the customer incidentally to the data processing services and was therefore not "sold" for sales and use tax purposes. The auditor also found, however, that the other four original copies ere sold to the customers and were subject to tax. Extra copies were also regarded as sold but are not involved in the petition.

The auditor's decision was based on subdivision (d)(5)(B) of Regulation 1502, which provides:

> "When additional copies of records, reports, tabulation, etc., are provided, tax applies to the charges made for the additional copies. 'Additional copies' are all copies in excess of those produced on multi-part carbon paper simultaneously with the production of the original and on the same printer, whether the copies are prepared by rerunning the same program, by using multiple simultaneous printers, by looping a program such that the program is run continuously, by using different programs to produce the same output product, or by other means. Where additional copies are prepared, the tax will be measured by the charge made by the service bureau to the customer. If no separate charge is made for the additional copies, tax applies to that portion of the gross receipts, which the cost of the additional computer time (if any), the cost of materials and labor cost to produce the additional copies bear to the total job cost. Charges for copies produced by means of photocopying, multi-lithing, or by other means are subject to tax."

Petitioner contends that the distinction between carbon copies and other types of copies is arbitrary and capricious in light of advances in the technology of high-speed printers. According to petitioner, multi-part form printing is slower, less efficient and more expensive than the high-speed laser printer which petitioner uses, and also produces a poorer quality copy.

With regard to the measure of tax, the auditor initially concluded that the four original copies upon which tax was asserted were sold for $7 each, since that was the price quoted for extra copies. Petitioner objected on the ground that the quoted price applied only to extra copies, not to any original copies, and the auditor ultimately agreed. A reaudit was initiated to calculate the selling price of the original copies by means of a cost ration, specifically, the costs of labor, equipment and materials devoted to making the extra copies divided by the total cost of the job. Petitioner agrees with this approach, but disagrees with the auditor's calculation of labor costs in two respects.

First, a large number or petitioner's employees spend some part of their time working on the original copies. The auditor estimated a "personnel equivalent"; that is, the number of employees which would have been required if they devoted all their time to making original copies. The estimate was 10.1, composed of four computer operators, six people in shipping and receiving, and .1 operations analyst. The auditor explained his estimate on Schedule R12A-1k as follows:

> "The printing of reports is an important part of their overall department, particularly during the nightshift when the printers automatically run full time. Printing is done seven days a week. Their department primarily handles paper coming in, being printed, and distributed in form of printed copies. [4] This is a nominal estimate of time involved in programming the computers for changes in number of copies going to clients, etc., as scheduled in the Report Distribution Files and other reports."

In response, petitioner has submitted an affidavit from its Vice President of Operations, Mr. W--- W---. Contrary to the auditor, Mr. W--- states that the priority assigned to producing paper reports is "very low" for most employees. He analyzes the employees' functions in detail, and based on his experience as a supervisor for nine years, estimates that the maximum personnel equivalent should be 3.17.

Second, petitioner contends that shipping and receiving personnel should be excluded from the calculation. Petitioner points out that the formula specified in the regulation includes "labor cost to produce the additional copies…" and argues that shipping and receiving labor is a distribution cost and not a production cost. Excluding shipping and receiving personnel from the calculation would reduce the personnel equivalent to 4.1 (using the auditor's figures) or 1.52 (using petitioner's figures).

Audit Item B. When the customer elected to receive the reports on microfische rather than paper, petitioner produced an original or "master" microfische copy of the report. Petitioner retained possession of the master for a period of 3 to 12 months, and used it to produce duplicate microfische copies of the report as needed by the customer. Petitioner transferred possession of the master to the customer at the end of the retention period.

Petitioner charged its customers a separately stated fee for the master and each duplicate copy. The charge for the master ranged from $3 to $4 during the audit period, and the charge for the duplicate copies ranged from 15¢ to 25¢ each. The masters were more expensive because they were made from a higher quality, more durable material which would withstand repeated reproduction use.

The auditor found that the transfer of the first duplicate copy of each report was incidental to the data processing services and therefore not subject to tax. The auditor further found that the master and all other duplicates were sold and tax was asserted . The rationale for taxing the master is that the master was used by petitioner as a printing aid prior to transfer to the customer.

Petitioner contends that the master was incidental to the data processing services and that tax should only apply to the duplicate copies. Petitioner argues that the master was the original report produced in conjunction with the data processing services.

Audit Item C. In addition to the paper or microfische reports, petitioner sometimes transferred other types of tangible personal property to its customers. The audit asserted tax on transfers of real estate loan collection cards, perforated index cards and gummed labels upon which petitioner had printed information.

The loan collection cards were imprinted with information received directly from the customers, such as the debtor's name and address, the principal amount and interest rate, and the periodic payment amount. The cards also included data which petitioner had calculated by processing the customer-furnished information. For example, the cards showed delinquent amounts which petitioner had computed from customer-furnished payment histories.

The index cards were imprinted with summaries or extracts of the information in the paper and microfische reports. For example, some customers wished cards to identify depositors whose accounts were no longer active. Petitioner searched its files to obtain the desired information, extracted it, and printed the information on the cards.

The gummed labels were imprinted with unassigned account numbers which petitioner generated by computer. When depositors or borrowers opened a new account with petitioner's customer, the customer could assign an account number by pasting the label to a savings passbook or other account documentation. According to petitioner, some calculation was required to generate these account numbers.

The audit concluded that the transfers of the cards and labels from petitioner to its customers were taxable sales, not incidental to the data processing services, because the customers desired the tangible personal property for physical use. The auditor relied on subdivision (d)(5)(A) of Regulation 1502, which provides that tax applies to charges for "inventory control cards for use by the customer, membership cards for distribution by the customer, labels (other than address labels), or similar items for use…."

Petitioner contends that physical use by the customer is not the proper test for taxation. Petitioner points out that exempt data processing services are described in the fourth full paragraph of subdivision (d)(5) of the regulation to include cases where the processed information is recorded on "payroll check forms or cards or W-2 forms or tax returns", even though those items are presumably intended for physical use.

Petitioner submits that taxation should depend on the nature of the information printed on the cards and labels. If the computer merely prints out information stored in memory (such as names and addresses on membership cards), petitioner agrees that tax applies. But if the computer has calculated, selected or otherwise manipulated information (such as payroll figures for paychecks), then the tax should not apply. Petitioner further contends that the loan collection cards, index cards and labels in this case all required calculation or manipulation of information.

Analysis and Conclusions

Audit Item A. Petitioner contends that the distinction between carbon copies and other types of copies is arbitrary and capricious. We disagree.

Carbons are produced simultaneously with the initial recording of the processed information. To the extent that the initial recording may be deemed incidental to the processing services, the production of the carbons may also be considered incidental. Other types of copies are produced subsequent to and independently of the initial recording of information and the Board therefore does not regard such copies as incidental to the processing services. Since the distinction between types of copies has a rational basis, it is neither arbitrary nor capricious.

Regarding the measure of tax, both petitioner and the auditor rely on estimates of the personnel equivalent. Neither party has conducted a test or survey of employees to determine the number of man-hours actually needed to produce the copies. However, petitioner's estimate was made by a supervisor with a number of years' experience on the job. Lacking evidence to contradict his estimate, we believe it should be accepted for purposes of this audit period.

Finally, since we are trying to determine the selling price of the copies, it would appear logical to include shipping personnel in the calculation. Selling prices must normally cover all costs, not only of producing, but also of distributing the property sold. Nevertheless, the regulation expressly states that the calculation should include "labor costs of producing the additional copies", with no mention of distribution costs. Faced with this language, we agree with petitioner that shipping and receiving personnel should be deleted from the computation.

Accordingly, we recommend a reaudit to recalculate the measure of tax using 1.52 as the personnel equivalent.

Audit Item B. Although the master microfische is intended for physical use and is in fact physically used, the true object of these contracts is still data processing services. Accordingly, the preparation and transfer of the initial report to the customer is not a taxable sale. Since the master microfische is the initial copy of the report called for in the data processing contract, we agree with petitioner that tax does not apply to the charge for the master. The reaudit should delete these charges from the measure of tax and assert tax on all charges for duplicate copies.

Audit Item C. Under subdivision (d)(5) of Regulation 1502, if data processing services are the true object of the contract, tax does not apply even if tangible personal property is incidentally transferred to the customer. This is true even if the property, such as payroll checks or W-2 forms, is intended for physical use by the customer. On the other hand, tax does apply when the true object is the tangible personal property, even if some calculation or manipulation of data is required to produce the property.

Petitioner receives information from its customers, processes or otherwise manipulates it, and records the information on loan collection cards and perforated index cards. Although these cards are undoubtedly intended for physical use by the customer, we conclude that the true object of such transactions is the data processing services and that tax accordingly does not apply. The reaudit should delete charges for loan collection and perforated index cards from the measure of tax.

We reach a different conclusion with respect to the gummed labels, however. Petitioner itself generates the unassigned account numbers, records them on the labels, and transfers the labels to the customer for physical use. Since no processing of customer-furnished information occurs, we conclude that the true object is the labels themselves and that tax therefore applies.

Audit Items E, F, G and H. These audit items allowed various credits for tax-paid purchases resold. To the extent we have concluded petitioner is a consumer and not a seller of various reports, the credits would not be allowable. The reaudit should make any necessary adjustments.

Other Issues. Petitioner raised various other points in its Petition for Redetermination. These other points were not discussed at the preliminary hearing or in subsequent correspondence, and we assume they are no longer at issue.

Recommendation

A reaudit is recommended to: (1) use a personnel equivalent of 1.52 in calculating the selling price of additional paper copies; (2) delete charges for master microfische copies from the measure of tax and assert tax on all charges for duplicate microfische copies; (3) delete charges for loan collection and perforated index cards from the measure of tax; and (4) make any necessary adjustments to the tax-paid purchases resold allowances. Necessary adjustments are to be initiated by _____.

_____ 6/26/87

James E. Mahler, Hearing Officer Date