

M e m o r a n d u m**515.0225**

To: Mr. Mark Noack
San Jose Auditing

Date: April 25, 1988

From: David H. Levine
Tax Counsel

Subject: O---, Inc.

SR -- XX-XXXXXX

This is in response to your memorandum dated March 23, 1988 regarding reverse engineering.

O--- will be provided an instrument by one of their customers. O--- will disassemble the instrument and evaluate it, and will then prepare drawings on velum, which are needed by the customer to design printed circuit boards and for assembly. O--- also prepares a listing of parts and materials and assembly instructions for the instrument. The drawings, parts listings, and instructions are transferred to the customer, and O--- makes a charge designated as for reverse engineering.

The customer then examines the reverse engineering package and decides whether to begin mass production of the instrument. If it decides to proceed, the customer may have O--- or another manufacturer begin that production. O--- claims that the contracts for reverse engineering and mass production are separate, and one is not dependent upon the other.

You ask whether the reverse engineering charges are subject to sales tax when O--- does not do any further manufacturing of the instruments and when O--- does manufacture the instruments.

This is a question of the true object of the contract as discussed in Regulation 1501 and in Albers v. State Board of Equalization (1965) 237 C.A.2d 494. If the true object of the contract is for O--- to provide services requiring actual engineering expertise to transfer only information, we would regard O--- as rendering a service to its customer. On the other hand, if the true object of the contract was for the customer to acquire a drawing which would be used in the actual production of the instruments, we would regard O--- as selling that drawing, with its services being part of that taxable sale.

We assume that the drawings on velum are transferred to the customer for the purpose of conveying information and that those drawings are not used in the manufacturing of the instruments. We also assume that the assembly instructions are based on engineering expertise and are important aspects of the contract. These assumptions lead to the conclusion that O---'s reverse engineering is nontaxable service. When O--- also mass produces the instruments, the reverse engineering would still be regarded as nontaxable service provided that there was no contract between the parties to produce the instruments before completion of the reverse engineering. If there were such a contractual obligation, we would generally regard the reverse engineering as a service part of the sale of the instruments.

If you have further questions, feel free to contact us again.

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