STATE OF CALIFORNIA

190.0522

BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	DECISION AND RECOMMENDATION
C--- F-- INC.	) No.	SR -- XX-XXXXXX-010
Petitioner	)	

The Appeals conference in the above-referenced matter was held by John Frankot, Staff Counsel on May 27, 1993 in Van Nuys, California.

Appearing for Petitioner: T--- E. S---, Esq.

A--- G. D---, CPA

A--- W---
President

F--- L. G---
Secretary/Treasurer

Appearing for the
Sales and Use Tax Department: Ira Anderson, CPA
Supervising Tax Auditor

Stephen C. Lau, CPA, CFE
Supervising Tax Auditor

Protested Item

The protested tax liability for the period July 1, 1988 through March 31, 1991 is measured by:

Item	State, Local and County
Understatement of reported extax purchases of materials per accountability tests for the audit period	$732,277

Petitioner's Contentions

1. Petitioner reported tax based on instructions received from Board employees at the Van Nuys District Office. Since these instructions led to the understatement of reported taxable measure, petitioner should not be held responsible for the liability recommended in the audit.

2. Petitioner does not use all the materials that it purchases in connection with particular sales or contracts. An appreciable part of the materials purchased by petitioner are consumed in the overhead process, as a necessary cost of being open for business in this specialty line which requires make-goods, field corrective work, and call backs for which petitioner and others in this trade are not expected to charge. Petitioner contends that an allowance should be made in the audit calculations for these materials.

3. Petitioner has diligently attempted to follow correct tax reporting procedures, based on advice received from the Board, and has relied in good faith upon the professional advice of a CPA for all sales tax return preparation and filing matters. In these circumstances, it is inequitable to impose the audit assessment upon petitioner, all at one time.

4. Prior to the Appeals conference, petitioner submitted additional information in support of its contentions that certain transactions or classes of transactions should not be assessed tax (see Exhibit A).

Summary

Petitioner is engaged in making sales and installations of fireplaces. Petitioner performs construction contracts on a lump sum basis, and makes over the counter sales. All purchases of fireplaces and related items are made for resale.

The Sales and Use Tax Department (Department) conducted an audit of petitioner's records for the period April 1, 1988 through March 31, 1991 (because of an error, the statute of limitations for the second quarter of 1988 has expired and it will not be included in the final determination). During the course of this audit, the auditor performed a materials accountability test covering all purchases and periods in the audit. In essence, the auditor started by taking beginning inventory, adding in purchases, and deducting ending inventories, to arrive at costs to be accounted for for each fiscal year (April 1 through March 31) under audit. From costs to be accounted for, the auditor deducted (after allowing for mark up) the cost of over-the-counter sales, thereby arriving at total costs to be accounted for on construction contracts. From this, the auditor deducted reported taxable measure to arrive at the indicated understatement of taxable contract material costs.

According to the Declaration of F--- L. G---, petitioner's Secretary/Treasurer, petitioner had been reporting tax based on total sales, less installation labor, to arrive at taxable measure.

Ms. G--- asserts in her declaration that this was the method advised by the State Board of Equalization. Petitioner has no written advice from the Board on the subject. Rather, the petitioner asserts that this advice was received by telephone and by a visit to the Board's Van Nuys office. Petitioner emphasizes that it was never made aware that advice could be obtained in writing. According to Ms. G---, the only items received from the Van Nuys Board office were a tax chart and general information, despite many calls and visits. This resulted in confusion.

At the Appeals conference, Ms. G--- stated that based on the Board's advice she decided to keep track of the materials used on each job, what was paid for them, and to report that amount.

The Department submitted a copy of petitioner's original application (see Exhibit B). On the application, in Block 20, "Forms Furnished Taxpayer", a list of documents furnished to petitioner at the time of registration shows that petitioner was not provided with Sales and Use Tax Regulation 1521[1], "Construction Contractors". Mr. D--- feels that the Board should have been on notice from petitioner's type of business (listed in Block 15 of the application) that petitioner was a construction contractor (a check of Board records indicates that petitioner was originally assigned Business Code 30, "Household and Home Furnishing Stores"; this was corrected to Code 82, "Construction Contractors and Manufacturers and Wholesalers of Lumber and Building Material", in June of 1991).

In connection with petitioner's argument that proper allowances have not been made for overhead and other losses of materials, petitioner argues that allowances should be made for excess inventory items that were given or thrown away, and for materials consumed in "overhead" processes as customization, corrections of problems, or exchanges of defective products. Petitioner argues that these materials should be exempt under Regulation 1521(b)(2)(A)(1) if they are not furnished and installed on any particular job. Overhead materials, supplies, warranty items, and modification jobs should be excluded from taxable materials according to petitioner because they are held in the ordinary course of business and are needed just to stay in business.

The Department responds that petitioner is a consumer of all materials and supplies used in performing construction contracts, including materials used in "overhead processes", repairs, warranty items, and modifications. The Department states that purchases of materials used in performing construction contracts are presumed taxable unless petitioner can prove that they were resold. The Department's position is that the measure of tax is cost, regardless of whether the items used are considered materials or fixtures. The Department notes that for reporting purposes petitioner tracked only materials committed to particular jobs, and that it was the

1All further references to Regulations are to Sales and Use Tax Regulations.

excess materials not accounted for that resulted in the audit assessment. According to the Department, if petitioner had tracked all materials used to perform construction contracts, including those used for warranty, repair, modification, and other purposes, then petitioner would not have suffered such a large assessment.

Petitioner argues that it relied on professional advice and made every good faith effort possible to communicate with the Board to determine the correct way to report its tax liability. If hit with such a large assessment at one time petitioner could be shut down, resulting in more unemployment. Petitioner feels that an installment payment proposal would be an appropriate resolution if tax is ultimately found to be due. Petitioner believes that everything was done correctly, and that there was no effort to misstate petitioner's tax liability.

The Department responds that it is ultimately petitioner's responsibility to assure that tax is being reported correctly. There is no written request for advice or written advice on file showing that the petitioner asked a specific question or questions and received a specific answer or answers. Under these conditions it is impossible to know precisely what the substance of the communications between petitioner and the Board were.

Petitioner submitted additional documentation shortly before the Appeals conference (see Exhibit A). This documentation was discussed in detail at the Appeals conference. These documents and the contentions therein will be discussed individually in the Analysis and Conclusions portion of this Decision and Recommendation.

The Petition Unit staff noted that an error had been made in preparing the audit report at the district office. Because of that, the Notice of Determination listed an incorrect audit period of 7/1/88 to 3/31/91. The audit period should have been listed as 4/1/88 to 3/31/91. As a result of the error, the second quarter of 1988 was allowed to expire under the applicable statute of limitations. Since the Notice of Determination as issued did not cover that period, and since the waiver of limitations procured by the auditor covering the second quarter of 1988 expired on January 31, 1992, before issuance of the Notice of Determination, that period cannot now be assessed tax (according to the Petition Unit). This results in a reduction of the taxable measure of $66,567.00. The total tax billed in the Notice of Determination includes the amount that has outlawed.

Analysis and Conclusions

1. Petitioner contends that taxes were reported based on instructions received from Board employees at the Van Nuys District Office. Since these instructions led to the understatement of reported taxable measure, petitioner should not be held responsible for the liability recommended in the audit.

Revenue and Taxation Code Section 6596[2] provides for relief from tax, penalty and interest under certain circumstances. However, some of the explicit prerequisites for obtaining relief under that statute are that the taxpayer has made a specific written request for advice from the Board, and that the Board has responded with a specific written answer. In this case, neither of those prerequisites have been fulfilled. Therefore, there is no possibility for obtaining relief under Section 6596.

The reasoning behind Section 6596 in requiring specific written communications between taxpayers and the Board is that without such documentation it is impossible to determine, after- the-fact, precisely what questions were asked and what answers were given. We recognize and are sympathetic to petitioner's concerns. However, this statute is very specific and it leaves little or no leeway for us to allow relief.

Accordingly, I cannot recommend any adjustment on this basis.

2. Petitioner contends that materials are not all used in connection with any particular sale or contract, and hence petitioner is not required to incur tax without an allowance for this fact. Petitioner contends that an appreciable part of the materials purchased are consumed in the overhead process, and are a necessary cost of being open for business in this specialty line. Allowances should be made for custom modifications, corrective work, and call backs for which petitioner and others in this trade are not expected to charge.

Regulation 1521(b)(2)(A)(1) provides that petitioner is the consumer of materials furnished and installed in connection with the performance of construction contracts. This would include all materials used to perform and make repairs and modifications on construction contracts. It would presumably not include, however, items such as defective merchandise returned to suppliers for which credit is given and deducted from materials purchases.

Here again, we are sympathetic to petitioner's position, however, the law and regulations are specific and require that all materials consumed in performing construction contracts have tax reported at cost.

Accordingly, I cannot recommend an adjustment on this basis.

3. Petitioner contends that it has diligently sought out and attempted to follow the correct California sales tax reporting procedures. In addition, petitioner has relied in good faith upon professional advice from a CPA for all tax return preparation and filing matters. Under these conditions, it would be inequitable to impose a large audit adjustment upon petitioner.

[2]All further code references are to the Revenue and Taxation Code.

Here again, we are not unsympathetic to petitioner's concerns, the problems petitioner encountered in dealing with the Board's Van Nuys office, and the difficulties petitioner experienced dealing with tax reporting requirements. Many taxpayers hire professionals to handle their tax matters. Although all of petitioner's actions in this regard demonstrate good faith and reasonable attempts to comply with the law, it is inevitable that in some cases errors will occur, and this case is one of them.

Petitioner bears the ultimate responsibility for any taxes due as a result of its operations. We note that a penalty has not been added to the determination, which indicates that the Department recognized the fact that petitioner acted with due care and in good faith.

While I am unable to recommend an adjustment on this basis, I will recommend that the Department negotiate a reasonable payment plan with petitioner.

4. Prior to the Appeals conference, petitioner submitted additional information in support of its contentions that certain transactions or classes of transactions should not be assessed tax (see Exhibit A).

I will individually discuss each of the matters submitted by petitioner below.

(a) Items Listed as Materials Purchases 7/1/88 - 3/31/91

(1) Refunds for Returned Materials ... $16,201.24

According to petitioner, these were over the counter sales that were canceled, and refund payments to customers were misrecorded in the materials purchases account. Petitioner uses a physical inventory system.

At the Appeals conference, the Department indicated that there was not enough information upon which to make a determination as to whether these items should be eliminated from materials purchases.

Accordingly, I recommend that the Department investigate this matter and determine if all or part of the amount listed should be deducted from materials purchases.

(2) Supplies Needed to Complete Installations ... $12,500.05

According to petitioner, this amount represents supplies purchased to complete installations. Many of the amounts were checks written as reimbursements to employees who purchased supplies from local hardware stores. Examples are pipe fittings, spray paint, leg bolts and anchors, caulking, attaching hardware and strapping tape. In many or all of these cases, tax

was paid to the vendor. Petitioner believes that the auditor did not allow credit for all or many of these items.

The Department contends that the auditor's material accountability calculations allowed for tax paid supplies. The auditor states that he knew about these purchases and allowed credit for them in the audit. According to the auditor, a $52,000 credit was allowed for tax paid supplies in his calculations.

Under these circumstances, I recommend that the Department investigate petitioner's concerns and determine if any additional credits need to be allowed for tax paid supplies. If additional credits are not allowed, the Department should explain fully.

(3) Items Listed Under Materials Purchases In Error ... $11,086.40

According to petitioner, these amounts represent loan payments to a bank on trucks, and payments to the post office for a stamp machine. Petitioner asserts that these items were recorded in the materials account, and petitioner isn't sure if an adjustment was included in the auditor's analysis for these items.

The Department asserts that these items were not included in materials purchases.

I recommend that the Department investigate petitioner's concerns and indicate whether or not these items were included in materials purchases and if so, an adjustment should be made.

(4) Sheet Metal Flashing and Surrounds ... $212,155.63

Petitioner asserts that these payments to D---'s F--- Inc. were for the fabrication of custom flashings for chases and spark arrester covers. Petitioner has a letter from D---'s dated December 18, 1987 which states that approximately 5% of petitioner's cost represents the materials used in the fabrication of these flashings and that the largest portion of the cost is the labor involved in fabricating the specialized materials. Petitioner installs these items in performing its constructions contracts. According to petitioner, D---'s did not charge them tax because a resale certificate was provided to them by petitioner. Ms. G--- verified at the time of audit that D---'s had a resale certificate on file dating back to 1983.

The Department asserts that D---'s charges to petitioner represent fabrication labor and materials, which is taxable to petitioner at the full price.

The main point of contention here is over the labor involved in D---'s fabricating these items for petitioner. Section 6011, "Sales price", section (a), defines the sales price of tangible personal property as follows:

> "'Sales price' means the total amount for which tangible personal property is sold or leased or rented, as the case may be, valued in money, whether paid in money or otherwise, without any deduction on account of the following:
>
> (1) The cost of the property sold.
>
> (2) The cost of materials used, labor or service cost, interest charged, losses, or any other expenses. ..." (emphasis added)

Section 6011(a)(2) includes D---'s fabrication labor within the definition of the sales price of the fabricated items to petitioner. Section 6094(a) provides as follows:

> "If a purchaser who gives a resale certificate makes any use of the property other than retention, demonstration, or display while holding it for sale in the regular course of business, the use shall be taxable to the purchaser under Chapter 3 (commencing with Section 6201) of this part as of the time the property is first used by him ... the sales price of the property to him shall be the measure of the tax."

Section 6201 imposes use tax on the storage, use or other consumption in this state of tangible personal property purchased from any retailer.

Since petitioner consumed the fabricated metal items in performing construction contracts, I conclude that petitioner's purchases from D---'s Fireplaces Inc. are properly taxable.

(5) Marble Installations for Front Facings on Fireplaces ... $50,256.25

Petitioner contends that these were payments to subcontractors for installation jobs which included materials and labor. Petitioner has documentation, including contracts and possibly specific invoices, to back up these claims. Petitioner asserts that the contracts are with Universal Marble. They were improperly recorded as materials purchases in the materials account.

The Department asserts that these purchases were probably not adjusted for in the materials accountability test. However, the Department also claims that they might not be included in the materials account in the first place because the audit calculations show labor adjustments.

Accordingly, I recommend that the Department investigate petitioner's claims and determine if any adjustments need to be made.

(b) Overhead, Corrective Work and Makeover

(1) Petitioner contends that certain items and materials are consumed or destroyed in the performance of petitioner's contracts. Petitioner asserts that an allowance should be made for the cost of these items in determining taxable materials cost.

Petitioner explains that certain refractory panels are broken during the process of removal, transport, and installation of certain units that it contracts to install. Petitioner replaces the refractory panels for up to one year, at no cost to customers, to maintain good relations. Petitioner replaces a minimum of one complete set per month at a material cost of $60 to $80 each.

In another example, petitioner discusses flashings placed at the tops of chimneys to keep rain from penetrating the buildings. Petitioner asserts that there are many cases where incorrect measurements or intervening events cause the flashings to fit incorrectly at the time of installation, and that new materials need to be fabricated to make new flashings which fit properly. The old flashings that did not fit must be discarded.

In another example, petitioner discusses glass doors on wood burning fireplaces. For various reasons, some of the hardware and glass in these fireplace covers is damaged or broken at or before installation, either during shipping or from handling. Petitioner discards a minimum of 4 to 5 of these items a month at a cost of $65 to $125 each.

Finally, petitioner discusses a specific tract of custom homes where over 80 units were installed. The finish work was done and workers began wiping off concrete residue, which caused the plated polished brass finish to be damaged. Petitioner had to replace the damaged doors with new ones, otherwise they would not have been paid by the contractor. Petitioner attempted to get reimbursed from the masonry workers that had done the damage, but was unable to recover anything.

Petitioner asserts that allowances should be made for the cost of items that are lost or discarded, as described above. The Department asserts that these are all items consumed in the performance of construction contracts, and therefore tax should apply to their cost.

The Department is correct in its assertion that Regulation 1521 applies tax to the cost of materials used in the performance of construction contracts. Additional materials used to replace damaged items and to make repairs and custom modifications are merely additional materials used to perform construction contracts. There is no specific or general exemption allowing a deduction for wasted materials.

Accordingly, no adjustment can be recommended on this basis.

(c) Obsolete or Unusable Materials

Petitioner contends that some materials purchased do not sell and are left in stock. After a period of time, they become outdated or discontinued and may no longer be used. Petitioner provided two examples in its documentation. One was of 24 fireplace doors purchased in January 1989, 22 of which are still in stock and are unused. The original invoice for the materials amounted to $4,431.50. The second example was a purchase of mantels from January, 1991 in the amount of $1,576.00. All of the 10 mantels originally purchased are still unsold.

According to petitioner these two examples are the largest purchases in this category, and there are more which have yet to be provided. These purchases were recorded in the materials account, but were not included in the materials physical inventory because of obsolescence, resulting in an overstatement of materials to account for.

The Department asserts that if these items were purchased for resale as were other materials, tax would not be due because they were not committed to any particular job and they were not resold. Tax would never become due if they were never used on a job or sold, according to the Department. (However, tax would be due if petitioner made some other use of the goods).

The Department is correct in its assertion that if these items were properly purchased for resale, the tax would not be due if they were never committed to an installation job or resold to a retail customer. In addition, if these materials were eventually discarded or destroyed because they simply could not be used or sold, tax would not be due. Sales and Use Tax Annotation 570.1380[3] provides as follows:

> "***Destruction of Property Purchased for Resale***. The deliberate destruction of goods purchased for resale is not a taxable use when the goods are not suitable for their intended purpose and the purchaser has sound business reasons for destroying the goods rather than marketing them. (10/23/64)"

Based on petitioner's assertions regarding the accounting for these items, it appears that they were included in materials purchases and excluded from ending inventories. This would result in their cost being taxed as materials consumed, without ever having been committed to a job. Even if these materials were not obsolete, it would not be correct to apply tax to them when they are actually still in resale inventory. However, if these items are ever committed to a job the tax is due regardless of whether or not they are included in the inventory accounting system and regardless of whether or not they are considered old, out-of-date, obsolete, etc. As noted in

[3]All further references to annotations are to Sales and Use Tax Annotations.

Annotation 570.1380, if these materials are destroyed or discarded tax would not be due on their cost. (In contrast, when materials are destroyed or discarded in the course of performing a construction contract, they are regarded as having been consumed).

Accordingly, I recommend that the Department investigate these and any other similar purchases that petitioner can provide evidence of, and determine whether or not any adjustments need to be made to the taxable materials assessed in the audit.

Finally, there is the matter of the second quarter of 1988, which has expired under the applicable statute of limitations. Taxable measure of $66,567 should be eliminated from the $732,277 total taxable measure in this audit. The Headquarters Petition Section agrees with this adjustment.

Recommendation

The Department should conduct a reaudit, making adjustments as follows:

1. The taxable measure for the second quarter of 1988 which was included in the audit determination should be eliminated.

2. With respect to Item 4 discussed under Analysis and Conclusions above, the following adjustments should be made:

(a) Items listed as materials purchases:

(1) The Department should investigate to determine whether or not refunds were erroneously recorded as materials purchases, and make any appropriate adjustments;

(2) The Department should investigate whether or not any tax paid supplies were included in materials purchases, and make any appropriate adjustments;

(3) The Department should determine whether loan payments on trucks and payments to the post office were erroneously included in materials purchases, and make any appropriate adjustments;

(4) The Department should investigate to see if any furnish and install subcontracts were included in materials purchases, and make appropriate adjustments as necessary.

(c) The Department should investigate whether obsolete materials were included in the materials purchases account, but were excluded from ending inventories, while not being used on installation contracts and not being resold. This would result in an overstatement of materials cost subject to tax. Appropriate adjustments should be made if warranted.

3. Finally, the Department should negotiate a reasonable payment plan with petitioner.

_____ _____

John Frankot, Staff Counsel Date
w/Exhibits A & B