STATE OF CALIFORNIA

280.0930

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
H--- P---, INC.	)	No. SR -- XX-XXXXXX-010
Petitioner	)	

The Appeals conference in the above-referenced matter was held by Senior Staff Counsel Stephen A. Ryan on February 9, 1994 in Hollywood, California.

Appearing for Petitioner:	Mr. R--- M--- Vice President
	Mr. H--- D--- C--- Assistant Controller
	Mr. J--- F--- --- & ---
Appearing for the Sales and Use Tax Department:	Mr. Ed Gonzales Tax Auditor
	Mr. Rick Rinetti Supervising Tax Auditor

Protested Items

The protested tax liability for the period October 1, 1988 through September 30, 1991 is measured by:

	Item	State, Local and County
A.	Estimated ex-tax cost of materials purchased from California vendors under resale certificates--based upon a test	$ 46,296

B.	Estimated ex-tax cost of materials purchased from out-of-state vendors-- based upon a test	$ 98,429
E.	Ex-tax cost of sample jewelry gifted in California to retailers	$626,534

Petitioner's Contentions

A., B. Petitioner purchased the products for resale to other persons in the regular course of business.

E. No California use tax applies on the samples delivered on consignment to out-of-state customers pursuant to Revenue and Taxation Code section 6009.1.

X. The Board should reimburse petitioner for its fees paid to the CPA because of [allegedly] improper Department action in this case.

Summary

Petitioner operated as a manufacturer, seller and retailer of jewelry. The Department completed this current audit and informed petitioner of the results in late May of 1992. The most recent prior Board audit covered a period which ended on March 31, 1988.

A. This test included the following transaction which the Department concluded subjected petitioner to use tax because petitioner had used the assets purchased. The $2,832 purchase price was included in the deficiency amount, and projected to the portion of the audit period outside the test.

Mr. Gonzales represented that the seller, C--- L---, had relied upon a 1983 resale certificate from petitioner for the purchase of lithography for resale in not charging sales tax reimbursement on this third quarter 1990 sale to petitioner of "500 pads of 9 units". The auditor described this product as order cards, and represented that petitioner had recorded the cost into asset account #1134. He denied petitioner's orally contended purchase-for- resale argument since assets are not inventory held for resale in the regular course of business, and no evidence was submitted of any actual resale by petitioner.

Petitioner's representatives merely had potential thoughts as to what may have factually or legally occurred regarding this product. One theory was that a subsidiary, H---, made the purchase directly from C--- L---, possibly with petitioner acting as an agent. Another possibility stated was that petitioner made the purchase, but resold the products to H--- for resale prior to any use. Yet another stated scenario was that petitioner made the purchase, physically transferred the products to H---, but merely recorded an intercompany transfer and receivable.

Petitioner's representatives indicated that petitioner had delivered the products to H--- which then packaged the products with other merchandise sold to H---'s customers.

Petitioner was requested to submit to me the relevant evidence regarding what had happened with this product. Nothing was received.

B. Petitioner argues that it resold rings and earrings, the $998 cost of which was included in another similar test. In 1991, petitioner purchased these products from A--- J--- in Taiwan. Mr. Gonzales described these as samples for which petitioner had recorded entries in expense account G/L 7315. Mr. M--- said these were finished goods, and that G/L 7315 is a marketing account. He further added that if these products had been finished goods inventory, an entry would have been made to a purchase account. He stated that he did not know why the resale contention was being made.

Petitioner was again requested to submit the relevant evidence on what had happened to these items. Again, nothing was received.

E. The Department established use tax against petitioner measured by the ex-tax costs paid both to sellers in Asia for purchases of sample jewelry and to Florida fabricators for fabrication work on those samples. It is the position of the Department that petitioner consumed these jewelry products in California as a result of short-term physical and legal ownership, fabrication, storage, assembly, packaging, and then placement of the package in the U.S. mail as a gift for delivery to certain retailers. Those retailers separately purchased real jewelry from petitioner, and used these sample jewelry items for display purposes. The packaging consisted of petitioner's placement of the samples into or onto a display tray. Mr. Gonzales believes petitioner made a gift of the samples with a transfer of title when each sample/display package was delivered by petitioner to the U.S. Postal Service in California. He indicated that he had no specific evidence to show a transfer of title in these sample jewelry items to any retailer, but had assumed that gifts had occurred. However, he indicated that petitioner did not want to re-take possession of the samples. The Department found that 10 percent of these retailers were located in California, and 90 percent were outside this state.

Petitioner recorded the cost of these samples into "sample" asset account #1960. The Department found that petitioner had thereafter capitalized those costs, and taken depreciation deductions for at least several years for federal income tax return purposes, measured by those costs.

Mr. Gonzales disclosed at the conference that some of the retailers had actually paid petitioner for the samples in response to some type of "memo" which petitioner sent with the sample/display package. He did not remember the amount of the payments to petitioner. No tax or tax reimbursement was collected, and no tax was paid to the Board. Petitioner did not attempt to collect any money for the samples sent to these retailers who did not pay, but petitioner also did not refund any collected amounts. Although the auditor did not recall the content of these memos, we found some relevant records in the audit workpapers. A "Consignment

Memorandum" had been sent by petitioner to each retailer along with a "packing slip" in the samples/display package. The Consignment Memorandum listed a total price, plus indicated "ship to" and "bill to" the retailer. The "packing slip" consisted of petitioner's usual invoice form, but with the added phrase "packing slip" and the lack of any identified charges. Petitioner had also prepared and retained a "Consignment Order Form" for internal use which identified the "customer", samples, and "N/C" for "cost". Mr. Gonzales indicated he did not understand the meaning of these records, or the reason why no sale had occurred when payment had been made by a retailer.

Petitioner contends that only a "consignment" was involved with petitioner remaining the owner of these samples without any sale, gift, or other transfer of title or ownership. Petitioner argues that since there was no functional use of these samples in California, Revenue and Taxation Code section 6009.1 results in an exclusion from California use tax for the 90 percent of these samples which were delivered to out-of-state retailers. When questioned about the terms of petitioner's agreements with the retailers regarding these samples, petitioner's representatives said they were not sure, but they thought it would show petitioner's continued ownership of the samples. Mr. M--- indicated that petitioner's salespeople and employee A--- R--- would know what had occurred. Petitioner was requested to submit any writings which evidenced these agreements.

On February 23, 1994, petitioner submitted as examples a copy of two virtually identical letters dated August 20, 1991 from Mr. M--- to G---'s, and to W--- Stores, respectively. Mr. M--- therein made reference to "displays and/or samples" being used by the retailers on consignment from petitioner. He indicated that those displays and/or samples have a value and are an integral part of petitioner's inventory. It was disclosed that --- & --- desired a confirmation that certain products, identified by number on an attached list, were in the retailer's store on June 30, 1991. Mr. M--- had requested a written signature response confirming that information. Each letter contained a signature response from the retailer.

X. Mr. F--- was quite adamant that the Board had improperly caused petitioner to incur the substantial fees to hire him, as a sales tax expert, to handle this case. Mr. F--- felt that the Department should have already acknowledged that petitioner owes no tax. He feels that Board reimbursement of his fees is appropriate.

Analysis and Conclusions

A. and B. Is petitioner liable for use tax?

Absent an exemption or exclusion, use tax is imposed upon a person who makes his or her first use, storage, or other consumption in California of tangible personal property which was purchased from a retailer for use, storage, or other consumption here (Revenue and Taxation Code sections 6201 and 6202). "Use" is defined to include the exercise of any right or power over the property incident to ownership, except the resale thereof in the regular course of business (Rev. & Tax. Code § 6009). A purchase for the purpose of reselling the property in the

regular course of business is not subject to use tax (Rev. & Tax. Code § 6007; Reg. 1595(b)(1)). As explained in that regulation, this applies to "stock in trade", which is also known as inventory.

It is our conclusion, based upon the available evidence, that petitioner is liable for use tax on these two purchases and usages of these products in California. Petitioner has not shown any reason for the lack of use tax, such as on resale grounds. The available evidence indicates that petitioner intended to purchase an asset and a supply item, respectively, rather than inventory for resale, since it apparently recorded the respectable purchase prices into an asset and an expense account rather than into inventory accounts. There is no satisfactory evidence of any actual resales of these products. Samples are used and consumed by the owner rather than resold. Order cards are also typically used and consumed by the owner rather than resold. In the absence of evidence to the contrary, these prices should remain in the test as errors, and constitute a basis for projection into other time periods.

E. Revenue and Taxation Code section 6009.1 excludes the following from the definition of "storage" and "use":

> "**'Storage' and 'use'--exclusion.** 'Storage' and 'use' do not include the keeping, retaining or exercising any right or power over tangible personal property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state, or for the purpose of being processed, fabricated, or manufactured into, attached to or incorporated into, other tangible personal property to be transported outside the state and thereafter used solely outside the state."

Further, "storage" is defined to include the keeping or retention in California of the property for any purpose, except for resale in the regular course of business or the subsequent use solely outside California (Rev. & Tax. Code § 6009.1).

We recommend a reaudit. The auditor will need to examine the available evidence and give meaning to the different factual situations.

(i) Although it is not clear, it appears that petitioner probably made retail resales of the samples to those retailers who paid petitioner based upon a packing slip and/or consignment memorandum. Whether or not this was intended by petitioner, this is apparently what occurred as a result of payment to petitioner by these particular retailers. Petitioner will be liable for sales tax on its gross receipts derived from such sales (Rev. & Tax. Code § 6051), except for sales for which it proves a shipment of the samples to an out-of-state location (Rev. & Tax. Code §§ 6352 and 6396; and Reg. 1620(a)(1) and (3)). Petitioner would have been required to return those gross receipts to those retailers in order to have avoided a sale. We have no evidence of petitioner having acted merely as agent for any of these retailers with that payment constituting mere reimbursement of expenses. The potential incorrect nature of petitioner's subsequent depreciation deductions for the cost of these particular samples does not negate the retail sales

which, in substance, appears to have taken place. Petitioner did not also incur use tax liability on its California use or storage of these same inventory samples prior to resale as long as the only use was to prepare the samples as needed for display purposes, and to ship them to the retailers, without any functional use.

(ii) It is our conclusion based upon the available evidence that petitioner incurred California use tax liability on its purchase and fabrication labor costs of the remaining samples which were delivered to retailers who were located in California. Petitioner used and consumed these samples as assets in California. No exemption or exclusion is applicable.

(iii) The available records appear to indicate that petitioner did not make any sale, gift, or other transfer of ownership or title in the remaining samples during the times when such samples were physically located in California prior to shipment to an out-of-state location. The auditor will need to verify this probable conclusion by examining the contents of the relevant records which evidence these "consignments". The objective manifestations of these parties in these remaining transactions appear to indicate that some situation less than a sale occurred with petitioner retaining title and ownership of these samples. Although the word "consignment" may not be entirely appropriate (Moulton v. Williams Fruit Corp. (1933) 218 Cal. 106), the critical point is that it evidences the lack of an absolute obligation of the retailer to pay for the goods received. "Bailment" might have been a more appropriate term under these circumstances (People v Seymour (1942) 54 Cal.App.2d 266, 273), but that can be one type of a consignment, although typically in a bailment-for-sale situation. Regarding the audit's concerns about the lack of an express term requiring the retailers to return the samples to petitioner, the bailee must deliver the property back to the bailor if demanded (Civil Code sec. 1822), but if no demand is made, no re-delivery is required (Civ. C. sec. 1823). Petitioner's capitalization and its depreciation deductions for federal income tax purposes after its consignment and shipment of these samples to the retailers, is also consistent with a bailment and inconsistent with the audit's assumption of a gift in California.

Since it appears that petitioner intended, and the evidence shows, that the only functional use of these remaining samples occurred outside California following California use which was merely of the type identified in section 6009.1, then no California use tax will apply as long as the auditor verifies this situation in his reaudit.

X. Petitioner's allegation of improper Department conduct in this case is misplaced. Petitioner misunderstands the Sales and Use Tax Law as well as the concept of evidence. Petitioner has always been under the obligation/burden to prove its lack of use tax on these three audit items. Prior to the Appeals conference, petitioner had not done so. As of today, it still has not done so on items A and B, and has only conditionally done so as to item E based in part upon newly submitted evidence and subject to reaudit verification. Petitioner has been able to submit evidence to support its allegations since May 1992 when the auditor was performing the audit. What petitioner submitted prior to February 23, 1994 was inadequate. This is not the fault of the Department.

Recommendation

Reaudit on item E as recommended herein, with the necessary adjustment to be made. No adjustment is recommended on items A and B.

Stephen A. Ryan, Senior Staff Counsel Date