

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

330.3327

BUSINESS TAXES APPEALS REVIEW SECTION

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

The Appeals conference in the above-referenced matter was held by Staff Counsel Susan M. Wengel on May 5, 1992 in Bakersfield, California.

Appearing for Petitioner:

Mr. R--- C. L---
Vice President

Ms. M--- K. P---
Controller

Mr. L--- E. C---
Attorney at Law

Appearing for the
Sales and Use Tax Department:

Ms. Eileen M. Baier
Senior Tax Auditor

Mr. J. Wayne Lazenby
Branch Office Supervisor

Protested Items

The protested tax liability for the period January 1, 1985 through March 25, 1988 is measured by:

<u>Item</u>	<u>State, Local and County</u>
E. Disallowed exempt sales for branches 32, 34 and 39 based on a test of four months' exempt sales less than \$5,000. (Amount protested is \$7,329.)	\$ 105,107

F. Disallowed exempt sales for branches 32, 37 and 39 based on all exempt sales \$5,000 and greater. (Amount protested is \$65,713.) \$ 1,825,093

G. Measure of tax understated for branches 36, 38 and 39 based on a statistical random sample of taxable sales. (Amount protested is \$314,629.) \$ 971,702

Contentions of Petitioner

1. The charges for installation and removal of the piping are exempt from tax.
2. The installation charges involving the City of [name] are not mandatory and should not be included in the measure of tax.
3. Several sales are sales in foreign commerce and should be exempt.
4. The negligence penalty is not warranted.

Summary of Petition

Petitioner is a corporation engaged in the business of selling and renting sprinklers, pipe, pumps and related irrigation equipment. Petitioner originally was comprised of three entities which included R--- F--- R--- C---. It now has merged into two entities which include petitioner and R--- F--- R--- A---.

During an audit by the Sales and Use Tax Department (Department) it was ascertained that certain installation and removal charges should be included in the measure of tax for rental sales. These charges were scheduled in audit items E and G. The Department concluded that the installation of the piping occurred prior to the sale and that the charges for removing the piping after the rental period expired was required as part of the rental contract.

Petitioner contends that the question as to the taxability of these charges was appealed for in the prior audit and that the charges were found to be exempt from tax. (See Exhibit A attached.) At the Appeals conference representatives for petitioner testified that petitioner arranges for the field layout and attachment of the sprinkler pipe as a convenience for its customers. It does not make a profit on this charge, which by contract is the responsibility of the lessee. Petitioner merely arranges a crew to perform the layout, or detachment as the case may be, and passes the bill on to the lessee. In many cases the lessee has its own workers do the layout work.

In his Decision and Recommendation Mr. Burkett concludes that the charges at issue were not for reassembly of components of personal property. Rather the charges were for field layout and attachment of sprinkler pipe to the real property. The charges for such installation contracted for by the customer are specifically exempt from the tax whether performed before or after the lease term begins and without reference to whether the installation service is mandatory or optional. (Revenue and Taxation Code Section 6011(c)(3).) In a Supplemental Decision and Recommendation Mr. Burkett added that the charges for the return of sprinkler pipe should also be deleted from the measure of tax. He based his conclusions on the fact that the performance of the service by the lessor is clearly at the option of the lessee and within the framework of Sales and Use Tax Annotations 295.1690 dated August 16, 1978 and 330.3280 dated December 28, 1966.

The Department also ascertained that a rental to the City of [name] included some mandatory installation and removal charges which should be subject to tax. The charges were included in the rental agreement and were found to be part of the sale. Petitioner contends that because of the bidding requirements set out by [name], the contract had to include all costs including the field layout and charges for the return of the sprinkler piping. Petitioner continues to assert that the field layout and attachment charges as well as the charges for returning the pipe were put in the bid at the request of the city and were not mandatory charges.

The Department further ascertained that petitioner was making sales to G--- P--- Inc. (G---) and that delivery of the property was made in [city], California where G--- off-loaded the property and re-loaded the goods on to a carrier that made deliveries in Mexico. Petitioner's representatives have testified that G--- is an agent for a group of Mexican growers. G--- orders supplies, stores the grower's fruit and helps them find buyers for their produce. Petitioner has an established working relationship with G--- and will often receive a phone call from them for an order of irrigation tape which is needed by a Mexican grower. Once petitioner has received the order from G--- it will call the manufacturer and request that the tape be sent to G--- in [city], California. G--- is located in ---, Arizona, however, the manufacturer's trucks only make deliveries in California. Once the tape arrives in [city] G--- personnel off-load the tape and re-load it onto trucks which will complete the delivery to the Mexican grower. Petitioner is paid by G--- and in turn pays the manufacturer.

Petitioner asserts that G--- does not take delivery inside California because the tape was in a continuous export journey from the time it left the manufacturer's plant to the time it was delivered in Mexico.

Finally, petitioner contends that the negligence penalty should not apply.

Analysis and Conclusions

1. The first issue is whether the charges for field layout and sprinkler pipe placement and removal are subject to tax. As Mr. Burkett stated in his Decision and Recommendation, the Department applied tax to the charge for the installation portion of the rental contracts on the basis that the charges were mandatory service charges for services performed prior to the beginning of the lease. He noted that charges for such services are properly includable as part of the leasing sales price when performed prior to the beginning of the lease for the purpose of placing the personal property in a form for leasing. He concluded that the charges at issue were not for reassembly of components of personal property rather they were for field layout and attachment of sprinkler pipe to the real property. He concluded that the charges for such installation contracted by the customer were specifically exempt from the tax whether performed before or after the lease terms begins and without reference to whether the installation service was mandatory or optional. (Revenue and Taxation Code Section 6011(c)(3).) He further concluded that there was no fabrication of components and that the actual labor of assembling the sprinkler components does not constitute a step or process in the production of property.

We agree with Mr. Burkett's analysis and conclude that the charges for the field layout and sprinkler placement should be excluded from the measure of tax. Likewise, the charges for the removal of the piping is also optional and should be excluded from the measure of tax.

2. The second issue involves the City of [name] and its contract with petitioner for a temporary irrigation system. The contract provided that petitioner would supply the equipment required by the city and that the city, in addition to the rental payments, agreed to pay labor and equipment charges to install all irrigation equipment. The labor and equipment rates were to be shown on a separate schedule and the city was to be billed at a later date. At the conclusion of the rental agreement petitioner was to remove the equipment and the city was to be responsible for the removal charges.

As was discussed above, petitioner has shown that the field layout and pipe placement were optional with each customer and that petitioner did not have the personnel to do the work. Rather petitioner hired a third company to do the labor and then passed the charges on to the customer without any markup. At the Appeals conference petitioner's representative testified that the city required that the installation charges be included in the contract. In other words, the city did not have the personnel to perform the installation labor so the responsibility for providing the labor was included in the city's contract. There is no evidence that the city contracted for the labor because it was required by petitioner. In petitioner's other contracts the labor was optional and a service that it provided for its customers at no additional charge over and above the charges made by the third party hired to perform the labor. Revenue and Taxation Code Section 6011(b)(1) provides that the total amount for which property is rented includes any services which are part of the sale. In defining what is "a part of the sale", the Department has consistently held that services that are a part of the sale include any the seller must perform in order to produce and sell the property, or for which the purchaser must pay as a condition of the purchase and/or functional use of the property. (See Sales and Use Tax Annotation 295.1690 (August 16, 1978).) As the city was not required to purchase the installation and return labor

from petitioner, but did so at its option, it is concluded that like the contracts discussed above, the charges should be excluded from the measure of tax. Audit item F should be reduced by \$65,713.

3. The third issue is whether the sales of irrigation tape to G--- should be exempt as sales in foreign commerce. The Department takes the position that because the delivery was to G--- at a California location, the sales is subject to sales tax. Petitioner contends that although the tape was delivered to a California location, it was merely unloaded from one carrier onto a second carrier that would transport the goods into Mexico. Petitioner alleges that the goods were committed to foreign commerce once they were shipped from the manufacturer's plant and thus should not be subject to tax.

For numerous reasons we find that the sales were made in California and that the goods are not exempt from California's sales tax. First, it is noted that the contract of sale lists G--- as the buyer. Although G--- is located in Arizona, delivery is to G---'s facilities in California. The export-import clause, under which petitioner seeks protection, was created to eliminate any advantage the seaboard states might have in laying duties on goods sent there from other states for export. Thus once goods were in the process of exportation their immunity from state taxation was absolute. However, goods which are the products of a state may be intended for exportation but until they become "exports" within the meaning of the constitutional provision, such goods do not cease to be part of the general mass of property in the state and as such subject to taxation in the usual way. (See Farmer's Rice Cooperative v. County of Yolo [1975] 14 Cal.3d 616.) The courts therefore view the export-import clause as conferring immunity from state taxation upon property being exported, not as relieving property which will be eventually exported from its share of the cost of local services.

Petitioner contends that when the irrigation tape was shipped by the manufacturer to the California location the property entered the stream of foreign commerce. The courts do not agree. In 1885 in the case of Coe v. Errol [1885] 116 U.S. 517 the court set out the test of whether goods had entered the process of exportation. The court stated that goods do not cease to be part of the general mass of property in the state until they have been shipped, or entered with a common carrier for transportation to another state or have been started upon such transportation in a continuous route or journey. The rule of Coe v. Errol remains the law today. There must be certainty that the goods are headed for their foreign destination and will not be diverted to domestic use. The court in Empresa Siderurgica v. Merced Co. (1948) 337 U.S. 154 stated that it is not enough that there was a purpose and a plan to export the property or that in due course the plan was fully executed. Coe v. Errol, and its numerous progeny, make it clear that it is only entry with a common carrier for transportation to the goods ultimate destination that will suffice. Use of a common carrier to carry the goods from one resting place to another within the state, and prior to movement abroad, is insufficient. (Farmer's Rice Cooperative v. County of Yolo, supra, 14 Cal.3d 625.)

The case of Gough Industries v. State Board of Equalization (1959) 51 Cal.2d 746 is distinguishable as in this case the goods were delivered directly to a carrier or forwarding agent for shipment to a point outside the United States. There is no authority where delivery to a common carrier for purely intrastate transportation has triggered the process of exportation. Sales and Use Tax Regulation 1620(a)(3)(A) provides that sales tax applies when the property is delivered to the purchaser or the purchaser's representative in this state, whether or not the disclosed intention of the purchaser is to transport the property to a point outside this state, and whether or not the property is actually so transported. The sales to G--- are subject to sales tax. No adjustment is recommended.

4. The final issue is whether the negligence penalty is warranted. The audit staff has recommended that the penalty be added as the prior audit contains the same type of errors and involves many of the same customers. No adjustment can be recommended.

Recommendation

It is recommended that the charges for the field layout, pipe attachment and pipe return be deleted from the measure of tax. The remaining liability to be redetermined in accordance with the revised audit dated March 29, 1989.

SUSAN M. WENGEL, STAFF COUNSEL

July 22, 1992

DATE

W/Exhibit A