

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

315.0308

In the Matter of the Petition)	
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law of:)	
)	
U--- C--- S---)	No. S- -- XX XXXXXX-020
dba C---)	
)	
<u>Taxpayer</u>)	

The preliminary hearing on the above taxpayer's petition for redetermination was held on December 22, 1987, in Sacramento, California

Hearing Officer:	James E. Mahler
Appearing for Petitioner:	S--- S--- State Tax Consultant
Appearing for the Board:	Bruce Henline District Principal Auditor
	Louie E. Feletto Tax Auditor

Protested Item

The protested tax liability for the period January 1, 1983, through December 31, 1985, is measured by:

<u>Item</u>	<u>State, Local and County</u>
A. Capital assets withdrawn from ex-tax inventories	\$ 578,554
B. CRT's returned from out-of-state leases and converted to own use not reported	111,758
C. Capital assets purchased under resale certificate or from unpermitted out-of-state vendors based on a detailed examination of payables for the audit period	293,742

D.	Consumable supplies purchased under resale certificate or from unpermitted out-of-state vendors based on a detailed examination of payables for the audit period	1,213,834
F.	Spare parts consumed on optional maintenance agreements	562,649

Taxpayer's Contentions

B. The cathode ray tubes were not purchased for use in California.

F. The storage of spare parts in California for use thereafter solely outside the state is not a taxable use.

C, D. For many transactions in these audit items, the applicable tax should be, and in some cases already has been, assessed against the vendors.

A. A number of nontaxable acquisitions are included in this audit item.

Introduction

Petitioner is a corporation which sells, leases and services computer hardware and software, primarily for the cable television industry. There was a prior audit through December 31, 1985.

Item B. Summary

Petitioner purchased computer monitors (cathode ray tubes or "CRT's") in California from California vendors. Petitioner issued resale certificates and therefore did not pay tax reimbursement to the vendors or use tax to the state. Petitioner leased the monitors to customers outside of California.

When the monitors became obsolete about four years later, the leases were terminated and the monitors were returned to California. Petitioner tried to sell them, and did sell some of them for less than 10 percent of their original cost. Petitioner then began to use the remaining monitors in its business.

The audit asserted use tax on the remaining monitors measured by the full purchase price. The audit relied on Revenue and Taxation Code Sections 6094 and 6244, which impose use tax when tangible personal property is purchased under resale certificates or for the purpose of resale, but then used in California.

Petitioner relies on Revenue and Taxation Code Section 6201, which provides that use tax applies when tangible personal property is purchased from a retailer for use in this state and actually used here. Petitioner points out that it purchased the monitors for resale and not for use in California.

Item B. Analysis and Conclusions

This issue was previously considered by the Board's legal staff. The legal staff has decided that use tax does not apply when tangible personal property is purchased for resale by way of lease, and leased outside California for at least six months, but then returned to California for use by the lessor. We understand that the legal staff's decision will be annotated and published in the near future.

In accordance with the legal staff's prior decision, we conclude that petitioner is not liable for use tax on the cathode ray tubes. Accordingly, we recommend a reaudit to delete this audit item from the measure of tax.

Item F. Summary

Petitioner and a related company lease computer hardware to the cable television industry. The leases require the customer to enter into maintenance contracts to keep the equipment in good repair, and many of the customers purchase maintenance contracts from petitioner. However, the customers always have an option to purchase maintenance contracts from third parties if they so desire. The audit staff concedes that the maintenance contracts are optional and not mandatory, so that petitioner is a consumer of the parts and materials used in performing repair services. (See Sales and Use Tax Reg. 1546(b)(3).)

This audit item involves spare parts and supplies which petitioner purchased ex-tax for use in performing the maintenance contracts. According to testimony at the preliminary hearing, the property can be grouped into four categories as discussed below. It must be emphasized that these categories are defined by the use to which the property is ultimately put, which is not known at the time the property is purchased. Further, petitioner does not distinguish among these categories for its own internal accounting purposes. In any event, the categories are:

1. Property which is purchased by petitioner's California facility, but stored at one of petitioner's out-of-state facilities pending need, and ultimately used outside California to perform repair contracts. The audit found that petitioner is not liable for California use tax on this type of property and it will not be discussed further.

2. Property which is stored at petitioner's California facility pending need, and ultimately used by petitioner to perform repair services in California, or transferred to the customer for the customer's own use in performing repairs in California. The audit found that petitioner is liable for use tax, but the tax in this audit period was measured only by petitioner's ending inventory. This is because petitioner had previously reported and paid tax on its charges for the maintenance contracts in the mistaken belief that the contracts were mandatory

maintenance contracts. The audit therefore concluded that petitioner's use tax liability would be partially offset by the excess tax reimbursement collected from customers and reported to the Board. Petitioner agrees with this treatment and we will therefore not discuss this type of property further.

3. Property which is stored at petitioner's California facility pending need, but later transferred to an out-of-state facility for storage or use there, or transferred to an out-of-state customer for the customer's own use in performing repairs outside this state. On its California Franchise or income tax returns for the period in question, petitioner claimed depreciation deductions with respect to this type of property.

4. Property which was stored at petitioner's California facility pending need, then used by the California facility outside California to perform repair services on leased equipment located out of state. (The California facility has responsibility for 14 western states and often sends its repairman to out-of-state locations.) Again, petitioner claimed depreciation deductions on this type of property for California franchise or income tax purposes.

With respect to the property in categories 3 and 4, petitioner contends that the storage of the property in California is not a use under Revenue and Taxation Code Section 6009.1. That section provides:

“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.”

The audit staff argues that Section 6009.1 does not apply because petitioner purchased and stored the property, not necessarily for use outside California, but for use wherever the need might arise, whether inside or outside this state. The staff argues that the storage in California is a “standby use” and is subject to tax. The staff relies on subdivision (c) of Sales and Use Tax Regulation 1701, which provides that a tax-paid purchases resold deduction may not be claimed for property which has been used for “standby” purposes.

The staff also points out that petitioner claimed depreciation deductions with respect to this property on its California franchise or income tax returns. Relying on McConville v. State Board of Equalization, 85 Cal.App.3d 156 (modified 85 Cal.App.3d 1032(a)), the staff argues that claiming depreciation deductions is a taxable use in this state.

Item F. Analysis and Conclusions

Sales and Use Tax Annotation 570,1080 (5/7/57) provides:

“Automobiles withdrawn from the taxpayer’s California resale inventories, without any use other than outlined in Section 6009.1 of the law, and shipped to points outside the state will not be subject to the tax provided they do not return to California within a period of six months. If they are returned to California within the six month period, the taxpayer must pay tax on the cost unless he elects to pay tax measured by rental receipts.”

Sales and Use Tax Regulation 570.1165 (8/24/70) further provides:

“Where property is purchased outside this state for use here, is brought here and later transported for use solely outside the state, and nothing is done with the property while it is here except store it, such property is exempt from use tax under Section 6009.1.”

Ignoring for the moment the fact that petitioner claimed depreciation deductions on this property, we would conclude that petitioner is not liable for use tax. If petitioner purchased the property in California under resale certificates, the storage in this state would not be a taxable use under Annotation 570.1080. If petitioner purchased the property outside California, the storage here would not be a taxable use under Annotation 570.1165. In other words, storage in California for “standby” purposes is excluded from “use” under Section 6009.1 provided, of course, that the other requirements of that section are satisfied.

The real issue, therefore, is whether claiming depreciation deductions precludes petitioner from obtaining the benefits of Section 6009.1. We conclude that it does not.

In the McConville case, the plaintiff had claimed depreciation deductions on property which it was allegedly holding for resale. The claiming of depreciation deductions was inconsistent with the alleged intent to resell, since depreciation deductions cannot be claimed on inventory. In our opinion, it is this inconsistency which convinced the court that plaintiff was liable for use tax.

There is no such inconsistency here. For all tax purposes, petitioner has consistently accounted for the property as property held for use in performing maintenance contracts. We know of no income tax rule which would preclude petitioner from claiming depreciation deductions on such property merely because the holding of the property is excluded from “use” for sales and use tax purposes.

For these reasons, we conclude that the property in categories 3 and 4 should be deleted from the measure of use tax by the reaudit. Two further points need to be mentioned, however.

First, we understand that petitioner purchased some of the property under resale certificates in California. Petitioner issued resale certificates because it mistakenly believed it would be reselling the property pursuant to mandatory maintenance contracts. The audit staff concedes that petitioner had sufficient reasons for its belief, and therefore has not attempted to deny the validity of petitioner’s resale certificates in this audit period. However, petitioner is

now aware that it is a consumer of property purchased for use on its optional maintenance contracts, and it therefore should no longer issue resale certificates for this type of property. If it continues to issue resale certificates, it may be liable for tax under Revenue and Taxation Code Section 6094.5.

Second, for property in categories 3 and 4 which petitioner may purchase outside California, petitioner will not be liable for use tax. Since petitioner's accounting system does not distinguish between the various types of property, however, we recommend that petitioner and the audit staff work together to find a ration of taxable to nontaxable purchases which can be used in future audit periods.

Items C, D. Summary

These audit items involve property (other than parts and supplies for maintenance contracts) which petitioner purchased for use in its business in California without paying tax reimbursement to the vendor or use tax to the Board. Item C includes capital assets, while item D includes supply-type items.

Petitioner used its own printed order form to make these purchases. We understand that petitioner's name, address and permit number were printed on the form. There were blank spaces provided for the date of sale and the signature of petitioner's authorized purchasing agent, and boxes which could be checked "taxable" or "for resale". Our description of these forms is based on testimony at the preliminary hearing, since no sample copy has been presented for our review. We have requested petitioner to verify whether our description is correct, but petitioner has not done so.

The audit found that petitioner had purchased some of this property outside California from out-of-state vendors. Petitioner concedes that it is liable for use tax on such property and it will not be discussed further.

The audit also found that petitioner purchased some of the property from California vendors under resale certificates. Petitioner concedes that it is liable for use tax on this type of property and it will not be discussed further.

Finally, the audit found that the petitioner had purchased some of the property from California "resale vendors". Apparently, the auditor used the term "resale vendor" to describe cases where he had no direct evidence to show whether petitioner had or had not issued a resale certificate. Since these vendors were all located in California, but had not charged tax reimbursement to petitioner, the auditor assumed that petitioner had either issued a formal resale certificate or, alternatively, a purchase order which qualified as a resale certificate.

Petitioner contends that the Board should have the burden of proving that it issued a resale certificate or a purchase order which qualified as a resale certificate. With one exception discussed below, petitioner states that it does not now know whether it issued a formal resale certificate. Petitioner further contends that it is now impossible to locate individual purchase

orders to determine whether they qualify as resale certificates. Petitioner concludes that these transactions should be deleted from the measure of tax on the ground that the audit staff has failed to prove that tax applies.

The exception is purchases from V--- T--- of [city], California, which holds seller's permit number S- -- XX XXXXXX. These purchases are listed on Schedule 12-D, page 19, lines 5 through 14 of the audit workpapers. Petitioner alleges that V--- was recently audited by the Board's [city] District and sales tax was asserted on the sales to petitioner on the ground that V--- did not have a resale certificate issued by petitioner.

Items C, D. Analysis and Conclusions

As noted above, Revenue and Taxation Code Section 6201 imposes a use tax when tangible personal property is purchased from a retailer for use in this state and actually used here. Further, Sections 6094 and 6244 impose the use tax when tangible personal property is purchased for resale or under resale certificates, but then used in California prior to resale.

Petitioner contends that it purchased the property in question from retailers for use in this state and actually used it here. The audit staff contends that petitioner purchased the property for resale or under resale certificates and used it in this state prior to resale. In either case, petitioner is liable for use tax unless there is some statutory basis for exemption.

Petitioner seeks exemption under Revenue and Taxation Code Section 6401, which provides:

“The storage, use, or other consumption in this state of property, the gross receipts from the sale of which the purchaser establishes to the satisfaction of the board were included in the measure of the sales tax, is exempted from the use tax; provided, however, that this exemption does not extend to the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease.”

Petitioner argues, in effect, that we should presume it is entitled to exemption under Section 6401 unless the audit staff can prove otherwise. We reject this argument for two reasons. First, it is contrary to the general rule that all taxpayers bear the burden of proving their right to exemption. (See Paine v. State Board of Equalization, 137 Cal.App.3d 438.) Second, and more importantly, it is directly contrary to the language of Section 6401 itself, which expressly provides an exemption only when “the purchaser establishes to the satisfaction of the Board” that the transaction was subject to sales tax.

Placing the burden of proof on the taxpayer is reasonable as a general proposition, since the taxpayer participates in the transaction and is in a position to compile and maintain the necessary records. It is even more reasonable under the circumstances of this case, since: petitioner's purchaser order form would qualify as a resale certificate by the simple expedient of checking the “for resale” box (see Sales and Use Tax Reg. 1668(b)(1)); petitioner has not made

any of the relevant purchase orders available for our review; and the customers were California retailers presumably familiar with the resale certificate requirements, but did not charge tax reimbursement to petitioner. These facts strongly suggest that petitioner did indeed issue resale certificates to the vendors. Accordingly, we conclude that petitioner is not entitled to exemption from the use tax absent supporting evidence. Except for the transaction with V---, no such evidence has been presented.

With respect to the purchases from V---, the [city] District staff advises us that sales to petitioner in the amount of \$30,750 were included in the audit of that company for 1984. This is substantially less than the 1984 purchases found in petitioner's audit, which are measured by \$225,415. At this time, we do not know whether V--- has actually paid the tax or, if so, whether it intends to file a claim for refund.

We recommend that the reaudit of petitioner prepare a schedule showing the exact extent to which there has been a duplication in the two audits. However, we do not recommend deletion of the tax from petitioner's audit at this time. An adjustment to petitioner's audit will depend on final resolution of the V--- audit or, alternatively, the submission of evidence showing with certainty whether V--- or petitioner is the proper taxpayer.

Item A. Summary

This audit item involves property which petitioner purchased from vendors without paying tax reimbursement and recorded as inventory for resale in its books and records. Petitioner later withdrew the property from inventory and used it in its business, without reporting use tax to the state. For reasons described below, petitioner contends that it is not liable for use tax on certain transactions.

Item A. Analysis and Conclusions

For most of the transactions at issue, petitioner contends that it is entitled to exemption under Section 6401 on the ground that the audit has failed to prove that petitioner issued a resale certificate to the vendor. What we have said above in connection with Audit Items C and D applies with equal force here. Petitioner is not entitled to a Section 6401 exemption unless it establishes to the satisfaction of the Board that the gross receipts from the sale were included in the measure of the sales tax. Petitioner has made no attempt to do so, and we therefore recommend no adjustment.

There is an additional reason for disallowing the Section 6401 exemption with respect to Audit Item A. Petitioner recorded this property in resale inventory immediately following the purchases. This is evidence that petitioner in fact purchased the property for the purpose of reselling it, without regard to whether petitioner issued a resale certificate to the vendor, and that petitioner is therefore liable for use tax under Section 6244.

For certain other transactions, petitioner contends that it issued a purchase order to the vendor which expressly stated that the property was not being purchased for resale. However, petitioner has not presented copies of those purchase orders for our review, and we can therefore recommend no adjustment at this time. Petitioner should present copies of the purchase orders to the audit staff for review during the course of the reaudit.

For certain other transactions, petitioner contends that it paid tax reimbursement to the vendor. Again, however, no supporting evidence has been presented. Petitioner should present its evidence to the audit staff for review.

For certain other transactions, petitioner contends that it purchased exempt repair services and not tangible personal property. Again, no evidence has been presented. Petitioner should present its evidence to the audit staff for review.

For certain other transactions, petitioner contends that the vendor was audited and paid sales tax to the Board. Again, no supporting evidence has been presented. Petitioner should present its evidence to the audit staff for review.

Finally, petitioner has listed certain transactions as protested items, but has not made any clear arguments for exemption. For example, with respect to the transactions listed on Audit Schedule 12-A, page 66, items 12548-12560, petitioner contends "allowed on pages 59 and 63, also on Sched. 12D, page 8". We have examined those pages and schedules and found no reference to the cited transactions. We simply have no idea what petitioner is contending. Petitioner should clarify its position and present its evidence and arguments to the audit staff.

Recommendation

[City] District is to initiate a reaudit in accordance with the views expressed herein.

James E. Mahler, Hearing Officer

2/29/88

Date