**330.4169**
11/7/86

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

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| In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of: | ) ) ) | DECISION AND RECOMMENDATION |

The preliminary hearing on the above taxpayer's petition for redetennination was held on September 25, 1986, in Sacramento, California.

Hearing Officer: H. L. Cohen

Appearing for Petitioner:

Appearing for the Board:

Protested Items

Petitioner submitted a petition for redetennination by letter dated May 29, 1986. The letter contained arguments and authority supporting petitioner's position. The protested tax liability for the period January I, 1982, through June 30, 1985, is measured by:

| Item | State, Local and County | Transit District |
|---|---|---|
| Unreported rentals of drapes | $5,435,202 | $2,572,113 |
| Credit for tax-paid purchases resold | -77.156 | - 72.230 |
| Totals | $5,358,046 | $2,499,883 |

Contentions

Petitioner contends that:

1. The drapes are tax-paid property leased in the substantially same form in which they are acquired, thus tax is not due on rental receipts.

2. Petitioner relied in good faith on the results of prior audits in which no tax was asserted on receipts from rentals of drapes, and petitioner should not therefore be held liable for the tax asserted here.

## Summary

Petitioner is a corporation which is a subsidiary of --- --- ---. Petitioner is in the business of providing equipment, services, and supplies to exhibitors at conventions. The last prior audit was for the period through December 31, 1978.

As part of its activities, petitioner rents tables and skirts or drapes for the tables. These skirts or drapes are rented separately and priced separately from the tables. Table drapes are cut to length from a bolt of material, banded, and pleated at petitioner's shop. The prefabricated table drapes are attached to tables at the convention site by petitioner's employees. Occasionally, customers who have not ordered table drapes will decide at the exhibition site that they want table drapes. Petitioner brings bolts of materials to exhibition sites to accommodate these customers. Petitioner's on-site personnel cut material and hand-pleat and attach the material to the tables. Petitioner charges the same rental for prefabricated drapes as for material furnished at the exhibition site.

Petitioner's general practice is to purchase all drapery material tax-paid. The auditor found, however, that petitioner had inadvertently purchased some material ex-tax. For reasons discussed below, the auditor did not assert tax on the cost of this material.

In prior audits, petitioner and its predecessors had been regarded as renting drapes which were purchased tax-paid and rented in substantially the same form as purchased. The form was considered to be substantially unchanged because testimony was given that the labor cost for banding and pleating was 6 to 7 Y2% of the material cost. Consequently, no tax was asserted on rental receipts.

In this audit, the auditor found that, besides the ex-tax purchase of some material, petitioner's labor costs averaged 33.8% of the material cost. In addition, petitioner capitalized and depreciated the labor cost for income tax purposes. The auditor concluded that the prefabricated drapes were not rented in substantially the same form in which they were acquired and that tax was therefore due on rental receipts. Credit was allowed for the tax reimbursement which petitioner had paid when purchasing the material.

Petitioner contends that since the rental value of prefabricated drapes and drapes direct from the bolt of material is the same, the fair market value is the same, and there has been no substantial change in form due to the prefabrication. Petitioner cites Business Taxes Law Guide (BTLG) Annotation 330.3900 (February 17, 1967), as support for its position. Petitioner states that the prefabrication is done as a convenience for its on-site employees and that the customers don't care how the drapes are prepared.

Petitioner also argues that if it is decided that tax applies to these rental charges, it should be applied prospectively only because petitioner did not collect tax reimbursement from its customers in reliance on the prior audits.

## Analysis and Conclusion

Section 6006 of the Revenue and Taxation Code provides in subdivision (g) that, in general, leases are included within the definition of sale. Thus, in general, the amount of a lease payment is the amount subject to tax. An exception to the general rule, subdivision (g)(5), is that

leases of tangible personal property leased in substantially the same form as acquired by the lessor as to which the lessor has paid sales tax reimbursement or use tax are not included within the definition of sale.

Sales and Use Tax Regulation 1660 provides in subdivision (c)(2) that where property is leased in the form in which it was acquired, but tax or tax reimbursement was not paid at the time of purchase, the lessor may elect to pay tax measured by the purchase price by reporting and paying the tax with the tax return for the period during which the property is first placed in rental service. Failure to make this election timely will result in the rental payments being subject to tax. See *Action Trailer Sale*s, *Inc*. v. *State Board of Equalization,* 54 Cal.App.3d 125. As to the material which petitioner purchased ex-tax, there is no question that tax applies to rental receipts. We note that this is a use tax levied on the lessee which the lessor is required to collect and pay to the Board. See Sections 6401, 6201, 6203, and 6204.

In determining whether property is leased in substantially the same form as acquired, the general rule is that if the value of the property is substantially in excess of the purchase price of the property leased, the item is not leased in substantially the same form as acquired. BTLG 330.3900 (February 17, 1967). We have previously concluded that where the cost of fabrication labor was 5% of the total cost, there was no substantial change in form, but where the cost of fabrication labor was 12% of the total cost, there was a substantial change in form. BTLG 330.3980 (November 1, 1967). Using this latter criteria, there has been a substantial change in form because petitioner's fabrication labor cost far exceeds 12%. Petitioner would have us use value, the term used in the former annotation, rather than a cost factor. Petitioner wants to base value on rental price. Petitioner places a different value on prefabricated drapes, however, than on material, for income tax purposes. Further, in the rental situation, we feel that by charging the same price for off-the-bolt drapery as for prefabricated drapery, petitioner is really charging for having material available on a stand-by basis and for the higher cost of on-site labor. We conclude that the prefabricated drapes are not rented in the form in which they were acquired. The auditor's approach to the application of tax is correct.

Section 6596 provides that if the Board finds that a person's failure to make a timely payment is due to the person's reasonable reliance on written advice from the Board, the person may be relieved of the tax and any penalty or interest added thereto. To qualify for this relief, the person must request in writing that the Board provide advice on a specific activity, the Board must respond to the person in writing, and the person must have reasonably relied on that advice. We do not regard a prior audit as meeting the conditions for a written request from petitioner or a written response from the Board. Although petitioner relied on the results of the prior audits, the Board's position in those audits was based on incorrect information as to the labor factor from petitioner or its predecessor. Therefore, we see no basis for applying tax prospectively only.

## Recommendation

Redetermine without adjustment.

/s/ H. L. Cohen
H. L. Cohen, Hearing Officer

11/7 /86
Date