STATE BOARD OF EQUALIZATION

October 6, 1965

Law Offices of
A---, D--- and H---
XXX West ---Street
--- ---, California XXXXX

SS -- XX XXXXXX
A--- I---, Inc.

Gentlemen:

This is to inform you of the position which we have taken with respect to the above named taxpayer's petition for redetermination. It is our recommendation that the determination of sales to California construction contractors for resale, which were disallowed in the audit, be redetermined excepting those few instances where the resale may not have occurred in the regular course of business. We regret, however, that we can recommend no adjustment with regard to the remainder of the determination and must recommend that a determination be issued for the audit period April 1, 1955, to September 10, 1957, including a 25 per cent penalty for fraud.

The sale for resale item, which amounted to a measure of tax of $1,164,111, was reduced by a reaudit dated October 9, 1964. It was later agreed that further adjustment would be made for resales to California air conditioning and plumbing contractors where it was reasonably probable that they had reported the tax. These adjustments reduced the amount to $86,640. Of this sum, $53,893 in sales were to a contractor named W---, evidenced by 10 invoices from May 1961 to April 1963. We understand this contractor operated under an assignment for the benefit of creditors. Neither W--- nor the assignee held a seller's permit, or reported tax.

We believe you have shown, however, that W--- purchased these items for resale and resold them in its regular course of business. No other deduction can be made from the following facts. W--- was listed in the Los Angeles telephone book as an air conditioning contractor. It purchased under 10 invoices a variety of air conditioning equipment suitable for commercial installation, some of which were delivered directly to the jobsite. A contractor would not have these items inventoried but would have to specially order them from the manufacturer.

With respect to the remaining sales to California contractors on which tax was not collected, there has been insufficient showing that these items were resold by the contractor in the regular course of business. They purchased under either one, two, or three invoices the items in question. In only one case was there three invoices within a 12-month period. It is possible, of course, that the goods purchased under separate invoices can be the subject of a single sale. Since these businesses did not have seller's permits and since their purchases are insufficient in number, scope,

and character to establish that, even though they were resold, the business would be required to hold a seller's permit under the sales tax law, we must conclude that you have not met the burden of proof in establishing the remaining items were resold in the regular course of the purchaser's business.

We have concluded that the remainder of the audit is proper. The taxpayer, for a period of seven years, collected California use tax from California customers but failed to report it to the state. The leading consideration here is that the parties to the transaction considered the sale of air conditioning fixtures as a retail sale. While this is improper under ruling 11, the California contractors relied on this payment of tax by either failing to report any tax or by taking a tax paid purchases resold deduction as provided by the Revenue and Taxation Code §6012(a). This section provides that a retailer may deduct the cost of property sold if he "… has reimbursed his vendor for tax which the vendor is required to pay to the State … and has resold the property prior to making any use … in the regular course of business." Because of these considerations, we do not believe the taxpayer can contend that these were not taxable sales but rather sales for resale. Proper administration of the tax requires that when buyer and seller treat a particular sale as a retail sale subject to tax and forego reporting tax on retail transactions, the sale designated by the parties is the retail sale.

In any event, the state's interest has been jeopardized by the parties' conduct. It has changed its position by accepting returns and allowing tax paid purchases resold credits (see ruling 71, copy enclosed). Therefore, we find no merit in the taxpayer's contention that these sales were not subject to the tax. Indeed, we believe the taxpayer cannot properly raise this point.

We also believe the excessive tax reimbursement doctrine established by the Revenue and Taxation Code § 6054.5 and Decorative Carpets, Inc. v. State Board of Equalization (1962) 58 Cal. 2d 252 [23 Cal. Rptr. 589] applies to this case. The taxpayer represented to its customers that the amounts in question constituted California use tax. Such monies constituted an involuntary trust in the hands of the taxpayer. The state may require the taxpayer to show, as a condition to refund, that such amounts will be refunded to the customers. However, refund to the customers in this case is improper because they failed to report tax on the resale or else received a tax paid purchases resold deduction. Section 6012(a) of the Revenue and Taxation Code provides that, "If such a deduction is taken by the retailer, no refund or credit will be allowed to his vendor with respect to the sale of property."

With respect to the audit period April 1, 1955 to September 10, 1957, we are recommending that a determination be issued against the taxpayer including a 25 per cent fraud penalty. We believe the theory of liability expressed above, in relation to the later audit, has equal force with respect to this audit. Since the taxpayer and buyers treated these as retail sales, we believe they constitute retail sales for the purpose of the tax. Since the state changed its position, the taxpayer cannot properly assert that they are anything other than retail sales. Moreover, the excessive tax reimbursement doctrine applies with equal force where the funds are in the hands of the taxpayer rather than with the state. While the Decorative Carpets case involved a claim for refund, there is nothing in the case to indicate the court's reasoning does not just as readily apply to petitions for

redetermination as claims for refund. The board has just as "vital interest in the integrity of the … (use) tax" in this case as in that and "to allow the taxpayer to retain these amounts would sanction a misuse of the … (use) tax by a retailer for his private gain." (58 Cal. 2d at p. 255).

You also argued that the board has no jurisdiction to tax because the Legislature did not require out-of-state retailers to collect the tax prior to September 11, 1957, unless they had places of business within this state. The answer to this is that while the board could not have required collection, they could and did make arrangements with out-of-state businesses to collect use tax in behalf of their customers. Amounts thus collected constituted a debt owed by the retailer to the state under § 6204 just as much as amounts collected by retailers having offices in the state. Similarly, the monies collected by this taxpayer constitute a debt owed the state because they were collected from California customers under the guise of California use tax. We cannot imagine the California Legislature denying competency to its taxing agency in this circumstance.

We think there is no jurisdictional problem in the constitutional sense in that the taxpayer, during this time, had representative living, operating, and soliciting sales in this state. Such contacts satisfy the requirements of due process. (Scripto v. Carson (1960) 362 U.S. 207.)

The final question is the propriety of a 25 per cent penalty on the ground that petitioner's failure to file returns was due to fraud or intent to evade the laws or rules and regulations. The burden of proof in the case of a fraud penalty is with the state who must prove by clear and convincing evidence the taxpayer's fraudulent intent to evade the tax. (Marchica v. State Board of Equalization (1951) 107 Cal. App. 2d 501 [237 P.2d 725].) We believe these requirements are amply met in this case.

Fraud is not limited to overt action. Civil Code § 157 defines fraud to include "… suppression of that which is true … ." Civil Code § 1710 includes in the definition of fraud "… suppression of a fact, by one who is bound to disclose it … ." Here the fraudulent acts were the failure to file returns and report tax. It is when this action is combined with the fraudulent intent to evade the tax that the penalty properly applies. The taxpayer's intent to evade the tax is shown by a continuing course of conduct lasting seven years. During this period the taxpayer billed and collected from its California customers California use tax. During all of this time, no attempt was made to pay any portion of it over to the state. There is no evidence that, had it not been for an audit investigation, this money would have ever been turned over.

The taxpayer cannot claim lack of knowledge of the tax laws. It billed the tax on its invoices. Furthermore, correspondence examined by our auditors makes it evident that the taxpayer knew of its responsibilities. California customers requested the taxpayer to bill them so that they would not have to report the tax. Others requested them not to bill the tax because they were paying it directly. The U---of California, in one instance, instructed them concerning the proper manner of giving them a receipt showing that the use tax was paid.

The taxpayer had a duty to disclose its tax liabilities by filing returns. It is not enough, as you have suggested, to file franchise tax returns or to list an agent for service of process with the

Secretary of State. Neither is it an answer to the fraud penalty that the taxpayer consulted their accountants. This was not done until it had been collecting tax for a period of seven years. Consulting with their accountants at this late date does not show good faith. It only shows an increased awareness of the ability of California to require payment of taxes collected by businesses located in Michigan.

You did not indicate in the petition that you desired an oral hearing before the board. If, after you receive notification from our out-of-state district office of the adjustments we have recommended and the notice of determination for the earlier audit period, you disagree with our contentions and desire such a hearing, you may make a request directed to our attention. We will then schedule the matter before the board. If you prefer the board to hear the matter in Los Angeles rather than Sacramento you should so indicate in the request.

Very truly yours,

John H. Knowles
Associate Tax Counsel

JHK:mm

cc: Out of State – District Administrator
Attached are two copies of hearing officer's report dated July 26, 1965, which has been approved. This hearing was held in Los Angeles on May 20, 1964.

Also attached are the work papers for the audit dated 1-24-64 covering the period from 9-11-57 to 9-30-63.

Also attached is Report of Field Audit covering the period 4-1-55 to 9-10-57.