STATE OF CALIFORNIA

BOARD OF EQUALIZATION

APPEALS UNIT

495.0750

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of:	)	HEARING DECISION AND RECOMMENDATION
[B]	)	No. S- -- XX-XXXXXX-010
Petitioner	)	

The above-referenced matter came on regularly for hearing before Hearing Officer Janice M. Fallman on March 22, 1990, in San Francisco, California.

Appearing for Petitioner:	--- -. [E], Partner --- ---
Appearing for the Department of Business Taxes:	Morris Verna, Jr. Supervising Tax Auditor Dana Chavarria Senior Tax Auditor

Protested Item

The protested tax liability for the period July l, 1983, through June 30, 1987, is measured by:

Item	State, Local County & SMCT
Exempt sales overstated by 22.28% based on a 4-quarter block samp1e	$412,584

The determination includes penalties in the total amount of $2,857.73 for negligence and: failure to file returns.

Petitioner's Contentions

Petitioner contended that it and --- --- --- --- (hereinafter "FFP") should be treated as a single entity under the holding in Mapo. Inc. v. State Board of Equalization, (1975) 5 Cal.App.3d 245, 125 Cal.Rptr. 727, so that its transfers of tangible personal property to FFP did not result in a sale under Revenue and Taxation Code section 6006(b).

Petitioner also contended that assertion of 10 percent penalties under Revenue and Taxation Code sections 6511 and 6484 were unmerited under the facts of this case.

Summary

Petitioner applied for a seller's permit in April 1985. The stated nature of its business was a machine shop. Mr. [G] is petitioner's sole shareholder. Mr. [G] also owns 96 percent of FFP. The remaining 4 percent of FFP is owned by [F] who is petitioner's chief financial officer. FFP and petitioner filed unitary state income tax returns with the State of California Franchise Tax Board.

FFP manufactures "packing peanuts" used by merchandisers to protect their products in shipping containers. Petitioner manufactures sheetmetal overhead storage bins to the specifications of various merchandisers who purchase packing peanuts from FFP so that the packing peanuts can be dispersed through a tube into packing containers below. Petitioner also fabricates and repairs tools, machinery and equipment that FFP uses in its day-to-day operations.

For calendar year 1986, Mr. [G] filed his personal income tax return electing 'S' corporation status for petitioner. Petitioner's losses, gains, credits, etc., appeared as offsets and adjustments against Mr. [G]'s personal income. Petitioner filed a separate informational federal income tax return for an S-Corporation.

Approximately 40 years ago, a predecessor business known as [S] commenced operating. Owned by Mr. [G]'s father, it manufactured ice cream cones and paper straws. The ends of the paper straws were used as packing material. Over the years, [S] evolved, and a machine shop was added which employed union labor.

In June 1983, [S] was sold. It is unclear if FFP was a division of [S] that was spun off or if it was created thereafter. FFP needed the machinery and repair labor that were previously available from [S]. [S]'s buyer did not want to retain the union laborers who operated the machine shop. Because FFP was non-unionized, Mr. [G] incorporated petitioner herein, primarily to avoid unionization of FFP. Making petitioner a separate entity allowed for the continued employment of four previous [S] union laborers who performed necessary repairs, machine tooling and fabrications.

Petitioner's physical plant is located less than two blocks from FFP. FFP maintains a blanket liability insurance policy for itself and petitioner. Petitioner maintains separate worker's compensation insurance for its employees.

Petitioner did not perform its own accounting or maintain its books and records. These services were performed by FFP which billed petitioner approximately $1,000 monthly for "services." (See Exhibit A.) No accounting expense entry appears on the 1986 Form 1120S, U.S. Income Tax Return for an S-corporation, filed by petitioner. However, there is a $23,530 professional fee deduction which petitioner's representative stated probably was the accounting charge. According to petitioner's Form 11205, it was a lessor of real estate and the owner of equipment for which it claimed depreciation expense.

Petitioner maintained separate bank accounts and paid its' own payroll taxes. Petitioner contracted for supplies and other materials under its' own name. Petitioner issued its own purchase orders and remitted payment for its payroll, facility costs, rents, and other business expenses from its own bank accounts. In issuing purchase orders, petitioner used its' own seller's permit number, issued resale certificates in its own name, and did not identify any purchase of materials or supplies to specific general work orders issued by FFP (hereinafter GWO'S.)

Petitioner and FFP annually negotiated an hourly wage for labor services provided by petitioner to FFP under GWO's. Petitioner billed FFP per job based upon the agreed hourly cost of labor and the actual material expenses incurred to complete each GWO. (Exhibit A). The accounting office segregated petitioner's billing into two categories, labor and materials, on the bookkeeping entries in the general ledgers of both FFP and petitioner.

Petitioner's officers and directors did not draw salaries. While petitioner issued its own purchase orders, it did not have a purchasing manager or personnel. The only payroll remitted from petitioner's bank accounts was that of the union employees. The union employees consisted of an electrician, two machinists, one sheetmetal worker, and one occasional extra man.

The day-to-day operations of petitioner's physical plant were supervised by a chief engineer who was employed by FFP. The engineer received his salary from FFP's payroll and participated in FFP's employee benefits plans). The chief engineer was charged with the responsibility for quality control, production scheduling, job assignment, and hiring and firing of petitioner's personnel.

All decisions as to what designs, engineering projects and purchasing, were made by Mr. [G] and Chief Financial Officer, Mr. [F], the other shareholder in FFP. There was no written agreement between petitioner and FFP as to the manner in which they would operate or would provide goods and services to each other.

According to petitioner, it never maintained a strong separate corporate identity, had no profit motive, and was operated primarily to avoid union problems. It mostly manufactured, fabricated, and repaired equipment for FFP or for FFP's clients. The reporting period in this case covered sixteen quarters. The tax auditor's investigation disclosed that in at least nine quarters, there were sporadic or incidental third party sales to entities other than FFP or FFP's clients. The tax auditor performed a sampling of reported exempt sales for resale for four of the sixteen quarters. In three of the test period quarters, there were no outside sales to entities other than FFP. In the fourth quarter of 1985, there were four third-party sales other than to FFP or FFP's clients. One sale, approximating $2,000, was made to [S] for a metal straw container. The three remaining third party sales during the test period amounted to less than $500.

Petitioner provides goods in connection with services to FFP in several ways:

(1) It manufactures tools, casings and parts as specified for use by FFP and repairs equipment and fixed assets for FFP. The tax auditor determined that petitioner acquired the materials ex-tax and that this fabrication labor was taxable as a sale of goods and services.

(2) It also fabricates bins and metal containers to the specification of FFP's clients to be used as overhead storage containers for the packing peanuts. The tax auditor treated the work performed for FFP's clients under GW01s as sales for resale.

When FFP contracted to sell packing peanuts, it issued a GWO to petitioner to fabricate an overhead sheetmetal container with a dispersal tube to be used as a storage bin by FFP's client. Petitioner's employees measured facilities of the buyers, fabricated the storage containers and ancillary equipment needed to disperse the packing peanuts into the buyer's shipping containers and crates, and then fabricated and installed the containers for use at the facilities of FFP's buyers. The finished containers did not bear any tag or identification that they had been manufactured by petitioner. Petitioner stated that many of FFP's buyers were unaware that petitioner was a separate entity from FFP. According to petitioner's representative, FFP bears the risk of loss and ultimate liability for containers and products fabricated by petitioner.

Analysis and Conclusion

Revenue and Taxation Code section 6006(a) and (b) provide as follows:

" 'Sale.' 'Sale' means and includes:

(a) Any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration. 'Transfer of possession' includes only transactions found by the board to be in lieu of a transfer of title, exchange, or barter.

(b) The producing, fabricating, processing, printing, or imprinting of tangible personal property for a consideration for consumers who furnish either directly or indirectly the materials used in the producing, fabricating, processing, printing, or imprinting.

At the hearing, petitioner's representative contended that Revenue and Taxation Code section 6006(b) was applicable under the mistaken belief that FFP provided the materials fabricated by petitioner. Subsequent investigation disclosed that petitioner acquired materials consumed to perform FFP's GWO's in its own name and thereafter billed FFP for materials and labor. (Exhibit A.) The accounting department at FFP then segregated material and labor components of all of petitioner's billings. In this case, however, Revenue and Taxation Code section 6006(a) is applicable. Petitioner transferred title and possession of tangible personal property to FFP or to its clients for consideration.

Numerous facts in this case and many of petitioner's operating procedures closely parallel those in Mapo, Inc., supra, upon which petitioner relies. At the hearing, the parties addressed these numerous similar or dissimilar factors in petitioner's day-to-day operations in order to parallel or distinguish Mapo. While it is tempting to engage in a balancing test, it is inappropriate to do so because the underlying facts and circumstances of this case are clearly distinguishable from those in Mapo.

The state has a compelling and fundamental interest in the collection of tax revenues. Thus, Mapo should be strictly construed as an exception to the otherwise general rule that relief from taxation should not be granted by disregarding separate legal entities even when one corporation wholly owns the other and there exists a commonality of corporate directors and shareholders. [Northwestern Pacific Railroad Company v. State Board of Equalization, (1943) 21 Ca1.2d 524, 530; Rexall Drug Co. v. Peterson, (1952) 113 Cal.App.2d 528, 530; Mapo supra at 248.] The court in Mapo decided not to apply the above general rule and considered factors which either are not relevant or are not present in this dispute:

(a) The Length of Time The Corporations Separately Existed.

Citing Superior Coal Company v. Department of Finance, (1941) 377 Ill. 282, the court in Mapo noted that for its entire six-year existence, Mapo did nothing for its own account or for anyone except its corporate relatives. The tax auditor's investigation disclosed that in nine of sixteen quarters, petitioner engaged in one or more outside sales to third parties other than to FFP or its clients. These sales were sufficient in frequency and recurrence to conclude that petitioner was a retailer and held itself out as being a business open to the general public.

(b) Independent Business Purposes of The Separate Corporations.

Petitioner greatly emphasized that its sole shareholder is also the controlling shareholder of FFP and that third-party sales only occurred if Mr. [G] instructed it to perform the work. Unlike all the cases cited and relied upon in Mapo, petitioner's relationship to FFP is not that of a wholly owned subsidiary. This lack of a complete identity of shareholders is relevant.

[G] treated petitioner as an 'S' corporation, returning profits, losses, credits, and other tax ramifications on his personal income tax return much in the same manner that a sole proprietor would offset his personal nonrelated income with credits or losses from a business appearing on a Schedule C. Petitioner truly related to FFP, they, presumably, would have filed consolidated federal income tax returns. As a 4-percent shareholder of FFP, Mr. [F] would then have also benefited from any losses, etc., incurred by petitioner. While petitioner and FFP may file a unitary tax return with the state of California Franchise Tax Board, in federal tax matters, Mr. [G], who has the controlling interest in both entities, exercised his ownership prerogatives to derive petitioner's flow-through tax benefits solely for himself.

Petitioner also relied heavily on the fact that a chief engineer employed by FFP ran petitioner's day-to-day operations and that the majority of petitioner's fabrications and services related to GWO'S issued by FFP. In this regard, petitioner and FFP are no different than thousands of other related entities that routinely subcontract exclusively between themselves for goods, labor and services.

FFP locked in petitioner as a supplier of bins and containers at a favorable negotiated price for labor. Prompt fabrication of storage containers was necessary to facilitate distribution of FFP' s product. Petitioner's availability enhanced and promoted FFP's sales of packing peanuts. Mr. [G]'s motive in creating petitioner, as a separate entity, may have been partially fueled by considerations of the impact of unionization on FFP's operations. Nevertheless, his primary consideration was that the four union laborers would be readily available to perform necessary fabricating and repair services at a favorable price. It is equally clear that when third parties needed fabrication of goods, Mr. [G] did not hesitate to exercise his management discretion as the controlling shareholder to engage in sales to the general public. FFP's loan of a supervisor to petitioner merely was a delegation of its controlling shareholder's authority to an agent. Whether payment of the supervisor's salary and benefits by FFP was an ordinary and necessary business expense of that entity involves income tax considerations, not business tax consequences.

Petitioner's services to FFP were not limited to fabrication of bins to enhance FFP's sales of packing peanuts to third parties. Petitioner also performed general tooling, fabricating, and repairs of equipment, machinery, and fixed assets for FFP. By negotiating annually an hourly wage for petitioner's labor, FFP obtained readily available labor, did not have to bid its contracts and deal with unknown subcontractors, and avoided incurring personnel expenses for employee benefit plan funding. Neither did FFP have to deal with the union. While petitioner's negotiated hourly wage apparently met union scale, petitioner's operation was labor intensive which created annual losses that Mr. [G] used to offset his personal income. These losses partially arose from billing materials to perform a GWO at cost without a markup.

(c) Observance of Usual Formalities of Purchase/Sale Between the Corporations.

Unlike Mapo, petitioner did not operate under an express written agreement with FFP nor were its main functions to serve as a paymaster and union negotiator. Due to the role of Mr. [G] as a controlling shareholder of both entities, [G] oversaw petitioner's day-to-day operations which he delegated to an employee of FFP. Mr. [G], however, did not treat petitioner as his alter-ego. Petitioner maintained separate bank accounts and contracted in its' own name for its real estate lease. Petitioner depreciated its fixed assets, held itself out to third parties to be a separate entity, contracted in its' own name for inventory, goods and services, and remitted payment for those items and for other operating expenses in its own name from its own·bank account. The aforementioned activities clearly exceed those engaged in by Mapo. They bear every indicia of independent business purpose and operation.

If it is ultimately determined that FFP and petitioner should be treated as a single entity for tax purposes, all disputed items were acquired ex-tax. Thus, use tax will be due.

Petitioner contended that many of the employees of FFP were unaware of petitioner's existence. It is irrelevant that FFP employees did not know petitioner existed. Petitioner did not advertise or have a listing in the yellow pages of the phone directory. According to the tax auditor, however, petitioner was listed in the white pages of the phone directory.

Petitioner alleged that it did not warranty its products and did not bear the risk of defects for products it fabricated under GWO's to provide storage bins for FFP' s buyers. Perhaps FFP's buyers were unaware that fabrication of the storage bins had been subcontracted by FFP to petitioner. This is of little or no relevance, except to explain why FFP maintained a blanket liability insurance policy on both companies. Many related entities provide goods and services through undisclosed subcontracts to each other's clients and yet maintain separate corporate existences, e.g., GMAC Motor Corporation and GMAC Acceptance corporation.

The fact remains that in nine of sixteen quarters; third parties unrelated to FFP's sale of packing peanuts contracted with petitioner direct to fabricate goods. Petitioner contracted with these buyers in its' own name and billed for the contract price in its' own name. Petitioner transferred possession and title of tangible personal property for consideration in each instance. Thus, it is irrelevant if these third parties discovered petitioner in the phone directory or by referral. Both parties knew with whom they were contracting. The resulting sales were at retail, and no tax consequences flowed from petitioner to FFP from these sales because no consolidated federal tax returns were filed.

Petitioner allegedly did not maintain separate liability insurance. Petitioner's 1986 Form 11208 reflected that it had incurred $6,000 of unidentified insurance expense. It is uncertain whether this amount was to reimburse FFP for its portion of the coverage under FFP's blanket liability insurance policy or to pay petitioner's insurance. In either instance, there is little, if any, relevance to FFP carrying petitioner as an "other insured," especially since petitioner alleges that its' subcontracting fabrication of goods to FFP's clients was undisclosed, which, presumably, exposed FFP to contingent liability in tort or contract.

Where a corporation and its 'subsidiary behave as separate entities, the transfers between them which comply with the statutory definition of a sale are subject to sales tax. [Northwestern Pacific Railroad supra, pp. 530-531.]

Unlike the cases cited in Mapo, the relationship between petitioner and FFP is not that of a parent corporation and its wholly owned subsidiary. The books of account and records were maintained by FFP, but according to their respective business practices, a charge was made by the parties whenever services were rendered or goods were transferred from one to the other.· Formal orders were issued by FFP to obtain services or goods from petitioner. This is also a common practice between prime contractors and subcontractors who are in no way interrelated.

Petitioner formally billed FFP for reimbursement of the cost of materials and the agreed hourly labor charge used in performing the GWO's. Petitioner and FFP engaged in the formality of negotiating an annual hourly wage. Advances made by FFP to petitioner for operating loans were carried as such on their respective books of account and, according to petitioner; loans were reimbursed at the end of each year by a check remittance. Every indicia of formality in recordkeeping and maintenance of a separate identity existed between these two entities. This allowed Mr. [G] to document petitioner's corporate losses that were returned on his personal federal income tax return to offset unrelated personal income.

Petitioner recommended ignoring these separate legal entities and treating petitioner as a subdivision of a single corporation.

The court, in Mercedes-Benz v. State Board of Equalization, (1982) 127 Cal.App.3d 871; 179 Cal.Rptr. 758, recognized that there was a significant difference between a wholly-owned but separate corporation and divisions of a single corporation.

Petitioner alleged that it never made a profit. The law does not require that a taxable sale be made with the intent to make a "profit." Revenue and Taxation Code section 6006 merely requires that tangible personal property be transferred for consideration. In fact, Revenue and Taxation Code section 6013 defines a "business" as an activity engaged in for "gain, benefit or advantage," not "profit." [Market Street Railway Company v. State Board of Equalization, (1955) 137 Cal.App.2d 87.] FFP clearly obtained an advantage and benefited by locking in petitioner's services at a fixed labor cost with no markup for materials under the contract. Petitioner has not demonstrated that the third party buyers enjoyed this no markup privilege.

Petitioner's sole shareholder also benefited by the S-Corporation election by which he availed himself of tax write-offs that were precluded to Mr. [F] as a 4-percent shareholder in FFP when petitioner and FFP did not file a consolidated federal income tax return.

If an entity elects to conduct business through the device of separately incorporated, although wholly owned subsidiaries and thereby obtains the advantages of separate corporate entities, it must also suffer whatever disadvantages attached to that election. Petitioner and FFP were not even parent and subsidiary. They were affiliated corporations through contract and common ownership. Any such affiliation, however, for business tax purposes was insufficient to deem them to be one entity. [Northwest Pacific Railroad, supra.] Petitioner's and FFP's separate business activities benefitted and enhanced each other. Their activities nevertheless met the statutory definition of a sale. [Rev. and Tax. section 6006(b).] Petitioner has failed to demonstrate the exclusivity in business activities discussed in Mapo which would preclude application of sales tax to its transactions with FFP.

This was petitioner's first audit. Based upon the facts of this case and petitioner's submission under penalty of perjury, imposition of the negligence and failure to file penalties are not merited.

Recommendation

Delete the penalties and redetermine the tax without adjustment

____________________________ July 13, 1990

Janice M. Fallman Date