

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION BOARD HEARING SUMMARY

In the Matter of the Petition for Redetermination)
Under the Sales and Use Tax Law of:)
TERRAVANT WINE COMPANY, LLC) Account Number SR Y AR 100-920650¹
Petitioner) Case ID 717959
Buellton, Santa Barbara County

Type of Business: Winery

Audit period: 01/01/08 – 12/31/11

<u>Item</u>	<u>Disputed Amount</u>	
Allowance for rental receipts reported as taxable	-\$1,370,609 ²	
Purchases of fixed assets subject to use tax		
Purchased from out-of-state vendors	\$1,500,023	
Purchased from in-state vendors under resale certificates	\$2,610,934	
Negligence penalty	\$ 39,033	
	<u>Tax</u>	<u>Penalty</u>
As determined and proposed to be redetermined	\$390,323.67	\$39,032.38
Less concurred	<u>- 182,408.58</u>	<u>00.00</u>
Balance, protested	<u>\$207,915.09</u>	<u>\$39,023.38</u>
Proposed tax redetermination	\$390,323.67	
Interest through 01/31/15	169,509.91	
Negligence penalty	<u>39,032.38</u>	
Total tax, interest, and penalty	<u>\$598,865.96</u>	
Monthly interest beginning 02/01/15	<u>\$1,951.62</u>	

UNRESOLVED ISSUES

Issue 1: Whether petitioner was required to report and pay use tax on the purchase price of winemaking equipment used under Alternating Proprietor Agreements. We find that it was.

¹ Although the seller's permit number was SR Y GH 100-920650 when the D&R was issued, the number has been changed to SR Y AR 100-920650.

² This amount represents the revenue received by petitioner that it regarded as receipts from the rental of equipment. Since the Department found petitioner is liable for tax on the cost of the equipment, it has regarded the reported rental receipts as an offset against the unreported cost.

1 Petitioner operates a winery with a tasting room. Petitioner also provides winemaking services
2 to other licensed winemakers under two types of agreements, Custom Crush Agreements (CCA's) and
3 Alternating Proprietor Agreements (APA's). The CCA states that petitioner shall produce wine for
4 customers to the customers' specifications at petitioner's premises. Under this agreement, petitioner is
5 responsible for receiving, weighing, crushing, and fermenting the grapes provided by the customer and
6 producing the wine to the best of petitioner's ability. Under the APA, petitioner makes space and
7 equipment available to licensed winemakers (AP vintners). Petitioner's employees operate the
8 equipment, while the APA provides that equipment and facilities will be under the control of an AP
9 vintner, with the AP vintner providing detailed written winemaking instructions to petitioner for each
10 stage of the winemaking process. Pursuant to the APA, petitioner's employees will not perform any
11 work unless and until petitioner approves, in writing, the AP vintner's work orders.

12 Petitioner had purchased equipment ex-tax (either from out-of-state vendors or from in-state
13 vendors, under a resale certificate) to be used in the execution of both types of agreements. The Sales
14 and Use Tax Department (Department) found that petitioner had made a taxable use of the equipment
15 in the execution of both the CCA's and APA's. Thus, the Department concluded that petitioner is the
16 consumer of the equipment, and the cost of the equipment is subject to use tax.

17 Petitioner concedes that the equipment purchased for the execution of CCA's is subject to use
18 tax. However, it contends that it leased the equipment to the AP vintners under the APA's. In that
19 regard, petitioner reported its charges related to equipment under the APA's as taxable rental receipts.
20 Petitioner asserts that it leases its premises and equipment to third-party licensed winemakers under the
21 APA's and that the APA's constitute leases, pursuant to California Code of Regulations, title 18,
22 section 1660, because the AP vintners exercise true control over petitioner's facility and employees
23 during the winemaking process under those agreements. Petitioner points specifically to Sections 1, 6,
24 and 16 of the APA which provide, in pertinent part, that petitioner's equipment and facilities will be
25 under the control of AP vintners pursuant to the APA (Section 1), that the AP vintner shall have
26 ultimate authority with respect to winemaking practices, will employ its own winemaker or
27 winemaking consultant for such purposes, and shall designate specific winemaking procedures by
28 providing special winemaking instructions in the form of written work orders to petitioner's designated

1 representative (Section 6), and that the AP vintner is solely responsible for its own winemaking
2 activities, winery bookkeeping and reporting, occupational and excise taxes, and for any violation at
3 petitioner's facilities during its periods of control (Section 16). Petitioner also states that its operations
4 are regulated by the Department of the Treasury, Alcohol and Tobacco Tax and Trade Bureau (TTB)
5 and quotes TTB Industry Circular 2008-4 (circular), which states, "The proprietor employing the
6 services of another proprietor's workers must direct and be fully responsible for those things that are
7 usual and customary for the production, bottling and storage of wine...". Petitioner also refers to a
8 California Alcoholic Beverage Control Trade Enforcement Information Guide (guide) issued in
9 November 2009, which states that the alternating proprietor uses the facilities of the host winery to
10 make its own wine.

11 It is undisputed that under the APA all of the equipment used in the winemaking process is
12 owned and maintained by petitioner, remains on petitioner's property at all times, and is operated
13 solely by petitioner's employees. While the AP vintner provides instructions for each stage of the
14 winemaking process and may be present during any stage of the process, the AP vintner may not
15 operate any of the equipment used to produce the wine at any time. The fact that petitioner's
16 employees actually operate the equipment means that petitioner did not lease the equipment to the AP
17 vintners, but instead provided a service. (See *Entremont v. Whitsell* (1939) 213 Cal.2d at 295.) In
18 addition, Section 9 of the APA provides that petitioner's employees will not perform any work unless
19 and until the AP vintner's work orders are approved in writing by petitioner. These requirements
20 demonstrate that possession and control of the equipment has not been transferred to the AP vintner
21 because petitioner controls when the work begins (upon approval of the work orders), where the work
22 is performed (on petitioner's premises), and who performs the work (petitioner's employees).
23 Therefore, we find that petitioner did not lease the equipment, but instead used it. We are not
24 persuaded otherwise by the section of the APA which states that the equipment and facilities used
25 under APA's will be under the control of the AP vintner, since we find that the statement relates to the
26 AP vintner's control over the wine-making process and does not negate the fact that petitioner's
27 employees actually operate the equipment at issue, which means that petitioner did not lease it.
28 Moreover, we find nothing in the circular or guide mentioned by petitioner that supports a finding that

1 petitioner transferred temporary possession and control of the winemaking equipment to the AP
2 vintners such that a lease of the equipment occurred.

3 **Issue 2:** Whether petitioner was negligent. We conclude that it was.

4 The Department imposed a negligence penalty because petitioner purchased a material amount
5 of fixed assets for use and did not report and pay use tax, and because it found petitioner's records
6 inadequate. Petitioner disputes the penalty on the basis that it was not negligent.

7 The audit disclosed a deficiency measure of \$5,144,517, all related to ex-tax purchases of
8 equipment from out-of-state vendors or from in-state vendors under a resale certificate, which
9 petitioner used in execution of the CCA's and APA's. The understatement represents an error ratio of
10 247 percent when compared to petitioner's reported taxable measure of \$2,086,086. We find that
11 substantial understatement to be strong evidence of negligence. While there is evidence that a portion
12 of the understatement may be the result of petitioner's misunderstanding as to whether equipment used
13 in relation to the APA's was leased, we note that \$2,404,169 of the understatement results from use tax
14 on petitioner's purchases of fixed assets used under CCA's, which is not disputed. The conceded
15 understatement alone represents an error ratio of 115 percent when compared to reported taxable
16 measure of \$2,086,086. Thus, we find petitioner was negligent, and the penalty was properly applied,
17 even though petitioner had not been audited previously.

18 **OTHER MATTERS**

19 None.

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21 Summary prepared by Deborah A. Cumins, Business Taxes Specialist III
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