

**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: )  
BAY AREA FENCE & DECK, INC., dba ) Account Number: SR GH 100-341414  
Bay Area Lumber Company ) Case ID 443761  
Petitioner )  
San Jose, Santa Clara County

Type of Business: Construction contractor

Audit period: 07/01/04 – 06/30/07

<u>Item</u>	<u>Disputed Amount</u>
Unreported taxable measure	\$499,920
Tax determined and protested	\$41,928.25
Interest through 05/31/12	<u>22,138.38</u>
Total tax and interest	<u>\$64,066.63</u>
Monthly interest beginning 06/01/12	<u>\$ 244.58</u>

This matter was previously scheduled for Board hearing in August 2010, but was postponed to allow petitioner additional time to prepare for the hearing. It was rescheduled for Board hearing in November 2010 but was postponed for settlement consideration.

**UNRESOLVED ISSUE**

**Issue:** Whether adjustments are warranted to the unreported taxable measure. We recommend no adjustment.

Petitioner is a construction contractor who builds decks and fences and has minor over-the-counter sales. Petitioner performed construction contracts on a lump-sum basis, and purchased all materials for resale. The Sales and Use Tax Department (Department) conducted a cost accountability test to evaluate whether the cost of all materials and selling price of all retail sales had been reported by petitioner. Based on a review of July 2005 transactions, the Department determined that 3.02 percent of petitioner's receipts were from retail sales. It applied the 3.02 percent to petitioner's gross receipts to determine its retail sales, and it then reduced that figure by petitioner's markup of 19.58 percent (computed by comparing the selling prices on three invoices with the related costs) to compute

1 cost of goods sold at retail. To compute the cost of materials consumed in construction contracts, the  
2 Department reduced the cost of goods sold recorded on petitioner's federal income tax returns for 2005  
3 and 2006 by the computed cost of goods sold at retail and by recorded amounts of dumping labor  
4 charges that had been recorded as purchases. To establish the audited taxable measure for 2005 and  
5 2006, the Department added the computed cost of materials consumed and the audited retail sales.  
6 Comparing audited and reported taxable measure for 2005 and 2006, the Department computed  
7 understatements of \$145,799 and \$292,893, respectively, which represented percentages of error of  
8 14.98 and 15.14 percent, and 15.07 percent overall. The Department applied those percentages to the  
9 taxable measure reported on sales and use tax returns for fiscal years ending 2005, 2006, and 2007,  
10 respectively, to compute the understatement of \$499,920.

11 Petitioner contends that the audited understatement is excessive, disagreeing with all of the  
12 Department's calculations, sampling, and projections. Petitioner specifically argues that an allowance  
13 should be made for waste, asserting that it is essentially a remanufacturing plant. Also, petitioner  
14 stated that bags of redi-mix concrete were damaged by forklifts, and there was further waste at the  
15 jobsites. Petitioner maintains that the cost of defective materials should be deducted from the total cost  
16 to establish the cost of materials subject to tax. Petitioner also contends that the retail sales ratio was  
17 about four percent rather than about three percent as computed by the Department.

18 A construction contractor may not purchase materials for resale unless it is also in the business  
19 of selling materials (Cal. Code Regs., tit. 18, § 1521, subd. (b)(6)(A)), which for these purposes means  
20 that the contractor makes substantial retail sales of the same type of materials that it uses on  
21 construction contracts. (Sales and Use Tax Department Audit Manual, § 1206.10.) Furthermore,  
22 where a construction contractor knows at the time of purchase that the materials will be consumed in  
23 the performance of a construction contract, the contractor may not issue a resale certificate to the  
24 vendor. If the contractor improperly issues a resale certificate for materials that will be consumed, tax  
25 is due based on the purchase date, not based on the date on which the materials were withdrawn from  
26 inventory. (Cal. Code Regs., tit. 18, § 1668, subd. (g); see also Audit Manual, § 1206.10.)

27 Petitioner purchased the subject materials to furnish and install on contraction contracts, that is,  
28 as a consumer, making only relatively incidental sales of such materials (whether the audited three

1 percent or asserted four percent). Thus, petitioner was not eligible to purchase materials for resale. As  
2 a consumer, petitioner incurred tax at the time of its purchase, measured by the cost of those materials.  
3 With respect to its incidental sales, it owed sales tax on taxable retail sales, and was entitled to  
4 allowance for tax paid (or, here, tax that should have been paid against the liability for that tax). Since  
5 petitioner's liability for tax was incurred upon purchase, no adjustment is warranted for waste as part  
6 of its consumption or for defective products (unless it received a credit from the supplier). With regard  
7 to petitioner's contention that the audited amount of retail sales should be increased, an increase in the  
8 audited percentage of retail sales would *not* decrease the deficiency but instead would increase it by a  
9 measure equal to the markup on those additional retail sales. Accordingly, we conclude that no  
10 reduction to the deficiency is warranted.

11 **OTHER MATTERS**

12 None.

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