

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:)
FENCE AMERICA, INC.) Account Number SR KH 100-332144
Petitioner) Case ID 479354
Sacramento, Sacramento County

Type of Business: Construction contractor

Audit period: 01/01/04 – 12/31/06

<u>Item</u>	<u>Disputed Amount</u>
Unreported taxable measure	\$5,102,421
Tax as determined	\$325,613.09
Post-D&R adjustment	<u>100,363.92</u>
Proposed redetermination	\$425,977.01
Less concurred	<u>- 50,410.20</u>
Balance, protested	<u>\$375,566.81</u>
Proposed tax redetermination	\$425,977.01
Interest through 05/31/12	<u>244,692.62</u>
Total tax and interest	<u>\$670,669.63</u>
Monthly interest beginning 06/01/12	<u>\$ 2,484.87</u>

This matter was scheduled for Board hearing on February 28, 2012, but was postponed at petitioner’s request to allow additional time to submit an opening brief.

UNRESOLVED ISSUE

Issue: Whether adjustments are warranted to the unreported taxable measure. We find no further adjustments are warranted.

Petitioner operated as a construction contractor, furnishing and installing fencing materials, from January 1, 2004, through December 31, 2007. Petitioner also sold some fencing materials over-the-counter without installation. Petitioner acquired all of its fencing materials without payment of tax or tax reimbursement by issuing resale certificates to its vendors, which were located both in California and outside of California. Petitioner did not report any purchases subject to use tax on line 2 of its

1 sales and use tax returns, and instead reported taxable measure only on line 1 of its returns as total
2 sales.

3 The Sales and Use Tax Department (Department) found that petitioner did not maintain cost
4 files for individual jobs. Since petitioner was a consumer of materials it furnished and installed in the
5 performance of construction contracts and a retailer of materials sold over-the-counter, the Department
6 performed a cost accountability test to establish the audited taxable measure. To establish the cost of
7 materials available for consumption or sale, the Department made various adjustments to recorded
8 purchases, including adjustments for changes in inventory, a five percent allowance for spoilage, and a
9 one percent allowance for theft. To establish the audited cost of materials consumed, the Department
10 reduced the cost of materials available by the cost of over-the-counter sales, which it computed using
11 the recorded taxable sales, net of sales tax reimbursement, and an audited markup of 45.5 percent,
12 which was computed in a shelf test. The Department then added the audited cost of materials
13 consumed in the performance of construction contracts and the recorded taxable over-the-counter sales
14 to establish the audited taxable measure. The Department found that the audited taxable measure
15 exceeded the reported amount by \$4,424,413.

16 Petitioner contends that the amount of understatement is excessive because: 1) the amount of
17 beginning inventory for 2004 should be reduced; 2) the allowances for spoilage and theft should be
18 increased; 3) there should be an adjustment for nontaxable sales for resale; and 4) certain freight-in
19 charges should be deducted from the cost of materials available. A construction contractor may not
20 purchase materials for resale unless it is also in the business of selling materials (Cal. Code Regs., tit.
21 18, § 1521, subd. (b)(6)(A)), which for these purposes means that the contractor makes substantial
22 retail sales of the same type of materials that it uses on construction contracts. (Sales and Use Tax
23 Department Audit Manual, § 1206.10.) Furthermore, where a construction contractor knows at the
24 time of purchase that the materials will be consumed in the performance of a construction contract, the
25 contractor may not issue a resale certificate to the vendor. If the contractor improperly issues a resale
26 certificate for materials that will be consumed, tax is due based on the purchase date, not based on the
27 date on which the materials were withdrawn from inventory. (Cal. Code Regs., tit. 18, § 1668, subd.
28 (g); see also Audit Manual, § 1206.10.)

1 We have calculated that the cost of materials petitioner sold over the counter represents about 7
2 percent of its cost of material purchases, meaning that petitioner purchased over 90 percent of the
3 materials for consumption. We conclude that, under these circumstances, petitioner was not entitled to
4 purchase the materials for resale under resale certificates (or from unregistered out-of-state suppliers
5 without timely reporting use tax on cost), and is thus liable for use tax measured by cost, based on
6 purchase date. Since petitioner owed tax based on purchase date (or the date the products entered
7 California if purchased from out-of-state), petitioner is not entitled to any allowances for spoilage or
8 theft that occurred thereafter, or for changes in inventory. However, we conclude that when petitioner
9 made sales of spoiled property, all sales of which were for resale, petitioner was entitled to a tax-paid
10 purchases resold adjustment against its liability for use tax on cost, limited to the sale price of such
11 spoiled property. Petitioner is also entitled to a tax-paid purchases resold adjustment with respect to its
12 over-the-counter sales of its regular inventory, measured by cost. Petitioner's remaining contention is
13 that the audited cost of materials should be adjusted for freight-in charges made by six specific
14 vendors, and it has provided samples of invoices from each vendor. We find that each vendor sold the
15 materials for a delivered price, and we find that the separately stated transportation charges from only
16 one of the vendors, Redwood Empire, are excludable from gross receipts because, for that vendor,
17 there is evidence that the transportation of the property occurred after the sale. (See Cal. Code Regs.,
18 tit. 18, § 1628, subd. (b)(2).)

19 In sum, we conclude that petitioner is liable for the tax on cost of materials of \$8,529,828,
20 without any adjustment for spoilage, theft, or inventories, and for the tax on its gross receipts from
21 retail over-the-counter sales of \$544,804. We also conclude petitioner is entitled to a tax-paid
22 purchases resold deduction of \$444,486 (\$374,436 related to retail sales and \$70,050 related to sales
23 for resale). Finally, we conclude that the cost of materials should be reduced by excludable
24 transportation charges of \$41,193. Thus, we calculate audited taxable measure of \$8,588,953
25 ($\$8,529,828 + \$544,804 - \$444,486 - \$41,193$) which, compared to the reported taxable measure of
26 \$2,801,663, represents an understatement of \$5,787,290. Since this amount is greater than the audited
27 understatement of \$4,424,413, the D&R recommends that the petition be denied.

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OTHER MATTERS

By letter dated September 30, 2010, the Department asserted an increase in the determination to tax of \$425,977.01, based on the \$5,787,290 measure of understatement we found in the D&R.

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