

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:)
GENERAL INDUSTRIAL TOOL & SUPPLY) Account Number SR AC 13-072009
Petitioner) Case ID 281207
Sun Valley, Los Angeles County

Type of Business: Sales of tools and supplies

Audit period: 01/01/00 – 12/31/02

| <u>Item</u> | <u>Disputed Amount</u> |
|--|--------------------------------|
| Disallowed claimed nontaxable contract fees | \$349,170 |
| Disallowed claimed nontaxable transportation charges | \$163,360 |
| Relief of interest | \$ 15,618 |
| Amnesty interest penalty | \$ 2,416 |
| Tax as determined | \$47,075.59 |
| Pre-D&R adjustment | - 16,245.06 |
| Post-D&R adjustment | <u>- 9,637.82</u> |
| Proposed redetermination protested | <u>\$21,192.72¹</u> |
| Proposed tax redetermination | \$21,192.71 |
| Interest through 10/31/13 | 14,179.47 ² |
| Amnesty interest penalty | <u>2,415.73</u> |
| Total tax, interest, and penalty | \$37,787.91 |
| Payments | <u>- 649.00</u> |
| Balance Due | <u>\$37,138.91</u> |
| Monthly interest beginning 11/01/13 | <u>\$ 616.32</u> |

UNRESOLVED ISSUES

¹ The amount of determined tax is based on an understatement of reported taxable measure of \$246,340, which is net of concurred credit audit items. Thus, petitioner protests the entire amount of determined tax and asserts that it overpaid the tax for the audit period. Since petitioner has filed a claim for refund, a refund can be issued if petitioner prevails.

² As explained below, we have herein revised our recommendation and now recommend relief of interest on the disputed tax amount from and after December 1, 2008, through October 31, 2013. We are unable to compute the remaining, accrued interest at this time. Thus, the interest listed in this table (which does not reflect our revised recommendation), is all of the accrued interest through October 31, 2013, net of \$2,449.20, the amount of interest for the period December 1, 2008, through December 31, 2009, for which we had initially recommended relief.

1 **Issue 1:** Whether adjustments are warranted to the disallowed claimed nontaxable contract
2 fees. We find no further adjustments are warranted.

3 Petitioner is a retailer of abrasive and safety products, precision equipment, hand tools, power
4 tools, and a wide range of maintenance, repair, and overhaul products and shop supplies primarily
5 servicing the industrial manufacturing industry. Senior Flexonics is petitioner's customer. Beginning
6 in 1999, petitioner and Senior Flexonics entered into an integrated supply contract (supply contract).

7 Senior Flexonics stores its physical inventory, including production items, maintenance items,
8 tools, spare parts, and consumable supplies, in a storage area referred to by the parties as the tool crib.
9 The basic terms of the supply contract in effect during the audit period are that petitioner would take
10 over management of the tool crib. Specifically, petitioner is responsible for: 1) stocking the tool crib
11 with inventory items, supplies, capital assets, tools, and spare parts, and taking inventory of fixed
12 assets and supplies, and 2) preparing reports pertaining to cost savings, purchasing, and distribution.
13 Pursuant to the supply contract, petitioner invoiced Senior Flexonics on a monthly basis for various
14 fees included in the supply contract. Petitioner reported \$1,653,505 in contract fees billed to Senior
15 Flexonics for the sale of goods as taxable sales, but regarded the disputed contract fees as nontaxable.
16 The Sales and Use Tax Department (Department) regarded most of the contract fees as taxable.

17 During the course of the appeal, the parties have reached agreement regarding the application
18 of tax to some portions of the various fee categories. Petitioner concedes that a portion of the service
19 fees (item 1 below) are subject to tax, and the Department has reduced the technology fees,
20 management fees, full-time crib person fees, and part-time crib person fees (items 2, 3, 4, and 5 below)
21 by 10 percent each to give effect to petitioner's undocumented assertion that some of those fees relate
22 to nontaxable services unrelated to taxable sales from the crib inventory. Also, we have recommended
23 that one of the categories of fees, "temporary labor" be deleted in its entirety. The amounts of fees
24 remaining in dispute, which we will address separately below, are:

| | | |
|----|---|------------------|
| 25 | 1. Service fees (seven percent of cost of goods sold) | \$ 96,450 |
| 26 | 2. Technology fees | \$ 17,723 |
| 27 | 3. Management fees | \$ 32,400 |
| 28 | 4. Crib person, full-time | \$ 98,894 |
| | 5. Crib person, part-time | \$ 83,052 |
| | 6. Freight fees | <u>\$ 20,651</u> |

1 Total \$349,170

2 Regarding the service fees, petitioner states that it provides services pursuant to the supply
3 contract, at petitioner's cost, which are not related to the sale of tangible personal property. Petitioner
4 states that the price of the products sold is merely a "measuring stick," and that the majority of the fees
5 are not related to the sale of tangible personal property. Of the total amount included in the audit,
6 \$119,074, petitioner concedes that \$22,624 of the fees relate to the sale of tangible personal property
7 and are subject to tax. It disputes the remaining \$96,450. We note that the service fee is a pre-
8 negotiated, mandatory charge, computed at 7 percent of the cost of goods sold. Since that charge is
9 tied solely and entirely to the volume of sales of tangible personal property, we find that evidence
10 strongly indicates that these fees relate to the sale of tangible personal property. Thus, we find that the
11 service fees are subject to tax.

12 Regarding the technology fees, petitioner asserts that the technology at issue is computer
13 hardware and software that petitioner purchased for use by Senior Flexonics, with some use of the
14 equipment by petitioner. The amount shown above, \$17,723, is net of the Department's adjustment of
15 10 percent to reflect technology fees that may relate to separable charges for nontaxable services.
16 Petitioner claims that it paid sales tax reimbursement when it purchased the technology and that it then
17 charged Flexonics for use thereof. Petitioner has provided invoices to show that it paid sales tax
18 reimbursement with respect to purchases of computers and software totaling \$42,055 and asserts that
19 the amount of contract fees subject to tax should be reduced by that amount. However, the total
20 amount of technology fees included in the audit was \$19,696 (before the 10 percent reduction). In any
21 event, petitioner claims that the amount of technology fees represent receipts from the lease of that tax-
22 paid equipment. However, petitioner has not shown how the invoices, with sales tax reimbursement
23 added, relate to the technology fees billed to Senior Flexonics. Accordingly, we find the evidence does
24 not support a conclusion that the technology fees represent receipts from the lease of tangible personal
25 property purchased tax-paid and leased in substantially the same form as acquired. Accordingly, we
26 find no further adjustment is warranted.

27 Regarding the management fees, petitioner billed Senior Flexonics \$1,000 per month, for a
28 total of \$36,000 for the audit period. After the Department's reduction of 10 percent, the amount

1 remaining in dispute is \$32,400. Petitioner states that these amounts relate to petitioner's review and
2 analysis of potential cost savings for Senior Flexonics, which may or may not relate to the purchase of
3 products sold by petitioner. Petitioner regards this as a nontaxable service to improve the
4 manufacturing process. Petitioner is a retailer of general industrial tools and supplies, and we find that
5 petitioner's value-added cost savings fees are a direct and inseparable part of petitioner's sales of tools
6 and supplies to Senior Flexonics. Further, petitioner has not identified any specific management fees
7 that are optional fees unrelated to the management, functional use, sale, etc., of products that petitioner
8 sold to Senior Flexonics. Specifically, petitioner sold special order products at cost for zero profit, and
9 had a special catalog for pricing of stock items sold to Senior Flexonics, and, under such facts, it is
10 doubtful that petitioner would have sold such products at these rates in absence of the management
11 fees. Thus, in the absence of documentation of additional separately identifiable optional charges for
12 nontaxable services included in the management fees, we find no further adjustment is warranted.

13 Regarding the fees for tool crib personnel (both full-time and part-time), petitioner stored and
14 maintained an inventory of items designated for sale to Senior Flexonics in the tool crib and billed
15 Senior Flexonics for such products at the time of sale. The stated selling prices were either equal to
16 cost (for special order items) or at a low markup. Petitioner asserts that the crib operator is responsible
17 for locating and organizing products, ensuring that the necessary tools and supplies are available
18 (along with any necessary accessories), and running various reports. Petitioner asserts that the fees do
19 not relate to the sale of tangible personal property. After the Department's reduction of 10 percent, the
20 amount of fees for the crib personnel (both full-time and part-time) is \$181,946. These fees are related
21 to the storing and maintaining of inventory of items designated for sale to Senior Flexonics. Petitioner
22 has not separately identified any tool crib personnel fees that are optional fees unrelated to the sale of
23 products to Senior Flexonics. Further, we find it doubtful that petitioner would have sold products to
24 Senior Flexonics at cost or at unusually low prices in the absence of the tool crib personnel fees.
25 Accordingly, we find that no further adjustments are warranted to the audited amount of crib personnel
26 fees subject to tax.

27 Regarding the contract fees for freight, petitioner billed Senior Flexonics \$42,259 in contract
28 fees for freight during the audit period. The Department disallowed contract fees of \$20,651, which

1 represents a flat monthly fee for pick-ups and deliveries, shipment via common carrier, or delivery via
2 petitioner's delivery truck, and the exact allocation is unclear because petitioner only billed one lump-
3 sum, all inclusive charge for transportation to Senior Flexonics. Regardless of any other requirement
4 for exclusion of transportation charges from gross receipts, petitioners' contract fees for freight are
5 taxable because the property was shipped to Senior Flexonic's location *for delivery to petitioner*
6 because petitioner manages the tool crib where all such property is inventoried and managed. Thus,
7 the fees at issue represent incoming transportation charges for delivery to the retailer, which are
8 taxable. (Cal. Code Regs., tit. 18, § 1628, subd. (a).) Accordingly, we find tax applies to the \$20,651
9 in contract fees for freight.

10 **Issue 2:** Whether relief of the disallowed claimed nontaxable transportation charges of
11 \$163,360 is warranted on the basis that petitioner's failure to report them as taxable was the result of
12 its reliance on erroneous advice from the Department in a prior audit. We find no relief is warranted.

13 In general, petitioner separately states transportation charges on its invoices, and accounts for
14 transportation charges on a transaction-by-transaction basis. Petitioner examined its own records and
15 submitted an analysis to the Department, separately itemizing six subcategories of transportation
16 charges that petitioner agrees represent taxable transportation charges that petitioner should have, but
17 did not include in taxable gross receipts. The total amount of those charges is \$163,360.

18 Petitioner does not dispute that tax applies to the \$163,360 in transportation charges, but it
19 asserts the Department never raised the issue in prior audits that tax applies to petitioner's
20 transportation charges for delivery using petitioner's own delivery truck (in absence of an explicit
21 written agreement executed prior to delivery that title transfers before transportation of the property to
22 the purchaser). Petitioner claims it performs a large percentage of deliveries using its own delivery
23 truck, which is unchanged from the prior audits, and therefore petitioner relied on the results of the
24 prior audits to its detriment and should be granted relief of 100 percent of the taxable deliver charges
25 disclosed by the audit, \$163,360.³ However, according to petitioner's calculations, the total measure
26

27 ³ Although petitioner had requested relief of only a portion of the \$163,360 when the D&R was issued, it stated in a
28 June 10, 2012 email that it requested relief of the entire \$163,360.

1 of taxable transportation charges related to deliveries made by petitioner's own delivery truck was only
2 \$25,916.03. Accordingly, the actual amount of transportation charges of that nature is \$25,916.03.

3 Petitioner's account was waived for audit after an office review twice prior to 1998, and it was
4 audited for the periods April 1, 1989, through March 31, 1992, and October 1, 1985, through
5 March 31, 1989. The Department and the Appeals Division have examined the audit workpapers for
6 both prior audits and have found no mention of any charges related to transportation, no sample
7 invoices, and no claimed deductions related to transportation charges.

8 Petitioner bears the burden of establishing that it detrimentally relied on written advice from the
9 Board, and petitioner has not provided evidence of erroneous written advice from the Board regarding
10 the application of tax to transportation charges on which petitioner may have relied. In fact, in its
11 June 10, 2012 email, petitioner specifically states that the application of tax to the transportation
12 charges at issue was never raised in prior audits. Thus, we find that petitioner's failure to report tax on
13 the charges for delivery of products by its own trucks was not the result of its reliance on erroneous
14 written advice from the Board, and no relief is warranted.

15 **Issue 3:** Whether relief of interest is warranted. We find relief is warranted on the disputed tax
16 amount for the period December 1, 2008, through October 31, 2013.

17 Petitioner filed a Request for Relief of Interest, requesting that the Board grant relief from
18 interest under Revenue and Taxation Code section 6593.5 from the time the petition for
19 redetermination was filed through the present. We first note that relief of interest is not warranted with
20 respect to any portion of tax that a taxpayer has conceded is due. Therefore, our analysis applies only
21 to interest accruing on the disputed tax. Based on our analysis of the chronology of events, we
22 concluded in the Supplemental D&R (SD&R), issued October 20, 2010, that there was an
23 unreasonable delay on the part of Board staff for the period December 1, 2008, through December 31,
24 2009.

25 In preparing our first revised summary for this appeal, we concluded that while there were
26 delays during some of the periods after December 31, 2009, none of them were unreasonable. Many of
27 the delays were attributable to unavoidable circumstances, such as workload and staffing issues.
28 (Some of the other delays lack a documented explanation, but often were a few months' duration or

1 less.) Taken in isolation, any single delay may not be unreasonable; however, numerous delays have
2 accumulated during the course of this appeal, and upon further reflection and review, we believe that
3 the aggregate delay is simply not reasonable. We also note that no significant portion of the delay is
4 attributable to petitioner. Accordingly, we now recommend relief of interest on the disputed tax for the
5 period December 1, 2008 through October 31, 2013.

6 **Issue 4:** Whether relief of the amnesty interest penalty is warranted. We find relief is not
7 warranted.

8 Petitioner timely applied for amnesty, but subsequently withdrew from the amnesty program
9 because it believed it would prevail entirely in its position. When it discussed that choice with the
10 Department, petitioner confirmed that it understood the risk but still chose to withdraw from the
11 amnesty program prior to making any payments or entering into an installment payment agreement.
12 Since the entire audit period is within the period covered by the amnesty program, an amnesty penalty
13 will be added when the determination becomes final. The amount of that penalty, after the most recent
14 reaudit adjustments, is \$2,415.73. Petitioner has requested relief of the amnesty interest penalty, on the
15 basis that the audit was not completed until after the deadline to file for amnesty, and petitioner
16 reasonably believed that the over-reporting allowances would ultimately equal or exceed the under-
17 reported amounts, and thus believed the amnesty penalty would not apply.

18 At the time petitioner withdrew from the amnesty program it was aware that the under-reported
19 liability substantially exceeded the over-re-reporting allowances, and had been informed that its
20 contract fees for services, as well as any other fees or charges related to integral expenses and services,
21 are taxable as a part of petitioner's sales of tangible personal property. Accordingly, we find that
22 petitioner's failure to comply with the amnesty program was a voluntary decision within petitioner's
23 control, and that there is no basis upon which to recommend relief of the amnesty interest penalty.

24 **OTHER MATTERS**

25 None.

26 Summary prepared by Jeffrey G. Angeja, Tax Counsel IV