

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:)
LASTING INTERIORS INC.¹) Account Number: SR EA 101-180855
) Case ID 554909
Petitioner) Laguna Niguel, Orange County

Type of Business: Interior design
Audit period: 04/01/05 – 03/31/08

<u>Item</u>	<u>Disputed Amount</u>
Unreported taxable sales of furnishings	\$2,030,616
Unreported taxable freight charges	\$ 219,750
Interest	Unspecified
Tax as determined	\$201,011.76
Post-D&R adjustment	<u>- 25,242.22</u>
Proposed redetermination, protested	\$175,769.54
Interest through 02/28/14	<u>98,974.32</u>
Total tax and interest	\$274,743.86
Payments	<u>- 47,577.00</u>
Balance Due	<u>\$227,166.86</u>
Monthly interest beginning 03/01/14	<u>\$ 640.96</u>

This matter was scheduled for Board hearing in October 2013, but was postponed at petitioner’s request for additional time to gather information to prepare for the hearing.

UNRESOLVED ISSUES

Issue 1: Whether additional adjustments to the amount of unreported taxable sales of furnishings are warranted. We find no further adjustments are warranted.

Petitioner has performed interior design, specializing in designing and furnishing model homes for real estate developers and builders, since April 2005. For audit, petitioner provided its federal income tax returns, income statements, general ledgers, sales and use tax returns, purchase invoices for

¹ In preparing for the hearing in this matter, the Sales and Use Tax Department noted that petitioner’s name is actually Lasting Interiors, Inc. rather than the name shown on the Board’s records, Lasting Interior, Inc. Apparently, the name entered in the Board’s records was transcribed from petitioner’s application for a seller’s permit. We have corrected the name for the summary.

1 2008, various job folders, and sales invoices. The Sales and Use Tax Department (Department) found
2 that petitioner had accrued \$10,635 more sales tax reimbursement in its general ledger than it had
3 reported on its sales and use tax returns for the audit period, and concluded that petitioner's reported
4 taxable sales were understated.

5 Petitioner stated that it billed change orders to its contracts on a time-and-materials basis with
6 sales tax reimbursement added to the separately stated selling price of furnishings. The Department
7 examined the general ledger account where petitioner posted change order invoices for its sales of
8 furnishings, and noted posting errors between sales of furnishings and design services. After adjusting
9 for the posting errors, and making additional adjustments in a post-D&R reaudit, the Department
10 compiled taxable sales of furnishings on change orders of \$1,266,669 for the audit period.

11 The Department then examined job folders for 18 projects from the audit period, which showed
12 a total of \$3,985,417 for lump-sum contracts, with a total cost of furnishings of \$1,878,336, and
13 \$137,608 for fabricated draperies and linens. The Department compared the cost of furnishings and
14 fabricated draperies and linens with the total contract amount for the 18 projects, and computed a ratio
15 of taxable costs to the total contract amount of 50.58 percent. The Department then examined the
16 general ledger account where petitioner posted invoices for progress payments on lump-sum contracts,
17 and compiled recorded design income of \$4,914,497 for the audit period, which included \$1,585,363
18 for design-only contracts, out-of-state projects, and cancelled contracts, leaving income of \$3,329,134
19 for lump-sum contracts that included the sale of furnishings. The Department multiplied income of
20 \$3,329,134 by the taxable ratio of 50.58 percent to establish the audited cost of furnishings sold under
21 lump-sum contracts of \$1,683,976 for the audit period.²

22 In order to compute the audited markup for furnishings sold under lump-sum contracts, the
23 Department decided to use three job folders for projects in the state of Washington during the audit
24 period because, according to petitioner, it was required to separately state selling prices on contracts in
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26 ² In a post-D&R reaudit, to adjust for petitioner's noted posting errors, the amount for design income was increased from
27 \$3,137,363 to \$3,392,134, and the costs of furnishings sold under change orders was reduced by a corresponding amount.
28 While these adjustments resulted in an increase to the costs of furnishings sold under lump-sum contracts from \$1,586,973
to \$1,683,976, the overall effect was a reduction to audited taxable sales.

1 that state (thus billing its Washington contracts on a time-and-materials basis). The Department
2 rejected one of the projects for purposes of calculating an audited markup because it found the
3 computed markup of -0.34 percent for this project to be unreasonable. For the other two projects,
4 petitioner had separately stated selling prices for furnishings equal to exactly 50 percent of the total
5 contract price. Even though that precise ratio of selling prices to the total contract price indicates that
6 the selling prices may have been estimated, rather than authentic selling prices, the Department relied
7 on them for its computation of an audited markup of 27.40 percent.³ The Department added the
8 audited markup to the audited cost of furnishings sold to compute taxable sales from lump-sum
9 contracts. However, based on documentation showing additional costs that petitioner provided for a
10 post-D&R reaudit, the Department recomputed a markup of 12.03 percent for these projects. For the
11 reaudit, the Department also computed markups from nine job folders that petitioner provided for
12 projects in California in 2011, several years after the end of the audit period. The Department rejected
13 the negative markups of -7.45 percent and -0.86 percent computed for two of these projects, but
14 computed an average markup of 15.33 percent for the other seven projects, which it combined with the
15 markup computed for the two Washington projects to establish an audited markup for furnishings sold
16 in lump-sum contracts of 14.60 percent. The Department then added the audited markup to the audited
17 cost of furnishings sold under lump-sum contracts to establish audited taxable sales of furnishings
18 under lump-sum contracts of \$1,929,836 for the audit period. Adding audited taxable sales of
19 furnishings on change orders of \$1,266,669 to the audited taxable sales under lump-sum contracts
20 resulted in audited taxable sales of \$3,196,505 for the audit period, which exceeded reported taxable
21 sales by \$2,030,616.

22 Petitioner contends that the audited markup should be 10.37 percent based on all three of the
23 Washington projects, arguing that the project that resulted in a loss should not have been excluded
24 from the markup computation, since it sometimes loses money on a project but makes up for it on
25 other projects. Petitioner also contends that the markup should not be applied to purchases of

27 ³ In the D&R, we noted that the Department made an error in computing the markup, and correcting the error would show
28 an audited markup of 37.75 percent.

1 furnishings where sales tax reimbursement was paid to the vendor. Furthermore, petitioner argues that
2 its sales to one of its major customers were nontaxable sales for resale and these contracts should be
3 deducted from design income in the computation of audited taxable sales. Petitioner submitted its own
4 computation of taxable sales from lump-sum contracts of \$780,423 using a markup of 10.37 percent.
5 The taxable sales computed by petitioner result in a reduction to unreported taxable sales from
6 \$2,030,616 to \$1,072,973. However, petitioner does not concede that it owes any additional tax.

7 We first note that the Department's markup analysis in this case merely allocates how much of
8 the total price for lump-sum contracts represents petitioner's taxable gross receipts for sales of
9 furnishings and how much represents petitioner's other charges for services unrelated to the sale of
10 tangible personal property. In other words, the markup is not computed using verifiable selling prices
11 and known costs of the merchandise, and there is reason to believe that the "selling prices" on the
12 Washington contracts are contrived and may be inaccurate.⁴ Nevertheless, the Department has used
13 these essentially estimated "selling prices" to establish an audited markup of 14.60 percent. When that
14 markup is added to the estimated costs of tangible personal property, computed at 50.58 percent of the
15 contract price, the total is 57.96 percent of the contract price, which has been allocated to taxable sales
16 of furnishings, with 42.04 percent allocated to design services or other services that are unrelated to the
17 sale of tangible personal property. Therefore, regarding petitioner's contention that negative markups
18 for projects should not be excluded from the computation of the audited markup, we find that it would
19 be unreasonable to assume that petitioner's sale of furnishings for any given project resulted in a loss,
20 and even more of the project price should be allocated to services. Therefore, we find that the audited
21 markup is conservative and recommend no adjustment.

22 Next, while petitioner claims that it paid tax to its vendors for some of the furnishings it resold,
23 petitioner has stated that the receipts showing the tax it paid have become impossible to read because
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26 ⁴ For example, on one of the Washington contracts, the tangible personal property sold represented 673 different items
27 ranging from towels purchased from Target to billiard balls purchased from Big 5. For that project, petitioner divided the
28 total contract price of \$129,416 by 2 to compute the selling price of \$64,708 stated in the contract for all of the furnishings.
However, the cost of the merchandise purchased was \$59,184, and thus the apparent gross profit on the sale of the
furnishings was \$5,524, about 9 percent of the cost. It seems highly implausible that such a minor amount represented
petitioner's actual gross profit, which would be expected to compensate petitioner for the effort of shopping for,
purchasing, and organizing 673 different, disparate and dissimilar items from numerous vendors.

1 they were printed on thermal receipt paper, which fades over time. In the absence of documentation
2 showing tax paid, we recommend no allowance for tax-paid purchases resold.

3 The Department rejected petitioner's claim that its sales to one of its major customers were
4 nontaxable sales for resale because petitioner did not obtain a resale certificate, and in response to an
5 XYZ letter, this customer confirmed that the furnishings purchased from petitioner were not purchased
6 for resale.⁵ Furthermore, our understanding is that the intended purpose of the furnishings sold by
7 petitioner is to promote the sale of homes, and is not merely for demonstration and display of the
8 furnishings. Therefore, even though petitioner's customer may have a contractual agreement with a
9 consignor to sell the furnishings at the consignor's retail outlet *after* the furnishings have been used to
10 promote the sale of homes, we conclude that petitioner's sales to the customer in question were retail
11 sales, and recommend no adjustments for nontaxable sales for resale.

12 **Issue 2:** Whether any additional adjustments to the amount of unreported taxable freight
13 charges are warranted. We conclude that no further adjustment is warranted.

14 In the Department's analysis of petitioner's job folders, the Department computed audited
15 taxable freight-in charges of \$102,747 for petitioner's lump-sum contracts that included sales of
16 furnishings, and accepted taxable freight-in charges of \$156,377 on change orders, as petitioner
17 recorded in its general ledger. Since petitioner had not reported taxable freight-in charges, the
18 Department established unreported taxable freight-in charges of \$259,124 (\$102,747 + \$156,377) in
19 the original audit. However, in the post-D&R reaudit, the Department corrected an error in its
20 computation of the taxable freight-in charges for lump-sum contracts, and reduced this measure of tax
21 to \$219,750.

22 Petitioner contends that audited taxable freight-in charges for lump-sum contracts are
23 overstated because the freight-in charges associated with the sales that petitioner claims are nontaxable
24 sales for resale should be regarded as nontaxable freight-in charges. However, based on our finding
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26 ⁵ With respect to this contention, petitioner has made various arguments, detailed in the D&R, including an allegation that
27 the Department coerced petitioner's customer to state on the XYZ letter that it had not purchased the furnishings for resale.
28 For the reasons explained in the D&R, petitioner's various arguments are not accurate and do not overcome the
presumption that a retailer's sale of tangible personal property is subject to sales tax. (Rev. & Tax. Code, § 6091).

1 that petitioner did not make nontaxable sales for resale, we conclude that no additional adjustments to
2 the amount of unreported taxable freight-in charges are warranted.

3 **Issue 3:** Whether petitioner is entitled to relief of interest. We conclude no relief is warranted.

4 On April 1, 2012, petitioner submitted a request for relief of interest, signed under penalty of
5 perjury, on the basis that there was an unreasonable delay in completing the audit. Petitioner contends
6 that the length of the audit, which extended from the first meeting on June 13, 2008, through
7 petitioner's receipt of the report of field audit on October 7, 2010, was due to the unresponsiveness of
8 the Department, extensive requests for documentation, duplicate requests for documentation already
9 provided, inexperience of the auditor, and inaccuracy of the audit findings. Petitioner also cites the
10 following three specific occurrences. Petitioner contends there was a delay during the summer of
11 2008, when the district office in Laguna Hills was moved to Irvine; a delay between the time petitioner
12 was promised a copy of the audit work papers on December 9, 2009, and petitioner's receipt of the
13 audit work papers on March 3, 2010; and a delay when the auditor left on maternity leave in May
14 2010.

15 We note that, from the time the audit commenced through the date the determination was
16 issued, there was nearly continual activity and contact between petitioner and the auditor or other
17 Board employees. We also note that petitioner requested and the Department granted several
18 extensions to provide additional records during the audit process. Since the Assignment Contact
19 History, notes in the file, and the audit work papers clearly indicate that the Department was not
20 satisfied with the documentation that petitioner provided, we find that the Department was justified in
21 its repeated requests for additional documentation. We examined the three periods cited by petitioner
22 in detail, and found that any delay during those periods was not unreasonable. Accordingly, we find
23 there was no unreasonable delay by a Board employee, and relief of interest is not warranted.

24 **OTHER MATTERS**

25 Petitioner's allegations regarding staff conduct were referred to the Taxpayer's Rights
26 Advocate.

27 On September 8, 2013, petitioner submitted 69 pages of documents, consisting of audit
28 schedules with petitioner's notes added, a copy of a contract and invoices, timelines, and copies of

1 correspondence, to outline or further support the contentions that already were addressed in the D&R.
2 We have reviewed this documentation and have found that, while some of the documents include
3 minor revisions from the evidence that petitioner provided previously, the evidence is not sufficient to
4 support any reduction to the taxable measure or relief of interest.

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Summary prepared by Lisa Burke, Business Taxes Specialist III