

CALIFORNIA STATE BOARD OF EQUALIZATION
APPEALS DIVISION FINAL ACTION 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	\$4,909,213
Tax as determined	\$325,613.09
Post-D&R adjustment ¹	+100,363.92
Post-Board hearing adjustment	<u>- 14,222.16</u>
Proposed redetermination	\$411,754.85
Less concurred	<u>- 50,410.08</u>
Balance, protested	<u>\$361,344.77</u>
Proposed tax redetermination	\$411,754.85
Interest through 11/30/12	<u>249,327.34</u>
Total tax and interest	<u>\$661,082.19</u>
Monthly interest beginning 12/01/12	<u>\$ 2,058.77</u>

The Board held a hearing regarding this matter on May 30, 2012, granting petitioner 30 days to provide additional records and the Sales and Use Tax Department (Department) 30 days to respond. Based on petitioner’s submissions and the Department’s response, we recommend adjustments, as discussed below under Post Hearing Developments.

UNRESOLVED ISSUE

Issue: Whether further adjustments are warranted to the unreported taxable measure. Except as noted, 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, 2007.² Petitioner also sold some fencing materials

¹ The Department asserted this increase in the determination pursuant to Revenue and Taxation Code section 6563 by letter dated September 30, 2010.

1 without installation. Petitioner acquired all of its fencing materials without payment of tax or tax
2 reimbursement by issuing resale certificates to its vendors, which were located both in California and
3 outside of California. Petitioner did not report any purchases subject to use tax on line 2 of its sales
4 and use tax returns, and instead reported taxable measure only on line 1 of its returns as total sales.

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

17 Petitioner contends that the amount of understatement is excessive because: 1) the amount of
18 beginning inventory for 2004 should be reduced; 2) the allowances for spoilage and theft should be
19 increased; 3) there should be an adjustment for nontaxable sales for resale; and 4) certain freight-in
20 charges should be deducted from the cost of materials available. A construction contractor may not
21 purchase materials for resale unless it is also in the business of selling materials (Cal. Code Regs., tit.
22 18, § 1521, subd. (b)(6)(A)), which for these purposes means that the contractor makes substantial
23 retail sales of the same type of materials that it uses on construction contracts. (Sales and Use Tax
24 Department Audit Manual, § 1206.10.) Furthermore, where a construction contractor knows at the
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26 ² At the hearing, petitioner stated that it remained in business. However, the seller's permit under which it operated during
27 the audit period was closed out effective December 31, 2007, and the Board's records reflect no known successor. We do
28 not know if petitioner obtained a different seller's permit for some reason, or if, perhaps, it ceased making all retail sales of
tangible personal property and now acts purely as a lump sum construction contractor furnishing and installing materials,
purchasing all tangible personal property tax paid, such that it no longer requires a seller's permit.

1 time of purchase that the materials will be consumed in the performance of a construction contract, the
2 contractor may not issue a resale certificate to the vendor. If the contractor improperly issues a resale
3 certificate for materials that will be consumed, tax is due based on the purchase date, not based on the
4 date on which the materials were withdrawn from inventory. (Cal. Code Regs., tit. 18, § 1668, subd.
5 (g); see also Audit Manual, § 1206.10.)

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

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1 In sum, we conclude that petitioner is liable for the tax on cost of materials of \$8,492,387, net
2 of a spoilage allowance of \$37,441, without any other adjustment for spoilage, theft, or inventories,
3 and for the tax on its gross receipts from retail over-the-counter sales of \$544,804. We also conclude
4 petitioner is entitled to a tax-paid purchases resold deduction of \$444,486 (\$374,436 related to retail
5 sales and \$70,050 related to sales for resale), and that the cost of materials should be reduced by
6 excludable transportation charges of \$196,960. Thus, we calculate audited taxable measure of
7 \$8,395,745 ($\$8,492,387 + \$544,804 - \$444,486 - \$196,960$) which, compared to the reported taxable
8 measure of \$2,801,663, represents an understatement of \$5,594,082. We recommend no further
9 adjustments.

10 POST HEARING DEVELOPMENTS

11 At the Board hearing, the Members granted petitioner 30 days to present documentation to
12 support additional adjustments for nontaxable transportation charges. In addition, the Members
13 directed the Department to make an allowance for spoilage with respect to the cost of retail sales.

14 In our letter to petitioner dated June 7, 2012, we noted that transportation charges from two
15 vendors that were not at issue at the time the D&R was issued were subject to tax since, as petitioner
16 conceded, the transportation charges were not separately stated as required by statute for exclusion
17 from tax.³ We also explained our finding that the sample invoices for California Cascade and Capital
18 Trading showed that the vendors delivered the goods by common carrier, and we noted that there was
19 no evidence of provisions in the contracts regarding delivery. As such, we concluded that the
20 transportation charges included in the sample invoices were not taxable (but not to exceed the cost of
21 transportation to the vendors), and we concluded that all separately stated transportation charges by
22 California Cascade and Capital Trading should be regarded as nontaxable, not to exceed the cost of
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25 ³ In its letter of June 29, 2012, petitioner objects to our statement that petitioner had conceded the deductions for the two
26 vendors. However, that is not what we said. Rather, as petitioner explained during the Board hearing, before the D&R was
27 issued it had not asserted that transportation charges by these two vendors should be excluded from tax because these
28 vendors did not separately state the transportation charges; thereafter, petitioner concluded that the charges should be
excludable under *Dell, Inc. v. Superior Court* (2008) 159 Cal.App.4th 911 since the amount of the transportation charges
could be computed from sources other than the invoice. As we explained in our letter, the *Dell* case is inapposite to the
situation here where the deduction sought must meet the explicit statutory requirements, including that the charges be
separately stated to the purchaser. That is, the exclusion that petitioner seeks is provided by statute, and it must therefore
satisfy the statutory requirements for exclusion.

1 transportation to the vendors, unless the Department found evidence that any of the other sales by these
2 vendors were delivered in their own facilities rather than by common carrier or that any of the other
3 sales included an F.O.B. destination provision. With respect to transportation charges by the three
4 remaining disputed vendors, Cascade Forest, Greenhill Lumber, and Sierra Pacific, we noted that the
5 sample invoices for these vendors reflect deliveries F.O.B. destination, and we explained that for any
6 additional adjustments, petitioner would need to show that these sample invoices were *not*
7 representative of all their sales to petitioner, and instead show that the vendors delivered some goods to
8 petitioner by common carrier without a delivery term under which title passed after delivery.
9 Petitioner did not provide evidence of any deliveries by these three vendors that were different from
10 the sample invoices it had already provided, but did provide copies of insurance policies to
11 demonstrate that the risk of loss during transit was on petitioner.

12 By memorandum dated July 30, 2012, the Department explained that it accepted our
13 conclusions with respect to the transportation charges made by Capital Trading and California
14 Cascade, and made adjustments totaling \$155,767 (transportation charges of \$139,060 by Capitol
15 Trading and \$16,707 by California Cascade). Since petitioner did not provide the additional
16 documentation described in our June 7, 2012 letter, the Department made no further adjustments for
17 transportation charges, and we agree. With respect to the spoilage allowance, the Department has
18 made an adjustment for 10 percent of the cost of over-the-counter retail sales, or \$37,441. We concur
19 with the Department's computations, and we recommend a reduction in the understatement of reported
20 taxable measure of \$193,208, from \$5,787,290 to \$5,594,082.

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