

1 CALIFORNIA STATE BOARD OF EQUALIZATION

2 APPEALS DIVISION SUMMARY FOR BOARD HEARING

3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)

5 LOS ANGELES PARTYWORKS, INC.)

6 Petitioner)

Account Number: SR AP 97-084360

Case ID 144839

Monrovia, Los Angeles County

7 Type of Business: Lessor of party equipment

8 Audit period 01/01/96 - 12/31/98

9 Item Disputed Amount

10 Disallowed set-up and tear-down labor charges \$144,537

11 Disallowed delivery charges \$ 91,391

12 Understatement of taxable rentals and sales \$ 403,616¹13 Unreported ex-tax purchases of equipment subject to use tax \$ 506,909²

14 Negligence penalty \$ 9,458

	<u>Tax</u>	<u>Penalty</u>
15 Tax as determined:	\$138,891.98	\$13,889.19
16 Adjustment – Post first Board hearing	<u>- 44,309.59</u>	<u>- 4,430.94</u>
17 Proposed redetermination	94,582.39	9,458.25
18 Less concurred	<u>- 37,286.12</u>	<u>00.00</u>
Balance, protested	<u>\$ 57,296.27</u>	<u>\$ 9,458.25</u>

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22 ¹ This item consists of \$292,408 for taxable sales of used equipment, \$47,224 for unreported taxable sales recorded (sales tax reimbursement included in invoices), and \$63,984 for taxable rental receipts (which is net of the other two taxable rental receipt items listed above as separate items in the reaudit for taxable set-up/tear-down charges of \$144,537 and taxable delivery charges of \$91,391). It is not clear what portion, if any, of the first two items, totaling \$339,632 (\$292,408 + \$47,224), that petitioner disputes, nor whether petitioner disputes all of the \$63,984 taxable rental receipts, so we have listed the entire amount as disputed.

25 ² As explained below, tax is due either on cost or on rentals payable with respect to the subject equipment. If petitioner had timely paid tax or tax reimbursement on cost of equipment leased in substantially the same form as acquired, then no further tax would be due with respect to rentals of that equipment. However, the dispute arises here because petitioner failed to timely pay tax or tax reimbursement on cost. Although petitioner claims it paid some tax to vendors (unproven), we understand that it concedes most of the equipment was purchased without payment of tax or tax reimbursement. Thus, tax is due on either rentals payable if the transactions were leases or on cost. This item is for the tax on the cost of the equipment the Department has found was *not* leased, consistent with petitioner's contention. We assume that petitioner concedes this tax is due *except* to the extent it believes that it already paid tax on cost. However, for purposes of this summary, we list the entire amount as disputed because it is not clear just what petitioner might concede.

1	Proposed tax redetermination	\$ 94,582.39
	Interest through 2/28/09	89,691.14
2	10% penalty for negligence	<u>9,458.25</u>
	Total tax, interest, and penalty	\$193,731.78
3	Payments	<u>26,907.44</u>
4	Balance Due	<u>\$166,824.34</u>
5	Monthly interest beginning 3/1/09	<u>\$ 451.30</u>

6 This matter was previously heard by the Board on October 4, 2007. The Board ordered that the
7 Sales and Use Tax Department (Department) conduct a reaudit. The Department has issued a reaudit
8 dated January 25, 2008 (the reaudit was revised on February 8, 2008, solely to add the negligence
9 penalty which had been inadvertently excluded from the reaudit). The matter was then scheduled for
10 Board hearing on August 6, 2008, but was postponed for settlement consideration.

11 BACKGROUND

12 Petitioner's business includes renting a variety of party equipment. During the audit period,
13 petitioner reported total sales of \$2,901,743. Of this amount, petitioner reported taxable sales of
14 \$216,044. Petitioner reported no amounts for use tax on line 2 of its returns, which means that it did
15 not report and pay tax to the Board on the cost of any rental equipment. Petitioner did not provide
16 purchase invoices for such equipment or any other evidence to show it paid tax or tax reimbursement
17 to its vendors. Accordingly, in the absence of evidence to the contrary, the Department treated all
18 rental equipment as extax.

19 Since there are no applicable exemptions for petitioner's purchase and lease of equipment, tax
20 is due on cost where petitioner consumed the equipment without leasing it, or on rentals payable where
21 petitioner leased the equipment. We do not understand petitioner to disagree (except to the extent it
22 argues it already paid tax on cost, as discussed later). The Department concluded that petitioner had
23 consumed certain equipment because petitioner maintained possession and control over the equipment
24 (by providing an employee who operated the equipment), and, with respect to that equipment, the
25 Department asserts tax on petitioner's cost of the equipment and *not* on the amounts payable to
26 petitioner by its customers. With respect to the remaining transactions, the Department concludes that
27 petitioner leased the equipment, and the Department asserts tax on the rentals payable from those
28 leases, and *not* on the purchase price of the equipment.

1 Petitioner argues that it provides a service and does not relinquish possession and control of its
2 equipment to its customers. Accordingly, petitioner contends that it was the consumer of all
3 equipment provided to its customers, and the applicable tax is on cost and not on rentals payable.³ The
4 Department, however, regarded petitioner as the lessor of the equipment for which it did not provide an
5 operator, although petitioner in some of those cases may have provided an employee to supervise the
6 use of the equipment. The Department concluded that, if petitioner had not provided an equipment
7 operator, it was not regarded as having maintained possession and control of the equipment. Since
8 petitioner did not establish tax was paid on cost of any such equipment, the Department regarded all
9 rentals payable from the lease of such equipment in California as subject to tax.⁴

10 At the Board hearing, petitioner described its business as more of an entertainment service than
11 a rental of equipment. Petitioner noted that much of its equipment is large and complicated, requiring
12 an operator as provided by petitioner. Petitioner noted that the corporate president was not consulted
13 during the audit regarding the nature of his business and the charges for specific equipment. The
14 Board ordered a reaudit so that the corporate president would be more involved.

15 REAUDIT

16 The Department has conducted the reaudit ordered by the Board, in which the audited
17 understatement of taxable measure has been reduced by \$537,086, from \$1,683,539 to \$1,146,453.
18 The Department reviewed the sales invoices for the month of July 2007, along with related payroll
19 information to establish the number of petitioner's employees involved in certain projects. The
20 Department was not able to observe any actual events because the only events scheduled during the
21 time of the reaudit were "casino" events, which are not representative of those in question here. Also,
22 petitioner did not provide contracts or general agreements regarding any of the events, although those
23 documents were requested by the Department.

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25 ³ Our understanding is that petitioner provided the subject equipment to its customers in substantially the same form as
26 acquired. If so, then petitioner could have avoided liability for tax on rentals payable by simply having made a timely
27 election to pay tax on cost. (Rev. & Tax. Code, §§ 6006, subd. (g)(5), 6010, subd. (e)(5); Cal. Code Regs., tit. 18, § 1660,
28 subd. (c)(1).) That is, the reason that this dispute arose in the first place is that petitioner failed to show it paid any tax or
tax reimbursement with respect to the subject equipment (though, as discussed below, it does claim it paid tax on the cost of
some of the equipment).

⁴ Petitioner did have some leases of the equipment outside California, and the rentals payable from such out-of-state leases
were *not* included in the audited taxable rentals payable.

1 In a memorandum to Board Proceedings dated February 27, 2008, a copy of which was sent to
2 petitioner, the Department notes that it gave petitioner the benefit doubt by considering petitioner as
3 the consumer of equipment in certain transactions for which the evidence was not conclusive.
4 Accordingly, the Department advises that the adjustments in this audit are not intended to provide a
5 basis for relief of liability under Revenue and Taxation Code section 6596 for future periods.

6 In the test conducted for the reaudit, the Department found that taxable rental receipts, taxable
7 set-up and tear-down charges, and taxable delivery charges combined represented 6.49 percent of the
8 total amount petitioner regarded as nontaxable charges for events. At the Board hearing, petitioner
9 estimated that 95 percent of his equipment is interactive, implying that 95 percent of the equipment
10 requires an attendant and 5 percent does not. We note that 5 percent is not substantially different from
11 the 6.49 percent calculated in the reaudit, particularly considering that petitioner's 5 percent figure was
12 simply an estimate and the Department's 6.49 percent figure is based on specific reaudit results.

13 The Department applied 6.49 percent to the total recorded amount of nontaxable sales to
14 calculate \$299,912 of taxable rental receipts, comprised of \$144,537 for taxable set-up and tear-down
15 charges, \$91,391 for taxable delivery charges, and \$63,984 for the remaining taxable rental receipts net
16 of taxable set-up/tear-down and delivery charges. The first two components were listed as separate
17 audit items, and the \$63,984 of taxable rental receipts net of set-up/tear-down and delivery charges was
18 included in the item "understatement of taxable rentals and sales" which totals \$403,616. This amount
19 includes \$292,408 for audited sales of used equipment for which petitioner did not report sales tax,
20 \$47,224 for sales not reported as taxable for which tax reimbursement was included on invoices (i.e.,
21 either a recorded versus reported taxable sales error or the collection of excess tax reimbursement), and
22 the \$63,984 of unreported taxable rental receipts net of taxable set-up/tear-down and delivery charges.

23 UNRESOLVED ISSUES

24 **Issue 1:** Whether petitioner was a lessor of party equipment provided to its customers that its
25 employees may have supervised but did not operate. We conclude that transactions involving
26 equipment that was not actually operated by petitioner's employees were true leases.

27 Petitioner describes itself as a service operation rather than as a lessor of equipment. Petitioner
28 asserts that in almost all cases, its employees either operated the equipment or supervised the

1 customer's operation of the equipment, but it has not submitted a copy of its standard rental agreement
2 to support this contention. As petitioner contends, the Department treated petitioner as the consumer
3 of equipment that petitioner established its employees operated. In the reaudit, the Department
4 concluded that only 6.49 percent of petitioner's recorded nontaxable charges for events represented
5 taxable rental receipts (which includes the taxable set-up/ tear-down charges and the taxable delivery
6 charges). Petitioner disputes the reaudit findings.⁵

7 We find that, when petitioner's employees provided only supervision of the equipment, the
8 customers had control of the equipment as long it was used in a proper and safe manner. Since
9 possession and control of the equipment were transferred to petitioner's customers, we conclude that
10 the transactions were true leases, and since petitioner failed to make a timely election to pay tax on
11 cost, the leases were taxable continuing sales and purchases with tax is due on the rentals payable.
12 Since petitioner has not shown that the Department's calculations are incorrect (and it appears the
13 Department gave the benefit of the doubt to petitioner for purposes of this audit period for any
14 questionable transactions), we find no further adjustments are warranted.

15 **Issue 2:** Whether petitioner's charges for delivery, assembly, and disassembly are part of its
16 taxable rentals payable from the leases. We find that they are.

17 Petitioner did not make a separate argument regarding the specific application of tax to charges
18 for delivery, assembly, and disassembly. Typically, petitioner's employees delivered the equipment to
19 the event site in petitioner's vehicles, set-up the equipment, and then, after the event, tore down the
20 equipment and transported it back to petitioner's warehouse. Petitioner separately itemized a charge
21 for the transportation (both to and from the event) and another charge for setup and tear down.

22 Under specified circumstances, a charge for delivery to the customer, itemized separately from
23 any other charge, may be excluded from the measure of tax, but there is no exclusion, under any
24 circumstances, for charges for transportation back to the warehouse. Here, the delivery charge was a
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26 ⁵ It seems that petitioner's statement at the Board hearing noted above coupled with its prior statement during the audit that
27 up to 5 percent of its equipment was provided to its customers with no operation or supervision by petitioner's employees,
28 should be regarded as a concession that up to 5 percent of its receipts from this activity was from leases. As such, it is
unclear whether petitioner disputes the entire 6.49 percent the Department asserts as taxable rental receipts or instead
contends that the Department's figures should be adjusted based on a percentage of up to 5 percent taxable rentals.

1 lump-sum charge for delivery both to the customer (which could qualify for exclusion under some
2 circumstances) and back to the warehouse (which cannot qualify for exclusion). That is, the charge for
3 delivery to the customer was not a separately stated charge as required for exclusion and thus does not
4 qualify for exclusion on this basis. Further, even if the charge in question were a separate charge for
5 delivery to the lessee, the charge would be excludible only if it were for delivery *after* the lease had
6 commenced. Here, petitioner delivered the leased property in its own facilities, and has provided no
7 evidence establishing that the lease commenced, and the lessees obtained the right to possession of the
8 leased equipment, prior to petitioner's delivery to the event location. This is an additional basis for
9 concluding that no portion of the charge for delivery is excludible.

10 With respect to assembly and disassembly, the evidence indicates that these charges were
11 mandatory. Thus, since the charges were required and there is no statutory exclusion from tax for
12 charges for assembly and disassembly, these charges are subject to tax. Further, charges for assembly
13 of leased property which is performed prior to the commencement of the lease are regarded as part of
14 the rentals payable required by the lease, even if the assembly is optional. There is no evidence that
15 the leases commenced prior to the time petitioner set up the equipment. This is an additional basis for
16 concluding that the charge attributable to set up is taxable.

17 **Issue 3:** Whether the Department has asserted tax on cost and also on rentals payable for the
18 same equipment. We conclude that the Department has not done so.

19 Petitioner contends that it should not have to pay tax both on the cost of equipment and on the
20 rentals payable from leases of the same equipment. Under the facts here, we agree, but we find that the
21 Department has not assessed tax on both events. Rather, we find that the Department assessed use tax
22 only on the cost of equipment that petitioner used in providing services to customers (the equipment
23 that was operated by petitioner's employees and was thus not leased), and that the Department did not
24 also assess tax on rentals of that equipment. Accordingly, the audit does not establish tax on the cost
25 of equipment and tax on rentals payable related to leases of the same equipment, and no adjustment is
26 warranted.

27 **Issue 4:** Whether an adjustment is warranted to the audited amount of unrecorded receipts. We
28 recommend no adjustment (addressed in the second SD&R).

1 The Department used a bank deposit reconciliation to establish the audited amount of total
2 sales. For the years 1997 and 1998, the Department calculated that the amount of funds deposited in
3 the bank, less non-sale deposits, exceeded total recorded sales by 10.20 percent. The Department
4 applied that percentage of understatement to recorded total sales for the audit period to establish an
5 audited amount of unrecorded receipts of \$479,159, which was added to recorded receipts to determine
6 total audited recorded receipts, which was then used as a base for calculation of the deficiency.

7 Petitioner contends that the 10.20 percentage of error should be disregarded. Petitioner asserts
8 that the error is immaterial and could be related to unidentified deposits of funds from sources other
9 than sales, such as loans, insurance settlements, or personal contributions to cover short-term expenses.
10 We find that the Department established the deficiency using recognized and standard audit
11 procedures, and petitioner has not provided evidence that the audited percentage of error is excessive.
12 We recommend no adjustment.

13 **Issue 5:** Whether an adjustment is warranted to the audited amount of excess tax
14 reimbursement. We recommend no adjustment.

15 The auditor identified several instances in which petitioner collected an amount as tax on
16 charges for services (that is, for transactions for which petitioner's employees operated the equipment,
17 and the Department agreed that petitioner was providing a nontaxable service rather than leasing the
18 equipment). Petitioner does not dispute that it collected excess tax reimbursement. However,
19 petitioner stated that it would issue refunds or credits to the specific customers from whom excess tax
20 reimbursement was collected. The second SD&R recommends adjustments for refunds or credits of
21 excess tax reimbursement petitioner was to make to customers within 30 days from the date of that
22 recommendation. Petitioner has not provided evidence that it made any such refunds or credits, and,
23 petitioner is liable to the Board for the excess tax reimbursement, and we recommend no adjustment.

24 **Issue 6:** Whether an adjustment is warranted for leases of equipment for which petitioner made
25 a timely election to pay tax on cost. We recommend no adjustment (addressed in second SD&R).

26 Petitioner contends that some of the leases of equipment were not taxable because the
27 equipment had been purchased tax paid. If this were true and if petitioner leased the equipment in
28 substantially the same form as acquired, then petitioner is correct that it would not owe tax on the

1 rentals payable from leases of such equipment. However, petitioner has provided no evidence that it
2 paid sales tax reimbursement or use tax to vendors or timely reported use tax on the purchase of any of
3 the leased equipment (it does not appear that it reported any purchases as subject to use tax on its
4 returns). Accordingly, we conclude that all of the disputed leases were continuing sales and purchases,
5 the rentals payable from which were subject to tax.

6 **Issue 7:** Whether petitioner was negligent. We conclude that petitioner was negligent.

7 Petitioner disputes the negligence penalty on the grounds that the majority of the deficiency
8 relates to the question of whether petitioner was providing a service or leasing equipment when its
9 employees provided only supervision of the equipment. Petitioner correctly observes that the audited
10 understatement would decrease if the disputed transactions were regarded as services. However, there
11 would still be a significant deficiency because of petitioner's failure to establish that it paid any tax at
12 all with respect to its purchase or lease of this equipment. That is, since petitioner does not claim that
13 the transactions were entirely exempt, *some* tax was due, but was not paid (and, as noted above, if
14 petitioner leased the equipment in the same form as acquired, then its payment of tax on cost would
15 have avoided the entire dispute regarding the tax on its rentals). We find that petitioner's failure to pay
16 any tax with respect to its purchase or lease of the subject equipment is clear evidence of negligence.
17 Additionally, petitioner provided inadequate records for audit, and the overall understatement of
18 reported taxable measure of \$1,146,453 is substantial, and compared to petitioner's reported taxable
19 transactions of \$216,044, is an understatement is 531 percent. We find that petitioner was negligent,
20 and the penalty properly imposed.

21 **AMNESTY**

22 The 50 percent amnesty interest penalty under Revenue and Taxation Code section 7074,
23 subdivision (a), is not applicable because petitioner filed an application for amnesty and entered into a
24 qualifying installment payment plan. However, since petitioner did not successfully complete the
25 installment payment plan as agreed, the negligence penalty has not been waived under Revenue and
26 Taxation Code section 7072, subdivision (a).

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