

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 TOM DWORKIN ASSOCIATES) Account Number: SR AC 99-186763
 6) Case ID 341727
 7 Petitioner) Canoga Park, Los Angeles County

8 Type of Business: Fabric retailer

9 Audit Period: 10/1/01 – 9/30/04

10 <u>Items</u>	<u>Amounts in Dispute</u>	
11 Disallowed netted sales in interstate commerce	\$65,657	
12 Negligence penalty	\$3,360	
13 Amnesty double negligence penalty	\$1,066	
14 Amnesty interest penalty	\$1,280	
	<u>Tax</u>	<u>Penalties</u>
15 As determined	\$42,291.12	\$5,556.84
16 Adjustment: Sales and Use Tax Department	-6,431.51	-877.05
Appeals Division	<u>-2,262.67</u>	<u>-253.94</u>
17 Proposed redetermination	\$33,596.94	\$4,425.85
Amount concurred in	<u>-28,222.88</u>	
18 Protested	<u>\$ 5,374.06</u>	<u>\$4,425.85</u>
19 Proposed tax redetermination	\$33,596.94	
Interest through 9/30/09	18,139.44	
20 Negligence penalty	3,359.73	
Amnesty double negligence penalty	1,066.12	
Amnesty interest penalty	<u>1,279.74</u>	
21 Total tax, interest, and penalties	<u>\$57,441.97</u>	
22 Monthly interest beginning 10/1/09	<u>\$223.98</u>	

23 This matter was previously scheduled for oral hearing on June 30, 2009, but was postponed
 24 because petitioner's representative was scheduled to appear in court on the same date.

25 UNRESOLVED ISSUES

26 **Issue 1:** Whether petitioner has established that additional adjustments are warranted for
 27 disallowed netted interstate commerce sales. We recommend no further adjustments.

28 Petitioner, a corporation, sells fabric at retail and wholesale to various hotels or their

1 purchasing agents. The fabric is used to manufacture bed spreads, upholstery, and drapes. It is not
2 uncommon for an out-of-state customer to direct that petitioner deliver the fabric to a fabricator for
3 final delivery to the customer outside of California.

4 During the audit, the Sales and Use Tax Department (Department) examined all sales invoices
5 for the audit period on an actual basis and found that petitioner did not collect sales tax reimbursement
6 or report sales tax on sales with final out-of-state destinations, without considering whether title
7 transferred to the customer or its purchasing agent in California, and instead petitioner netted such
8 sales from its reported gross receipts. The Department also noted that a portion of these netted sales in
9 interstate commerce were actually delivered to California fabricators, as directed by the customers'
10 purchase orders, prior to shipment out of state. The Department found that title transferred to the
11 customers upon delivery of the fabric to the California fabricators in these sales and that sales tax
12 applied because the sales were not exempt interstate sales.

13 The Department also noticed recorded sales in interstate commerce to Indian tribes located in
14 California for which petitioner delivered the fabric directly to California fabricators pursuant to the
15 tribes' purchase orders. According to Mr. J. Caleb Donner, petitioner's representative, the fabric was
16 thereafter shipped to the Indian reservations by common carriers chosen and paid for by the tribes.
17 Since the sales of fabric to Indian tribes were delivered to fabricators, the Department again found that
18 title transferred to the tribes off the reservation upon delivery to the fabricators in California.
19 Therefore, the Department found that these sales did not qualify for the exemption for sales to Indians
20 on reservations and concluded that the transactions were subject to sales tax.

21 Four transactions with an Indian Tribe, the Morongo Band of Mission Indians (Morongo),
22 totaling \$60,698, and a portion of the sale to the Oklahoma State University totaling \$4,958.64, remain
23 at issue.

24 With respect to the transactions with Morongo, petitioner notes that Morongo is a sovereign
25 Indian tribe not subject to sales and use tax. Petitioner asserts that Morongo's purchase orders contain
26 a clause specifying that Morongo does not take title to any purchased item until the property is actually
27 delivered on the reservation. Petitioner argues that Morongo was not at risk for damaged goods prior to
28 their reaching the reservation, and thus title to the property did not transfer to Morongo prior to delivery

1 on the reservation. Petitioner also contends that various purchase orders with FOB East Coast and FOB
2 Los Angeles title clauses were actually exempt sales in interstate commerce and not subject to tax.

3 California Code of Regulations, title 18, section (Regulation) 1616, subdivision (d)(4)(A),
4 provides that sales tax does not apply to sales of tangible personal property made to Indians negotiated
5 at places of business located outside Indian reservations if, and only if, the property is delivered to the
6 purchaser on the reservation and ownership of the property transfers to the purchaser on the
7 reservation. Petitioner relies on the provision in the Morongo purchase orders that states that “title to
8 the property transfers to the tribe upon delivery on the reservation and not before.” However, title to
9 property can pass no later than when the seller completes its duties with reference to physical delivery
10 of the property, and a provision in the contract retaining title in the seller after that time is merely as a
11 security interest. (Cal. UCC, § 2401, Cal. Code Regs., tit. 18, § 1628, subd. (b)(3)(D).)

12 The available evidence indicates that petitioner delivered the fabric only to the California
13 fabricator, and Morongo arranged and paid for delivery by common carrier of the fabric from the
14 California fabricator to the tribe on the reservation. That is, petitioner had no part in, or contractual
15 duty for, delivery of the fabric to Morongo on the reservation. As such, petitioner completed its duties
16 with reference to physical delivery of the property when it tendered the property to the common carrier
17 for shipment to the fabricator, and the sale occurred at that time, *off* the reservation. Thus, the sales did
18 not did satisfy the conditions for the exemption from sales tax.

19 With respect to petitioner’s claims that Morongo did not bear the risk of loss prior to delivery
20 on the reservation, not only does risk of loss not necessarily pass at the same time as title passes, but
21 also petitioner has not shown any instance in which petitioner, and not Morongo, bore the risk of loss
22 at any time after the delivery of the product to the fabricator, and based on the documentation
23 presented, we conclude that petitioner did not bear such risk.

24 After the \$22,253.22 adjustment recommended by the Department (\$21,336 fabric + \$917.22
25 freight charges), the remaining disallowed measure from invoice OSU-404 is \$9,123, of which
26 petitioner contends that an additional \$4,958.64 should be allowed because it was merely a sales
27 representative of Northeast Textile, Inc. for this transaction. In support, petitioner provided a copy of
28 its sales representative agreement with Northeast and a copy of Northeast invoice number 40705 dated

1 March 31, 2003. Invoice 40705 refers to purchase order number OSU-404 and shows that Northeast
2 made a sale of fabric to Rausch Purchasing Management/Oklahoma State University Foundation
3 totaling \$22,253.22 (\$21,336 fabric + \$917.22 freight charges). However, the remaining charges
4 reflected on order number OSU-404 are not included in invoice 40705, and petitioner has not provided
5 any corresponding Northeast invoice to show that Northeast also sold any of the \$9,122.64 in
6 additional fabric to Rausch or that petitioner was a Northeast sales representative for these particular
7 sales. In addition, the purchase order makes no reference to Northeast or any Northeast invoice
8 numbers for these sales. Thus, petitioner has failed to produce evidence that shows it was acting as a
9 sales representative on behalf of Northeast for the additional fabric sales on purchase order number
10 OSU-404.

11 While preparing this summary, we inquired of the Department regarding the source of the
12 goods sold for the remaining \$9,122. This is relevant because the goods were apparently delivered to
13 an in-state fabricator, who then shipped the goods outside California for use outside California. If
14 petitioner's sale occurred outside California, then the applicable tax would be use tax on the use of the
15 property in California, and it appears that no taxable use of the property would be regarded as having
16 occurred based on the exclusion from taxable use under Revenue and Taxation Code section 6009.1. If
17 the goods were shipped to the in-state fabricator from a California location (whether directly by
18 petitioner or by a supplier drop shipping the goods from a California location), then the applicable tax
19 is sales tax, and section 6009.1 cannot apply. If, instead, the goods were shipped to the in-state
20 fabricator from outside California, then, unless petitioner did not complete its duties with reference to
21 physical delivery of the property until delivery in California, the sale have occurred outside California
22 and section 6009.1 might apply.

23 The remaining \$9,122 under order number OSU-404 comprises two transactions, one for
24 \$4,959, and the other for \$4,164. Petitioner disputes the tax only with respect to the former. The
25 Department responded to our inquiry that it does not know where the goods came from which
26 petitioner sold for \$4,164 (which sale petitioner does not dispute), but that, although there are
27 discrepancies on the invoices, it believes the goods petitioner sold for \$4,959 may have been delivered
28 from outside California. However, the Department notes that the purchase order issued to petitioner

1 states “F.O.B.: Los Angeles CA,” and based on this provision, the Department concludes that the sales
2 occurred in California, and that sales tax applies. We agree. The F.O.B. Los Angeles provision means
3 that petitioner did not complete its duties with respect to physical delivery of the property until
4 delivery in Los Angeles. (Cal. UCC, § 2401, Cal. Code Regs., tit. 18, § 1628, subd. (b)(3)(D).) Thus,
5 unless the contract expressly passed title sooner, which we understand was not the case, then the sale
6 occurred upon delivery at Los Angeles. Thus, we recommend no further adjustment.

7 **Issue 2:** Whether petitioner was negligent. We conclude that petitioner was negligent.

8 The Department found that the same type of error as in the prior audit was repeated in the
9 current audit period. Additionally, in the prior audit, the Department sent petitioner a letter dated
10 June 18, 2001, granting relief under Revenue and Taxation Code section 6596 for the errors found in
11 the prior audit, but explaining the proper application of tax and advising petitioner that its failure to
12 report sales properly in the future would result in assessments of additional tax, interest, and possible
13 penalties, particularly for reporting periods commencing after July 1, 2001 (which includes all the
14 reporting periods at issue here). However, petitioner continued to not report as taxable transactions in
15 which the fabric was delivered to in-state fabricators.

16 Petitioner claims that it did not intend to report its tax liability in a negligent manner and
17 therefore lacked the “requisite intent.” However, the penalty is applicable when a taxpayer *is*
18 negligent, not merely where it *intends* to be negligent. The evidence here shows that petitioner was
19 made aware of its reporting problems and failed to take appropriate action to correct them. A
20 reasonably prudent person under similar circumstances would have taken corrective action to correct
21 the problems after being advised of the incorrect reporting, and would not have allowed them to
22 continue. Even after the allowed reduction of \$27,426, disallowed netted sales still result in a sizable
23 understatement of \$410,467 (or 28.18 percent). The large amount and percentage of understatement
24 also indicates a standard of conduct below that of a reasonably prudent businessperson and constitutes
25 evidence of negligence. We conclude that petitioner was negligent and the penalty is appropriate.

26 **AMNESTY**

27 Two amnesty penalties apply in this case. An amnesty double negligence penalty of \$1,066.12
28 was included in the Notice of Determination because the determination was issued after the amnesty

1 period and, although petitioner submitted a timely amnesty application, petitioner failed to pay the
2 amnesty-eligible tax and interest due, or enter into a qualifying installment payment agreement to do
3 so, by May 31, 2005. (Rev. & Tax. Code, § 7073, subd. (c).) An amnesty interest penalty of
4 \$1,279.74 will also be imposed when the liability is final. (Rev. & Tax. Code, §§ 7073, subd. (a)(3),
5 7074, subd. (a).) Mr. Scott Dworkin, petitioner's president, submitted a statement under penalty of
6 perjury contending that the penalty is not applicable because petitioner filed a timely application and
7 received written confirmation on May 28, 2005, that its amnesty application had been accepted.

8 As noted above, it is true that petitioner submitted a timely application for amnesty. On May
9 28, 2005, petitioner was advised that it had to file amended sales and use tax returns and pay all
10 amnesty-eligible tax and interest, or enter into an installment payment agreement to do so, by May 31,
11 2005. However, petitioner chose not to file amended returns to report its understatement or fulfill the
12 payment requirements of the amnesty program as a means of satisfying its liability. Had petitioner
13 complied with the requirements of the amnesty program, it would have avoided the amnesty penalties
14 *and* the negligence penalty imposed on the tax for the amnesty-eligible periods would have been
15 waived. However, petitioner did not comply with the requirements of the amnesty program.

16 We conclude that petitioner's failure to satisfy its amnesty-eligible liability as required by the
17 amnesty program was not due to reasonable cause and petitioner is not entitled to relief from the
18 amnesty penalties.

19 **OTHER DEVELOPMENTS**

20 In our D&R, we recommended adjustments totaling \$36,576. In the reaudit, the Department
21 found that, with respect to the reduction of \$12,504 we recommended, only \$3,354 had actually been
22 disallowed. Thus, this was the maximum adjustment that was available for that transaction. The total
23 adjustment allowed totaled \$27,426. We recommend no further adjustments.

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26 Summary prepared by Rey Obligacion, Business Taxes Specialist III
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