

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

BUSINESS TAXES APPEALS REVIEW SECTION

|                               |   |                             |
|-------------------------------|---|-----------------------------|
| In the Matter of the Petition | ) |                             |
| for Redetermination Under the | ) | DECISION AND RECOMMENDATION |
| Sales and Use Tax Law of:     | ) |                             |
|                               | ) |                             |
| W--- M--- A---                | ) | No. SR -- XX XXXXXXX-010    |
|                               | ) |                             |
|                               | ) |                             |
| <u>Petitioner</u>             | ) |                             |

The Appeals conference in the above-referenced matter was held by Staff Counsel Lucian Khan on February 1, 1994 in --- ---, California.

|                               |                         |
|-------------------------------|-------------------------|
| Appearing for Petitioner:     | W--- M---               |
|                               | President               |
|                               | M--- H---               |
|                               | Attorney at Law         |
| Appearing for the             |                         |
| Sales and Use Tax Department: | Harold J. Murray        |
|                               | Supervising Tax Auditor |
|                               | Savina Cho              |
|                               | Tax Auditor             |

Protested Items

The protested tax liability for the period January 1, 1982 through December 31, 1989 is measured by:

| <u>Items</u>   | <u>State, Local &amp; County</u> |
|--|----------------------------------|
| A. Disallowed sales in interstate commerce   | \$624,866                        |
| B. Taxable sales of tangible personal property on an actual basis from 1986 through 1989 | \$638,484                        |

|    |  |           |
|----|--|-----------|
| C. | Services related to the sale of tangible personal property on an actual basis from 1986 through 1989   | \$280,430 |
| D. | Projected taxable sales for the period 1982 through 1985 using a 27.24 percent factor computed from test of taxable sales from 1986 through 1989 | \$966,022 |

The deficiency determination includes a 10 percent penalty for failure to file.

#### Contentions

1. The disallowed sales in interstate commerce were exempt.
2. The true object of petitioner's contracts was for a service; thus, any training manuals, computer disks, or camera-ready artwork were merely incidental.
3. Projected sales from 1982 through 1985 were in error.
4. The failure-to-file penalty should not apply.

#### Summary

Petitioner was engaged as a marketing consultant with its main customers consisting of X---, I---, and R---. To fulfill its contracts with its customers, petitioner furnished items such as training manuals, computer disks, and camera-ready artwork. On April 2, 1991, the Sales and Use Tax Department (SUTD) issued a Report of Field Audit for the above period, and assessed a 10 percent penalty for failure to file returns. After discussions with petitioner, the measure assessed in the audit was reduced from \$2,790,191 to \$2,509,802 in a revised audit report dated August 30, 1991. A determination was billed on October 15, 1991, and petitioner filed a petition for redetermination on November 6, 1991 contesting the entire amount assessed. The facts and arguments are as follows:

#### Audit Item A

This item includes printing materials (manuals) or artwork which petitioner claims was delivered out of state, but was disallowed by the auditor because the invoices showed an in-state address for the customers. There were no back-up shipping documents to show out-of-state delivery.

Petitioner argues all property was delivered outside California by its own employees. To perform training services for its customers, it was necessary for the employees to fly to the customer's out-of-state location. The property relating to petitioner's training services was physically taken onboard the aircraft and subsequently delivered to the customers outside California. Petitioner attempted to show the auditor airline tickets to prove the out-of-state deliveries, but the auditor disregarded this documentation. Petitioner will attempt to obtain further documentation on this issue. The customers were only billed at in-state addresses at their request. This does not prove that the delivery was also made within California.

SUTD argues the transactions were disallowed because of the in-state billing addresses, there was no back-up shipping documents, and the airline tickets would in no way prove that the employee personally delivered the property outside California. Without further documentation, no further adjustments are warranted.

#### Audit Items B and C

These two audit items relate to sales of the same type of property indicated in Item A, and services related to the sale of that property which SUTD deemed to be taxable. The sales and related services were audited on an actual basis from 1986 through 1989.

Petitioner argues that its main business is to evaluate and review clients' existing software programs, perform marketing research, train and teach clients' personnel on how to utilize the software, and put these educational items on computer disks and into training manuals. Occasionally, petitioner provides camera-ready artwork upon the client's request. Accordingly, under the true object of the transaction test, these activities would be deemed a service rather than a sale (Regulations 1501 and 1502(g)).

SUTD argues that a review of the contracts revealed the true object sought by the clients were training manuals, computer disks, and camera-ready artwork. Services provided in the beginning phase of the contract were simply the steps necessary to produce these finished products. Therefore, the total contract amount, including those services, should be included in the taxable measure.

#### Audit Item D

This item relates to projected sales from 1982 through 1985. The figures were based on a review of petitioner's income tax returns for that same period, and using a 27.24 percent factor based on a test of petitioner's sales from 1986 through 1989.

Petitioner argues the figures used are not representative of taxable activity in the earlier years. Petitioner's business was mostly for consulting, with very little sales of tangible personal property in the earlier years of the eight-year audit period.

SUTD argues that for the years 1982 through 1985, petitioner was only able to furnish three invoices, one for a sale occurring in the third quarter of 1983, one for a sale in the fourth quarter of 1984, and the remaining invoice for a sale in the first quarter of 1985. Because the invoices were not representative of activity during this period, and petitioner did not present further documentation, no further adjustments are warranted.

\* \* \*

Petitioner was allowed until March 15, 1994 to submit any additional invoices, copies of contracts, or evidence to show out-of-state deliveries for the disallowed sales in interstate commerce. In a declaration dated March 10, 1994, which is signed by petitioner's president, W--- M---, he states the corporation's failure to collect and pay sales tax was inadvertent and not intentional. It was their belief that they were selling a service, rather than a product which required collection and payment of sales tax. Through ignorance they ran the business as though sales tax did not apply to them. Even their professional advisors were of the opinion that no sales tax was due. This statement has been accepted as a request for relief of the failure-to-file penalty for the above period.

### Analysis and Conclusions

#### Audit Item A

Exemptions from tax are strictly construed against the taxpayer who has the burden of proving that the statutory requirements have been satisfied (see Standard Oil Co. v. State Board of Equalization (1974) 39 Cal.App.3d 765, 114 Cal.Rptr. 571; and H.J. Heinz Co. v. State Board of Equalization (1962) 209 Cal.App.2d 1, 25 Cal.Rptr. 685). An exemption from tax cannot be granted just because the taxpayer says so (Paine v. State Board of Equalization (1982) 137 Cal.App.3d 438, 443, 187 Cal.Rptr. 47; and People v. Schwartz (1947) 31 Cal.2d 59, 66, 187 P.2d 12). Credible evidence must be presented to prove the exemption.

Sales tax does not apply when the property, pursuant to a contract of sale, is required to be shipped and is shipped to a point outside this state by a retailer, through any of the following means:

1. Facilities operated by the retailer, or
2. Delivery by the retailer to a carrier, customs broker, or forwarding agent, whether hired by the purchaser or not, for shipment to an out-of-state point. (Rev. & Tax. Code § 6396; Reg. 1620(a)(3)(B).)

A bill of lading or other documentary evidence of delivery of the property to a carrier, customs broker, or forwarding agent for shipment outside this state must be retained by the retailer to support deductions taken. (Reg. 1620(a)(3)(D).)

As the above authority so states, petitioner bears the burden of proving it is entitled to the exemption for the claimed sales in interstate commerce. To obtain this exemption, petitioner is required to maintain in its records a copy of a bill of lading or other documentary evidence. Here, the invoices showed the clients were billed at an in-state address. The only documentation offered to prove the employees made out-of-state delivery were airline tickets for out-of-state flights. This documentation is inadequate. Proving an employee took an out-of-state flight does not prove they also carried and delivered goods to that same out-of-state destination. Accordingly, we conclude petitioner has not met its burden of proof.

#### Audit Items B and C

Revenue and Taxation Code Section 6051 imposes sales tax on retailers based on gross receipts from the sale in this state of tangible personal property. Section 6007 defines "retail sale" as a sale for any purpose other than resale in the regular course of business. Section 6012(b)(1) includes "Any services that are a part of the sale" in the definition of "gross receipts" for sales tax purposes.

Sales and Use Tax Regulation 1501, "Service Enterprises Generally", implements Sections 6006 and 6015 and provides as follows:

"The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true object of the contract; that is, is the real object sought by the buyer the service per se or the property produced by the service. If the true object of the contract is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred."

Where the true object of the transaction is the finished article, a sale of tangible personal property within the meaning of Section 6006 will be found (Albers v. State Board of Equalization (1965) 237 Cal.App.2d 494).

Regulation 1502(g) entitled "Service Charges" provides that charges for the performance for normal service activities are nontaxable unless the services are performed as part of the sale of tangible personal property. Revenue and Taxation Code Section 6091 presumes that all gross receipts are subject to tax until the contrary is established.

Here, SUTD argues that based on a review of the contracts, the true object sought by the clients was the training manuals, computer disks, and camera-ready artwork. Services provided in the beginning phase of the contract were part of the steps necessary to come up with the finished products. Petitioner, on the other hand, argues that the majority of its activity involved nontaxable services and the property furnished was merely incidental.

It is noted from a review of the audit papers that the auditor obtained copies of various contracts between petitioner and its clients. The contracts are entitled "Agreement for Custom-Developed Training Program" and are form contracts, with some variations. Generally, the contracts require petitioner to design, develop, produce, and deliver to the client certain enumerated items which relate to training programs. Those items are normally listed on a referenced attachment and consist of overhead transparencies, workbooks, data disks, trainer guides, master disks, reproduction masters, hardcopy masters, booklets and disk copies. The contracts generally state that the price to be paid by the client for the design, development, and all items delivered shall be according to an attached fee schedule, or a specific amount is listed in the body of the contract. Where a contract has an attached fee schedule, the individually listed charges appear to relate to the sale of tangible personal property, or in some instances, an advance payment to begin a particular project for the production of tangible personal property. The contracts further state that petitioner retains a security interest in all delivered materials until the purchase price has been paid in full. The remainder of the contract which deals with copyright, design and production credit, archive copies, right-to-use copies, and confidential information, continually refer to "items" or "copies" which are to be delivered.

Based on a review of the contracts obtained, we conclude that although petitioner's activities involve some form of training, the items provided for in the contracts and the charges made relate to the sale of tangible personal property. Accordingly, we agree with SUTD.

#### Audit Item D

The use of test sampling is an auditing procedure specifically authorized by the Board of Equalization. It is also recognized as a proper procedure by national accounting associations and by the courts (see particularly Paine v. State Board of Equalization, supra). The burden of providing evidence establishing error in the audit staff's computations rests with petitioner. (See, e.g., Riley B's Inc. v. State Board of Equalization (1976) 61 Cal.App.3d 610; Sales and Use Tax Regulation 1698.)

Every retailer has a mandatory duty to keep and maintain adequate and complete business books and records, including receipts and invoices evidencing purchases and sales as well as the normal books of account ordinarily maintained by the average prudent businessperson in order that the Board may make a proper and accurate determination of taxes due. (Rev. & Tax. Code § 7053; Reg. 1698(a).)

Here, we conclude that SUTD properly projected sales from 1982 through 1985 on income tax returns for that period and sales figures from 1986 through 1989. Although petitioner argues the figures are not representative of its taxable activity in the earlier years, it has only produced three invoices representing transactions in three different quarters (3Q83, 4Q84, and 1Q85). The argument that most gross receipts in the earlier years were not taxable simply relates to the true object of petitioner's contracts, for which copies have already been reviewed, and the contracts indicate otherwise.

#### Negligence Penalty

Revenue and Taxation Code Section 6511 imposes a ten percent penalty where any person fails to file a return paying the appropriate amount of sales or use tax due. Section 6592 provides that relief may be granted from the penalty imposed under Section 6511 if the Board finds that the failure to make a timely return is due to reasonable cause and circumstances beyond the person's control, and occurred notwithstanding the exercise of ordinary care and in the absence of willful neglect. Any person seeking to be relieved of the penalty shall file with the Board a statement under penalty of perjury setting forth the facts upon which he or she bases his claim for relief.

It was also noted from a review of petitioner's sample contracts that the standard agreement contains a clause providing that the clients shall pay all applicable sales and use taxes. Based on this finding, we cannot conclude that petitioner's failure to collect and pay sales tax was inadvertent, and not intentional. The presence of this clause would indicate petitioner had considered the implication of sales tax to its activities and simply elected to shift this burden to the client. Accordingly, we recommend the request for relief of penalty be denied.

#### Recommendation

Deny the petition and redetermine the tax liability without adjustment.

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Lucian Khan, Staff Counsel

\_\_\_\_\_  
Date