

795, 0372

Date: 1/6/87

STATE OF CALIFORNIA  
BOARD OF EQUALIZATION

In the Matter of the Petition )  
for Redetermination of State ) DECISION AND RECOMMENDATION  
and Local Sales and Use Tax: )  
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The above-entitled matter came on regularly for hearing on Thursday, October 30, 1986 in , California before Robert H. Anderson.

Appearing for Petitioner:

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Appearing for the Board:

Protest

Petitioner was audited for the period from 1-1-82 through 12-31-84 and a notice of determination was issued on 9-26-85 for tax and interest on the sale of a fixed asset measured by \$55,000.

On October 24, 1985, counsel filed a petition for redetermination, a copy of which is in the petition file.

Petitioner protests the assessment for sales tax and California transactions tax on the sale of one lathe measured by \$55,000.

Contentions

1. The sale was an exempt occasional sale as defined under Section 6006.5(a), the Sales and Use Tax Law (Law).

2. The lathe was never in, nor was it sold in a transit district, so the tax, if any is due, should not have a transit district tax.

### Summary

Petitioner is a corporation that commenced in November of 1983 when it applied for and obtained a seller's permit. The type or nature of its business, as entered on the application for a seller's permit, is "Metal Specialties".

Petitioner was placed on a yearly reporting basis. During the period covered by the audit and the year following the audit (1985) petitioner reported no taxable sales in California. The majority of its sales are to the United States Government although small amounts of gross receipts were reported as sales in interstate and foreign commerce and sales for resale.

The lathe, in question, was purchased in 1982 tax-paid and was rented to a subcontractor dealing with petitioner; it was also depreciated as a capital asset and ultimately sold in the third quarter of 1984. The sale was reported on line 10 of the 1984 Sales and Use Tax Return and claimed as an exempt sale under the occasional sale exemption (Section 6367 of the Law) as defined in Section 6006.5(a) of the Law.

Petitioner is described as an engineering firm engaged in the business of "solving problems" such as, for example, a faulty or poorly engineered part for the F-111 fighter aircraft flown by the U.S. Air Force.

For example, the Air Force has problems with a pump on the F-111. Petitioner's engineers will undertake to solve the problem by redesigning the pump. Petitioner subcontracts to have a prototype of the redesigned pump made. The prototype is turned over to petitioner who tests it to prove the problem has been solved. Assuming the problem is solved, and the Air Force wants to purchase pumps to replace the problem pumps on the F-111 aircraft fleet, petitioner then subcontracts to have the pumps manufactured for sale to the Air Force.

It was emphasized that petitioner: (1) has no machine shop; (2) has no machinists; (3) does not fabricate prototypes or parts of any kind; and (4) has no equipment for doing metal work. Petitioner does test and verify what it has redesigned, and is to be sold. Also, on occasion petitioner assembles a given part.

A normal project is described as: (1) to redesign a part; (2) subcontract for a prototype; (3) test the prototype, and if OK; (4) get a contract (generally a government contract) for the manufacture and sale of the redesigned part; and (5) let a subcontract to manufacture the part.

The above-described example sets the stage for the facts relating to the purchase of the lathe, the rental of it, and ultimately the sale of it.

A firm known as \_\_\_\_\_ was located in \_\_\_\_\_, and did manufacturing as a subcontractor on some occasions. Mr. \_\_\_\_\_ was with \_\_\_\_\_ at the time when \_\_\_\_\_ entered into a contract with petitioner to construct a prototype part; the part was constructed manually. After testing, the prototype proved workable. \_\_\_\_\_ wanted the subcontract to manufacture the part on a large scale, but could not do it manually; it needed a particular kind of lathe, but did not have the capital to make such a purchase. Petitioner told \_\_\_\_\_ it would purchase the lathe and rent it to \_\_\_\_\_ for use under the subcontract with petitioner to manufacture the part.

Petitioner purchased the lathe, a \_\_\_\_\_ make, which was shipped directly to \_\_\_\_\_ in \_\_\_\_\_ from \_\_\_\_\_. I sent personnel to \_\_\_\_\_ to train \_\_\_\_\_ personnel on how to operate the lathe since petitioner did not have any personnel with the knowledge of how to operate it. Tax was paid on the purchase of the lathe by petitioner who set it up on the books as a capital asset and depreciated it for almost two (2) years claiming approximately \$1,500 per month depreciation. The fact of depreciation was verified by the \_\_\_\_\_ District audit staff who, at the hearing officer's request, called on \_\_\_\_\_ to learn how the lathe was treated on the books.

In the course of events, Mr. \_\_\_\_\_ left and went with \_\_\_\_\_. He verified that the lathe was never in a transit district. Petitioner sold the lathe to \_\_\_\_\_ in August of 1984. It is this sale that gives rise to the controversy in this matter.

#### Analysis and Conclusions

Petitioner is required to hold a seller's permit under the Law, and does in fact hold permit number \_\_\_\_\_

Petitioner cites Section 6006.5(a) which defines a type of occasional sale to include a sale of property not held or used by the seller in the course of activities for which the seller

is required to hold a seller's permit provided such sale is not one of a series of sales sufficient in number, scope and character to constitute an activity for which the seller is required to hold a seller's permit, or would be so required if the activity were conducted in this state.

Petitioner contends that its use of the lathe was not a use in petitioner's business activity for which it held the seller's permit, and accordingly the use meets the test of a Section 6006.5(a) occasional sale. The audit verified the fact that petitioner did not make sales of assets sufficient in number, scope and character to require a seller's permit.

Petitioner purchased the lathe tax-paid and rented it. The rental is a use of the lathe rather than a (continuing) sale as defined under Section 6006 of the Law.

Petitioner cites Ontario Community Foundation, Inc. v. State Board of Equalization (1984) 35 Cal.3d 811 as case law authority for exempting the sale of the lathe.

Ontario was engaged in two separate and distinct business activities; one was a service and the other a selling activity. The Ontario case involved the sale of hospital assets used only in rendering services to patients. No seller's permit was required for rendering the hospital services.

The Board taxed the sale of the hospital assets because the hospital also had a seller's permit which it was required to hold in order to make sales of such items as meals to non-patients, gifts, pharmaceuticals, etc. The selling activity was minor or negligible compared to the activity of rendering services to patients. If Ontario had not had the selling activity, the Board would not have taxed the sale of the hospital equipment, but under the unitary business concept, set forth in Regulation 1595 (18 Cal. Admin. Code 1595) the Board taxed the sale of the hospital equipment. The Court held that the Board's Regulation (unitary business concept) conflicted with Section 6006.5(a).

Regulation 1595 still provides that tax applies to all retail sales of tangible personal property, including capital assets whether sold in one transaction or in a series of sales, held or used by the seller in the course of an activity or activities for which a seller's permit or permits is required.

The Regulation also provides that tax applies to the sales of assets of a business which is not essentially a service enterprise; examples include grocery stores selling taxable and

exempt items, service stations that sell gas and oil and also perform automotive repairs and lubrication services, and service stations that operate a car wash service.

In this case petitioner was not engaged in the business of leasing equipment like a leasing company who leases equipment to the general public. In other words, petitioner was not engaged in a service enterprise type of business. The purchase of the lathe and the purpose of the lease of it was directly tied to petitioner's business activity for which it held the seller's permit; i.e., it facilitated letting the subcontract to manufacture the part or parts that petitioner was purchasing and thereafter selling.

The lease of the lathe, in and of itself, was a use of the lathe by petitioner, and the lathe was a capital asset of petitioner's business. We recognize the fact that petitioner's employees did not physically use the asset (lathe) to manufacture the part or parts, but there was a business reason directly connected with petitioner's business, for purchasing and renting the lathe, and, as noted, that purpose was to make it possible to contract with to manufacture the part or parts petitioner was purchasing. Thus, the rental use was related to the business activity for which petitioner held a seller's permit.

Accordingly, it is our conclusion that the lathe was used in petitioner's activity for which it held the seller's permit.

At least some of petitioner's gross receipts from leasing the lathe to were directly related to its cost of producing parts for sale, the same as its cost of subcontracting the production of parts. Only, here the lease receipts from leasing a capital asset to a subcontractor who used the lathe to produce the parts had the effect of directly offsetting or cutting down the cost of the parts petitioner was purchasing from

In this case, the lease of the lathe to was integrated with petitioner's principal business activity of purchasing parts from for sale to the U.S. Government or others as the case might be. If it was not so related, we would see the lease, in and of itself, as a use activity unrelated to the activity for which petitioner held the seller's permit.

Section 6357 of the Law is an exemption statute. Statutes granting exemption from taxation must be reasonably, but nevertheless strictly, construed against the taxpayer claiming

the exemption. (Santa Fe Transp. v. State Bd. of Equalization (1959) 51 Cal.2d 531; Luer Packing Co. v. State Bd. of Equalization (1950) 101 Cal.App.3d 99; Good Humor Co. v. State Bd. of Equalization (1957) 152 Cal.App.2d 879.

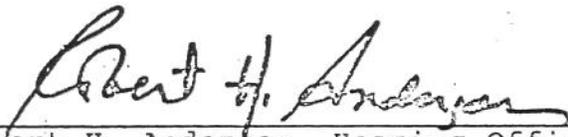
It is clear that the lathe was used by petitioner in petitioner's business activity and that activity required holding a seller's permit. Thus, the rental use, in this case, does not meet the test for an occasional sale under the definition in Section 6006.5(a), and the Ontario Community Foundation (supra) case is not authority for exempting the sale of the lathe from sales tax.

Finally, evidence does not support a finding that the lathe was used or sold in a transit district. Thus, the sale is not subject to the Transactions Tax.

Recommendation

Redetermine. Recompute the tax at the 6% rate.

Action on the recommendation to be taken by Petition Unit.

  
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Robert H. Anderson, Hearing Officer  
*RJA*

1-6-87  
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Date

Reviewed for Audit:

\_\_\_\_\_  
Principal Tax Auditor

\_\_\_\_\_  
Date