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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18032508
SHAWN VICTOR BACHOR dba Carmel Mountain Cabinetry	) Date Issued: April 11, 2019

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellant: Harold C. Newman, E.A.

For Respondent: Kevin B. Smith, Tax Counsel III

For Office of Tax Appeals: Matthew D. Miller, Tax Counsel III

N. DANG, Administrative Law Judge: On July 28, 2017, an oral hearing on this matter was held by the California State Board of Equalization (SBE), where it granted Shawn Victor Bachor's (appellant's) petition for redetermination of the September 26, 2013 Notice of Determination issued to him for the period January 1, 2007, through December 31, 2012.[1] On February 23, 2018, the California Department of Tax and Fee Administration (CDTFA) issued a Notice of Redetermination to appellant formally notifying him of SBE's decision. On March 19, 2018, CDTFA filed a petition for rehearing of this matter (Petition) with the Office of Tax Appeals (OTA).

OTA's Jurisdiction

In his April 18, 2018 response, appellant asserts that CDTFA's Petition should be denied because it is barred by res judicata, and regardless, CDTFA has introduced no new evidence or arguments to warrant a new hearing. Because appellant's response raises issues concerning OTA's jurisdiction to hear this Petition, we address these contentions first.

[1] A transcript of the hearing is available at: < http://www.boe.ca.gov/meetings/transcripts/2017-07-28C7.txt> (as of December 12, 2018).

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The doctrine of res judicata prevents parties or their privies from relitigating a cause of action after a final judgment on the merits has been entered by a court of competent jurisdiction. (*Commissioner v. Sunnen* (1948) 333 U.S. 591, 597.) "The rule is based on the sound policy of limiting litigation by preventing a party who has had one fair trial on an issue from again drawing it into controversy." (*Bernhanrd v. Bank of America National Trust & Savings Association* (1942) 19 Cal.2d 807, 810.) While SBE is not a court, it is well-established that res judicata applies to a final determination made by SBE. (Rev. & Tax. Code, § 7176; *State Board of Equalization v. Superior Court* (1985) 39 Cal.3d 633.) Therefore, for res judicata to apply here, CDTFA must have filed its Petition after SBE's decision became final.

Revenue and Taxation Code section 6564 states that the order or decision of SBE upon a petition for redetermination becomes final 30 days after service upon appellant of notice thereof. Here, CDTFA formally notified appellant of SBE's decision on February 23, 2018, when it mailed the Notice of Redetermination.[2] Absent a petition for rehearing, the earliest that SBE's decision could have become final was March 25, 2018. However, respondent filed its Petition on March 19, 2018, which is within 30 days of the Notice of Redetermination. Therefore, SBE's decision is not yet final, and thus, res judicata is inapplicable to CDTFA's Petition and OTA has jurisdiction over CDTFA's Petition. (Cal. Code Regs., tit. 18, § 30832.)

With respect to appellant's contention that CDTFA failed to provide new evidence or arguments, we note any of the following conditions are sufficient to warrant a new hearing: (1) an irregularity in OTA's proceedings that prevented the fair consideration of the party's appeal; (2) an accident or surprise that occurred with respect to the appeal which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the party could not have reasonably discovered and provided prior to OTA's decision or; (4) insufficient evidence to justify OTA's decision or that the decision is contrary to law. (Cal. Code Regs., tit.

[2] Generally, formal notice of SBE's decision will be mailed to all parties within 45 days from the date of the Board's decision. (Cal. Code Regs., tit. 18, § 5560.) However, the hearing transcript indicates that SBE considered issuing a precedential opinion in this matter. If that were the case, notice of SBE's decision would necessarily be delayed until the opinion could be prepared by staff and then approved by SBE. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(3).) Further, effective July 1, 2017, SBE's sales and use tax duties and much of its staff were transferred to the newly created CDTFA, which may have caused delay due to confusion as to which agency was responsible for issuing the Notice of Redetermination. In any event, the failure to issue the Notice of Redetermination within 45 days has no bearing on the timeliness of CDTFA's Petition (that is, whether CDTFA's Petition was filed prior to SBE's decision becoming final), which we address below.

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18, § 30604, subds. (a)–(c).) CDTFA's Petition asserts that SBE's decision was contrary to law; therefore, it states sufficient grounds for a petition for rehearing.

CDTFA's Petition

Having now determined that this petition is properly before OTA, we turn to the undisputed facts of this case. During the liability period, appellant (a sole proprietor), operated as a construction contractor within the meaning of the Sales and Use Tax Law. Specifically, appellant produced, furnished, and installed custom-made cabinets for high-end homes, and billed his customers on a lump-sum basis; that is, appellant did not separate his charges for labor and materials when invoicing his customers.[3] Because of the regulatory climate in the U.S. regarding wood staining and the high cost of labor, appellant took advantage of Mexico's Maquiladora Program to produce a portion of the cabinets in Mexico at significantly reduced cost.[4] Appellant states that in order to participate in this program, Mexican law required him to form a separate Mexican entity to operate in that country, which he named Carmel Mountain Cabinetry (CMC).[5]

CMC is a Mexican limited liability entity referred to as a "Sociedad de Responsabilidad Limitada de Capital Variable" (SRL). An SRL has the characteristics of both a partnership and a corporation, and requires at a minimum two members. (Solano and Grosselin, The Bureau of National Affairs (BNA) 7240-1st Tax Management portfolio, *Business Operations in Mexico*, at section III, subheading E.) To meet this requirement, appellant retained a 99 percent ownership interest in CMC and apportioned the remaining 1 percent to a CMC employee who is a Mexican national. CMC also kept its own bank accounts, maintained its own books and records, and filed tax returns in its own name as an SRL in Mexico.

Appellant began the cabinet fabrication process by purchasing and shipping materials to CMC. After CMC completed its fabrication work, it shipped the partially-finished cabinets back to appellant in California, where he completed the fabrication of the custom cabinets at the job

[3] A "construction contractor" is generally considered to mean any person who for himself or herself, in conjunction with, or by or through others, erects, constructs, alters, or repairs any building or other structure, project, development, or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521.)

[4] This program allows foreign companies and individuals, such as appellant, to import raw materials, supplies, machinery, and equipment from the United States duty-free into Mexico to be used in the local assembly or manufacture of goods for subsequent export at preferential tariff rates.

[5] All further references to CMC are specific to this Mexican entity and not appellant's dba.

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site and installed them. CMC invoiced appellant for the fabrication labor it performed and any additional materials or supplies required to complete its work. Upon audit, CDTFA determined that appellant's use of the partially-finished cabinets in the performance of his construction contracts in California was subject to tax, as measured by the purchase price of the materials and CMC's charges for fabrication labor and additional materials or supplies.[6]

In response, appellant contends that economic realities and Mexican law "forced" him to form CMC in order to participate in Mexico's Maquiladora Program, and that he held near total ownership and control of that entity, which produced cabinetry solely for appellant. For these reasons, appellant asserts that CMC should be disregarded for sales and use tax purposes, and that appellant should be treated as if he performed the disputed fabrication labor himself. Consequently, appellant asserts that CMC's charges for fabrication labor should be removed from the measure of tax.

In support of this argument, appellant relies on *Mapo, Inc. v. State Board of Equalization* (1975) 53 Cal.App.3d 245 (*Mapo*). In *Mapo,* the transactions at issue involved the fabrication of animated mechanical figures by Mapo, Inc. (Mapo) a wholly-owned subsidiary of WED Enterprises, Inc. (WED), which in turn was wholly owned by Walt Disney Productions, Inc. (Disney). Mapo was formed solely to resolve multi-jurisdictional union problems, so that fabrication work could be carried out by the same employees under one vertical union agreement. Mapo performed work exclusively for Disney, and acted solely at the direction of its corporate relatives, who were also responsible for Mapo's operations, payroll, and accounting functions. Mapo did nothing for itself and existed in name only; "[i]t owned no materials, kept no books, bore no liability for its operation, recorded no profits." (*Id.* at p. 249.) In deciding whether Mapo could be disregarded for tax purposes, the court held that application of the "general rule" that taxpayers are bound by the form of the transaction they choose, depends on the facts of the particular case.

Specifically, the court relied upon the following four-part test to determine whether Mapo should be disregarded: (1) the length of time the corporations separately existed and the benefit derived from such an arrangement; (2) the maintenance of distinct corporate identities; (3) the

[6] Generally, construction contractors are the consumers of the materials they furnish and install in the performance of a construction contract. (Cal. Code Regs., tit. 18, § 1521, subd. (b)(2)(A)1.) The storage, use, or other consumption in this state of tangible personal property purchased from a retailer is subject to tax measured by the sales price of the property. (Rev. & Tax. Code, § 6201.) "Sales price" includes the cost of materials used, and any associated labor or service cost. (Rev. & Tax. Code, § 6011.)

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independent business purpose of each corporation; and (4) the observance of usual formalities of purchase and sale between the corporations. Applying this test to the facts of this case, the court found that the transactions between Mapo and Disney were not subject to sales tax because in considering the substance of these transactions over their form, Disney was essentially "fabricating these items for itself through its employees." (*Ibid*.)

At the conclusion of the oral hearing, SBE granted appellant's petition for redetermination when it approved the following motion: "I would move to grant the petition based upon the findings the maquiladora is the same ownership as the sole proprietorship. And we would acknowledge this as a Section 40 case, and that it be a precedential decision based upon the Board's finding." (Trans., at p. 60, lines 1 – 6.).[7]

In its Petition, CDTFA contends that a new hearing is warranted because SBE's decision is contrary to law. Specifically, CDTFA contends that *Mapo* is inapplicable to the facts of this appeal, and there is no other basis for excluding CMC's charges for fabrication labor from the measure of tax.

Good cause for a new hearing may be shown where there was insufficient evidence to justify the decision or the decision is contrary to law, such that the substantial rights of the complaining party is materially affected. (*Appeal of Sjofinar Masri Do* (2018-OTA-002P); *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654.) The question of whether the decision is contrary to law is not one which involves a weighing of the evidence, but instead, requires a finding that the decision is "unsupported by any substantial evidence"; that is, the record would justify a directed verdict against the prevailing party. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.) This requires a review of the decision in a manner most favorable to the prevailing party, and an indulging of all legitimate and reasonable inferences to uphold the decision if possible. (*Id*. at p. 907.) The question before us on a petition for rehearing does not involve examining the quality or nature of the reasoning behind SBE's decision, but whether that decision is valid according to the law. (*Appeal of NASSCO Holdings, Inc*. (10-SBE-001) 2010 WL 5626976.)

With few exceptions, the longstanding rule is that "the taxpayer does not have the same freedom to disregard the form [of a transaction] he has chosen, as does the government." (*W.E.*

[7] Contrary to its motion, SBE did not issue a written opinion explaining its decision as required by Revenue and Taxation Code, section 40.

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Hall Co. v. Franchise Tax Board (1968) 260 C.A.2d 179, 184.) "While a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." (*Commissioner v. National Alfalfa Dehydrating & Milling Co.* (1974) 417 U.S. 134, 149.) "To make the taxability of the transaction depend upon the determination whether there existed an alternative form which the statute did not tax would create burden and uncertainty." (*Founders General Corp. v. Hoey* (1937) 300 U.S. 268, 275.)

It is well-established that for tax purposes, corporations are treated as separate entities apart from their owners. (*Moline Properties v. Commissioner* (1943) 319 U.S. 436.) Thus, in applying the general rule, appellant and CMC (a corporation-like foreign entity), would be treated as separate entities, and tax would apply to the charges for fabrication labor performed by CMC. (Rev. & Tax. Code, § 6201.)

As discussed above, *Mapo* offers a rare departure from the general rule. And for *Mapo* to apply, it must be established that the two entities in question were in substance the same entity. However, in making such a determination, SBE did not properly apply the four-part test set forth in *Mapo*. Indeed, SBE ruled in favor of appellant solely because CMC and the sole proprietorship were primarily under the "same ownership."

Further, SBE's decision is unsupported by any substantial evidence. Here, CMC was not wholly owned by appellant, but by appellant and another individual. CMC also maintained its own books and records, kept its own bank accounts, and filed and reported taxes in Mexico as an SRL under its own name. These facts demonstrate that contrary to appellant's assertions, CMC maintained a clear and distinct corporate identity separate from that of appellant. In addition, appellant formed CMC to manufacture cabinets, which is an entirely different business than the one operated by appellant, a construction contractor; that is, CMC's primary purpose was to manufacture the cabinets, while appellant's was to install them. CMC also invoiced appellant for its fabrication labor, materials, and supplies, indicating that the ordinary formalities of sale were observed between them. Finally, appellant operated under such an arrangement with CMC for at least the entire liability period, and realized a significant economic benefit from doing so. Taken in their entirety, these facts overwhelmingly show that CMC was a separate entity from appellant not only in form, but in substance as well. Appellant's reasons for forming CMC, his near total

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control and ownership of CMC, or the fact that CMC produced cabinets solely for appellant does not refute the evidence showing that CMC was in fact a separate entity. And where a taxpayer elects to conduct business through separate entities, although wholly owned, the taxpayer must suffer the attendant disadvantage as well as receiving the intended benefit of such an arrangement. (*Mercedes-Benz of North America, Inc. v. State Board of Equalization* (1982) 127 Cal.App.3d 871, 874.) Thus, even when viewed in a manner most favorable to appellant, there is insufficient evidence to support SBE's decision. Accordingly, SBE's decision was contrary to law.

For all the foregoing reasons, CDTFA's Petition for rehearing is hereby granted.

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Administrative Law Judge

We concur:

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