OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18124119
	) CDTFA Case No. 982985
MEHDI ASGARINEJAD	) CDTFA Acct. No. SR EA 097-137895
dba Net Micro	)
	) Date Issued: September 12, 2019
	)
	)

OPINION

Representing the Parties:

For Appellant: Cruz Saavedra, Law Offices of Cruz Saavedra

For Respondent: Jarrett Noble, Tax Counsel III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Mehdi Asgarinejad (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's timely petition for redetermination of CDTFA's Notice of Determination (NOD), which assessed a tax liability of $584,213, plus accrued interest, and penalties totaling $204,474.59[2] for the period July 1, 2000, through December 31, 2002 (liability period).

Appellant waived his right to an oral hearing; therefore, this matter is being decided based on the written record.

ISSUE

Whether adjustments are warranted to unreported taxable computer sales.

[1] Sales taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to the CDTFA. (Gov. Code, § 15570.22; 2017.) When referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the board; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

[2] The penalties include a 25-percent fraud penalty of $146,053.26 and a failure-to-file penalty of $58,421.33. Appellant does not dispute these penalties and, therefore, the penalties will not be discussed further.

FACTUAL FINDINGS

1. During the liability period, appellant operated a continuing education center in California as a sole proprietorship under the name South Coast College.
2. The offered courses were marketed toward employees at companies such as Verizon Communications, Inc. (Verizon) and The Boeing Company (Boeing), which provided tuition reimbursement.
3. Appellant charged $2,345 for each student per course. Appellant provided computers to the students as part of the course, which they could purchase for an additional $299.
4. Advertisements for the course stated: "Learn how to build and troubleshoot computers from the inside out"; "Enroll in the class and receive the computer for $295";[3] and "Tuition Reimbursement is Available for Boeing Employees."
5. According to purchase invoices obtained by CDTFA, appellant purchased 526 computers from Abacus Computer Corporation (Abacus), 2,378 computers from American Sunrex Corporation (Sunrex), and 1,568 computers from International Data Supply ex tax[4] at a cost of $1,140 to $1,200.
6. During the liability period, 1,672 Boeing employees and 3,433 Verizon employees attended courses and received computers from appellant in California, while 122 Verizon employees attended courses and received computers outside California.
7. A letter from South Coast College to Verizon dated April 8, 2002, indicates that the reasonable value of the computers was $1,200.
8. CDTFA determined that appellant purchased and then sold 4,350 computers (i.e., 526 + 2,378 + 1,568 – 122) at $1,200 each to his students in California, resulting in unreported taxable computer sales of $5,220,000 (i.e., $1,200 x 4,350).
9. CDTFA's determination did not include an assessment of tax on services.[5]
10. In an audit report dated May 2, 2007, CDTFA found an aggregate deficiency measure of $7,775,358, which included unreported taxable computer sales of $5,220,000.

[3] While the advertisement states $295, the computers at issue were sold for $299.

[4] "Ex tax" means the purchase of property without the payment of tax or tax reimbursement.

[5] While any services that are a part of a sale are included in the total sales price (R&TC, § 6012(b)(1)), CDTFA did not assess tax for any tuition related services provided by appellant. Therefore, we will not address whether appellant owes tax on any services related to the sale of the computers.

11. CDTFA issued an NOD on January 17, 2008, which assessed a tax liability of $584,213, plus penalties and interest, for the liability period.
12. Appellant paid the balance due and filed a claim for refund. Appellant argued that he did not owe tax on the sales of computers purchased from Abacus and Sunrex.
13. CDTFA issued a Decision on May 17, 2018, which denied appellant's claim.
14. Appellant filed a timely request for reconsideration disputing the Decision's finding.
15. CDTFA issued a Supplemental Decision dated November 21, 2018, which again denied appellant's claim. This timely appeal followed.

DISCUSSION

California imposes sales tax on a retailer for its retail sales of tangible personal property in this state, measured by the retailer's gross receipts, unless the sales are specifically exempt or excluded from tax by statute. (R&TC, § 6051.) All of the retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) "Gross receipts" are the total amount of the sale price without any deduction for labor, service cost or other expense, and include any services that are part of the sale. (R&TC, § 6012(a)(2) & (b)(1).)

The providing of a service that is not part of a purchase of tangible personal property is not subject to tax. In such a case, the person rendering the service is the consumer, not the retailer, of any tangible personal property that the person uses incidentally in rendering the service. (Cal. Code Regs., tit. 18, § 1501.) 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. (*Id.*) 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. (*Id.*) For example, a firm which performs business advisory, record keeping, payroll and tax services for small businesses and furnishes forms, binders, and other property to its clients as an incident to the rendition of its services is the consumer and not the retailer of such tangible personal property. (*Id.*) The true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property. (*Id.*)

Essentially, California Code of Regulations, title 18, section 1501 provides a test to determine whether a transaction is a transfer of tangible personal property, or merely a service.

If the transfer of tangible personal property is incidental to the service (i.e., *de minimis*), then the transaction is merely a service and not a sale of tangible personal property. If the transfer of tangible personal property is more than incidental, it is a sale of tangible personal property. (Cal. Code Regs., tit. 18, § 1501; *Simplicity Pattern Co. v. State Board of Equalization* (1980) 27 Cal.3d 900, 912; see also *A&M Records, Inc. v. State Board of Equalization* (1988) 204 Cal.App.3d 358, 376.)[6]

Appellant contends that he did not make retail sales of computers and does not owe sales tax on the transactions because the transfers of the computers were incidental to the services he provided. Appellant argues that he was engaged in educational services, not the retail sale of tangible personal property, and that the true object of the course was to teach students, not to sell computers. Appellant also argues that he does not owe use tax measured by the cost of his computers. However, appellant concedes that he owes use tax on his purchases of computers from International Data Supply. On the other hand, appellant argues that he is not liable for use tax on his purchases from Abacus and Sunrex because he did not issue a resale certificate to Abacus, and because Sunrex did not take the resale certificate issued in good faith.

In this case, the transfers were more than incidental to the teaching of the course. The $1,200 cost of the computers, at over one-half the price of the $2,345 tuition charge, indicates that they were clearly more than de minimis and of considerable value. Additionally, appellant enticed the students to enroll in the course with advertisements largely devoted to explaining the offer to receive the computers as well as the specifications of the computers. The advertisements stated in large letters: "Tuition Reimbursement is Available for Boeing Employees." Such employees would have significant interest in receiving a $1,200 computer for only $299, with the remainder of their costs reimbursed by their employer. Therefore, we conclude that a significant purpose (i.e., far more than incidental) for a person enrolling in the class was to purchase the

[6] In *Simplicity*, the taxpayer argued "that regulation 1501 exempts not only transfers incidental to services but also transfers of tangible objects for a primary purpose of supplying their intangible content rather than the objects themselves." (*Simplicity Pattern Co. v. State Board of Equalization, supra*, 27 Cal.3d at p. 908.) The court found that the film negatives and master recordings at issue, though valued in part for their intellectual content, were also physically useful. The court concluded in relevant part that the transfer of the tangible personal property was not incidental to any service and was thus a sale of tangible personal property for tax purposes. In *A&M Records*, the court found that master tapes were used in the production of records and tapes and thus were not used only for their intellectual or artistic content. The court found that the tangible personal property at issue was not merely incidental to the performance of a service. (*A&M Records, Inc. v. State Board of Equalization, supra*, 204 Cal.App.3d at p. 376-377.)

computer, and that the transfer of the computer was more than incidental, which constitutes a sale of the computer.

Appellant asserts that the computers were used as an integral teaching aid and were only incidental to the educational services. In support, appellant claims that he did not retain the computers because they were disassembled as part of the course and were not suitable for use by new students. However, the fact that 4,350 computers were transferred to appellant's students strongly suggests that the computers were not inoperable once the course was completed. Therefore, appellant's uncorroborated arguments fail to establish that computers valued at $1,200 were merely a consumable teaching aid furnished to students for one-time use only.

We find that the computers were more than incidental to the services provided, and not merely *de minimis*. Accordingly, the transactions at issue were not sales of services, but taxable sales of tangible personal property. Thus, appellant is liable for sales tax as the retailer of the computers.[7]

We note that CDTFA only assessed sales tax on the sale of the computers but failed to include tax on the measure of services that were part of the sale, which are included in gross receipts. (See R&TC, § 6012(b)(1).) CDTFA's error favors appellant; however, since the untaxed measure is not included in CDTFA's assessment and not before us in this appeal, we need not further address it.

[7] Appellant contends that he is not liable for the tax because he did not issue a resale certificate to Abacus, and because Sunrex did not take the resale certificate issued in good faith. CDTFA notes that the record is unclear as to whether appellant actually issued a resale certificate to Abacus. However, exclusive of whether resale certificates were issued, appellant is liable for the sales tax because he made retail sales to his students (R&TC, § 6051), whereas Abacus and Sunrex made non-taxable sales to appellant for resale. (R&TC, § 6007.)

HOLDING

No adjustments are warranted to unreported taxable computer sales.

DISPOSITION

CDTFA's action is sustained.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

I concur:

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

D. CHO, Concurring:

I concur with the majority opinion's holding; however, I do not join in the analysis. I believe that California Code of Regulations, title 18, section (Regulation) 1501 is clear and contains one test to determine whether a transaction is a service or a sale of tangible personal property. Regulation 1501 states, "[t]he 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." However, the majority opinion has shifted the focus of the test to examining whether the tangible personal property has any value compared to the service, which is in contradiction to the language of the regulation.

In addition, the majority opinion's reliance on *Simplicity Pattern Co. v. State Bd of Equalization* (1980) 27 Cal.3d 900 (*Simplicity Pattern*) as support for its position is misplaced. The relevant issue in *Simplicity Pattern* was whether the transfer of intangible property rights was subject to tax when the purchaser's primary interest was to exploit the intellectual products embodied on the tangible personal property. "The sale of completed films and recordings here *was not incidental to any services* of the transferor but was part of a simultaneous transfer of virtually all of the assets of a going business." (*Id.* at p. 908, emphasis added.) There was no performance of any service by the transferor, and California Supreme Court did not address the question of whether the transaction was a service or sale of tangible personal property. Instead, the California Supreme Court held that a sale does not become "nontaxable whenever its principal purpose is to transfer the intangible content of the physical object being sold." (*Id.* at p. 909.) Therefore, the majority's test applies to situations in which an intangible property right is being transferred and not in determining whether a transaction was for the sale of a service or tangible personal property.[1]

[1] See also *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197, which made a distinction between the true object test as found in Regulation 1501 and the test in *Simplicity Pattern*, *supra*. The California Supreme Court in *Preston* stated that the "'true object' test described in Regulation 1501, by its terms, applies only to transactions involving 'the performance of a service.'" (*Id.* at 209.) However, the test in *Simplicity Pattern*, *supra* involved the transfer of intangible property. In fact, the California Supreme Court also found "Regulation 1501 inapplicable because the 'transfer was not incidental to any service.'" (*Id.* citing *Simplicity Pattern*, *supra*.) Lastly, the California Supreme Court stated, "Since *Simplicity Pattern*, appellate courts have consistently held that a transfer of

Instead, as stated above, Regulation 1501 contains the test to determine whether the transaction was a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service, which is the true object test. In *Culligan Water Conditioning of Bellflower, Inc. v. State Bd. of Equalization* (1976) 17 Cal.3d 86, the California Supreme Court applied the true object test as found in Regulation 1501, and stated, "[e]ssentially the crucial point of inquiry is whether the true object of the transaction is the finished article or the performance of labor." (*Id*. at 96, citing *Albers v. State Bd. of Equalization* (1965) 237 Cal.App.2d 494, 497.) The Supreme Court did not look at the value of the tangible personal property to determine whether the transaction was a service or a sale of tangible personal property. As a result, I believe the majority's analysis and reliance on the value of the tangible personal property should not be the primary inquiry in this case. Although examining the value of the tangible personal property will help in determining the true object of the contract, it is not enough to find that the tangible personal property had a value that was more than *de minimis* to conclude that the transaction is subject to tax. Instead, one must look at all of the facts and circumstances surrounding the transaction to ultimately determine the true object of the contract, and if the true object is the service, then the transaction is not subject to tax. (See Cal. Code Regs., tit. 18, § 1501.)

When examining the facts of this appeal, I believe that the true object of these contractsis the tangible personal property, i.e. the computers. Appellant's specific marketing to certain employees made it apparent that he was trying to entice those employees to take his course for the primary reason that they would receive a computer that was heavily subsidized through an employee reimbursement option. As a result, I believe that the customers' predominant interest in taking these courses was the ability to receive a computer at a very low out-of-pocket cost to the customer. Therefore, appellant was the retailer of the computers, and as the majority also concluded, the entire amount of the charges related to the sale of the computers is subject totax.

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Daniel Cho
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Daniel K. Cho
Administrative Law Judge

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tangible personal property physically useful in the manufacturing process in conjunction with a transfer of intangible property rights in that property results in a taxable sale." (*Id*. at p. 210.) Therefore, the California Supreme Court in *Preston v. State Bd. of Equalization*, *supra*, made a distinction between the test employed by the majority and the true object test that applies to transactions involving the performance of a service.