OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **S. BACHOR,** **dba, Carmel Mountain Cabinetry**	OTA Case No. 19044689 CDTFA Case ID: 771334 CDTFA Account No.: SR EH 52-046779

OPINION ON REHEARING

Representing the Parties:

For Appellant: William Shubin, CPA

For Respondent: Kevin Smith, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, S. Bachor, (appellant) appeals an action by the respondent California Department of Tax and Fee Administration (respondent) determining $389,936 of additional tax, and applicable interest, for the period January 1, 2007, through December 31, 2012 (liability period).[1]

Appellant waived his right to an oral hearing. Therefore, we decide the matter based on the written record.

ISSUE

Is appellant entitled to a further reduction of the $4,790,916 measure of use tax due in connection with unreported fabrication labor appellant purchased from a Mexican limited liability entity in which appellant owned a 99-percent interest?

[1] As further explained below, respondent initially determined additional tax of $415,763.28, interest, and a failure-to-file penalty of $41,576.36. Respondent later deleted the penalty and reduced the liability.

FACTUAL FINDINGS

1. At all relevant times, appellant was a construction contractor in the business of building and installing custom cabinets for customers in California.[2]
2. Appellant was also the principal (99-percent) owner of a Mexican limited liability entity, also named Carmel Mountain Cabinetry (CMC).
3. Appellant purchased wood and other materials in the United States, some tax-paid, and shipped some of the materials to CMC for fabrication.[3] When the fabrication was completed, the materials were returned to appellant for use, and appellant used the materials to build and install custom cabinets in California.
4. Prior to the audit at issue here, appellant did not hold a seller's permit and had not filed a California sales and use tax return. Appellant's position was, and remains, that he sells no tangible personal property (TPP) in his construction services business, and, therefore, he is not required to hold a seller's permit or file sales and use tax returns.
5. Respondent learned from the U.S. Customs and Border Protection that from January 5, 2004, through September 21, 2010, appellant imported from Mexico TPP (the fabricated materials) with a declared value of $1,743,578. Appellant explained to respondent that the TPP was material that he owned and fabricated at his facility in Mexico, but respondent concluded that an audit was necessary.
6. Respondent performed an audit and initially concluded that appellant purchased prefabricated cabinets from CMC, and that sales tax was owed in connection with appellant's sales of those cabinets. Respondent included all costs that appeared to have been paid by appellant to CMC in the measure of tax, allowing appellant a credit for tax paid on some materials (a tax-paid-purchases-resold or TPPR credit).
7. On September 26, 2013, respondent issued a Notice of Determination (NOD) to appellant for $415,763.28 in tax, plus applicable interest, and a failure-to-file penalty of $41,576.36 based on appellant's alleged failure to report and pay sales tax. The NOD was based on a

[2] The audit work papers indicate that appellant may have operated as a corporation during part of the liability period. A change in the form of the business is of no real consequence to our analysis.

[3] By "fabrication," we mean that the materials were processed in some way for use in constructing the cabinets. It is our understanding that the fabrication included at least cutting, sanding and some finishing of the wood that appellant used to construct the cabinets in California. It is undisputed that CMC did fabrication at its facility in Mexico, and the precise nature of the fabrication work is of little, if any, significance to our findings below.

February 6, 2013 field billing order that determined a deficiency measured by $5,107,702 in unreported fabrication costs.

8. Appellant filed a timely petition for redetermination contesting the liability.
9. Respondent later agreed that the TPP appellant received from Mexico was not prefabricated cabinets. However, respondent concluded that appellant supplied TPP (materials) to CMC for fabrication and then used the fabricated TPP in California without reporting or paying use tax measured by the cost of the fabrication. Respondent performed a reaudit to make adjustments in appellant's favor based on new information, which resulted in a decrease of the measure from $5,107,702 to $4,790,916, which reduced the tax to $389,936 and the penalty to $38,994.
10. Respondent issued a decision on September 6, 2016, which relieved the penalty and reduced the liability as recommended by the reaudit. Appellant requested reconsideration, and on April 12, 2017, respondent determined that no additional adjustments were warranted.
11. At a July 28, 2017 oral hearing, the Board of Equalization (BOE) granted appellant's petition for redetermination.
12. More than five months later, on January 1, 2018, the duty of resolving administrative appeals of sales and use tax matters transferred from BOE to the Office of Tax Appeals (OTA).
13. On February 23, 2018, respondent issued a Notice of Redetermination to appellant to notify him regarding BOE's decision, which began the 30-day period within which respondent was allowed to file a petition for rehearing (PFR) with OTA.
14. On March 19, 2018, respondent filed a timely PFR with OTA.
15. On April 11, 2019, OTA issued an opinion granting the PFR.

DISCUSSION

California imposes a tax on a retailer's retail sales of TPP 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.) The term "sale" includes producing, fabricating, or processing TPP for a consideration for consumers who furnish the materials used in the production, fabrication, or processing and a transfer for a consideration of the title or possession of TPP which has been produced, or fabricated to the special order of the customer. (R&TC, § 6006(b), (f).) When

sales tax does not apply, use tax applies to the storage, use, or other consumption of TPP purchased from any retailer for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.) Generally, use tax is owed by the person using or storing the property in this state. (R&TC, § 6202(a).)

California Code of Regulations, title 18, section (Regulation) 1521(a)(1)(A) defines "construction contract" to include a contract to erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. Regulation 1521 classifies property furnished under a construction contract into three categories: materials, fixtures, and machinery and equipment. (Cal. Code Regs., tit. 18, § 1521(a)(4)-(6).) As relevant here, a construction contractor is the consumer of materials they furnish and install in the performance of a construction contract and tax applies with respect to the sale of the materials to or the use of the materials by the construction contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A).)

Regulation 1521(c)(2) provides that "a cabinet will be considered to be "prefabricated" and a "fixture" when 90 percent of the total direct cost of labor and material in fabricating and installing the cabinet is incurred prior to affixation to the realty. In determining this 90 percent, the total direct cost of all labor and materials in fabricating the cabinet to the point of installation will be compared to the total direct cost of all labor and materials in completely fabricating and installing the cabinet. Conversely, according to Regulation 1521, cabinets that are not determined to be prefabricated are considered custom cabinets, and, pursuant to Regulation 1521(b)(2)(A), the construction contractor who builds and installs custom cabinets is the consumer of the materials used to complete the job.

When a taxpayer challenges an NOD, respondent has the burden to explain the basis for that deficiency. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610.) Generally, where a taxpayer challenges the additional tax, the government bears a minimal, initial burden of producing evidence to show that its determination has a reasonable and rational basis. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950.) Where the government has met its initial burden, the burden of proof shifts to the taxpayer to explain why the asserted deficiency is not valid. (*Riley B's, Inc.*, *supra*, at pp. 615-616.) The applicable burden of proof is by a preponderance of the evidence. (Evid. Code, § 115; *Appeal of Estate of*

Gillespie, 2018-OTA-052P, at p. 4.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

Here, there is no dispute that appellant is a construction contractor who built and installed custom cabinets. There is no dispute that appellant was the consumer of the materials used to build and install the cabinets. Appellant has not argued that respondent's calculations are inaccurate, and he has not attempted to prove a more accurate measure of tax, other than zero.

Respondent argues that CMC is a separate entity, that the fabrication services performed by CMC are properly included in the measure of tax, and that it has correctly calculated the measure of that tax to include appellant's costs of the fabrication labor performed by CMC.

Appellant has made several arguments against the asserted liability. Appellant argues that respondent's PFR was not timely, and that OTA improperly granted the rehearing. Appellant asserts that he is a subcontractor and not subject to sales or use tax on completion of a job for the general contractor. Appellant also contends that CMC is a maquiladora[4] and that the expenses incurred by appellant in connection with its ownership and operation of CMC are not properly included in any taxable measure, just like those expenses would not be included in the taxable measure if they were incurred in appellant's domestic operation. Appellant states that he shipped wood to CMC, which cut and stained the wood according to appellant's specifications, and returned the wood to appellant, who used the pre-cut and pre-stained components to construct the cabinets in place at the customer's property. He argues that there should be no distinction between his California business and CMC, particularly given his 99 percent

[4] Generally, a "maquiladora" is a Mexican entity that assembles and produces goods in Mexico, using imported materials, for export to the United States. (6 U.S.C.A., § 1401.)

ownership and total control of CMC, since the person holding the one percent ownership interest has no input into or control over the company.[5]

Regarding appellant's argument that OTA improperly granted the rehearing, that matter has already been decided by OTA on the PFR. We will not revisit it here. As relevant to this appeal, OTA's jurisdiction arose from respondent's filing of a timely PFR.[6] (Cal. Code Regs., tit.18, § 30106(b).) The question of whether an appeal to OTA is barred by the statute of limitation is certainly within our jurisdiction, and we found, correctly, that respondent's PFR in this case was timely. Where, as here, a taxpayer argues that respondent unnecessarily delayed issuance of a decision, resulting in BOE's loss of jurisdiction, its remedy, if any, lay elsewhere. (See Cal. Code Regs., tit.18, §§ 30103(b)(1), 30104(d).)

Appellant's argument that, as a subcontractor, he is not subject to sales or use tax lacks any legal support. Sales or use tax is due in connection with a subcontractor's purchase or use of materials. Appellant's status as a subcontractor has no bearing on the issue presented here.

We are also not persuaded that appellant and CMC should be treated as one and the same for sales and use tax purposes. According to the audit work papers, appellant operated the California businesses as a corporation during part of the liability period and as a sole proprietor during the greater part of the liability period. CMC has always been a Mexican limited liability entity and was not wholly owned by appellant.[7]

It is undisputed that CMC was a registered business entity in Mexico. It kept its own books and paid taxes in Mexico. Although the parties have provided little, if any, evidence regarding CMC's day-to-day finances, it must have had a physical plant in Mexico where the fabrication was performed, which means that it paid costs typically associated with the operation of a such a facility, including rent and utilities. Although these costs may have been covered by appellant, the evidence indicates that appellant simply wired money to CMC, which then paid its expenses.

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[5] Appellant previously argued that the transfer of the fabricated materials was not a sale because appellant never transferred title to CMC. It is our understanding that appellant no longer makes this argument, which is contrary to R&TC section 6006(b).

[6] OTA's jurisdiction over sales and use tax appeals generally begins either with issuance of a decision adverse to the taxpayer and the filing of an appeal. (Cal. Code Regs., tit. 18, § 30103(b)(1).)

[7] The reason why CMC is not wholly owned by appellant is of no consequence to our analysis, and, for the reasons explained below, we cannot speculate regarding whether our findings would be different if appellant was the sole owner of CMC.

In addition, the record suggests that appellant benefitted from the clear separation between his business and CMC's business. According to appellant, CMC came into existence in 2007, the first year at issue. Appellant states that it outsourced the fabrication to CMC to take advantage of cheap labor costs and more relaxed governmental controls, but it appears that CMC provided other benefits. For example, the audit work papers indicate that after CMC returned the fabricated materials to California, appellant, appellant's father, and several employees from Mexico completed the fabrication and installation of the cabinets in California. However, appellant did not file federal or state payroll tax returns here because all employees were paid through CMC.[8] In other words, it was to appellant's advantage that he was able to use CMC's employees to assist with on-site fabrication and installation of the cabinets in California, and there is no evidence that appellant treated these employees as anything other than the employees of CMC, a separate and distinct foreign entity that was not bound by U.S. or California labor laws. The fact that appellant chose to treat CMC as if it was simply a foreign location of his wholly-owned California cabinet business when it suited his purposes to do so does not persuade us that we should ignore the fact that CMC was at all times a legal entity separate and distinct from appellant.

Considering the state of the evidence, we find that appellant's reliance on *Mapo, Inc. v. State Bd. of Equalization* (*Mapo*) (1976) 53 Cal.App.3d 245 is misplaced. In that case, the trial court found in favor of the taxpayer, which fabricated animated mechanical figures for its corporate grandparent, Walt Disney Productions (Disney). Prior to 1965, Disney did the fabrication work in-house. Multi-union jurisdictional problems necessitated the creation of Mapo, which dissolved in 1971 when it became a division of Disney. The trial court found, among other things, that Mapo's personnel were directed, employed, and controlled by the corporate grandparent, and that the sole reason for Mapo's existence was to enable the corporations to negotiate agreements with a single vertical labor union. The *Mapo* court notes that the general rule is that courts should not disregard separate legal entities merely to grant tax relief; and whether the general rule should not be applied in a particular case depends upon the facts. (*Mapo*, 53 Cal.App.3d 245, at p. 248.) Factors include the length of time the corporations separately exist, the degree to which the corporations maintain distinct corporate identities, the

[8] The work papers indicate that appellant paid his social security taxes through his individual income tax return. It is unclear whether or how appellant's father was paid.

independent business purposes of the corporations, and the observance of the usual formalities of purchase and sale between corporate entities.

A parent corporation's ownership of all the stock of its subsidiary does not, alone, establish that the separate entities should be treated as one and the same for sales and use tax purposes. (*Macrodyne Industries, Inc. v. State Bd. of Equalization* (1987) 192 Cal.App3d 579, 582, disapproved on another ground in *Beatrice Co. v. State Bd. of Equalization* (1993) 6 Cal.4th 767, 779.) On the other hand, *Mapo* involved a corporation and its wholly owned subsidiary, while this appeal involves a foreign, limited liability business entity owned in small part by someone other than appellant. Appellant has not cited a case that followed *Mapo* when there was less than total common ownership. Appellant did not own all of CMC, and that factor alone provides an adequate basis for distinguishing our facts, particularly given that *Mapo* carves out an exception to the general rule. On this basis, we find that *Mapo* does not apply here. Based on the evidence, we find that the transfer of TPP from CMC to appellant after CMC had applied fabrication labor to the materials supplied by appellant constituted sales of TPP, and that the charges for such fabrication were correctly included in the determined measure of use tax.

Finally, we look at the costs respondent attributed to CMC's fabrication labor. Although appellant has not specifically argued in his appeal to OTA that respondent did not correctly determine the measure of use tax due, we note that there was some discussion of this issue during the appeal to BOE. It appears from the audit work papers that the measure was determined by combining the costs of operating CMC. According to an audit comment on Schedule R1-12B, respondent calculated the cost of materials by adding the cost of materials delivered from Mexico to the expenses appellant allocated to the operation of CMC, including fabrication labor, supplies, mail and shipping, hotel expenses, part-time help, customs expenses, exchange rate fees, equipment and tool expense, wages, and miscellaneous unspecified expenses. Respondent concluded that the sum of these would be the minimum price to break-even.[9] We find that respondent's conclusions in this regard are reasonable and rational and that appellant has the burden of proving respondent's error and a more accurate measure of tax, which he has not done.

[9] Respondent allowed a credit for appellant's tax-paid purchases.

HOLDING

Appellant is not entitled to a further reduction of the $4,790,916 measure of use tax due in connection with unreported fabrication labor appellant purchased from a Mexican limited liability entity in which appellant owned a 99-percent interest.

DISPOSITION

We sustain respondent's September 6, 2016 decision, which relieved the failure-to-file penalty and reduced the measure of fabrication costs subject to use tax from $5,107,702 to $4,790,916, which reduced the tax to $389,936.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Daniel K. Cho
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Daniel K. Cho
Administrative Law Judge

DocuSigned by:
Josh Lambert
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Josh Lambert
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