OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18063355
HITCO CARBON COMPOSITES, INC.	) CDTFA Case IDs: 112-086, 112-087

OPINION

Representing the Parties:

For Appellant:	Janet L. Pass, Attorney
For Respondent:	Jarrett Noble, Tax Counsel III Scott Claremon, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Corin Saxton, Tax Counsel IV

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 6561 and 6901 and California Code of Regulations, title 18, section30103(b)(1), Hitco Carbon Composites, Inc. (appellant) appeals a decision issued by California Department of Tax and Fee Administration (respondent)[1] denying appellant's petition for redetermination of a January 20, 2016 Notice of Determination (NOD) for $1,030,546.34 tax, plus accrued interest, for the period January 1, 2010, through December 31, 2013 (liability period) and denying appellant's claim for refund of tax accrued and paid in error on a measure of $5,448,640 during the same period. The NOD was based on an audit that determined an aggregate deficiency measure of $10,790,084, consisting of seven audit items. Appellant originally contested three items, all generally identified as appellant's ex-tax purchases of tangible personal property (TPP), which appellant claims it purchased for resale to the U.S.

[1] Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of the BOE relevant to this case to respondent. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to the Office of Tax Appeals effective January 1, 2018.) When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

Government, with a combined measure of $9,508,267.[2] During this appeal, appellant filed two additional claims for refund or credit items: one for use tax accrued and paid in error on sales for resale to the U.S. Government; and the other for tax-paid purchases resold to the U.S. Government. The parties reached agreement on most questioned transactions. Seven transactions referenced on respondent's audit schedule R3-12I (use tax accrued and paid in error on sales for resale to the U.S. Government) are all that remain at issue.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Josh Lambert, and Keith T. Long held an electronic oral hearing in this matter on June 15, 2021.[3] At the conclusion of the hearing, the parties submitted the matter for decision, and we closed the record.

ISSUE

Is appellant entitled to additional adjustments to the determined liability for use tax accrued and reported in error?

FACTUAL FINDINGS

1. Appellant, a California corporation, is a manufacturer of carbon composite materials and components for aerospace, thermal management, metal and chemical processing, and automotive use.
2. As relevant herein, appellant purchased TPP, including special tooling,[4] to fulfill its obligations to provide materials, components, and related services to its clients, including Lockheed Martin Corporation (Lockheed) and its subsidiaries.

[2] In this context, "ex-tax" refers to purchases made without payment of sales tax reimbursement or use tax.

[3] Appellant requested an oral hearing in Cerritos. However, OTA has temporarily suspended live hearings to comply with restrictions in effect to minimize the spread of COVID-19. The parties have agreed to this electronic hearing process, which allows audio and video participation in real time using a web-based application.

[4] In this context, the term "special tooling" generally refers to a wide variety of machinery, equipment, and structures specially designed and built to be used in the manufacture and delivery of particular aircraft supplies or parts to the U.S. Government. "Special tooling" is not defined in the Sales and Use Tax Law, but is defined in the Federal Acquisition Regulations (FARs) as "jigs, dies, fixtures, molds, patterns, taps, gauges, and all components of these items including foundations and similar improvements necessary for installing special tooling, and which are of such a specialized nature that without substantial modification or alteration their use is limited to the development or production of particular supplies or parts thereof or to the performance of particular services. Special tooling does not include material, special test equipment, real property, equipment, machine tools, or similar capital items." (46 C.F.R. § 2.101(b).)

3. At all times relevant, Lockheed was a global security and aerospace company, which entered into a series of low-rate initial production (LRIP) contracts with the U.S. Government to produce F-35 fighter aircraft (Government Contracts).
4. The LRIP 4 Government Contract was numbered N00019-09-C0010.[5] It contained a title transfer clause based on that contained in Title 48 of the Code of Federal Regulations, Chapter 1, Subchapter H, Part 52, section 52.245-1.[6] This accelerated title transfer clause transferred title to the special tooling to the U.S. Government prior to Lockheed's use of it.[7]
5. On December 10, 2009, appellant entered into Master Purchase Order (PO) number M7539 with Lockheed. The Master PO covered wing skin parts required for LRIP contracts 4-8. It stated that the Government Contract number N00019-09-C0010 was for LRIP 4 only and that the LRIP 5-8 contract numbers were not yet known.
6. Pursuant to the Master PO, which was effective October 8, 2009, through December 31, 2016, appellant sold or transferred composite parts and tooling to Lockheed for a total fixed price of $146,029,975, $16,097,317 of that amount being for special tooling. Lockheed used these components to build the F-35 fighter aircraft pursuant to the Government Contracts. The Master PO states in Section II ("FAR Flowdown Provisions") that the Master PO is specifically in support of a Government Contract and that the accelerated title transfer clause similar to that contained in the U.S. Government contract applies, thus making appellant's sales of special tooling to Lockheed for use on the Government Contracts nontaxable sales for resale.
7. On April 17, 2013, respondent began an audit of appellant's business for the liability period.

[5] It appears from the evidence that the LRIP contracts were numbered sequentially.

[6] The Code of Federal Regulations, title 48, section 1.101 states, in part, "The [FARs] System is established for the codification and publication of uniform policies and procedures for acquisition by all executive agencies. [It] consists of the Federal Acquisition Regulation, which is the primary document, and agency acquisition regulations that implement or supplement the FAR." There are 53 parts to the FARs System. Parts 1 through 51 are substantive regulatory law, part 52 is an appendix with sample clauses that implement the regulations, and part 53 is an appendix consisting of sample forms.

[7] The record does not contain copies of Lockheed's contracts with the U.S. Government, but it is undisputed that contract number N00019-09-C0010 contained an accelerated title passage clause.

8. On January 21, 2014, while the audit was ongoing, appellant filed a timely claim for refund of tax accrued and paid in error during the liability period in connection with its purchase of tooling for resale to Lockheed.
9. On December 30, 2015, respondent completed a second revised audit, which identified seven audit items with a combined measure of $10,970,084.[8] Additionally, respondent examined on an actual basis appellant's claims for refund for use-tax-paid purchases resold measuring $4,771,885.11 and sales-tax-paid purchases resold measuring $676,755.20.[9] Respondent denied these claims for refund, finding that title to the tooling appellant used on its contract with Lockheed did not pass prior to appellant's use.
10. On January 20, 2016, respondent issued the NOD for tax of $1,030,546.34.[10]
11. Appellant filed a timely petition for redetermination, and respondent issued a Decision on May 22, 2018, denying the claims for refund and petition for redetermination. This timely appeal followed.
12. On appeal, respondent agreed that appellant's contract with Lockheed contained a title passage clause for special tooling. After several reaudits, respondent has reduced the deficiency measure for audit item 6 (Schedule 12G) by $5,732,348, from $5,884,578 to $152,230. Respondent also identified credit measures for use-tax-paid purchases resold of $1,341,580 and for sales-tax-paid purchases resold of $676,755, in essence granting the latter claim for refund in its entirety.
13. Appellant no longer disputes respondent's determination regarding the seven audit items included in the NOD, now measured by $5,237,736. The allowed credit measures

[8] These audit items consist of the following: (1) a deficiency measure of $606,232 for unreported taxable sales and purchases subject to sales tax or use tax based on the difference between sales tax and use tax recorded and reported (Schedule 12B); (2) a credit measure of $345,256 for use tax reported in error on equipment purchases (Schedule 12C); (3) a deficiency measure of $85,883 for unreported purchases of consumable supplies subject to use tax established by a statistical sample of purchases greater than $200 and less than $6,000 (Schedule 12D); (4) a deficiency measure of $63,040 for unreported purchases of consumable supplies subject to use tax established by a statistical sample analysis of purchases equal to or greater than $6,000 (Schedule 12E); (5) a deficiency measure of $1,658,150 for unreported purchases of fixed assets subject to use tax examined on an actual basis (Schedule 12F); (6) a deficiency measure of $5,884,578 for unreported purchases of tooling subject to use tax (purchased for resale to a U.S. Government supply contractor and allegedly resold prior to use) based on an actual basis review of vendor invoices (Revised Schedule 12G); and (7) a deficiency measure of $3,017,457 for unreported purchases of self-consumed tooling subject to use tax based on an actual basis review of purchase invoices (Schedule 12H).

[9] The respective claim amounts were $430,451.27 and $64,348.10.

[10] According to the NOD, a $56,789 credit against that amount was allowed for a payment made on December 23, 2013.

reflected on audit schedules R3-12I ($1,341,580) and R3-12J ($676,755) further reduce the liability measure to $3,219,401. The sole remaining dispute is whether appellant is entitled to additional credit for use-tax-paid purchases resold.[11]

DISCUSSION

California imposes sales tax on a retailer's gross receipts from the retail sale of TPP in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When sales tax does not apply, use tax, measured by the purchase price, applies to the storage, use, or other consumption of TPP in this state. (R&TC, §§ 6201, 6401.) Use tax is imposed on the person storing, using, or otherwise consuming the TPP. (R&TC, § 6202.) A person who purchases TPP for storage, use or other consumption in this state, but resells the TPP before making any use of it (other than retention, demonstration, or display while holding it for sale in the regular course of business) may take a deduction of the purchase price of the TPP if the retailer has reimbursed his vendor for the sales tax or paid the use tax in connection with the purchase. (R&TC, § 6012(a)(1); Cal. Code Regs., tit. 18, § 1701(a).) This is often referred to as a deduction for tax-paid purchases resold.

When respondent is not satisfied with the amount of tax reported by the taxpayer, respondent may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, § 6481.) When a taxpayer appeals a determination, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Appeal of Talavera*, 2020-OTA-022P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

[11] Schedule R3-12I is entitled "Claim for Refund - Use Tax Accrued and Reported in Error on Purchases For Resale to U.S. Government," but, as explained below, one transaction was a sale for resale to a private party.

The transactions that remain in dispute represent an aggregate measure of $3,090,533 and tax of $273,744.32. For six of those, involving special tooling, the question is whether the evidence shows that appellant purchased the TPP for resale to Lockheed to be used on the Government Contracts. For the final transaction, involving appellant's purchase of a custom-designed machine from vendor Parpas America Corp. (Parpas), the question is whether appellant resold the TPP to another company without first making a taxable use of the TPP.[12] We will examine these contentions below.

The first six disputed transactions all involve special tooling. Respondent explained that it disallowed these transactions because the description and price of the TPP in question did not appear in a Lockheed PO.[13] Respondent argues, in essence, that appellant has the burden of identifying each item to the contract that has been shown to contain the accelerated title transfer provision and, failing that, appellant should not prevail. Regarding the six transactions (lines 27, 29, 32, 34, 35, and 37), respondent argues that none of the descriptions or amounts can be matched to a Lockheed PO. Regarding the last three, it also contends that the available documents refer to a Government Contract number that does not match the one known to contain the accelerated title transfer provision.

Appellant argues that it is sufficient that the Lockheed documents identify the type of tool referred to in the invoice(s) and that the price need not match because the price charged to Lockheed is fixed, but the price charged by appellant's vendor can vary, sometimes higher and sometimes lower than the fixed price. It further contends that the evidence shows that all of the six transactions involve special tooling for the F-35 fighter jet versions and that these contracts are carefully audited by the U.S. Government.

Before discussing the POs, invoices, and other evidence, we should note that the various initialisms used in the evidence to describe the TPP shed some light on the identification of the TPP. One of the articles provided by appellant refers to the Joint Strike Force F-35 fighter program to which the various contracts pertain. That evidence identifies the three models of the F-35 aircraft that were the subjects of the Government Contracts, each having different take-off and landing capabilities: those designed for short take-off and vertical landing (STOVL); those

[12] Although the transaction involving the Parpas machine is contained on Schedule R3-12I, the evidence does not show that the machine was purchased for resale to the U.S. Government.

[13] The Lockheed POs that are in evidence are the Master PO, including attachment D, and the amended PO.

designed for conventional take-off and landing (CTOL); and those designed for use with aircraft carriers, which are identified as carrier variant (CV).

The TPP identified on lines 27 and 32 of audit schedule R3-12I are both strap trim tools purchased from the vendor Visioneering. Line item 27 is identified as one for use on the CTOL version of the F-35.[14] Appellant purchased it for $227,262. Line item 32 is identified as one for use on the STOVL version of the F-35. Appellant purchased it for $244,902. Appellant's PO number SP168198 refers to the same tools and prices and states that the PO is related to a Lockheed PO. Appellant's PO also identifies the Government Contract number ending in 0010 (Contract 0010), which is the contract known to contain the accelerated title passage provision. Although we cannot locate a reference to these specific tools on any Lockheed PO, we find from all the evidence that appellant purchased these tools for use in the manufacture of the CTOL and STOVL versions of the F-35 fighter aircraft and that appellant sold both items to Lockheed for use on Contract 0010. Consequently, tax paid by appellant in connection with its acquisition of both items should be refunded.

The TPP referred to on line 29 is identified as a STOVL Strap Trim Fixture purchased from Hampson/Odyssey for $250,569.50. Appellant's PO for the TPP refers to an unidentified Lockheed PO and Contract 010. At hearing, appellant referred us to Attachment D to the Master PO, stating that its reference to "STOVL Trim/Machining Fixtures" is sufficient to identify the TPP as purchased for resale pursuant to the Government Contracts and related POs. We agree and, based on the evidence, find that appellant purchased this tool for use in the manufacture of the STOVL version of the F-35 fighter aircraft and that appellant sold the item to Lockheed for use on Contract 0010. Therefore, tax paid by appellant in connection with its purchase of this TPP should be refunded.

The last three of the six transaction are all purchases from Futuramic. One PO (45621777) was purportedly issued by AVCORP Composite Fabrication (AVCORP) on November 28, 2012, for the purchase of one STOVL LH trim tool and one STOVL RH Trim Tool for $70,000 each. The other PO (45723683) was purportedly issued by AVCORP on December 5, 2012, for the purchase of similar LH and RH trim tools, one set for use in building the CV and one set for use in building the CTOL versions of the F-35 fighter aircraft for $70,000

[14] Although audit schedule R3-12I uses the designation "ICTOL," this appears to be an error.

each, and a total of $280,000.[15] Both POs state that they are related to a Lockheed PO, and both contain the reference "N00019-14-C-0002." We also have the corresponding invoices, all of which were issued by Futuramic to appellant and refer to the Contract 0010. The descriptions of these tools, and in particular the references to the three versions of the F-35 fighter aircraft, and the invoice references to a Government Contract persuade us that appellant purchased all for use in the manufacture of the F-35 fighter aircraft and that appellant sold the TPP to Lockheed for use on Contract 0010. Tax paid by appellant in connection with these transactions should be refunded. Although this finding is dispositive of the Futuramic transactions, we will address respondent's argument about the PO references to a different contract.

Regarding respondent's argument that the POs' reference to "N00019-14-C-0002" indicates that the TPP was not for use in performance of the Government Contract known to contain the accelerated title transfer provision, we note the following: these deliveries occurred in 2013; the evidence indicates that Government Contract N00019-14-C-0002, which appellant contends was an extension to Contract 0010, dates from 2014, long after delivery of the TPP; and the Master PO was to remain effective through 2016. We also note that both POs were printed on February 24, 2020, by AVCORP and request delivery to AVCORP at the address to which other items were shipped to appellant in 2012 and 2013. Appellant identifies AVCORP as the buyer of the Parpas machine. All of this suggests that AVCORP purchased appellant's business or assets. AVCORP's system for printing old invoices automatically updated the name of the company. It also may have automatically updated to the then current contract number. For these reasons, we give little weight to the POs' references to what appears to be a different contract.

The last transaction at issue is appellant's purchase of the Parpas machine. According to comments on audit schedule 1R-12F-1, which documents respondent's examination of fixed assets examined on an actual basis, appellant agreed to purchase the TPP from Parpas for $8,812,700.[16] Appellant apparently reported to respondent that after delivery, appellant decided that its planned use of the machine was not practical. The equipment was not installed for use. Instead, appellant hired an equipment broker to resell the machine and shipped the machine to a storage facility to await a sale. Appellant did not depreciate the machine, which was eventually

[15] We have pages 1, 2, 3, and 5 (of 6) only, which refer to CV LH and RH Trim Tools and the CTOL LH Trim Tool, but we deduce with some confidence that page 4 contains a reference to a CTOL RH Trim Tool.

[16] The same comment appears on the later audit schedule 2R-12F-1.

resold for a fraction of its cost to AVCORP. After confirming the operative facts with Parpas, respondent concluded that the transactions should not be included in the measure of use tax on fixed assets because appellant resold the machine before making any taxable use of it. No portion of the purchase price was included in the taxable measure for fixed assets.

On the basis of the above facts, appellant argued at the hearing that it had agreed to purchase the machine long before delivery and had made periodic payments toward the purchase price. Appellant asserts that it accrued and paid use tax on a couple of the early progress payments, which are included in its claim for refund. Appellant contends that although respondent acknowledges in the audit that appellant made no taxable use of the Parpas machine, respondent has declined to allow these transactions.

Respondent initially argued at hearing that appellant purchased the Parpas machine for approximately $1,947,800 during 4Q11 and that appellant's plan was to use the machine in California. At the hearing, respondent asserted that the evidence does not support appellant's arguments and that it is not clear that the audit comment upon which appellant relies was a record of the auditor's analysis or simply a recitation of appellant's position at the time. Respondent referred us to audit schedule R3-12I for a statement of why the transaction was disallowed. The reason for disallowance stated on that audit schedule reads "What account [number]? Nothing provided to show it was resold before any use." Respondent did agree, though, that it appears appellant paid far more than $1,947,800 to Parpas, and that respondent has thus far not asserted that tax is owed measured by most of the price paid for the Parpas machine.

The circumstances surrounding appellant's purchase of the Parpas machine and respondent's action to assert appellant's use tax liability are far from clear. There are numerous references in the audit work papers to purchases from Parpas, including: four transactions from a list of accounts payable for expenses described as purchases of parts and supplies in 2012 and 2013 totaling $2,310 (rounded); nine transactions on audit schedule 1R-12F-1 (fixed assets), seven of which (totaling $7,319,420) are described (purportedly based on appellant's general ledger (GL) entries) as "construction in progress – aero" and appear to be periodic payments of the type described by appellant in its argument, and two of which (totaling $1,906,540) are described as "new equipment – outside supply – projects;" and the single entry on audit schedule 12-I (all iterations) showing a transaction cost of $1,947,800. This last entry, which is the one at

issue here, does not refer to an invoice number, and the parties have not provided any evidence to show the source of this number. Audit schedule R2-12F-1 shows that appellant accrued tax measured by $2,139,800 for 4Q11 in connection with the Parpas transactions, which is $192,000 more than the amount the parties agree is at issue here.[17]

We accept that the parties do not dispute the amount at issue for the Parpas machine: $1,947,800. The audit comment on audit schedule 12F-1 upon which appellant relies appears to show respondent's determination that appellant made no taxable use of the Parpas machine before reselling it to AVCORP. That audit schedule indicates that respondent did not include in the measure of tax due for purchases of fixed assets any of the nine payments made by appellant to Parpas, including those by which appellant measured self-assessed use tax. In other words, audit schedule 12F-1 memorializes respondent's determination that no tax measured by any of the nine payments made for the Parpas machine was due and that appellant mistakenly accrued and paid tax measured by four of those payments. Nowhere in the audit has respondent asserted additional tax due measured by the other five payments to Parpas. Nevertheless, respondent takes the position that the claimed additional refund is not due. Respondent concedes the disparate treatment of the payments not self-reported as a measure of use tax, but has failed to explain that treatment. We find that respondent's determinations and comments on audit schedule 12F-1 are sufficient to support appellant's claim that it sold the Parpas machine without making a prior taxable use of it. On that basis, the Parpas transaction included on audit schedule R3-12I, measured by $1,947,800, should be allowed.

[17] The total of the nine payments to Parpas is $9,225,960.

HOLDING

Appellant is entitled to additional adjustments to the determined liability for use tax accrued and reported in error.

DISPOSITION

Pursuant to respondent's third reaudit, the measure of audit item 6 shall be reduced by $5,732,348 from $5,884,578 to $152,230. In addition, appellant's claims for refund shall be granted in part, as follows: the measure of appellant's refund of use tax accrued and paid in error on exempt sales to the U.S. Government shall be increased to $1,341,580; the measure of appellant's refund for tax-paid purchases resold to the U.S. Government shall be increased to $676,755; the measure of appellant's refund of use tax accrued and paid in error on sales for resale to the U.S. Government shall be further increased by $1,142,733 to $2,484,313; and appellant shall be allowed an additional refund for use tax accrued and paid in error on a measure of $1,947,800, which represented a partial payment for the Parpas machine, which was mischaracterized in the audit as a claimed nontaxable sale for resale to the U.S. Government. Otherwise, respondent's action as set forth in its Decision is sustained.

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Michael F. Geary
Administrative Law Judge

We concur:

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Josh Lambert
Administrative Law Judge

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Keith T. Long
Administrative Law Judge

Date Issued: 8/30/2021