OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19125560
	) CDTFA Case ID: 000-035
OLYMPUS AMERICA, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Amy L. Silverstein, Attorney Robert Tobin, VP of Tax & Corporate Insurance for Olympus Corporation of the Americas[1]
For Respondent:	Kevin B. Smith, Tax Counsel III Scott Claremon, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Corin Saxton, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561 Olympus America, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] denying appellant's petition for redetermination of the Notice of Determination (NOD) dated September 30, 2016. The deficiency measure of $78,076,402.00 on which the NOD is based consists of tax of $7,070,318.62, applicable interest, and a negligence penalty of $707,032.42, for the period April 1, 2008, through September 30, 2011 (current audit period).

[1] Olympus Corporation of the Americas is the parent company of appellant.

[2] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE.

In a reaudit report dated November 27, 2017, CDTFA reduced the aggregate deficiency measure to $73,512,472.00, the tax liability to $6,674,443.54, and the negligence penalty to $667,444.82.

Office of Tax Appeals Administrative Law Judges Josh Lambert, Michael F. Geary, and Sheriene Anne Ridenour held an oral hearing for this matter in Sacramento, California, on September 20, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for an Opinion.

ISSUES

1. Whether parts used to repair non-California customers' equipment, pursuant to optional maintenance contracts, at a repair facility in California are excluded from use tax under R&TC section 6009.1.
2. Whether appellant is entitled to relief from tax, penalties, and interest, pursuant to R&TC section 6596.
3. Whether appellant is liable for the negligence penalty.

FACTUAL FINDINGS

1. Appellant, a New York corporation, is a distributor, retailer, and repairer of endoscopes and other medical devices.
2. Appellant offered optional lump-sum maintenance contracts with the sale of its products and provided the materials, parts, and labor for warranty repairs free of charge.[3]
3. Appellant purchased repair parts ex-tax[4] from the manufacturer, Olympus Medical Systems Corporation (OMSC), a related company located in Tokyo, Japan, and stored the parts in its San Jose, California facility until it withdrew the parts from resale inventory to perform repairs.

[3] Appellant also performed repairs on equipment that was covered by the included warranty for new equipment and on equipment that was out of warranty. For the latter repairs, the customer paid for parts and labor charges.

[4] In general, ex-tax means without payment of California sales tax reimbursement or use tax to the seller or CDTFA.

4. Appellant's customers from California and elsewhere shipped equipment needing repair to appellant's California facility. After completion of repairs, appellant shipped the products back to customers by common carrier.
5. Generally, appellant reported use tax due, measured by its cost of the materials (wires, screws, etc.) used to perform repairs because appellant understood that it consumed those materials in the course of making the repairs. However, at no time prior to the end of the current audit period did appellant report use tax due, measured by its cost of the repair parts furnished and installed (consumed) during the course of warranty repairs because appellant believed that it was not the consumer of those parts, and that those parts were consumed only by its customer when the repaired equipment was used for its intended purpose.
6. CDTFA audited appellant for multiple periods prior to the current audit period. Three of those prior audits are relevant to the current audit.

First prior audit for the period April 1, 1996, through March 31, 1999

7. It appears from the few pages of audit records provided by appellant[5] that it did not provide business records from which CDTFA could determine appellant's cost of parts used for warranty repairs done pursuant to optional warranty agreements (optional warranty repairs).
8. For CDTFA's examination of use tax due in connection with optional warranty repairs, appellant provided only the total charges that appellant attributed to optional warranty repairs performed for California customers. CDTFA examined the limited data available and concluded that the total charge should be attributed equally to labor, parts, overhead, and profit. There is nothing in the evidence to show that appellant provided any information regarding, or that CDTFA examined, charges for warranty repairs for customers outside California.[6]
9. CDTFA determined a deficiency measure for use tax, based only on the estimated cost of parts consumed in California for optional warranty repairs, measured by $207,123. CDTFA also determined deficiencies in the following areas, among others: unreported

[5] CDTFA states that it no longer has the records from any of the three prior relevant audits.

[6] According to testimony at the hearing, optional warranty repairs for California customers constitute approximately eight percent of the total of such repairs.

fixed asset purchases subject to use tax, unreported ex-tax purchases of expense items subject to use tax, and unreported cost of loaner and demonstration units first used in California.

Second prior audit for the period April 1, 1999, through December 31, 2002

10. The few pages of audit records provided by appellant indicate that CDTFA noted during the audit that appellant was not self-assessing use tax owed in connection with its use of parts for warranty repairs, and that it informed appellant that, pursuant to California Code of Regulations, title 18, (Regulation) sections 1546 and 1655, appellant is the consumer of those parts.
11. Appellant purportedly provided what was characterized as "detail[ed] contract reports," which, according to appellant, showed retail prices for parts. Appellant represented to CDTFA that its cost for parts was 60 percent of the retail price. On the basis of this information, CDTFA calculated unreported use tax for parts used in connection with warranty agreements measured by $200,804.
12. A provided schedule documenting the transactions from which CDTFA calculated the measure contains cost of parts incurred and indicates that appellant was then able to provide specific information regarding the cost of the parts and that it continued to provide such information for California customers only. CDTFA also determined deficiencies in the following areas, among others: unreported fixed asset purchases subject to use tax, unreported ex-tax purchases of expense items subject to use tax, and unreported cost of loaner and/or demonstration units first used in California.

Third prior audit for the period January 1, 2003, through December 31, 2007

13. During the third prior audit, CDTFA once again informed appellant regarding its obligation to report and pay use tax in connection with parts removed from inventory for use in optional warranty repairs and this time requested that appellant provide a listing of all California customers with optional warranty agreements.
14. Appellant claimed to be having difficulty providing the requested information, and ultimately it was agreed that CDTFA would calculate the subject measure using an error percentage based on the amounts determined in the second audit. CDTFA did this to determine a $259,922 taxable measure for parts consumed in optional warranty repairs.

In addition, CDTFA determined deficiencies in the following areas, among others: unreported fixed asset purchases subject to use tax, unreported ex-tax purchases of expense items subject to use tax, and unreported cost of loaner units subject to use tax.

Current audit for the period April 1, 2008, through September 30, 2011

15. For the current audit period, CDTFA again requested that appellant provide the cost of repair parts consumed in optional warranty repairs for all customers, including out-of-state customers. Appellant provided a listing of the parts purchased from OMSC, and based on this data, CDTFA established a use tax deficiency measure of $66,901,140 for repair parts consumed in connection with optional warranty repairs.[7]

16. CDTFA issued the NOD, and appellant filed a timely petition for redetermination, disputing the deficiency for use tax on repair parts consumed in connection with optional warranty repairs.[8] This timely appeal followed.

DISCUSSION

Issue 1: Whether parts used to repair non-California customers' equipment, pursuant to optional maintenance contracts, at a repair facility in California are excluded from use tax under R&TC section 6009.1.[9]

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) When sales tax does not apply, use tax applies to the storage, use, or other consumption of tangible personal property purchased from any retailer for storage, use or other consumption in this state, measured by the sales price, unless that use is specifically

[7] This audit item was one of 12 audit items included in CDTFA's September 15, 2016 audit report, which established an aggregate deficiency measure of $78,076,402. CDTFA only established a deficiency for this audit item for a portion of the audit period (April 1, 2009, through September 30, 2011) because, according to the audit workpapers, "for the period April 1, 2005, to December 31, 2009, the service location was included as part of [OMSC]."

[8] By reaudit report dated November 27, 2017, CDTFA applied unreported tax credits to the liability, which reduced the aggregate deficiency measure to $73,512,472.00 and reduced the negligence penalty to $667,444.82. On October 27, 2016, appellant made a payment of $2,135,850.20, which reduced the tax liability to $4,538,593.34. Appellant has not filed a claim for refund for this payment.

[9] Appellant paid $2,135,850.20 of the tax liability. Appellant states that this amount represents use tax on parts used to repair equipment for California customers, pursuant to optional maintenance contracts, and that it does not dispute this amount.

exempted or excluded by statute. (R&TC, §§ 6201, 6401.) Generally, when sales and use tax regulations use the words "tax applies," in reference to a sale or to an amount included in a sale, it means that either sales tax, measured by gross receipts, or the use tax, measured by purchase price (or cost) applies. (Cal. Code Regs., tit. 18, § 1500(c)(1).)

It is presumed that tangible personal property shipped or brought to this state by the purchaser was purchased from a retailer for storage, use, or other consumption in this state. (R&TC, § 6246.) Exemptions from tax are strictly construed against the taxpayer. (*H. J. Heinz Co. v. State Bd. of Equalization* (1962) 209 Cal.App.2d 1, 4.) Any doubt must be resolved against the right to an exemption. (*Associated Beverage Co. v. State Bd. of Equalization* (1990) 224 Cal.App.3d 192, 211.) The burden is on the taxpayer to show that its activity clearly falls within the terms of the exemption. (*H. J. Heinz Co. v. State Bd. of Equalization* (1962) 209 Cal.App.2d 1, 4.)

Regulation section 1655(c)(3) provides that "[t]he person obligated under an optional warranty contract to furnish parts, materials, and labor necessary to maintain the property is the consumer of the materials and parts furnished and tax applies to the sale of such items to that person." Regulation section 1546(b)(3)(C) states that "[i]f repair work is performed under an optional lump-sum maintenance contract or optional warranty providing the furnishing of parts, materials, and labor necessary to maintain the property, the repairer is regarded as the consumer of the parts and materials furnished." When it is stated that certain persons are "consumers" of tangible personal property under stated conditions, the sales to such persons are retail sales in respect to which either the sales or use tax applies. (Cal. Code Regs., tit. 18, § 1500(c)(3).)

Appellant contends that its installation of parts when making optional warranty repairs for out-of-state customers is not a taxable use; consequently, no use tax is owed. Citing R&TC section 6009.1 and Regulation section 1620(b)(9), appellant argues that its "use" of the parts consisted solely of attaching or incorporating the parts into the equipment being repaired and then transporting the repaired equipment outside the state where it was thereafter used exclusively outside the state by its customers. Appellant asserts that its "use" of the parts is analogous to the uses described in the first two examples provided under Regulation section 1620(b)(9). Appellant contends that Regulation sections 1546(b)(3)(C) and 1500(c)(3) do not impose tax but instead indicate which party in the transaction would be liable assuming

the transaction were taxable and that "an exemption or exclusion from use or use tax trumps the imposition of tax in the first instance."

R&TC section 6009.1 provides that, "[f]or purposes of imposition of the use tax, the terms 'storage' and 'use' do not include the keeping, retaining, or exercising any right or power over tangible personal property for the purpose of being processed, fabricated, or manufactured into, attached to or incorporated into, other tangible personal property to be transported outside the state and thereafter used solely outside the state." Regulation section 1620(b)(9) further provides that "'[s]torage' and 'use' do not include the keeping, retaining or exercising any right or power over property for the purpose of subsequently transporting it outside the state for use thereafter solely outside the state, or for the purpose of being processed, fabricated or manufactured, into, attached to, or incorporated into, other property to be transported outside the state and thereafter used solely outside the state."

Regulation section 1500(c)(3) states that either sales tax or use tax applies to sales to consumers. Regulation section 1655 states that the person obligated under an optional warranty contract is the consumer of the materials and parts furnished, and Regulation section 1546(b)(3)(C) states that repairers are the consumer of the parts and materials furnished under optional maintenance contracts. Taken together, these regulations set forth that use tax applies to the installation of ex-tax repair parts in optional maintenance/warranty contracts. Here, the property was used in the repairs and consumed in the state; therefore, use tax applies pursuant to Regulation section 1500(c)(3).

In this case, the property was not "used solely outside the state" as required by the statute. There was taxable use other than as outlined in R&TC section 6009.1 because the repairs, which are taxable use, occurred in California. Specifically, the property was used in the repairs and consumed in the state, pursuant to Regulation sections 1655 and 1546; therefore, use tax applies pursuant to Regulation section 1500(c)(3). As a result, the parts were not used solely outside the state because there was taxable use within the state, and the exclusion under R&TC section 6009.1 does not apply.[10]

[10] To the extent this Opinion does not address appellant's other arguments, they are without merit, as the plain language of R&TC 6009.1 is clear, and the facts of this case do not qualify for the exclusion.

Issue 2: Whether appellant is entitled to relief from tax, penalties, and interest, pursuant to R&TC section 6596.

If a taxpayer's failure to timely pay the tax is due to reasonable reliance on written advice provided by CDTFA, the taxpayer may be relieved of the taxes, interest, and any penalties. (R&TC, § 6596(a).) Office of Tax Appeals has statutory authority to decide an appeal involving a request for relief of taxes, interest, and penalties pursuant to R&TC section 6596. (Gov. Code, § 15671(a)(6).) R&TC section 6596 imposes four general requirements to grant relief: First, the taxpayer must have requested written advice on the application of tax from CDTFA and the request must set forth the specific facts and circumstances of the activity or transactions for which the advice is requested. (R&TC, § 6596(b)(1).) Second, CDTFA must have responded in writing, stating whether or not the described activity or transaction is subject to tax, or stating the conditions under which the activity or transaction is subject to tax. (R&TC, § 6596 (b)(2).) Third, as relevant here, in reasonable reliance on the written advice, the taxpayer must have failed to pay use tax on the storage, use, or other consumption in this state of tangible personal property. (R&TC, § 6596(b)(3)(B).) Fourth, the liability for taxes must have occurred before CDTFA rescinds the advice or a change in law renders the advice no longer valid. (R&TC, § 6596(b)(4).) Any person requesting relief of the taxes must file a statement under penalty of perjury setting forth the facts on which a request for relief of taxes is based.[11] (R&TC, § 6596(c).)

Appellant asserts that it is entitled to relief under R&TC section 6596 based upon written advice provided in prior audits. The presentation of a person's books and records for examination by an auditor is deemed to be a written request for the audit report for purposes of the first requirement (requesting written advice). (Cal. Code Regs., tit. 18, § 1705(c).) As it is undisputed that CDTFA produced audit reports and workpapers from the prior audits of appellant, the first element is met.

With respect to the second element, if a prior audit report of the person requesting relief contains written evidence which demonstrates that the issue in question was examined, either in a sample or census (actual) review, such evidence will be considered written advice from

[11] Appellant filed this statement.

CDTFA.[12] (Cal. Code Regs., tit. 18, § 1705(c).) Audit comments, schedules, and other writings prepared by CDTFA that become part of the audit workpapers which reflect that the activity or transaction in question was properly reported and no tax amount was due are sufficient for a finding for relief from liability, unless it can be shown that the person seeking relief knew such advice was erroneous.[13] (Cal. Code Regs., tit. 18, § 1705(c).)

Appellant argues that the taxability of the repair parts installed at the California facility pursuant to optional maintenance contracts was examined by CDTFA during the prior audits. Appellant contends that CDTFA made a conscious decision to tax only the parts for the California customer repairs based on a determination that tax was not due on parts shipped to non-California customers. Appellant asserts that in the first and second audit workpapers, CDTFA stated that it reviewed records of sales reported by state, which demonstrates that there was an examination of both California and non-California customers. Appellant asserts that in the third audit, CDTFA asked for sales to California customers, which demonstrates that CDTFA affirmed its prior determination that parts used for non-California customers are not taxable.

Specifically with respect to the first prior audit, appellant asserts that the records presented to CDTFA contained all amounts billed for optional maintenance contracts, including for both California and non-California customers, and were examined on an actual basis. Appellant provides testimony from Mr. Tobin, who stated at the hearing that CDTFA did not tax out-of-state optional maintenance contracts for the first audit period (as well as the second and third). Appellant also provides a declaration from Mr. Tobin, in which he states that appellant had out-of-state optional maintenance contracts for the first prior audit period. Appellant also provides spreadsheets dated August 2001, which list out-of-state optional maintenance contracts for the prior audit period and an out-of-state optional maintenance contract proposal dated November 12, 1999.

The evidence, including the audit workpapers, does not show that CDTFA examined repairs for out-of-state customers. For the first audit, the workpapers indicate that CDTFA

[12] A census (actual) review, as opposed to a sample review, involves examination of 100 percent of the person's transactions pertaining to the issue in question.

[13] For written advice contained in a prior audit to apply to the person's activity or transaction in question, the facts and conditions relating to the activity or transaction must not have changed from those which occurred during the period of operation in the audit period. (Cal. Code Regs., tit. 18, § 1705(c).) There is no dispute that the facts and conditions did not change.

estimated the parts consumed under optional maintenance contracts due to a lack of records. As to the second audit, the few workpapers in the record include only transactions for only California customer contracts on which CDTFA assessed use tax. For the third prior audit, the workpapers indicate that appellant was unable to provide any records relating to parts consumed in optional maintenance contracts and agreed to use the second prior audit to determine the liability.

There is no evidence that CDTFA gave written advice as to the taxability of non-California customer contracts and there are no express statements by CDTFA indicating that non-California customer repairs were non-taxable. However, CDTFA advised appellant that "parts used to perform the Optional Maintenance are taxable" and provided Regulation sections 1546(b)(3) and 1655(c)(3). Therefore, appellant was provided express written advice that all parts used to perform optional maintenance contracts are taxable but did not follow that advice.[14]

Based on the foregoing, the evidence does not show that CDTFA examined repairs for out-of-state customers. Accordingly, appellant has not established that it is entitled to relief.

Issue 3: Whether appellant is liable for the negligence penalty.

R&TC section 6484 provides that if any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co*. (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court* (2016) 248 Cal. App. 4th 434, 447.)

A taxpayer shall maintain and make available for examination on request by CDTFA, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax return. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) Such records include but are not limited to the following: (1) the normal books of account ordinarily maintained by the average prudent

[14] It is unclear whether this is rescinded or modified advice or CDTFA's position throughout the entire audit. If it was rescinded or modified advice then, because the liability for taxes applied to an activity or transaction that occurred after this point, appellant would not be entitled to relief. (See R&TC, § 6596(b)(4)(A).)

businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1)(A)-(C).) Failure to maintain and keep complete and accurate records is considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

CDTFA imposed a negligence penalty based on its determination that appellant made errors in the current audit similar to those made in its previous audits. Specifically, CDTFA determined that, during the two previous audits, appellant's records indicated, among other items, unreported parts consumed in optional maintenance contracts shipped from California, unreported purchases of fixed assets subject to use tax, unreported ex-tax purchases of consumable supplies, and unreported use of loaner pool equipment.

At the hearing, appellant stated that it was not disputing the portion of the negligence penalty related to parts for California customers. Appellant argues that any negligence attributable to the failure to report tax for California customer contacts should not be attributed to the failure to report tax for non-California customer contracts.

Appellant's repeated failure to correct these errors from prior audits is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323.) Appellant did not report tax for California customer contracts, even though CDTFA previously assessed use tax parts used to repair parts for California customers. Despite being assessed a deficiency three times previously on those in-state contracts, appellant continued to report those contracts incorrectly, which is evidence of negligence. Appellant also repeatedly failed to report purchases of fixed assets subject to use tax, purchases of consumable supplies, and the use of loaner equipment. Appellant's continued failure to report its purchase of parts for in-state customers and failure to report numerous other transactions is evidence that appellant was negligent in failing to report its purchase of parts for out-of-state customers.[15] In addition, CDTFA expressly advised appellant during the prior audits that use tax was owed on parts repaired under optional maintenance contracts, and appellant failed to follow that advice. Overall, appellant knew or should have known the transactions were taxable after notification in

[15] As stated in *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at pp. 323-324: "In addition to this evidence that supports the imposition of the 10 percent negligence penalty, there was evidence of numerous transactions that just were not reported by the taxpayer, and which failure had nothing to do with the accounting system adopted by it. This, too, was evidence of negligence."

prior audits, which is evidence of negligence. (See *Independent Iron Works, supra*, 167 Cal.App.2d at pp. 323-324.)

Appellant argues that the parts for California customers was *de minimus* or insubstantial. Appellant asserts that the time and effort to report and pay the tax was not necessary because appellant knew that it was going to be audited and that it would pay the tax, as it had in past audits. However, appellant's acknowledgment that it chose to not report tax on California customer contracts and chose to wait until it was audited to pay the tax indicates an intentional disregard of the requirement to report and pay the tax.[16] Therefore, appellant is liable for the negligence penalty.

[16] Appellant asserts that CDTFA's audit manual indicates that there is discretion to apply the penalty to only a portion of the deficiency when it would be inequitable to apply it to all of it. CDTFA's Audit Manual, section 0506.30 states that "where the condition warranting the imposition of a negligence penalty is not present during the entire period under audit," such as when there is "a complete change of management occurred and conditions under one management were entirely different from those under the other…the auditor will select the appropriate penalty for the appropriate period(s) only." However, in this case, there was no complete change of circumstances. Moreover, if any part of the deficiency is due to negligence, the 10 percent negligence penalty applies to the entire assessment. (See R&TC, § 6484.)

HOLDINGS

1. The parts used to repair non-California customers' equipment, pursuant to optional maintenance contracts, at a repair facility in California are not excluded from use tax under R&TC section 6009.1.
2. Appellant is not entitled to relief from tax, penalties, and interest, pursuant to R&TC section 6596.
3. Appellant is liable for the negligence penalty.

DISPOSITION

CDTFA's action in reducing the measure of tax to $6,674,443.34 and the negligence penalty to $667,444.82 is sustained.

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 12/20/2022