

STATE OF CALIFORNIA
BOARD OF EQUALIZATION
APPEALS DIVISION

395.0673

In the Matter of the Petition)
for Redetermination Under the)
Sales and Use Tax Laws:)
)
)
)
Petitioner)

DECISION AND RECOMMENDATION
No. ----

The above-referenced matter came on regularly for hearing before Hearing Officer James E. Mahler on February 6, 1991, in San Diego, California.

Appearing for Petitioner:

Appearing for the Sales and Use Tax Department: James M. Stillwell
Senior Tax Auditor

Protested Item

The protested tax liability for the period April 1, 1985, through December 31, 1986, is measured by:

| <u>Item</u> | <u>State, Local and County</u> |
|---------------------------------|--------------------------------|
| Unreported sale of fixed assets | \$33,857 |

Petitioner's Contention

Petitioner was engaged primarily in the business of performing nontaxable computer programming services, and tax does not apply to the sale of assets held or used in that business.

Summary

The petitioner corporation obtained a seller's permit in April 1984 to engage in the business of selling "computer hardware and software; computer services." From October 1985 through October 1986, petitioner filed monthly sales and use tax returns reporting sales as shown in the following charts (For the months not shown on the chart, petitioner filed returns showing zero receipts.)

| | <u>Total Receipts (ex tax)</u> | <u>Labor</u> | <u>Tangible Personal Property</u> |
|---------------|--------------------------------|---------------|-----------------------------------|
| October '85 | \$18,674.87 | \$17,325.67 | \$1,349.20 |
| December '85 | 250.00 | -0- | 250.00 |
| January '86 | 2,875.20 | -0- | 2,875.20 |
| February '86 | 659.50 | 32.50 | 627.00 |
| September '86 | 2,411.60 | 2,411.60 | -0- |
| October '86 | <u>70,034.05</u> | <u>385.00</u> | <u>69,649.05</u> |
| | \$94,905.22 | \$20,154.77 | \$75,750.45 |

The audit found that petitioner had made a close-out sale of its business assets to an entity called (C) , which was not reported on petitioner's sales and use tax returns. The audit asserted tax on this sale and petitioner protests.

According to the audit comments, the sale to (C) occurred on October 31, 1986, but was backdated to January 2, 1986. The total selling price as shown on petitioner's 1986 federal income tax return was \$33,857, allocated as follows:

| | |
|------------------------------|--------------|
| Computer hardware & software | \$23,760 |
| Office furniture | 1,155 |
| Computer equipment (1984) | 7,842 |
| Computer equipment (1985) | <u>1,100</u> |
| | \$33,857 |

The auditor originally prepared a Schedule 12A-3 stating that the computer hardware and software was "used exclusively in conjunction with the T/P's customized programming business, therefore qualifying it as an occasional sale." Despite this comment, the schedule showed the entire \$33,857 selling price as subject to tax. (The schedule also broke down the selling price between furniture, \$1,380; computer hardware, \$21,759; and computer software and manuals, \$14,931, which does not add up.)

Subsequently, the auditor's supervisor ordered the auditor to rewrite this schedule. As incorporated into the final audit workpapers, the schedule is retitled Schedule 12A-1 and comments that the occasional sale exemption is not available to petitioner because: "Although the TIP contends he was operating two separate and distinct businesses, the development of customized software, and the sale of computer hardware, the fixed assets of the business were commingled." (The revised schedule breaks down the \$33,857 selling price between furniture, \$1,155; and computer hardware, software and software manuals, \$32,702.)

A copy of the original Schedule 12A-3 was provided to petitioner. No copy of the revised Schedule 12A-1 was provided to petitioner.

At the appeal hearing, Mr. --- petitioner's president and principle shareholder, explained that he had always been primarily interested in computer programming. Hardware sales were initially intended only as a way to finance the acquisition of equipment for use in the programming business. Over the years, the amount of hardware sales decreased as the income from programming increased. In fact, in later years hardware was often sold at cost as an accommodation to programming customers.

By 1985, (C) was petitioner's major customer, and most of the reported sales between October 1985 and October 1986 were to that company. For example, the \$69,649.05 reported sale in October 1986 was from a single sale of hardware to (C) at cost.

(C) had proposed to form a partnership with petitioner to engage in the business of writing computer programs for the entertainment industry. Early in 1986, although the partnership had not as yet been officially formed, petitioner began charging (C) only one-half of the normal hourly charge for programming work, and in return kept one-half of the ownership rights in the programming. The close-out sale in question was a step in the formation of the partnership with (C). The transaction was structured as a sale of business assets solely to provide funds to petitioner to finance additional program development.

Mr. --- also stated that the amounts reported as "labor" on petitioner's sales and use tax returns were mostly for the labor of installing hardware sold. Receipts from programming services were not reported on the returns. After the hearing, Mr. --- advised the Hearing Officer by letter that "consulting" or programming income for the calendar year 1986 was \$280,369.40, about three times the reported receipts from hardware sales and labor.

Petitioner concedes that \$5,416 of the \$33,357 close-out selling price was for computer hardware and office furniture used in all aspects of the business. Petitioner admits that tax applies to that amount. As for the remaining \$28,441, petitioner contends that it was for computer hardware and software used solely in "the consulting or programming business. Petitioner argues that such assets were not held or used in an activity requiring a seller's permit, so that the sale of those assets qualifies as an exempt occasional sale.

Analysis and Conclusions

Revenue and Taxation Code Section 6367 provides that tax does not apply to "occasional sales". In relevant part, the term "occasional sale" is defined in Section 6006.5(a) of the Code to include the:

"... sale of property not held or used by a seller in the course of activities for which he or she is required to hold a seller's permit... provided the sale is not one of a series of sales sufficient in number, scope, and character to constitute an activity for which he or she is required to hold a seller's permit..."

Petitioner contends that assets sold for \$28,411 were held or used in the business of consulting or custom computer programming, an activity which in itself would not require the holding of a seller's permit. Petitioner concludes that the sale of these assets therefore qualifies as an exempt occasional sale. In support, petitioner relies on the provisions of Sales and Use Tax Regulation 1595(a)(5)(A) dealing with the occasional sale exemption as applied to operators of "service enterprises".

The audit staff responds that all of the assets sold to (C) were held or used in a single business, a business which included hardware sales as well as computer programming, and that a seller's permit was required for the business. The staff accordingly concludes that the close-out sale was not an occasional sale. The staff apparently relies on Sales and Use Tax Regulation 1595(a)(5)(B), which discusses the occasional sale exemption as applied to any business which is not "essentially a service enterprise."

Whether petitioner's business was or was not "essentially a service enterprise" is certainly an intriguing philosophical question, but we find it unnecessary to decide the point. Assuming without deciding that custom programming was petitioner's main business activity, the close-out sale to (C) would still be subject to tax.

The definition of "occasional sale" in Section 6006.5(a) expressly excludes any sale which is "one of a series of sales sufficient in number, scope, and character to constitute an activity" requiring a seller's permit. Regulation 1595(a) (4) further provides:

"When a person not otherwise engaged in an activity requiring the holding of a seller's permit makes a series of sales sufficient in number, scope and character to require the holding of a seller's permit, the gross receipts from all of such sales are subject to tax."

Petitioner made a series of sales of computer hardware from October 1985 through October 1986 which totalled \$74,750.45, a series sufficient in number, scope and character to require the holding of a seller's permit. The close-out sale in question was merely another step in this series and therefore does not qualify as an occasional sale.

The examples listed in Regulation 1595(a)(5)(A) are not to the contrary. The regulation lists enterprises such as hospitals (which might have made taxable sales of non-prescription medicines through a pharmacy) and hotels (which may have made taxable sales through a restaurant or bar). In these situations, a final sale of equipment used in the business could not reasonably be considered part of a series with the prior sales. Here, however, petitioner was engaged in the business of selling computer hardware and software, and the final sale to (C) was also computer hardware and software.

We recognize that petitioner's prior sales were new equipment, while the final sale to C was used equipment. However, sales tax applies to all sales of tangible personal property without regard to whether the property is new or used. (See Rev. & Tax. Code § 6051.) There is accordingly no rational basis for treating a final sale of used assets as inherently different from prior sales of new equipment. As the court held in Sutter Packing Co. v. State Bd. of Equal., 139 Cal.App.2d 889 at 896:

"The fact alone that the last sale was made in liquidation of a business is apparently not such a distinction in the nature of the sale as to warrant an exemption if it would otherwise have been considered part of a series of sales sufficient in number, scope and character to constitute an activity requiring a seller's permit and subjecting it to the tax."

Petitioner also relies on Ontario Community Foundations, Inc. v. State Bd. of Equalization, 35 Cal.3d 811 and Hotel del Coronado Corp. v. State Board of Equalization, 15 Cal.App.3d 612. Neither case supports its position. In Ontario, the court was careful to note that the "single sale" of hospital assets was not "one of a series" of such sales which independently might require a permit under the statute." (35 Cal.3d at 815.) In Hotel del Coronado, the court concluded that a close-out sale of hotel assets was subject to tax, and was not an exempt occasional sale, because it was part of a series of prior sales of hotel assets.

For these reasons, we conclude that petitioner's close-out sale to (C) does not qualify as an occasional sale.

* * *

In discussions with the audit staff prior to the appeal hearing, petitioner apparently contended that the portion of the close-out selling price attributable to its custom software library would qualify for exclusion under Revenue and Taxation Code Section 6010.9. This contention was not raised in the written petition for redetermination or discussed at the appeal hearing, but we have reviewed it on our own motion and conclude that no adjustment to the tax is warranted. The California Court of Appeal has recently held that the sale of an existing software library consisting of custom computer programs does not qualify for exclusion under Section 6010.9. (Touche Ross & Co. v. State Bd. of Equalization, 203 Cal.App.3d 1057.)

Recommendation

Redetermine without adjustment to the tax.

James E. Mahler, Hearing Officer

6/6/91
Date