LIST OF CASES

CORPORATE FOOD SERVICES VS. STATE

The Law. Sales of tangible personal property are subject to tax measured by gross receipts. "Gross Receipts" mean the total amount of the sales price, valued in money, whether received in money or otherwise. The total amount of the sales price includes all of the following: (1) All receipts, cash, credits and property of any kind. (2) Any amount for which credit is allowed by the seller to the purchaser.

"Gross receipts" do not include cash discounts allowed and taken on sales.

The Facts. Corporate Food Services operated cafeterias on the premises of public and private employers as a convenience to their employees. The employers provided the physical plant and equipment. Corporate hired and trained cafeteria personnel; purchased, prepared and served the food; and purchased maintenance supplies and services.

Corporate had a management operating agreement with each employer. Each employer determined or approved food prices and set cafeteria locations and hours. Prices were based on projected operating results and were in substantial relation to costs, but profitability varied from item to item and from cafeteria to cafeteria.

The agreements therefore provided for Corporate to recover from cafeteria sales its expenses plus a management fee based on a percentage of cafeteria sales (4 or 5 percent). If cafeteria sales exceeded the total of Corporate's expenses plus its management fee (as it did in some cases), Corporate paid the excess to the employer. If cafeteria sales fell short of that total (as it did in the majority of cases), the employer made up the deficit.

Corporate's total cafeteria sales under the management agreements were about $8 million and total subsidies from employers amounted to more than $1 million. In no case did an employer subsidy exceed 30 percent of sales. Corporate reported and paid sales taxes only on amounts

received from employees for cafeteria sales. The Department, after an audit, contends Corporate owes sales tax on the employer subsidies also.

Question: Did Corporate Food Services owe sales tax on the employer subsidies?

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DUFFY VS. STATE

The Law. Charges for "fabrication labor" are taxable. Charges for steps in the process of completing a new article are fabrication labor. Labor for making new items from material furnished directly or indirectly by the customer is fabrication labor.

The Facts. Dennis Duffy has a dry cleaning and tailoring shop. Duffy and his employees altered new clothing for customers who had purchased the clothing elsewhere and had not worn the clothing except for trying on or fitting. For all the years Duffy has operated, he has never charged tax on his alteration services, but one of his customers told him a competitor does charge tax. Duffy doesn't want to risk an audit liability, but also doesn't want to collect a tax that isn't due.

Question: As Duffy's CPA, what advice do you give him about the taxation of his alteration charges?

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STATON VS. STATE

The Law. In this state, the servicing of, and the repair of, motor vehicles are subject to sales tax.

The Facts. Deborah Staton purchased a new car and an optional extended warranty on the car at the same time. She paid $50 sales tax on the extended warranty, as well as sales tax on the car. She questioned the dealer about the tax on the extended warranty, and the dealer told her the Department of Revenue had advised dealers extended warranties on motor vehicles were taxable.

Question: You are Staton's CPA for her small business. Staton is upset over the principle of having to pay the $50 sales tax for a service she may never use, and asks you whether she is entitled to a refund from the Department. What advice do you give her?

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BLOCKHEAD VS. STATE

The Law. [1] A sales tax is imposed on the retail purchaser, and any vendor making a retail sale in the state is required to collect the tax at the time of the sale.

[2] Under *Quill Corporation v. North Dakota* (1992) 504 U.S. 298, a state cannot impose a sales or use tax collection obligation on an out-of-state seller unless the out-of-state seller has a "substantial nexus" with the state.

[3] The *Quill* Court stated: "Under *Complete Auto*'s four-part test, we will sustain a tax against a Commerce Clause challenge so long as the 'tax [1] is applied to an activity with a substantial nexus with the taxing State, [2] is fairly apportioned, [3] does not discriminate against interstate commerce, and [4] is fairly related to the services provided by the State.' *Bellas Hess* [(1967) 386 U.S. 753] concerns the first of these tests and stands for the proposition that a vendor whose only contacts with the taxing State are by mail or common carrier lacks the 'substantial nexus' required by the Commerce Clause."

The Facts. Blockhead is an out-of-state retailer of concrete blocks. Blockhead voluntarily applied for and received a sales and use tax vendor's license from the state, but disputes that it had any physical presence within the state during the audit years in question. During these audit years, Blockhead collected sales tax on some, but not all, of its destination sales (i.e., title passing in the taxing state) to retail purchasers in the state. Blockhead shipped all blocks via common carrier from its out-of-state warehouses. The state assessed tax against Blockhead for the sales on which it failed to collect the sales tax.

Question: Do you advise Blockhead to contest the state's audit assessment?

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WBNS TV, INC. VS. STATE

The Law. "Sale" does not include personal service transactions that involve the transfer of tangible personal property as an inconsequential element. "Personal service" means a recognized skill performed by a person specifically engaged by the purchaser to perform the act. If the "overriding purpose" is to obtain the service rather than the tangible property, the transaction is not subject to sales or use tax.

The Facts. WBNS TV contracted with A. C. Nielsen Co. to obtain its quarterly reports for $4400 per month. Nielsen's reports include statistical information on the demographic makeup and TV viewing habits of households in the station's viewing area. Nielsen employed skilled personnel experienced in data collection, statistical analysis, and sociology. Nielsen surveyed selected samples of households within the viewing area to obtain the information. At the same time, Nielsen provided copies of the same report to other stations in the viewing area for the same fee.

Question: Did WBNS TV owe use tax on the reports?

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CAPE PAGING CO. VS. STATE

The Law. All charges for paging services are subject to sales tax. Leases are also subject to tax. Sales for resale are not subject to tax. Property purchased for the purpose of leasing may be purchased for resale. Property purchased for the purpose of providing services may not be purchased for resale; instead, the property is consumed by the service provider.

The Facts. Cape Paging was engaged in the business of providing paging services. It purchased Nokia pagers ex-tax under resale certificates. Cape paid sales tax on its charges to its customers for services, leases, and sales. Its customers had to use Nokia pagers in order to

receive Cape's paging services; however, they were not required to purchase or lease the pagers from Cape.

About 35% of Cape's customers leased pagers from Cape; about 45% purchased pagers from Cape; and about 20% used Nokia pagers they acquired from suppliers other than Cape. Cape did not lease pagers to persons who did not contract for its paging services.

The Department agreed Cape could purchase for resale the pagers it resold, but assessed tax on its purchases of the pagers it "leased." The Department contended Cape was purchasing those pagers to provide paging services, not to lease.

Question: Did Cape owe tax on the pagers it purchased for lease in connection with its paging services?

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NATIONAL ENGINE CORP. VS. STATE

The Law. [1] Sales tax applies to sales of tangible property. Sales tax does not apply to services or sales of intangible property.

[2] Intangible property is a "right" rather than a physical object. An intangible right may be represented by a physical object; the object is considered intangible property for tax purposes.

The Facts. National Engine sold all of the assets of its turbine division. The turbine business involves many trade secrets, patents, know-how, designs, and similar confidential information. National Engine had developed technology that it used to manufacture turbines.

The agreement described the assets as including, among other things, intangibles and intellectual property. "Intellectual Property" included "licenses, invention disclosures, trade secrets, data, drawings, concepts, know-how, copyrights, patents, patent applications . . . ."

The parties allocated the purchase price among various assets. Included in that allocation were: [1] drawings and designs, at $45.3 million, and [2] manuals and procedures, at $2.2 million.

"Drawings and designs" were National Engine's in-house turbine engine technology. They contained confidential information and trade secrets. The 42,000 drawings depicted the process of manufacturing the turbine engines.

The principal component of "manuals and procedures" was engineering specifications. They included manufacturing and equipment specifications, and test requirements. They also depicted many patented components.

The purchaser classified these items as intangibles on its federal income tax returns, and the IRS, after audit, accepted this classification.

Question: Did National Engine owe sales tax on its transfers of either of these items?

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PC WORLD COMPUTERS VS. STATE

The Law. (a) When personal property is both used and resold by a manufacturer, the "primary purpose" test determines whether a transaction is taxable. The courts have consistently looked to the primary intent of the purchaser or the primary purpose of the purchase.

(b) "Use" includes the exercise of any right or power over tangible property incident to the ownership of that property, except that it does not include the sale of that property in the regular course of business.

(c) Tax applies to the sale of tangible property for the purpose of use in manufacturing other tangible property. But tax does not apply to the sale of tangible property for the purpose of incorporating it into the manufactured article to be sold.

The Facts. PC World operated four computer manufacturing plants in the state. The components from the different plants were brought together to form a complete computer system.

As each component was completed, it had to be tested together with other components. As new designs were incorporated into various components, a problem might develop in the way other components interfaced with them. For this reason, each component had to be subjected to "interactive" testing.

PC World utilized what it refers to as "captive components" for interactive testing. There were several important technical reasons for using captives for testing, so captives were used to test components at the plant before installation in the field.

Once the captive itself was tested for compatibility with other PC World components, it could be used to test unknown entities, the newly manufactured components. In practice, most captives rotated between one and two years.

When a captive was rotated it was refurbished, outstanding engineering changes were incorporated, and ultimately PC World sold or leased it at full value.

Question: Did PC World owe use tax on its use of captives, in addition to tax on its sales and leases of the refurbished captives?

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NUCOR CORP. VS. STATE

The Law. Materials that become ingredient or component parts of tangible personal property manufactured or processed for ultimate sale at retail are not subject to use tax, and may be purchased for resale. Materials which only incidentally become incorporated into a finished product, and which are not essential ingredients, are subject to tax when purchased. Materials that are essential ingredients are nontaxable when purchased even if they may be used for more than one purpose during manufacturing.

The Facts. Nucor purchased processing oils (i.e., drawing, turning, and grinding oils) to use in manufacturing steel bars in its cold finishing processes. The oils were applied to protect the steel bars, and to protect the machinery used to process the bars, from damage or defects. The oils also acted as temporary rust inhibitors for several days until a permanent rust inhibitor was applied. Fine films of the oils remained on the finished bars; almost all of the oils were recovered, recycled, and reused in the cold finishing processes.

Questions: [1] Do you advise Nucor to report use tax on its purchases of the processing oils? [2] If so, do you advise Nucor to exclude from tax that portion of the oils remaining on the steel bars?

McDONNELL DOUGLAS CORPORATION VS. CALIFORNIA

The Law. (1) Sales tax applies when the property is delivered in this state to the purchaser or its representative prior to an irrevocable commitment of the property into the process of exportation. It is immaterial that the purchaser's intention is to ship the property to a foreign country, or that the property is actually exported.

(2) Sales tax does not apply when the property is exported. The property must be intended for a foreign destination, it must be irrevocably committed to exportation at the time of sale, and it must actually be delivered to the foreign country.

Export movement does not begin until the property has been started upon a continuous route or journey that constitutes the final and certain movement of the property to its foreign destination.

There is an irrevocable commitment of the property to export when a carrier, forwarding agent, or customs broker ships the property in a continuous route or journey to the foreign country.

The Facts. McDonnell Douglas sold Aeromexico aircraft parts at its Long Beach factory. All orders originated in Mexico, showed Mexico City as the destination, and stated that the parts

were for export to Mexico. Aeromexico received title to the parts free on board (FOB) in Long Beach.

Aeromexico's passenger aircraft could only carry a small percentage of the parts. Mexican law prohibited U.S. common carriers from operating in Mexico, and U.S. law permitted Mexican common carriers to operate in the U.S. only in the immediate border area.

Aeromexico had the parts shipped, already packaged for export, from the McDonnell Douglas plant in Long Beach, on U.S. truck common carriers to the U.S.-Mexican border at San Ysidro. Separate lading bills were prepared at Long Beach and San Ysidro. Aeromexico had no facilities at San Ysidro.

At San Ysidro, Aeromexico employees assisted AM MEX, an independent freight forwarder, in processing the shipments through U.S. and Mexican customs. Aeromexico used AM MEX's facilities and expertise in U.S. and Mexican customs regulations and fees.

AM MEX neither took title to the shipments nor was legally obligated to ship the parts to Mexico City. The shipments were not opened, inspected, or repackaged. After the 48 hours required to complete customs processing, AM MEX loaded the parts onto Mexican common carriers. All the parts arrived in Mexico City.

Question: Did McDonnell Douglas owe sales tax on its sales of parts to Aeromexico?

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COMMUNITY HOSPITAL, INC. VS. STATE

The Law. (1) Tax applies to all retail sales of tangible property including capital assets, held or used by the seller in the course of an activity for which a seller's permit is required.

Tax does not apply to a sale of property held or used in the course of an activity not requiring a seller's permit.

(2) A seller's permit is required of a person engaged in the business of selling tangible property.

(3) A person engaged in an activity requiring a seller's permit may also be engaged in separate activities that do not require a seller's permit. Tax applies to the sale of tangible property held or used in an activity requiring a seller's permit. Tax does not apply to the sale of property held or used by the seller in the non-selling activities that do not require a permit.

The Facts. Community Hospital, a corporation, operated a general hospital in the state. Community Hospital had a seller's permit because its divisions:
[a] operated a food service facility which sold meals to patients and non-patients, such as hospital visitors and employees,
[b] sold miscellaneous personal items from its supply unit, and [c] operated a pharmacy.
The food service facility, supply department and pharmacy all operated at the same location as the hospital.

During the three years prior to the sale of the hospital, retail sales attributable to the three divisions averaged about 10 percent of the hospital's gross receipts. Of these retail sales, the vast majority were pharmacy sales exempt from taxation. Taxable sales amounted to about 2 percent of the hospital's gross receipts.

Community Hospital sold its entire assets, including the real property and the furnishings, machinery and equipment of the hospital. Of the tangible personal property sold, about 7% was allocable to kitchen and dietary equipment.

Question: You are the CPA in the accounting firm handling the sale. Do you report sales tax on all the tangible personal property, or only on the kitchen and dietary equipment?

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BROWN VS. STATE

The Law. If a corporation collects sales taxes, but fails to pay the taxes to the state, then the Department may also assess the taxes against "persons under a duty to pay over the taxes imposed". Such a duty means "an obligation to remit taxes that arises from a person's position, function, or responsibility" with a corporation.

The Facts. Richard Brown was a minority shareholder, treasurer, and director of Hillco, Inc. Brown's accounting firm audited Hillco and filed its income tax returns. Brown also raised capital and performed financial planning for Hillco. He was authorized to sign Hillco checks. He met frequently with the general manager of Hillco, but seldom visited the offices.

The general manager had authority over Hillco's daily operations, prepared the sales tax returns, and signed the checks. At the end of the fourth quarter, the general manager filed a sales tax return but failed to pay the taxes collected.

The Department of Revenue assessed the taxes due against Hillco, the general manager, and Brown.

Question: You are Brown's partner in the accounting firm. Do you advise Brown to contest the assessment?

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VSA CANDY CO. VS. STATE

The Law. The sale of any tangible property in this state by any wholesaler to anyone other than (among others) a nonresident retailer for resale, is a retail sale subject to tax. A "nonresident retailer" means a person who, among other things, does not have a place of business

in this state, and is selling property outside this state. "Sale" means any transfer of title or possession of tangible property for a consideration.

The Facts. VSA Candy Co., an in-state wholesaler, sold its products to an out-of-state retailer, Sweets 4U, which instructed VSA Candy to deliver some of the products to customers of Sweets 4U located in the same state as VSA Candy. Sweets 4U did not have a place of business in the state, and its employees did not travel into the state to negotiate or contract with its customers in the state.

Pursuant to Sweets 4U's directions, VSA Candy drop shipped the products from its warehouse in the state directly to Sweets 4U's customers also in the state. This saved the time and expense of two shipments, one to Sweets 4U and the second to the in-state customers. VSA Candy had no contact with the in-state customers other than to ship the products to them.

It is agreed that if VSA Candy had shipped the products to Sweets 4U out of state, and if Sweets 4U had in turn shipped the products to its customers in the state, VSA Candy would have made a nontaxable sale for resale.

Question: Did VSA Candy owe sales tax on its sales of its products to Sweets 4U, when it shipped the products to the in-state customers?

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USA BOOKS VS. STATE

The Law. Under the Sales Tax Act, a seller is liable for the sales tax, and may collect the tax from a purchaser at the time of sale. A seller is entitled to deduct bad debts from its gross proceeds subject to tax.

Under the Use Tax Act, a consumer is liable for the use tax, and a seller is required to collect the tax from the consumer. There is no deduction for bad debts. If the seller fails to collect the tax, the seller is liable for the amount he failed to collect.

The Facts. USA Books, an out-of-state retailer, sold educational materials (e.g., books and encyclopedias) to customers in this state. It solicited the sales through its employees in this state, but contracted with the customers at its out-of-state headquarters, collected a down payment, and shipped the educational materials from its out-of-state warehouse to the customers in this state.

Later some of USA Books' customers defaulted on their agreements to pay the balance due, despite USA Books' best attempts to collect payment. USA Books originally reported tax on the total amounts of these sales. But after attempting collection, it wrote off the balances due on these transactions as bad debts for sales and use tax purposes, and for income tax purposes.

After an audit, the Department of Revenue has assessed use tax against USA Books on the balances due on these sales.

Question: You are the CPA for USA Books. Do you advise it to contest the assessment or agree with the assessment?

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ASSOCIATED TESTING LABS, INC. VS. STATE

The Law. Sales and purchases of machinery used directly and exclusively in an industrial plant in the actual manufacture, conversion, or processing of tangible personal property to be sold, are exempt from tax. An "industrial plant" means a factory engaged in the manufacture, conversion or processing of tangible personal property to be sold in the regular course of business. Machinery is deemed to be used "directly and exclusively" only where such machinery is used solely during a manufacturing, conversion or processing operation to (among other

things) test or measure such property where such function is an integral part of the production flow or function.

The Facts. Associated Testing Labs operated a testing laboratory. Associated rendered testing services for its customers' products, to ensure that the products met certain specifications. Associated did not own the products tested; rather, the products remained the property of Associated's customers throughout the testing process. Once Associated completed the required tests, it returned the products to the customers. Almost all customers hired Associated to test the products they manufactured prior to their sale to third parties; a few customers hired Associated to test manufactured products they planned to purchase subject to approval. Upon audit, the Department of Revenue has disallowed Associated's claim of exemption for its purchases of testing machinery.

Question: Was Associated entitled to claim as exempt its purchases of the testing machinery?

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GUARDIAN CORP. VS. STATE

The Law. Tangible property purchased for use in this state is subject to the use tax. "Use" means the exercise of right or power over tangible property incident to the ownership of that property. Tangible property is presumed subject to tax if it is brought into the state within 90 days after the date of purchase. A purchaser is entitled to credit against the use tax for any sales or use taxes paid to another state.

The Facts. In late August, in Delaware, Guardian purchased a Gulfstream corporate jet for use in its business. Guardian registered the aircraft with the FAA at the time of purchase. The Delaware Department of Revenue advised Guardian it did not have to register the aircraft in Delaware.

Its first use of the aircraft was a flight from Delaware to Georgia two days after the date of purchase. During September, October, and November, Guardian flew the aircraft on business trips between Georgia, Ohio, and several European cities.

In mid-December, more than 90 days after its purchase, Guardian flew the aircraft to this state for the first time. Thereafter it hangared the aircraft in this state and used it for business flights to and from this state. It has not paid sales or use tax to any other state or tax reimbursement to any retailer for the aircraft.

Question: You are the CPA for Guardian. Do you advise the tax department to report and pay use tax to this state on the purchase price of the aircraft?

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LWD EQUIPMENT, INC. VS. STATE

The Law. Occasional sales are exempt from sales or use tax. "Occasional sale" includes, among other things, any transfer of substantially all the property held or used by a person in the course of a selling or leasing activity when after such transfer the real or ultimate ownership of such property is substantially similar to that which existed before such transfer. For the purposes of this exemption, stockholders holding an interest in a corporation are regarded as having the "real or ultimate ownership" of the property of such corporation.

The Facts. LWD Equipment, Inc.'s stock was 100 percent owned by LWD Holding, Inc. LWD Equipment was solely in the business of leasing equipment. Throughout the audit period, LWD Equipment bought a variety of equipment, from industrial to office, and immediately leased that equipment to a dozen sister corporations, all of which were 100 percent owned by LWD Holding. LWD Equipment neither sold tangible personal property, nor leased its equipment to outside third parties.

Question: You are the tax manager for LWD Equipment. Do you report tax on its leases of equipment?

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BOWLING FOR DOLLARS VS. STATE

The Law. Taxable "use" is defined as "the exercise of a right or power over tangible personal property incident to the ownership of that property including transfer of the property in a transaction where possession is given."

The Facts. Bowling For Dollars (BFD) transfers bowling balls from its retail division's resale inventory to its promotional division and ships them to out-of-state Professional Bowling Association (PBA) tournaments. At the tournament sites, a contractor hired by BFD takes possession of the bowling balls and stores them on shelf space leased by BFD from the PBA. When asked, the contractor takes a ball from BFD's leased storage space, drills it and prepares it for use, and gives it to a BFD-sponsored professional bowler for use in the tournament. Any bowling balls that are not given away are transferred back to BFD's retail division and returned to BFD's in-state resale inventory.

Question: You are the tax manager for BFD. You know you should report use tax on bowling balls given away to BFD-sponsored professional bowlers at in-state tournaments. Should you report use tax on bowling balls given away at the out-of-state tournaments?