OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SONIC LIGHTING, INC.**	OTA Case No. 18011878 Date Issued: March 6, 2019

OPINION

Representing the Parties:

For Appellant:	Irene P. Tse, Attorney
For Respondent:	Kevin C. Hanks, Chief Headquarters Operations Division
For Office of Tax Appeals:	Richard Zellmer, Business Tax Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code section 6561,[1] Sonic Lighting, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA), on a timely petition for reconsideration of a Notice of Successor Liability (NOSL). The NOSL is for $334,889.08 in tax, plus applicable interest, and penalties totaling $66,977.84, representing the unpaid liability of A.N.W. Group, Inc. (ANW) for the period May 1, 2006, through December 31, 2007. The NOSL reflects CDTFA's determination that appellant is liable as a successor for ANW's unpaid tax liability in accordance with section 6812.

Appellant did not respond to our letter dated April 23, 2018, asking appellant to indicate if it wished to have a hearing. Therefore, a hearing in this matter was not held, and the matter is being decided based on the written record.

[1] Unless otherwise indicated, all statutory ("section" or "§") references are to sections of the Revenue and Taxation Code.

ISSUES

1. Whether CDTFA was justified in using the markup method to compute ANW's taxable sales.
2. Whether appellant has established that the unreported taxable sales include exempt sales in interstate commerce.

FACTUAL FINDINGS

1. Appellant concedes that it is ANW's successor for purposes of section 6812. Appellant protests the amount of ANW's unpaid tax liabilities.
2. For the relevant period, ANW operated an auto parts store known as Spyder Auto.
3. CDTFA audited ANW for the period May 1, 2006, through December 31, 2007. Upon audit, ANW provided CDTFA federal income tax returns (FITR's), bank statements, sales journals, purchase invoices, and shipping documents. CDTFA found ANW's records were insufficient to support its reported gross sales based on the following: 1) ANW's gross receipts of $16,286,438 as reported on its FITR's exceeded total sales reported on its sales and use tax returns by $8,250,878; 2) ANW's recorded book markup was negative 7.7 percent for the audit period (meaning that recorded cost of goods sold exceeded recorded sales); 3) ANW's bank deposits exceeded recorded sales for 2007 by over $3,000,000; and 4) ANW did not provide its general ledger, sales tax return worksheets, or a complete set of its sales invoices (which CDTFA found were not sequentially numbered). As a result, CDTFA impeached ANW's records (i.e., found them unreliable), and used the markup method to compute ANW's sales.[2] The audit resulted in unreported taxable sales of $3,708,316 (as explained below, this amount was reduced in a reaudit). The audit also resulted in unreported taxable transportation charges of $164,040.
4. CDTFA issued a Notice of Determination to ANW on January 20, 2011, based on the above audit.
5. On February 25, 2011, ANW filed an untimely petition of the Notice of Determination, which CDTFA accepted as an administrative protest.

[2] The markup method is one of several indirect audit methods that CDTFA utilizes in audits when the books and records have been impeached.

6. In response to ANW's administrative protest, CDTFA performed a reaudit. In the reaudit, CDTFA asked ANW to perform a shelf test, which is an accounting comparison of known costs and associated selling prices, used to compute markups. ANW performed a shelf test, which resulted in a markup of 27.56 percent. CDTFA reviewed ANW's shelf test and accepted it. CDTFA added the markup of 27.56 percent to the audited cost of taxable goods sold[3] to compute audited taxable sales of $1,752,686. CDTFA compared this amount to ANW's reported taxable sales to compute unreported taxable sales of $1,712,248. In the reaudit report, dated May 14, 2013, the measure of tax of $164,040 for unreported taxable transportation charges remained unchanged, but the reaudit reduced the tax to $154,793, and the penalties to $30,958.78.
7. Prior to the issuance of the May 14, 2013 reaudit report, CDTFA determined that appellant is liable for the unpaid liabilities of ANW as a successor, and issued an NOSL to appellant on September 16, 2011, for tax of $334,889.08, penalties of $66,977.84, and accrued interest.
8. Appellant filed a timely petition for reconsideration of the NOSL on October 12, 2011.
9. CDTFA held an appeals conference with appellant, and thereafter prepared a Decision and Recommendation (D&R). In its D&R, CDTFA recommended that the liability be reduced to tax of $154,793 in accordance with the May 14, 2013 reaudit report of ANW, and that the penalties be deleted from appellant's successor liability. The D&R recommended that appellant's petition for reconsideration be otherwise denied.
10. Appellant filed the instant appeal with the Office of Tax Appeals (OTA). In its opening brief, appellant argued that the books and records provided by ANW were adequate for sales tax audit purposes, and thus, CDTFA had no justifiable reason to use an indirect audit method (the markup method) to compute ANW's taxable sales. Appellant also argues that the understatement includes exempt sales in interstate commerce.

[3] CDTFA computed the audited cost of taxable goods sold by using the amounts of costs of goods sold reported on ANW's FITR's, and removing non-inventory costs (such as shipping, tooling, and shrinkage), and costs of inventory related to sales for resale and sales in interstate commerce.

DISCUSSION

Issue 1 – Whether CDTFA's use of the markup method to compute ANW's taxable sales was appropriate.

It is well-settled that CDTFA may examine the books, papers, records, and equipment of any retailer in order to verify the accuracy of any sales tax return (§ 7054), and if CDTFA is not satisfied with the accuracy of the sales and use tax returns filed, it may base its determination of the tax due upon the facts contained in the returns or upon any information that comes within its possession (§ 6481). These statutes clearly contemplate an examination "behind the books," in which CDTFA may examine a taxpayer's original records (such as purchase invoices, sales slips, cash register tapes, and inventory records) even if there are no errors, omissions, or discrepancies in a taxpayer's tax returns or books of account. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 615.)

When a taxpayer challenges a Notice of Determination, CDTFA has the burden to explain the basis for that deficiency. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610 [interpreting section 6481].) Generally, where a taxpayer challenges the additional tax, the government bears the initial burden of establishing a prima facie case that taxes are owed. (*Schuman Aviation Co. Ltd. v. U.S.* (2011) 816 F.Supp.2d 941, 950.) Based on *Riley B's, Inc.* and *Schuman Aviation Co. Ltd.*, we conclude that when a taxpayer challenges a Notice of Determination, CDTFA must establish a prima facie case that taxes are owed by proving the basis for that deficiency and providing evidence sufficient to establish that its determination is reasonable.

Where CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to explain why CDTFA's asserted deficiency is not valid. (*Riley B's, Inc., supra,* at pp. 615-616.) The applicable burden of proof is by a preponderance of the evidence. (Evid. Code, § 115; *Appeal of Estate of Gillespie*, 2018-OTA-052P, June 13, 2018, at p. 4 [citation].) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442 (*Paine*); *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

Here, in the audit of ANW, CDTFA computed a negative book markup for total sales of 7.7 percent. A negative book markup means that cost of goods sold exceeds sales. We would normally expect sales to exceed cost of goods sold. Also, ANW's own retail shelf test resulted in a markup of 27.56 percent, which is evidence that ANW's true markup is much greater than the negative 7.7 percent markup reflected in its records. Thus, we find that, by itself, the book markup of negative 7.7 percent is a strong reason to question the reliability of ANW's books and records.

In addition, we note that ANW's bank deposits exceed its reported total sales by over $3,000,000 for 2007, and the gross receipts reported on ANW's FITR's exceeded total sales reported on the sales and use tax returns by $8,250,878. Furthermore, ANW failed to provide its general ledger, sales tax return worksheets, or a complete record of its sales invoices. Each of the foregoing discrepancies or omissions is a sufficient reason to question the reliability of ANW's reported total sales. Accordingly, we find that CDTFA was justified in impeaching ANW's records and computing ANW's sales using the markup method. CDTFA has established that its determination is reasonable and based on the best-available evidence. Appellant has not shown that CDTFA's determination is erroneous, nor has appellant provided evidence from which a more accurate determination may be made.

Issue 2 – Whether appellant has established that the unreported taxable sales include exempt sales in interstate commerce.

California imposes sales tax on a retailer's retail sales of tangible personal property in this state, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (§ 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (§ 6091.) When a right to an exemption from tax is involved, the taxpayer has the burden of proving this right to the exemption. (*H.J. Heinz Company v. State Board of Equalization* (1962) 209 Cal.App.2d 1, 4.) Any taxpayer seeking exemption from the tax must establish that right using the evidence specified by the authorizing statute or regulation. A mere allegation that sales are exempt is insufficient. (*Paine v. State Board of Equalization* (1982) 137 Cal. 3d 438, 442.)

There are exempted from the computation of the sales tax the gross receipts from the sale of tangible personal property which, pursuant to the contract of sale, is required to be shipped and is shipped to a point outside this state by means of: 1) facilities operated by the retailer; or 2)

delivery by the retailer to a carrier, customs broker, or forwarding agent, whether hired by the purchaser or not, for shipment to such out-of-state point. (§ 6396; Cal. Code Regs., tit. 18, § 1620, subd. (a)(3)(B).) [4] Bills of lading or other documentary evidence of the delivery of the property to a carrier, customs broker, or forwarding agent for shipment outside this state must be retained by the retailer to support deductions for exempt sales in interstate commerce. (Reg. 1620(a)(3)(D).)

In its opening brief, appellant states that only about three percent of ANW's sales were made within California. Thus, appellant believes that most of the unreported taxable sales represent exempt sales in interstate commerce. Appellant has provided no documentation to support exempt sales in interstate commerce.

We note that ANW claimed deductions on its sales and use tax returns for exempt sales in interstate commerce and nontaxable sales for resale. CDTFA's audit method essentially accepted all of ANW's claimed nontaxable sales in interstate commerce and sales for resale.[5] Thus, the issue here is whether an *additional allowance* should be made for exempt sales in interstate commerce that were not claimed on the sales and use tax returns. Appellant has the burden of providing documentation to support exempt sales. Appellant has provided no such documentation. Therefore, we conclude that no adjustment for exempt sales in interstate commerce is warranted.

HOLDINGS

1. CDTFA's use of the markup method was appropriate in this case.
2. Appellant failed to establish that the underreported taxable sales include exempt sales in interstate commerce.

[4] Regulatory references are to Title 18 of the California Code of Regulations, unless otherwise noted.

[5] Cost of goods sold was reduced to account for the cost of claimed sales for resale and sales in interstate commerce, which has the effect of allowing the claimed deductions.

DISPOSITION

CDTFA's action in reducing the successor liability to tax of $154,793, plus applicable interest, and relieving the penalties, but otherwise denying the petition for reconsideration, is sustained.

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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge