

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:  <b>SUSAN MARIE HENDRICKSON</b> <b>dba Berkeley Performance Motorcycle</b>	) OTA Case No. 18063320 ) ) CDTFA Case ID 836376 ) CDTFA Acct. No. SR CH 100-530617 ) ) Date Issued: July 1, 2019
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**OPINION**

Representing the Parties:

For Appellant:	Robert L. Goldstein, Attorney
For Respondent:	Scott Lambert, Business Taxes Specialist III Stephen M Smith, Tax Counsel IV Kevin C. Hanks, Chief, Headquarters Operations Bureau
For Office of Tax Appeals:	Richard Zellmer Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Susan Marie Hendrickson (appellant) appeals an action by respondent, California Department of Tax and Fee Administration (Department)<sup>1</sup> determining \$39,377.35 of additional tax, and applicable interest, for the period January 1, 2009, through December 31, 2011.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Andrew J. Kwee, and Teresa A. Stanley held an oral hearing for this matter in Sacramento, California, on March 26, 2019. At the conclusion of the hearing, the judges closed the record and took the matter under submission.

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<sup>1</sup>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; 2017 Stats. 2017, ch. 16, § 5.) 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.) For ease of reference, we will use the term “Department” herein to refer to both the BOE and respondent. When referring to events that occurred before July 1, 2017, “Department” shall refer to the BOE; and when referring to events that occurred on or after July 1, 2017, “Department” shall refer to respondent.

ISSUE

Is appellant entitled to a reduction of the liability determined by audit (audit liability)?

FACTUAL FINDINGS

1. During the relevant audit period, appellant operated a motorcycle repair shop in Berkeley, California, doing business as Berkeley Performance Motorcycle.<sup>2</sup> In that business, appellant sold parts “over-the-counter” and for use in repairs performed at the shop. Appellant also provided towing and storage services and provided repair estimates to insurance companies and perhaps others. These estimates would typically include prices for parts that would be required to complete a repair, but they would not reflect actual sales of parts.
2. The Department audited appellant for the period January 1, 2009, through December 31, 2011. Initially, the Department noted consistent material discrepancies in recorded versus reported sales. Appellant did not provide a sales journal for the audit period, and the provided invoices appeared to be incomplete. The Department tested two quarters (the second quarter of 2009 (2Q09) and 2Q13<sup>3</sup>) and found that parts purchases far exceeded reported taxable sales of parts during those periods. Based on these findings, the Department concluded that reported taxable sales were understated, and it decided to compute appellant’s sales using the markup method.
3. Because appellant initially did not provide sufficient records to do a reliable shelf test<sup>4</sup> for any period under audit, the Department did its first markup analysis using invoices from 2Q13. The result was a markup of 44.98 percent. Appellant objected to the determined markup, arguing that it was too high and did not reflect her business practices. In response, the Department invited appellant to provide at least 20 sales invoices and the corresponding purchase invoices for each of the three years of the audit period. Appellant selected and provided to the Department 44 sales invoices from 2009 and 45

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<sup>2</sup> Some of the evidence indicates the business may have been known as Berkeley Performance Motorcycle and Truck.

<sup>3</sup> The later tested period is outside of the audit period, but these tests were not used to determine the liability.

<sup>4</sup> A shelf test is an accounting comparison of known costs and associated selling prices used to compute markups.

sales invoices from 2011 for a new shelf test. Appellant also selected 5 sales invoices from 2010, but the Department rejected those 5 sales invoices because none of them included parts sales.

4. The Department compared the selling price from parts sales on the sales invoices to the cost of the parts from corresponding purchase invoices, computing audited markups for all parts sales of 41.55 percent for 2009, 40.14 percent for 2011, and an average markup of 40.91 for both years (which the Department used for 2010). The Department used appellant's purchase invoices to schedule parts purchases for each year in the audit period, and then reduced the purchase amounts by 2 percent each year for shrinkage to compute audited cost of parts sold for each year.<sup>5</sup> It added the audited markups for each year (41.55 percent 2009, 40.91 percent for 2010, and 40.14 percent for 2011) to audited cost of parts sold to compute audited taxable sales of \$563,699. The Department then subtracted reported taxable sales of \$123,297 from audited parts sales of \$563,699 to compute unreported taxable parts sales of \$440,402.
5. Based on the audit, the Department issued a Notice of Determination (NOD) to appellant in the amount of \$39,377.35 tax, plus applicable interest, based on a \$425,177 measure of unreported taxable sales.<sup>6</sup>
6. Appellant filed a timely petition for redetermination of the liability.
7. On January 11, 2018, the Department's Appeals Bureau held an appeals conference with appellant and the Department. At the appeals conference, appellant argued that the audited markup should be 30 percent based on appellant's shelf test of 29 sales invoices, which showed markups ranging from 30 percent to 50 percent. Appellant also argued that the markups computed using her federal income tax returns are lower than the markups computed in the audit.
8. On May 29, 2018, the Department issued its Decision, which denied appellant's petition for redetermination. This timely appeal followed.

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<sup>5</sup> In this context, shrinkage is an allowance for pilferage, theft, or other loss of the part.

<sup>6</sup> The measure of unreported taxable sales was \$440,402, but a second audit item (a tax-paid-purchases-resold deduction) was a credit measure of \$15,225, which reduced the overall measure to \$425,177.

## DISCUSSION

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) It is a taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability under the Sales and Use Tax Law, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).)

The Department may determine a tax deficiency on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) When there is an appeal, the Department has a minimal, initial burden of showing that its determination is reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Michael E. Myers* (2001- SBE- 001) 2001 WL 37126924.) If the Department carries that burden, the burden of proof shifts to the taxpayer to establish that a result differing from the Department's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) California Code of Regulations, title 18, section 30219(c) states that unless there is an exception provided by law, "the burden of proof requires proof by a preponderance of the evidence." Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *Ibid*; see also *Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.)

In this case, we note that appellant purchased parts costing \$113,153 during 2009 but reported taxable sales of only \$15,349 for that year. Similarly, she purchased parts costing \$121,562 during 2010 but reported taxable sales of \$19,330 for that year. For the last year of the audit, 2011, appellant purchased parts costing \$173,531 but reported taxable sales of \$88,618 for that year. According to a comment in the audit work papers, appellant reported to the Department that she generally purchased parts as needed and did not maintain a substantial inventory. Appellant does not dispute the purchases, and she acknowledges that she sells parts for prices that exceed her costs to buy the parts. Given the fact that for each of the three years in question, appellant's reported sales of parts were only a fraction of her cost to purchase them, we

find that it was reasonable for the Department to calculate the deficiency using the markup method.

Appellant disputes the audited markups. Prior to the hearing, she argued that 95 percent of parts were sold in repair jobs (repair parts), and that repair parts have lower markups than parts sold over-the-counter (over-the-counter parts), and the audit does not properly weigh the different markups for repair parts and over-the-counter parts. She now objects to the use of invoices from 2Q13 to calculate the markup. She also argues that the auditor conceded that there were discrepancies in the audit, which resulted from the auditor's inclusion of estimates in her calculations using the 2Q13 invoices, and her treatment of those estimates as sales. Appellant contends that the auditor left the Department shortly after this disclosure, and she argues that there is no evidence that the Department ever reviewed the audit and corrected the auditor's error.

Incomplete records limited the Department's ability to perform its shelf tests. We find that it was reasonable for the Department to perform its initial shelf test using invoices from 2Q13. While that quarter was after the audit period, one would not expect the markup for the parts to decrease. However, appellant objected to the 44.98 percent markup established by that shelf test, and the Department agreed to allow appellant another opportunity to provide parts invoices from the audit period that the Department could use in its shelf test. The Department suggested that appellant provide at least 20 sales invoices for each year with the corresponding purchase invoices. Appellant provided more than twice that number for 2009 and 2011, but none for 2010 that showed parts sales. There is no evidence that these invoices inaccurately stated the retail prices of parts sold by appellant during the audit period. The Department used sound audit methodology to calculate the markup for 2009 and 2011, and its decision to use the average from those years for 2010 was reasonable. We find that the Department established a reasonable and rational basis for this audit that determined the measure at issue here. The burden of proof thus shifted to appellant to establish a more accurate measure.

Appellant provided no evidence to show that most of her sales were repair parts; but more importantly, she did not show that the shelf test overstated unreported taxable sales because it did not correctly account for a high percentage of repair parts. Furthermore, although it is conceivable that the Department's second shelf test using invoices appellant provided for 2009 and 2011 did not account for the correct proportions of parts sold in repair jobs versus parts sold

over-the-counter, the Department's first shelf test used all the parts sales for 2Q13. A test of all the parts sales for an entire three-month period (2Q13) would be representative of the correct proportions of parts sold in repair jobs and parts sold over-the-counter, and that one resulted in a markup of 44.98 percent, several points higher than the audited markups of 41.55 percent for 2009, and 40.14 percent for 2011. Thus, we find that the Department's shelf test for 2Q13 supports the audit results and refutes appellant's argument about repair parts versus over-the-counter parts.

Appellant's arguments at the hearing, which objected to the use of 2Q13 invoices and suggested the audit results were wrong because the auditor included estimates in her analysis, ignore the fact that the audit was not based on the 2Q13 invoices. The Department determined the liability using invoices that appellant pulled from her records for the audit period and provided to the Department. Furthermore, appellant did not provide any evidence to show that estimates contained overstated retail prices for parts.<sup>7</sup>

Based on the evidence, we find that appellant has not established a measure more accurate than that determined by the Department. Therefore, we conclude that no adjustment to the audited markup is warranted.

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<sup>7</sup> Understated retail prices would result in a lower markup, to appellant's benefit.

HOLDING

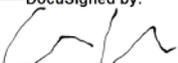
Appellant is not entitled to a reduction of the audit liability.

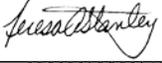
DISPOSITION

The Department's action denying appellant's petition for redetermination is sustained.

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Michael F. Geary  
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