OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18083556
	) CDTFA Account No. 100-384723
MATRIX CAB PARTS, INC.	) CDTFA Case ID 595388
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Patrick E. McGinnis, Attorney

For Respondent: Jarrett Noble, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Matrix Cab Parts, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration denying appellant's timely petition for redetermination of a Notice of Determination (NOD), which assessed a tax liability of $74,886.99, plus applicable interest, for the period January 1, 2008, through December 31, 2010 (liability period).

Because appellant waived its right to an oral hearing, we decide the matter on the basis of the written record.

ISSUE

Are further adjustments to the measure of disallowed claimed nontaxable labor charges warranted?[1]

[1] Respondent designated the audit item at issue "Disallowed fabrication labor claimed as sales for resale based on [year] 2009 block sampling."

FACTUAL FINDINGS

1. Appellant, a California corporation, is a cabinet manufacturer, wholesaler, and retailer.
2. At all relevant times, appellant held a valid California seller's permit issued by respondent effective May 1, 2004.
3. Appellant manufactures and sells cabinets and cabinet components, primarily for residential use, and does finish work and millwork (e.g., cutting, edge banding, Computer Numerical Control (CNC) machining) on cabinets and cabinet components provided by appellant or its customers.[2]
4. For the liability period, appellant reported gross sales of $1,922,591 and claimed a deduction for sales for resale totaling $1,223,885, or 63.66 percent (rounded) of gross sales.
5. Appellant added sales tax reimbursement to the price of tangible personal property (TPP) it sold at retail. It did not add sales tax reimbursement to its labor charges.
6. Respondent reasonably concluded, based on appellant's statements and records, that appellant did not operate as a construction contractor, as defined by California Code of Regulations, title 18, (Regulation) section 1521, in connection with any of the transactions at issue because appellant did not enter into construction contracts to furnish and install cabinets or other TPP onto real property.[3]
7. Appellant did not use written contracts. Its sales invoices separately state sales of TPP and labor charges, along with descriptions of the property sold and the work performed. The original invoices included descriptions of labor performed during the audit period. Common descriptions were "cutting service 1 guy on beam saw per hr. on customers [sic] material goods," "edge banding service on customers [sic] material goods," and "CNC machining service on customers [sic] material goods."

[2] A typical milling job for appellant during the liability period involved resizing a cabinet or component that had been made to order originally by appellant or someone else, but the cabinet or component required modification to meet the customer's needs. In some cases, the cabinet or component had already been at least partially installed, which required that it be uninstalled to allow appellant to do the work.

[3] A "construction contract" means a contract to erect, construct, alter, or repair any building or other structure or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(I).) A "construction contractor" is any person who, for itself, in conjunction with, or by or through others, agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).)

8. Respondent audited appellant, which provided sales and use tax returns and supporting schedules, sales invoices, purchase invoices, resale certificates, its federal income tax return for 2008, and a fixed assets depreciation schedule. Respondent considers the records adequate for sales and use tax purposes.

9. According to the audit work papers, the parties agreed that appellant's claimed sales for resale would be examined on the basis of a block sample of 2009. Respondent scheduled all (478) sales invoices for 2009 and verified that total sales recorded reconciled with total sales reported.

10. Appellant recorded $576,671 in total sales (net of tax) for 2009. Respondent accepted all claimed sales for resale (including labor charges) that were supported by valid resale certificates. It disallowed the remaining claimed resale transactions but offered appellant an opportunity to send XYZ letters[4] to its customers. Appellant eventually did so, but approximately one month later, appellant reported a poor response from its customers and suggested that the audit be finalized. Appellant did not then provide any additional information to establish that it was entitled to additional adjustments to the measure of disallowed claimed sales for resale.[5]

11. Respondent reasonably concluded that appellant's sales to customers for whom no valid resale certificate was on file were retail sales and that the labor charges were for fabrication and, therefore, subject to tax. These labor charges then totaled $255,602.

12. Respondent used the determined disallowed labor charges for 2009 to establish a 44.3237 percentage of error (255,602 ÷ 576,671 = 44.3237), which it applied to the total recorded sales (less tax) of $1,901,220 for the liability period, to calculate a measure of disallowed claimed nontaxable labor of $842,693 for the liability period.

13. Respondent issued an audit report dated July 27, 2011, with a total deficiency measure of $843,749 consisting of two audit items: (1) $842,693 for disallowed fabrication labor

[4] An XYZ letter is a letter, in a form approved by respondent, which a seller who has not timely obtained a resale certificate may send to a purchaser to inquire about the disposition of the property purchased from the seller. A purchaser's response to an XYZ letter may establish that the purchase was for resale. (Cal. Code Regs., tit. 18, § 1668(f).)

[5] Generally, this would require proof that those customers resold the property without any intervening taxable use, continued to hold the property for resale without any intervening taxable use, or consumed the property and reported or paid tax to respondent. (Cal. Code Regs., tit. 18, § 1668(e).)

claimed as nontaxable sales for resale based on a block test of 2009; and (2) $1,056 for the difference between recorded and reported taxable sales.

14. On October 21, 2011, respondent issued an NOD to appellant for $74,886.99 in tax, plus applicable interest, for the liability period.

15. On November 8, 2011, appellant filed a timely petition for redetermination contesting audit item 1 of the NOD only.

16. The parties participated in an appeals conference at which appellant confirmed that it concedes audit item 2 and disputes audit item 1 only.

17. On December 18, 2013, in the course of post-conference discussions between the parties, appellant contended that some invoices for the 2009 test period were scheduled with alleged errors.

18. Respondent re-examined appellant's invoices and made adjustments totaling $40,667 for 16 invoices in the 2009 test period that it found were scheduled with inputting errors. The $40,667 adjustment resulted in a reduction in taxable fabrication labor charges during the 2009 test period from $255,602 to $214,935 and a corresponding reduction to the percentage of error to 37.2717 percent. Respondent applied the 37 percent error rate to appellant's total recorded sales (less tax) during the audit period of $1,901,220 to establish a revised measure of tax of $708,620. In addition, respondent agreed to allow an additional 10 percent of the $708,620 measure as nontaxable repair labor to repair used cabinets, which results in an additional adjustment of $70,862 (i.e., $708,620 x 10 percent) for a total revised measure of $637,758 (i.e., $708,620 - $70,862).

19. In its July 16, 2014 Decision and Recommendation (D&R), respondent recommended that the measure of audit item 1 be reduced from $842,693 to $637,758 and that the petition for reconsideration otherwise be denied.

20. In a February 25, 2016 Supplemental D&R, respondent confirmed its recommendation but clarified its position that, given the fact that there was no dispute that the subject transactions were all retail transactions, the dispositive finding was that the claimed nontaxable labor was taxable fabrication labor.[6] This appeal followed.

[6] Additionally, in a letter to appellant dated September 7, 2018, respondent indicated that it had determined that appellant was entitled to relief of interest accrued during the period July 1, 2016, through July 31, 2018.

DISCUSSION

California imposes sales tax on a retailer's retail sales in this state of TPP, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) A "sale" includes producing, fabricating, or processing TPP for a consideration for consumers who furnish the materials used. (R&TC, § 6006(b); Cal. Code Regs., tit. 18, § 1526(a).) Thus, charges for fabricating TPP for a consumer are subject to sales tax unless specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) Fabrication includes any operation that results in the creation or production of TPP, or which is a step in a process or a series of operations resulting in the creation or production of TPP. (Cal. Code Regs., tit. 18, § 1526(b); see also Cal. Code Regs., tit. 18, § 1524(a).) Fabrication does not include operations which constitute merely the repair or reconditioning of TPP to refit it for the use for which it was originally produced. (Cal. Code Regs., tit. 18, § 1526(b).) The retailer bears the burden of establishing its entitlement to any claimed deduction or exemption. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 443.)

All of a retailer's gross receipts are presumed subject to tax until the contrary is established, and the burden of proving to the contrary is on the retailer. (R&TC, § 6091.) "Gross receipts" means the total amount of the sale price of a retailer's retail sales of TPP, including the cost of labor or services, as well as any services that are a part of the sale. (R&TC, § 6012(a)(2), (b)(1).) Charges for labor or services used in installing or applying the property sold are excluded from the measure of tax, but such labor and services do not include the fabrication of property in place. (R&TC, § 6012(c)(3); Cal. Code Regs., tit. 18, § 1546(a).)

A "construction contractor" is any person who, for itself, in conjunction with, or by or through others, agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) A construction contract means a contract to erect, construct, alter, or repair any building or other structure or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1).) In general, construction contractors are consumers of the materials they furnish and install when they perform construction contracts, and either sales tax or use tax applies to the sale of materials to, or the use of materials by, the construction contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1.) "Materials" includes construction materials and components, lumber, millwork and builder's hardware. (Cal. Code Regs., tit. 18, § 1521(a)(4);

Cal. Code Regs., tit. 18, § 1521, Appendix A.) On the other hand, construction contractors are retailers of the fixtures they furnish and install in the performance of construction contracts and tax applies to their sales of fixtures. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)1.) Prefabricated cabinets are fixtures.[7] (Cal. Code Regs., tit. 18, § 1521(a)(5); Cal. Code Regs., tit. 18, § 1521, Appendix B.)

When respondent 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. (R&TC, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, 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(b)(1).)

When a taxpayer challenges an NOD, respondent has a minimal, initial burden of showing that its determination is reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) If respondent carries that burden, the burden of proof shifts to the taxpayer to show that a result differing from respondent's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit.18, § 30219(c).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) To satisfy the burden of proof, a taxpayer must prove (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; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

We have reviewed the audit, described in findings of fact 9 through 12, above. Based on the evidence, we find that respondent has established a reasonable and rational basis for the audit

[7] Cabinets are considered "prefabricated" and a "fixture" when 90 percent of the total direct cost of labor and material in fabricating and installing the cabinet is incurred before the contractor affixes the cabinet to the realty. (Cal. Code Regs., tit. 18, § 1521(c)(2).)

findings upon which the liability is based. Consequently, appellant has the burden of proving a more accurate measure of tax.

Appellant has made several factual assertions and various arguments during this appeal. According to the audit work papers, appellant initially stated that it was not aware that fabrication labor was subject to tax, and that, due to the economic downturn of the last recession, it could not afford to pay the determined tax. More recently, appellant contends that the 2009 test period previously agreed upon by the parties is not fairly representative because it was during the worst of the recession. It also asserts that most of the questioned transactions involved its installation and/or repair of cabinets or cabinet components manufactured by others, which is not subject to tax;[8] and to support this position, appellant submitted invoices, which it altered to reflect what it contends is a more accurate description of the labor involved, and what appellant characterizes as work description verifications wherein appellant describes the work stated in the altered invoices. In addition, appellant argues that respondent erred in its inclusion of 15 invoices, allegedly totaling $41,586, in the calculation of the error rate.

Appellant further argues that Regulation sections 1526 and 1546 do not adequately define "repair," and are therefore unworkable, making it impossible for taxpayers to accurately report taxable sales. It also asserts that the regulations are ambiguous and must therefore be construed against respondent, and that they are unconstitutionally vague, which results in a denial of due process.

Finally, appellant argues that respondent has not given adequate consideration to the "testimony" of its president. Appellant requests that we "define "fabrication labor" so that [the parties] can do a re-review of the records and apply the correct standard."[9]

Appellant's assertions that it did not know fabrication labor charges were subject to tax and that it has insufficient funds to pay the liability do not raise viable issues. Ignorance of the law is not an excuse for noncompliance (*Appeal of LaVonne A. Hodgson*, 02-SBE-001) and our

[8] At times, appellant has alleged that most of the transactions at issue were repair labor, while at other times it has alleged they were installation labor.

[9] We have no testimony before us because appellant waived its right to an oral hearing and did not submit declarations under penalty of perjury for our consideration. In addition, OTA's role is to determine the correct liability. We do not issue opinions to define terms, and we will not discuss this particular assertion or request further herein.

role is to determine the correct liability. Ability to pay is something for the agency's consideration, not ours.

The parties agreed to base the determination on a 2009 block sample, and appellant has failed to explain how that sample is not representative for testing sales for resale. Even if appellant's business suffered in the recession, we have no evidence to even suggest that the type of work or the percentage of sales for resale changed during the liability period. We find that this argument lacks substance, and on that basis, we reject it.

Regarding appellant's contention that some, if not most, of the labor was for installation and/or repair, we first note that the audit work papers indicate that appellant stated early in the audit process that it manufactured and sold cabinets and cabinet components but did no installation. Furthermore, we have no argument or evidence that appellant was a construction contractor licensed to install cabinets or cabinet components. The original invoices that were provided to customers as evidence of the work performed and payment made do not refer to installation or repair.[10] We also note that the names of appellant's customers, as shown on the invoices, indicate that almost all of the disputed transactions are sales to people in the building trades, including cabinet companies, and construction contractors, and appellant offered no argument or evidence to explain why the customers required appellant's services to install cabinets. Moreover, the "new" invoices, and appellant's descriptions of the work, simply reflect alterations to support appellant's arguments. We found only a single altered invoice and description that could arguably be entitled to reconsideration, but because we find that the 10-percent adjustment allowed by respondent is more than adequate to cover any installations or repairs actually performed, we conclude that no further adjustment for installation or repair is warranted.

Regarding appellant's arguments about the 15 invoices (including claimed errors totaling $41,586), most of those sales are no longer at issue because respondent previously conceded they were mistakenly included in the calculation of the error rate. According to the audit work papers (reaudit) and other evidence, the Department allowed adjustments to 14 of those invoices. While respondent also identified additional taxable invoice entries in the process, it ultimately agreed to allow a net of $40,667, which reduced the error rate from 44.3237 percent to 37.2717 percent.

[10] As previously stated, the original invoices indicate that appellant sold cabinet components and parts, and performed labor such as CNC machining, edge banding, boring holes, and cutting on cabinet components and parts that were either furnished by appellant's customers or purchased from appellant.

Respondent's analysis and calculation are detailed in the evidence and we find its allowances generous, particularly given the fact that respondent: neglected to delete a $974 credit (corresponding to an allowed invoice); failed to include an additional $2,000 taxable item discovered during the reaudit; and allowed multiple and substantial adjustments in appellant's favor without requiring verification from the customer. Appellant has not acknowledged or addressed respondent's analysis. We find no additional adjustments for these invoices are required.

Regarding appellant's challenges to respondent's regulations, we observe that they are generally made without citation to legal authority and in some respects run directly contrary to established authority. The fact that appellant's reporting was not in compliance with the law is not evidence of a problem with the law. We have examined the applicable regulations in connection with this appeal and many others, and we find appellant's argument that Regulations 1521, 1526, and 1546 are ambiguous, and that they must be construed against respondent, entirely unpersuasive.[11] If a taxpayer is unsure about how to report, it can ask respondent for guidance. We have no evidence that appellant requested such guidance. To the extent appellant asserts that any regulation is unconstitutionally vague, we note that OTA is an administrative agency, and we are precluded by the Constitution of the State of California from declaring a statute unenforceable or refusing to enforce the clear and unambiguous provisions of a statute, unless an appellate court has determined that the statute is unconstitutional. (Cal. Const., Art. III, § 3.5.)

[11] If there is an ambiguity in a regulation, the rules of statutory/regulatory construction, including the rule of deference to the agency's interpretation, would apply. (See *Kisor v. Wilkie* (2019) 139 S.Ct. 2400; *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1.) Appellant has not correctly identified even one of those rules.

HOLDING

Further adjustments to the measure of disallowed claimed nontaxable labor charges are not warranted.

DISPOSITION

Respondent's action reducing the measure of audit item 1 from $842,693 to $637,758 but otherwise denying the remainder of the petition is sustained.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

Date issued: 6/4/2020