OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18053172
	) CDTFA Account No. 101-207349
SULLY GREEN, INC.,	) CDTFA Case ID 673751
dba Sullivan's Shutters	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Russell L. Davis, Esq. Kevin Cahill, C.P.A. N. Sullivan, Owner
For Respondent:	Chad Bacchus, Tax Counsel III Scott Claremon, Tax Counsel IV Jason Parker, Chief, Hdqrs. Ops. Div.

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, appellant Sully Green, Inc. appeals a decision issued by respondent California Department of Tax and Fee Administration[1] denying, in part, appellant's petition for redetermination of a Notice of Determination (NOD), for a tax liability of $71,221.65, plus interest, and a 10-percent negligence penalty of $7,122.16 for the period January 16, 2009, through December 31, 2011 (liability period). The NOD was based on an August 3, 2012 report of an audit that established an $829,490 deficiency measure that consisted of unreported taxable sales measured by $1,514,448 and an allowable deduction for tax-paid purchases resold (TPPR) measured by $684,958. Since issuance of the NOD, respondent has agreed to delete the negligence penalty and reduce the measure of unreported taxable sales to $1,288,864, with a corresponding deduction for TPPR to $515,653.

Office of Tax Appeals Administrative Law Judges Richard Tay, Andrew J. Kwee, and Michael F. Geary held an oral hearing in this matter in Cerritos, California, on January 24, 2020.

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of the BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "respondent" shall refer to the BOE.

After completion of post-hearing briefing, we closed the record on April 3, 2020, and took the matter under submission for decision.

ISSUES[2]

1. Is appellant entitled to a further reduction in the measure of unreported taxable sales?
2. Is appellant entitled to an increase in the allowable deduction for TPPR?
3. Should R&TC section 6596 be applied to relieve any of the liability?

FACTUAL FINDINGS

1. At all times relevant, appellant, a corporation, has been in the business of manufacturing, selling, and installing wood shutters and louvered doors. During the liability period, appellant purchased its materials tax paid or paid use tax on its consumption of materials, and it billed its customers on a lump-sum basis.
2. Most of appellant's sales are direct to the consumer, typically homeowners. However, appellant also sells shutters without installation to contractors and builders.[3]
3. Before incorporating appellant, two of its owners, B. Sullivan and his son, N. Sullivan, had been owners of another company that manufactured, sold, and installed wood shutters. That company was The Sullivan Group, a corporation that was at some point owned equally by B. Sullivan and his former wife, P. Sulivan, and later by them, each owing 45 percent, and by N. Sullivan, who owned 15-percent.
4. During the years immediately preceding the liability period, The Sullivan Group did not consider itself a retailer of tangible personal property (TPP), and it did not report or pay sales tax. Rather, it considered itself to be the consumer of all materials used in the manufacture and installation of its products, and it reported and paid use tax with its sales

[2] Appellant argued in its brief that Regulation 1521 is unconstitutionally vague, but it did not so argue at the hearing. As a precaution, we address what appears to be an abandoned issue here. To the extent there is any ambiguity in California Code of Regulations, title 18, section (Regulation) 1521 regarding what is or is not a material or fixture, respondent's interpretation would generally be entitled to deference unless it is clearly erroneous or inconsistent with the regulation. (*Bowles v. Seminole Rock & Sand Co.* (1945) 325 U.S. 410, 414; *Auer v. Robbins* (1997) 519 U.S. 452, 461.) However, we do not conclude Regulation 1521 is vague. Furthermore, the Office of Tax Appeals is not a court. (Gov. Code, § 15672.) It 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; see also *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1.)

[3] In its brief, appellant states it sells its products (without installation) to builders of primarily new homes "on an isolated basis."

and use tax return measured by its cost of materials purchased without payment of tax to the vendor. Respondent audited The Sullivan Group during this time, and it accepted The Sullivan Group's reporting method.

5. In late 2004, after respondent's prior audits of The Sullivan Group, P. Sullivan acquired 100 percent of The Sullivan Group as a result of a property settlement in a marital dissolution action between her and B. Sullivan.[4] During that period of ownership, respondent informed P. Sullivan on January 22, 2008, that The Sullivan Group had been reporting its sales and use tax incorrectly, and that its shutters, or at least a substantial component of the shutters, were fixtures, the sale of which was subject to tax.[5]

6. Sometime later, The Sullivan Group filed for bankruptcy protection. Appellant (or a group of investors who eventually incorporated appellant) purchased the assets of The Sullivan Group in the bankruptcy proceeding.

7. Appellant incorporated in 2008 or 2009 and has held a seller's permit since January 16, 2009. The initial shareholders were B. Sullivan, now deceased, who held 70 percent of the shares, N. Sullivan, who held 15 percent of the shares, and three unnamed individuals, who held 5 percent each. With the exception of P. Sullivan, all former employees of The Sullivan Group became employees of appellant.

8. Appellant reported and paid taxes as The Sullivan Group had done when B. Sullivan and his former wife operated that company. For the liability period, appellant reported gross sales of $3,288,269, claimed deductions of $3,288,269 and reported taxable purchases of materials costing $592,505.

9. In its audit of appellant, respondent concluded that the lumber, nails, screws, caulking, and related items that were used to manufacture and attach the shutter frames to the real property were materials and that appellant was the consumer of the materials. Because appellant purchased these items tax-paid or reported use tax on its use of these items, respondent determined that no additional tax was due in connection with appellant's consumption of these materials.

---

[4] It is undisputed that P. Sullivan acquired 100 percent of The Sullivan Group in the marital dissolution action.

[5] Respondent submitted a copy of its January 22, 2008 letter as Exhibit B to its post-hearing brief. Appellant objected to admission of the letter on the grounds that it lacked adequate foundation and was irrelevant. That objection, noted here for the record, is overruled.

10. Respondent, which has long considered wood shutters to be fixtures (see, e.g., Sales and Use Tax Annotations 190.0829 and 190.1790[6]) also concluded that the shutter panels, consisting of the stiles (vertical solid wood), rails (horizontal solid wood) and louvers, were fixtures that appellant sold at retail. Because appellant reported and paid no sales tax, respondent concluded that appellant owed sales tax measured by its cost of producing the panels plus a reasonable profit.

11. To determine the correct measure of tax, respondent performed a segregation test of appellant's sales for the third quarter of 2009, during which appellant made total sales of $297,466: $75,177 for doors and repairs, and the remaining $222,289 for shutters. It thus calculated that 74.73 percent of sales were shutter sales (222,289 ÷ 297,466 = .74727). Respondent then applied that percentage to total reported sales for the liability period ($3,288,269) on a quarterly basis to establish total shutter sales (including installation) of $2,457,321. Next, respondent used a job cost sheet[7] appellant provided to calculate a percentage of nontaxable costs (i.e., the percentage of costs attributable to installation and frames).[8] Based on the amounts listed on appellant's job cost sheet (which, as discussed more below, included installation costs of $4.25 per square foot (psf)), respondent calculated a nontaxable percentage of shutter sales of 38.37 percent (i.e., the percentage of costs attributable to the manufacture of frames and to installation),[9] which respondent applied to total shutter sales of $2,457,321 to calculate nontaxable shutter costs of $942,873.[10] Respondent removed this amount from total shutter sales to establish a deficiency measure of $1,514,448.

---

[6] In the sales and use tax context, an annotation is a legal opinion issued by respondent to provide guidance. They are collected and available for review in the Business Taxes Law Guide and may be cited to show how respondent interprets and applies the law. (<https://www.cdtfa.ca.gov/lawguides/#BTLG>.) Annotations do not have the force and effect of law.

[7] The job cost sheet stated the various costs for the job per square foot of shutter.

[8] At times, respondent's decisions refer to this percentage as the percentage of installation costs; however, it is the percentage of installation costs and frame costs.

[9] At times, respondent's decisions mistakenly state that this percentage was 38.26 percent.

[10] When determining whether a transaction is exempt or excluded from sales tax, reference is typically made to nontaxable sales; however, when a construction contractor is the manufacturer of fixtures, the sales price is determined based on a calculation of the cost price. Thus, we refer to nontaxable costs because these costs are used to determine the amount of nontaxable sales.

12. To calculate the deduction for TPPR, respondent first removed reported purchases subject to use tax of $592,505 from total recorded purchases of $1,320,878, leaving purchases of $728,373, including tax. Respondent then deducted included sales tax reimbursement to calculate tax-paid purchases of $671,736, net of tax, and added that amount to reported purchases subject to use tax of $592,505 to establish total recorded tax-paid purchases of $1,264,241, net of tax. Respondent applied the shutter sales percentage of 74.73 to this figure to calculate the cost of tax-paid purchases used for shutters of $944,768. Using the figures on appellant's job cost sheet, respondent determined that 72.50 percent of the material costs for appellant's shutters (i.e., wood, nails, screws, caulking, and related items) are attributable to materials used to construct the shutter panels, and respondent applied this percentage to the cost of tax-paid shutter purchases of $944,768, to calculate tax-paid purchases of panels (i.e., a tax paid purchases resold deduction) of $684,958.[11]
13. On October 11, 2012, respondent issued a timely NOD to appellant for the liability period. The NOD, based on the audit report, assessed a tax liability of $71,221.65, plus interest, and imposed a 10-percent negligence penalty of $7,122.16.
14. Appellant filed a timely petition for redetermination. The parties participated in an appeals conference on March 2, 2016, and on July 11, 2016, respondent issued a decision recommending that the negligence penalty be deleted, but otherwise denying the petition for redetermination.
15. Appellant requested reconsideration, arguing that the percentage of costs attributable to frames and installation should be 52.98 percent, not 38.37 percent. In support of its request, appellant provided its analysis of labor allocation (labor analysis) for one week outside of the audit period,[12] and respondent's analysis of material costs (board foot study), which was based on job cut sheets appellant provided for five jobs. Respondent agreed to a consider the new information in a reaudit.
16. Based on the new information, respondent determined that 88.64 percent of appellant's total payroll was attributable to production and installation labor, and it applied this percentage to appellant's total recorded payroll of $753,827 to establish production and

[11] Nominal differences are due to rounding.

[12] The analysis identifies the weekly payroll rates in 2015 for its employees and the type of work (e.g., frame production, general production, non-production) each employee performed.

installation labor of $668,192. Respondent then applied the shutter sales percentage of 74.73 percent to this amount to establish labor of $499,349 attributable to shutter production and installation. Respondent divided this amount by the total square footage of shutters sold of (59,800 according to appellant) to calculate a shutter labor cost $8.35 psf, $3.46 being attributable to frame production labor, $4.17 being attributable panel production labor, and $0.73 being attributable to installation labor.[13]

17. Based on the board foot study, respondent determined that 64.74 percent of appellant's material costs are attributable to panels and 35.26 percent of appellant's material costs are attributable to frames. Respondent applied these percentages to the $10.24 cost psf of materials used for shutters (as identified by appellant), to establish a $6.63 psf cost for panel materials and a $3.61 psf cost for frame materials. Respondent combined frame material costs psf of $3.61 with frame production labor costs psf of $3.46 and installation costs psf of $0.73 to establish nontaxable costs of $7.80 psf, which represents a nontaxable percentage of 41.96 percent when compared to total material and labor costs of $18.59 (i.e., $10.24 + $8.35). Respondent applied this nontaxable percentage of costs to the total shutter sales of $2,457,321 to calculate nontaxable shutter costs of $1,031,093. Respondent removed this amount from total shutter sales to establish unreported taxable panel sales of $1,426,228.

18. Because respondent reduced the percentage of taxable material costs, it applied the new taxable percentage of 64.74 percent to the $944,768 cost of tax-paid purchases to calculate an adjusted deduction for TPPR of $611,643.

19. Appellant disagreed with the reaudit. It argued that respondent manipulated the data to maximize the tax.[14] It agreed with respondent's calculation of the total production costs (frames and shutters) of $10.24 psf, but it disagreed with respondent's allocations of those costs to frames and panels and argued that respondent failed to reconcile the audit results with appellant's financial statements and tax returns.

[13] The labor study identified total production and installation labor costs of $14,057.42 and installation labor costs of $1,223. Based on these figures, respondent determined that installation labor constitutes 8.70 percent of total labor costs ($1,223 ÷ $14,057.42). Respondent applied this percentage to total labor costs per square feet of $8.35 to establish installation labor costs per square feet of $0.73.

[14] Appellant stated that the auditor "cherry-picked the jobs" and used only those that supported respondent's position.

20. Respondent agreed to a second reaudit. It abandoned its conclusions based on the analysis of the material cost data provided by appellant (discussed above) and the parties agreed that the correct allocation of material cost psf is $4.65 for frames and $5.59 for panels. Respondent combined frame material costs psf of $4.65 with frame construction labor costs psf of $3.46 and installation costs psf of $0.73 to establish nontaxable costs of $8.84 psf, which represents a nontaxable percentage of 47.55 percent when compared to total material and labor costs of $18.59.[15] Respondent applied this nontaxable percentage of costs to the total shutter sales of $2,457,321 to calculate nontaxable shutter costs of $1,168,457. Respondent removed this amount from total shutter sales to establish unreported taxable panel sales of $1,288,864.
21. For tax-paid purchases resold, based on appellant's figures, respondent determined that 54.58 percent of appellant's material costs are attributable to panel materials costs. Respondent applied this percentage to the cost of tax-paid purchases used for shutters of $944,768, to calculate tax-paid purchases resold of $515,653.
22. By letter dated April 28, 2017, appellant stated that it disagreed with the second reaudit.
23. On March 19, 2018 respondent issued a supplemental decision reducing the deficiency as recommended in the second reaudit and otherwise denying appellant's petition for redetermination. This timely appeal followed.

DISCUSSION

Issue 1 - Is appellant entitled to a further reduction in the measure of unreported taxable sales?

Fixtures or Materials

California Code of Regulations, title 18, section (Regulation) 1521, subsection (a)(2), provides that 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. A "construction contract" is 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).)

[15] It appears that respondent continued to use the same labor allocation it used in the first reaudit. According to an April 27, 2017 internal memorandum, respondent argued then that using the different labor allocation proposed by appellant would have resulted in an increase in the taxable measure.

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, and other tangible personal property incorporated into, attached to, or affixed to real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property." (Cal. Code Regs., tit. 18, § 1521(a)(4).) A list of examples includes conduit, doors, ducts, roofing, and windows. (Cal. Code Regs., tit. 18, § 1521, Appendix A.)

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.) "Fixtures" are "accessory to a building or other structure and do not lose their identity as accessories when installed." (Cal. Code Regs., tit. 18, § 1521(a)(5).) A list of examples includes air conditioning units, counters, elevators, lighting and plumbing fixtures, and Venetian blinds. (Cal. Code Regs., tit. 18, § 1521, Appendix B.) To determine whether an item is a fixture, we look to the nature of the property in the hands of the seller. (*Gen. Elec. Co. v. State Bd. of Equalization* (1952) 111 Cal.App.2d 180, 185; *Richard Boyd Industries, Inc. v. State Bd. of Equalization* (2001) 89 Cal.App.4th 706, 714.) Integration of the TPP into or onto the realty is not determinative. (See, for example, *Coast Elevator Co. v. State Bd. of Equalization* (1975) 44 Cal.App.3d 576 (disapproved on other grounds *in Culligan Water Conditioning v. State Bd. of Equalizatio*n (1976) 17 Cal.3d 86 [rejecting an argument that certain parts of an elevator system are materials by virtue of their integration into the building].)

While a cabinet is among the items identified as a fixture in Regulation 1521, Appendix B, it is more accurately an example of TPP that might be materials, fixtures, or a combination, depending on the circumstances. Prefabricated cabinets are fixtures, regardless of their integration into the building. (Cal. Code Regs., tit. 18, § 1521(c)(2) and Appendix B.) A cabinet is considered prefabricated when 90 percent of the total direct cost of labor and material used to fabricate and install the cabinet is incurred before the contractor affixes the cabinet to the realty. (Cal. Code Regs., tit. 18, § 1521(c)(2).) To determine whether the 90-percent threshold has been met, the total direct cost of all labor and materials in producing each cabinet to the point of

installation is compared to the total direct cost of all labor and materials required to produce and install that cabinet. (*Ibid*.)

The main thrust of appellant's argument is that its shutter panels are materials because they and the frames are an indivisible component of a single item, a shutter, which appellant manufactures from raw materials and permanently affixes to buildings. Appellant asserts that removal of the shutters will leave damage that would likely require the services of several tradespersons to repair. It also contends that its shutters function more like doors, which are materials according to Regulation 1521, Appendix A, than Venetian blinds, which are fixtures, according to Regulation 1521, Appendix B.[16] Appellant contends that while its shutters do control light and to some extent heat in a manner similar to a Venetian blind, its shutters also provide an additional level of insulation and some level of security that Venetian blinds do not provide. It also argues that its sales are distinguishable from sales by others who do not manufacture shutters from raw materials, and that respondent's analyses in annotations and other appeals involving sellers who were not also manufacturers are inapplicable here.

N. Sullivan testified that each set of shutters is designed and manufactured by appellant to fit a specific window or French door.[17] He explained that appellant takes raw lumber, which it cuts, planes, shapes, sands, paints (or stains), and assembles into two primary components: panels, consisting of stiles, rails, and louvers; and frames, which is the component that appellant attaches to the building structure in some applications. Mr. Sullivan stated that after the frame, with hinge pieces, is attached to the structure, the panel, with matching hinge pieces, is attached to the frame using hinge pins. In some applications, particularly on older homes, a frame may not be used at all. Instead, appellant attached the hinge directly to the window frame. However, in all applications, including French doors, the panels swing on hinges to allow access to the window (or French door).[18]

We find that the shutter panels fit within the regulatory definition of fixtures. They are "accessory to a building or other structure and do not lose their identity as accessories when

[16] Respondent allowed the frames as materials. We are only concerned here with the panels.

[17] Louvered doors that are designed to fit particular openings and function as the only door for that opening are not at issue here because respondent allowed those as materials.

[18] Respondent stated at the hearing that panels installed on French doors were included in the taxable measure. Appellant's accountant testified otherwise. We need not address that dispute.

installed." (Cal. Code Regs., tit. 18, § 1521(a)(5).) Merriam-Webster's online dictionary defines "accessory" as "an object or device that is not essential in itself but adds to the beauty, convenience, or effectiveness of something else."[19] Mr. Sullivan's description of the function of the shutters fairly describes why the shutter panels are fixtures. They add something to the building, perhaps even some additional security or insulation value, but they are not essential.[20] Appellant's argument that the panel and frame have no independent identity and, therefore, both must be considered materials as a matter of law is inconsistent with the evidence, which shows that the panels are attached without frames in some applications. The evidence also shows that the panels do not lose their identity as accessories when installed. In fact, they do not change at all.

Appellant's argument that its actions are distinguishable from shutter retailers who purchase manufactured shutters or shutter components for resale (or assembly and resale) because appellant manufactures the shutter components from raw materials is unpersuasive. The fact that appellant manufactures the panels from raw materials is immaterial. The last acts required of appellant to complete the sale were delivery and installation. At the moment of attachment to the buildings, the panels were completed fixtures.[21] The fact that appellant incorporated its shutters into buildings where they were firmly affixed – and even considered permanent, at least by appellant – is not determinative. Plumbing fixtures and prefabricated cabinets are "permanently" affixed to a building and the removal of those fixtures can require repair to the surrounding structure.

Based on the evidence, we find that the shutter panels are fixtures and that appellant's retail sales of the panels were subject to tax.

Measure of Tax

All of a retailer's gross receipts are presumed subject to tax until the contrary is established. (R&TC, § 6091.) "Gross receipts" means the total amount of the sale price of a

[19] See <https://www.merriam-webster.com/dictionary/accessory (as of April 20, 2020.)>

[20] The limited testimony provided by Mr. Sullivan regarding the shutters' potential security or insulation value was insufficient to persuade us that the panels are not fixtures.

[21] Appellant does not assert that the panels are analogous to custom cabinets, and even if it did, the evidence shows that the panels were more analogous to prefabricated cabinets in that they were essentially ready to install when brought to the site and that installation of the panels required comparatively little labor.

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).) The term "sale" includes a transfer for a consideration of the title to or possession of TPP which has been produced or fabricated to the special order of the customer. (R&TC, § 6006(f).) Charges for labor or services used in installing or applying the TPP sold are excluded from the measure of tax, but such excludable labor and services do not include the fabrication of property in place. (R&TC, § 6012(c)(3); Cal. Code Regs., tit. 18, § 1546(a).)

Regulation 1521(b)(2)(B) dictates the method for determining the retail sales price of fixtures sold by the manufacturer. Generally, the measure of tax for the sale of a fixture is determined by the contract price. (Cal. Code Regs., tit. 18, §1521(b)(2)(B)2.) If the contract does not state the sales price of the fixture, the sales price is the price at which similar fixtures in similar quantities ready for installation are sold by the manufacturer to consumers. (*Ibid*.) If there are no such sales, the sales price is the amount stated in the price lists, bid sheets or other records of the contractor. (*Ibid*.) If the sale price cannot be established in the above manner, the sales price is the manufacturing cost plus a reasonable profit. Manufacturing costs should include: (1) the cost of materials, including such items as freight-in and import duties; (2) direct labor, including fringe benefits and payroll taxes; (3) specific factory costs attributable to the fixture; (4) any manufacturer's excise tax; (5) a pro rata share of all overhead attributable to the manufacture of the fixture, and (6) a reasonable profit from the manufacturing operation which, in the absence of evidence to the contrary, shall be deemed to be 5 percent of the sum of the preceding factors. (*Ibid*.) Jobsite fabrication labor and its prorated share of manufacturing overhead must be included in the sale price of the fixture. (*Ibid*.) Jobsite fabrication labor includes assembly labor performed prior to attachment of a component or a fixture to a structure or other real property. (*Ibid*.)

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).)

Generally, where a taxpayer challenges the additional tax, the government bears a minimal, initial burden of producing evidence to show that its determination has a reasonable and rational basis. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950.) Where the government has met its initial burden, the taxpayer has the burden of proving the asserted deficiency is incorrect. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 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, at p. 4.) 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.) To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the correct 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.)

Respondent followed the prescribed procedure for determining the sales price of the shutters. Appellant used lump-sum contracts for its retail sales to consumers, so respondent had no contract price to determine the measure. Although appellant sells shutters, without installation, to contractors and builders, it has not provided evidence of the sales prices it charged to those buyers.[22] However, it did provide what might have been equivalent data: the job cost sheet upon which respondent based its original audit. Appellant disagreed with the results of that audit, asserting that the data in the job cost sheet were only estimates and asking respondent to instead base its determination, first, on the board foot study and labor analysis, and finally, on the agreement regarding the correct allocation of production costs: $4.65 for frames and $5.59 for panels.

The first question is whether the evidence establishes a reasonable and rational basis for determination. The original audit determined price from the job cost sheet provided by appellant. The first reaudit was done at appellant's request, after it filed a request for reconsideration by respondent, and was based on the new information provided by appellant, the board foot study and labor analysis. For the second reaudit, also at appellant's request, the parties agreed that the correct allocation of material cost psf was $4.65 for frames and $5.59 for

[22] In its opening brief, appellant states it sells to such customers for less than the average cost psf of $21.25. While such sales may only occur infrequently, there were some sales. Yet, appellant did not provide evidence regarding pricing for those customers.

panels, and respondent ultimately determined that 54.58 percent of appellant's material costs were attributable to panel materials costs. The evidence establishes a reasonable and rational basis for the measure of unreported taxable sales determined in all three audits. The first and second reaudits resulted in successive reductions to the taxable measure. The measure of unreported taxable sales that remain at issue following the second reaudit is $1,288,864. We find that respondent has met its burden of producing evidence to show a reasonable and rational basis for its findings. Consequently, appellant bears the burden of proving a more accurate measure.

While appellant argues extensively about the board foot study provided for the first reaudit, the parties agreed that for the second reaudit respondent would use wood (and other construction material[23]) costs psf of $5.59 for panels and $4.65 for frames. Therefore, although appellant devotes considerable attention to the board foot study, it appears that the wood and construction material costs psf of $5.59 for shutters and $4.65 for frames are not in dispute.

Appellant disputes nontaxable installation labor costs of $0.73 psf, as identified in both reaudits, noting that it is a substantial reduction as compared to the $4.25 installation labor cost psf that respondent identified in the original audit.[24] Although appellant describes this decrease is "an egregious overreach . . . only done for purposes of securing a larger taxable measure to the detriment of the taxpayer," the evidence simply indicates that installation labor costs have been based on information provided by appellant. The original audit was based on the job cost sheet provided by appellant, which apparently indicated that job-site installation costs were $4.25 psf. Appellant requested the first reaudit because it decided that it did not agree with the job cost sheet and instead wanted the reaudit to be based on its labor analysis and board foot study.[25] The first, and to a lesser extent the second, reaudits were based on this new information. Both reaudits concluded, based on the information provided by appellant, that nontaxable installation labor costs were $0.73 psf, and appellant has not established a more accurate measure.

[23] Other material costs included all material costs used in the construction process, including glue, paint and other supplies.

[24] Although respondent states that it did not reduce the installation labor costs, the evidence indicates otherwise.

[25] Appellant disputed the original deficiency measure on the basis that the job cost sheet it provided contained only estimates. It argues that it would have performed a more thorough analysis in 2012 (i.e., during the original audit) had it known respondent would deem the shutters to be fixtures. As discussed later in this opinion, respondent informed appellant that it considered the shutters, or at least the shutter panels, to be fixtures long before the audit even began.

Appellant makes a number of arguments regarding why the measure of tax is overstated, but the arguments are based on unsupported assumptions and have little, if any, evidence to support them, and appellant's numbers do not work. Appellant asserts that the determined measure is wrong because the stiles and rails are materials, but we have already determined that the entire panel is a fixture. It alleges that respondent manipulated the data or chose to rely only on data that supported its position, but we see no evidence of that in the record and appellant has not drawn our attention to any such evidence. Appellant complains that respondent's calculation of costs does not fairly take all costs, including equipment depreciation, vehicle costs, insurance, travel costs, small tools, and more, into consideration; but it has not shown how its analysis of manufacturing costs results in a lower and more accurate measure.[26] It has allegedly calculated total labor costs of $7.57 (compared to respondent's $8.35) psf, frame production labor costs $3.52 (compared to respondent's $3.46) psf, installation labor costs of $3.05 (compared to respondent's $0.73) psf, and total construction material and labor costs of $16.25 (compared to respondent's $18.59) psf, but it has not shown how it made these calculations or provided persuasive evidence in support. Furthermore, given the parties' agreement that total wood and construction material costs were $10.24 psf, appellant's assertion that labor costs and material costs total $16.25 psf is inconsistent with appellant's alleged calculations (e.g., $10.24 + $7.57 = $17.81).

In summary, the evidence shows that respondent agreed on two occasions to conduct reaudits based on different, and to some degree unverified data, at appellant's request. The evidence establishes a reasonable and rational basis for each of the three audits. Appellant, who bears the burden of showing that the determination from the second reaudit is wrong and proving a more accurate measure of tax, challenges respondent's findings, but evidence is mostly lacking. In some respects appellant's assertions are internally inconsistent and possibly contrary to appellant's interests. Based on the evidence, we find that the deficiency measure determined in the second reaudit has a reasonable and rational basis, and that appellant has not met its burden of establishing that a further reduction in the measure is warranted.

[26] Because Regulation 1521(b)(2)(B) states the pricing analysis should include a pro rata share of all overhead attributable to the manufacture of the fixture, it seems unlikely that failure to include these amounts would have noticeably skewed the results.

Issue 2 - Is appellant entitled to an increase in the allowable deduction for TPPR?

A retailer who resells tangible personal property before making any use thereof (other than retention, demonstration, or display while holding it for sale in the regular course of business) may take a deduction of the purchase price of the property if, with respect to its purchase, the retailer has reimbursed the vendor for the sales tax or has paid the use tax. (R&TC, § 6012(a)(1); Cal. Code Regs., tit. 18, § 1701(a).)

The evidence shows how respondent calculated the TPPR deduction, and on the basis thereof, we find that there is a reasonable and rational basis for respondent's determination of the amount of the allowable deduction in each of the three audits. Appellant has the burden of proving otherwise and establishing a more accurate TPPR deduction.

Appellant argues that it is entitled to an increase in the TPPR deduction. Apparently relying, at least in part, on its interpretation of information obtained from respondent's Taxpayer's Rights Advocate Office (TRAO) prior to July 1, 2017, appellant contends that the TPPR deduction should be based on gross profit. In support, appellant provided copies of emails authored by the TRAO. At the hearing, Mr. Cahill argued that when respondent agreed to decrease the measure of unreported taxable sales in the reaudits, it also decreased the allowed TPPR deduction, resulting in no real change to the liability.

The TPPR deduction is based on the principle that when a retailer (including a manufacturer who also sells its products at retail) purchases an item for resale (including for incorporation into an item that will be sold at retail), it should not have to pay sales tax reimbursement or use tax measure by its cost to purchase that item and later pay sales tax again on the same item. Thus, if appellant paid tax on its cost of materials that were later used to manufacture frames, no deduction is allowed because it consumed and did not resell those materials. But if appellant paid tax on its cost of materials that were later used to manufacture panels, the deduction is allowed because it sold those panels at retail and would owe sales tax measured by the sales price. This explains why the deduction went down as the percentage of costs attributable to the manufacture and installation of nontaxable frames went up. Profit is immaterial to the analysis. We find that the evidence does not establish an error in respondent's determination of the credit, and we conclude that appellant is not entitled to an increase in the allowable deduction for TPPR.

Issue 3 - Should R&TC section 6596 be applied to relieve any of the liability?

We are authorized to relieve the liability if we find that appellant's failure to accurately report and pay its taxes was due to its reasonable reliance on written advice from respondent. (R&TC, 6596.) Appellant concedes that it never specifically requested written advice from respondent regarding whether the shutters or any portion thereof were fixtures, the sale of which was subject to tax. However, that is not the only way written advice can be given by respondent. If the report of a prior audit of the person requesting relief, or of a person with shared accounting and common ownership with that person, shows that the issue in question was examined in a prior audit, and the taxpayer reasonably relied on what respondent found in that prior audit, relief may be available. (Cal. Code Regs., tit. 18, § 1705(c).)

Regulation 1705(a) provides that written advice may be relied upon only by the person to whom it was originally given or a legal or statutory successor to that person and, in the case of written advice given in a prior audit, by the person audited, by a person with shared accounting and common ownership with that person, or by a legal or statutory successor to those persons. A person is considered to have shared accounting and common ownership if, during the period(s) for which relief is sought, the person: (1) is engaged in the same line of business as the audited person; (2) has common verifiable controlling ownership of 50% or greater ownership or has a common majority shareholder with the audited person; and (3) shares centralized accounting functions with the audited person.

There is some confusion regarding whether appellant seeks relief under R&TC section 6596. Appellant has indicated on more than one occasion that it does not. Yet, it has consistently argued that its position, i.e., that the shutters (all components) are materials consumed by it, is correct, as evidenced, in part, by respondent's findings in prior audits of The Sullivan Group. Respondent addressed the question of relief under section 6596 in its decision out of an abundance of caution. We raised the question at hearing for the same reason. When asked if appellant contends that it is entitled to relief under section 6596, appellant responded in the negative, but went on to state that it views the taxability of the shutters exactly how The Sullivan Group viewed that issue, that respondent accepted that position as legally correct in the prior audits, and that appellant relied on that. The panel of judges had questions about the availability of relief and, ultimately, we allowed the parties to submit post-hearing briefs limited to the availability of relief under section 6596. Appellant's post-hearing brief stated at the outset

that if we wanted to grant relief under section 6596, it had no objection, but it did not make an argument that it was entitled to relief, instead using the post-hearing brief for the impermissible purpose of reiterating its other arguments.

There is no dispute that respondent agreed in prior audits of The Sullivan Group that the shutters (all components) were materials.[27] However, the evidence does not show that appellant shared accounting and common ownership with The Sullivan Group during the liability period, or that appellant was a legal or statutory successor to The Sullivan Group. Thus, there is no evidence that appellant was ever entitled to rely on the prior audit findings communicated to The Sullivan Group. We conclude that R&TC section 6596 should not be applied to relieve any of the liability.

[27] Although, as we have already found, the position taken by respondent in the prior audit(s) was in error, The Sullivan Group was allowed to rely on that erroneous finding until it became aware of respondent's error. Respondent informed The Sullivan Group about the error, and that the shutter panels (at least) were fixtures, in January 2008. The Sullivan Group could not thereafter rely on the prior audit findings. Given that appellant's accounting staff and The Sullivan Group's accounting staff were the same, it is unlikely that appellant was not aware that Respondent corrected its position in January 2008.

HOLDINGS

1. Appellant is not entitled to a further reduction in the measure of unreported taxable sales.
2. Appellant is not entitled to an increase in the allowable deduction for TPPR.
3. R&TC section 6596 should not be applied to relieve any of the liability.

DISPOSITION

We sustain respondent's determination in the second reaudit to reduce the measure of unreported sales to $1,288,864 and to reduce the allowable TPPR deduction to $515,653.

DocuSigned by:
1A9B52EE88AC4C7...
Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
3CADA62EB4864CB...
Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
F8E81582726F448...
Richard Tay
Administrative Law Judge

Date Issued: 6/4/2020