OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19125615
	) CDTFA Case No. 064-042
NEUROSKY, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Stanley Yang, Chief Executive Officer
For Respondent:	Amanda Jacobs, Tax Counsel III Scott Claremon, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals	Lisa Burke, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, NeuroSky, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) issued on November 22, 2017. The NOD is for $22,420.07 in tax (representing a deficiency measure of $302,659), plus applicable interest, for the period April 1, 2013, through March 31, 2016 (audit period).

Office of Tax Appeals (OTA) Administrative Law Judges Daniel K. Cho, Natasha Ralston, and Suzanne B. Brown held an electronic hearing for this matter on October 21, 2021. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] Sales and use taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" refers to its predecessor, the board.

ISSUE

Whether appellant established that an adjustment is warranted to the amount of disallowed claimed nontaxable sales for resale.

FACTUAL FINDINGS

1. Appellant has operated as a retailer of microchips and electronic components designed for use in health and fitness devices since October 1, 2008. Appellant also sells various biosensor products, such as headsets and wristbands, designed to monitor a users' vital signs, brain waves, and other biometric information, and makes online subscription sales of a software application, which customers download electronically. Appellant's merchandise is manufactured in Asia and warehoused in Hong Kong before being shipped to customers in California and out of state. Appellant maintains a small amount of inventory in San Jose, California.
2. For the audit period, appellant reported total sales of $22,199,852 and claimed deductions totaling $21,857,276 (nontaxable sales for resale of $1,230,659, exempt sales in interstate commerce of $20,546,480, and "other" nontaxable sales of $80,137 related to sales of software delivered electronically), which resulted in reported taxable sales of $342,576. Additionally, appellant reported purchases of $68,658 subject to use tax.
3. For audit, appellant provided its federal income tax returns, a list of fixed assets, quarterly summary reports, sales invoices showing its recorded nontaxable sales for resale for a test period of April 1, 2014, through March 31, 2015, resale certificates, sales invoices showing its recorded exempt sales in interstate commerce for a test period of the third quarter of 2014, and shipping documents.
4. CDTFA examined the sales invoices for the test periods together with corresponding purchase orders, resale certificates, and shipping documents. Appellant's recorded nontaxable sales for resale consisted of 20 transactions in the test period with a total measure of $204,640. CDTFA concluded that 18 of the 20 transactions constituted valid nontaxable sales for resale, but that the two remaining sales lacked a valid resale certificate from the customer, Mobe, LLC (Mobe), or other documentation to support appellant's claimed nontaxable sales for resale to Mobe. Since it found no other errors in the test periods, CDTFA focused its examination on appellant's recorded nontaxable

sales for resale to Mobe, which consisted of 10 transactions totaling $404,870 during the period March 2, 2015, through April 13, 2015.

5. Mobe is a health and fitness advisor based in Tennessee. Mobe does not hold a California seller's permit. On or about February 12, 2015, appellant entered into an agreement with Mobe for the sale of 6,000 LifeBeat wearable electronic wristband devices and related software applications. In accordance with instructions in Mobe's purchase orders, appellant shipped its products to Mobe in New York, Minnesota, and, as relevant here, South San Francisco, California. CDTFA concluded that none of the sales were supported by a resale certificate, but determined that tax did not apply to eight sales of products delivered to Mobe out of state. However, appellant's two remaining sales invoices to Mobe, measuring $130,000 and $195,000,[2] show a ship-to address in South San Francisco that CDTFA found was registered to True Life Botanicals, Inc. (TLB), which was in the business of selling artificial flowers, vases, and decorative fruits. The invoice and packing list for the sales measuring $130,000 are dated March 31, 2015, and the invoice and packing list for the sales measuring $195,000 are dated April 13, 2015.

6. As support for its claimed nontaxable sales for resale to Mobe, appellant provided CDTFA with documents including: a copy of an email dated March 27, 2015, from N. Tong, identified as Mobe's vice president of operations, listing a "Reseller ID Number," stating that this number "is associated with" TLB, and stating that "Mobe is associated with" TLB; a copy of a page generated from appellant's online search on CDTFA's website, printed on March 23, 2015, showing that the seller's permit number provided by Ms. Tong was valid and was issued to TLB; a copy of Mobe's purchase order dated February 12, 2015; a contractual Term Sheet between appellant and Mobe dated February 12, 2015; an "XYZ" letter response from Mobe,[3] dated May 26, 2016, with "N/A" written in the area designated for the seller's permit number of the purchaser, listing purchases of appellant's wearable devices measuring $130,040, and indicating that the property was purchased for resale, was being held in resale inventory, and had not

[2] The March 31, 2015 packing list shows that shipment consisted of 2,000 wearable devices, and the April 13, 2015 packing list shows that shipment consisted of 3,000 wearable devices. The two packing lists show that all of these items were shipped from appellant's location in San Jose, California.

[3] An XYZ letter is a letter in a form approved by CDTFA that a seller may send to its customer inquiring as to the disposition of the property purchased from the seller. (Cal. Code Regs., tit. 18, § 1668(f).)

been used for any purpose other than retention, demonstration, or display while being held for sale; and an August 17, 2016 email from Mobe employee J. Domeier stating that Mobe had not sold any of the wearable devices it purchased from appellant, but had used them and had paid or intended to pay use tax to the states (Minnesota and Washington) where the property was used.

7. Because Mobe did not hold a seller's permit during the audit period, CDTFA concluded that appellant's two sales transactions, for sales totaling approximately 5,000 wearable devices delivered to Mobe at TLB's address in South San Francisco, were subject to tax. Accordingly, CDTFA established disallowed claimed nontaxable sales for resale of $325,000.[4]

8. On November 22, 2017, CDTFA issued the NOD to appellant. Appellant filed a timely petition for redetermination, disputing the disallowed claimed nontaxable sales for resale.

9. Following an appeals conference, CDTFA issued a Decision on November 20, 2019, denying the petition for redetermination. This timely appeal to OTA followed.

DISCUSSION

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property (TPP), measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) "Sale" means and includes any transfer of title or possession, in any manner or by any means whatsoever, of TPP for a consideration. (R&TC, § 6006.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.)

When 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. (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).)

[4] The audit also included a credit for use tax remitted to CDTFA in error measured by $22,341, which reduced the deficiency measure from $325,000 to $302,659. That credit is not in dispute in this appeal.

The burden of proving that a sale of TPP is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale (resale certificate). (R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(a).) Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a resale certificate with respect to the sale of the property described in the document if it contains all of the following essential elements: 1) the signature of the purchaser, purchaser's employee or authorized representative of the purchaser; 2) the name and address of the purchaser; 3) the number of the seller's permit held by the purchaser;[5] 4) a statement that the property described in the document is purchased for resale; and 5) the date of execution of the document. (Cal. Code Regs., tit. 18, § 1668(b)(1).)

If the seller does not timely obtain a valid and complete resale certificate, the seller will be relieved of liability for the tax only where the seller shows that the property: 1) was in fact resold by the purchaser and was not used by the purchaser for any purpose other than retention, demonstration, or display while holding it for sale in the regular course of business; 2) is being held for resale by the purchaser and has not been used for any purpose other than retention, demonstration, or display, while being held for sale in the regular course of business; or 3) was consumed by the purchaser and tax was reported by the purchaser directly to CDTFA on the purchaser's returns or in an audit of the purchaser. (Cal. Code Regs., tit. 18, § 1668(e).) One way to prove that property was resold without intervening use is through the use of XYZ letters. (Cal. Code Regs., tit. 18, § 1668(f).) However, a response to an XYZ letter is not equivalent to a timely and valid resale certificate, and CDTFA is not required to relieve a seller from liability for sales tax or use tax collection based on a response to an XYZ letter. (Cal. Code Regs., tit. 18, § 1668(f)(3).)

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.)

[5] If the purchaser is not required to hold a permit because the purchaser sells only property of a kind the retail sale of which is not taxable, e.g., food products for human consumption, or because the purchaser makes no sales in this state, the purchaser must include on the certificate a sufficient explanation as to the reason the purchaser is not required to hold a California seller's permit in lieu of a seller's permit number. (Cal. Code Regs., tit. 18, § 1668(b)(1)(C).)

There is an exemption from tax on sales in interstate commerce; this exemption may apply when pursuant to a contract, TPP must be delivered to a point outside this state by the retailer by means of facilities operated by the retailer or delivery by the retailer to a carrier, customs broker, or forwarding agent. (R&TC, § 6396.) Sales tax applies when the property is delivered to the purchaser or its representative in this state, regardless of whether the intention of the purchaser is to transport the property to a point outside this state, and whether or not the property is actually so transported. (Cal. Code Regs., tit. 18, § 1620(a)(3)(A).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, § 6481.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) 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 to be correct. (*Appeal of AMG Care Collective*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Here, CDTFA examined appellant's recorded nontaxable sales for resale for the period April 1, 2014, through March 31, 2015, and its recorded exempt sales in interstate commerce for the third quarter of 2014. Because CDTFA found that only two of the recorded nontaxable sales for resale lacked sufficient supporting documentation, and those two sales were made to one customer, Mobe, CDTFA focused its examination on appellant's recorded nontaxable sales for resale to Mobe, rather than projecting a percentage of error from the test period to establish disallowed claimed nontaxable sales for resale in other periods. The March 31, 2015 and April 13, 2015 invoices and packing lists establish that two of appellant's shipments of products to Mobe were delivered in California for a combined selling price of $325,000, excluding charges for shipping and handling. Mobe did not hold a California seller's permit.

Appellant contends that one shipment to the South San Francisco address occurred at the request of a Mobe employee who was visiting from Massachusetts, and who stated that he would pick up the box of TPP at his wife's sister's flower shop in South San Francisco so that he could

bring the box with him on his airplane flight back to Massachusetts.[6] There is no dispute that this shipment was delivered in South San Francisco, as reflected on the March 31, 2015 and April 13, 2015 invoices and packing lists. Thus, because delivery of the TPP occurred in California, sales tax applies regardless of whether the intention of the purchaser was to transport the property to a point outside this state, and whether or not the property was actually so transported. (Cal. Code Regs., tit. 18, § 1620(a)(3)(A).) Accordingly, the sales were not exempt sales in interstate commerce, and no adjustment on that basis is warranted.[7]

In addition, appellant contends that the documents and emails it received contain all five of the essential elements of a resale certificate listed in California Code of Regulations, title 18, (Regulation) section 1668(b)(1). Appellant contends it obtained the documentation before it shipped the products to Mobe in California, and that it accepted these components of a resale certificate in good faith. Hence, we examine whether appellant timely obtained the essential elements of a resale certificate for these two sales. Regarding three of the required elements – the signature of the purchaser, the name and address of the purchaser, and the date of execution of the document – appellant states that the name, address, and date are present in Mobe's purchase order dated February 12, 2015, and states that it considered the email Mobe sent with the purchase order to be the purchaser's signature.

To meet the regulation's requirement of a statement that the property described in the document is purchased for resale, appellant points to the Term Sheet appellant emailed to Mobe on February 12, 2015, which indicates that Mobe would be incorporating appellant's product as a Mobe-branded product, and therefore, Mobe would be responsible for all end-user support, warranty and returns. Appellant alleges that all of the documents it received regarding the transactions in question indicated that Mobe was buying appellant's products to be incorporated

[6] We note that appellant stated at the hearing that the only sales in dispute involved this shipment of a single box. In contrast, the March and April 2015 invoices reflect two separate shipments to the South San Francisco address; the March 2015 packing list states the shipment consisted of 40 carton boxes on two pallets, and the April 2015 packing list states the shipment consisted of 60 carton boxes on two pallets.

[7] A comparison of the sales and use tax permit verification with the packing lists shows that the ship-to address in South San Francisco was registered to TLB. Thus, although not asserted by the parties, one possible explanation is that Mobe may have purchased the property from appellant for drop-shipment directly to TLB. We note that if, hypothetically, this is what occurred (i.e., that Mobe was the true retailer), it would not eliminate appellant's liability for the sales tax because, since Mobe does not have a California seller's permit, appellant would still be liable for the tax at issue as a drop-shipper. (See R&TC, § 6007(a)(2); Cal. Code. Regs., tit. 18, § 1706(c)(1).) Because this would not reduce appellant's liability, we need not make a finding on this question.

into Mobe's brand of products for resale, and that it had no reason to believe that Mobe would buy 6,000 units for any purpose other than for resale.

Regarding the element requiring the number of the seller's permit held by the purchaser, appellant claims that it decided that it could rely on the seller's permit number provided by Ms. Tong in her March 27, 2015 email, even though the seller's permit number belonged to TLB, because Ms. Tong assured appellant that TLB was associated with Mobe. Appellant points out that in the email, Ms. Tong stated, "in the event that [appellant] is asked about this issue, Mobe will confirm that this reseller number is associated with Mobe." Appellant argues that it performed due diligence by verifying on CDTFA's website that the seller's permit was valid. Appellant contends that because it relied on Mobe's representation in good faith, Mobe should be held liable for the tax on the transactions, and appellant should be relieved of the liability.

Although appellant contends that it relied in good faith on Mobe's assurance that TLB's seller's permit number was associated with Mobe, the fact remains that appellant was put on notice that there was no valid California seller's permit issued to Mobe. Regardless of Mobe's claims that it could use TLB's seller's permit, TLB was not a party to the transactions at issue, and a purchaser may not use the seller's permit of another entity to exclude the sale of TPP from sales tax as a sale for resale. Under these circumstances, we consider the guidance from Sales and Use Tax Annotation 475.0511 (3/3/1989)[8] that a resale certificate "is not valid if the name of the purchaser shown on the certificate is other than the purchaser."[9] In light of all evidence, we find that a seller's permit number clearly not belonging to the purchaser fails to meet that essential element of a resale certificate.

[8] Annotations are not binding authority and do not have the force or effect of law. (Cal. Code Regs., tit. 18, § 5700(a)(1); *Appeal of Martinez Steel Corporation*, 2020-OTA-074P.) However, OTA may give some consideration to annotations and will independently determine the appropriate weight to afford an annotation. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 15; *Appeal of Martinez Steel Corporation*, *supra*.)

[9] We note that an older sales and use tax annotation states that a resale certificate, regular on its face, taken in good faith from the buyer by the seller, which later proves to have false information regarding a required element of Regulation section 1668(b), relieves the seller from liability from the sales tax. (Sales and Use Tax Annotation 475.0045 (9/24/1986).) However, we find that this annotation is distinguishable on its facts because in the present case, there was no single document constituting a resale certificate that was regular on its face. Moreover, because our analysis concerns seller's permit information readily verifiable on CDTFA's website, we give this annotation less weight because it was published before the existence of CDTFA's website, when sellers were not able to use the internet to verify seller's permit information.

Accordingly, appellant did not timely take in good faith all the essential elements of a resale certificate.[10] Therefore, we find that the various documents and communications from Mobe, taken together, did not qualify as a valid resale certificate and do not relieve appellant from the tax liability.

In the absence of a valid resale certificate, appellant bears the burden of establishing that it is not liable for the tax on the sales at issue. In support of its position, appellant provided Mobe's XYZ letter response dated May 26, 2016, which indicated that Mobe had not used the products it purchased from appellant, and instead, was holding them in its resale inventory. However, Mobe's XYZ letter response is inconsistent with the information provided in the August 17, 2016 email from Ms. Domeier, which appears to be a response to questions from appellant's former chief financial officer, C. Hu, after the completion of the audit at issue. The email states that while Mobe had intended to resell the wearable devices purchased from appellant, it had not sold any as of the date of the email, that Mobe used the wearable devices for marketing, testing software, training, employee use, and client use, and that it paid use tax in the states in which the products were used. According to Ms. Domeier's email, Mobe had paid use tax in Minnesota on 1,691 wearable devices, and intended to pay use tax in Washington on 2,259 wearable devices.

Because the XYZ letter response conflicts with the information provided in the August 17, 2016 email from Ms. Domeier, we find that the XYZ letter response is not sufficiently reliable to relieve appellant from its tax liability. Further, no argument or evidence has been presented showing that Mobe paid California use tax on its purchases from appellant. Thus, we conclude that appellant has failed to meet its burden of establishing that the wearable devices it sold to Mobe were resold by Mobe, or were used by Mobe with use tax paid directly to CDTFA.[11] Consequently, we conclude that no adjustment is warranted and appellant is liable for the sales tax on those sales.

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[10] Because appellant has not established the essential element concerning the seller's permit number, we need not discuss whether the other essential elements were met.

[11] While we have not received proof of Mobe's payments of use tax to Minnesota or Washington, such payments would not entitle appellant to receive any credit or offset against its California tax liabilities. R&TC section 6406 allows a credit against a taxpayer's California tax on its own use of TPP in this state only to the extent that the same taxpayer has paid tax imposed with respect to that property to any other state prior to the use of that property in this state. Thus, even if Mobe paid use tax to another state, a credit pursuant to R&TC section 6406 would not be available to appellant because Mobe and appellant are separate entities.

HOLDING

Appellant has not established that an adjustment is warranted to the amount of disallowed claimed nontaxable sales for resale.

DISPOSITION

Sustain CDTFA's decision to deny the petition for redetermination.

DocuSigned by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

DocuSigned by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

DocuSigned by:
Daniel Cho
7B28A07A7E0A43D...
Daniel K. Cho
Administrative Law Judge

Date Issued: 1/11/2022