2022 – OTA – 107
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **UNITED STEEL FABRICATORS, INC.**	) OTA Case No. 21037468) CDTFA Case IDs 139-059, 139-060, 139-061

OPINION

Representing the Parties:

For Appellant: Mitchell Stradford, Esq.

For Respondent: Jason Parker Chief of Headquarters Operations

For Office of Tax Appeals: Richard Zellmer
Business Taxes Specialist III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, United Steel Fabricators, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),[1] partially denying appellant's petition for redetermination of the Notice of Determination (NOD) for tax of $263,164.90, applicable interest, and a negligence penalty of $26,316.50, and for the period July 1, 2012, through March 31, 2013,[2] and partially denying appellant's petition for redetermination of a second NOD for tax of $487,388.58, and applicable interest, for the period October 1, 2013, through December 31, 2015. The total tax in the two NODs is $750,553.[3]

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of 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, "CDTFA" shall refer to BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

[2] The first NOD was not included in our record, but the appellant does not dispute the amount as stated in CDTFA's decision.

[3] CDTFA did not issue an NOD for the period April 1, 2013, through September 30, 2013, because the statute of limitations had expired for these two quarters.

In its subsequent decision, CDTFA reduced the understated measure of tax for both NODs combined to $5,642,330, which will result in reductions to the tax and interest. CDTFA deleted the negligence penalty.

Appellant waived its right to an oral hearing; therefore, we decide the matter based on the written record.

ISSUES

1. Has appellant shown that any further reduction to the amount of unreported taxable sales computed using the markup method is warranted?
2. Has appellant shown that a reduction to the unreported cost of fixed assets subject to use tax is warranted?

FACTUAL FINDINGS

1. Appellant was audited for the period July 1, 2012, through December 31, 2015 (audit period). During the audit period, appellant was a retailer of rebar steel. Appellant obtained a seller's permit with a start date of July 1, 2012. Prior to July 1, 2012, appellant reported its sales under the seller's permit issued to appellant's parent company. Appellant's primary customer is a related company (not the parent company) that operates as a construction contractor installing steel.

First Audit

2. CDTFA audited appellant for the period July 1, 2012, through December 31, 2015. As explained above, CDTFA issued two separate NODs for the audit liability. For audit, appellant provided federal income tax returns (FITRs) for 2012, 2013, and 2014; general ledger history reports for accounts receivable for the audit period; some bank statements for the audit period; and merchandise purchase invoices for the audit period.
3. Gross receipts appellant reported on the FITRs exceeded total sales reported on the sales and use tax returns by a substantial amount in 2012 and 2013, and by $26,542 in 2014. Appellant did not explain these differences. Using information from appellant's FITRs,

CDTFA calculated book markups of 2.4 percent for 2012, -23.41 percent for 2013, and 44.21 percent for 2014,[4] which are lower than CDTFA expected for this type of business.

4. CDTFA compared total sales reported on the sales and use tax returns to cost of goods sold (COGS) reported on the FITRs to compute another set of book markups of -67.37 percent for 2012, -58.52 percent for 2013, and 42.69 percent for 2014. CDTFA found the 42.69 percent markup for 2014 reasonable for appellant's business but found the negative book markups for 2012 and 2013 to be an indicator that total sales reported on the sales and use tax returns for those two years were understated. Thus, CDTFA decided to compute appellant's taxable sales using an indirect method, here, the markup method.
5. Appellant did not sign a waiver of limitations to extend the statute of limitations for issuing deficiency determinations, and CDTFA issued the above-mentioned NODs before the audit was completed.
6. Appellant filed timely petitions for redetermination of the NODs.
7. In an audit of appellant's parent company, CDTFA computed a markup of 28.64 percent, which resulted in an error ratio of 335.54 percent for 2012 when applied to COGS for that year. CDTFA used the 28.64 percent markup and applied it to the audited COGS for 2013 to compute unreported taxable sales for 2013 of $4,956,420, which represents an error ratio of 57.66 percent for that year. CDTFA applied the parent company's error ratio of 335.54 percent to recorded taxable sales for the period July 1, 2012, through December 31, 2012, applied the error ratio of 57.66 percent to recorded taxable sales for 2013, and applied the error ratio of 196.6 percent (average of 335.54 and 57.66) to recorded taxable sales for 2015, to compute unreported taxable sales using the markup method of $7,513,840 for the audit liability period.[5]
8. Appellant purchased fixed assets subject to use tax during the audit liability period. In

[4] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup) is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (.30 ÷ 1.00 = 0.3). A negative book markup means that reported COGS exceeds reported sales.

[5] No understatement was computed for 2014 using the markup method because CDTFA accepted recorded taxable sales for 2014 as substantially accurate based on the book markups.

the audit of appellant's parent, the cost of purchases of fixed assets subject to use tax averaged $4,617 per quarter. Thus, CDTFA applied the $4,617 amount to each quarter in 2013, 2014, and 2015, for a total of $46,170 for the audit liability period. Appellant did not dispute this measure of tax in its appeal with CDTFA but disputes this measure of tax in its appeal with OTA.

9. In addition, taxable sales recorded in appellant's general ledger exceeded reported taxable sales by $4,498,909 for the audit period. Appellant was unable to provide source documentation to support recorded taxable sales. The audit also includes unreported taxable sales based on a comparison of recorded taxable sales to reported taxable sales, and a deduction for tax-paid purchases resold.[6]

10. CDTFA asserted increases in both NODs.[7]

11. Appellant filed timely petitions for redetermination of the asserted increases. CDTFA ordered a reaudit to adjust for sales at cost made to a related entity and to adjust for sales tax included in reported taxable sales on the sales and use tax returns. CDTFA invited appellant to provide its 2015 FITR for the related company, and other documentation, to show appellant's recorded sales to the related company.

Reaudits

12. In the second reaudit, CDTFA made two adjustments resulting in an increase to the measure of tax for unreported taxable sales from $2,554,099 to $3,810,882. Appellant does not protest the $3,810,882 measure of tax.

13. CDTFA made an adjustment to account for sales of $8,213,854 in 2013 that appellant sold to a related entity at cost,[8] which reduced the unreported taxable sales for 2013 to $2,896,519, and which in turn produced an error ratio of 36.36 percent for that year (as

[6] In its appeal with CDTFA, appellant protested the $2,554,099 measure of tax based on a comparison of recorded taxable sales to reported taxable sales. As explained below, adjustments were made to this measure of tax in a reaudit, and in its appeal with OTA appellant states that it no longer protests the measure of tax based on a comparison of recorded taxable sales to reported taxable sales.

[7] CDTFA may increase the amount of an NOD only if CDTFA asserts an increase at or before a hearing before OTA. (R&TC, § 6563(a).) Also, as relevant here, the increase must be asserted within three years after the first NOD or within three years after the time tax records requested by CDTFA are made available, whichever is later. (R&TC, § 6563(a)(1).)

[8] The effect of this adjustment was to treat $8,213,854 of the COGS as being sold for zero markup (cost) instead of the 28.64 percent markup used in the original audit.

compared to the error ratio of 57.66 percent computed in the original audit. CDTFA recalculated the error ratio from the audit of the parent company to account for sales made to a related company at cost and to correct an error in calculating COGS. CDTFA applied the adjusted error ratio of 7.00 percent to recorded taxable sales for the period July 1, 2012, through December 31, 2012, applied the error ratio of 36.36 percent to recorded taxable sales for 2013, and applied the error ratio of 24.22 percent (average of 7.00 percent and 36.36 percent) to recorded taxable sales for 2015, to compute unreported taxable sales for the audit liability period of $1,837,651, using the markup method.

14. The measure of tax of $46,170 for the unreported cost of purchases of fixed asset subject to use tax (which appellant disputes), and the deduction of $52,373 for tax-paid purchases resold (which appellant does not dispute) were unchanged in the second reaudit. Thus, the second reaudit resulted in a total measure of tax of $5,642,330. Of the $5,642,330 amount, $3,824,670 is for the period July 1, 2012, through March 31, 2013, and $1,817,660 is for the period October 1, 2013, through December 31, 2015.

15. Appellant filed the instant appeal with OTA.

DISCUSSION

Issue 1: Has appellant shown that any further reduction to the unreported taxable sales based on a markup analysis is warranted?

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All gross receipts of a retailer are presumed subject to tax unless the retailer can prove otherwise. (R&TC, § 6091.)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may determine the amount required to be paid based on 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. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Here, CDTFA identified substantial differences between total sales reported on the sales and use tax returns and gross receipts reported on the FITRs. Moreover, CDTFA identified substantial differences between gross receipts reported on the FITRs and recorded taxable sales. Appellant now agrees that there were substantial differences between recorded and reported taxable sales. CDTFA computed negative book markups for 2012 and 2013, which shows that reported sales were understated for those years. Also, appellant did not provide sales invoices to support sales recorded in the general ledger, and thus, the records provided by appellant for audit were incomplete. For those reasons, we find that CDTFA was justified in questioning the accuracy of appellant's books and records and concluding that reported and recorded taxable sales were understated. When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect audit method. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) The markup method is a standard and accepted audit procedure. (See, *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610 (*Riley B's*), 612-613.)

CDTFA could not compute appellant's markup using the books and records provided; therefore, we find that it was reasonable for CDTFA to use the 28.64 percent markup that was computed in a prior audit of the parent company. Furthermore, we find it was reasonable for CDTFA to calculate COGS for 2013 using amounts of beginning inventory, merchandise purchases, and ending inventory reported on appellant's own 2013 FITR. We also find that the adjustment made by CDTFA to account for sales sold at zero markup to the related entity benefitted appellant. Finally, we find that CDTFA acted reasonably in accepting recorded taxable sales for 2014 based on the book markup of 42.69 percent, and not using the markup method to calculate an understatement for that year. Thus, we find that CDTFA has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit.

Appellant contends that *Riley B's*, *supra*, at pp. 612-613, should not be used as blanket support for the use of a markup to compute taxable sales. Appellant argues that its business is distinctly different from the bar business that was involved in *Riley B's.* First, we note that CDTFA may determine the amount of tax required to be paid by a taxpayer based on *any* information which is in its possession or may come into its possession. (R&TC, § 6481.) Such information could form the basis for a markup analysis. Thus, R&TC section 6481 is the bedrock support for the use of the markup method. As cited herein, *Riley B's* stands for the proposition that because the markup method is an accepted and standard audit procedure, it is reasonable for CDTFA to use the markup method to calculate a taxpayer's sales. We find no authority that would limit CDTFA's use of the markup method to bars, restaurants, and similar businesses, or exclude the markup method from use in an audit of a steel distributor, such as appellant. Thus, we reject appellant's argument that we cannot rely on *Riley B's* to apply the markup method to a steel distributor.

Appellant alleges that although it erroneously recorded some taxable sales as nontaxable sales, it recorded all its sales, and thus, there is no need to use the markup method (or any other method) to calculate additional sales that were not recorded. Instead, appellant alleges that CDTFA should use its recorded sales wherein appellant erroneously recorded $1,758,403 of taxable sales as nontaxable sales. Appellant has not shown that all other taxable sales were properly recorded, and that its records are therefore reliable. Thus, we reject this argument.

Appellant prepared a bank deposit analysis, in which appellant calculates that after making an adjustment to account for a note payable to a related company, of $2,500,000, recorded total sales exceeds bank deposits by $376,066, which represents an error ratio of 2.38 percent. Appellant argues that the 2.38 percent error ratio could be the result of timing differences but has not presented evidence to support the allegation. Appellant asserts that it did not receive cash for any of its sales because its sales are typically for large amounts. Appellant argues that the additional taxable sales of $1,837,651 computed in CDTFA's markup analysis would have to have been paid for with cash that was not deposited into the bank account. Since appellant did not receive any cash for its sales, appellant asserts it is not possible to have any sales that are not accounted for in the bank deposits. Appellant contends that its bank deposit analysis refutes CDTFA's markup analysis.

CDTFA responds that appellant provided bank statements from two banks and that these bank statements show transfers to and from other bank accounts. Appellant has not provided bank statements for the other bank accounts. While it is possible that appellant's contentions with respect to lack of cash payments is true, we do not have the bank statements for the other bank accounts and cannot confirm the accuracy of appellant's statements. Therefore, we reject appellant's argument regarding bank deposits.

Appellant notes that CDTFA treated as accurate the COGS amount reported on the 2013 FITR but did not accept as accurate the gross receipts amount reported on the 2013 FITR.

Appellant contends that it is inconsistent for CDTFA to accept some amounts and reject other amounts on a federal return, and thus, CDTFA's markup calculations should be disregarded. We find no authority that would require CDTFA to either accept or reject all amounts reported on an FITR. Moreover, recorded total sales of $8,596,353 exceeds the gross receipts of $8,068,782 reported on the 2013 FITR by $527,571. This is strong evidence that the gross receipts reported on the 2013 FITR are understated. On the other hand, there is no evidence to indicate that COGS reported on the 2013 FITR is erroneous. Therefore, we find it reasonable for CDTFA to accept appellant's reported COGS on the 2013 FITR and reject reported gross receipts on that same FITR.

Appellant's primary customer is a related entity, and appellant provided evidence that the purchases reported by the related entity are very close to the amount of appellant's recorded total sales. Appellant asserts that this is evidence that its recorded total sales are accurate, because the related entity has no reason to understate its purchases, as doing so would increase its income tax liability. However, the evidence shows that appellant made substantial amounts of sales to third party customers other than the related company.[9] Thus, accounting for the related company's purchases does not account for all appellant's sales.

Appellant alleges that the large differences in beginning and ending inventories used by CDTFA does not provide for accurate inventory calculations to calculate COGS for each year. Appellant cites CDTFA Audit Manual section 0407.10, stating that purchases may be considered COGS when inventories cannot be verified.[10] In this case, if one were to disregard the inventories, then COGS for 2013 would be $7,038,614 instead of $10,535,427. Appellant asserts that CDTFA has not verified the inventory amounts reported on the 2013 FITR. Thus, appellant contends that the inventories reported on the 2013 FITR should be disregarded, and COGS for 2013 should be $7,038,614.

Section 0407.10 of the CDTFA Audit Manual states, in relevant part, "In many cases, the taxpayer will not have inventories which can be checked for accuracy. In this event, the purchases may be considered the cost of sales *if there is evidence that inventories were*

[9] For example, in 2012, appellant's recorded sales were $7,550,302, and the sales made to the related company were $2,256,467. Thus, in that year, less than half of appellant's sales were to the related company. In 2013, recorded sales were $8,596,353 and sales to the related company were $8,213,854, a difference of $382,499.

[10] CDTFA's Audit Manual does not provide binding legal authority; however, OTA may look to it for guidance. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

substantially constant." (Italics added). On its FITRs, appellant calculated COGS as merchandise purchases plus beginning inventory less ending inventory, which is the same method proposed in section 0407.10 of CDTFA's Audit Manual. Thus, calculating COGS in this manner is an accepted and standard accounting procedure. (See, *Riley B's, supra*, at pp. 612-613.) Therefore, CDTFA acted reasonably in calculating COGS for 2013 using this same formula and appellant's inventory figures.

The evidence here indicates that appellant's inventories for 2013 were not constant. Also, appellant sold merchandise to its related company at cost, and appellant's sales to the related company in 2013 were $8,213,854. Thus, at a minimum, appellant's COGS for 2013 had to be at least $8,213,854, which is significantly greater than the COGS amount of $7,038,614 that appellant argues should be used for that year. Appellant has not provided any documentation to show that the inventory amounts reported on the 2013 FITR are inaccurate. In fact, appellant acknowledges that the ending inventory for 2012 is $3,696,611, which is also the beginning inventory for 2013. On its FITR for 2014, appellant reported beginning inventory of $196,798, which is the ending inventory for 2013. Thus, appellant's reported ending inventory for 2012 and beginning inventory for 2014 support the inventory amounts used for 2013. For those reasons, and because it is an option instead of a requirement to disregard inventory, we reject appellant's argument that inventories should be disregarded in the calculation of COGS for 2013.

Appellant argues that because CDTFA accepted recorded total sales as accurate for 2014, CDTFA should do the same for the remainder of the audit period. We find no authority that would prevent CDTFA from accepting recorded and/or reported sales for one period and rejecting reported and/or recorded sales for other periods. Here, CDTFA compared total sales reported on the sales and use tax returns to COGS reported on the FITRs to compute book markups of -67.37 percent for 2012, -58.52 percent for 2013, and 42.69 percent for 2014. Because of the negative book markups for 2012 and 2013, reported sales were clearly understated. CDTFA's acceptance of the recorded sales for 2014 is reasonable based on its analysis of book markups, and for the same reason CDTFA's non-acceptance of recorded sales for the other periods in the audit is reasonable.

Appellant argues that based on a "preponderance of the evidence" the markup approach is unwarranted. Essentially, appellant argues that the totality of all the above arguments should persuade us that the markup approach is unwarranted. However, we have rejected each of appellant's arguments, and thus we reject appellant's argument that the markup approach is unwarranted.

In conclusion, appellant has failed to provide documentation or other evidence from which a more accurate determination could be made and has failed to meet its burden of establishing that a further reduction to the measure of unreported taxable sales is warranted.

Issue 2: Has appellant shown that a reduction to the unreported cost of purchases of fixed assets subject to use tax is warranted?

An excise (use) tax is imposed on the storage, use, or other consumption in this state of tangible personal property purchased from any retailer, measured by the sales price of that property. (R&TC, § 6201.) Every person storing, using, or otherwise consuming tangible personal property from a retailer in this state is liable for the use tax. (R&TC, § 6202(a).) That person's liability is not extinguished until the use tax has been paid to the state, or a retailer licensed to do business in this state issues a receipt showing taxes paid. (R&TC, § 6202(a).) It shall be presumed that tangible personal property sold by any person for delivery in this state is sold for storage, use, or other consumption in this state until the contrary is established. (R&TC, § 6241.)

Appellant did not provide any records relating to its purchases of fixed assets. The only evidence available to CDTFA was that which came into its possession in the prior audit of the parent company, which revealed that appellant's parent purchased fixed assets subject to use tax. It was, therefore, reasonable for CDTFA to conclude appellant likely purchased fixed assets subject to use tax in the current audit period, and to use the $4,617 quarterly average from the prior audit of the parent company to estimate appellant's purchases of fixed assets. Thus, the burden of proof shifts to appellant to show error in the audit.

Appellant disputes this measure of tax but provided no specific reason. Appellant did not provide a record of its fixed asset purchases for the audit liability period. A taxpayer's failure to produce evidence that is within his or her control gives rise to a presumption that such evidence, if provided, would be unfavorable to the taxpayer's case. (*Appeal of Morosky*, 2019-OTA-312P.) Because appellant did not provide any documentation or other evidence from which a more accurate determination could be made, we conclude that appellant has failed to meet its burden of establishing that a reduction to the measure of the unreported cost of purchases of fixed assets subject to use tax is warranted.

HOLDINGS

1. Appellant has not shown that any further reduction to the measure of tax for unreported taxable sales established using the markup method is warranted.
2. Appellant has not established that a reduction to the measure of tax for the unreported cost of purchases of fixed assets subject to use tax is warranted.

DISPOSITION

Respondent's action in deleting the negligence penalty, reducing the total measure of tax for both NODs combined, to $5,642,330, and otherwise denying the petitions, is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

DocuSigned by:
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Josh Lambert
Administrative Law Judge

DocuSigned by:
DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

Date Issued: 2/23/2022