OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No.: 19125556
SCHAT COMMUNICATIONS, INC.	CDTFA Case ID: 037-058

OPINION

Representing the Parties:

For Appellant: Marianne Schat, President

For Respondent: Nalan Samarawickrema, Hearing Representative
Chad Bacchus, Tax Counsel IV
Jason Parker, Chief of Headquarters Operations

For Office of Tax Appeals (OTA): Craig Okihara, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Schat Communications, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) dated June 6, 2017, which is for $19,556.91 in tax, a negligence penalty of $1,955.69, and applicable interest, for the period January 1, 2015, through March 31, 2016 (liability period). Subsequently, CDTFA deleted the negligence penalty and otherwise denied the appeal.

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.[2]

[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 referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

[2] This matter was previously scheduled for an oral hearing on June 16, 2021. Prior to going on the record, appellant requested for the matter to be converted from an oral hearing matter to a nonappearance matter citing privacy concerns; appellant's request was granted.

ISSUE

Whether any adjustments to the amount of unreported taxable sales are warranted.

FACTUAL FINDINGS

1. Appellant is an internet service provider (ISP) located in Bishop, California, with sales of internet services, computer equipment, and computer repair as part of its business.
2. CDTFA audited appellant for the period January 1, 2015, through March 31, 2016. For the liability period, appellant reported total sales of $173,396,[3] claiming deductions of $19,888 for exempt sales in interstate and foreign commerce, $111,121 for nontaxable repair and installation labor, and $34,195 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of $8,192. After applying a deduction, appellant reported sales tax due and payable of $655 for the liability period.[4] Appellant did not claim a tax-paid purchase resold deduction on its sales and use tax returns (SUTRs) during the liability period.
3. Upon audit, appellant provided profit and loss statements for the liability period; sales tax reports for the liability period; bank statements for May 2016 and June 2016 (after the liability period); purchase tax reports for the liability period; and examples of merchandise purchase invoices from vendors listed on the purchase tax report. Appellant did not provide source documentation, such as sales invoices, to support reported sales and claimed deductions. Appellant's reporting method is unknown.
4. The cost of goods sold for equipment of $110,829 recorded in appellant's profit and loss statement for 2015 exceeded taxable sales of $102,094 recorded in the sales tax report for 2015, which results in a negative markup. Based on the negative markup, CDTFA determined that additional examination was warranted.

[3] The reported total sales by quarter are as follows: first quarter of 2015 (1Q15) $45,484; 2Q15 $44,010; 3Q15 $46,842; 4Q15 $32,656; and 1Q16 $4,404.

[4] We note that the returns for the last three quarters of 2015 were completed incorrectly. Appellant reported charging $34,195 in sales tax reimbursement from its customers on those returns, which corresponds to a self-reported sales tax liability of $34,195, and a taxable measure of approximately $427,425 for those three quarters alone. Nevertheless, the reported total sales for the entire period (all of 2015 and the first quarter 2016) were only $173,396, which is impossible considering the amount of the deduction claimed. Thus, returns for the last three quarters of 2015 were, on their face, incorrect.

5. Taxable sales recorded in appellant's sales tax reports exceeded taxable sales reported on its SUTRs by $113,452.[5]

6. CDTFA requested that appellant provide support for claimed deductions of $19,888 for exempt sales in interstate and foreign commerce and $111,121 for nontaxable repair and installation labor. The $19,888 in claimed deductions for exempt sales in interstate and foreign commerce were for the first quarter of 2015 (1Q15). Appellant did not provide source documentation to support claimed deductions; thus, CDTFA disallowed claimed deductions for claimed exempt sales in interstate and foreign commerce and nontaxable repair and installation labor in their entirety.

7. Based on its determination that appellant failed to establish a basis for any deductions, CDTFA billed appellant for the difference between appellant's recorded and reported taxable sales excluding sales tax[6] ($113,452) and added the disallowed deductions for nontaxable labor ($111,121) and claimed exempt sales ($19,888). This resulted in audited underreported taxable sales of $244,461 for the liability period.

8. CDTFA issued an NOD to appellant on June 6, 2017, with a tax liability of $19,556.91, a negligence penalty of $1,955.69, and applicable interest.

9. Appellant filed a timely petition for redetermination disputing the NOD in its entirety.

10. CDTFA issued a decision recommending that the negligence penalty be deleted, but otherwise denying the petition. This timely appealed followed.

11. On November 29, 2020, appellant submitted a statement, signed by A. Schat,[7] that describes appellant's business practice as selling and servicing internet, tech support for internet service issues, computer tech service, and retail sales. A. Schat indicates that appellant, or its predecessor, began pre-paying all sales tax to vendors on all inventory it purchased after a prior unrelated audit. A. Schat explains that when items were sold for a higher markup, appellant paid the tax on the difference between the purchase price and the selling price. A. Schat also explains that appellant self-consumed many items it purchased at retail.

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[5] Recorded taxable sales of $121,644 – reported taxable sales of $8,192 = $113,452.

[6] Although appellant claimed tax-included sales on its return, because CDTFA examined the recorded amounts exclusive of sales tax, it was not necessary to bill appellant for the erroneous $34,195 deduction.

[7] Appellant's predecessor was the sole proprietor A. Schat, who is married to appellant's president.

12. On November 30, 2020, appellant submitted e-mails with approximately 253 pages of attachments. The attachments include the following: customer activity reports for tribal sales for 1Q15 through 4Q16; 41 labor reports for 1Q15 through 3Q15; and invoices for purchases (e.g., PlayStation controllers, printer ink, a dual fuel power generator, power supply units, and other items).

13. The 41 labor reports included the following services: (1) performing diagnostics (e.g., identifying faulty computer components, restoring e-mails, restoring internet connectivity, diagnosing overheating issues, and identifying virus or malware issues); (2) formatting storage drives (e.g., hard disc drive or pen drive) or customer data; (3) installing, reloading, or updating software (e.g., operating systems, antivirus software, service packs, or drivers); (4) replacing defective components (e.g., power supply unit, cooling fan, storage device); (5) backing up or transferring customer's data from a defective storage device to a functional device; and (6) testing to ensure the repair was properly completed. Of the labor reports that required parts, appellant separately stated a charge for parts and otherwise it appears that appellant's customers provided the part. There are also parts included on some labor reports. There is no evidence of sales tax reimbursement being charged or collected on those parts. On several labor reports, the total charge was blank, but included a preapproved repair budget. Excluding the cost of parts, the labor reports show approximately $6,125 in charges.

14. On May 18, 2021, CDTFA submitted a revised Exhibit H. Exhibit H analyzed appellant's November 30, 2020 submission as well as appellant's California S Corporation Franchise or Income Tax Return for 2015, appellant's U.S. Income Tax Return for an S Corporation for 2015, and appellant's California S Corporation Franchise or Income Tax Return for 2016 (income tax returns). According to appellant's income tax returns: appellant reported $1,252,181 for 2015 in gross receipts or total sales with $577,465 costs of goods sold; $1,282,811 for 2016, in gross receipts or total sales with $480,428 costs of goods sold; and for 1Q16, appellant's reported gross receipts or total sales were $323,425 with $121,221 costs of goods sold. CDTFA also included 1099-K

data for 2015, which totaled $850,527 for 2015.[8] The 1099-K amounts for 1Q16 are $196,218 ($62,648 for January, $66,711 for February, and $66,859 for March).

15. On September 23, 2021, we sent the parties an additional briefing request for further clarification regarding their positions.

16. On November 23, 2021, CDTFA responded to our additional briefing request.

17. On November 29, 2021, CDTFA's response to our additional briefing request was acknowledged in writing. Appellant was given until December 29, 2021, to respond. On January 13, 2022, the written record closed.

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.) All of a retailer's gross receipts are presumed subject to tax unless the retailer can prove otherwise. (R&TC, § 6091.) "Gross receipts" are the total amount of the sales price without any deduction for labor, service cost or other expense, and include any services that are part of the sale. (R&TC, § 6012(a)(2), (b)(1).) Gross receipts do not include the price received for labor or services used in installing or applying the property sold. (R&TC, § 6012(c)(3); Cal. Code Regs., tit. 18, § 1546(a).) A "sale" means and includes any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of TPP for a consideration. (R&TC, § 6006(a).)

A sale includes the producing, fabricating, processing, printing, or imprinting of TPP for consideration for consumers who furnish, either directly or indirectly, the materials used. (R&TC, § 6006(b).) However, the providing of a service that is not part of a sale or purchase of TPP is not subject to tax. (Cal. Code Regs., tit. 18, § 1501.) If the true object of the contract is the service per se, the transaction is not subject to tax even though some TPP is transferred. (*Ibid*.) Charges for labor or services used in installing or applying the property sold are excluded from the measure of the tax. (Cal. Code Regs., tit. 18, § 1546(a).) If the retail value of the parts and materials furnished in connection with repair work is more than 10 percent of the total charge, or if the repairer makes a separate charge for such property, the repairer is the retailer

[8] Form 1099-K is used to report a taxpayer's income received from electronic or online payment services (e.g., credit cards, debit cards, PayPal, etc.). It is authorized by the IRS for tax administration purposes.

and tax applies to the fair retail selling price of the property. (Cal. Code Regs., tit. 18, § 1546(b).)

Pursuant to California Code of Regulations, title 18, (Regulation) section 1701(a), a retailer who resells TPP before making any use thereof 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 use tax. The deduction under the caption "Tax-paid purchases resold" must be taken on the retailer's return in which its sale of the property is included. (*Ibid*.) If the deduction is not taken in the proper quarter, a claim for refund of tax must be filed. (*Ibid*.)

R&TC section 6396 provides an exemption from tax when the property pursuant to the contract of sale is required to be shipped 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. (See Cal. Code Regs., tit. 18, § 1620(a)(3)(B).) A retailer seeking an exemption or exclusion bears the burden of proving by credible evidence that the statutory requirements have been satisfied. (*Appeal of Thomas Conglomerate*, 2021-OTA-030P.)

If CDTFA is not satisfied with the accuracy of the SUTRs 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 or may come into its possession. (R&TC, § 6481.) It is the retailer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When a taxpayer challenges an NOD, CDTFA has a minimal, initial burden showing that its determination is reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) If CDTFA carries that burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.) To satisfy its burden of proof, a taxpayer must prove both (1) that the tax assessment is incorrect and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

During the liability period, appellant claimed deductions for nontaxable repair and installation labor, exempt sales in interstate and foreign commerce, and sales tax reimbursement included in reported total sales. Upon audit, appellant did not provide source documentation (e.g., sales invoices together with shipping documents, labor reports, etc.). CDTFA determined that the cost of goods sold for equipment of $110,829 recorded in appellant's profit and loss statement for 2015 exceeded taxable sales of $102,094 recorded in appellant's sales tax report for 2015, which results in a negative markup.[9] CDTFA, therefore, relied upon appellant's sales tax reports and its purchase reports to determine the audited taxable sales of the liability period. CDTFA treated all sales as taxable unless appellant provided documentation sufficient to show the sale was properly deducted or otherwise exempt from tax. 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.

Appellant makes several arguments: appellant contends that it made exempt sales in interstate or foreign commerce; that it properly deducted nontaxable repair and installation labor; that an adjustment is warranted for tax-paid purchases resold; and that it could provide documentation to support reductions to the measures of tax but is uncertain as to what to provide. On November 30, 2020, appellant submitted 253 pages comprised of labor reports, customer activity reports for tribal sales, and purchase invoices of TPP.

In response to appellant's November 30, 2020 submission, CDTFA incorporated appellant's submission and compared appellant's income tax returns to appellant's SUTRs for the liability period. CDTFA determined that reported total sales on appellant's SUTRs were significantly understated when compared to gross receipts reported on its income tax returns for the liability period. CDTFA also applied the credit card sales ratio method to compute a much larger measure of tax than the measure computed for the liability period, which CDTFA used to

[9] "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 $0.70 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 = 0.30).

further support that the determination at issue is reasonable.[10] In addition, CDTFA recomputed cost of goods sold using audited sales and cost of goods sold according to appellant's income tax returns, which showed a negative 80.08 percent markup of for the liability period.[11] CDTFA reiterated its position that the negative markup for this kind of business is unacceptable and that no additional adjustments are warranted.

Here, appellant did not provide any support for its contention that it made exempt sales in interstate or foreign commerce. However, appellant did provide a customer activity report for tribal sales without supporting documentation (e.g., shipping information, invoices, etc.) or further explanation. From appellant's submission, it is unclear whether the customer activity reports for tribal sales are intended to support appellant's argument regarding the disallowed exempt sales in interstate and foreign commerce or if appellant is making a new argument by claiming that an adjustment is warranted based on nontaxable tribal sales.[12] In general, "[s]ales tax does not apply to sales of [TPP] made to Indians negotiated at places of business located outside the Indian reservations if the property is delivered to the purchaser and ownership to the property transfers to the purchaser on the reservation." (Cal. Code Regs., tit. 18, § 1616(d)(4)(A).) The tribal sales reports indicate that sales were made throughout the liability period. In contrast, appellant only claimed exempt sales in interstate or foreign commerce during 1Q15. With respect to appellant's claimed exempt sales, no shipping information or other supporting information was provided to show that the TPP was delivered to a point outside of California or, alternatively, onto an Indian reservation.[13] (*Ibid*.) We, therefore, find that appellant failed to support its contentions regarding exempt sales in interstate or foreign

[10] The credit card sales ratio method is a standard audit procedure that is effective in establishing taxable sales because it relies on readily verifiable information: the amount of credit card receipts. This audit method is described in further detail in CDTFA's Audit Manual section 0810.12. (*Appeal of Amaya*, 2021-OTA-328P.)

[11] (Reported total sales of $139,201 – cost of goods sold $698,686 = -559,485) ÷ cost of goods sold $698,686 = -80.08 percent.

[12] On September 23, 2021, we sent the parties an additional briefing request which sought various clarifications and documents. We asked for clarification regarding appellant's claimed nontaxable tribal sales. Appellant, however, did not respond to our request.

[13] "For purposes of this regulation 'Indian' means any person of Indian descent who is entitled to receive services as an Indian from the United States Department of the Interior. … 'Reservation' means Indian country as defined in section 1151 of title 18 of the United States Code. The term includes reservations, rancherias, and any land held by the United States in trust for any Indian tribe or individual Indian. 'On a reservation' and 'on an Indian reservation' mean within the boundaries of a reservation." (Cal. Code Regs., tit. 18, § 1616(d)(2).)

commerce or, alternatively, its contention regarding nontaxable tribal sales.

Regarding the labor reports, appellant has not made additional argument or otherwise explained its position despite the opportunities to do so.[14] Nonetheless, according to CDTFA's response to our additional briefing request, CDTFA does not dispute that the labor, identified in the labor reports, is nontaxable repair labor as opposed to taxable fabrication labor.[15] However, CDTFA asserts that there were separately stated sales of parts reflected on the labor reports and appellant did not charge or collect sales tax reimbursement on those sales. CDTFA also asserts that the labor report invoice totals do not match with appellant's sales tax reports. CDTFA argues that appellant did not specify the amount of non-taxable labor adjustments it seeks in conjunction with the labor reports. CDTFA argues that the 41 labor reports are a very small sample of appellant's total claimed exempt sales and are, therefore, not a representative sample.[16] In a similar vein, CDTFA argues that appellant did not provide any computations or other information that is required to compute non-taxable repair labor for the audit period. In addition, CDTFA maintains its position that the audit was substantially understated in appellant's favor and that no additional adjustments are warranted based on the labor reports.

Based on our review, there is no evidence that sales tax reimbursement was collected on the sale or transfer of parts identified in the labor reports. Effectively, the labor reports that include transfers of TPP are evidence that appellant was understating its taxable sales. Of particular concern, the labor reports do not correspond to appellant's sales tax reports, which means that these sales are not internally consistent, or independently verifiable, with appellant's own records, specifically appellant's sales tax reports. Since appellant has not provided additional explanations regarding the labor reports and the labor reports are not internally consistent with appellants own records, we do not find the labor reports to be credible evidence

[14] According to our June 18, 2021 Orders, appellant was given the opportunity to submit additional information. Then, on September 22, 2021, we requested additional briefing from the parties, which included requests for clarification regarding appellant's contentions. In response to CDTFA's November 23, 2021 submission, appellant was given until December 29, 2021 to file a reply. Thereafter, OTA notified the parties that the record closed on January 13, 2022.

[15] CDTFA has several annotations interpreting and implementing the R&TC with respect to taxable fabrication labor versus nontaxable repair labor. (See, e.g., Sales and Use Tax Annotations 315.0055 (4/13/92) [computer additions]; 120.0015 (6/9/89) [charges related to installation and hardware]; 120.0115 (2/14/95) [installation of software]; 120.0531 (4/10/97) [software and software updates install into customer's computer]; and 120.1176 (3/16/17) [data recovery services].)

[16] CDTFA indicated that the 41 labor reports are 1.65 percent of appellant's claimed and netted monthly exempt sales ($6,564, parts included / $395,584).

that an adjustment is warranted. Based on the foregoing, we find that no adjustment for nontaxable labor is warranted.

While the previous finding is dispositive, we now address CDTFA's contention that no adjustments are warranted based on the audited understatement. Adjustments to a NOD may be offset against underpayments for the same period. (R&TC, §§ 6483, 7081; *Appeal of Praxair*, 2019-OTA-310P; see also *Sprint Communications Company v. State Bd. of Equalization* (1995) 40 Cal.App.4th 1254.) According to appellant's income tax returns, appellant reported $1,252,181 for 2015 in total sales and total sales of $323,425 for 1Q16. In contrast, for 2015 appellant reported $168,992 in total sales on its SUTRs, claiming $111,121 as nontaxable labor; and for 1Q16 appellant reported $4,404 in total sales on its SUTR. We find that these figures support CDTFA's position that reported total sales were substantially understated in its audit. Also, we note that appellant claimed a $34,195 deduction for sales tax reimbursement on tax-included sales, as reported on appellant's SUTRs, but only paid $655 in sales tax for the liability period. In contrast, CDTFA only determined an additional sales tax liability of $19,556.91 for the liability period. As such, the tax for which appellant was billed on the NOD is still less than the unremitted sales tax reimbursement of $34,195 that appellant self-reported. Thus, even if we were to accept appellant's labor reports as true and accurate, the potential adjustment would be offset based on the audited understatement.

Appellant also contends that an adjustment is warranted for tax-paid purchases resold. Appellant, however, did not claim a tax-paid purchase resold deduction on its SUTRs during the liability period. Also, we found no claim for refund for tax-paid purchases resold during our review of the record. Thus, appellant did not comply with the requirements of Regulation section 1701(a). While the purchase invoices in appellant's submission show that tax was paid on those purchases of TPP, appellant has not tied the purchase invoices to its sales during the liability period to show that the TPP was resold. Without more information (e.g., appellant's sales invoices), it remains unclear whether the TPP was retained in inventory, consumed by appellant, or resold. For example, the invoices in appellant's submission show that appellant purchased a dual fuel generator, PlayStation controllers, printer ink, and other items that appellant may have used or consumed. We note that appellant is an ISP with sales of internet services, computer equipment, and computers repairs. Given the nature of appellant's business, we would not typically expect appellant to make sales of dual fuel generators. If an item

remained in resale inventory or if it were used or consumed by appellant, then appellant would not be entitled to the tax-paid purchases resold deduction. (See Cal. Code Regs., tit. 18, § 1701(a), (b).) Accordingly, we find that appellant did not comply with the requirements of Regulation section 1701(a) or provide the necessary evidence to support a tax-paid purchases resold deduction.

Appellant contends that it can show more proof, but it needs to know what is required. However, appellant's predecessor was involved in a prior audit "several years ago" according to the November 29, 2020 statement from A. Schat. We surmise that appellant would become more familiar with record keeping requirements through the prior audit. We also note that CDTFA requested that appellant submit supporting documentation during this audit, and CDTFA's Appeals Bureau again allowed appellant the opportunity to provide specific documentation to support adjustments to the audited taxable measure. During the appeals process at OTA, appellant was informed of the kind of documentation that was required to support its contentions; and appellant had several opportunities to submit additional documentation to support its contentions.[17] Appellant also has not identified any errors in its own sales tax reports or purchase reports that were relied upon by CDTFA to determine the liability.

In sum, we find that an adjustment for claimed nontaxable labor is not warranted based on the lack of credible evidence. Alternatively, even if we were to accept appellant's labor reports, the potential adjustment would be offset based on the audited understatement. Likewise, we find that appellant has not provided sufficient evidence to support claimed deductions of $19,888 for exempt sales in interstate and foreign commerce. We also find that appellant has not provided adequate documentation to warrant an adjustment for tax-paid purchases resold.

[17] Our November 18, 2020 Minutes and Order of Pre-Hearing Conference noted that appellant's Request for Appeal indicated it was unsure of which documents to provide to contest the audit items. Therein, we indicated that the kinds of documentation that should be submitted to address the audit items include, but are not limited to, the following: invoices from vendors that show sales tax reimbursement was paid; invoices for services or service contracts; and invoices for out-of-state customers with shipping information (e.g., carrier used, tracking numbers, out-of-state addresses of customers, and receipts for postage).

HOLDING

No adjustments to the amount of unreported taxable sales are warranted.

DISPOSITION

CDTFA's action in deleting the negligence penalty and denying the petition is sustained without further adjustments.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Teresa A. Stanley
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Teresa A. Stanley
Administrative Law Judge

DocuSigned by:
Andrea L.H. Long
272945E7B372445...
Andrea L.H. Long
Administrative Law Judge

Date Issued: _____