

**OFFICE OF TAX APPEALS  
STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 21088455  
YUBA CITY STEEL PRODUCTS CO. ) CDTFA Case IDs 087-898; 087-899  
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**OPINION**

Representing the Parties:

For Appellant: William A. Buck, Representative

For Respondent: Jason Parker, Chief of Headquarters Operations

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

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Yuba City Steel Products, Inc. (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (respondent),<sup>1</sup> partially denying appellant’s petition for redetermination of two Notices of Determination (NODs) issued on July 13, 2018, for the period October 1, 2014, through December 31, 2017 (liability period).<sup>2</sup> One NOD was for tax of \$166,367.00, and applicable interest, and the other NOD was for a negligence penalty of \$16,636.72.

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<sup>1</sup> Sales and use taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, “respondent” refers to BOE.

<sup>2</sup> Respondent originally planned the audit for the period October 1, 2014, through September 31, 2017, but appellant sold its business in December 2017, so respondent extended the audit to include the final quarter of operation.

The tax liability was determined by audit, which found a total deficiency measure of \$2,438,220 consisting of nine audit items.<sup>3</sup> In a subsequent audit, respondent reduced the deficiency measure from \$2,438,220 to \$2,105,459, which will result in reductions to the tax and penalty.

This matter is being decided on the basis of the written record because appellant waived the right to an oral hearing.

### ISSUES

1. Does the evidence establish that a reduction to the measure of disallowed claimed nontaxable labor is warranted?
2. Does the evidence establish that a reduction to the measure of disallowed claimed sales for resale is warranted?
3. Does the evidence establish that a reduction to the measure of disallowed claimed partial exemptions for tangible personal property (TPP) sold for use as farm machinery and equipment is warranted?
4. Does the evidence establish that a reduction to the measure of disallowed claimed partial exemptions for TPP sold for use in manufacturing is warranted?
5. Does the evidence establish that a reduction to the measure of unreported taxable sales (or excess sales tax reimbursement collected) based on a sales tax reconciliation (recorded or accrued versus reported) is warranted?
6. Does the evidence establish that a further reduction to the measure of unreported taxable sales based on a reconciliation of appellant's federal income tax returns (FITRs) is warranted?

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<sup>3</sup> The items were: (1) disallowed claimed nontaxable labor, measured by \$70,865 (\$5,294 in tax); (2) disallowed claimed sales for resale, measured by \$602,675 (\$44,835 in tax); (3) disallowed claimed partial exemption for sales of farm equipment or machinery, measured by \$198,603 (\$10,896 in tax); (4) disallowed claimed partial exemption for sales of machinery or equipment used in manufacturing, measured by \$308,189 (\$12,639 in tax); (5) unreported taxable sales (or excess sales tax reimbursement collected) based on a sales tax reconciliation (reported or accrued versus reported) measured by \$190,882 (\$14,311 in tax); (6) unreported taxable sales based on a reconciliation of appellant's federal income tax returns, measured by \$344,893 (\$25,654 in tax); (7) unreported purchases of fixed assets (see footnote 4, below) subject to use tax, measured by \$101,962 (\$7,647 in tax); (8) unreported taxable sales for the fourth quarter of 2017 (4Q17) based on the average determined audit liability for other quarters, measured by \$244,976 (\$17,761 in tax); and (9) unreported sales of fixed assets (sold with the business premises), based on county property tax records, measured by \$375,175 (\$27,200 in tax).

7. Does the evidence establish that a reduction to the measure of unreported purchases of fixed assets<sup>4</sup> subject to use tax is warranted?
8. Does the evidence establish that a further reduction to the measure of unreported taxable sales for the fourth quarter of 2017 is warranted?
9. Does the evidence establish that a reduction to the measure of unreported sales of fixed assets (sold with the business premises) is warranted?
10. Did respondent correctly impose the negligence penalty?

#### FACTUAL FINDINGS

1. Appellant held a seller's permit since at least 1948 and was engaged in the manufacture, fabrication, and repair of TPP until appellant sold its business and respondent closed appellant's seller's permit effective December 18, 2017.
2. For the period October 1, 2014, through September 30, 2017 (audit period)<sup>5</sup> appellant filed sales and use tax returns (SUTRs), reporting total sales of \$8,713,465 and claiming total deductions of \$7,490,402, thus reporting taxable sales of \$1,223,063.<sup>6</sup> Appellant did not file an SUTR for the fourth quarter of 2017 (4Q17).
3. Appellant was audited on three occasions prior to the audit at issue in this appeal; and in two of those audits, respondent identified deficiencies that included disallowed claimed sales for resale, differences between recorded and reported amounts, and failure to pay use tax on purchases from out-of-state vendors.
4. For the audit, appellant provided its FITRs for 2015 and 2016, sales reports for the audit period, and sales invoices for 1Q17 and 3Q17 only. Appellant did not provide a general ledger, a purchase journal, or purchase invoices for audit. Respondent concluded that the books and records were incomplete and inadequate for sales and use tax purposes.

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<sup>4</sup> In this Opinion, we use the term "fixed asset" to describe TPP used in the course of regular business operations to produce income. It could include portable machinery and equipment, including forklifts and other vehicles, fixtures, office furniture, tools, and supplies, but would typically not include inventory, such as TPP held for sale or lease in the ordinary course of business.

<sup>5</sup> In this Opinion we use "audit period" to describe a period examined in the audit *and* for which appellant filed SUTRs, as distinguished from the liability period, which also includes 4Q17.

<sup>6</sup> The claimed deductions were: \$187,228 for nontaxable labor; \$6,762,991 for nontaxable sales for resale; \$198,603 for property sold for use as farm machinery and equipment; \$8,946 for diesel fuel used in farming and food production; \$308,189 for property used in manufacturing; \$8,652 for exempt sales to the U.S. Government; \$13,924 for exempt sales in interstate or foreign commerce; \$256 for tax-paid purchases resold; and \$1,613 for unexplained "other." Appellant also reported purchases subject to use tax totaling \$548.

5. Appellant claimed \$187,228 in deductions for nontaxable labor. Respondent tested the validity of the claimed deductions for nontaxable labor by performing a block test<sup>7</sup> of sales during 1Q17. In the test, respondent relied on the descriptions of the work performed (as stated on the sales invoices) to determine that four invoices that appellant counted as nontaxable installation or repair labor were actually taxable fabrication labor. The four errors totaled \$6,025, which was divided by the claimed nontaxable labor deductions for 1Q17 of \$15,915 to compute an error ratio of 37.85 percent. That error ratio was applied to the claimed total labor deductions of \$187,228 for the audit period to compute disallowed claimed nontaxable labor deductions of \$70,865 (audit item 1).
6. Appellant claimed deductions for sales for resale totaling \$547,987 for the audit period. Respondent tested the validity of the claimed deductions for nontaxable sales for resale by performing a block test of the sales during 3Q17, for which appellant did not provide resale certificates or any other evidence to support the claimed deductions. Nevertheless, respondent looked for information about the buyers in respondent's internal data system and treated a sale as one for resale if respondent concluded the buyer was in a type of business that would normally sell the type of TPP purchased from appellant. During the block test period, there were eight sales (totaling \$48,836) that respondent could not identify as probable sales for resale. Respondent treated these eight sales as errors. The errors totaling \$48,836 were divided by the claimed sales for resale of \$547,987 for 3Q17, to compute an error ratio of 8.91 percent, which respondent then applied to claimed deductions for sales for resale for the audit period to compute disallowed nontaxable sales for resale measuring \$602,675 (audit item 2).
7. Appellant claimed deductions of \$198,603 for property sold for use as farm machinery and equipment. Because appellant did not provide any evidence to support the claimed deductions, respondent disallowed them (audit item 3).
8. Appellant claimed deductions of \$308,189 for property sold for use in manufacturing. Because appellant did not provide any evidence to support the claimed deductions, respondent disallowed them (audit item 4).

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<sup>7</sup> A "block" test is one in which the transactions for only part of the liability period (the block test period) are examined in detail. The findings, usually expressed in terms of percentages of error calculated from the errors and differences disclosed by the test, are then applied to the liability period. The validity of the test is generally dependent on the block test period being representative of the liability period, but, as explained below, the burden of proving that the block test period is *not* representative of the liability period often falls on the taxpayer.

9. For each quarter in the audit period, respondent compared sales tax reimbursement collected to sales tax reported. Sales tax reimbursement collected exceeded sales tax reported by a total of \$14,311 for five quarters.<sup>8</sup> Respondent concluded that those tax differences represented unreported taxable sales.<sup>9</sup> Respondent divided the tax of \$14,311 by the applicable tax rate of 7.5 percent to compute unreported taxable sales based on a reconciliation of sales tax accrued measuring \$190,882 (audit item 5).
10. Respondent compared income reported on the FITRs (the sum of gross receipts and “other income”) with total sales reported on SUTRs (FITR reconciliation) and found that FITR income exceeded reported total sales by \$88,880 (gross receipts of \$88,638 and other income of \$242) in 2015 and \$179,436 (gross receipts of \$147,672 and other income of \$31,764) in 2016. Respondent concluded that these differences also represented unreported taxable sales. To calculate unreported taxable sales on this basis for 4Q14 and the first three quarters of 2017, respondent divided these differences by the total sales reported on the SUTRs for the same periods to compute error ratios of 2.54 percent for 2015, 6.64 percent for 2016, and 4.33 percent for both years combined. Respondent then applied the 4.33 percent error ratio to reported total sales for 4Q14, 1Q17, 2Q17, and 3Q17, to compute understatements for those periods totaling \$108,583. In total, respondent computed unreported taxable sales based on a reconciliation of the FITRs of \$344,893 (\$88,638 + \$147,672 + \$108,583) (audit item 6).
11. Respondent examined appellant’s asset depreciation schedules (from its FITRs) and found that appellant paid a total of \$101,962 to purchase 10 fixed assets during the liability period. Appellant did not provide purchase invoices or other documentation to show that it paid sales tax reimbursement or use tax in connection with its acquisition of this TPP. Thus, respondent included those purchases in the audit as unreported purchases of fixed assets subject to use tax (audit item 7).

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<sup>8</sup> For the remaining quarters, sales tax reported exceeded sales tax reimbursement collected. However, respondent made no adjustment for those differences because appellant did not explain why it reported more sales tax than it collected for some quarters. Respondent concluded that appellant could have reported more in sales tax than its recorded sales tax reimbursement collected because appellant did not collect the latter on some sales. While sales tax is due on taxable sales, a retailer’s authority to collect sales tax reimbursement from the purchaser depends on the terms of the sale. (Cal. Code Regs., tit. 18, § 1700(a)(1); Civ. Code, § 1656.1(a).)

<sup>9</sup> As we explain later in this Opinion, it may also have been due to appellant’s collection of excess tax reimbursement.

12. Appellant did not file a SUTR for 4Q17. Appellant used averages from the audit period to calculate appellant's taxable sales for that quarter. Respondent started with the average reported taxable sales of \$101,968. Respondent then adjusted that reported amount for the following quarterly averages for the audit period: (1) disallowed claimed nontaxable labor of \$5,905; (2) disallowed sales for resale of \$50,223; (3) disallowed claimed partial farm exemption of \$16,550; (4) disallowed claimed exempt sales for manufacturing of \$25,682; (5) unreported taxable sales based on the sales tax reconciliation of \$15,907; and (6) unreported sales based on a reconciliation of the FITRs of \$28,741. Respondent thus computed average audited taxable sales of \$244,976 per quarter, which respondent used to establish unreported taxable sales for 4Q17 (audit item 8).
13. Evidence indicates that appellant sold the business premises on December 18, 2017, for \$2,300,000. Property tax assessment rolls for the county in which the business was located indicate that appellant also had personal property valued at \$375,175. Respondent reports that no one reported the sale of the business to respondent, and our record does not show whether appellant sold the business, in addition to the business property. Nevertheless, respondent concluded that appellant sold the business, including the TPP valued at \$375,175. Thus, respondent included the \$375,175 amount in the audit as an unreported sale of fixed assets (audit item 9).
14. The total taxable measure in the audit was \$2,438,220 ( $\$70,865 + \$602,675 + \$198,603 + \$308,189 + \$190,882 + \$344,893 + \$101,962 + \$244,976 + \$375,175$ ).
15. Respondent added the 10 percent negligence penalty to the audit liability because it concluded that the understatement was due to negligence or intentional disregard of the law or authorized rules and regulations.
16. Respondent issued the above-referenced NODs to appellant on July 13, 2018.
17. Appellant filed a timely petition for redetermination, which respondent accepted as filed in connection with both NODs.

18. Respondent held an appeals conference on February 24, 2021. According to respondent, appellant appeared at the conference but did not meaningfully participate.<sup>10</sup>
19. On July 19, 2021, respondent issued its Decision denying the petition. This timely appeal followed.
20. Respondent conducted a reaudit, which resulted in adjustments to the measures of audit items 6 (FITR reconciliation) and 8 (unreported taxable sales for 4Q17).
21. For the reaudit of item 6, respondent examined “other income” separately and adjusted for nontaxable sales. As in the original audit, respondent began by noting that gross receipts reported on the FITRs exceeded total sales reported on the SUTRs by \$88,638 in 2015 and \$147,672 in 2016, and using that information, it computed error ratios of 2.53 percent for 2015, 5.46 percent for 2016, and 3.81 percent for both years combined. The 3.81 percent error ratio was applied to reported total sales for 4Q14, 1Q17, 2Q17, and 3Q17, to compute understatements for those periods combined totaling \$95,630. Respondent thus computed \$331,940 as the total difference between gross receipts reported on the FITRs and total sales reported on the SUTRs (\$88,638 + \$147,672 + \$95,630). To account for the portion of the \$331,940 amount that represented nontaxable sales, respondent compared audited taxable sales for the audit period to reported total sales for the same period to compute a taxable sales ratio of 21.77 percent,<sup>11</sup> which respondent applied to the \$331,940 difference to calculate unreported taxable sales of \$72,263. To account for the other income reported on the FITRs of \$242 for 2015 and \$31,764 for 2016, respondent compared those amounts to reported total sales for the same years to compute ratios of .01 percent for 2015, 1.17 percent for 2016, and .52 percent for both years combined. Respondent applied the .52 percent ratio to reported total sales for 4Q14, 1Q17, 2Q17, and 3Q17, to compute other income for those periods combined totaling \$12,951. Respondent thus computed total “other income” of \$44,958 for the audit period (\$242 + \$31,764 + \$12,951). Respondent concluded that it was unlikely that appellant would include nontaxable sales in “other income,” and on that

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<sup>10</sup> According to the audit work papers, appellant closed its business the day after the audit started and respondent’s efforts to contact appellant during the audit were unsuccessful. According to respondent’s decision in the agency-level appeal, appellant appeared at the appeals conference and requested a copy of the audit work papers, but made no arguments; and respondent allowed appellant time to submit written arguments and evidence.

<sup>11</sup> The taxable sales ratio refers to the ratio of taxable sales to total sales.

basis, it considered the entire “other income” amount taxable. In total, respondent computed unreported taxable sales of \$117,222 based on the reconciliation of FITRs (\$72,263 + \$44,958), which constitutes a \$227,671 reduction to the measure of audit item 6.<sup>12</sup>

22. For the reaudit of audit item 8 (unreported taxable sales for 4Q17), respondent concluded that the measures of disallowed claimed partial exemptions for sales of farm equipment or machinery, disallowed claimed partial exemptions for sales of machinery or equipment used in manufacturing, and unreported taxable sales (or excess sales tax reimbursement collected) based on the sales tax reconciliation should not be part of the calculation of the measure. Also, respondent recognized that measure of audit item 8 should be adjusted on the basis of the reduction to the measure of audit item 6 and that an adjustment was needed to account for the termination of business before December 31, 2017. Respondent recalculated the measure of unreported taxable sales for 4Q17 by starting with the average quarterly reported taxable sales of \$101,968 and adding to that amount the average quarterly unreported taxable sales of \$9,768 ( $\$117,222 \div 12$ ) from the reconciliation of the FITRs, the average quarterly sales from the disallowed labor sales of \$5,905, and the average quarterly sales from the disallowed sales for resale of \$50,223, to compute average quarterly sales of \$167,864. Since appellant closed its business in mid-December, respondent computed that the period of time appellant’s business was open in 4Q17 was 83.33 percent of that quarterly period ( $2.5 \div 3$ ). Respondent multiplied the \$167,864 average quarterly amount by 83.33 percent to compute unreported taxable sales of \$139,887 for 4Q17 (as compared to the \$244,976 amount computed in the original audit).
23. The other seven measures of tax remained the same as in the original audit. The reaudit reduced the total taxable measure from \$2,438,220 to \$2,105,459 ( $\$70,865 + \$602,675 + \$198,603 + \$308,189 + \$190,882 + \$117,222 + \$101,962 + \$139,887 + \$375,175$ ), a reduction of \$332,761.

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<sup>12</sup> In the original audit, respondent computed unreported taxable sales of \$344,893 based on the reconciliation of FITRs.



## DISCUSSION

### Issue 1: Does the evidence establish that a reduction to the measure of disallowed claimed nontaxable labor is warranted?

California imposes a sales tax on a retailer's retail sales of TPP sold in this state, 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 do not include the price received for labor or services used in installing or applying the property sold. (R&TC, § 6012(c)(3).) However, labor to fabricate or produce TPP is subject to tax. (R&TC, §§ 6006, 6012(a)(2).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, respondent 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to prove that a different result (i.e., different from that asserted by respondent) is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) A taxpayer also bears the burden of proving entitlement to an exemption or exclusion and must provide credible evidence of that entitlement. (*Appeal of Owens-Brockway Glass Container, Inc.*, 2019-OTA-158P.) The applicable burden of proof is by a preponderance of the evidence, which means that the party with the burden must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Ibid.*)

Appellant claimed \$187,228 in deductions for nontaxable labor. It was appropriate for respondent to audit appellant's SUTRs and, as part of the audit, to verify the accuracy of appellant's claimed deductions and exemptions, including this one. It appears from the evidence that respondent accurately calculated the measure for audit item 1 using a block test, which is a generally accepted sales and use tax audit methodology. (See respondent's Audit Manual, § 0405.20.<sup>13</sup>) To identify total sales, respondent used appellant's invoices for one of the two

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<sup>13</sup> Respondent's Audit Manual does not provide binding legal authority; however, the Office of Tax Appeals may look to it for guidance. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

quarters for which appellant provided invoices. To determine whether the labor was taxable, respondent used appellant's descriptions of the labor performed.<sup>14</sup> On these bases, we find that respondent has met its initial burden to show that its determination disallowing the claimed nontaxable labor was reasonable and rational. Therefore, the burden of proof shifts to appellant to prove a more accurate measure.<sup>15</sup>

Appellant disagrees with this measure of tax, but it has not stated grounds for its disagreement. Appellant has not made any argument, and it has not provided any evidence to persuade this panel that any of the four disallowed sales should have been allowed. Consequently, we find that appellant has failed to carry its burden of proof; and on that basis, we conclude that the evidence does not establish that a reduction to the measure of disallowed claimed nontaxable labor is warranted.

Issue 2: Does the evidence establish that a reduction to the measure of disallowed claimed sales for resale is warranted?

The burden of proving that a sale of TPP is not at retail is upon the seller unless the seller timely and in good faith takes from the purchaser a resale certificate verifying that the property is purchased for resale. (R&TC, § 6091; *Appeal of V.A. Auto Sales, Inc.*, 2019-OTA-299P.) If the seller does not timely obtain a valid resale certificate, the seller will be relieved of liability for the tax only when the evidence establishes that the property: 1) was in fact resold by the purchaser prior to use 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 respondent on the purchaser's returns or in an audit of the purchaser. (Cal. Code Regs., tit. 18, § 1668(e).)

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<sup>14</sup> For example, sales invoice 174449 dated January 30, 2017, describes the work performed as "Fabricate 12 GA mild steel." In this instance, respondent found the labor to be taxable fabrication labor based on the description on the sales invoice.

<sup>15</sup> When we refer to appellant's burden to prove a more accurate measure, we do not mean that appellant must perform every calculation to and including the calculation of the tax, penalty, if any, and interest due. We mean that appellant must prove facts that are sufficient to enable the Office of Tax Appeals to prescribe to respondent a reasonably clear path to the correct result.

Appellant claimed deductions for sales for resale totaling \$6,762,991 for the audit period. As with the nontaxable labor deduction just discussed, it was also entirely appropriate for respondent to use a block test of appellant's invoices from 3Q17, the only other quarter for which appellant provided invoices, to verify the validity of appellant's claimed sales for resale. Given appellant's failure to provide resale certificates or any other evidence to support its claimed sales for resale, respondent correctly disallowed them. During its agency-level appeal and here, appellant has not made an argument or provided evidence to support its claimed sales for resale. We thus find that appellant has failed to prove facts from which a more accurate determination can be made, and on that basis, we conclude that a reduction to the measure of disallowed sales for resale is not warranted.

Issue 3: Does the evidence establish that a reduction to the measure of disallowed claimed partial exemptions for TPP sold for use as farm machinery and equipment is warranted?

R&TC section 6356.5(a) partially exempts from sales and use tax the sale, storage, and use of farm equipment and machinery, and the parts thereof, purchased by a qualified person to be used primarily in producing and harvesting agricultural products. (See also Cal. Code Regs., tit. 18, § 1533.1(a).) "Farm equipment and machinery" means implements of husbandry, which include any new or used tool, machine, equipment, appliance, device, or apparatus used in the conduct of agricultural operations, except where such items are intended for sale in the ordinary course of business. (R&TC, § 6356.5(b)(2); Cal. Code Regs., tit. 18, § 1533.1(b)(1)(A).) Tax exemptions are to be strictly construed against the taxpayer. (*Appeal of Owens-Brockway Glass Container, Inc., supra.*)

For a retailer to claim the partial exemption, the qualified person who purchases or leases qualified property from an in-state retailer (or from an out-of-state retailer obligated to collect use tax) must provide the retailer with a partial exemption certificate. (Cal. Code Regs., tit. 18, § 1533.1(c)(1).) If the retailer timely and in good faith takes a partial exemption certificate from a qualified person, the partial exemption certificate relieves the retailer from the liability for the sales tax subject to exemption (or the duty of collecting the use tax subject to exemption). (*Ibid.*) A seller will be presumed to have taken a partial exemption certificate in good faith in the absence of evidence to the contrary. (Cal. Code Regs., tit. 18, § 1533.1(c)(5).)

Appellant claimed deductions of \$198,603 for property sold for use as farm machinery and equipment. However, because appellant did not provide exemption certificates or any other

evidence to support the claimed partial exemption, respondent correctly disallowed all of these claimed exemptions. Here, too, appellant has not made an argument or provided evidence to support the claimed partial exemptions. Therefore, we find that appellant has failed to carry the burden of proof. On that basis we find that a reduction to the measure of disallowed claimed deductions for property sold for use as farm machinery and equipment is not warranted.

Issue 4: Does the evidence establish that a reduction to the measure of disallowed claimed partial exemptions for TPP sold for use in manufacturing is warranted?

R&TC section 6377.1(a)(1) partially exempts from the sales tax the sale of qualified TPP to a qualified person to be used primarily in any stage of the manufacturing, processing, refining, fabricating, or recycling of TPP, beginning at the point any raw materials are received by a qualified person and introduced into the process, and ending at the point at which the manufacturing, processing, refining, fabricating, or recycling has altered the property to its completed form. “Primarily” means 50 percent or more of the time. (R&TC, § 6377.1(b)(5); Cal. Code Regs., tit. 18, § 1525.4(b)(7)<sup>16</sup>.) “Qualified TPP” includes machinery and equipment and component parts and contrivances such as belts, shafts, moving parts, and operating structures. (R&TC, § 6377.1(b)(9)(A)(i); Cal. Code Regs., tit. 18, § 1525.4(b)(11)(A)(1)<sup>17</sup>.) “Qualified TPP” also includes equipment or devices used or required to operate, control, regulate, or maintain the machinery and equipment, including, but not limited to, computers, software, and repair and replacement parts with a useful life of one or more years. (R&TC, § 6377.1(b)(9)(A)(ii); Cal. Code Regs., tit. 18, § 1525.4(b)(9)(A)(2).)

Generally, and as relevant here, qualified persons who purchase or lease qualified TPP from an in-state retailer must provide the retailer with a partial exemption certificate in order for the retailer to claim the partial exemption. (Cal. Code Regs., tit. 18, § 1525.4(c)(1).) If the retailer timely takes a partial exemption certificate in proper form from a qualified person in

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<sup>16</sup> We note that according to respondent’s current Business Taxes Law Guide (BTLG), available on respondent’s website, the correct citation is to California Code of Regulations, title 18, (Regulation) section 1525.4(b)(5).

<sup>17</sup> According to the BTLG, the correct citation is to Regulation section 1525.4(b)(9).

good faith, the partial exemption certificate relieves the retailer from the liability for the sales tax subject to exemption.<sup>18</sup> (*Ibid.*)

Appellant claimed deductions of \$308,189 for property sold for use in manufacturing. It did not make an argument or provide evidence to respondent in support of these claimed partial exemptions, and it has provided none on this appeal. Appellant has not provided exemption certificates and it did not cooperate in the audit. We find that appellant has failed to prove that it was entitled to claim the partial exemption; on that basis, we conclude that a reduction to the measure of disallowed claimed partial exemptions for TPP sold for use in manufacturing is not warranted.

Issue 5: Does the evidence establish that a reduction to the measure of unreported taxable sales (or excess sales tax reimbursement collected) based on a sales tax reconciliation (recorded or accrued versus reported) is warranted?

Generally, sales tax is accrued and recorded when the sale is made to the purchaser. (See Cal. Code Regs., tit. 18, § 1642(c).) However, a retailer is relieved from liability for sales tax insofar as the measure of the tax is represented by accounts found worthless and charged off for income tax purposes. (Cal. Code. Regs., tit. 18, § 1642(a).) Having heard nothing to the contrary from appellant here, we find that the sales tax accrued and recorded in appellant's sales reports is evidence of appellant's collection of sales tax reimbursement from purchasers. We thus find that it was reasonable for respondent to use the accrued sales tax to establish additional taxable sales, and to calculate additional tax for those quarterly periods where the sales tax accrued exceeded the sales tax reported. We also find that it was reasonable for respondent to not include in the calculation those quarters for which sales tax reported *exceeded* sales tax accrued, given appellant's failure to explain those discrepancies, which could have been due to appellant's failure to collect sales tax reimbursement on some taxable sales.<sup>19</sup> On these bases, we find that respondent used a rational audit analysis to produce a reasonable determination of

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<sup>18</sup> For the purposes of this analysis, we need not delve into the other details of the law governing this exemption.

<sup>19</sup> When sales tax is due, collection of sales tax reimbursement from the purchaser depends upon the terms of the sale. (See R&TC, § 1700(a)(1).)

unreported taxable sales based on the sales tax reconciliation.<sup>20</sup> Respondent has thus carried its minimal, initial burden, and the burden of proof shifts to appellant to prove a more accurate measure.

Appellant has provided no evidence to show errors in the sales tax accruals, or to show errors in the audit calculations relating to this measure of tax, or to show evidence of bad debts charged off for income tax purposes. Appellant has not shown that it collected excess sales tax reimbursement and refunded the excess tax reimbursement to the customer. Also, in those cases where reported sales tax exceeded accrued sales tax, appellant has not shown that it overpaid its tax liability. Appellant has also not shown that any of the differences found in the reconciliation of sales tax accrued were due to timing issues; that is, accruing sales tax in one quarterly period but reporting that sales tax in the prior or subsequent quarterly period. On the basis of the foregoing, we find that appellant has failed to provide evidence from which a more accurate determination can be made, and we thereon conclude that a reduction to the measure of unreported taxable sales (or excess sales tax reimbursement collected) based on a sales tax reconciliation is not warranted.

Issue 6: Does the evidence establish that a further reduction to the measure of unreported taxable sales based on a reconciliation of appellant's FITRs is warranted?

We note, first, that respondent correctly presumed, in the absence of evidence to the contrary, that gross receipts and “other income” reported on appellant’s FITRs constitute income from sales of TPP. (R&TC, § 6091.) In the original audit, respondent computed unreported taxable sales of \$344,893 based on a reconciliation of the FITRs. The reaudit reduced the measure to \$117,222, a \$227,671 reduction. We have examined the reaudit and find that the methodology was rationally designed to calculate appellant’s additional taxable sales reported on its FITRs and that the determined measure is the reasonable result of the correct application of

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<sup>20</sup> We note that the assessed differences found in this category could be the result of unreported taxable sales or the result of appellant collecting sales tax reimbursement in excess of what was due (excess sales tax reimbursement). When respondent ascertains that a retailer has collected excess tax reimbursement, the retailer must be afforded an opportunity to refund the excess tax to the customers from whom it was collected, and in the event of failure or refusal of the retailer to make such refunds, the retailer must pay the excess tax reimbursement to respondent. (R&TC, § 1700(b)(2).) Considering appellant’s minimal participation in the audit and subsequent appeals, we find no fault with respondent’s conclusion that the sales tax reconciliation established additional unreported taxable sales.

that methodology. This showing satisfies respondent's initial burden of proof. Appellant now has the burden of proving a more accurate measure.

Appellant disputes this measure of tax without explanation, argument, or evidence. For example, appellant has not shown that a greater allowance for nontaxable and exempt sales is warranted or that there are errors in the audit calculation of this measure of tax. On this basis, we find that appellant has failed to carry its burden of proof, and we conclude that no further reduction is warranted to the measure of unreported taxable sales based on a reconciliation of the FITRs.

Issue 7: Does the evidence establish that a reduction to the measure of unreported purchases of fixed assets subject to use tax is warranted?

When sales tax does not apply, use tax, measured by the sales price, applies to the storage, use, or other consumption in this state of TPP purchased from a retailer for storage, use, or other consumption in this state, unless that use is specifically exempted or excluded by statute.<sup>21</sup> (R&TC, §§ 6201, 6401.) Every person storing, using, or otherwise consuming such TPP in this state is liable for the tax. (R&TC, § 6202(a).) That person's liability is not extinguished until the tax has been paid to this state, though if a retailer engaged in business in this state (or who is authorized by respondent to collect the tax) gives a receipt to the purchaser, such receipt is sufficient to relieve the purchaser from liability for the tax to which the receipt refers. (R&TC, § 6202(a).) It shall be presumed that TPP 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.)

The depreciation schedules from appellant's FITRs show appellant's purchases of fixed assets totaling \$101,962 during the liability period. That evidence is sufficient to show that respondent's determination on this basis was reasonable and rational. Appellant has the burden of proving a more accurate measure, but it has not argued otherwise or provided receipts showing payment of the tax. On that basis, we thus find that appellant has failed to prove facts from which a more accurate determination can be made, and we thereon conclude that a reduction to the measure of unreported purchases of fixed assets subject to use tax is not warranted.

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<sup>21</sup> As an example, sales tax would not apply when a purchaser buys TPP from an out-of-state retailer who is not required to pay sales or use tax to respondent in connection with the transaction.

Issue 8: Does the evidence establish that a further reduction to the measure of unreported taxable sales for 4Q17 is warranted?

As relevant here, sales and use tax is payable quarterly and is due on or before the last day of the month first following the end of the quarter. (R&TC, § 6451.) As previously stated, when a taxpayer fails to timely file a return, respondent 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, § 6511.)

It is undisputed that appellant operated in California until at least December 18, 2017. Its SUTR for 4Q17 was due by January 31, 2018, but appellant has not filed the return. Under the circumstances, it was entirely appropriate for respondent to determine the amount due. Respondent originally determined appellant's taxable sales for the quarter totaled \$244,976. The reaudit reduced that measure to \$139,887. We have reviewed the reaudit and find that the methodology was rationally designed to calculate a reasonable estimate of appellant's liability for 4Q17. We also find that the methodology was correctly employed and resulted in a reasonable estimate of appellant's liability. Thus, we find that respondent has met its initial burden, and the burden of proof shifts to appellant to prove a more accurate measure.

Appellant disputes this measure of tax but has not made any specific argument or provided any evidence in opposition to this audit item. We therefore conclude that appellant has failed to meet its burden to prove a more accurate measure, and on that basis, we find that a further reduction to the measure of unreported taxable sales for 4Q17 is not warranted.

Issue 9: Does the evidence establish that a reduction to the measure of unreported sales of fixed assets sold with the business premises is warranted?

We have already explained that California imposes a sales tax on a retailer's retail sales of TPP sold in this state, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute (R&TC, § 6051) and that all of a retailer's gross receipts are presumed subject to tax, unless the retailer proves otherwise (R&TC, § 6091). Tax also applies to sales of TPP held or used by the seller in the course of an activity or activities for which a seller's permit is required. (Cal. Code Regs., tit. 18, § 1595(a)(1).)

Here, appellant was engaged in a business that required a seller's permit. The evidence indicates that appellant sold the business premises in December 2017 for \$2,300,000. Other



evidence suggests the business was also sold or merged into another company.<sup>22</sup> The county in which the business premises are located valued the TPP owned by the business at \$375,175. While there are circumstances under which a business might be sold without sales tax being due, we find that it was reasonable for respondent to conclude under these circumstances that appellant sold the fixed assets when it sold the business premises in December 2017 and that the property was sold for the value indicated on the county tax rolls.<sup>23</sup> We therefore find that respondent has met its initial burden to show that its determination regarding the sale of fixed assets was reasonable and rational. Therefore, the burden of proof shifts to appellant to prove a more accurate measure.

Appellant disputes this measure of tax but has stated no grounds for its dispute. Appellant has not provided a copy of the contract for its sale of the business premises or fixed assets. Appellant has not argued or provided evidence to show that it did not sell the fixed assets when it sold the business premises. For the reasons stated above, we find that appellant has failed to prove facts from which a more accurate determination can be made; and on that basis, we conclude that a reduction to the measure of unreported sales of fixed assets sold with the business premises is not warranted.

Issue 10: Did respondent correctly impose the negligence penalty?

R&TC section 6484 provides that if any part of the deficiency for which an NOD is issued is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Although the term “negligence” is not specifically defined in the Sales and Use Tax Law, it is a common legal concept and is generally defined as a failure to act as a reasonably prudent person would have acted under similar circumstances. (*Acqua Vista Homeowners Assn. v. MWI, Inc.* (2017) 7 Cal. App. 5th 1129, 1157.)

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<sup>22</sup> There are several references in the Assignment Activity History (CDTFA Form 414Z) that refer to the company having gone through a merger or a “major entity change,” or having been sold, all prior to December 19, 2017. On Friday, December 15, 2017, the auditor recorded that she had been informed that all employees had been fired but expected to be rehired by the following Monday. When the auditor called appellant on January 2, 2018, she learned that the telephone was disconnected, but she observed employees working in the shop area on January 11, 2018.

<sup>23</sup> While it is at least possible that appellant sold the business with the physical assets, for our purposes, we need only find that appellant sold the fixed assets.

A taxpayer is required to maintain and make available for examination on request by respondent all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k).) A negligence penalty can also be based on reporting errors, particular when the areas are substantial or when the errors continue from one audit to the next. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318.)

Respondent imposed the negligence penalty on appellant because: 1) appellant failed to maintain or provide adequate books and records for sales and use tax reporting purposes; 2) appellant failed to explain its reporting, provide evidence to support claimed deductions, or explain discrepancies upon which respondent based some liabilities; 3) the size of the understatement is large in relation to the reported measure of tax; and 4) on two of the three prior audits of appellant, respondent identified deficiencies that included disallowed claimed sales for resales, differences between recorded and reported amounts, and failure to pay use tax on purchases from out-of-state vendors, all which are deficiency items in the current audits. Appellant disputes the negligence penalty, but it has made no argument and provided no evidence to support its dispute.

Appellant was previously audited three times, and thus knew, prior to the start of the current audit (the audit at issue here), that it was required to maintain and provide a complete and accurate set of books and records sufficient for sales and use tax purposes. Yet, it did not do that for the current audit. This constitutes persuasive evidence of negligence.

In addition, audited unreported taxable sales total \$1,628,322,<sup>24</sup> which represents an error ratio of 133 percent when compared to reported taxable sales of \$1,223,603 ( $\$1,628,322 \div \$1,223,603 = 1.3307$ ). In other words, appellant reported substantially less than half of its taxable sales. On this basis, we also find that the amount of the unreported taxable sales and the

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<sup>24</sup> This amount does not include the purchases or sales of fixed assets.

large error ratio are persuasive evidence of negligence.

Finally, appellant was previously audited three times, and two of those audits included disallowed claimed sales for resale, differences between recorded and reported sales, and unreported purchases subject to use tax, all of which are at issue in the current audit. We find that these persistent errors are strong evidence of negligence.

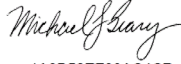
For all the above reasons, we find that appellant was negligent, and that respondent correctly imposed the negligence penalty.

#### HOLDINGS

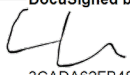
1. The evidence does not establish that a reduction to the measure of disallowed claimed nontaxable labor is warranted.
2. The evidence does not establish that a reduction to the measure of disallowed sales for resale is warranted.
3. The evidence does not establish that a reduction to the measure of disallowed claimed deductions for property sold for use as farm machinery and equipment is warranted.
4. The evidence does not establish that a reduction to the measure of disallowed claimed partial exemptions for TPP sold for use in manufacturing is warranted.
5. The evidence does not establish that a reduction to the measure of unreported taxable sales (or excess sales tax reimbursement collected) based on a sales tax reconciliation is warranted.
6. The evidence does not establish that a further reduction to the measure of unreported taxable sales based on a reconciliation of the FITRs is warranted.
7. The evidence does not establish that a reduction to the measure of unreported purchases of fixed assets subject to use tax is warranted.
8. The evidence does not establish that a further reduction to the measure of unreported taxable sales for 4Q17 is warranted.
9. The evidence does not establish that a reduction to the measure of unreported sales of fixed assets sold with the business premises is warranted.
10. Respondent correctly imposed the negligence penalty.

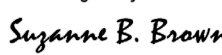
DISPOSITION

The measures of audit items 6 and 8 shall be reduced from \$344,893 to \$117,222 and from \$244,976 to \$139,887, respectively, thus reducing the overall taxable measure from \$2,438,220 to \$2,105,459, but respondent’s action denying appellant’s petition for redetermination is in all other respects sustained.

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Michael F. Geary  
Administrative Law Judge

We concur:

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Andrew J. Kwee  
Administrative Law Judge

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Suzanne B. Brown  
Administrative Law Judge

Date Issued: 5/6/2022