OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **NEWPORT JEWELERS BY GABE ARIK CORP (REHEARING)**	OTA Case No. 19044686 CDTFA Case IDs: 757324, 796213

OPINION ON REHEARING

Representing the Parties:

For Appellant:	Steve Mather, Attorney
For Respondent:	Randy Suazo, Hearing Representative Chad Bacchus, Tax Counsel IV Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6902, and former California Code of Regulations, title 18, (Regulation) section 5220, Newport Jewelers by Gabe Arik Corp (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] in response to appellant's late protest of a Notice of Determination (NOD) issued on July 25, 2013, and appellant's related claims for refund.[2] The NOD was for tax of $627,099.41, plus accrued interest, and a negligence penalty of $62,709.96, for the period January 1, 2009, through December 31, 2012 (liability period).[3] Pursuant to R&TC section 6565, an additional 10 percent penalty of $62,709.94 was

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

[2] Under regulations promulgated by CDTFA and applicable at the time appellant filed its petition, if a taxpayer files a petition for redetermination after the 30-day time period specified in former Regulation section 5211, CDTFA may accept it as an administrative (late) protest. (Former Cal. Code Regs., tit. 18, § 5220.)

[3] Appellant signed a waiver of the otherwise applicable three-year statute of limitations, and the waiver allowed CDTFA until October 31, 2013, to issue the NOD. (See R&TC, § 6487(a), 6488.)

added to the NOD for appellant's failure to pay the NOD before it became final (finality penalty). In its decision, CDTFA deleted the negligence penalty and reduced the understated taxable measure from $7,681,507.00 to $3,350,478.00, which reduced the tax by $322,748.26 and correspondingly reduced the 10 percent finality penalty. CDTFA's decision denied the remainder of the protested amount and related refund claims. Appellant paid the remaining tax of $304,351.15, plus interest and the reduced finality penalty, in full as of October 27, 2016, within a year after CDTFA issued its decision denying the late protest.[4] Appellant filed, or intended to file, refund claims for some or all of these payments.[5]

On November 16, 2016, the State Board of Equalization (board) voted to grant appellant's appeal. CDTFA timely petitioned for a rehearing, and OTA granted the petition on March 26, 2019.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew J. Kwee, Andrew Wong, and Suzanne B. Brown held a rehearing for this matter in Cerritos, California, on January 19, 2023. At the conclusion of the rehearing, the record was held open to allow time for additional briefing from the parties. During the additional briefing period, CDTFA conceded to delete and refund the finality penalty, resulting in an undisputed overpayment of $30,435.12. Thereafter, this matter was submitted for an opinion.

ISSUES

1. Whether an adjustment is warranted to the measure of audited unreported taxable sales.
2. Whether an adjustment is warranted to the measure of disallowed claimed nontaxable or exempt sales.
3. Whether the refund claims were timely.

FACTUAL FINDINGS

1. Appellant began operating a retail store in Newport Beach, California, on October 1, 2008, selling jewelry, such as rings, bracelets, watches, and diamonds.

[4] OTA understands that the claims for refund are in the total amount of $390,310.30, which includes $304,351.15 in tax, $55,524.03 in interest, and a negligence penalty of $30,435.15. The difference from the NOD amount represents the reductions already conceded by CDTFA.

[5] The timeliness and validity of the refund claims are at issue in this appeal.

Appellant fabricates some of the jewelry that it sells, and it also performs jewelry repair services.

2. For the liability period, appellant reported total sales of $26,298,609 and claimed deductions of $10,758,065 for nontaxable sales for resale, $902 for nontaxable labor, $11,257,198 for exempt sales in interstate commerce,[6] and $322,958 for sales tax included. After subtracting the claimed deductions, appellant reported taxable sales of $3,959,486.
3. For audit, appellant provided federal income tax returns (FITRs) for 2009, 2010, and 2011, as well as general ledgers, income statements, bank statements, sales invoices, and purchase invoices for the liability period. Appellant used sales invoices to record sales in the general ledger and used figures from the general ledger to report its sales on its sales and use tax returns (SUTRs).
4. In its preliminary examination of appellant's records, CDTFA found material differences between gross receipts reported on the FITRs and total sales reported on the SUTRs.
5. CDTFA used the gross receipts and costs of goods sold to compute book markups[7] of 21.42 percent for 2009, 12.68 percent for 2010, and 12.15 percent for 2011,[8] which were substantially lower than the markup CDTFA expected for this type of business (100.00 to 250.00 percent).
6. CDTFA's audit schedules compiled bank deposits of $30,619,439 and adjusted that figure for documented non-sales revenue of $2,016,449 and sales tax included of $284,270 to establish funds from sales deposited in the bank of $28,318,720.[9] That amount exceeded reported total sales (net of tax) of $26,080,304, by $2,238,416.

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[6] The $11,257,198 includes $646,566 for exempt sales in interstate commerce, which appellant inadvertently claimed as exempt sales to the United States Government.

[7] "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.

[8] In footnote 8 of its decision, CDTFA notes that the correct computation of the book markups would have been a comparison of total sales reported on the SUTRs and costs of goods sold claimed on FITRs. CDTFA computed those markups as 19.64 percent for 2009, 13.81 percent for 2010, and 10.56 percent for 2011.

[9] CDTFA's decision calculated adjusted bank deposits of $28,280,032, but it also noted that the difference would have been unlikely to change the initial audit approach taken by the auditor.

7. CDTFA used sales invoices for the third quarter 2011 (3Q11) to compile sales of $171,842, which exceeded by $13,569 taxable sales of $158,273 recorded in the general ledger for that quarter.
8. As a result of the various discrepancies in appellant's records, CDTFA concluded that appellant's records were not reliable. CDTFA decided to perform an audit and establish audited taxable sales on a markup basis.
9. CDTFA conducted an audit and established a total understatement of reported taxable sales of $7,681,507 ($7,119,572 for unreported taxable sales established on a markup basis, $139,092 for disallowed exempt sales in interstate commerce, and $422,843 for disallowed nontaxable sales for resale).
10. On July 25, 2013, CDTFA issued the aforementioned NOD.
11. In a letter dated August 27, 2013, appellant disputed the findings of the NOD. Although the letter was not a timely petition for redetermination, CDTFA accepted it as an administrative protest (CDTFA Case ID 757324).
12. Appellant made numerous payments towards the NOD and filed several claims for refund (the claims were consolidated under CDTFA Case ID 796213).
13. After filing its administrative protest, appellant provided new documentation, including a shelf test, for which it used sales invoices dated in November and December 2012. Appellant computed a markup of 11.06 percent for sales for resale. For retail sales, appellant computed a markup of 8.79 percent. Following receipt of appellant's new information, CDTFA conducted a reaudit.
14. CDTFA performed a reaudit, the results of which are summarized in a Reaudit Report dated November 8, 2013. In the reaudit, CDTFA concluded, based on its audit experience, that the 11.06 percent markup for sales for resale appeared reasonable. However, upon review of appellant's shelf test for retail sales, CDTFA found that it could not verify the scheduled costs of precious metals and stones in the jewelry. There are 29 transactions in the shelf test. Using all 29 transactions results in a markup of 8.79 percent. CDTFA used only four of the 29 transactions to compute a markup of 23.32 percent for retail sales of watches in California. CDTFA rejected the remaining 25 transactions for various reasons all pertaining to the lack of supporting documentation. CDTFA used the shelf test to establish the audited markup only for watches.

15. CDTFA noted that appellant had purchased precious metals and stones in bulk, and CDTFA could not readily identify the parts of a specific piece of jewelry to which they were added. Accordingly, CDTFA rejected appellant's computed markup for jewelry and diamonds. However, for watches, CDTFA found four sales for which appellant had provided adequate cost and selling price information. CDTFA used those four transactions to compute a markup of 23.32 percent for watches.

16. CDTFA then computed an audited markup for jewelry and diamonds using reported sales for 2009, as explained below.

17. CDTFA first compared reported taxable sales and the cost of taxable goods sold for the years 2009, 2010, and 2011. To compute the costs of taxable sales, CDTFA deducted the audited costs of sales for resale, interstate commerce sales for resale, and interstate commerce retail sales[10] from the costs of goods sold recorded in appellant's general ledger and FITRs. CDTFA then used reported taxable sales and the audited costs of taxable sales to compute a book markup for taxable sales of 86.92 percent for 2009. For 2010 and 2011, the audited costs of taxable sales of $758,224 and $1,242,348 exceeded reported taxable sales of $734,880 and $1,049,686.[11] Since costs exceeded sales for 2010 and 2011, CDTFA concluded that reported taxable sales for those years were substantially understated.

18. CDTFA concluded that the book markup for taxable sales for 2009 was reasonable, although it was somewhat lower than the markup of at least 100 percent that CDTFA expected. Accordingly, CDTFA accepted appellant's reported taxable sales for 2009 as substantially accurate.

19. CDTFA therefore used recorded amounts for 2009 to compute an audited markup for jewelry and diamonds. CDTFA had computed an audited cost of retail sales in California for 2009 of $300,536. Using appellant's general ledger, CDTFA computed that

[10] To compute the audited costs of sales for resale, CDTFA divided recorded sales for resale (compiled from the general ledger) by 111.06 percent (the audited markup for those sales plus 100.00 percent). To compute the audited costs of interstate sales, CDTFA first used appellant's records to compute percentages of interstate sales that were for resale or at retail. It used those percentages to compute interstate commerce sales for resale and interstate commerce sales at retail for each year. It then divided the sales for resale by 111.06 percent. It divided the interstate commerce retail sales by 200.00 percent, which represented an estimated markup of 100.00 percent plus 100.00 percent.

[11] Appellant did not provide the 2012 FITR until after the appeals conference with CDTFA.

34.07 percent of appellant's merchandise purchases were watches. It applied that percentage to $300,536 to compute an audited cost of watches of $102,393 for 2009; the remainder of $198,143 ($300,536 - $102,393) thus represented the cost of jewelry and diamonds for that year. CDTFA used the audited markup factor of 1.2332 (the markup of 23.32 percent plus 100.00 percent) to compute sales of watches of $126,271 ($102,393 x 1.2332). It deducted that amount from reported taxable sales of $561,775 to compute audited taxable sales of jewelry and diamonds of $435,504 for 2009. CDTFA compared $435,504 to $198,143 to compute an audited markup of 119.79 percent for retail sales of jewelry and diamonds. CDTFA subsequently identified a computation error which resulted in an increase of that markup to 120.94 percent.[12]

20. To compute audited taxable sales for 2010, 2011, and 2012, CDTFA computed the audited costs of taxable sales of watches[13] and of jewelry and diamonds for each year. For each year, CDTFA added a markup of 23.32 percent to the audited cost of taxable sales of watches and added a markup of 119.79 percent to the audited cost of taxable sales of jewelry and diamonds to compute audited taxable sales in each category. CDTFA added audited taxable sales of watches and audited taxable sales of jewelry and diamonds to establish audited taxable sales for 2010 and 2011. It computed understatements of reported taxable sales of $579,598 for 2010 and $1,031,719 for 2011. CDTFA then computed an error rate of 98.29 percent for 2011, which it applied to reported taxable sales for 2012. In total, CDTFA established unreported taxable sales of $3,196,897 on a markup basis.

21. Using appellant's sales invoices for 3Q11, CDTFA compiled recorded sales for resale of $782,349 for that quarter. Appellant failed to accept or maintain resale certificates for its claimed nontaxable sales for resale. CDTFA reviewed its records and accepted sales to businesses with active seller's permits and engaged in selling jewelry, totaling $751,755. CDTFA rejected sales totaling $30,594 to two different businesses, because those businesses did not hold a seller's permit at the time of the sale. Appellant made the disallowed sales for resale to Newport Watch and Jewelry (NWJ), and J8J8 Jewelry

[12] The error was an erroneously scheduled amount of recorded nontaxable sales for resale for 2009.

[13] CDTFA used appellant's general ledger to compute percentages of watch purchases to total merchandise purchases for each year. It applied those percentages to the audited costs of taxable sales for each year to compute the audited costs of watch purchases included in the audited costs of taxable sales.

22. CDTFA computed an error ratio of 3.91 percent ($30,594 ÷ $782,349) for sales to NWJ and J8J8 Jewelry. CDTFA added sales for resale of $7,076,097 recorded in the general ledger for the period January 1, 2009, through December 31, 2011, to sales for resale of $3,738,261 as claimed on the SUTRs for 2012,[14] to compute recorded sales for resale of $10,814,358. CDTFA multiplied recorded sales for resale of $10,814,358 by the error ratio of 3.91 percent to compute disallowed sales for resale of $422,843 (rounded). CDTFA applied 3.91 percent to sales for resale recorded in the general ledger for 2009, 2010, and 2011 and to claimed sales for resale for 2012 to compute disallowed nontaxable sales for resale of $422,843.
23. Using sales invoices for 3Q11, CDTFA found that recorded exempt sales in interstate commerce totaling $16,464, representing four sales, were not adequately supported. For one of those sales (totaling $6,900), the ship-to address was in California. For the other three sales (totaling $9,564), the ship-to address was outside California (in Nevada, Illinois, and Texas), but appellant provided no shipping documents.
24. CDTFA compiled sales in interstate commerce of $8,722,373 from the general ledger for the period January 1, 2009, through December 31, 2011, and added sales in interstate commerce of $4,914,063 claimed on the SUTRs for 2012[15] to compute recorded sales in interstate commerce of $13,636,436.
25. CDTFA computed an error ratio of 1.02 percent ($16,464 ÷ $1,608,811 recorded interstate commerce sale for 3Q11), which it applied to recorded sales in interstate commerce for the years 2009, 2010, and 2011, and claimed exempt sales in interstate commerce for 2012 to compute disallowed exempt sales in interstate commerce of $139,092.
26. On March 11, 2015, CDTFA held an appeals conference with appellant.
27. After the appeals conference, appellant provided additional records for 2012.
28. CDTFA performed a second reaudit, the results of which are summarized in schedule dated March 31, 2015. CDTFA used those newly provided records to compute the

[14] Appellant did not provide a general ledger summary of sales for resale for 2012; thus, amounts claimed on the SUTRs were used for that year.

[15] Appellant did not provide a general ledger summary of sales in interstate commerce for 2012, and thus, amounts claimed on the SUTRs were used for that year.

audited costs of goods sold for 2012 and applied the same procedure it had applied for 2010 and 2011 to compute audited taxable sales for 2012.[16]

29. After computing the audited costs of goods sold in the second reaudit, CDTFA used those figures and reported taxable sales to compute book markups for retail sales made in California of 87.68 percent for 2009, -3.08 percent for 2010, -15.51 percent for 2011, and -19.37 percent for 2012.

30. In the second reaudit, CDTFA reduced the audited understatement of reported taxable sales established on a markup basis to $2,788,543. The amounts of disallowed exempt sales in interstate commerce and disallowed sales for resale remained the same.

31. On December 16, 2015, CDTFA issued its decision recommending that the liability be redetermined in accordance with the second reaudit.[17] CDTFA also deleted the negligence penalty.

32. On November 16, 2017, the board held a hearing in this matter. The board voted to grant appellant's administrative protest in its entirety and to grant a refund of all amounts paid.

33. On March 23, 2018, CDTFA filed a timely petition for rehearing with OTA.

34. On March 26, 2019, OTA issued an Opinion on Petition for Rehearing, granting a rehearing.

DISCUSSION

Issue 1: Whether an adjustment is warranted to the measure of audited unreported taxable sales.

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support

[16] It was during this review that CDTFA identified the error in the audited markup for retail sales and increased the markup from 119.79 percent to 120.94 percent.

[17] CDTFA's decision states that the understatement will be redetermined in accordance with the reaudit report dated November 8, 2013 (the first reaudit) and also states that the understatement of reported taxable sales will be reduced to $2,788,543, which is the amount computed in the second reaudit. It is undisputed that the intended reference is to the second audit report.

reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If CDTFA is not satisfied with the amount of tax reported by the taxpayer, or if a person fails to make a return, CDTFA may determine the amount required to be paid on the basis of any information in its possession or that may come into its possession. (R&TC, §§ 6481, 6511.) 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, appellant provided summary records and source documents. However, CDTFA identified various discrepancies in the records, including differences between amounts reported for income tax and sales tax purposes, differences between bank records and reported sales, and an unexplained difference between sales invoice totals and the amounts recorded in the general ledger for 3Q11. In addition, CDTFA computed book markups that were significantly lower than the markup it expected for this business. Under those circumstances, CDTFA's use of an indirect audit method was warranted. The difference between the sales invoice totals and the amounts recorded in the general ledger for 3Q11, along with the extremely low book markups of 21.00 percent for 2009, and 12.15 percent for 2010 and 2011, are sufficient to call into question the reliability of appellant's records. Furthermore, the markup audit approach, which was used in this case, is a well-established audit method that has been shown effective and reliable if based on sufficient information to establish a reasonable markup and cost of taxable merchandise sold. (*Appeal of Amaya,* 2021-OTA-328P.) In this case, CDTFA considered appellant's general ledger, which included costs of goods sold, reported taxable sales, and documented cost and selling price information for watches. Therefore, OTA finds CDTFA has shown that its audit was reasonable and rational, and appellant has the burden of establishing that further adjustments are warranted.

Appellant first contends that CDTFA should have accepted appellant's returns as filed because CDTFA failed to "impeach" appellant's records. In support, appellant makes two points: (1) the differences between amounts reported for federal income tax and sales and use tax purposes was 1.5 percent or less of the total gross receipts for 2009, 2010, and 2011,

respectively;[18] and (2) appellant provided a reasonable explanation for substantial discrepancies with its bank records during the appeal before OTA.[19] In summary, appellant contends that its records are substantially reconciled and reasonably accurate.

Nevertheless, the law creates no obligation or requirement for CDTFA to impeach a taxpayer's records before it may assert a deficiency. To the contrary, the law allows CDTFA to assert a deficiency based on any information which is in its possession if CDTFA "is not satisfied with the return" filed by the taxpayer. (R&TC, § 6481.) Thus, for example, a taxpayer took the position that CDTFA must demonstrate an inadequacy with a taxpayer's records before conducting an audit but conceded that no California caselaw established such a position that "records must first be deficient before [CDTFA] can conduct an audit." (*Riley B's v. State. Bd. of Equalization* (1976) 61 Cal.App.3d 611, 614.) The California appellate court deciding the appeal ultimately rejected the taxpayer's position on the basis that "affirmance of appellant's argument would allow an unscrupulous taxpayer to avoid his tax liability simply by maintaining inaccurate but voluminous and consistent records. Tax evasion would be facilitated and [CDTFA's] statutory duty to fairly administer and enforce the tax laws would be effectively thwarted." (*Id.* at p. 616.)[20] Here, the information within CDTFA's possession that it used to support the determination was appellant's own records. Furthermore, to shift the burden to appellant to establish error, CDTFA need only show that its determination was reasonable and rational, and OTA concluded above that it was reasonable and rational. As such, OTA need not address whether CDTFA impeached appellant's records, because it is not an element required for CDTFA to assert a deficiency.[21]

Appellant's second contention is that CDTFA's audit calculations are erroneous. Here, appellant asserts that CDTFA estimated at least five different items in the markup calculations.

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[18] The dollar amount of the difference was: $29,631 for 2009, -$56,897 for 2010, and $147,872 for 2011.

[19] Appellant contends the discrepancy is due to cash loans (non-sales revenue).

[20] This language is cited to note that the court's rationale for its holding was that it was necessary to ensure CDTFA can fairly administer and enforce the tax laws for the concerns noted. This Opinion does not intend to suggest that the specific concerns noted by the court are demonstrated under the facts of this case.

[21] At the time of the audit, there was no explanation available for the substantial discrepancies between the bank receipts and reported taxable sales. CDTFA has since acknowledged that appellant reasonably explained over half the differences in the bank deposit analysis.

CDTFA segregated appellant's sales into various categories, with each category having its own markup. CDTFA estimated the markup for retail sales made in interstate commerce (including watches, jewelry, and diamonds) at 100 percent. All the other markups were calculated in some manner. The record shows no other estimates in the markup calculations. CDTFA established certain ratios based on factual information from a test of sales invoices for 3Q11 (e.g., recorded sales in interstate commerce were segregated into retail interstate commerce sales, and wholesale interstate commerce sales using ratios from a test of sales invoices for 3Q11) and from appellant's own general ledgers (e.g., the ratio of watch purchases to total purchases for each year). OTA finds that it was reasonable for CDTFA to compute the various ratios in this manner. Furthermore, appellant has not provided documentation to support more accurate ratios. As such, no adjustment is warranted on this basis.

Appellant also argues that it was improper for CDTFA to accept reported sales for 2009 as accurate and to reject the reported sales for the other years in the audit. Appellant asserts that 2009 is different from the other years because appellant made far fewer sales in its first year in business, and thus, the higher book markups achieved in 2009 are not representative of the true markups for subsequent years. Also, appellant asserts that there were fewer out-of-state sales in 2009 than in subsequent years, and appellant argues that the lower levels of out-of-state sales resulted in an increased book markup, as evidenced by a markup analysis appellant performed using FITRs, which shows a markup of 21.42 percent for 2009, 12.68 percent for 2010, 12.15 percent for 2011, and 13.90 percent for 2012.[22] Nevertheless, CDTFA provided evidence casting doubt on the reliability of appellant's calculations. For example, appellant failed to provide support for the scheduled costs of precious metals and stones in the jewelry that it sold. In addition, for items with available documentation, those parts had been purchased in bulk, and CDTFA could not readily identify the individual parts of a specific piece of jewelry.

Furthermore, after it had computed the audited costs of taxable sales in the second reaudit, CDTFA used those figures and reported taxable sales to compute book markups for retail sales made in California of 87.68 percent for 2009, -3.08 percent for 2010, -15.51 percent for 2011, and -19.37 percent for 2012. The negative markups indicate that reported taxable sales

[22] These markups are the same as those computed by CDTFA using the FITRs for 2009 and 2010. For 2011, CDTFA computed a markup of 13.28 percent, which is comparable to the 12.15 percent computed by appellant. CDTFA did not compute a book markup for 2012 because it did not have that FITR during its preliminary examination of the records.

were less than the computed costs of retail sales for all years of the liability period except 2009. This is further evidence that reported taxable sales for 2009 were substantially accurate and that reported taxable sales for the other years were significantly understated.

Appellant also contends that CDTFA was inconsistent in evaluating appellant's shelf test, accepting only those transactions that were in line with CDTFA's preconceived notion of what the markups should be. In particular, appellant notes that CDTFA rejected most of the transactions in the retail shelf test but accepted all of the transactions in the shelf test for sales for resale, even though both shelf tests resulted in similar markups. Appellant notes that accepting the low markup for sales for resale results in allocating more inventory to nontaxable sales, which leaves less inventory for taxable sales, which in turn results in a higher markup for taxable jewelry sales. Appellant contends that its markup for all sales (both sales to other retailers and retail consumer transactions) is about 13 percent.

The shelf test for retail sales is on CDTFA Audit schedule R1-12A-4 in the first reaudit. There are 29 transactions in this shelf test. Using all 29 transactions results in a markup of 8.79 percent. CDTFA used only four of the 29 transactions to compute a markup of 23.32 percent for retail sales of watches in California. CDTFA rejected the remaining 25 transactions. Of the 25 rejected transactions, CDTFA rejected 22 because the documentation provided by appellant was insufficient to establish a purchase price.[23] Of the remaining three rejected transactions, CDTFA rejected one because it could not determine the value of a trade-in. CDTFA rejected another transaction because the selling price listed in the shelf test was $5,500, which was far below the suggested retail selling price of $7,100. CDTFA accepted the costs and selling prices for one transaction involving jewelry; however, CDTFA concluded that one transaction was not enough to compute a reliable markup for jewelry. Thus, CDTFA decided that it would only use the shelf test to establish the audited markup for watches. Based on the above, CDTFA had a reasonable and rational basis for rejecting the 25 transactions listed in appellant's retail shelf test. Furthermore, while the remaining four transactions form a small sample size for determining a markup, those four transactions are the best information available regarding appellant's markup for watches sold at retail in California. As such, appellant failed to

[23] For those 22 transactions, CDTFA noted various issues, such as: 1) appellant provided no documentation at all to support the costs listed in the shelf test; 2) appellant provided an internally prepared "memo" rather than a purchase invoice to support the costs listed in the shelf test; or 3) CDTFA was unable to determine the cost because appellant buys gold, diamonds, and jewels in bulk, and items from the co-mingled bulk inventory were used to fabricate an item.

show an adjustment is warranted to the audited markup of 23.32 percent for watches sold at retail in California.

Appellant also submitted a shelf test for sales for resale which showed a markup of 11.06 percent. CDTFA accepted all 45 of the transactions listed in the sale for resale shelf test with little or no verification because the 11.06 percent markup was in line with what CDTFA expected for jewelry and watch sales made at wholesale. CDTFA states that, based on its auditing experience, the markup for wholesale sales made at a jewelry store is typically much lower than the markup for retail sales made at a jewelry store. OTA finds no error with CDTFA's decision to accept appellant's documentation; CDTFA, at its own discretion, may choose to accept the results of a taxpayer-provided test without asking the taxpayer to provide supporting documentation for the test, or may choose to ask the taxpayer for supporting documentation and reject transactions for which taxpayer does not provide adequate documentation. Appellant has not submitted documentation to refute the 11.06 percent markup that appellant previously computed in its own shelf test, and thus, appellant has no basis for establishing that an adjustment is warranted to the audited markup of 11.06 percent for sales for resale, as calculated by appellant.

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

Issue 2: Whether an adjustment is warranted to the measure of disallowed claimed nontaxable or exempt sales.

Sales for resale

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales in this state of tangible personal property, 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.) The burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. (*Ibid*.)

Regarding the disallowed sales for resale, the law presumes that appellant's sales are taxable retail sales because appellant failed to obtain a resale certificate from its customers to support any of the five disallowed transactions from the test period. (See R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(a).) In such cases, the law provides, in pertinent part:

> [I]f the seller does not timely obtain a resale certificate . . . the seller will be relieved of liability for the tax only where the seller shows that the property:
>
> (1) Was in fact resold by the purchaser [prior to use[24]] or
>
> (2) Is being held for resale by the purchaser and has not been used by the purchaser . . . or
>
> (3) Was consumed by the purchaser and tax was reported directly to the [b]oard by the purchaser on the purchaser's sales and use tax return, or
>
> (4) Was consumed by the purchaser and tax was paid to the Board by the purchaser pursuant to an assessment against or audit of the purchaser . . . .

(Cal. Code Regs., tit. 18, § 1668(e).)

For audit, CDTFA used 3Q11 as a test period. Using appellant's sales invoices, CDTFA compiled recorded sales for resale of $782,349 for that quarter. Appellant did not provide resale certificates, but CDTFA reviewed its computer records and found that most of the sales were to businesses which held seller's permits and sold the types of merchandise purchased from appellant. However, for sales totaling $30,594 to two different businesses, CDTFA found that neither of the purchasers had an active seller's permit at the time of the questioned sales.

Appellant made the disallowed sales for resale to NWJ and J8J8 Jewelry. According to CDTFA's records, these customers held seller's permits at some point in time but closed them out between three to four years prior to the date of the sales at issue (meaning the customers could not have purchased the type of property at issue without payment of tax pursuant to a resale certificate.) Thus, there was no evidence that the purchaser in fact resold the property, held the property for resale, or paid tax to the state on the purchase price.

CDTFA computed an error ratio of 3.91 percent for the sales to these two customers ($30,594 ÷ $782,349). CDTFA computed recorded sales for resale of $10,814,358. CDTFA

[24] For these purposes, "use" means a use for any purpose other than retention, demonstration, or display while holding the property for sale in the regular course of business. (Cal. Code Regs., tit. 18, § 1668(e)(1).)

multiplied recorded sales for resale of $10,814,358 by the error ratio of 3.91 percent to compute disallowed sales for resale of $422,843 (rounded).

Appellant argues that the disallowed sales for resale to NWJ and J8J8 Jewelry are valid sales for resale. Appellant has not provided resale certificates from either purchaser, or a statement from either purchaser concerning the disposition of the property. Further, appellant has not provided any other documentation to support its assertion that the sales were valid sales for resale, or sales for resale in fact.

Appellant argues that these sales should be regarded as sales for resale because, at the November 16, 2017 board hearing, the board concluded that these sales were for resale based on an investigation done by the staff of the board's chair. As stated in OTA's Opinion on Petition for Rehearing, the board decided to delete this audit liability in its entirety based, in part, on statements from the chair of the board that the chair and her office had conducted their own independent investigation and "researched TEAL[E] ourselves."[25] Based on the investigation, the board's chair determined that a successor to one of the customers at issue held a seller's permit, and the board's chair further alleged (without providing support or an opportunity for CDTFA to address these new allegations) that during an unrelated "investigation audit" of the other customer, the customer reported it last sold products four years prior to the unspecified date on which it was contacted.

Nevertheless, OTA is required to follow the law. Here, because appellant did not ever obtain a resale certificate from these customers, as a matter of law OTA must accept that the sales are presumed taxable unless appellant can establish that they qualified as sales for resale in fact. (See R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(e).)

Regarding NWJ, the evidentiary record before OTA contains no information about a potential successor or a seller's permit held by the alleged successor. Even if there were a successor, the existence of a seller's permit held by the successor is insufficient to show that appellant's sales to NWJ were sales for resale in fact. Regarding J8J8 Jewelry, OTA's

[25] TEALE is an electronic database containing confidential taxpayer records for all accounts maintained by CDTFA, including return history, audit history, social security numbers, and registered account information.

evidentiary record contains no statements made by the customer.[26] Even if this evidence were contained in the record, the unsupported statement (that, according to the purchaser, it last sold products four years prior to the unspecified date on which it was contacted) is insufficient to show that J8J8 Jewelry resold the products in question. Furthermore, even if true, the alleged statement by the customer that it had at some point in time been engaged in selling tangible personal property has no legal relevance with respect to whether the merchandise at issue that appellant sold to J8J8 Jewelry qualified as a nontaxable sale for resale in fact, because there is no evidence as to the ultimate disposition of the property.[27]

In summary, no adjustment is warranted to the audited amount of disallowed claimed nontaxable sales for resale.

Sales in interstate commerce

R&TC section 6396 provides, in pertinent part, an exemption from sales tax if the tangible personal property, pursuant to the contract of sale, was required to be shipped, and was in fact shipped, to a point outside this state by means of facilities operated by the retailer, or delivery by the retailer to a common carrier, for shipment to such out-of-state point. (R&TC, § 6396; Cal. Code Regs., tit. 18, § 1620(a)(3)(B).) Bills of lading or other documentary evidence of the delivery of the property to a carrier, customs broker, or forwarding agent for shipment outside this state must be retained by the retailer to support any such claimed deductions from the sales tax. (Cal. Code Regs., tit. 18, § 1620(a)(3)(D).)

For this audit, CDTFA used 3Q11 as a test period. It used appellant's sales invoices to compile sales in interstate commerce for that quarter of $1,608,811. Appellant provided sales invoices and shipping documents to show that sales totaling $1,592,347 represented sales of merchandise shipped to the purchaser outside of California. Accordingly, CDTFA concluded that those sales were exempt from tax. CDTFA found that the evidence was insufficient to show

[26] The transcript of the board hearing includes a statement from the board's Chairperson quoting an unspecified document (which is not in the record before OTA). According to the board's Chairperson, someone affiliated with J8J8 had at some time stated J8J8 last made sales approximately four years prior to an unspecified date, but that the person was not entirely sure. Because the underlying document is not in the record, OTA affords the statement made by the board's chair no evidentiary value. The specific statement is: "When asked when she last sold product, either retail or wholesale, she said roughly four years ago but was not entirely sure."

[27] The mere fact that this customer had a seller's permit is evidence that it was at some point in time engaged in the sale of tangible personal property. The issue here is that the customer's seller's permit (and authority to purchase jewelry without paying tax for purposes of resale) was terminated three years *prior* to the sale at issue.

that the remaining sales, totaling $16,464, were exempt sales in interstate commerce. The $16,464 was the total of four sales. For one of those sales, the ship-to address was in California. For the other three sales, the ship-to address was outside California (in Nevada, Illinois, and Texas), but appellant provided no shipping documents.

Here, appellant failed to maintain shipping or delivery documentation as required by Regulation section 1620(a)(3)(D), to support any of the four disallowed transactions from the test period. Additionally, appellant's own records reflect that it actually shipped one of the four disallowed transactions to a purchaser in California, which as a matter of law defeats the claimed exemption.

Appellant contends that the disallowed sales in interstate commerce should all be allowed. Appellant still has not provided any shipping documents or other documentation to show that the property in question was shipped to an out-of-state point. Instead, appellant argues that these sales should be regarded as sales in interstate commerce because, at the November 16, 2017 hearing, the board concluded that these sales were exempt sales in interstate commerce.

By itself, a ship-to address listed on a sales invoice is not enough to support a sale as exempt. To the contrary, the law requires that the shipping documents (or other documentary evidence of delivery) must be retained by the retailer to support the claimed exemption. (Cal. Code Regs., tit. 18, § 1620(a)(3)(D).) Appellant has provided no shipping documents or other evidence to show that the sales with ship-to addresses in Nevada, Texas, or Illinois printed on the sales invoice were in fact shipped out of state.

The sale with the ship-to address in Santa Barbara, California, is clearly a taxable sale that was shipped within this state. There is also no evidence that this is a non-recurring error. CDTFA's Audit Manual, section 0405.20(e)[28] explains that nonrecurring errors "are normally items of considerable size, and the opposition to including them in the percentage of error is quite strong." Here, the sale in question was a sale of merchandise routinely sold by appellant, in a price range normally sold by appellant ($6,900). Thus, the evidence fails to establish that this was a non-recurring error, and OTA further finds no basis for removing this sale from the projected error ratio on those grounds.

[28] CDTFA's Audit Manual summarizes CDTFA's audit policies and procedures. The Audit Manual is not binding legal authority and should not be cited as such. (*Appeal of Micelle Laboratories, Inc*., 2020-OTA-290P.)

CDTFA's records reflect that, during the appeals conference with CDTFA, appellant "did not raise a specific contention regarding disallowed sales in interstate commerce." Furthermore, appellant did not offer any evidence or testimony regarding these transactions at the board hearing, to rebut the statutory presumption that tax applies. (See R&TC, § 6091; Cal. Code Regs., tit. 18, §§ 1667(a), 1668(a).) On rehearing before OTA, appellant still did not provide any documentation. Thus, there is no evidence in the record from which OTA could otherwise conclude appellant met its burden of establishing entitlement to the exemption.

In summary, OTA finds that appellant failed to provide sufficient evidence to show that any of the four sales in interstate commerce were disallowed in error. As such, no adjustment is warranted to the disallowed sales in interstate commerce.

Issue 3: Whether the refund claims were timely.

Based on CDTFA's concession to refund the entirety of the conceded overpayment amount, and OTA's finding that appellant failed to establish a basis for any additional adjustments, OTA need not address this issue. Appellant is not entitled to any additional refund regardless of whether the refund claims are timely.

HOLDINGS

1. Appellant failed to establish that an adjustment is warranted to the measure of audited unreported taxable sales.
2. Appellant failed to establish an adjustment to the measure of unreported nontaxable or exempt sales.
3. OTA need not address the timeliness of the refund claims because this issue is moot considering CDTFA's concession to refund the overpayment.

DISPOSITION

The $30,435.12 finality penalty shall be refunded to appellant as conceded by CDTFA.[29] CDTFA's action is otherwise sustained.

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:
8A4294817A67463...

Andrew Wong
Administrative Law Judge

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

Date Issued: 6/22/2023

[29] CDTFA's letter concedes to the entirety of the finality penalty, which it identifies as: $30,345.12. However, CDTFA's decision lists an amount of $30,435.12. Since CDTFA concedes to refund the entire penalty, OTA need not address the nominal difference. The disposition is to refund the entire finality penalty amount.