OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20096720
	) CDTFA Case ID: 114-012
ADDISON POOLS INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Barry Moser, CPA
For Respondent:	Nalan Samarawickrema, Hearing Rep. Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Addison Pools Inc. (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's timely petition for redetermination of the Notice of Determination (NOD) dated January 20, 2016. The NOD is for tax of $73,298.95, plus applicable interest, for the period April 1, 2010, through March 31, 2013 (audit period).[2] Pursuant to its Decision, CDTFA performed a reaudit that reduced the tax from $73,298.95 to $54,920.00.

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Michael F. Geary, and Andrew Wong held an oral hearing for this matter in Cerritos, California, on February 15, 2023. At the conclusion of the hearing, the record was left open to allow time

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

[2] The NOD was timely issued because for the period April 1, 2010, through September 30, 2012, appellant signed waivers that extended the statute of limitations until January 31, 2016. (See R&TC, §§ 6487, 6488.)

for submission of additional briefing concerning relief of interest. Thereafter, the record was closed and this matter was submitted for an opinion.

ISSUES

1. Whether additional adjustments are warranted to the unreported taxable measure based on the cost accountability test.
2. Whether additional relief of interest is warranted.

FACTUAL FINDINGS

1. Appellant has operated as a construction contractor[3] furnishing and installing swimming pools, spas, and related fixtures and equipment since May 2009. Appellant contracts primarily on a lump-sum basis,[4] but also contracts on a time-and-material basis[5] with sales tax reimbursement added to appellant's charge for the materials, fixtures, and/or equipment furnished pursuant to the contract.[6] Additionally, appellant provides maintenance and repair services. In late 2010, appellant also began operating a store making retail sales of pool- and spa-related supplies and merchandise, which it records on a point-of-sale (POS) system.
2. For the period April 1, 2010, through September 30, 2012, appellant reported only its taxable sales, which totaled $181,672. For the period October 1, 2012, through

[3] "Construction contractor" means any person who agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) "Construction contract" means and includes a contract to erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A).)

[4] "Lump sum contract" means a contract under which the contractor for a stated lump sum agrees to furnish and install materials or fixtures, or both. (Cal. Code Regs., tit. 18, § 1521(a)(8).) Generally, a construction contractor is the consumer of materials and the retailer of fixtures furnished and installed in the performance of construction contracts. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1, (b)(2)(B)1.) When a construction contractor furnishes and installs fixtures pursuant to a lump sum contract, the sale price for the fixtures shall be deemed to be the cost price of the fixtures to the contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)2.) Construction contractors are retailers of machinery and equipment even though the machinery and equipment is furnished in connection with a construction contract, and tax applies to the contractor's gross receipts from such sales. (Cal. Code Regs., tit. 18, § 1521(b)(2)(C)1.)

[5] "Time and material contract" means a contract under which the contractor agrees to furnish and install materials or fixtures, or both, and which sets forth separately a charge for the materials or fixtures and a charge for their installation or fabrication. (Cal. Code Regs., tit. 18, § 1521(a)(7).)

[6] In the case of a time and material contract, if the contractor bills his or her customer an amount for "sales tax" computed upon his or her marked-up billing for materials, it will be assumed, in the absence of convincing evidence to the contrary, that he or she is the retailer of the materials. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)2.)

March 31, 2013, appellant reported total sales of $1,947,232 and claimed deductions of $1,853,870 for sales under lump sum contracts and $18,059 for nontaxable sales of labor, which resulted in reported taxable sales of $75,303. For the audit period, appellant reported taxable sales of $256,975 ($181,672 + $75,303).

3. For audit, appellant provided its federal income tax returns (FITRs) for 2010 and 2011; its sales journals, general ledger, and paid bills for 2010, 2011, and 2012; and a report from its POS system showing sales of merchandise in its store for the period June 5, 2013, through June 30, 2013.

4. CDTFA found that appellant's purchases account in its general ledger and the available merchandise purchase invoices showed purchases of materials, fixtures, equipment, and supplies totaling $2,013,066 for the period April 1, 2010, through December 31, 2012, with sales tax reimbursement paid to the vendor for purchases totaling $1,104,447 (tax-paid purchases) and purchases totaling $908,619 without payment of tax or tax reimbursement (ex-tax purchases). CDTFA noted that appellant's sales and use tax returns did not report any purchases subject to use tax; CDTFA concluded that tax was due in connection with ex-tax purchases of merchandise consumed or sold in lump-sum contracts.

5. To determine the amount of ex-tax purchases subject to tax, CDTFA performed a cost accountability test.[7] CDTFA compared the beginning inventory reported on appellant's FITR for 2010 with the ending inventory reported on the FITR for 2011 and found that appellant's inventory had increased. To allow for purchases of merchandise that remained unused or unsold at the end of the audit period, CDTFA subtracted the difference between the 2011 ending inventory and the 2010 beginning inventory from total merchandise purchases to compute total costs of $1,963,066 to be accounted for in the cost accountability test. CDTFA then reduced that amount by $1,104,447 for tax-paid purchases to compute total ex-tax purchases of $858,619.[8]

[7] CDTFA Audit Manual section 1205.10 requires that a reconciliation accounting schedule (cost accountability test/examination) be prepared in an audit of a construction contractor, unless the contractor purchases all materials on a tax-paid basis.

[8] Here, CDTFA assumed that appellant's ending inventory was comprised entirely of merchandise purchased ex-tax. However, approximately 46 percent of appellant's merchandise purchases during the audit period were ex-tax, with the remaining purchases tax-paid, which makes it seem likely that approximately 54 percent of the ending inventory consisted of merchandise purchased tax-paid. CDTFA's assumption that appellant's ending

6. Because there was no evidence that appellant withdrew merchandise from its resale inventory for an exempt or nontaxable purpose, CDTFA determined that tax applied to the total ex-tax merchandise purchases of $858,619. However, CDTFA was unable to determine how much of the merchandise purchased ex-tax was consumed or sold in lump-sum contracts, and how much was sold at retail. Therefore, for purposes of establishing the audited taxable measure, CDTFA assumed that all merchandise sold at retail was purchased tax-paid, such that all merchandise purchased ex-tax was presumed to have been consumed or sold in lump-sum contracts. Using those assumptions, CDTFA found that the taxable measure consisted of appellant's gross profit on the merchandise sold at retail (since tax already had been paid on the cost of the merchandise) and the total ex-tax merchandise purchases of $858,619.

7. To determine appellant's gross profit on its retail sales, CDTFA used appellant's sales journal to compile retail sales of material, fixtures, and equipment under time and material (plus tax) contracts of $124,137 and retail store sales of $189,144 for the period April 1, 2010, through December 31, 2012. Next, CDTFA compared selling prices for items shown in appellant's POS reports for the period June 15, 2013, through June 30, 2013, with the respective costs for the items, and computed that appellant marked up its merchandise sold at retail by 30.49 percent, on average. CDTFA divided total retail sales of $313,281 ($124,37 + $189,144) by the markup factor of 1.3049 (1 + markup) to compute costs of retail sales of $240,086 ($313,281 ÷ 1.3049). Next, CDTFA subtracted costs of $240,086 from retail sales of $313,281 to calculate gross profit of $73,195.

8. CDTFA added gross profit of $73,195 to ex-tax merchandise purchases of $858,619 to establish audited taxable measure of $931,814 for the period April 1, 2010, through December 31, 2012. A comparison of the audited taxable measure with appellant's reported taxable measure showed an error ratio of 318.99 percent. CDTFA applied that error ratio to appellant's reported taxable measure for the audit period to establish unreported taxable measure of $819,722, upon which the NOD issued on January 20, 2016, is based.

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inventory was comprised entirely of merchandise purchased ex-tax resulted in a lower amount of ex-tax purchases to be accounted for in the cost accountability test than the amount that would have resulted from a more precise estimate, and ultimately, resulted in a benefit to appellant.

9. Appellant timely filed the petition for redetermination, disputing the NOD in its entirety. During CDTFA's internal appeals process, appellant provided a copy of its FITR for 2012 and a 12-page Item Value List showing extended costs and selling prices for items allegedly in inventory on April 28, 2013.[9]
10. In a Decision issued on March 13, 2019, CDTFA ordered a reaudit to increase the allowance for inventory in the cost accountability test based on the increased ending inventory reported on appellant's FITR for 2012, recalculate the percentage of error, and apply that percentage of error to the measure of reported taxable sales for the audit period to compute unreported cost for materials, fixtures, and supplies .
11. Pursuant to the Decision, CDTFA issued its first reaudit report dated March 21, 2019, with revisions on May 6, 2020, followed by a second reaudit report on July 14, 2020, which ultimately reduced the unreported taxable measure from $819,722 to $614,164. On August 4, 2020, CDTFA's Appeals Bureau sent appellant an "options letter" informing appellant of its options to appeal to OTA or accept the reaudit results.
12. This timely appeal to OTA followed.
13. During this appeal, CDTFA conceded that, based on unreasonable delay by CDTFA employees, relief of interest is warranted for the following periods: December 1, 2013, through December 31, 2013; May 1, 2014, through June 30, 2014; August 1, 2015, through October 31, 2015; August 1, 2017, through September 30, 2017; June 1, 2019, through August 31, 2019; and October 1, 2019, through January 31, 2020.

DISCUSSION

Issue 1: Whether additional adjustments are warranted to the unreported taxable measure based on the cost accountability test.

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from retail sales of tangible personal property sold 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 the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established.

[9] Based on the extended costs and selling prices shown in the Item Value List, CDTFA computed an overall markup of 44.93 percent.

(R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support 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 any person fails to make a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 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.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Talavera*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Here, there is no dispute that appellant is a construction contractor, and that tax applies to its costs of materials and fixtures furnished and installed under lump-sum construction contracts. (See Cal. Code Regs., tit.18, § 1521(b)(2)(A)1, (B)2.) There also is no dispute that appellant is the retailer of materials and fixtures furnished and installed under time and material contracts because appellant added sales tax reimbursement to its selling prices for the materials and fixtures. (See Cal. Code Regs., tit. 18, § 1521(b)(2)(A)2.) Further, appellant is the retailer of equipment and pool- and spa-related supplies and merchandise. Appellant purchased approximately 46 percent of its merchandise without tax paid to the vendors because the vendors were out of state or because appellant purchased the merchandise for resale. Because appellant did not purchase all materials on a tax-paid basis, and did not provide records that were sufficient for sales and use tax purposes, a cost accountability test was an appropriate audit method to determine whether appellant's tax liability was correctly paid. (CDTFA Audit Manual, § 1205.10.) OTA has reviewed the workpapers generated in all the audits and concludes that the test was correctly done, and that the resulting taxable measure is a reasonable one. In light of all evidence, OTA finds CDTFA's determination to be reasonable and appellant has the burden to show that adjustments are warranted.

Appellant contends that the unreported taxable measure is overstated because CDTFA's cost accountability test calculated tax twice on the cost of merchandise sold at retail. According

to appellant, when CDTFA added the markup on its retail sales to the taxable measure, CDTFA duplicated the taxable measure from the calculation of purchases. Appellant argues that comparing several of its invoices against the transactions listed in the audit schedules shows that CDTFA incorrectly included nontaxable transactions, such as "service route" invoices, as taxable. Appellant disputes CDTFA's approach and argues that CDTFA should have simply relied on appellant's invoices and asked appellant to explain any apparent discrepancies.

A detailed examination of the cost accountability test in the audit and reaudit work papers reveals no duplication of the taxable measure. OTA notes that in the absence of evidence showing that appellant withdrew merchandise from its resale inventory for an exempt or nontaxable purpose, CDTFA determined that total ex-tax merchandise purchases of $858,619 for the period April 1, 2010, through December 31, 2012, were subject to tax. CDTFA then added appellant's gross profit of $73,195 on its retail sales to ex-tax merchandise purchases of $858,619 to establish audited taxable measure of $931,814 for that period. OTA finds that it was appropriate to include both the gross profit on retail sales and the ex-tax cost of the merchandise sold or used in the audited taxable measure. Appellant has not identified any nontaxable transactions that were incorrectly included in the taxable measure, and nothing in the evidence or appellant's contentions establishes any double taxation. For example, appellant argues that CDTFA's reaudit schedule 1R-12B-1a shows that CDTFA incorrectly included a transaction of $37,330 as taxable; however, the audit did not include that transaction in the taxable measure, which is based on ex-tax purchases reflected in Schedule 12D. In light of all of the above, appellant's arguments do not support any adjustment to the audited taxable measure.

Issue 2: Whether additional relief of interest is warranted.

There is no statutory right to interest relief. The law allows CDTFA, in its discretion, to grant relief of all or any part of the interest imposed on a person under the Sales and Use Tax Law where the failure to pay the tax is due in whole or in part to an unreasonable error or delay by an employee of CDTFA acting in his or her official capacity. (R&TC, § 6593.5(a)(1).) Such an error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or failure to act by, the taxpayer. (R&TC, § 6593.5(b).) Any person requesting interest relief must include a statement signed under penalty of perjury setting forth the facts on which the request is based. (R&TC, § 6593.5(c); *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

OTA will not generally second-guess the standard timeframes determined by CDTFA for purposes of granting discretionary relief, and will instead defer to CDTFA's timeframes absent evidence of an abuse of discretion. (*Appeal of Eichler*, 2022-OTA-029P.) To show an abuse of discretion, a taxpayer must establish that, in refusing to relieve interest, CDTFA exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of Eichler*, *supra*.)

CDTFA provided an analysis of the timeline of the audit process and concedes that there were some delays. Thus, CDTFA recommends relief of interest for a total of 15 months, as follows: December 1, 2013, through December 31, 2013; May 1, 2014, through June 30, 2014; August 1, 2015, through October 31, 2015; August 1, 2017, through September 30, 2017; June 1, 2019, through August 31, 2019; and October 1, 2019, through January 31, 2020.

Appellant has filed a request for relief of interest, signed under penalty of perjury, setting forth the facts on which the claim is based, as required by R&TC section 6593.5(c). Appellant contends that an unreasonable delay occurred following issuance of CDTFA's Decision in March 2019 because CDTFA took until July 2020 to complete the reaudit, which delayed until September 2020 appellant filing this appeal to OTA. Within that timeframe, CDTFA has conceded interest relief for June 2019 through August 2019; and October 2019 through January 2020. In addition to those time periods, appellant requests relief of interest for the following periods: March 2019 through May 2019; September 2019; and February 2020 through August 2020.

The time period between the issuance of the Decision and completion of the reaudit was approximately 16 months. CDTFA already has recommended interest relief for a total of seven months during that timeframe (June 2019 through August 2019, and October 2019 through January 2020). The remaining nine-month period for conducting the reaudit, during which CDTFA sent appellant reaudit letters dated March 21, 2019, and May 6, 2020, does not appear to reflect any unreasonable delay. OTA finds no evidence that CDTFA has abused its discretion in denying the remaining periods that were eligible for interest relief.

Regarding the period following July 14, 2020, CDTFA's Appeals Bureau issued the options letter three weeks later; the transmittal of the reaudit from CDTFA's Business Tax and Fee Division to the Appeals Bureau and the Appeals Bureau's review of the reaudit and issuance of the options letter within that three-week period does not constitute an unreasonable delay.

Issuance of the options letter completed CDTFA's role in handling appellant's appeal. Hence, OTA finds no evidence that CDTFA has abused its discretion in denying any additional interest relief, and thus no additional interest relief is warranted.

HOLDINGS

1. No additional reduction to the unreported taxable measure is warranted.
2. Pursuant to CDTFA's concession, interest should be relieved for the periods December 1, 2013, through December 31, 2013; May 1, 2014, through June 30, 2014; August 1, 2015, through October 31, 2015; August 1, 2017, through September 30, 2017; June 1, 2019, through August 31, 2019; and October 1, 2019, through January 31, 2020, but no additional relief of interest is warranted.

DISPOSITION

Relief of interest is granted for the following periods only, pursuant to CDTFA's concession: December 1, 2013, through December 31, 2013, May 1, 2014, through June 30, 2014; August 1, 2015, through October 31, 2015; August 1, 2017, through September 30, 2017; June 1, 2019, through August 31, 2019; and October 1, 2019, through January 31, 2020. CDTFA's decision to reduce the unreported taxable measure from $819,722 to $614,164, and otherwise deny the petition, is sustained.

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

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Andrew Wong
Administrative Law Judge

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

Date Issued: 6/14/2023