OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20035940) CDTFA Case ID: 869048
CRUZ, PRADO & ASSOCIATES, INC., dba CP SYSTEMS	)

OPINION

Representing the Parties:

For Appellant:	Michael Steiniger, Attorney
For Respondent:	Joseph Boniwell, Tax Counsel III
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Cruz, Prado & Associates, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated April 15, 2015. The NOD is for tax of $169,200.13, plus applicable interest, and a negligence penalty of $16,962.02, for the period October 1, 2009, through September 30, 2012 (liability period).

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

ISSUES

1. Whether appellant has established that adjustments are warranted to the disallowed claimed deductions for labor, sales for resale, nontaxable teleproduction charges, or unspecified "other" deductions.

[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. Whether appellant's understatement of reported taxable sales was the result of negligence or intentional disregard of relevant authorities.

FACTUAL FINDINGS

1. Appellant has operated an audio-visual business since July 1, 2001. Appellant was a construction contractor that entered into time and materials contracts. Appellant describes itself as a company that installs audio-visual projects from concept to completion, including the design and installation of lighting fixtures and control systems, theatrical dimming systems, as well as audio and visual design and installation.
2. During the liability period, appellant reported total sales of $3,160,260 and claimed deductions totaling $1,821,529, which resulted in reported taxable sales of $1,338,731. Appellant's claimed deductions included the following: $130,131 for sales tax reimbursement included in total reported sales; $1,329,792 for labor; $94,403 for sales for resale; $226,721 for nontaxable charges for teleproduction;[2] and $40,482 for "other" deductions.
3. For the audit, appellant did not provide a complete set of books and records. Appellant provided its federal income tax returns for 2009, through 2012 showing reported gross receipts of $2,550,417 for 2009, $2,109,247 for 2010, $2,062,070 for 2011, and $2,017,177 for 2012.
4. Appellant also provided some boxes of records for the audit. According to CDTFA's Form 414-Z (*Audit Assignment History*), CDTFA examined these records and found "no

[2] R&TC section 6378(a) exempts from tax the sale of tangible personal property for use by a qualified person to be used primarily in teleproduction or other postproduction services. The term "teleproduction or other postproduction services" means services for film or video that include editing, film and video transfers, transcoding, dubbing, subtitling, credits, close captioning, audio production, special effects (visual or sound), graphics or animation. (R&TC, § 6378(c)(3).)

useful information aside from some purchase invoices."[3] Despite multiple requests by CDTFA, appellant did not provide other records such as summary records of sales or purchases, a complete set of purchase invoices, or sales invoices for any portion of the liability period.

5. CDTFA disallowed the deductions claimed on appellant's sales and use tax returns for the liability period because appellant failed to provide substantiating documents.

6. On April 15, 2015, CDTFA issued the aforementioned NOD for tax of $169,200.13. CDTFA also imposed a negligence penalty of $16,920.02 based on appellant's failure to keep adequate books and records. Appellant timely filed a petition for redetermination, which CDTFA denied.

7. This timely appeal followed.

DISCUSSION

Issue 1: Whether appellant has established that adjustments are warranted to the disallowed claimed deductions for labor, nontaxable sales for resale, nontaxable teleproduction charges, or unspecified "other" deductions.

California imposes sales tax on a retailer's retail sales of tangible personal property 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, §§ 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. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support

[3] On appeal, appellant contends that electronic books and records were lost following a computer crash. Appellant asserts that "at some point [it] did furnish six banker boxes of documents which were eventually returned to [appellant] in March 2019 and which [appellant has] ready and available for perusal." It is unclear whether these are the same records that CDTFA reviewed. By email dated June 19, 2020, appellant requested 30 days to scan and submit six boxes of records. In response, the Office of Tax Appeals (OTA) allowed appellant until July 29, 2020, to do so. Appellant did not submit the documentation by that deadline and requested a two-week extension. OTA then provided appellant with an additional 30-day extension to make its submission. On September 20, 2020, OTA received a thumb drive containing appellant's submission, which included the following: a document labeled "Sales Journal," which purports to schedule invoices with payments made from October 1, 2009, through September 30, 2012; a document labeled "Payments Received Against Invoices," which purports to schedule all payments received and posted against invoices; a document labeled "Invoices with Labor and/or Service Non Taxable," which purports to schedule all invoices with nontaxable services; and a document labeled "Invoices Without Labor and/or Service Nontaxable." Appellant also provided an incomplete set of invoices, which is discussed below.

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

The retailer bears the burden of establishing its entitlement to any claimed deduction or exemption. (*Paine v. State Bd. or Equalization* (1982) 137 Cal.App.3d 438, 443 (*Paine*); *Appeal of Owens-Brockway Glass Container, Inc.*, 2019-OTA-158P.) When a right to an exemption from tax is involved, the taxpayer has the burden of proving its right to the exemption. (*H.J. Heinz Company v. State Bd. of Equalization* (1962) 209 Cal.App.2d 1, 4.) Exemptions are strictly construed against the taxpayer who has the burden of proving that the statutory requirements have been satisfied. (See *Standard Oil Co. v. State Bd. of Equalization* (1974) 39 Cal.App.3d 765, 769.)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file 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.) 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 did not provide a complete set of books and records for CDTFA to audit. According to CDTFA's audit workpapers, appellant claimed that a computer crash caused it to lose a Quickbooks file. Instead, appellant only provided federal income tax returns and an incomplete set of purchase invoices for the audit. Appellant bears the burden of establishing entitlement to any claimed deduction or exemption. (*Paine*, *supra*.) As appellant did not provide sufficient records to support its claimed deductions or exemptions, CDTFA's decision to disallow appellant's claimed deductions was reasonable and rational.

On appeal, there is no dispute that appellant bears the burden of proving entitlement to the disallowed claimed deductions. Appellant asserts that it is entitled to all of the claimed deductions, and, in support, provided the following: a document labeled "Sales Journal," which purports to schedule invoices with payments made from October 1, 2009, through September 30, 2012; a document labeled "Payments Received Against Invoices," which purports to schedule all payments received and posted against invoices; a document labeled "Invoices

with Labor and/or Service Non Taxable," which purports to schedule all invoices with nontaxable services; and a document labeled "Invoices Without Labor and/or Service Nontaxable." Appellant also provided an incomplete set of sales invoices.

The Office of Tax Appeals (OTA) considers each of the claimed deductions in turn.

Non-taxable labor charges

Initially, OTA notes that both CDTFA and appellant have at times referred to appellant as a construction contractor that entered into lump sum contracts. For example, CDTFA's decision states, "the audit working papers describe petitioner as a construction contractor with contracts performed primarily on a lump sum basis that purchases fixtures and materials without the payment of tax or tax reimbursement (ex-tax)." Similarly, in a letter dated April 23, 2015, appellant stated that it is "in disagreement with the disallowance of claimed labor in that it is exempt installation labor on lump sum contracts." However, on appeal, appellant contends that it properly segregated nontaxable labor on its invoices.

A construction contractor is any person who, whether alone, in conjunction with, or by or through others, agrees to perform and does perform a construction contract, and a construction contract means a contract to erect, construct, alter, or repair any building or other structure or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A), (2).) When an item is furnished and installed onto real property pursuant to a construction contract, the application of tax depends in part on the classification of the item as either materials, a fixture, or machinery and equipment. (Cal. Code Regs., tit. 18, § 1521(b).) Construction contractors who bill on a lump sum basis are generally the consumers of materials (with tax due at the time of sale to the contractor or upon use), retailers of fixtures,[4] and retailers of machinery and equipment. (Cal. Code Regs., tit. 18, § 1521 (b).)

A construction contractor may also contract on a time and material basis, agreeing to furnish and install materials or fixtures, or both. A "time and material contract" 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).) If the contract explicitly provides for the transfer of title to the materials prior to installation and separately states the selling price of the materials, the contractor is deemed to be the retailer of the materials. In the case of a time and material

[4] In general, the measure of tax on the sale of a fixture included in a lump sum construction contract is the cost of the fixture to the contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)(2)(a).)

contract, if the contractor bills the customer an amount for "sales tax" computed on the marked-up billing for materials, it is assumed that the contractor is the retailer of the materials. (Cal. Code Regs., tit. 18, § 1521 (b)(2)(A)(2).)

As discussed above, California imposes sales tax on a retailer's retail sales of tangible personal property 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, §§ 6012, 6051.) However, "gross receipts" does not include the price received for labor or services used in installing or applying the property sold. (See R&TC, § 6012(c)(3).) The definition of gross receipts does include charges for the fabrication of property in place. (Cal. Code Regs., tit 18, § 1546(a); Cal. Code Regs., tit 18, § 1546(a).) However, charges for labor or services used in installing or applying the property sold are excluded from the measure of the tax. (Rev. & Tax. Code, § 6012(c)(3).)

On appeal, appellant provided an incomplete set of invoices. On review, the invoices reveal separately stated amounts billed as "products," "labor," and "services." In addition, the invoices contain a separate charge for sales tax reimbursement applied to the total for "products." Thus, OTA finds that appellant was the retailer of tangible personal property sold to clients in its time and material construction contracts (as opposed to lump sum contracts). (Cal. Code Regs., tit. 18, § 1521(b)(2)(A).)

Since appellant separately stated its charges for labor on its invoices, the question is whether appellant documented that the claimed deductions for labor represent charges for nontaxable labor that were reported as total sales and then claimed as deductions. Appellant describes itself as a company that creates and installs audio-visual projects from concept to completion. Appellant asserts that its labor includes consulting services and installation fees. As previously stated, labor used in installing or applying the property sold is not subject to tax.

On review, OTA cannot determine from appellant's invoices and sales journal whether appellant's labor was nontaxable installation labor or taxable fabrication labor. For example, appellant's sales journal simply indicates charges for total labor, without further explanation. Appellant's invoices include a line item for "install lab," which OTA takes to mean installation labor. However, it is unclear from the invoices whether appellant is installing individual

materials or if something must be fabricated prior to installation because the tangible personal property appears to be a list of parts.[5]

It is also unclear whether the "install lab" charges account for all of the labor charges on an invoice. This is because appellant does not provide for any units with respect to its installation charges. Appellant simply lists an amount for "install lab," and then a different amount for "total labor." For example, on one contract, appellant lists a charge of $80 and zero units for "install lab," but "total labor" charges of $7,040. OTA notes that the failure to provide itemized charges is counter to appellant's practice with respect to tangible personal property it sold. In the case of tangible personal property, appellant lists the number of parts, the unit price, and the total for each part. Thus, in the example above, it is unclear whether appellant charged $80 for installation and then different amounts for other labor, or if appellant charged $80 per hour of labor. Still, other invoices include charges for things like "engin.," which appear to be included in the labor charge. Consequently, based on the information provided, OTA cannot determine whether these items are nontaxable. Based on the foregoing, OTA finds that appellant has failed to show that any of the claimed deductions for nontaxable labor were disallowed in error.

Non-taxable sales for resale

A retail sale is a sale for any purpose other than resale in the regular course of business. (R&TC, § 6007.) It is presumed that all gross receipts from the retail sale of tangible personal property are subject to tax, until the contrary is established, and the burden of proving that a sale of tangible personal property is not a sale at retail is upon the person who makes the sale unless that seller timely and in good faith takes from the purchaser a certificate to the effect that the property is purchased for resale. (R&TC, §§ 6091, 6092; Cal. Code Regs., tit. 18, § 1668(a).) A seller who does not timely obtain a resale certificate will be relieved of the liability for tax only where the seller shows that the property: was in fact resold by the purchaser prior to any taxable

[5] OTA also notes that the sales journal, which records sales from June 12, 2009, through October 31, 2012, appears incomplete. For example, the sales journal records total sales of $3,035,028.05. On the other hand, appellant reported total sales of $3,160,260.00 during the liability period, which spans from October 1, 2009, through September 30, 2012 (i.e., five months less than the period recorded in the sales journal). Moreover, the invoice numbers are nonsequential and also appear to be incomplete. For example, on May 15, 2010, appellant recorded invoice number 2105, and the next recorded invoice is number 2110. There is no explanation for the missing invoice numbers, and similar gaps occur throughout appellant's sales journals. As such, OTA finds the sales journal to be unreliable.

use; is being held for resale by the purchaser and has not been used for purposes other than retention, demonstration, or display for resale in the regular course of business; or was consumed by the purchaser and tax was paid to CDTFA. (Cal. Code Regs., tit. 18, § 1668(e).)

As discussed above, appellant was a construction contractor that entered into time and materials contracts. Thus, appellant was in the business of selling materials. Appellant's sales journal includes a column for "wholesale sales" and appellant provided invoices for those sales. However, appellant has not provided any resale certificates. Appellant has also not provided any evidence that any property was actually resold (e.g., XYZ letters, declarations from customers, etc.). Appellant's unsupported assertion is not sufficient to satisfy its burden of proof. (*Appeal of Talavera*, *supra*.)

Non-taxable teleproduction charges

California Code of Regulations, title 18, (Regulation) section 1532 explains that there is a partial exemption for property purchased for use in teleproduction or other postproduction services. Appellant asserts that it is entitled to deductions for claimed nontaxable teleproduction charges. However, appellant has not provided any evidence, information, or detail regarding its claimed nontaxable teleproduction charges that could be used to evaluate whether appellant met the requirements of Regulation section 1532. In the absence of evidence or explanation, OTA finds appellant has not shown that any of the claimed deduction for nontaxable teleproduction charges was disallowed in error. (See *Appeal of Talavera*, *supra*.)

"Other"(unspecified) non-taxable charges

Appellant argues that it is entitled to the disallowed claimed "other" deductions. However, the nature of these allegedly nontaxable amounts has not been specified on the sales and use tax returns. Appellant has not provided any evidence to support its assertion that these amounts were properly claimed as deductions on the sales and use tax returns, or even an explanation of what types of charges are included in its claimed "[o]ther deductions." Appellant's unsupported assertion is insufficient to meet its burden of proof. (*Appeal of Talavera*, *supra*.) In the absence of evidence or explanation, OTA finds appellant has not shown that any of the claimed deduction for "other" nontaxable charges was disallowed in error.

Issue 2: Whether appellant's understatement of reported taxable sales was the result of negligence or intentional disregard of relevant authorities.

R&TC section 6484 provides that if any part of the deficiency for which a deficiency determination is made 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.

Taxpayers are required to maintain and make available for examination on request by CDTFA, or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of the tax returns. (Cal Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, will be considered evidence of negligence and may result in the imposition of penalties. (Cal Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to determinations associated with the first audit of a taxpayer. (Cal. Code Regs, tit. 18, § 1703(c)(3)(A); also see *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal. App.2d 318, 321-324.) However, a negligence penalty should be upheld in a first audit if the understatement cannot be attributed to a bona fide and reasonable belief that the bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. (*Ibid*.)

CDTFA imposed the negligence penalty based on appellant's incomplete books and records. Further, when compared to appellant's reported taxable sales of $1,338,221, the audited understatement of $1,821,529 represents an error of 136 percent. On appeal, appellant contends that its incomplete records were due to a lost Quickbooks file following a computer crash. Appellant also attributes its failure to provide sufficient books and records to difficulty compiling hard copies of records. Appellant asserts that it ultimately provided six boxes of

records. Additionally, appellant argues that its former representative advised that it was not necessary to provide records.

Even though appellant was required to maintain and make available necessary records, here it has not done so. OTA notes that appellant may have lost electronic books and records. However, appellant also asserts that physical copies of the electronic books and records were provided to CDTFA in bankers boxes. According to the audit workpapers, CDTFA reviewed the boxed records and found "no useful information."

Further, appellant has failed to provide other substantiating documentation. For example, with respect to the claimed nontaxable labor deduction, appellant did not provide a complete set of invoices. Appellant also did not provide documentation (i.e., a contract) specifically describing the type of labor associated with its labor charges. Appellant also has not provided resale certificates to support claimed nontaxable sales for resale. Appellant also has not provided any evidence that it made sales of tangible personal property for resale that were, in fact, resold. Finally, appellant has not provided any evidence in support of the other disallowed claimed deductions.

OTA notes that appellant's claimed deductions make up more than half of appellant's total sales. Despite this fact, appellant has failed to provide a non-negligent explanation for its lack of books and records. Thus, OTA finds that appellant could not have held a bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law.

Finally, appellant has not provided any evidence that a former representative advised against providing books and records. Even if that were the case, appellant has since changed representatives but still has not provided sufficient documentation. As noted above, appellant is required to maintain and make available all records necessary for CDTFA to determine the correct sales tax. Therefore, although this was the first audit of appellant, OTA find that the understatement cannot be attributed to a bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently compliance with the requirements of the Sales and Use Tax Law. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

HOLDINGS

1. Appellant has not established that adjustments are warranted to the disallowed deductions for labor, sales for resale, nontaxable teleproduction charges, or unspecified nontaxable charges identified on sales and use tax returns as "other."
2. Appellant's understatement of reported taxable sales was the result of negligence.

DISPOSITION

Sustain CDTFA's decision to deny the petition.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:
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Josh Aldrich
Administrative Law Judge

DocuSigned by:
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Lauren Katagihara
Administrative Law Judge

Date Issued: 8/28/2023