OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SHERVIN ENTERPRISES, INC.**	) OTA Case No. 20086474) CDTFA Case ID: 185-019))))

<u>OPINION</u>

Representing the Parties:

        For Appellant: Farzin Lajevardi, President

        For Respondent: Randy Suazo, Hearing Representative
                                                 Christopher Brooks, Attorney
                                                 Jason Parker, Chief of Headquarters Ops.

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

        K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Shervin Enterprises, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's petition for redetermination of a Notice of Determination (NOD) dated July 13, 2017. The NOD is for tax of $56,639.76, plus applicable interest, and a negligence penalty of $5,663.97 for the period April 1, 2014, through March 31, 2017 (liability period). In its decision, CDTFA reduced the measure of tax from $709,215.00[2] to $219,099.00, and deleted the negligence penalty.

        Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Andrew Wong, and Keith T. Long held an oral hearing for this matter in Cerritos, California, on

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[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] There is a one-dollar difference between the taxable measure shown in the original audit work papers of $719,215 and the revised audit work papers of $719,214. The cause of this difference is likely due to rounding. However, it does not affect the result of the reaudit as CDTFA's adjustments are in accordance with its appeals decision and reflect a tax measured by $219,099.

August 9, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

<div align="center">ISSUE</div>

Whether any further reduction to the amount of unreported taxable parts sales is warranted.

<div align="center">FACTUAL FINDINGS</div>

1.   Appellant operates an auto body and repair shop, with used automobile sales. During the liability period, appellant reported total sales of $2,347,558, and claimed deductions of $1,861,007 for nontaxable repair labor, which resulted in taxable sales of $486,551.

2.   During the liability period, appellant used Mitchell automotive repair software, which is a point of sale (POS) system designed for the auto body repair industry. Appellant used the software to generate POS reports, which appellant then used to prepare sales and use tax returns.

3.   For the audit, appellant provided the following: federal income tax returns for 2014 and 2015; bank statements for April 1, 2014, through December 31, 2016; and POS reports for the period April 1, 2014, through December 31, 2016. Appellant did not provide source documents. CDTFA considered appellant's records to be inadequate for sales and use tax purposes.

4.   Upon audit, CDTFA compared appellant's federal income tax returns to appellant's sales and use tax returns for 2014 and 2015, finding immaterial differences. CDTFA also found that appellant's POS reports reconciled with appellant's federal income tax returns.

5.   CDTFA compared the gross sales reported on appellant's federal income tax returns (less sales tax) to the cost of goods sold (COGS) and found a gross profit of $450,186 for 2014 and $529,988 for 2015. CDTFA calculated markups[3] on appellant's total sales of 207.76 percent for 2014 and 205.38 percent for 2015.

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[3] "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. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30.00 percent (.30 ÷ 1.00 = 0.3).

6.   CDTFA also performed a markup test on appellant's sales of parts. CDTFA compared appellant's reported taxable parts sales to appellant's recorded parts purchases and found gross profits of negative $49,569 for 2014 and negative $81,583 for 2015. CDTFA then calculated markups on parts sales of negative 25.05 percent for 2014, negative 34.09 percent for 2015, and negative 30.00 percent overall. The negative markups indicate that appellant sold parts for less than it paid for those parts.

7.   CDTFA used the POS reports to compile recorded parts sales of $480,933, recorded labor charges (less discounts) of $1,835,296, and total recorded sales of $2,316,229 for the period second quarter of 2014 (2Q14) through 1Q17.[4] Appellant's recorded parts sales represented 21 percent of appellant's recorded total sales. CDTFA expected appellant's parts sales to be 50 percent of total sales based on CDTFA's experience auditing similar businesses in the area.

8.   CDTFA multiplied total sales of $2,316,229 by an estimated 50 percent parts sales ratio to establish audited taxable parts sales of $1,158,115. CDTFA subtracted appellant's reported taxable sales from audited taxable parts sales to compute unreported taxable parts sales of $671,565.

9.   CDTFA also obtained information from the California Department of Motor Vehicles (DMV) and determined that appellant sold 15 used vehicles for a total of $37,650, which were not recorded in the POS reports. These were considered unreported taxable sales. Thus, the audit found the total measure of unreported taxable sales was $709,215 ($671,565 + $37,650).[5]

10.   Appellant filed a timely petition for redetermination disputing the NOD. During CDTFA's appeals process, appellant provided sales invoices, preliminary repair estimates, and insurance estimates for the periods January 10, 2014, through January 20, 2014, January 10, 2015, through January 20, 2015, and January 10, 2016, through January 20, 2016 (collectively "test periods"). Appellant also provided an incomplete set of sales invoices for the period November 4, 2016, through November 15, 2016.

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[4] Appellant did not provide a POS report for 1Q17. As a result, CDTFA applied the calculated average recorded parts sales for 2Q14 through 4Q16 of $43,000, to estimate appellant's parts sales for 1Q17. CDTFA also applied the average recorded labor charges (less discounts) for 2Q14 through 4Q16 of $161,200.

[5] The measure of unreported vehicle sales is not in dispute. Accordingly, OTA does not discuss it further.

11.   CDTFA conducted a reaudit by reviewing appellant's preliminary repair estimates, insurance estimates, sales invoices, and the POS reports. CDTFA found that appellant recorded parts sales on its estimates that were not recorded on appellant's sales invoices or in the POS reports. In those instances, the total charges for parts and labor were recorded on appellant's sales invoices and in the POS reports as labor only.[6] CDTFA also found instances where the parts sales price recorded on the sales invoice and the POS reports was less than the amount recorded on appellant's estimates. Based on this, CDTFA concluded that appellant included taxable sales of parts in its calculation of nontaxable labor sales.

12.   CDTFA reviewed the test period documentation and found that appellant recorded total sales of $97,098 and taxable sales of $28,006 during the test periods. CDTFA used these amounts to calculate a parts sales ratio of 28.84 percent (28,006 ÷ $97,098). CDTFA then applied the parts sales ratio to the total sales recorded in appellant's POS reports for the liability period of $2,316,229, to compute audited taxable parts sales of $668,000. CDTFA subtracted this amount from appellant's reported taxable parts sales and found a difference of $181,449. Based on this, the measure of unreported taxable sales was reduced from $709,215 to $219,099 in the reaudit. CDTFA issued a decision on January 7, 2020, ordering the aforementioned reduction to the audited taxable measure and deleting the negligence penalty.

13.   This timely appeal followed.

<div align="center">DISCUSSION</div>

Issue: Whether any further reduction to the amount of unreported taxable parts sales is warranted.

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

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[6] For example, appellant's sales invoice no. 022457 shows total sales of $3,589.78, all of which is listed as repair labor (with no charge for parts). The POS reports also shows this sale as being a labor-only charge of $3,589.78. However, the corresponding State Farm Insurance estimate for this repair job shows a total charge of $3,589.78, of which $1,587.30 is specifically identified as being for parts.

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 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 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 the audit. For the audit, CDTFA reviewed appellant's reported taxable parts sales and appellant's recorded taxable parts purchases and found negative book markups. In other words, appellant's books and records revealed that appellant was selling parts for less than their purchase price. In addition, CDTFA reviewed appellant's POS reports and found that appellant's recorded parts sales made up 21 percent of its total sales, which CDTFA believed to be low for this type of industry. Based on these facts, it was reasonable for CDTFA to continue the audit. When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect approach to calculate the taxable measure. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) Thus, to calculate the audited taxable sales, CDTFA used the available POS reports and based on its knowledge of similar businesses, applied a 50 percent taxable parts sales ratio to appellant's recorded total sales. When compared to reported taxable sales, the audited taxable sales revealed unreported taxable sales of $709,215.

Appellant also did not provide a complete set of books and records for the reaudit. Instead, appellant provided sales invoices, preliminary repair estimates, and insurance estimates, and other documents, for the test periods. OTA notes that CDTFA may use testing techniques in its audits. (*Paine v. State Board of Equalization* (1982) 137 Cal.App.3d 438). CDTFA reviewed the new documents and found that they were not consistent with the POS reports. For example, appellant recorded taxable parts sales on insurance estimates, but not in the POS reports. In

those instances, appellant recorded additional charges as nontaxable labor in the POS reports. Therefore, it was reasonable for CDTFA to determine that appellant failed to report all of its taxable sales. To calculate the taxable measure on reaudit, CDTFA used the test period documentation to calculate a taxable parts sales ratio of 28.84 percent, which resulted in a reduction of the audit measure by $490,116, from $709,215 to $219,099.

In light of these facts, it was reasonable and rational for CDTFA to use the records that appellant provided for the test period to calculate a ratio of taxable parts sales, which was then applied to the total sales recorded in appellant's POS reports to compute the taxable measure. Accordingly, the burden shifts to appellant to show whether a reduction is warranted. (*Appeal of Talavera*, *supra.*)
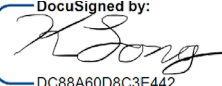
Appellant asserts that the test periods are not representative of the liability period. In support of its contentions, appellant provides POS reports for the liability period. However, CDTFA previously compared the POS reports to the test period documents and found that appellant erroneously failed to record taxable sales of parts. CDTFA also found that appellant recorded additional amounts for sales of nontaxable labor. As such, OTA cannot conclude that the taxable measure should be further reduced without additional documentation verifying the accuracy of the POS reports submitted on appeal. Appellant has not shown that the parts sales ratio is less than 28.84 percent as computed by CDTFA in the reaudit. Appellant also has not provided sufficient evidence to show that CDTFA's calculation was incorrect or that the audit measure should be otherwise reduced. Accordingly, OTA finds that appellant has failed to meet its burden of proof.

HOLDING

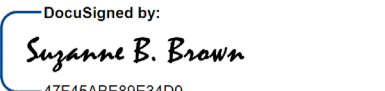No further reduction to the amount of unreported taxable sales is warranted.

DISPOSITION

CDTFA's decision to reduce the measure of unreported taxable sales from $709,215 to $219,099, and otherwise deny the petition, is sustained.
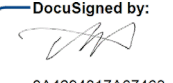
Keith T. Long
Administrative Law Judge

We concur:

Suzanne B. Brown
Administrative Law Judge

Andrew Wong
Administrative Law Judge

Date Issued: 9/14/2023