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2024 – OTA – 026
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **AMERICAN VETERAN SUPPLY COMPANY**	OTA Case No. 220811097 CDTFA Case ID: 01-234-033

OPINION

Representing the Parties:

For Appellant: Matthew Briglio, CPA

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Lisa Burke, Business Taxes Specialist III

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, American Veteran Supply Company (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 April 18, 2019. The NOD is for tax of $88,899, plus applicable interest for the period January 1, 2015, through December 31, 2017 (liability period).[2] CDTFA completed three reaudits, the latest of which reduces the determined tax to $8,288.

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

[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] The NOD was timely issued because appellant signed a series of waivers of the otherwise applicable three-year statute of limitations, providing CDTFA until April 30, 2019, to issue an NOD for the period January 1, 2015, through December 31, 2015. (R&TC, §§ 6487(a), 6488.)

ISSUES

1. Whether adjustments are warranted to the measure of unreported taxable sales.
2. Whether adjustments are warranted for nontaxable sales for resale.
3. Whether adjustments are warranted for tax paid purchases resold.

FACTUAL FINDINGS

1. Appellant is a retailer engaged in the business of furnishing construction materials such as industrial pipes, valves, and fittings. Appellant operates out of Long Beach, California, and has been in business since 2012. Appellant works closely with Columbia Specialty Company (CSC), its primary vendor.
2. Appellant is owned by a military veteran(s). Appellant uses its status as a veteran-owned business to secure government contracts that CSC is otherwise unable to procure.
3. As part of appellant's core business model, appellant serves as an intermediary on behalf of CSC. Appellant sells CSC's construction materials (e.g., pipes and pipe fittings) for use in government contracts. Appellant adds a small markup over cost in exchange for selling CSC's pipes, values, and fittings to third party construction contractors for use in such government contracts. CSC would be unable to sell materials directly to these construction contractors. Appellant operates, in whole or part, as a drop shipper.[3]
4. During the liability period, appellant reported total sales of $2,846,202, claimed a $865,350 deduction for nontaxable sales for resale, and reported taxable sales of $1,980,852.
5. For the audit, appellant provided federal income tax returns for 2014 through 2017, summary information for purchase invoices for 2015 through 2017, and various resale certificates, general ledgers, and electronic summary information for sales invoices.
6. According to appellant's purchase invoice data, appellant's primary supplier was CSC. During the liability period, appellant purchased $1,596,227 in construction materials from CSC. Appellant's total purchases from all suppliers during this same period (including CSC) was $2,796,010.

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[3] Appellant contends that its sales include "flow through sale[s] to government contractors." Appellant did not explain what it meant by "flow through sale"; however, this phrase appears consistent with the summary provided in CDTFA's Audit Schedule R1-12A-1a, and the evidence (sales statements and purchase invoices) provided by appellant. Thus, OTA understands that appellant is a drop shipper. (See, e.g., Cal. Code Regs., tit. 18, § 1706(a)(2) [defining "drop shipper" and "drop shipment"].)

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7. Appellant recorded approximately 500 sales transactions, totaling $2,932,085 in total sales (which included $165,006 invoiced for "Sales Tax") during the liability period. All the orders included a ship-to address in California.
8. Appellant reported $0 in beginning and $0 in ending inventory on its federal income tax returns for calendar years 2014 through 2017, which indicates that appellant reported to the IRS that it did not maintain any inventory (such as may be the case when a person operates exclusively as a drop shipper).
9. CDTFA's decision includes, as exhibits, copies of a small number of appellant's sales statements and supporting purchase invoices (representing $319,120 in purchases). All the available sales statements from appellant include the title "Drop Ship Order," and reflect shipments directly from the vendor to the construction contractor. The evidentiary record does not contain documentation to indicate or support that appellant maintained a warehouse or made any retail sales at its physical location.
10. CDTFA compared appellant's reported total sales with its recorded purchases to compute markups[4] of -0.41 percent for 2015, -11.19 percent for 2016, and 23.97 percent for 2017.[5]
11. With respect to the measure of unreported taxable sales (audit item 1), CDTFA considered the 23.97 percent markup for 2017 to be within the range expected for appellant's type of business. On that basis, CDTFA accepted appellant's reported total sales for 2017. Based on the negative markups for 2015 and 2016, CDTFA concluded that appellant understated its total sales for those years.
12. In the original (field) audit, CDTFA estimated a markup of 25 percent and applied that markup to appellant's recorded purchases for 2015 and 2016, establishing total audited sales of $2,745,731 for those two years. Appellant reported total sales of $2,103,109 for 2015 and 2016 combined, resulting in unreported total sales of $642,622, which CDTFA considered to be 100 percent taxable.

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[4] "Markup" is the amount by which the cost of merchandise or inventory 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" is one that is calculated from the retailer's records.

[5] The negative book markups for 2015 and 2016 could have meant, for example, that appellant was selling items for less than its recorded cost, that appellant did not sell all of its inventory in the same year it was purchased, or that appellant understated its sales. The negative markup might also have been the result of differences between cash and accrual reporting methods.

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13. In addition, CDTFA reviewed appellant's claimed resale deductions on an actual basis (audit item 2). CDTFA considered XYZ letter responses from appellant's customers.[6] Based on the available information, CDTFA allowed a $470,912 deduction. CDTFA disallowed the remaining claimed resale transactions ($424,185), primarily representing sales to United States construction contractors of materials for use in the performance of construction contracts with the United States.[7]
14. In total, CDTFA's audit established a deficiency measure of $1,066,807 for both audit items (i.e., $642,622 + $424,185).
15. On April 18, 2019, CDTFA issued an NOD for the liability disclosed by the field audit, which appellant timely petitioned.
16. Appellant provided purchase invoices to CDTFA for the period November 15, 2017, through November 30, 2017. The purchase invoices (in conjunction with appellant's previously provided sales invoices) supported the markup of 4.15 percent for that two-week period during 2017, which CDTFA accepted as representative of the liability period.
17. CDTFA issued a first reaudit that reduced its estimated 25 percent markup of appellant's 2015 and 2016 purchases to 4.15 percent. This reduced the measure of audit item 1 from $642,622 to $184,626.
18. CDTFA also examined contracts and invoices that reflected appellant made certain sales for resale and paid sales tax reimbursement on its purchases of certain equipment that it resold. Based on these documents, CDTFA reduced the measure of disallowed claimed nontaxable sales for resale from $ 424,185 to $394,438. CDTFA also included an allowance of $41,440 for tax paid purchases resold (audit item 3).
19. In total, CDTFA's reaudit established a deficiency measure of $537,624 for all three audit items (i.e., $184,626 + $394,438 – $41,440).
20. On May 11, 2022, CDTFA issued its decision, which ordered a second reaudit to allow an increase to the tax paid purchases resold deduction for appellant's tax-paid purchases from vendors (other than CSC). Appellant paid sales tax reimbursement on $319,120 in

[6] "XYZ letters" are letters sent to a retailer's customers inquiring into the disposition of the purchased property. (Cal. Code Regs., tit. 18, § 1668(f).)

[7] CDTFA's audit schedule computed an amount of $424,183; however, due to rounding the amount disallowed was $414,185. Any difference is mooted by the subsequent reaudit.

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purchases from these vendors ($89,121 of which CDTFA allowed in error, to appellant's benefit).[8] The second reaudit increased the tax paid purchases resold deduction from $41,440 to $360,560.

21. By letter dated August 3, 2022, CDTFA informed appellant of the results of the second reaudit, and that it could appeal the decision to OTA within 30 days. The second reaudit reduced the deficiency measure to $218,504 for all three audit items ($184,626 + $394,438 – $360,560).

22. Appellant timely filed this appeal to OTA.

23. CDTFA subsequently completed a third reaudit. CDTFA observed that appellant made significantly less purchases in 2017 than it did in 2015 ($599,425 and $1,412,755, respectively). Based on this observation, CDTFA made audit revisions to account for possible inventory carryover from prior years.[9] Due to undocumented, but theoretically possible, adjustments to beginning and ending inventories (which are not reported on appellant's federal income tax returns), CDTFA calculated the markup for the liability

[8] The $89,121 reflects purchases appellant made in 2014, and that were drop-shipped to appellant's customer during 2014, and which are covered under statements generated by appellant and dated March 2, 2015, and March 30, 2015, respectively. As one example, vendor Haldeman issued invoice I03733 to appellant on October 31, 2014, for property drop-shipped to appellant's customer. This order was shipped to appellant's customer on October 27, 2014, under terms FOB Shipment. This transaction is listed on appellant's March 2, 2015 statement. The audit did not cover 2014 and, as such, 2014 transactions are statutorily ineligible for deduction during 2015. CDTFA allowed this deduction during 2015. In summary, the $89,121 represents drop-ship transactions shipped directly from appellant's supplier to the construction contractor (consumer) during 2014. However, appellant printed Drop Ship Order statements dated during 2015 for these transactions, resulting in statements for 2015 for deliveries made in 2014. Aside from the FOB terms, there are no specific title provisions in the documents. Because the purchasers would have held title and possession during 2014, these transactions are properly excluded from the liability period and were allowed in error. (See R&TC, § 6006(a); Cal. Code Regs., tit. 18, § 1628(b)(3)(D).)

[9] Any carryover should be treated as beginning inventory in later years, which would increase cost of goods sold in the later years (and, hence, decrease the achieved markup). In addition, the unsold items would be treated as ending inventory for the prior years in which it remained unsold, which would have decreased the achieved markup for the prior years. If this occurred, this could, in theory, indicate that the calculated markups of -0.41 percent for 2015 and -11.19 percent for 2016 from the field audit were understated for earlier years (because ending inventory decreases cost of goods sold), and the 23.97 percent markup was overstated for 2017 (because beginning inventory increases cost of goods sold). In other words, CDTFA determined that the calculated 23.97 percent markup for 2017 may be overstated because it did not account for purchases in prior years that were sold in 2017.

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period in its entirety, as opposed to calculating markups on a year-by-year basis.[10] CDTFA applied the 4.15 percent markup to appellant's recorded purchases of $2,796,010 for the liability period, resulting in audited total sales of $2,912,033 (i.e., 1.0415 x $2,796,010). CDTFA subtracted reported total sales of $2,846,202, to arrive at audited unreported taxable sales of $65,831 (i.e., $2,912,033 - $2,846,202) for the liability period. This represents an error rate of 2.31 percent for the liability period for this audit item (i.e., $65,831 ÷ $2,846,202 = 2.31).[11] CDTFA made no adjustments to the other two audit items in the third reaudit.

24. In total, CDTFA's third reaudit resulted in a deficiency measure of $99,709 for all three audit items (i.e., $65,831 + $394,438 - $360,560).

DISCUSSION

Issue 1: Whether adjustments are warranted to the measure of unreported taxable sales.

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

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,

[10] The evidence, including federal income tax returns reporting to the IRS that appellant maintained $0 inventory, indicates that appellant did not maintain inventory and, instead, that this discrepancy was due to inconsistencies between appellant's statement date and the delivery date (as explained in footnote 8). As a result, the premise of CDTFA's third reaudit allowance is in error. Because this error favors appellant (i.e., the third reaudit reduces the liability and grants a net allowance for 2017), this Opinion does not address it further.

[11] The error rate is less than 4.15 percent because CDTFA's audit approach resulted in CDTFA accepting audited total sales which are less than reported total sales for 2017, and effectively resulted in a net allowance of $118,794 for 2017 (i.e., $64,376 [2015] + $120,250 [2016] - $118,794 [2017] = $65,831 in unreported sales.) CDTFA separately notes that its audit procedure of calculating a 2.31 percentage of error for a three-year period eliminated any potential credit for 2017; however, CDTFA effectively allowed this $118,794 overreporting in its audit computations (i.e., $65,831 unreported ÷ $2,846,202 reported = 2.31 percentage of error).

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§§ 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.*) To satisfy its burden of proof, a taxpayer must prove both: (1) that the tax assessment is incorrect; and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Here, appellant's recorded purchases for 2015 and 2016 exceeded its reported and recorded total sales for those two years, resulting in a negative book markup. Appellant failed to maintain comprehensive supporting documentation for its recorded sales and purchases. Appellant's available supporting source documentation reflects a 4.15 percent markup on purchases during a two-week period in November 2017. Thus, and in absence of complete source documents, it was reasonable and rational for CDTFA to conclude that appellant's markup was at least 4.15 percent for each year of the liability period, instead of a negative markup. As such, appellant has the burden of establishing error.

On appeal, appellant objects to the markup method because, according to appellant, CDTFA failed to consider factors such as inventory changes, pilferage, items in transit, price changes, and shrinkage. However, appellant has not provided any evidence that consideration of these factors would further reduce appellant's liability. Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *Appeal of AMG Care Collective*, *supra*.) Moreover, CDTFA made adjustments to allow for inventory changes, even though there is no evidence that appellant maintained any inventory, and the available evidence indicates that it did not. As such, OTA finds that no further adjustments are warranted on this basis.

Appellant also argues that its reported taxable sales are accurate because (1) appellant's available sales invoices support its sales, and (2) CDTFA has not identified any specific examples of sales that appellant failed to report. CDTFA is neither required, nor in a position, to establish the accuracy of appellant's reported taxable sales. CDTFA may base its determination on any documentation within its possession. (R&TC, § 6481.) CDTFA's burden of proof is minimal and only requires that its determination be reasonable and rational, which it is. (*Appeal of Talavera*, *supra*.) Therefore, it is appellant that carries the burden to prove a more accurate measure of the audited understatement of taxable sales. (*Ibid.*) Appellant did not provide comprehensive source documents for the liability period to support reported amounts. As such,

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no additional adjustments are warranted for this audit item.

Issue 2: Whether adjustments are warranted for nontaxable sales for resale.

It is presumed that all of a retailer's gross receipts are subject to tax until the contrary is established, unless the seller timely takes in good faith a certificate from the purchaser indicating that the property is purchased for resale (resale certificate). (R&TC, §§ 6091, 6092; Cal. Code Regs., tit. 18, § 1668(a).) If the seller does not timely obtain a valid and complete 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 an intervening use; or (2) is being held for purposes of resale by the purchaser and there has been no intervening use; or (3) was consumed by the purchaser who reported or paid tax directly to CDTFA. (Cal. Code Regs., tit. 18, § 1668(e).) A seller may use any verifiable method to make such a showing, including the use of XYZ letters. (Cal. Code Regs., tit. 18, § 1668(f).) However, a response to an XYZ letter is not equivalent to a timely and valid resale certificate in proper form, and CDTFA is not required to relieve a seller from liability for tax based on a customer's response to an XYZ letter. (Cal. Code Regs., tit. 18, § 1668(f)(3).)

Appellant claimed deductions totaling $865,350 for nontaxable sales for resale it made during the liability period. These amounts are presumed taxable because appellant failed to obtain resale certificates for these claimed resale deductions. (See R&TC, § 6091.) CDTFA reviewed the available documentation and accepted $470,912 of appellant's sales as nontaxable sales for resale. Appellant did not substantiate any additional nontaxable sales for resale.

On appeal, appellant makes one argument regarding the measure of disallowed claimed nontaxable sales for resale: CDTFA "used a faulty method on one transaction that should not be taxable but was assumed taxable." Appellant neither identified this particular transaction nor provided evidence to support its contention. An unspecified and unsupported assertion is not sufficient to rebut the presumption that appellant's sales are taxable. (See *Appeal of Talavera*, *supra*.) Therefore, no additional adjustments are warranted for this audit item.

Issue 3: Whether adjustments are warranted for tax paid purchases resold.

Under certain circumstances, a retailer who resells tangible personal property before making any use thereof (other than retention, demonstration, or display while holding it for sale in the regular course of business) may generally take a deduction of the purchase price of the

property if, with respect to its purchase, the retailer has reimbursed his vendor for the sales tax or has paid the use tax. (R&TC, § 6012(a)(1); Cal. Code Regs., tit. 18, § 1701(a).)

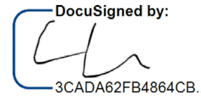
The evidence submitted by appellant established that it is entitled to a tax paid purchases resold deduction of $271,439, and CDTFA allowed a deduction of $360,560, exceeding the allowable deduction and which is to appellant's benefit (see footnote 8). Appellant has not provided any evidence to support any additional adjustments. As such, OTA finds that no further adjustments are warranted.

HOLDINGS

1. No additional adjustments are warranted to the measure of unreported taxable sales.
2. No additional adjustments are warranted for nontaxable sales for resale.
3. No additional adjustments are warranted for tax paid purchases resold.

DISPOSITION

Reduce the taxable measure to $99,709, as conceded by CDTFA pursuant to its third reaudit, and otherwise deny the petition for redetermination.



Andrew J. Kwee
Administrative Law Judge

We concur:

Michael F. Geary
Administrative Law Judge

Lauren Katagihara
Administrative Law Judge

Date Issued: 11/3/2023