OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 220610514
	)	CDTFA Case IDs: 3-059-714 & 118-035;
M. ZEPEDA	)	118-036
dba Central Tire	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant:	M. Zepeda Abel Moreno, Representative
For Respondent:	Ravinder Sharma, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief Headquarters Operations Bureau

L. KATAGIHARA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Zepeda dba Central Tire (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's petitions for redetermination (petitions) of the Notices of Determination (NODs) issued pursuant to the audit of the combined period of February 1, 2013, through June 30, 2017 (liability period).[2] The first NOD, dated October 25, 2017, is for tax of $87,556.56, plus applicable interest, and a negligence penalty of $8,755.69 for the period February 1, 2013, through December 31, 2014.[3] The second NOD, dated February 6, 2018, is for tax of $124,398.48, plus applicable interest, and a negligence penalty of $12,439.85 for the period

[1] Sales and use taxes were formerly administered by the State Board of Equalization (BOE). 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" shall refer to BOE.

[2] Appellant's Request for Appeal to the Office of Tax Appeals (OTA) specifies a liability period of February 1, 2013, through July 31, 2019. However, appellant subsequently conceded that the liability period at issue in this appeal spans from February 1, 2013, through June 30, 2017.

[3] The NOD was timely issued for the period February 1, 2013, through June 30, 2014, because appellant signed a series of waivers of the otherwise applicable statute of limitations, which extended the period for issuing an NOD to October 31, 2017. (See R&TC, § 6488.)

January 1, 2015, through June 30, 2017. Thus, for the liability period, the determined tax and penalty amounts total $211,955.04 and $21,195.54, respectively.[4] Over the course of one revised audit and two reaudits, CDTFA reduced the tax and penalties for the liability period to $162,694 and $16,269.36, respectively.[5]

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Huy "Mike" Le, and Lauren Katagihara held a virtual hearing for this matter on September 21, 2023. At the conclusion of the hearing, OTA held the record open for additional briefing. After the additional briefing period ended, OTA closed the record and this matter was submitted for an Opinion.

ISSUE[6]

Whether further adjustments to the measure of unreported taxable sales are warranted.

FACTUAL FINDINGS

1. Appellant has operated a tire and auto repair shop since February 2013.
2. For the liability period, appellant reported total sales of $1,538,393; claimed nontaxable labor of $937,794 and sales tax included of $10,963; and reported taxable sales of $589,636.
3. For audit, appellant provided federal income tax returns (FITRs) for 2013 and 2014; profit and loss statements (P&Ls) pertaining to portions of the liability period;[7] reports related to appellant's cost of goods sold (COGS) for 2014 through 2017; purchase and sales invoices for May and June 2016; and job worksheets for the period November 4, 2017, through November 11, 2017.
4. CDTFA's review of appellant's records revealed that between January 2015 and June 2016, appellant recorded purchases (i.e., COGS) totaling $716,993, but only reported

[4] $87,556.56 + $124,398.48 = $211,955.04; $8,755.69 + $12,439.85 = $21,195.54.

[5] CDTFA also created a "reaudit" in its internal revenue system either to correct its partial billings or to transfer the audit to its Centralized Revenue Opportunity System. CDTFA did not revise the audit work papers or change the total amount of its determination. Consequently, OTA does not consider CDTFA's correction or transfer a reaudit.

[6] Prior to and during the hearing, appellant requested relief of both the interest and the negligence penalties. Appellant, in response to OTA's request for additional briefing, indicated that he was withdrawing his request for both.

[7] Appellant provided his yearly P&Ls for 2013 through the first half of 2016, but CDTFA's determined that appellant's P&Ls for 2013 and 2014 were incomplete.

$147,784 in taxable sales for the same period, resulting in a negative markup. Moreover, appellant reported $352,635 more in gross sales on his 2014 FITR than he reported in total sales to CDTFA for the same year.

5. After further review of appellant's records, CDTFA established audited taxable sales using a markup method, which revealed an understatement of reported taxable sales. Consequently, CDTFA issued the aforementioned October 25, 2017, and February 6, 2018 NODs.

6. Appellant timely filed petitions with CDTFA disputing the NODs.

7. Thereafter, CDTFA revised the audit to reduce the tax liability and negligence penalty associated with the October 25, 2017 NOD to $69,524.68 and $6,952.46, respectively. CDTFA did not revise the liability or penalty associated with the February 6, 2018 NOD. Therefore, appellant's tax liability for the entire liability period (inclusive of both NODs) was reduced to $193,923.16, and the negligence penalties were reduced to a combined total of $19,392.31.[8]

8. CDTFA subsequently conducted its first reaudit, held an appeals conference, and issued a Decision ordering a second reaudit.[9]

9. CDTFA's second reaudit continued to implement the markup method as its audit methodology but reduced the combined tax liabilities to $162,694 and penalties to $16,269.36 for the entire liability period. Appellant does not dispute CDTFA's audit methodology and concedes the entire portion of the taxable measure attributable to his sale of tires. Appellant only disputes CDTFA's calculated markup of appellant's purchased parts and the corresponding calculation of appellant's nontaxable sales of labor. As such, OTA focuses on this portion of CDTFA's audit.

10. According to CDTFA, the invoices appellant provided did not separately state the charge for parts from the charge for labor, and instead, reflected a lump sum charge. As a result, CDTFA was unable to differentiate the amount of appellant's nontaxable labor charges from his taxable sales of parts.

[8] $124,398.48 + $69,524.68 = $193,923.16; $12,439.85 + $6,952.46 = $19,392.31.

[9] The second reaudit supersedes the previous audits and therefore, the original audit, revised audit, and first reaudit will not be discussed further.

11. CDTFA therefore requested appellant create and retain job worksheets for the period November 4, 2017, through November 11, 2017. The job worksheets included the following information for each job: (1) the invoice number; (2) the cost of the parts required for the job; (3) the number of hours, or increment thereof, of labor required to complete the job; and (4) the total sale amount (listed as a lump sum).

12. There is no dispute that appellant paid his employees $17.50 per hour. As such, to compute the total cost of labor for each job, CDTFA multiplied the number of hours of labor appellant recorded on the job worksheets by $17.50. CDTFA then divided the total cost of labor by the total cost (labor plus parts) to calculate the percentage of the cost attributable to labor for each job. CDTFA then applied that same percentage to the sale amount to calculate the amount of the sale that constituted nontaxable labor (with the remainder constituting a taxable sale of parts). These calculations revealed audited hourly labor charges spanning from $20.67 to $44.67 and an average labor charge of approximately $27 per hour. Last, CDTFA divided the amount of appellant's sale of parts by the cost of the part to determine appellant's markup.[10]

13. CDTFA repeated these calculations for each job recorded on the job worksheets. CDTFA's calculations revealed audited markups of parts ranging from 18.7 percent to 154.7 percent and an average markup of 46 percent (rounded). CDTFA then applied that markup to appellant's audited purchases of $305,909 to calculate $447,997 of audited taxable sales of parts.[11]

14. Using CDTFA's audited taxable sales of parts (in addition to appellant's undisputed audited taxable sales of tires), and appellant's reported taxable sales, CDTFA calculated appellant's error rate for each year in the liability period: 261.16 percent for 2013;

[10] By way of example, job 10951 required five hours of labor at a cost of $17.50 to install a part or parts. Therefore, the cost of labor was $87.50 ($17.50 × 5 hours). Appellant purchased the part(s) for $605, so appellant's total cost of the job was $692.50 ($87.50 + $605 = $692.50). The cost of labor represented 12.64% percent of the total cost of the job ($87.50 ÷ $692.50 = 12.64%). Appellant charged his customer $1,125 for job 10951 as a lump sum. Because labor represented 12.64% percent of the total cost, CDTFA determined the same percentage should be allocated to the nontaxable labor charge ($1,125 × 12.63% = $142 [rounded])). Thus, by CDTFA's calculation, $142 of the $1,125 sale constituted the nontaxable labor charge and the remaining $983 ($1,125 - $142) constituted the taxable sale of parts. The sale of the part(s) divided by the cost of the part(s) ($983 ÷ $605) represented appellant's markup of the part(s) (for this particular job, approximately 62.50 percent).

[11] Appellant's recorded purchases totaled $330,262, but CDTFA provided both a two percent adjustment for pilferage and a $17,748 adjustment to account for ending inventory. Appellant does not dispute CDTFA's calculation of audited purchases.

399.62 percent for 2014; 535.32 percent for 2015; and 257.14 percent for both 2016 and the first two quarters of 2017.[12] CDTFA then applied each year's respective error rate to appellant's reported taxable sales to reach understated taxable sales for parts and tires in the amount of $1,924,380.

15. Appellant continued to disagree with CDTFA's determined markup of parts and labor, and therefore this timely appeal followed.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales of all tangible personal property in this state 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.) 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).)

California Code of Regulations, title 18, section 1546(b) states that if the retail value of parts and materials furnished in connection with repair work is more than 10 percent of the total charge, or if the repairperson makes a separate charge for such property, the repairperson is the retailer and tax applies to the fair retail selling price of the property. Appellant does not dispute that tax applies to his sale of parts.

If CDTFA is not satisfied with the amount of tax reported by any person, CDTFA may determine the amount required to be paid based on any information within its possession or that may come into its possession. (R&TC, § 6481.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Amaya*, 2021-OTA-328P.) Upon such a showing, the burden of proof shifts to appellant to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, appellant must establish by documentation or other evidence that the

[12] The error rate was calculated by dividing CDTFA's audited understated taxable sales by appellant's reported total sales. Due to the lack of records for 2017, CDTFA adopted the 2016 error rate and applied it to the first two quarters of 2017.

circumstances he asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

In this case, CDTFA identified a significant discrepancy between the gross receipts appellant reported on his 2014 FITR and the total sales he reported to CDTFA that year. In addition, for the period January 1, 2015, through June 30, 2016, appellant's recorded COGS were significantly higher than his reported taxable sales for the same period, resulting in a negative markup. Under these circumstances, it was appropriate for CDTFA to conclude that appellant's reported taxable sales were likely understated and that appellant's books and records were not reliable. CDTFA utilized the markup method, which is a recognized and accepted accounting procedure, and has been accepted by appellant. (*Appeal of Amaya*, *supra*.) For these reasons, and because CDTFA used the records made available to it by appellant, OTA finds CDTFA's determination to be reasonable and rational. Accordingly, the burden shifts to appellant to establish that an adjustment is warranted.

Although appellant agrees with CDTFA's utilization of the markup method, appellant disputes the method in which CDTFA allocated his taxable sales of parts and nontaxable sales of labor for use in the application of the markup method. Specifically, appellant argues that CDTFA's calculated labor rate is understated.

Appellant asserts that CDTFA should have applied a rate of $55 per hour to appellant's sales of labor.[13] In support of this assertion, appellant provided nonconsecutive invoices from June 3, 2016, through June 28, 2016, but did not provide any documents to further substantiate the labor and parts charges therein (e.g., purchase invoices associated with those parts). While the invoices do not support appellant's asserted $55 per hour labor rate, the invoices do suggest appellant charged his customers more than $27 per hour for labor. For example, invoice number 6816 reflects appellant changed the tires and oil of a vehicle. For this service, appellant charged his customer $125 for parts and $190 for labor. Appellant indicated that it took 2.25 hours to complete the service. Adopting CDTFA's $27 per hour labor rate, however, would result in appellant taking seven hours to complete a relatively routine and quick service.

Appellant also submitted two invoices from other automotive repair businesses that appear to show an hourly labor rate of $76.72 and $166, but the invoices do not coincide with the

[13] While this appeal was under review by CDTFA, appellant claimed he charged a labor rate of $25 or more for simple repairs and $80 or more for complex repairs. Appellant confirmed at the hearing that he is now asserting a labor rate of $55 an hour for the liability period, a rate which he claims is conservative.

liability period and are in different markets than that of appellant. Additionally, appellant submitted an article written by AAA indicating that in January 2017, automotive repair businesses in the AAA-approved auto repair network charged between $47 and $215 per hour. Neither the invoices from the other businesses nor the AAA article are evidence that appellant himself charged these rates (or the specifically asserted labor rate of $55 per hour).

None of appellant's submitted documents, standing alone, are dispositive. However, when considered as a whole, the documents do support a finding that, more likely than not, appellant charged a labor rate of more than $27 per hour during the liability period. The lowest per hour labor rate listed on appellant's invoices from June 2016 is $40. This rate is similar to the low-end of the AAA rates listed for 2017 ($47), which, when factoring in inflation for each year in the liability period, equates to an average hourly rate of $45.58.[14] The average of appellant's listed $40 rate and AAA's $45.58 rate is $42.80. Coupled with the fact that a significant portion of the amount charged by automotive repair businesses is generally attributable to the labor and expertise provided rather than the sale of parts, OTA finds a $42.80 per hour labor rate to be a more reasonable representation of the rate charged by appellant.

Therefore, CDTFA shall apply a $42.80 per hour labor rate in schedule R2 12A-2 to calculate the revised markup of parts and resulting error rates.[15] Due to the lack of documentation evidencing the justification of a higher labor rate, OTA declines to make any other adjustment to the labor rate or resulting measure of tax.

[14] See https://www.bls.gov/data/inflation_calculator.htm.

[15] By OTA's calculation, the resulting markup for parts is approximately 38 percent.

HOLDING

Further adjustments to the measure of unreported taxable sales are warranted. CDTFA shall recalculate appellant's unreported taxable sales of parts by increasing appellant's charge for labor to $42.80 per hour, which will result in a corresponding reduction to CDTFA's audited markup on the sale of parts and the applied error rates.

DISPOSITION

CDTFA shall reduce the liability as conceded by CDTFA in its second reaudit. In addition, CDTFA shall further reduce the audited taxable measure related to the sale of parts by applying a markup based on the rate of $42.80 per hour for labor charges (in the manner described above) and make a corresponding reduction to the negligence penalties. CDTFA's action in denying the petitions is otherwise sustained.

DocuSigned by:
Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
CB1F7DA37831416...
Josh Lambert
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
A11783ADD49442B...
Huy "Mike" Le
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