

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)	OTA Case No. 221212161
ALFA TIRE & SHOP INC.)	CDTFA Case ID: 2-579-471
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)	

OPINION

Representing the Parties:

For Appellant: Lusy Brutyan, Enrolled Agent

For Respondent: Jason Parker, Chief of Headquarters Ops.

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

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Alfa Tire & Shop 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 January 26, 2021. The NOD is for a tax liability of \$96,554, plus applicable interest, for the period July 1, 2016, through December 31, 2019 (liability period).² After issuing the NOD, CDTFA performed a reaudit, which reduced the determination from tax of \$96,554 to \$91,895.³

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 issued timely because, on October 1, 2020, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which extended until April 30, 2021, the time within which CDTFA could issue an NOD for the period July 1, 2016, through December 31, 2017. (See R&TC, §§ 6487(b), 6488.)

³ This amount is reflected in CDTFA's November 21, 2022 options letter to appellant. The options letter explains the outcome of CDTFA's reaudit of appellant and explains the options available to appellant. OTA notes a one-dollar difference between the amount contained in the options letter of \$91,895 and the amount contained in the audit workpapers of \$91,894, which is likely due to rounding differences.

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, (Regulation) section 30209(a).

ISSUE

Whether further adjustments to the measure of disallowed sales for resale are warranted.

FACTUAL FINDINGS

1. Appellant operated an automotive parts and repair business in Los Angeles. Appellant's business included sales of new and used tires, and repair parts. Appellant also performed automotive repairs and maintenance (e.g., oil changes, etc.).
2. During the liability period, appellant filed sales and use tax returns reporting the following: total sales of \$3,092,859, claimed deductions for nontaxable labor of \$2,778,859, and taxable sales of \$266,100. Appellant reported zero taxable sales for the period second quarter of 2019 (2Q19) through 4Q19.
3. For the audit, appellant provided federal income tax returns for the years 2016 through 2019, an incomplete set of sales invoices for the year 2018, purchase invoices for the years 2017 through 2018, and bank statements for the liability period.
4. CDTFA compared the gross receipts that appellant reported on its federal income tax returns to the total sales that appellant reported on its sales and use tax returns. For 2016, appellant's reported total sales exceeded appellant's reported gross receipts by \$70,214. For 2017, appellant's reported gross receipts exceeded reported total sales by \$3,880. For 2018, appellant's reported gross receipts exceeded reported total sales by \$791,828. For 2019, appellant's reported gross receipts exceeded reported total sales by \$15,174.
5. CDTFA reviewed appellant's bank statements and found total deposits of \$3,673,932, which exceeded appellant's reported total sales of \$3,117,462 for the liability period by \$556,470. CDTFA found that appellant's bank deposits exceeded reported total sales by large amounts for some quarters, including \$94,801 in 3Q16, \$107,680 for 1Q18

- \$181,644 for 2Q18, and \$172,346 for 3Q18.⁴ Based on these discrepancies, CDTFA decided to continue the audit.
6. CDTFA compiled the available sales invoices and found total recorded sales of \$756,691 for 2018. Upon comparison, the gross receipts reported on appellant's 2018 federal income tax return exceeded the sales recorded on appellant's invoices. Based on this, CDTFA concluded that appellant's sales invoices were incomplete.
 7. Appellant recorded nontaxable sales for resale of \$466,770 and exempt labor sales of \$24,347 on its invoices for 2018. Appellant's recorded nontaxable and exempt sales exceeded the total claimed nontaxable and exempt sales reported on appellant's sales and use tax returns of \$717,128 by \$226,011.
 8. CDTFA took the sum of appellant's recorded nontaxable sales of tires for resale of \$466,770, recorded taxable sales of tires of \$283,140, and recorded taxable sales of parts of \$22,434 for 2018 to find total recorded sales less tax and labor of \$772,344. CDTFA used this information and found that 39.56 percent of appellant's sales of tires and parts were subject to tax⁵ and 60.44 percent were nontaxable.⁶
 9. The recorded taxable sales compiled by CDTFA included the following: sales on which appellant had collected sales tax reimbursement; unsupported nontaxable sales for resale,⁷ and unsupported exempt sales of tires to common carriers. According to CDTFA, the proof required to support an exemption for sales to common carriers, as provided in Regulation section 1621(c)(1) was discussed with appellant. Although CDTFA allowed additional time to provide supporting documentation following the

⁴ Appellant's bank deposits also exceeded reported total sales by \$11,500 for 2Q19, and \$14,165 for 3Q19. However, appellant's reported total sales exceeded bank deposits by amounts ranging from \$227 to \$4,005 in the remaining quarters.

⁵ This is calculated by taking the sum of appellant's taxable tire and parts sales to find total taxable sales of \$305,574 (\$283,140 + \$22,434) and dividing it by total recorded sales less tax and labor of \$772,344.

⁶ CDTFA indicates that appellant provided no resale certificates to support nontaxable sales for resale but only provided copies of its customers' seller's permits. CDTFA used its internal electronic records to verify the validity of the seller's permits and when it found that the customers held valid seller's permits at the time of their purchases from appellant, were in the business of selling tires, and had purchased a high volume of merchandise from appellant, CDTFA allowed the nontaxable sales for resale despite the absence of valid resale certificates.

⁷ Unsupported nontaxable sales for resale included sales made after the purchasers had closed their seller's permits and sales made to a business that held a valid seller's permit but was not engaged in the business of selling tires.

- discussion, none was provided. Nevertheless, CDTFA noted that because the 2018 invoices were incomplete, it would increase the audited nontaxable sales ratio by 10 percent from 60.44 percent to 70.44 percent.
10. CDTFA performed a markup test, as follows. First, CDTFA reduced the purchases that appellant reported on its federal income tax returns of \$4,038,648 by 70.44 percent to establish audited costs of merchandise sold in taxable transactions of \$1,193,824 for the period 2016 through 2019. Next, CDTFA compared the retail sales price for tires shown on appellant's invoices from 1Q18 with their respective costs and computed an average markup of 27.32 percent.⁸ Finally, CDTFA applied the 27.32 percent markup to the audited cost of merchandise sold for the years 2016 through 2019 to establish audited taxable sales of \$1,519,978 for that period.
 11. CDTFA reduced the four-year audited taxable sales to exclude the first two quarters of 2016, which resulted in audited taxable sales of \$1,307,310. Appellant's audited taxable sales exceeded reported taxable sales for the liability period by \$1,041,210.
 12. CDTFA issued the aforementioned NOD on January 26, 2021. Appellant filed a timely petition for redetermination and provided additional documentation to support its claimed nontaxable sales for resale.
 13. In a memorandum dated June 16, 2022, CDTFA explained that it reviewed appellant's additional documents, including: a resale certificate for Quality Wholesale Tire (Quality), which was dated October 9, 2018; a resale certificate for OD-Trans Corporation (OD-Trans), which was signed on April 10, 2018; and an XYZ letter response for Axios Truck Tire (Axios).⁹
 14. CDTFA found that the resale certificate issued by Quality was not timely received because the first registered sale occurred on January 11, 2018, well before appellant received the resale certificate. CDTFA also noted that Quality's seller's permit was closed on September 30, 2017.

⁸ "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 $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($.30 \div .70 = 0.42857$).

⁹ XYZ letters are letters in a form approved by CDTFA which are sent to some or all of a seller's purchasers inquiring as to the purchasers' disposition of the property purchased from the seller. (Cal. Code Regs., tit. 18, § 1668(f).)

15. CDTFA noted that OD-Trans had a valid seller's permit when the resale certificate was issued, and that the resale certificate met the requirements of Regulation section 1668. As a result, CDTFA stated that it would accept appellant's claimed sales for resale to OD-Trans.
16. CDTFA found that Axios had two seller's permits. The first seller's permit was closed on December 31, 2017. The second seller's permit was opened on April 15, 2021. CDTFA opined that there were two separate Axios business entities. CDTFA states that it attempted to contact Axios but could not verify the validity of the XYZ letter response. CDTFA also stated that in this case, appellant's sales occurred during the period when Axios did not have a seller's permit. Based on the foregoing, CDTFA did not allow appellant's claimed sales for resale to Axios.
17. The June 16, 2022 memorandum states that the audited nontaxable sales ratio should be increased from 70.44 percent to 71.29 percent. CDTFA also recommended a reduction to appellant's audited cost of merchandise sold at retail by one percent to allow for shrinkage.
18. On October 10, 2022, CDTFA issued a decision ordering a reaudit in accordance with the June 16, 2022 memorandum. This resulted in a reduction of the taxable measure from \$1,041,210 to \$990,920. Otherwise, CDTFA denied the petition.
19. This timely appeal followed.

DISCUSSION

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).)

The retailer bears the burden of showing that a sale of tangible personal property is not a retail sale unless the retailer timely and in good faith obtains a resale certificate from the purchaser. (R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(a).) A resale certificate which is not

timely taken is not retroactive and will not relieve the seller of the liability for the tax. (Cal. Code Regs., tit. 18, § 1668(e).) If a seller fails to timely obtain a resale certificate in proper form, the seller will be relieved of liability for the tax only where the seller shows that the purchaser: (1) in fact resold the property and the property was not used for any purpose other than retention, demonstration, or display while holding it for sale in the regular course of business; or (2) is holding the property sold for resale and has not made a taxable use of that property; or (3) consumed the property sold, and reported the tax due directly to respondent on its sales and use tax returns; or (4) consumed the property sold, and paid the tax due to respondent pursuant to an assessment or an audit. (*Ibid.*)

A seller who does not timely obtain a resale certificate may use any verifiable method of establishing that it should be relieved of liability for the tax, including the use of “XYZ letters,” which are letters in an approved format sent to the seller’s customers inquiring as to the disposition of the property purchased. (Cal. Code Regs., tit. 18, § 1668(f)(1)-(3).) However, a response to an XYZ letters 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).) When there is no response to any XYZ letter, CDTFA should consider whether it is appropriate to use an alternative method to ascertain whether the seller should be relieved of tax with respect to the questioned or unsupported transaction(s). (Cal Code Regs., tit. 18, § 1668(f)(4).)

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. CDTFA examined the available books and records, including federal income tax returns, sales invoices, and bank statements, and found discrepancies that could not be explained. When

CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect audit method. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.)

To calculate the taxable measure, CDTFA used appellant's sales invoices from 2018 to establish a ratio of taxable to nontaxable sales. Appellant did not provide valid resale certificates, XYZ response letters, or evidence that its claimed sales for resale were actually resold. As such, it was reasonable for CDTFA to exclude the unsupported claimed nontaxable sales from the nontaxable sales ratio. However, CDTFA gave appellant the benefit of the doubt and increased the nontaxable sales ratio by 10.00 percent from 60.44 to 70.44 percent, without any additional support from appellant.

CDTFA applied the 70.44 percent nontaxable sales ratio to the purchases recorded on appellant's federal income tax returns to establish appellant's cost of merchandise sold in taxable transaction for the period 2016 through 2019. CDTFA then applied a markup of 27.32 percent to the cost of merchandise sold in taxable transactions to establish audited taxable sales. OTA has previously recognized the markup method as an accepted audit method. (*Appeal of Amaya*, 2021-OTA-328P.) Upon comparison to reported taxable sales, appellant's audited taxable sales revealed a deficiency measuring \$1,041,210.

Upon reaudit, CDTFA increased appellant's nontaxable sales ratio to 71.44 percent based on additional documentation provided by appellant. However, CDTFA did not allow adjustments for sales made to Quality and Axios. CDTFA found that appellant did not timely obtain a resale certificate from Quality, and Quality did not have a valid seller's permit at the time of the claimed nontaxable sale; CDTFA found that Axios did not have a valid seller's permit at the time of the claimed nontaxable sale. CDTFA attempted to but could not verify the XYZ response letter from Axios. A resale certificate which is not timely taken is not retroactive and will not relieve the seller of the liability for the tax. (Cal. Code Regs., tit. 18, § 1668.) 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).) Therefore, CDTFA was not required to accept the untimely resale certificate or XYZ response letter. Considering the foregoing, CDTFA's decision to calculate a nontaxable sales ratio and perform a markup test from the available books and records was both reasonable and rational. As such, appellant bears the burden of establishing that adjustments are warranted.

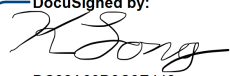
On appeal, appellant asserts that the nontaxable sales ratio should be increased to 85 percent. Appellant also argues that it is a small business and should not be required to investigate the validity of a seller's permit. Nevertheless, the taxpayer bears the burden of showing that a sale of tangible personal property is not at retail unless they obtain a timely resale certificate in good faith. (R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(a).) Appellant failed to timely obtain resale certificates for the disputed transactions and has not provided any documentation to support additional nontaxable sales for resale. For example, appellant has not provided evidence that it received timely resale certificates from its customers. Appellant also has not provided additional XYZ response letters or any evidence that it sold tangible personal property, which was then resold. Appellant's unsupported assertions are insufficient to meet its burden of proof. (See *Appeal of Talavera, supra.*)

HOLDING

Further adjustments to the measure of disallowed sales for resale are not warranted.

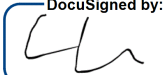
DISPOSITION

CDTFA's actions in reducing the amount of unreported taxable sales from \$1,041,210 to \$990,920 and otherwise denying the petition are sustained.

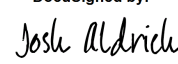
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Keith T. Long
Administrative Law Judge

We concur:

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Andrew J. Kwee
Administrative Law Judge

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Josh Aldrich
Administrative Law Judge

Date Issued: 10/12/2023