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2024-OTA-453
Nonprecedential

**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

| In the Matter of the Appeal of: **PREMIER WHEELS/PRO TIRE, INC.** | OTA Case No. 20096668<br>CDTFA Case ID: 289-221 |
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# OPINION

Representing the Parties:

For Appellant: Marc Brandeis, Representative

For Respondent: Nalan Samarawickrema, Hearing Representative
Randy Suazo, Hearing Representative
Christopher Brooks, Attorney

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Premier Wheels/Pro Tire, Inc. (appellant) appeals a decision by the California Department of Tax and Fee Administration (respondent)[1] regarding appellant's timely petition for redetermination of respondent's Notice of Determination (NOD) dated July 2, 2018.[2] The NOD is for a tax liability of $1,391,797.00, plus applicable interest, and a negligence penalty of $139,179.73 for the period January 1, 2013, through September 30, 2017 (liability period).

In its decision, issued on December 18, 2019, respondent ordered a reaudit to reduce the total measure of tax (i.e., the aggregate amount of unreported taxable sales respondent had determined upon audit) from $15,480,889 to $14,536,642 because appellant provided documentation of additional nontaxable sales for resale; otherwise, respondent denied appellant's

[1] The State Board of Equalization (BOE) formerly administered sales and use taxes. On July 1, 2017, BOE functions relevant to this case transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "respondent" will refer to BOE.

[2] Respondent timely issued the NOD because appellant had waived the applicable statute of limitations and extended respondent's issuing deadline. (See R&TC, §§ 6487(a), 6488.)

petition. This reduction to the measure of tax will correspondingly reduce the tax liability, applicable interest, and the associated negligence penalty.

On September 13, 2023, Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Lauren Katagihara, and Josh Aldrich held an oral hearing for this matter in Cerritos, California. At the conclusion of the hearing, the record was closed and this matter was submitted for an Opinion.

## ISSUES

1. Whether the aggregate amount of unreported taxable sales should be further reduced.[3]
2. Whether appellant was negligent.

## FACTUAL FINDINGS

1. Appellant, a corporation, operated four tire shops in Norwalk, California. Appellant sold new and used tires, wheels, and mufflers both at retail and for resale. Appellant also made sales through online marketplaces such as eBay. In addition, appellant offered related services such as installation, balancing, and repair of tires; alignment; and custom fabrication of wheels such as drilling and polishing.
2. Appellant opened a seller's permit with an effective start date of February 1, 1997.
3. Previously, respondent audited appellant for the period April 1, 1997, through March 31, 2000. This audit disclosed that appellant had made unsupported sales for resale of $46,207. Respondent did not recommend imposing a negligence penalty because appellant's understatement was just a small percentage of its total sales. However, respondent did discuss with appellant the proper application of the law regarding sales for resale.
4. Respondent also previously prepared for appellant a field billing order (FBO) for the period April 1, 2006, through March 31, 2009.[4] The FBO disclosed an aggregate taxable measure of $2,199,591, of which $1,621,544 consisted of disallowed claimed nontaxable sales for resale based on a block sample. Respondent imposed a negligence penalty for

[3] The aggregate amount of unreported taxable sales, $14,536,642, consists of the following two items: (1) unreported taxable sales of $14,195,521 based on the markup method and (2) unreported taxable sales of $341,121 based on differences with appellant's federal income tax returns (FITRs).

[4] An FBO is prepared to recommend an additional tax liability or refund using procedures other than those used in a regular audit.

three reasons: (a) appellant did not provide complete and adequate books and records to support its reported sales; (b) appellant's total understatement of $2,199,589 represented an "egregious" error ratio of 654.82 percent when compared to reported taxable sales of $335,907; and (c) appellant repeated the same errors disclosed in respondent's prior audit, which concerned disallowed claimed nontaxable sales for resale of $46,207.

5. For the liability period at issue here, appellant reported the following on its sales and use tax returns (SUTRs): (a) total sales of $11,958,110; (b) total deductions of $9,577,137 (consisting of (i) nontaxable sales for resale of $8,091,012, (ii) nontaxable labor of $556,260, (iii) exempt sales in interstate and foreign commerce of $715,466, (iv) sales tax reimbursement included in reported total sales of $213,919, and (v) unexplained deductions of $480 claimed on line 10 of its SUTRs ("other")); and (c) total taxable sales of $2,380,973.

6. For audit, appellant provided the following books and records: (a) federal income tax returns (FITRs) for fiscal year ending (FYE) June 30, 2013, through FYE June 30, 2017 (on which appellant claimed total bad debts of $17,184);[5] (b) monthly sales reports for 2013 through June 2017; (c) statements of income for the liability period except for FYE June 30, 2015; (d) monthly bank statements for 2013 through June 2017; (e) sales invoices and eBay sales reports for November 2015 through April 2016, along with associated shipping documents for November 2015;[6] (f) merchandise purchase invoices for November 2016; and (g) various resale certificates.

7. Appellant stated that, on a monthly basis, it provided sales invoices and eBay sales reports to its outside accountant, who prepared monthly sales reports, which the accountant then used to prepare the quarterly SUTRs.[7] Sales invoices were pre-printed in booklets and filled out by hand. Respondent noted that the hand-written information on the sales invoices were often illegible and, although sales invoices were pre-numbered, appellant did not use them in sequential order, so respondent could not verify the completeness of provided sales invoices and monthly sales reports. Further, respondent

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[5] Appellant's fiscal year covered the period from July 1st of one year to June 30th of the next year.

[6] Appellant asserted that sales invoices for 2013 and 2014 were lost in a fire that occurred in December 2014.

[7] Appellant stated that all eBay sales are recorded as sales in interstate and foreign commerce.

observed that appellant lacked internal controls and concluded that appellant may not have recorded some sales.

8. Due to the lack of reliable source documentation and the results of additional analyses it performed (respondent's analyses relevant to the issues on appeal are explained below), respondent found that the provided books and records were inadequate for sales and use tax audit purposes.

9. In one analysis, respondent compared gross receipts reported on the FITRs for FYE June 30, 2014, FYE June 30, 2015, FYE June 30, 2016, and FYE June 30, 2017, to the total sales reported on contemporaneous SUTRs. Gross receipts exceeded total sales by $2,527,154, $2,460,552, $2,828,182, and $3,142,877 for each fiscal year, respectively. Appellant stated that these differences related to income for drilling and polishing services performed for other businesses. Appellant stated it considered drilling and polishing sales as nontaxable and excluded these sales from amounts reported on its SUTRs. Appellant did not provide documentation supporting reported gross receipts or sales invoices supporting the alleged drilling and polishing sales.

10. In another analysis, respondent used monthly sales reports and compiled recorded total sales of merchandise (nontaxable sales for resale + nontaxable sales in interstate and foreign commerce + taxable sales) for the period July 1, 2013, through June 30, 2017. Respondent compared total sales of merchandise to the corresponding cost of goods sold (COGS) reported on the FITRs and computed recorded book markups of -46.93 percent for FYE June 30, 2014, -45.09 percent for FYE June 30, 2015, -48.43 percent for FYE June 30, 2016, and -44.49 percent FYE June 30, 2017.[8] Appellant's recorded sales agreed with sales reported on the SUTRs, so the negative book markups indicated to respondent that sales as reported would result in a substantial loss for appellant. As a result, respondent concluded that the monthly sales reports were incomplete and unreliable and appellant potentially underreported sales on its SUTRs. Respondent also

[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 $0.70 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 (0.30 ÷ 0.70 = 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 percent (0.30 ÷ 1.00 = 0.30).

concluded that it needed an alternate audit method to verify appellant's sales and decided to use the markup method to compute audited sales.[9]

11. Using merchandise purchase invoices and sales prices provided by appellant, respondent prepared a shelf test of tires, wheels, and mufflers, and computed audited markups of 12.69 percent, 5.26 percent, and 11.08 percent, respectively.[10] Appellant stated that the same markups were used for retail, wholesale, and interstate sales.

12. Respondent performed a purchase segregation test using available merchandise purchase invoices for the month of November 2016, which disclosed that tire purchases accounted for 73.39 percent, wheel purchases accounted for 20.59 percent, muffler purchases accounted for 3.87 percent, and miscellaneous item purchases accounted for 2.15 percent of the merchandise purchases.[11] Respondent noted that total merchandise purchases of $242,728 for November 2016 was significantly less than average monthly purchases of $378,134 based on COGS reported on the FITR for FYE June 30, 2017. However, based on its experience of audits of similar businesses in appellant's area, respondent concluded that the purchase ratios were reasonable.

13. Respondent multiplied the audited markups by the respective purchase percentages to compute a weighted markup of 10.82 percent.

14. Next, respondent computed the cost of taxable merchandise sold by deducting the cost of allowable nontaxable sales from COGS reported on the FITRs. As relevant here, there were two main categories of nontaxable sales: (a) sales for resale and (b) sales in interstate or foreign commerce. Respondent examined each category of claimed nontaxable sales using November 2015 as a test period.

15. Regarding sales for resale, respondent disallowed appellant's claimed nontaxable sales for resale to customers from whom respondent did not acquire a valid resale certificate or where respondent was unable to find other evidence of the validity of the sale for resale. Respondent provided appellant the opportunity to support claimed sales for resale using

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[9] Generally, a markup audit method entails adding a markup amount or percentage to the cost of taxable merchandise sold.

[10] A shelf test is an accounting comparison of costs and selling prices used to compute markups.

[11] A purchase segregation test establishes the proportion of merchandise purchases in various product categories.

the “XYZ” letter procedure.[12] Respondent computed a ratio of disallowed sales for resale to claimed sales for resale of 39.13 percent, allowing 60.87 percent of appellant’s claimed sales for resale.

16. Regarding sales in interstate and foreign commerce, respondent examined the eBay sales reports and available shipping documents and computed a ratio of disallowed sales in interstate and foreign commerce to claimed sales in interstate and foreign commerce of 1.34 percent, allowing 98.66 percent of appellant’s claimed sales in interstate and foreign commerce.

17. Respondent multiplied sales for resale claimed on the SUTRs for January 1, 2013, through June 30, 2017, by the ratio of allowed sales for resale to claimed sales for resale of 60.87 percent and computed allowable claimed sales for resale of $4,707,294 (disallowing $3,026,062).

18. Respondent multiplied sales in interstate and foreign commerce claimed on the SUTRs for January 1, 2013, through June 30, 2017, by the ratio of allowed sales in interstate and foreign commerce to claimed sales in interstate and foreign commerce of 98.66 percent and computed allowable claimed sales in interstate and foreign commerce of $687,174.

19. Respondent combined allowable sales for resale and sales in interstate and foreign commerce, which totaled $5,394,468, and computed a cost of $4,867,775 for these nontaxable sales ($5,394,468 ÷ (1 + 10.82 percent audited markup)).

20. From appellant’s FITRs, respondent compiled COGS of $19,550,785 for January 1, 2013, through June 30, 2017. Respondent deducted the $4,867,775 cost of allowable nontaxable merchandise sales to compute the cost of taxable merchandise sold of $14,683,010 ($19,550,785 - $4,867,775). Respondent added the weighted markup of 10.82 percent and computed audited taxable sales of $16,271,712 (rounded) for January 1, 2013, through June 30, 2017. Upon comparison to reported taxable sales of $2,139,800, respondent computed unreported taxable sales of $14,131,912 for January 1, 2013, through June 30, 2017. Respondent also computed a percentage of error of 409.9 percent for FYE June 30, 2017. For the third quarter of 2017 (3Q17), respondent multiplied reported taxable sales of $241,173 by the error ratio of

[12] XYZ letters are respondent-approved letters sent to a seller’s customers when the seller has claimed the transaction as a nontaxable sale for resale; the XYZ letters inquire as to the disposition of property the customer has purchased. (Cal. Code Regs., tit. 18, § 1668(f).)

409.9 percent and computed unreported taxable sales of $988,559 (rounded). In total, for the liability period, respondent computed unreported taxable sales of $15,120,471 ($14,131,912 + $988,559) based on the markup method.

21. Respondent noted that audited taxable sales based on the markup method were less than gross receipts reported on the FITRs, and decided to analyze the differences to see if they represented additional taxable sales. From this analysis of appellant's FITRs, respondent ultimately computed additional unreported taxable sales of $360,417 for the liability period. Along with unreported taxable sales of $15,120,471 based on the markup method, respondent computed an aggregate taxable measure of $15,480,889 (rounded).
22. Based on the audit, respondent issued to appellant the July 2, 2018 NOD with a tax liability of $1,391,797.00, plus applicable interest, and a negligence penalty of $139,179.73. Respondent imposed the negligence penalty because this was appellant's "third" audit and respondent had previously discussed with appellant its recordkeeping and reporting requirements, as well as appellant's responsibility to collect and report sales taxes correctly.[13]
23. Appellant timely filed a petition for redetermination (petition).
24. On December 18, 2019, respondent issued a decision, which, based on documentation appellant provided upon appeal, ordered a reaudit to recompute audited taxable sales after factoring in additional allowable sales for resale that respondent had conceded. Respondent otherwise denied the petition.
25. Respondent performed a reaudit, which decreased the aggregate measure of tax by $944,247 (from $15,480,889 to $14,536,642), the tax liability by $84,902 (from $1,391,797 to $1,306,895), and the negligence penalty by $8,490.25 (from $139,179.73 to $130,689.48).
26. By letter dated August 4, 2020, respondent informed appellant of the reaudit's results.
27. By email dated September 3, 2020, appellant filed a request for reconsideration.
28. Respondent's audit staff reviewed appellant's contentions in the request for reconsideration and concluded that no further adjustments were warranted. On May 11, 2021, respondent issued a supplemental decision, which ordered that the liability

[13] OTA assumes that respondent is counting the FBO as appellant's second audit.

be redetermined in accordance with the reaudit, but otherwise denied appellant's petition for redetermination.

29. Appellant appealed to OTA on June 8, 2021.[14]

30. OTA held appellant's appeal in abeyance while respondent considered appellant's case for settlement. OTA returned appellant's appeal to active status and held a hearing in this matter on September 13, 2023.

## DISCUSSION

Issue 1: Whether the aggregate amount of unreported taxable sales should be further reduced.

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales of tangible personal property sold in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) "Gross receipts" means the total amount of the sale price of a retailer's retail sales of tangible personal property (TPP), including the cost of labor or services, as well as any services that are a part of the sale. (R&TC, § 6012(a)(2), (b)(1).) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, it is presumed 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 respondent is not satisfied with the amount of tax reported by any person, or if any person fails to make a return, respondent may compute and 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Amaya*, 2021-OTA-328P.) If respondent carries its initial, minimal burden, then the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid.*)

The appellant bears the burden of proof as to all issues of fact unless the law specifies otherwise. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence unless the law also specifies otherwise. (Cal. Code Regs., tit. 18, § 30219(b).)

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[14] The letter is erroneously dated June 8, 2020.

Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Amaya*, *supra*.) 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 books and records were inadequate for sales and use tax audit purposes. Although sales invoices were pre-numbered, appellant did not use them in sequential order and lacked other internal controls, so respondent could not verify the completeness of the sales invoices. Respondent also found that the handwritten information on the sales invoices was often incomplete and/or illegible. Additionally, respondent's preliminary analyses disclosed large differences between gross receipts reported on appellant's FITRs and total sales reported on contemporaneous SUTRs, as well as negative book markups. Appellant stated that these differences related to income from its sales of drilling and polishing services, which it provided to other businesses and considered nontaxable. However, respondent noted that drilling and polishing as described by appellant constituted taxable fabrication labor, and appellant did not provide any evidence supporting their nontaxability. Thus, respondent concluded that it could not rely on appellant's records or use a direct audit method to verify sales that appellant reported on its SUTRs for the liability period.

Based on these facts, OTA finds that respondent appropriately questioned the accuracy of reported sales and reasonably used indirect audit methods to compute appellant's sales. Respondent used the markup method as the basis for its determination. The markup method is a recognized and accepted accounting procedure, though it is only effective and reliable if respondent has sufficient information to establish the cost of taxable merchandise sold and a reasonable markup. (*Appeal of Amaya*, *supra*.) Here, respondent established the cost of taxable merchandise sold and the weighted markup of 10.82 percent using appellant's FITRs, merchandise purchase invoices, and information (including selling prices) provided by appellant. Specifically, OTA finds that appellant's FITRs, which it filed with the IRS (an independent, third party to this matter), are evidence of appellant's sales and constitute a reliable source of data from which respondent established appellant's audited sales. Similarly, appellant's merchandise purchase invoices and sale price information came from appellant, who does not dispute them on appeal. Accordingly, OTA concludes that respondent's use of the markup method was

appropriate, and that respondent has established that its determination is reasonable and rational. The burden of proof now shifts to appellant to establish that a different result is warranted.

On appeal, appellant makes four arguments: (1) although respondent used COGS from appellant's FITRs, it did not further reduce COGS for inventory shrinkage or self-consumption; (2) respondent failed to properly analyze COGS to determine purchases of tangible personal property versus fabrication labor; (3) respondent did not allow for taxable bad debt deductions; and (4) respondent did not take into consideration all relevant factors in disallowing sales for resale.

*First Argument: Shrinkage & Self-Consumption*

In its first argument, appellant asserts that appellant should further reduce COGS because of shrinkage and self-consumption. However, appellant has not specified the amount of alleged shrinkage or self-consumption that occurred during the liability period, and appellant did not provide any documentation supporting shrinkage or self-consumption. Appellant also did not report the cost of any taxable merchandise it may have self-consumed on its SUTRs during the liability period. Appellant's unsupported assertions are not sufficient to satisfy its burden of proof. (*Appeal of Amaya*, *supra*.) Accordingly, OTA concludes that appellant has not shown that an adjustment is warranted based on its first argument.

*Second Argument: Fabrication Labor*

In its second argument, appellant asserts that respondent's analysis of COGS failed to consider fabrication labor charges included in COGS. Based on respondent's purchase segregation for November 2016, appellant computed that annual merchandise purchases would be approximately $2,900,000 ($243,000 × 12 months), which materially differs from the average COGS of approximately $4,450,000 reported on the FITRs for FYE June 30, 2017, and FYE June 30, 2018. Appellant notes that comments in the audit working papers indicate that respondent believed the purchases were incomplete. Appellant argues that this should have alerted respondent to the possibility that COGS included fabrication labor charges. OTA understands appellant's argument to be that *costs* related to fabrication labor sales are included in COGS (purchases) and should be deducted before applying the audited weighted markup to compute audited taxable sales.

Fabrication includes any operation that results in the creation or production of TPP, or which is a step in a process or a series of operations resulting in the creation or production of TPP. (R&TC, § 6006(b); Cal. Code Regs., tit. 18, § 1526(b).) Tax applies to the gross receipts of, or sales price charged by, the manufacturer, producer, processor, or fabricator, from which no deduction may be taken on account of the cost of the raw materials or other components purchased, or labor or service costs to create or produce the TPP, or of any step in the manufacturing, producing, processing, or fabricating, including work performed to fit the customer's specific requirements, whether or not performed at the customer's specific request, or any other services that are a part of the sale. (Cal. Code Regs., tit. 18, § 1524(a).)

Here, appellant has not stated the amount of fabrication labor charges that were allegedly included in COGS and did not provide documentation of any fabrication labor charges. OTA also notes that appellant stated that it did not report fabrication labor sales on its SUTRs because it did not consider them to be taxable (they are). Even if OTA concluded that the purchase segregation was incomplete and the implied differences allegedly represented fabrication labor as opposed to additional merchandise purchases (which OTA has not), appellant has not provided evidence that its markup on the taxable fabrication labor was lower than the audited weighted markup on merchandise. Appellant's unsupported assertions are not sufficient to meet its burden of proof. (*Appeal of Amaya*, *supra*.) Accordingly, OTA concludes that appellant has not shown that an adjustment is warranted on the basis of fabrication labor.

*Third Argument: Bad Debts*

In its third argument, appellant asserts that audited taxable sales should be reduced for bad debts.

A retailer is relieved from liability for sales tax that became due and payable, insofar as the measure of tax is represented by accounts that have become worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. (R&TC, § 6055(a); Cal. Code Regs. tit. 18, § 1642(a).) If the amount of an account found to be worthless and charged off is comprised in part of nontaxable receipts such as interest, insurance, repair, or installation labor and in part of taxable receipts upon which tax has been paid, a bad debt deduction may be claimed only with respect to the unpaid amount upon which tax has been paid. (Cal. Code Regs., tit. 18, § 1642(b)(1).) In support of deductions for bad debts, retailers must

maintain adequate and complete records showing the date of original sale, the name and address of purchaser, the amount purchaser contracted to pay, the amount on which the retailer paid tax, all payments or other credits applied to the account of the purchaser, evidence that the uncollectible portion of gross receipts on which tax was paid actually has been legally charged off as a bad debt for income tax purposes, and the taxable percentage of the amount charged off as a bad debt properly allocable to the amount on which the retailer reported and paid tax. (Cal. Code Regs., tit. 18, § 1642(e).)

Here, appellant's FITRs for FYE June 30, 2013, through FYE June 30, 2017, reflect claimed bad debts of $17,184. However, appellant has not stated the amount of bad debts on taxable sales that occurred during the liability period, identified the uncollectable taxable sales, or provided evidence supporting any bad debts. Again, appellant's unsupported assertions are not sufficient to meet its burden of proof. (*Appeal of Amaya*, *supra*.) Accordingly, OTA concludes that appellant has not shown that an adjustment is warranted based on its third argument.

*Fourth Argument: Sales for Resale*

In its fourth argument, which concerns disallowed claimed nontaxable sales for resale, appellant contends that respondent did not follow the written policies of its audit manual. Specifically, appellant asserts that respondent did not consider other evidence for the validity of disallowed claimed nontaxable sales for resale per California Department of Tax and Fee Administration's Audit Manual (CDTFA's Audit Manual) section 0409.50. Appellant also asserts that respondent did not exercise professional judgement per CDTFA's Audit Manual section 0101.20 and did not consider all relevant factors, such as the frequency or dollar volume of sales to customers with names that are clearly in same line of business as appellant.[15]

Appellant argues that respondent made its decision to disallow certain claimed sales for resale "solely on the basis of (1) do they have a *flawless* resale certificate, and (2) did [the auditor] obtain a suitable XYZ response." (Emphasis in original.) However, appellant contends that neither a resale certificate nor XYZ letters are necessary to finding a valid sale for resale per

[15] CDTFA's Audit Manual has not been adopted pursuant to a formal rulemaking process, so no state agency (including OTA) can enforce, attempt to enforce, or even utilize CDTFA's Audit Manual as a manual, guideline, or standard of general application. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P, at p. 15, fn. 20, citing Gov. Code, § 11340.5.) Accordingly, OTA will not consider or discuss appellant's arguments to the extent that they rely upon CDTFA's Audit Manual for authority.

*Appeal of V.A. Auto Sales, Inc.*, 2019-OTA-299P (*V.A. Auto Sales*). Rather, appellant asserts that respondent must use common sense when analyzing the salient facts of each transaction in order to determine whether appellant made a valid sale for resale.

During the oral hearing, appellant highlighted a number of disallowed sales for resale that it made to 18 customers during the November 2015 test period. Appellant contends that these transactions were in fact nontaxable sales for resale based on the customers' names, which allegedly suggested that they made retail sales of tires and related accessories, as well as the frequency of sales. OTA will describe these specific transactions in more detail below.

The burden of proving that a sale of TPP is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. (R&TC, § 6091.) If the seller does not timely obtain a resale certificate containing the essential elements described in California Code of Regulations, title 18, (Regulation) section 1668(b)(1), 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 before any intervening taxable use by the purchaser; or (2) is being held for purposes of resale by the purchaser and there has been no intervening taxable use by the purchaser; or (3) was consumed by the purchaser and tax was reported by the purchaser directly to respondent on the purchaser's returns or in an audit of the purchaser. (Cal. Code Regs., tit. 18, § 1668(e).) 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 tax. (Cal. Code Regs., tit. 18, § 1668(f).)

In *V.A. Auto Sales*, OTA found that the taxpayer, a DMV-licensed wholesaler of vehicles, provided sufficient evidence showing that the transactions at issue were in fact nontaxable sales for resale rather than taxable retail sales. Specifically, OTA found that, during the audit period, the taxpayer purchased hundreds of total-loss salvage vehicles from insurance auction houses and then sold the bulk of them to two individual volume purchasers. OTA considered the sheer volume of sales (hundreds of vehicles), the comparatively far fewer number of purchasers (just two), the nature of the TPP at issue (wrecked vehicles, which were not typically sold at retail), and the fact that taxpayer was a licensed vehicle wholesaler, and concluded that the sales at issue were in fact nontaxable sales for resale.

Below are the 18 customers (plus the disallowed alleged sales for resale made to them during the November 2015 test period) that appellant highlighted during the oral hearing; also

included are the corresponding reasons why respondent disallowed these sales per the audit working papers:

(1) Buena Park Service Center (four sales between $350 and $770, totaling $2,145): respondent contacted customer's owner who stated that this customer did not issue any resale certificate.

(2) Caliber Collision (three sales between $140 and $320, totaling $760): questionable resale certificate; respondent contacted customer's office manager whose name was on the resale certificate, but office manager denied signing it. Customer's records also indicated that it did not do business with appellant.

(3) California Auto Body (two sales totaling $655): no resale certificate.

(4) Cannillo's Tires (three sales between $250 and $540, totaling $1,310): discrepancy between the customer's name on the sales invoices and the name on the resale certificate (Carrillo's Auto Sales), which suggested to respondent that these were two different businesses in two different industries (used car dealer versus tire shop). Respondent also could not verify whether this sale was a nontaxable sale for resale because the sales invoices did not contain customer's address or phone number.

(5) Fast Road Service (two sales totaling $2,300): no resale certificate.

(6) GM Specialist (four sales between $170 and $220, totaling $770): no resale certificate.

(7) Good Auto Repair (one sale of $120): no resale certificate.

(8) Hai Tech (three sales between $60 and $300, totaling $478): no resale certificate.

(9) Kurtis Tires (one sale of $360): discrepancy between the customer's name on the sales invoice and the name on the resale certificate (Ultimate Performance). Respondent also could not verify whether this sale was a nontaxable sale for resale because the sales invoice did not contain customer's address or phone number.

(10) Long Beach Truck Sales (two sales totaling $3,440): no resale certificate.

(11) Lozano's Tires (four sales between $260 and $540, totaling $1,420): no resale certificate.

(12) Mario Elmore (two sales totaling $518): business name on resale certificate was Elmore Toyota but was not signed. Respondent found that the person who allegedly completed the resale certificate did not work at Elmore Toyota, and the sales invoices did not have information about the purchaser that respondent could use to further research and verify.

(13) Norwalk Auto Auction (seven sales between $350 and $980, totaling $4,095): resale certificate did not have a valid seller's permit number, and person who allegedly completed the resale certificate was not an employee of customer. This customer also indicated to respondent that it was an auto auction business only and did not provide any repair services.

(14) PCH Auto (three sales between $90 and $420, totaling $665): discrepancy between the customer's name on the sales invoices and the name on the resale certificate (PCH Garage).

(15) Purfect Auto (five sales between $130 and $530, totaling $1,460): respondent could not verify whether these sales were nontaxable sales for resale because the sales invoices did not contain customer's address or phone number. Respondent also found that there were also multiple businesses with this customer's name but different permit numbers and different locations.

(16) Smog Pro's (two sales totaling $630): respondent accepted that this customer was a resale customer in a prior audit but could not verify whether it was still in business during the liability period because no permit number was recorded.

(17) Star Auto/Smog (two sales totaling $410): resale certificate provided, but customer did not have a seller's permit when appellant made this sale.

(18) Tamazula Tires (one sale of $280): no resale certificate, and customer did not have a seller's permit when appellant made this sale.

Here, with respect to these 18 customers, appellant failed to provide either any resale certificates or resale certificates containing the essential elements described in Regulation section 1668(b)(1) but was given the opportunity to send XYZ letters. Respondent reports that it did not receive any responses from the XYZ letters. Although respondent appears to have made some attempts to verify the validity of the above-described alleged sales for resale using the resources at its disposal, there are other

disqualified sales where respondent only notes that there was no resale certificate without further elaboration or documented efforts to verify. Nevertheless, tax exemptions are strictly construed against the taxpayer, who has the burden of proving that the statutory requirements have been satisfied. (*H. J. Heinz Co. v. State Bd. of Equalization*, (1962) 209 Cal.App.2d 1, 4.) For the sales at issue, appellant did not provide any additional, verifiable evidence that suggested that these were in fact sales for resale—for example, information from third-party business review websites indicating that these customers made retail sales of the items purchased (or even customer information beyond solely its name that respondent could use to contact and verify sales for resale). As noted previously, appellant's unsupported assertions are not sufficient to meet its burden of proof. (*Appeal of Amaya*, *supra*.)

As for *V.A. Auto Sales*, the salient factors that tipped the evidentiary scales in taxpayer's favor in that case are absent from the transactions appellant highlighted at the oral hearing. Specifically, for these transactions, appellant has not shown that any of the 18 alleged resale customers at issue made volume purchases on the scale of the taxpayer's two customers in *V.A. Auto Sales, Inc.* And, in contrast to the salvage title vehicles in that case, appellant's TPP of tires, wheels, and mufflers are typically sold at retail. Without more information about appellant's 18 customers' businesses beyond their names, OTA finds that appellant has not established that respondent's ultimate determination was unreasonable or lacked any rational basis. Accordingly, OTA finds no basis to recommend further adjustment to the measure of disallowed claimed sales for resale established in the reaudit.

In summary, OTA finds that respondent computed audited taxable sales based on the best-available evidence. Appellant has not identified any errors in respondent's computation of audited taxable sales or provided new documentation or other evidence in support of its contentions from which a more accurate determination could be made. Accordingly, OTA concludes that the aggregate amount of unreported taxable sales should not be further reduced.

Issue 2: Whether appellant was negligent.

If any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and

regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. (R&TC, § 6484; Cal. Code Regs., tit. 18, § 1703(c)(3)(A).)

Taxpayers are required to maintain and make available for examination on request by respondent 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 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, the following: (a) 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 of 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 will be considered evidence of negligence or intent to evade the tax and may result in penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

If a taxpayer has been notified of reporting errors committed during an audit period, and continues to commit the same reporting errors during a subsequent audit period, then that is also evidence of negligence. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-323.) Further, a taxpayer's failure to report numerous transactions is evidence of negligence if the failure had nothing to do with the taxpayer's accounting system. (*Id.* at p. 323.)

On appeal, appellant concedes that it did not maintain books or records for its fabrication labor sales. Appellant states that its current owner inherited the business from his parents and is inexperienced in business and accounting matters, including proper recordkeeping. At the same time, appellant asserts that no business keeps perfect records, and its recordkeeping was comparable to that of other businesses. On that basis, appellant argues that it was not negligent.

Here, appellant conceded that it did not keep adequate records regarding its sales of fabrication labor, which constitutes evidence of negligence. Additionally, appellant has previously been the subject of both an audit and an FBO by respondent, and these respectively disclosed that appellant had made unsupported sales for resale totaling $46,207 for the period April 1, 1997, through March 31, 2000, and $1,621,544 for the period April 1, 2006, through March 31, 2009. The current audit disclosed that appellant made unsupported sales for resale totaling $3,026,062 for the period January 1, 2013, through June 30, 2017. Appellant repeated

its error of making unsupported sales for resale in the current liability period despite being notified of these errors in prior audit and FBO periods. This, too, is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, at pp. 321-323.) Further, appellant reported taxable sales of $2,380,973 for the liability period, but failed to report $14,536,642, which represents an error ratio of 610.53 percent ($14,536,642 ÷ $2,380,973).[16] Appellant's failure to report such a large amount of transactions is further evidence of negligence. (*Id.* at p. 323.) Finally, regarding the alleged inexperience of appellant's current owner with respect to proper recordkeeping, the law requires taxpayers to maintain proper records (see R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1)), and taxpayers are charged with knowledge of the law such that ignorance of the law is no defense for failing to comply with statutory requirements. (See, e.g., *Macfarlane v. Dept. of Alcoholic Beverage Control* (1958) 51 Cal.2d 84, 90.) Thus, OTA finds appellant's arguments on appeal unavailing.

For the reasons just described, OTA concludes that appellant was negligent during the liability period.

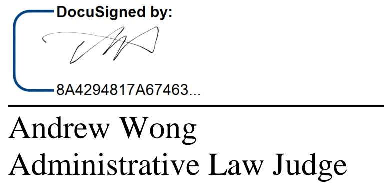
[16] Put another way, appellant only reported 14.07 percent of its audited total taxable sales ($2,380,973 ÷ $16,917,618).

## HOLDING

1. The aggregate amount of unreported taxable sales should not be further reduced.
2. Appellant was negligent.

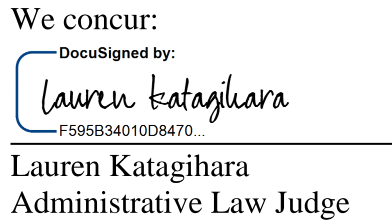
## DISPOSITION

Sustain respondent's action to reduce the determined measure of tax by $944,244 (from $15,480,889 to $14,536,642), the tax liability by $84,902 (from $1,391,797 to $1,306,895), and the negligence penalty by $8,490.25 (from $139,179.73 to $130,689.48), but to otherwise deny appellant's petition for redetermination.

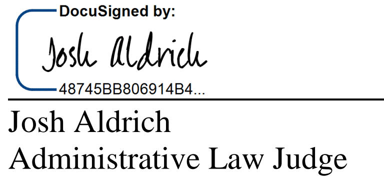



Andrew Wong
Administrative Law Judge

We concur:




Lauren Katagihara
Administrative Law Judge




Josh Aldrich
Administrative Law Judge

Date Issued: 12/14/2023