

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:  
**ADDISON POOLS INC.**

) OTA Case No.: 230813985  
) CDTFA Case ID: 3-227-718  
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**OPINION**

Representing the Parties:

For Appellant:

Barry Moser, Representative

For Respondent:

Jason Parker, Chief of Headquarters Ops.

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Addison Pools Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)<sup>1</sup> partially denying appellant's administrative protest<sup>2</sup> of a Notice of Determination (NOD) issued on June 9, 2021.<sup>3</sup> The NOD is for tax of \$169,946, plus applicable interest, and a 10 percent negligence penalty of \$16,859.46 for the period April 1, 2016, through March 31, 2019 (liability period).<sup>4</sup> Pursuant to R&TC section 6565 an additional 10 percent penalty of \$16,859.46 was added to the NOD for appellant's failure to timely appeal or pay the NOD before it became final (finality penalty).

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<sup>1</sup> 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, "respondent" shall refer to the board.

<sup>2</sup> If a taxpayer files a petition for redetermination after the 30-day period authorized in R&TC section 6561 expires, respondent may accept it as an administrative (i.e., late) protest; however, such an appeal does not qualify as a valid petition for redetermination. (Cal. Code Regs., tit. 18, § 35019.)

<sup>3</sup> The NOD was timely issued because on March 11, 2021, appellant signed the most recent waiver in a series of waivers of the otherwise applicable three-year statute of limitations for the period April 1, 2016, through March 31, 2018, which allowed respondent until July 31, 2021, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

<sup>4</sup> The tax shown on the NOD was \$169,946 with a credit adjustment of \$1,352. This resulted in a net tax of \$168,594 (\$169,946 - \$1,352) which was the same as the tax amount due on the audit report dated May 28, 2021, of \$168,595 (rounding difference). The 10 percent negligence penalty of \$16,859.46 was computed on the tax amount of \$168,595.

CDTFA subsequently prepared a reaudit that reduced the tax to \$157,431, the negligence penalty to \$15,743.18, and the finality penalty to \$15,743.20.

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).

### ISSUES<sup>5</sup>

1. Whether further adjustments to the unreported purchases subject to use tax are warranted.
2. Whether CDTFA properly imposed the negligence penalty.

### FACTUAL FINDINGS

1. Appellant operated as a construction contractor<sup>6</sup> furnishing and installing swimming pools, spas, and related fixtures and equipment on a lump-sum basis.<sup>7</sup> In addition, appellant provided maintenance and repair services, and operated a retail store, which closed in June of 2018.<sup>8</sup>
2. For the liability period, appellant reported total sales of \$19,493,159 (excluding sales tax) and claimed a deduction of \$18,892,005<sup>9</sup> for nontaxable labor and repair services. As a

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<sup>5</sup> On appeal, appellant only disputes the tax and negligence penalty. As a result, the remaining issues, finality penalty and interest will not be addressed in this Opinion.

<sup>6</sup> "Construction contractor" means any person who agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) "Construction contract" means and includes a contract to erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A).)

<sup>7</sup> "Lump-sum contract" means a contract under which the contractor for a stated lump sum agrees to furnish and install materials or fixtures, or both. (Cal. Code Regs., tit. 18, § 1521(a)(8).) Generally, a construction contractor is the consumer of materials, and the retailer of fixtures furnished and installed in the performance of construction contracts. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)(1), (b)(2)(B)(2).) When a construction contractor furnishes and installs fixtures pursuant to a lump sum-contract, the sales price for the fixtures shall be deemed to be the cost price of the fixtures to the contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)(2).) Construction contractors are retailers of machinery and equipment even though the machinery and equipment are furnished in connection with a construction contract, and tax applies to the contractor's gross receipts from such sales. (Cal. Code Regs., tit. 18, § 1521(b)(2)(C)(1).)

<sup>8</sup> According to CDTFA's audit discussion with appellant and the available records, the retail store closed June 2018. However, CDTFA's Decision states the retail store closed September 30, 2018.

<sup>9</sup> Appellant reported these claimed deductions as nontaxable sales for resale; however, these transactions were nontaxable labor and repair services. Appellant did not have any sales for resale.

result, appellant reported taxable sales of \$601,154. Appellant reported its total sales by combining its construction contract sales with its retail store sales.

3. This was appellant's second audit. Appellant's first audit was for the period covering April 1, 2010, through March 31, 2013, and resulted in unreported purchases subject to use tax of \$614,164 based on a cost accountability test method.<sup>10</sup>
4. For the audit at issue in this appeal, appellant provided the following records: federal income tax returns (FITRs) for 2016, 2017, and 2018; QuickBooks summary reports for construction contract sales for the liability period (except the second quarter of 2018 [2Q18]); point-of-sale (POS) retail store sales reports for 2Q16 through 3Q17; retail store sales invoices for 2017; purchase invoices for 3Q17 and 4Q18; and cash and credit card retail store sales summary reports for 4Q17 and 1Q18.<sup>11</sup> In addition, CDTFA obtained copies of two resale certificates issued to vendors.
5. For the liability period, CDTFA prepared an audit, a revised audit, and a reaudit.<sup>12</sup> The following is an explanation of the computation of audited taxable sales in the revised audit report dated May 28, 2021 (which was later superseded by the reaudit).
6. CDTFA compared reported gross receipts on appellant's 2016, 2017, and 2018 FITRs to reported total sales on the corresponding sales and use tax returns (SUTRs). For 2016 and 2017, CDTFA found reported total sales on appellant's SUTRs exceeded reported gross receipts on the FITRs by \$889,056 and \$753,542, respectively. For 2018, CDTFA found reported gross receipts on the FITR exceeded the reported total sales on the SUTR by \$1,566,592.
7. Using gross receipts and cost of goods sold (COGS) information, CDTFA computed book markups<sup>13</sup> of 84.62 percent for 2016, 93.52 percent for 2017, and 72.16 percent for

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<sup>10</sup> CDTFA's Audit Manual section 1205.10 instructs auditors to perform a reconciliation accounting schedule (cost accountability test) be prepared in an audit of a construction contractor, unless the contractor purchases all materials on a tax-paid basis.

<sup>11</sup> CDTFA requested purchase invoices to verify whether sales and use tax had been paid. However, appellant did not provide them.

<sup>12</sup> A revised audit is prepared to make adjustments to the original audit working papers, prior to issuing an NOD. A reaudit is an audit of a period that was previously posted and billed and for which an NOD or a notice of refund (NOR) was issued. (See CDTFA's Audit Manual, § 0702.10 (May 2022).)

<sup>13</sup> "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 ( $0.30 \div 0.70 = 0.42857$ ). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

2018, and an overall book markup of 81.58 percent for all three years. However, when comparing the estimated taxable purchases<sup>14</sup> to appellant's reported taxable sales on its SUTRs, CDTFA computed book markups of negative 83.28 percent for 2016, negative 73.47 percent for 2017, and negative 83.33 percent for 2018, and an average taxable book markup of negative 80.67 percent for all three years.

8. Based on appellant's records for the retail store for the liability period, taxable sales were \$156,063, nontaxable sales were \$173,065, and sales tax reimbursement was \$14,091 for the retail store location. This resulted in total recorded retail store sales of \$343,218.
9. Based on appellant's construction contracts, taxable sales were \$379,257, nontaxable construction contracts were \$16,363,382, and sales tax reimbursement collected was \$34,976.<sup>15</sup> This resulted in total recorded construction contract sales of \$16,777,616.
10. CDTFA combined appellant's recorded retail store sales and construction contract sales, which included total taxable sales of \$535,320, total nontaxable sales of \$16,536,447, total sales tax reimbursement collected of \$49,067, and total sales of \$17,120,834 for the liability period.<sup>16</sup>
11. CDTFA performed a cost accountability test to evaluate whether appellant had reported all its retail sales and materials subject to use tax for the liability period.
12. Using appellant's general ledger, purchase invoices for 3Q17 and 4Q18, and FITRs, CDTFA calculated purchases of materials, fixtures, equipment, and supplies totaling \$6,240,799 for the period 2016 through 2018. In addition, CDTFA determined that appellant had an initial beginning inventory amount of \$407,584 and an ending inventory amount of \$432,621 for these items, as reported on appellant's 2016 and 2018 FITRs.<sup>17</sup> As a result, CDTFA concluded that appellant had total materials, fixtures, equipment, and supplies with a cost of \$6,215,762 available for retail sale or subject to use tax during the 2016 through 2018 period.

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<sup>14</sup> The estimated taxable purchases were estimated using a 51.14 percent taxable merchandise purchase ratio that was computed in the prior audit. In the prior audit, CDTFA used general ledger information from 2011 to separate the construction material purchases from the store purchases.

<sup>15</sup> The taxable construction sales are from the maintenance contracts. Appellant added sales tax reimbursement to items sold with the maintenance service.

<sup>16</sup> This figure does not include 2Q18 sales because appellant did not provide any records for this quarter.

<sup>17</sup> It is unclear how appellant maintained an ending inventory amount because the retail store location closed in 2018. Nonetheless, CDTFA does not dispute the ending inventory amount, and OTA will not disturb CDTFA's determination in this respect.

13. CDTFA reduced the total materials, fixtures, equipment, and supplies of \$6,215,762 by the cost of these items furnished (sold or consumed) with maintenance contracts and the retail store sales of \$325,705 and \$151,041, respectively. CDTFA also reduced the materials, fixtures, equipment, and supplies for any of the purchases in which appellant paid the tax to its vendors, which was \$3,647,968. As a result, CDTFA determined that appellant had total materials, fixtures, equipment, and supplies purchases without tax (ex-tax) of \$2,091,048 (\$6,215,762 - \$325,705 - \$151,041 - \$3,647,968) that was subject to use tax for the period 2016 through 2018.
14. CDTFA added appellant's recorded taxable sales of maintenance contracts and retail store sales of \$425,003 and \$197,087, respectively. This resulted in an audited taxable measure of \$2,713,138. CDTFA compared the audited taxable measure to reported taxable sales of \$622,088, which resulted in a difference of \$2,091,050. CDTFA calculated an error rate of 336.13 percent and applied that rate to reported taxable sales for the liability period which resulted in a deficiency measure of \$2,020,685.
15. CDTFA also determined that appellant was entitled to a tax-paid purchases resold allowance for the materials, fixtures, equipment, and supplies sold as part of the taxable sales of maintenance contracts. CDTFA calculated an allowance of \$188,786 for the liability period.
16. Based on the foregoing, CDTFA issued the June 9, 2021 NOD.
17. Appellant did not file a timely petition for redetermination; thus, the NOD became final on July 9, 2021. In addition, appellant did not pay the liability listed in the NOD by the due date, and the finality penalty was added to the liability pursuant to R&TC section 6565.
18. By a Notice of Collection Fee letter dated October 12, 2021, CDTFA informed appellant that a collection cost recovery fee was added to the liability because the liability remained unpaid for more than 90 days.
19. On November 2, 2021, appellant filed an untimely petition for redetermination with CDTFA, which CDTFA accepted as an administrative protest. Appellant provided additional invoices supporting tax-paid fixture and material purchases.
20. Based on the additional invoices provided with appellant's administrative protest, CDTFA conducted a reaudit dated March 30, 2022, which reduced the deficiency measure from \$2,020,685 to \$1,905,353, and increased the tax-paid purchases resold allowance from \$188,786 to \$194,689. CDTFA also made corresponding reductions to the negligence and finality penalties.

21. CDTFA issued a Decision that the liability be reduced in accordance with the March 30, 2022 reaudit but otherwise denying the administrative protest.
22. This timely appeal followed.
23. OTA requested additional briefing from appellant but appellant failed to provide additional invoices.

### DISCUSSION

#### Issue 1: Whether further adjustments to unreported purchases subject to use tax are warranted.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law 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).)

A construction contractor is a person who agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) As relevant here, a construction contract includes a contract, whether on a lump sum, time and material, cost plus, or other basis to erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A)(1).)

In general, construction contractors are consumers of materials which they furnish and install in the performance of construction contracts. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1, b)(2)(B)(2).) Either sales tax or use tax applies with respect to the sale of the materials to or the use of the materials by the construction contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)(1).) In general, construction contractors are retailers of fixtures which they furnish and install in the performance of construction contracts and tax applies to their sales of the fixtures. (Cal. Code Regs., tit. 18, § 1521(a)(2)(B)(1).) When a construction contractor furnishes and installs fixtures pursuant to a lump-sum contract, the sales price for the fixtures shall be deemed to be the cost price of the fixtures to the contractor. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)(2).)

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, there is no dispute that appellant was a construction contractor engaged in lump-sum contracts, and purchased materials, fixtures, and supplies both tax-paid and ex-tax, which it furnished pursuant to its construction contracts. Because appellant did not pay tax on all its purchases or report tax on its sales of fixtures, tax is due on the cost of the purchases obtained ex-tax and used in its construction contracts. Therefore, it was reasonable for CDTFA to conduct a cost accountability test<sup>18</sup> during the audit of appellant's business. OTA's review of the audit working papers did not disclose any errors in the audit. Accordingly, OTA concludes that the resulting taxable measure was reasonable and rational, and the burden of proof shifts to the appellant to demonstrate that further adjustments are warranted.

On appeal, appellant argues that CDTFA did not review all the merchandise purchase invoices, which would have supported appellant's reported taxable sales. Appellant also explains that the merchandise purchases held in inventory were for the retail store, and therefore, not subject to use tax. Appellant states that use tax would have been incurred and paid if the merchandise purchases were used in the construction contracts. Also, appellant argues that pool constructions were billed on a lump-sum contract, and sales tax was paid on all purchases. Finally, appellant states that all the merchandise purchase invoices are available for review to establish that there was no tax liability.

Here, CDTFA concluded that appellant's records were not sufficient to verify appellant's taxable retail sales and purchases subject to use tax. Appellant states that it has all its purchase invoices. OTA requested that appellant provide all the purchase invoices that it claims to have; however, appellant has not provided any new invoices in this appeal. As a result, OTA concludes that this argument, without supporting evidence, does not warrant any further adjustment to the determined measure of unreported purchases subject to use tax.

With respect to appellant's argument that its inventory was not subject to use tax, there is no dispute that appellant's retail store closed in 2018, which was during the liability period. As

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<sup>18</sup> A cost accountability test assists the auditor in determining whether the contractor's tax liability was correctly paid on all costs available for sales or use. (See CDTFA's Audit Manual, § 1205.10 (January 2017).)

a result, appellant should no longer have any retail inventory, but only items that could be used in the service contracts. Nonetheless, CDTFA allowed an adjustment to the total amount of purchases subject to use tax of \$432,621 for ending inventory, which was in appellant's favor. Therefore, appellant's argument does not warrant any further adjustment.

Finally, appellant argues that it paid tax on all its purchases; however, the evidence in the record does not support such a finding. In fact, when CDTFA requested purchase invoices from appellant, appellant only provided 3Q17 and 4Q18 invoices but failed to provide any additional invoices. Thus, CDTFA used an alternative audit approach and determined from the cost accountability test that only \$3,767,315 of appellant's purchases (out of a total of \$6,215,762) represented tax-paid purchases. As previously stated, appellant states that it has all the purchase invoices to demonstrate that it does not owe any additional tax; however, appellant has not provided these invoices for review, even though OTA requested such invoices. As a result, this argument does not warrant any further adjustments to the determined measure of tax.

Issue 2: Whether appellant was negligent.

R&TC section 6484 provides that, if any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court* (Sokolich) (2016) 248 Cal.App.4th 434, 447.)

A taxpayer shall maintain and make available for examination on request by CDTFA, 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 the sales and use tax return. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) All records required to be retained under this regulation must be preserved for a period of not less than four years. (Cal. Code Regs., tit. 18, § 1698(i).) 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 or other appropriate administrative action. (Cal. Code Regs., tit. 18, § 1698(k).)

The audit in this appeal is appellant's second audit. The assessment on the first audit was based on a cost accountability test, which resulted in unreported purchases subject to use tax of \$614,164 and an error percentage of 239 percent. In this audit, the assessment was



again based on a cost accountability test, which resulted in unreported purchases subject to use tax of \$1,905,353 with an increased error percentage of 316.95 percent. Appellant, for the liability period, neither reported purchases subject to use tax in any of its returns, nor provided complete records on which CDTFA could verify the taxable measure basis that accounted for retail sales and all material costs used in its construction contracts. OTA finds that appellant failed to exercise due care in reporting its taxes. In addition, the large understatement, increased percentage of error, failure to provide requested records, and lack of effort to correct errors found in the first audit are evidence of negligence.

For the reasons cited above, OTA concludes that appellant was negligent and CDTFA properly imposed the negligence penalty.

### HOLDINGS

1. Further adjustments to the unreported purchases subject to use tax are not warranted.
2. Appellant was negligent, and CDTFA properly imposed the negligence penalty.

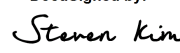
### DISPOSITION

CDTFA's action to redetermine the audit liability based on the reaudit dated March 30, 2022, but otherwise denying the administrative protest, is sustained.


Signed by:  
  
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Kim Wilson  
Hearing Officer

We concur:

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Steven Kim  
Administrative Law Judge

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Michael F. Geary  
Administrative Law Judge

Date Issued: 2/19/2025