OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **HILVERS CONSTRUCTION, INC.**	OTA Case No.: 231014463 CDTFA Case ID: 1-418-872

OPINION

Representing the Parties:

For Appellant: Gary Kimzey, Representative

For Respondent: Jennifer Barry, Attorney

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

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Hilvers Construction, Inc. (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying, in part, appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on October 17, 2019, based on a determined audit measure of $4,179,766.[2] The NOD is for tax of $294,678, plus applicable interest, and a negligence penalty of $29,467.76 for the period July 1, 2014, through June 30, 2017 (liability period).

CDTFA performed a reaudit which reduced the audit measure to $4,135,428, and the tax to $291,148, plus applicable interest, with a corresponding reduction to the negligence penalty.

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

[1] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to the board.

[2] The NOD was timely issued because on June 28, 2019, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period July 1, 2014, through September 30, 2016, which allowed CDTFA until January 1, 2020, to issue an NOD for the liability period. (See R&TC, §§ 6487(a), 6488.)

ISSUES

1. Whether an adjustment is warranted to the measure of tax for unreported ex-tax purchases of materials and assets subject to use tax.
2. Whether appellant is entitled to claimed deductions for tax-paid purchases resold.
3. Whether the negligence penalty is warranted.

FACTUAL FINDINGS

1. Appellant, a corporation, operated as a construction contractor in Tulare, California, specializing in dairy-structure-related projects.
2. Appellant was previously audited for the period September 1, 2003, through June 30, 2006. In the prior audit, CDTFA determined an audit measure of $1,249,324 after making a reduction to the measure during a reaudit, and CDTFA imposed a negligence penalty. For the prior audit period, appellant reported taxable sales of $71,539, which means that the audit revealed a reporting error ratio of 1,746 percent.[3]
3. On its sales and use tax returns (SUTRs) for the current liability period, appellant reported total sales of $3,286,469, taxable sales of $1,698,104, a partial exemption for sales of farm equipment of $1,520,878, and several deductions which are comprised of $44,338 for nontaxable sales for resale, nontaxable labor of $1,510,133, tax-paid[4] purchases resold of $12,601, and "other" deductions for tax-paid purchases resold of $21,293,[5] resulting in reported taxable sales of $177,226.
4. During CDTFA's audit, appellant provided: (1) federal income tax returns (FITRs) for fiscal years ending (FYE) September 30, 2015; September 30, 2016; and September 30, 2017;[6] (2) profit and loss statements for the liability period; (3) sales tax worksheets for the liability period; (4) incomplete material purchase reports; and (5) deposit income reports for the liability period.

[3] The "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

[4] "Tax-paid" refers to purchases made with payment of tax or tax reimbursement to the vendor.

[5] CDTFA's audit workpapers state that the claimed "other" deductions are for the cost of tax-paid purchases resold.

[6] Appellant filed FITRs on a fiscal year basis covering the period beginning October 1 of one year through September 30 of the following year.

5. Appellant did not provide documentation, such as purchase invoices or proof of payments, to establish that any purchases of materials were made tax-paid to vendors. Therefore, CDTFA determined that all purchases of materials were made ex-tax.[7]
6. CDTFA compared gross receipts reported on the FITRs for FYE September 30, 2015, through September 30, 2017, to the corresponding total sales reported on the SUTRs, noting that gross receipts reported on the FITRs substantially exceeded total sales on the SUTRs in each fiscal year. CDTFA also noted that materials and supplies included in reported cost of goods sold on the FITRs exceeded total sales reported on the corresponding SUTRs. Appellant was unable to explain the reason for the differences. Therefore, CDTFA conducted further investigation.
7. CDTFA determined that appellant contracted on a lump-sum basis and was a consumer of materials.[8] However, appellant did not report any purchases of materials subject to use tax on its SUTRs. Therefore, to segregate purchases of materials between those used in lump-sum contracts and those sold, and to determine the amount of ex-tax purchases of materials subject to use tax, CDTFA performed a cost accountability test.
8. Appellant's SUTRs indicated that the materials were allocated between retail sales, sales for resale, and construction contract jobs. To determine the materials used in lump-sum contracts, CDTFA computed the cost of materials for retail sales and sales for resale and then removed those amounts from total purchases as recorded in appellant's profit and loss statements.
9. In computing the cost of materials for retail sales and sales for resale, CDTFA was unable to compute markup factors[9] for retail sales or sales for resale because appellant did not provide sales contracts and invoices with corresponding purchase invoices. Therefore, CDTFA applied an estimated markup factor of 200 percent to cost of goods

[7] "Ex-tax" purchases refers to purchases made without payment of tax or tax reimbursement to the vendor.

[8] During the prior audit, CDTFA determined that appellant contracted on a lump-sum basis. For the current audit, CDTFA determined that appellant contracted on a lump-sum basis because appellant did not provide documentation to verify how it contracted, and it did not appear to CDTFA that appellant's business practice had changed since the prior audit.

[9] "Markup factor" is the factor by which cost of goods sold is multiplied to determine total sales. The markup factor is calculated by dividing sales by the cost of goods sold. The markup factor is equal to the markup (the amount by which the cost of merchandise is increased to set the retail price) plus 100 percent.

sold to compute the cost of retail sales for the liability period.[10] CDTFA also applied an estimated markup factor of 150 percent to recorded sales for resale to compute the cost of sales for resale for the liability period.

10. After removing the cost of retail sales and sales for resale from total purchases, CDTFA computed the cost of materials used on construction contracts to be $3,988,075 for the liability period.[11]
11. CDTFA disallowed claimed deductions for tax-paid purchases resold of $12,601 and $21,293 because appellant failed to provide purchase supporting invoices.[12]
12. CDTFA noted that appellant's FITRs showed purchases of fixed assets totaling $113,459. Appellant failed to provide purchase invoices to verify that it paid sales tax to the vendors, and appellant did not report any purchases of fixed assets subject to use tax on its SUTRs. As a result, CDTFA determined unreported purchases of fixed assets totaling $113,459 subject to use tax.
13. CDTFA also disallowed sales for resale of $44,338 claimed on the SUTRs for the liability period.
14. CDTFA issued the aforementioned NOD to appellant.
15. Appellant filed a timely petition for redetermination, stating that it disagreed with the audit liability.
16. CDTFA issued a Decision on May 10, 2023, ordering a reaudit to remove the measure for disallowed claimed sales for resale but otherwise denying the petition.
17. CDTFA prepared a reaudit that deleted the measure for disallowed claimed sales for resale, reducing the audit measure from $4,179,766 to $4,135,428. The taxable measure of $4,135,428 represents an error ratio of 243.53 percent when compared to reported taxable sales of $1,698,104 during the liability period.

[10] CDTFA's markup estimates were based on its experience in audits of similar businesses in appellant's area.

[11] CDTFA then combined the material costs with recorded taxable sales of $211,058, which is not in dispute.

[12] CDTFA also determined that appellant erroneously reported sales as subject to the partial exemption under R&TC section 6356.5 and that, as a result, appellant should be allowed a credit measure of $1,520,878. This item is not in dispute; thus, OTA does not discuss it further.

18. This timely appeal followed.[13]

DISCUSSION

Issue 1: Whether an adjustment is warranted to the measure of tax for unreported ex-tax purchases of materials and assets.

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, §§ 6091, 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.) When sales tax does not apply, use tax applies to the storage, use, or other consumption in this state of tangible personal property purchased for storage, use, or other consumption in this state, measured by the sales price, unless that use is specifically exempted or excluded by statute. (R&TC, §§ 6201, 6401.)

A "construction contractor" means any person who agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) A "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); R&TC, § 6012(a).) A "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).) 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.) 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. (*Ibid*.)

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. (Cal. Code Regs., tit. 18, § 1698(b)(1); see also R&TC, §§ 7053, 7054.) 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

[13] During the appeal, CDTFA identified transactions in appellant's recorded material purchases that it determined were for services or other nontaxable fees of $50,764. However, CDTFA also found that audited material purchases for July 1, 2014, through December 31, 2014, were understated by $144,393. Thus, CDTFA declined to make an adjustment because it would result in a net increase to the measure of use tax.

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 is 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*.) 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.)

There is no dispute that appellant is a construction contractor. Thus, appellant is the consumer of materials furnished and installed in the performance of lump-sum construction contracts, and use tax applies to the cost of materials used in the performance of those contracts. (See Cal. Code Regs., tit.18, § 1521(b)(2)(A)1.) Appellant made ex-tax purchases of materials during the liability period, and its SUTRs indicate that the materials were used for retail sales, sales for resale, and lump-sum contract jobs.[14] Therefore, CDTFA performed a cost accountability test to segregate materials used in lump-sum contracts and materials sold.

A cost accountability test is an appropriate audit method to determine whether a taxpayer has a sales or use tax liability. (CDTFA Audit Manual, § 1205.10.)[15] For the cost accountability test, CDTFA computed the cost of materials for retail sales and sales for resale and removed those amounts from total purchases. Appellant did not provide sales contracts and invoices with corresponding purchase invoices. As a result, CDTFA estimated the markup factors to determine the costs of materials for retail sales and sales for resale. CDTFA obtained the total material cost to be considered in the cost accountability test from amounts appellant recorded in its profit and loss statements. CDTFA then removed the determined cost of retail sales and sales for resale from the total material cost to compute the cost of materials used in lump-sum construction contracts for the liability period, which are subject to use tax.

[14] There is no dispute as to retail sales and sales for resale.

[15] CDTFA's Audit Manual section 1205.10 states that 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, and that such a test is to be prepared in an audit of a construction contractor unless the contractor purchases all materials on a tax-paid basis. CDTFA's Audit Manual "is an advisory publication providing direction to [CDTFA's] staff administering the Sales and Use Tax Law and Regulations." OTA is not required to follow CDTFA's Audit Manual; however, OTA may look to it for guidance, such as when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

In addition, based on the FITRs, CDTFA discovered that appellant made purchases of fixed assets, but did not report any purchases of fixed assets subject to use tax on its SUTRs or provide purchase invoices to show that tax was paid to the vendors. Therefore, based on the lack of documentation, CDTFA determined that the fixed assets were subject to use tax. Appellant did not provide sufficient documentation, such as purchase invoices, to determine the use tax. In addition, CDTFA's determination utilized the available documentation provided by appellant in computing the cost of materials and assets subject to use tax. Accordingly, CDTFA's determination is reasonable and rational, and the burden shifts to appellant to show error.

Appellant contends that CDTFA has not considered some of the documentation that appellant presented related to tax-paid purchases, nontaxable labor, and purchases where the vendor was responsible for the sales tax. Appellant also argues that the audited markups are not accurate. However, appellant does not provide any documentation, such as purchase invoices, to support its contentions. Appellant does not provide any evidence to show adjustments should be made for tax-paid purchases, nontaxable labor, or for sales tax owed by the vendor. Appellant does not explain how the markup factors computed by CDTFA are incorrect or provide evidence establishing an adjustment. Accordingly, appellant has not shown error in CDTFA's determination.

Issue 2: Whether appellant is entitled to the disallowed claimed deductions for tax-paid purchases resold.

A "tax-paid purchases resold" deduction may be taken from gross receipts if a retailer has purchased property for some other purpose than resale, has reimbursed its vendor for tax which the vendor is required to pay to the state or has paid the use tax with respect to the property, and has resold the property prior to making any use of the property other than retention, demonstration, or display while holding it for sale in the regular course of business. (R&TC, § 6012(a)(1); see also Cal. Code Regs., tit. 18, § 1701(a).) It is well settled that tax deductions are a matter of legislative grace, and the burden is on the taxpayer to show entitlement to deductions. (See *Hotel Del Coronado Corp. v. State Bd. of Equalization* (1971) 15 Cal.App.3d 612, 617.)

CDTFA disallowed claimed tax-paid purchases resold for the liability period because appellant failed to provide purchase invoices or other evidence establishing that it paid tax on its purchases. Appellant contends that CDTFA has not considered some of the documentation that it presented related to tax-paid purchases resold. However, appellant does not provide any

documentation, such as purchase invoices, establishing that it paid tax on resold purchases. Accordingly, appellant is not entitled to the disallowed claimed deductions for tax-paid purchases resold.

Issue 3: Whether the negligence penalty is warranted.[16]

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* (2016) 248 Cal.App.4th 434, 447.) A negligence penalty is warranted where errors are continued from one audit to the next. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323.)

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) 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 provide complete and accurate records is considered evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k).)

Appellant does not make any specific arguments regarding the negligence penalty. Appellant contends that CDTFA did not consider some of the documentation that it presented during its audit and that the liability is overstated. Appellant failed to maintain and provide complete books and records for audit, which is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at p. 323.) In addition, the current audit found a substantial understatement of unreported cost of materials subject to use tax. The taxable measure of $4,135,428 represents an error ratio of 243.53 percent when

[16] In its appeal to OTA, appellant has not explicitly disputed the negligence penalty. However, out of an abundance of caution, OTA will address the negligence penalty.

compared to the reported taxable sales of $1,698,104 during the liability period. This substantial understatement and large error ratio are evidence of negligence.

Furthermore, a substantial understatement of unreported cost of materials subject to use tax was found in the prior audit. For the prior audit period, appellant reported taxable sales of $71,539, which equates to an error ratio of 1,746 percent when compared to the audited taxable measure of $1,249,324. While the error ratio decreased in the current audit period, the amount of unreported taxable sales and purchases subject to use tax increased. Therefore, the errors in reporting continued from one audit to the next. Appellant failed to improve its recordkeeping and reporting, despite the assessment of a negligence penalty in the prior audit.

The failure to maintain and provide complete books and records for audit, and the failure to correct errors from a previous audit, are evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k); *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at p. 323.) In addition, CDTFA's current audit determined there was a substantial understatement of tax and large error ratio. Accordingly, the negligence penalty is warranted.

HOLDINGS

1. An adjustment is not warranted to the measure of tax for unreported ex-tax purchases of materials and assets.
2. Appellant is not entitled to the disallowed claimed deductions for tax paid purchases resold.
3. The negligence penalty is warranted.

DISPOSITION

CDTFA's action in reducing the determined audit measure to $4,135,428, and corresponding reductions to the tax and negligence penalty, but otherwise denying the petition is sustained.

Signed by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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DC88A60D8C3E442...

Keith T. Long
Administrative Law Judge

Signed by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

Date Issued: 4/23/2025