

**OFFICE OF TAX APPEALS  
STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No.: 240817129  
**CALIFORNIA ENVIRONMENTAL SYSTEMS,**  
**INC.** ) CDTFA Case ID: 644-882, 676-820  
 )  
 )

## **OPINION**

## Representing the Parties:

For Appellant: Ted Matthies, Representative

For Respondent: **Vanessa Bedford, Attorney**

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 6561 and 6901, California Environmental Systems, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)<sup>1</sup> partially denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on October 30, 2018, for tax of \$409,140, plus applicable interest, for the period January 1, 2014, through December 31, 2016 (liability period),<sup>2</sup> and fully denying a corresponding protective claim for refund filed by appellant.

Prior to this appeal, CDTFA completed a reaudit, which reduced the unreported taxable measure from \$4,675,894 to \$4,673,593. This results in a reduction to the tax liability of \$200, from \$409,140 to \$408,940.

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

<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, “CDTFA” shall refer to the board.

<sup>2</sup> For 2014, the NOD was timely issued because on July 16, 2018, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations, which allowed CDTFA until January 31, 2019, to issue an NOD. (See R&TC, §§ 6487(b), 6488.) The NOD was timely with respect to 2015 and 2016 because appellant was an annual filer and the NOD was issued less than three years after the last day of the calendar month following the one-year period for which the amount was determined. (See R&TC, § 6487(b).)

ISSUE

Whether further adjustments are warranted to the unreported taxable measure.

FACTUAL FINDINGS

1. Appellant, a corporation, operated as a construction contractor performing construction contracts for the U.S. Government. Appellant furnished, installed, and repaired components for heating, ventilation, and air conditioning systems, and plumbing. Appellant contracted on both a lump-sum basis and a time and material basis. Appellant issued resale certificates to its suppliers for purchases to be installed under such contracts. Appellant also issued purchase orders to its suppliers, which included a statement that the purchases were exempt due to their usage in contracts with the U.S. Government. Appellant opened its seller's permit effective January 1, 2013. Appellant had not been previously audited.
2. As a construction contractor, appellant was the consumer of materials and the retailer of fixtures furnished and installed in the performance of construction contracts. Appellant did not report any purchases subject to use tax on its sales and use tax returns. Appellant did not collect sales tax reimbursement on its time and material contracts.
3. Appellant filed sales and use tax returns on an annual basis. During the liability period, appellant reported total sales of \$4,030,445 and claimed nontaxable sales to the U.S. Government of \$4,030,445, which resulted in zero taxable sales.
4. For the audit, appellant provided books and records, which CDTFA deemed adequate for audit purposes.
5. CDTFA performed a cost accountability test for 2016 because appellant made purchases of materials without payment of tax (ex-tax purchases).<sup>3</sup> The cost accountability test was performed as follows.
6. First, CDTFA used appellant's general ledger to compile the following amounts of recorded purchases of materials and fixtures installed under construction contracts: \$791,049 for 2014; \$2,138,589 for 2015; and \$2,950,179 for 2016.

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<sup>3</sup> CDTFA's Audit Manual section 1205.10 states that a reconciliation accounting schedule (cost accountability test/examination) should be prepared in an audit of a construction contractor unless the contractor purchases all materials on a tax-paid basis. A cost accountability test assists the auditor in determining whether the contractor's tax liability was correctly paid on all costs for sales or use. According to its cover page, CDTFA's Audit Manual "is an advisory publication providing direction to [CDTFA's] staff administering the Sales and Use Tax Law and Regulations." According to the audit workpapers, a cost accountability test could not be performed for other years in the liability period due to incomplete information regarding material charges made with time and material contracts.

7. Next, CDTFA performed a detailed test of material purchases for the second quarter of 2015 (the test period) because the purchases recorded in appellant's general ledger included nontaxable charges (i.e., sales and use taxes paid to vendors, freight charges by common carriers, service charges, and excise fees). CDTFA examined appellant's purchase invoices and compiled total purchases of \$602,854, which includes ex-tax purchases of \$470,857.78, tax paid purchases (excluding sales tax) of \$118,619.43, sales tax paid to vendors of \$9,275.25, and tax-exempt charges of \$4,100.74 for the test period.
8. CDTFA added appellant's recorded sales tax paid of \$9,275.25 and tax-exempt charges of \$4,100.74 to find total recorded expenses (exempt from sales and use taxes) of \$13,376, which is 2.22 percent of appellant's total recorded purchases for 2Q15 ( $\$13,376 \div \$602,854$ ). CDTFA applied the 2.22 percent ratio of sales tax paid and exempt charges from the test period to appellant's recorded purchases for 2014, 2015, and 2016, to calculate adjusted recorded purchases of \$773,488 for 2014, \$2,091,112 for 2015, and \$2,884,685 for 2016.
9. CDTFA also subtracted appellant's recorded expenses (exempt from sales and use taxes) of \$13,376 from appellant's total recorded purchases of \$602,854 to compute adjusted recorded purchases of \$589,478 for the test period. CDTFA compared recorded ex-tax purchases for the test period of \$470,858 to adjusted recorded purchases to calculate an ex-tax purchase ratio 79.88 percent.
10. CDTFA examined appellant's time and material sales contracts and the corresponding fixture purchase invoices for May 1, 2017, through May 15, 2017, to perform a shelf test<sup>4</sup> and compute a markup factor of 1.7234.<sup>5</sup> CDTFA then applied the markup factor to the fixture sales that appellant recorded as included in time and material contracts of \$99,550 for 2016 to estimate the cost of fixtures installed with time and material contracts of \$57,764 for 2016.
11. To calculate the taxable measure for 2016, CDTFA multiplied appellant's adjusted recorded purchases of \$2,884,685 for that year by the ex-tax purchase ratio of 79.88 percent to compute ex-tax purchases of \$2,304,286 for 2016. CDTFA deducted

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<sup>4</sup> A shelf test is an accounting comparison of known costs and associated selling prices used to compute markups. (See CDTFA's Audit Manual § 0407.10.)

<sup>5</sup> "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.

the cost of fixture sales of \$57,764 from ex-tax purchases to compute the “unaccounted cost” of \$2,246,522 (\$2,304,286 - \$57,764). CDTFA increased the unaccounted cost by appellant’s taxable fixture sales with time and material contracts of \$99,500, which resulted in the audited taxable measure of \$2,346,072. When compared to adjusted recorded purchases of \$2,884,685, the audited taxable measure represents an error rate of 81.33 percent.

12. CDTFA applied the 81.33 percent error rate to appellant’s adjusted recorded purchases of \$773,488 to estimate an audited taxable measure of \$629,078 for 2014. CDTFA applied the 81.33 percent error rate to appellant’s adjusted recorded purchases of \$2,091,112 to estimate an audited taxable measure of \$1,700,702 for 2015.
13. In total, CDTFA found an audited taxable measure of \$4,675,894 (\$629,078 + \$1,700,702 + \$2,346,114).
14. On October 30, 2018, CDTFA issued the aforementioned NOD. Appellant filed a timely petition for redetermination and a protective claim for refund disputing the liability.
15. During CDTFA’s internal appeals process, appellant disputed three transactions included in the detail test of material purchases, including: two purchases from Shortridge Instruments;<sup>6</sup> and a purchase from Engineered Air of five 80-ton MC802/W chillers (chillers). Appellant argued that the purchases from Shortridge Instruments represent nontaxable recalibration and repair services. Appellant also asserted that chillers were machinery and equipment that was resold to the U.S. Government and should not be considered an ex-tax purchase subject to tax. In support, appellant provided CDTFA a purchase order copy and an image of the property. Appellant also disputed the inclusion of audited fixture sales with time and material contracts of \$99,550, asserting that only materials were involved in the time and material contracts reviewed.
16. CDTFA reviewed appellant’s contentions and agreed to remove the two purchases from Shortridge Instruments. However, CDTFA concluded that the chillers required installation as fixtures and could not be considered machinery. CDTFA also concluded that no adjustment to the amount of fixture sales included with time and material contracts was warranted because the \$99,550 figure was obtained from a worksheet provided by appellant.

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<sup>6</sup> The audit workpapers describe these purchases as “Shortridge Recalibration of HVAC meter for Sierra College job” and “Service of Air Calibration.”

17. On May 29, 2024, CDTFA issued a decision ordering a reaudit based on the foregoing information. The reaudit reduced the taxable measure by \$2,301, from \$4,675,894 to \$4,673,593. Otherwise, CDTFA denied the petition for redetermination and protective claim for refund.
18. Attached to CDTFA's decision is the Installation, Operation and Maintenance Manual for MC & MH Series Fluid Chiller and/or Fluid Heater Modules Indoor Models, which state that the chillers "must be installed on a concrete foundation or support structure, with enough strength to support the operation weight of the module" and also that the chillers require a technician that is "responsible for the design, selection and installation of the refrigerant piping"
19. This timely appeal followed.

#### DISCUSSION

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

A construction contractor is any person who, whether alone, in conjunction with, or by or through others, agrees to perform and does perform a construction contract, and a construction contract means a contract to erect, construct, alter, or repair any building or other structure or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A), (2).) A U.S. Government construction contractor means a construction contractor who for himself or herself, in conjunction with, or by or through others, agrees to perform and does perform a construction contract for the U.S. Government. (Cal. Code Regs., tit. 18, § 1521(a)(3).)

When an item is furnished and installed onto real property pursuant to a construction contract, the application of tax depends in part on the classification of the item as either materials, a fixture, or machinery and equipment. (Cal. Code Regs., tit. 18, § 1521(b).) Regulation 1521, appendix B lists refrigeration and air conditioning units as items that are "typically regarded" as fixtures. (Cal. Code Regs. § 1521, appx. B.)

Either the sales tax or the use tax applies with respect to sales of tangible personal property (including materials, fixtures, supplies, and equipment) to contractors for use in the performance of such contracts with the U.S. Government for the construction of improvements on or to real property in this state. (*Ibid.*) U.S. Government construction contractors are consumers of materials and fixtures which they furnish and install in the performance of contracts with the U.S. Government. (Cal. Code Regs., tit. 18, § 1521(b)(1)(A).) Conversely, U.S. Government construction contractors are retailers of machinery and equipment furnished in connection with the performance of a construction contract with the U.S. Government. (Cal. Code Regs., tit. 18, § 1521(b)(1)(B).) Tax does not apply to sales of machinery and equipment to U.S. Government contractors or subcontractors provided title to the property passes to the U.S. Government before the contractor makes any use of it. (*Ibid.*) Exemptions from tax are strictly construed against the taxpayer which 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.)

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 is a U.S. Government construction contractor engaged in construction contracts with the U.S. Government. Because appellant did not purchase all materials and fixtures on a tax-paid basis, it was appropriate for CDTFA to perform a cost accountability test to determine whether appellant had a sales or use tax liability. For the audit, CDTFA used appellant's books and records to compile appellant's costs for 2014, 2015, and 2016. However, CDTFA found that appellant's books and records were most complete with respect to material charges made with time and material contracts for 2016. As such, CDTFA reasonably concluded that a cost-accountability test could be performed most reliably for that year. It was also reasonable and rational for CDTFA to use the results of the cost accountability test to compute an error ratio, which it then used to calculate the taxable measure for 2014 and 2015. Upon reaudit, CDTFA removed charges for recalibration and repair services based on appellant's contentions. Thus, OTA finds that CDTFA used a rational audit method for the audit

and reaudit, and the result is reasonable. Accordingly, the burden shifts to appellant to show whether a reduction is warranted. (See *Appeal of Talavera, supra.*)

On appeal, appellant contends that the audit liability is overstated because “the sample projections include sales to U.S. Government.” Appellant has not pointed to any specific transaction with the U.S. Government. However, OTA notes that during CDTFA’s appeals process, appellant disputed the purchase of chillers, arguing that they should be considered sales of machinery to the U.S. Government, which are not subject to tax. However, CDTFA found that the chillers were not readily removable like machinery or equipment. CDTFA’s finding is consistent with the chillers’ manual which requires the chillers to be placed on their own concrete foundation or support structure and the installation of refrigeration piping and electrical wiring. Further Regulation section 1521, Appendix B, lists refrigeration units and air conditioning among those that are “typically regarded” as fixtures. Appellant has not provided any evidence to show that the chillers are machinery or equipment. Thus, appellant has failed to meet its burden of showing that the chillers are not fixtures. Accordingly, OTA finds no basis to reduce the taxable measure for appellant’s purchase of chillers.

Next, during CDTFA’s appeals process, appellant disputed the inclusion of audited fixture sales included with time and material contracts of \$99,550, asserting that only materials were involved in the time and material contracts reviewed. As discussed above, CDTFA’s audit workpapers state that the figure for audited fixture sales with time and material contracts was taken from appellant’s own worksheet. On appeal to OTA, appellant has not provided any evidence to show that only materials were used in the disputed contracts. Appellant’s unsupported assertions are insufficient to meet its burden of proof. (See *Appeal of Talavera, supra.*) Accordingly, no further adjustments to the audit measure are warranted.

HOLDING

No further adjustments are warranted to the unreported taxable measure.

DISPOSITION

CDTFA's actions partially denying appellant's petition for redetermination and denying appellant's protective claim for refund are sustained.

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Keith T. Long  
Administrative Law Judge

We concur:

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Michael F. Geary  
Administrative Law Judge

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Teresa A. Stanley  
Administrative Law Judge

Date Issued: 8/14/2025