OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **HM CARPET INC.**	OTA Case No.: 240616486 CDTFA Case ID: 3-990-301

OPINION

Representing the Parties:

For Appellant: Manny Almeida, Representative

For Respondent: Kevin B. Smith, Attorney
Jarrett Noble, Attorney
Jason Parker, Chief of Headquarters Ops.

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, HM Carpet Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on July 12, 2022.[1] The NOD is for tax of $865,992, plus applicable interest, and a 10 percent negligence penalty of $86,599.18 for the period July 1, 2015, through June 30, 2018 (liability period).[2] CDTFA based the tax on unreported purchases of $8,741,831 subject to use tax.

Office of Tax Appeals (OTA) Panel Members Andrew Wong, Josh Aldrich, and Suzanne B. Brown held an oral hearing for this matter in Cerritos, California, on May 13, 2025. At the conclusion of the oral hearing, the record closed, and this matter was submitted to OTA for an Opinion based on the oral hearing record pursuant to California Code of Regulations, title 18, section 30209(b).

[1] The State Board of Equalization (board) formerly administered sales and use taxes. On July 1, 2017, administrative functions of the board relevant to this case transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events occurring before July 1, 2017, "CDTFA" refers to the board.

[2] CDTFA timely issued the NOD because appellant waived the otherwise applicable three-year statute of limitations and extended the NOD issuance deadline to July 31, 2022. (See R&TC, §§ 6487(a), 6488.)

ISSUES

1. Whether the amount of unreported purchases subject to use tax should be reduced.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. During the liability period, appellant operated as a construction contractor that furnished and installed flooring materials (e.g., carpet, laminate, and floor tile), billing on a lump-sum basis. Appellant also made over-the-counter sales.
2. Appellant reported the following for the liability period: total sales of $37,853,552; deductions totaling $32,869,942; and taxable sales of $4,983,610. Appellant did not report any purchases subject to use tax.
3. The audit at issue was appellant's second. CDTFA had first audited appellant for the period April 1, 2011, through June 30, 2014, determining that appellant had made unreported purchases of $10,485,584 subject to use tax during that period.
4. For this second audit, appellant provided the following books and records: federal income tax returns (FITRs) for 2015, 2016, and 2017; an accounts payable (AP) journal for the liability period; a sales report for the liability period; detailed QuickBooks sales reports for the liability period; some purchase invoices issued by one of appellant's vendors; and some sales invoices and packing slips for the fourth quarter of 2015 (4Q15) and 1Q18.
5. As relevant here, CDTFA surveyed 12 of appellant's major vendors and examined its AP journal to verify whether any of appellant's purchases were subject to use tax. CDTFA found that appellant had issued resale certificates with respect to nearly 91 percent of its purchases of flooring materials during the liability period and calculated that appellant had not paid use tax or sales tax reimbursement with respect to purchases totaling $24,967,757. CDTFA then reduced this amount by $11,242,315 for the following: beginning and ending inventories; nontaxable freight charges and recycling fees; costs of supplies and non-inventory items; costs of tangible personal property resold or sold in interstate commerce; and miscellaneous fees related to these nontaxable sales. In total, for the liability period, CDTFA determined that appellant made purchases of materials in the amount of $13,725,442 that were subject to tax.
6. CDTFA compared this amount to reported taxable sales of $4,983,610 (which CDTFA assumed equaled the cost of materials sold without any markup) and determined that

appellant consumed unreported purchases of $8,741,831 (rounded) subject to use tax during the liability period.

7. CDTFA also found that appellant failed to report and pay district taxes to jurisdictions where it performed construction contracts, determining unreported sales of $4,286,748 subject to district taxes during the liability period.
8. CDTFA imposed a 10 percent negligence penalty on appellant for the following reasons: this was appellant's second audit; appellant did not report any of its purchases of materials subject to use tax for the liability period; unreported purchases of $8,741,831 subject to use tax exceeded 175 percent of appellant's reported taxable sales of $4,983,610 for the liability period; and appellant underreported district taxes owed to jurisdictions where it performed construction contracts.
9. On July 12, 2022, CDTFA issued the NOD to appellant.
10. On July 27, 2022, appellant petitioned CDTFA for redetermination. By a decision dated January 2, 2024, CDTFA denied appellant's petition.
11. On January 31, 2024, appellant requested that CDTFA reconsider. By a supplemental decision dated June 13, 2024, CDTFA continued to deny appellant's petition.
12. This appeal to OTA followed.

DISCUSSION

Issue 1: Whether the amount of unreported purchases subject to use tax should be reduced.

California imposes use tax upon the storage, use, or other consumption in this state of tangible personal property purchased from any retailer for storage, use, or other consumption in this state. (R&TC, § 6201.) For the proper administration of the Sales and Use Tax Law and to prevent evasion of the use tax and the duty to collect the use tax, it is presumed that tangible personal property sold by any person for delivery in California is sold for storage, use, or other consumption in California until the contrary is established. (R&TC, § 6241.) The burden of proving the contrary is upon the person who makes the sale unless he takes from the purchaser a certificate to the effect that the property is purchased for resale. (*Ibid*.; see also Cal. Code Regs., tit. 18, § 1668(a).) A sale for resale is not subject to sales tax. (Cal. Code Regs., tit. 18, § 1668(e).) The certificate relieves the person selling the property from the duty of collecting the use tax only if taken in good faith from a person who is engaged in the business of selling tangible personal property and who holds a seller's permit. (R&TC, § 6242; Cal. Code Regs., tit. 18, § 1668(a).) The certificate must be signed by and bear the name and address of the purchaser, indicate the purchaser's seller's permit number, and indicate the general character of

the tangible personal property sold by the purchaser in the regular course of business. (R&TC, § 6243; see also Cal. Code Regs., tit. 18, § 1668(b)(1).) Absent evidence to the contrary, a seller will be presumed to have taken a resale certificate in good faith if the resale certificate contains these essential elements and otherwise appears to be valid on its face. (Cal. Code Regs., tit. 18, § 1668(c).)

When a person issues a resale certificate to a seller, that person is representing to the seller that he or she is purchasing the property for the purpose of reselling it. (See R&TC, § 6244(a).) But a person cannot first issue a resale certificate to a seller and then deny the validity of the resale certificate. (*Appeal of Spurlock* (SBE Memo.) 1993 WL 658054 (*Spurlock*).)[3] A person who purchases property for resale and who subsequently uses the property owes tax on that use. (Cal. Code Regs., tit. 18, § 1668(e).)

Items typically regarded as "materials" include floor coverings such as linoleum, floor tile, and wall-to-wall carpeting. (Cal. Code Regs., tit. 18, § 1521, appen. A.) "Construction contractors" include persons installing floor coverings, including linoleum, floor tile, and wall-to-wall carpeting, by permanently affixing such coverings to a floor. (Cal. Code Regs., tit. 18, § 1521(a)(2).) Construction contractors are consumers of materials that they furnish and install when performing construction contracts. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1.) Either sales tax applies with respect to the sale of the materials to the construction contractor or use tax applies with respect to the construction contractor's use of the materials (but not both). (*Ibid*.)

It is the responsibility of every person storing, using, or otherwise consuming in this state tangible person property purchased from a retailer 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 CDTFA is not satisfied with the tax returns or the amount of tax required to be paid to the state by any person, CDTFA may compute and determine the amount required to be paid on the basis of any information within its possession or that may come into its possession. (R&TC, § 6481.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Las Playas #10*, 2021-OTA-204P.) If CDTFA's determination is not reasonable and rational, then the determination should be rejected. (*Appeal of Landeros*, 2024-OTA-655P.) If CDTFA's determination is reasonable and

[3] Precedential board memorandum opinions adopted prior to January 1, 2018, retain their precedential status unless OTA withdraws that status. (Cal. Code Regs., tit. 18, § 30504.) OTA has not withdrawn *Spurlock's* precedential status.

rational, then the determination is presumed correct. (*Ibid*.) The burden of overcoming this presumption is on the taxpayer. (*Ibid*.)

Generally, the appellant bears the burden of proof as to all issues of fact. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10*, Inc., *supra*.) To satisfy its burden of proof, a taxpayer must prove both that the tax assessment is incorrect and what the proper amount of tax should be. (*Appeal of AMG Care Collective*, *supra*.)

Here, appellant operated as a construction contractor that furnished and installed flooring materials pursuant to lump-sum construction contracts. To the extent appellant furnished, installed, and thus consumed flooring materials, *either* sales tax applied with respect to the sale of the materials to appellant *or* use tax applied with respect to appellant's use of the materials. (See Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1.) During its second audit of appellant, CDTFA found that appellant had issued resale certificates with respect to nearly 91 percent of its flooring material purchases during the liability period. Additionally, appellant does not dispute that it purchased the flooring materials at issue without paying sales tax reimbursement to its vendors. Further, nothing in the record indicates that appellant's vendors charged or collected sales tax reimbursement with respect to appellant's purchases at issue (which would be sales from the vendors' perspective) or reported appellant's purchases as taxable sales. And appellant has not claimed that it resold these flooring materials at retail and does not dispute that it used/consumed them. Thus, based on the evidentiary record before OTA, use tax is the relevant tax and applies to appellant's use/consumption of the materials at issue. OTA has reviewed CDTFA's audit method, calculations, and adjustments (for unsold inventory, nontaxable sales for resale or in interstate commerce, etc.), and concludes that CDTFA's ultimate determination that appellant consumed unreported purchases of $8,741,831 subject to use tax during the liability period is reasonable and rational, and thus presumably correct. Appellant now bears the burden of proving otherwise.

On appeal, appellant argues that the resale certificates associated with the flooring material purchases at issue were invalid and appellant's vendors did not take them in good faith. Specifically, appellant contends that certain resale certificates were invalid because they either

were not signed by an individual authorized by appellant,[4] were unsigned altogether, or included the seller's permit number of appellant's predecessor (a sole proprietorship).[5] Because appellant's vendors did not verify the validity of these resale certificates, appellant reasons that the vendors did not take the certificates in good faith and concludes that the vendors are liable for the sales tax on the transactions at issue.[6] Thus, appellant would shift the tax liability from itself to its vendors.

Here, if appellant issued to its vendors resale certificates that were missing authorized signatures or were unsigned, then appellant cannot subsequently deny the validity of these resale certificates and attempt to shift the tax liability away from itself and onto its vendors. (See *Spurlock*, *supra*.) Now if a person other than appellant issued the resale certificates, then those resale certificates would not necessarily relieve appellant's vendors of liability for sales tax on their sales of flooring materials to appellant. However, because appellant thereafter consumed the flooring materials ostensibly purchased for resale, appellant is primarily liable for use tax on this consumption. (See Cal. Code Regs., tit. 18, § 1668(e).) And unless the vendors knew the business that had issued a resale certificate (i.e., appellant's predecessor dba "HM Carpets")[7] was not the same as appellant, then appellant was required to affirmatively notify the vendors that they may not rely on that resale certificate when making sales to appellant. (See Sales and Use Tax Annotation 475.0175 (02/06/1990) and backup letter.)[8] Nothing in the evidentiary record indicates appellant's vendors knew that appellant and its predecessor were different business entities or that appellant affirmatively notified its vendors that they could not rely on its predecessor's resale certificate. Accordingly, appellant is regarded as having adopted its predecessor's resale certificates and owes tax on its

[4] At the oral hearing, appellant speculated that some of its vendors signed and provided resale certificates in appellant's name when contacted by CDTFA during the audit but acknowledged that this was mere speculation on its part.

[5] The record indicates that appellant's treasurer, H. Montealegre, owned the predecessor, which was doing business as "HM Carpets."

[6] Appellant further asserts that the correct course of action would have the vendors then attempt to collect sales tax reimbursement from their construction contractor customer (i.e., appellant).

[7] See footnote 5.

[8] CDTFA's Annotations are digests of opinions written by CDTFA's legal staff and constitute CDTFA's administrative interpretations made in the normal course of administering the Sales and Use Tax Law. (*Appeal of Martinez Steel Corporation*, 2020-OTA-074P.) They have substantial precedential effect within CDTFA and are entitled to some consideration by OTA; moreover, annotations are entitled to great weight when CDTFA is construing a statute it is charged with administering and that statutory interpretation is longstanding. (*Ibid*.)

subsequent consumption of the flooring materials purchased for resale. (*Ibid*.) Thus, for the reasons stated, OTA finds appellant's arguments on appeal unpersuasive and concludes that the amount of unreported purchases subject to use tax should not be 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).) 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.)

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 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.)

Following appellant's first audit, CDTFA determined that appellant made unreported purchases of $10,485,584 subject to use tax during the period April 1, 2011, through June 30, 2014. Following the audit at issue, CDTFA imposed the negligence penalty on appellant due to the following: (1) this was appellant's second audit; (2) appellant did not report any of its purchases of materials subject to use tax for the liability period; (3) unreported purchases of $8,741,831 subject to use tax exceeded 175 percent of appellant's reported taxable sales of $4,983,610 for the liability period; and (4) appellant underreported district taxes owed to jurisdictions where it performed construction contracts. On these facts, OTA finds that appellant was negligent in its reporting.

On appeal, appellant argues that it was not negligent because it was "somewhat uneducated when it comes to understanding what the resale certificate does when it comes to having lump sum contracts for a construction contractor" and it did not know it was liable for use tax on its consumption of flooring materials. Appellant also asserts that the first audit took too long so it could not improve its reporting until CDTFA finalized the first audit's results.

OTA finds appellant's first argument lacks merit because "[k]nowledge of the law is presumed." (See *Macfarlane v. Dept. of Alcoholic Beverage Control* (1958) 51 Cal.2d 84, 90.)

Regarding appellant's second argument, nothing in the evidentiary record indicates the date on which CDTFA completed the first audit, whether appellant petitioned for redetermination, or when CDTFA's audit determination became final in relation to the liability period at issue. As relevant here, CDTFA only provided two excerpts from the first audit's working papers, respectively dated November 26, 2014, and November 18, 2015. The former date predates the liability period, and the latter date occurs early in the liability period, which ended on June 30, 2018. If the first audit ended in or around November 2015, appellant would have had at least two and a half years remaining in the liability period to adjust or improve its reporting of purchases subject to use tax; but appellant failed to report any such purchases for the liability period. For its part, appellant bears the burden of proof as to all issues of fact (see Cal. Code Regs., tit. 18, § 30219(a)) but has not supplied any documentation or evidence showing that the first audit took too long. Finally, appellant has not explained why it was not negligent when it underreported its district taxes. Accordingly, OTA finds appellant's arguments unpersuasive and concludes that appellant was negligent in its reporting.

HOLDINGS

1. The amount of unreported purchases subject to use tax should not be reduced.
2. Appellant was negligent.

DISPOSITION

CDTFA's action denying appellant's petition for redetermination is sustained.

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Andrew Wong
Administrative Law Judge

We concur:

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Josh Aldrich
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Josh Aldrich
Administrative Law Judge

DocuSigned by:
Sheila Pacheco
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For
Suzanne B. Brown
Administrative Law Judge

Date Issued: 7/23/2025