2019 – OTA – 039
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18011954
	)	
SRN, INC.	)	Date Issued: February 5, 2019
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellant: Scott A. Sarran, CPA

For Respondent: Scott A. Lambert, Hearing Representative
Pamela Bergin, Tax Counsel III

A. ROSAS, Administrative Law Judge: Pursuant to California Revenue and Taxation Code section 6561,[1] appellant SRN, Inc. (Appellant) appeals a determination by respondent California Department of Tax and Fee Administration (Respondent)[2] assessing a tax deficiency of $242,173.70, plus applicable interest, and a negligence penalty of $24,217.39 for the audit period January 1, 2011, through December 31, 2013 (Audit Period).

Office of Tax Appeals (OTA) Administrative Law Judges Sara Hosey, Jeffrey Angeja, and Alberto Rosas held an oral hearing in this matter on October 30, 2018, in Sacramento, California. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] Statutory references are to the California Revenue and Taxation Code, unless otherwise noted.

[2] Sales taxes were formerly administered by the State Board of Equalization. In 2017, functions of the board relevant to this case were transferred to the California Department of Tax and Fee Administration (CDTFA). (Gov. Code, § 15570.22; 2017 Stats., ch. 16, § 5.) The term "Respondent" shall refer to both, depending on the context and timing. When referring to acts or events that occurred before January 1, 2018, "Respondent" shall refer to the board; and when referring to acts or events that occurred on or after January 1, 2018, "Respondent" shall refer to CDTFA.

ISSUES

1. Whether Appellant established that adjustments to Respondent's determination of unreported taxable sales are warranted.
2. Whether the negligence penalty is warranted.

FACTUAL FINDINGS

The Restaurant

1. During the Audit Period, Appellant, a California corporation, operated a French restaurant in San Francisco, doing business as "Le P'tit Laurent" (Restaurant). The Restaurant was open for dinner only. It opened daily at 5:30 p.m. and closed at either 9:30 p.m. or 10:30 p.m.[3] In addition to selling French cuisine, the Restaurant also sold alcohol, beer, and wine. It accepted cash, credit cards, and gift certificates. It charged and collected sales tax reimbursement on its sales.
2. The Restaurant's staff used guest checks to take customers' orders and rang up the sales in a cash register. Appellant used the Restaurant's cash from daily cash sales to pay the Restaurant staff any credit card tips reported on the credit card sales receipts.
3. Appellant contends it regularly sold wine inventory to nearby businesses and restaurants, and did not collect sales tax reimbursement on these sale-for-resale transactions.[4]
4. Laurent Legendre, Appellant's president and Restaurant operator, was solely responsible for the Restaurant's bookkeeping. He recorded the sales from the cash register Z-tapes to Appellant's profit and loss (P&L) statements. He then used information from the Z-tapes to prepare the sales and use tax returns for the Audit Period (Sales Tax Returns), which reported total sales and taxable sales of $679,000 and claimed no deductions.

[3] We reject Respondent's unsupported argument that the Restaurant also opened from 10:00 a.m. to 2:00 p.m. on Sundays for brunch. Appellant submitted notarized declarations from two individuals who worked at the Restaurant during the Audit Period, stating "the restaurant was only open for dinner." Appellant submitted copies of the Restaurant menus, which did not contain brunch options. The witness declarations and menus were admitted as evidence with no objections from Respondent. Additionally, Appellant's witnesses testified that the Restaurant served brunch before 2011, but that it was not open for brunch during the Audit Period, except for a two- to three-week period in 2013. Respondent did not cross-examine these witnesses, nor did it offer any evidence contradicting their testimony. Moreover, one of Respondent's own exhibits shows that the Restaurant opens daily at 5:30 p.m.

[4] Laurent Legendre testified that the Restaurant did in fact resell some of its wine inventory to other businesses. But Appellant did not provide any evidence to establish the exact amount of wine resales. Appellant did not provide any resale certificates, any documentation to identify who purchased the wine, or any documentation to identify whether they held a seller's permit and were engaged in the business of selling tangible personal property.

5. Prior to the Restaurant, Mr. Legendre co-owned another restaurant with a business partner, but Mr. Legendre was not involved with the sales and use tax returns. The Restaurant marked the first time that Mr. Legendre had any experience with and responsibility for the preparation of sales and use tax returns.
6. Mr. Legendre reported the following taxable sales on the quarterly Sales Tax Returns: $54,000 for the first quarter of 2011 (1Q-11); $52,000 (2Q-11); $60,000 (3Q-11); $70,000 (4Q-11); $60,000 (1Q-12); $70,000 (2Q-12); $65,000 (3Q-12); $65,000 (4Q-12); $58,000 (1Q-13); $33,000 (2Q-13); $35,000 (3Q-13); and $57,000 (4Q-13).
7. During non-operating hours, Appellant leased the Restaurant premises for private meetings and social functions. There were no contracts for these leases. Appellant contends it did not provide food or beverages for these events, and that the lease charges totaled $35,000, $54,800, and $115,000 for 2011, 2012, and 2013, respectively.

The Audit and Determination

8. In 2014, Respondent audited Appellant for the Audit Period. This was the first time Respondent had audited Appellant. As part of the audit, Appellant provided federal income tax returns for 2011, 2012, and 2013 (Federal Returns), credit card merchant statements for seven quarters, bank statements for 33 months, and credit card tips recorded on the P&L statements for the same 33 months.
9. Despite requests, Appellant did not provide any Z-tapes, guest checks, sales journals, purchase journals, credit card sales receipts, or any sales and use tax worksheets.
10. Scott A. Sarran, CPA, prepared the Federal Returns, which reported gross receipts of $1,068,638, $1,149,798, and $1,228,519 for 2011, 2012, and 2013, respectively. These gross receipts totaled $3,446,955 (excluding sales tax reimbursement).[5]
11. Respondent compared the reported taxable sales on the Sales Tax Returns to the cost of goods sold (COGS) claimed on the Federal Returns for the same period, and it determined that the reported book markups[6] are as follows: -37.71 percent, -21.46

[5] Appellant argues that the gross receipts included sales tax; however, there is no evidence of this, and Appellant did not claim a deduction on the Federal Returns for any sales tax included in gross receipts.

[6] The book markup, stated as a percentage, is calculated as the taxable sales price divided by the COGS. A negative markup means the retailer sold products for less than the COGS.

percent, and -44.69 percent for 2011, 2012, and 2013, respectively. Based on this comparison, Respondent determined Appellant's reported taxable sales were unreliable.

12. Respondent determined that the gross receipts, as reported on the Federal Returns, was the best evidence of Appellant's taxable sales. These gross receipts exceeded the $679,000 reported on the Sales Tax Returns by $2,767,955, and this difference of approximately $2.8 million was the basis for Respondent's deficiency determination.

13. On September 15, 2014, Respondent issued a Notice of Determination (NOD), providing written notice to Appellant of Respondent's deficiency determination of $242,173.70, plus applicable interest, and a negligence penalty of $24,217.39 for the Audit Period.[7]

The Markup Analysis

14. To test the reasonableness of its determination, Respondent performed a markup analysis. The Federal Returns showed COGS of $455,406, $397,630, and $419,254 for 2011, 2012, and 2013, respectively. Respondent's auditor calculated a 231 percent average reflective markup of the gross profits.[8] According to Respondent, the markup analysis indicates that Respondent's determination is reasonable.

The Credit Card Sales Ratio

15. To further test the reasonableness of its determination, Respondent performed a credit card sales ratio analysis. The auditor computed a ratio of cash sales to gross receipts of 16.82 percent (cash sales ratio) and a ratio of credit card sales to gross receipts of 83.18

[7] Respondent stated that the NOD was timely because Appellant purportedly signed a waiver of the applicable three-year statute of limitations. Although Respondent failed to provide evidence of the signed waiver, Appellant did not dispute Respondent's contention, and the statute of limitations is not an issue in this case.

[8] Respondent's calculations of the average reflective markup are reflected in the following table:

	2011	2012	2013	TOTAL
Adjusted COGS	$378,854	$331,045	$330,871	$1,040,770
Gross Profit	$689,784	$818,753	$897,648	$2,406,185
Markup (from Adjusted COGS to Gross Profit)	182.07%	247.32%	271.30%	231.19%

Respondent presented several arguments about this average reflective markup, including a comparison to similar businesses. However, Respondent provided no evidence in support of its arguments, e.g., it provided no evidence of the average reflective markup for similar businesses in the same area during the same or similar period.

percent (credit card sales ratio). The auditor used the 83.18 percentage as the audited credit card sales ratio.[9]

16. During an audit test period, Appellant provided credit card sales receipts for February 1 through February 6, 2014. Appellant provided no evidence of cash sales during this test period. Using the six-day test period, the auditor computed an audited credit card tips ratio of 18 percent.

17. The auditor analyzed credit card merchant statements from the seven quarters: 2Q-11, 3Q-11, 1Q-12, 1Q-13, 2Q-13, 3Q-13, and 4Q-13.[10]

18. These credit card merchant statements show that the electronic deposits from the credit card merchant to Appellant's bank account totaled $1,516,913 (excluding tips and sales tax) during these seven quarters. In the Sales Tax Returns for these same seven quarters, Appellant reported total taxable sales of $355,000.

19. The auditor compared audited taxable sales to taxable sales reported for the corresponding quarters and computed the understatement amount and error ratio for each of the seven quarters.[11]

20. The auditor applied the average error ratio (413.704507%) to the $679,000 reported on the Sales Tax Returns to compute an understatement total of $2,809,054 (rounded).[12]

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[9] The audit report indicated that "the credit card ratio of 83.18% is within a reasonable range when compared to other restaurant audits." However, Respondent provided no supporting evidence, e.g., it provided no evidence of the credit card ratios for similar restaurants in the same area during the same or similar period.

[10] The auditor used recorded deposits, the 18 percent audited credit card tips ratio, applicable sales tax rates, and the 83.18 percent credit card sales ratio to compute audited taxable sales for each of the seven quarters.

[11] Respondent's calculations of understated amounts and error ratios are reflected in the following table:

Period (Quarter and Year)	Gross Sales per Sales Tax Returns	Audited Total Sales Based on 83.18% Credit Card Ratio per Federal Returns	Understated Total Sales	Percentage of Error (rounded)
2Q-11	$52,000	$244,664	$192,664	370.51%
3Q-11	$60,000	$192,701	$132,701	221.17%
1Q-12	$60,000	$269,230	$209,230	348.72%
1Q-13	$58,000	$270,852	$212,852	366.99%
2Q-13	$33,000	$276,054	$243,054	736.53%
3Q-13	$35,000	$222,534	$187,534	535.81%
4Q-13	$57,000	$347,616	$290,615	509.85%
TOTAL	$355,000	$1,823,651	$1,468,651	413.70% (avg.)

[12] Appellant does not dispute the credit card sales ratio audit method described in fns. 15 through 20.

According to Respondent, the credit card sales ratio analysis indicates that Respondent's determination is reasonable.

The Appeal

21. Appellant filed this timely appeal. At appeal, Appellant conceded that it underreported its taxable sales; however, Appellant contends that its unreported taxable sales totaled $1,752,826 (rounded), not $2,767,955.

DISCUSSION

Issue 1 – Whether Appellant established that adjustments to Respondent's determination of unreported taxable sales are warranted.

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts,[13] unless the sale is specifically exempt or excluded from taxation by statute. (§ 6051; *Southern Pacific Co. v. Gallagher* (1939) 306 U.S. 167, 171; *City of Pomona v. State Bd. of Equalization* (1959) 53 Cal.2d 305, 309.)

All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (§ 6091.) Although sales of food products are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (§ 6359, subds. (a), (d)(1), (d)(2), and (d)(7).)

When Respondent is not satisfied with the accuracy of the sales and use tax returns filed, it may base its determination of the tax due upon the facts contained in the returns or upon any information that comes within its possession. (§ 6481.)[14] It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability. (§§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)[15]

[13] The term "gross receipts" means the total amount of the sale price without any deduction for the cost of materials used, labor or service costs, interest paid, losses, or any other expense. (§ 6012(a).)

[14] See also *People v. Schwartz* (1947) 31 Cal.2d 59, 63 (deficiency determination based on failure to explain excess of disbursements over reported gross receipts); *People v. Buckles* (1943) 57 Cal.App.2d 76, 81 (purchaser of business who did not obtain certificate of no tax was liable for deficiency assessment); and *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 615 (board may calculate theoretical sales, based on information furnished, even though taxpayer's records are comprehensive and consistent).

[15] Regulatory references are to Title 18 of the California Code of Regulations, unless otherwise noted.

When a taxpayer challenges a Notice of Determination, Respondent has the burden to explain the basis for that deficiency. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610.) Generally, in circumstances where a taxpayer challenges the additional tax, the government bears the initial burden of establishing a *prima facie* case that taxes are owed. (*Schuman Aviation Co. Ltd. v. U.S.* (2011) 816 F.Supp.2d 941, 950.) Based on *Riley B's, Inc.* and *Schuman Aviation Co. Ltd.*, we conclude that when a taxpayer challenges a Notice of Determination, Respondent must establish a *prima facie* case that taxes are owed by proving the basis for that deficiency and providing evidence sufficient to establish that its determination is reasonable.

Where Respondent has met its initial burden, the burden of proof shifts to the taxpayer to explain why Respondent's asserted deficiency is not valid. (*Riley B's, Inc., supra,* at pp. 615-616.) The applicable burden of proof is by a preponderance of the evidence. (Evid. Code, § 115; *Appeal of Estate of Gillespie*, 2018-OTA-052P, June 13, 2018, at p. 4, internal citation omitted.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.)

To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442 (*Paine*); *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

Here, Respondent was not satisfied with the accuracy of Appellant's Sales Tax Returns for at least three main reasons. First, Mr. Legendre reported the following taxable sales on the 12 quarterly Sales Tax Returns: $54,000; $52,000; $60,000; $70,000; $60,000; $70,000; $65,000; $65,000; $58,000; $33,000; $35,000; and $57,000.[16] There may be nothing wrong with reporting a round amount on a quarterly return; such a rarity is bound to happen once in a while. However, to report perfectly round amounts, time and time again, quarter after quarter, for 12 consecutive quarters, is unlikely and may raise suspicions. Reporting round amounts creates the appearance of estimating the sales amounts.

[16] We are not rounding these amounts to the nearest thousand for ease of discussion; rather, these are the exact amounts Appellant reported on the Sales Tax Returns.

Second, there was a large discrepancy of $2,767,955 between the Sales Tax Returns ($679,000) and the Federal Returns ($3,446,955).[17] The taxable sales on the Sales Tax Returns amounted to approximately 20 percent of the gross receipts reported on the Federal Returns.

And third, when comparing the reported taxable sales on the Sales Tax Returns to COGS claimed on the Federal Returns for the same period, Respondent computed a negative book markup: -37.71 percent (2011), -21.46 percent (2012), and -44.69 percent (2013). Based on these negative book markups, Respondent determined that Appellant's reported taxable sales were unreliable. Respondent argues that a negative book markup is "a strong indication of unreported taxable sales."

Respondent based its determination on the fact that Appellant's gross receipts reported on the Federal Returns exceeded the taxable sales reported on the Sales Tax Returns by $2,767,955. Respondent explained that the gross receipts were reasonable and verified the reasonableness using an indirect audit method—the credit card sales ratio audit method. As part of this indirect audit method, the auditor used 83.18 percent as the audited credit card sales ratio. This credit card sales ratio audit method resulted in an understatement total of $2,809,054 (rounded). The de minimis difference of $41,099 ($2,809,054 - $2,767,955) supported the reasonableness of Respondent's determination that Appellant had underreported its taxable sales by approximately $2.8 million, the amount by which the gross receipts reported on the Federal Returns exceeded the taxable sales reported on the Sales Tax Returns.

Respondent's explanation of its deficiency determination appears to be reasonable and is based on the best available information; thus, the burden of proof shifts to Appellant to explain why Respondent's asserted deficiency is not valid, and also of producing evidence from which another and proper determination may be made. Appellant's gross receipts of $3,446,955, as reported on the Federal Returns, established the audited taxable sales, and it is presumed that all gross receipts are subject to tax unless Appellant establishes the contrary. Although Appellant conceded that it underreported its taxable sales, it contends that its unreported taxable sales

[17] Respondent's audit manual indicates that comparing gross receipts reported on federal income tax returns to reported taxable sales is an acceptable audit method. California is not the only state that uses this reasonable and acceptable audit method. (See, e.g., *Masini v. Ill. Dept. of Rev.* (Ill. App. Ct. 1978) 376 N.E.2d 324, 327 [allowing the tax agency to use the receipts reported on the taxpayer's federal income tax return where those receipts were higher than those reported on the state sales tax return and there were discrepancies between the taxpayer's sales tax return and its books and records].)

totaled $1,752,826 (rounded), not $2,767,955. Thus, the amount in dispute is approximately $1,015,129 ($2,767,955 - $1,752,826).

To prevail, Appellant must prove by a preponderance of the evidence that approximately $1,015,129 of the gross receipts were not subject to tax. In support of its position, Appellant argues that the gross receipts included the following nontaxable items: (1) sales for resale, (2) employee tips, and (3) charges for leasing the Restaurant premises.

1. Nontaxable Sales for Resale

All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise; for example, by obtaining a resale certificate from the purchaser. (§ 6091.) It is Appellant's position that it resold some of its wine inventory to nearby businesses and restaurants in nontaxable sales for resale. But Appellant did not obtain resale certificates and did not provide any evidence to establish the exact sales amounts. Here, as in *Paine*, "the taxpayer's position is an unsuccessful attempt to shift their tax liability to other persons, with full knowledge that their incomplete records render impossible collection by the state of the tax from those allegedly liable . . . . Plaintiffs are not entitled to an exemption merely because they say they are; they must offer some credible evidence of exemption entitlement." (*Paine, supra,* 137 Cal.App.3d at p. 443.)

If a resale certificate is not obtained, the seller may still be able to prove by other evidence that the sale was for resale. (Reg. § 1668, subd. (e).)[18] Appellant not only failed to obtain resale certificates, it also failed to prove by other evidence that it sold portions of the wine for resale. Appellant provided no evidence to rebut section 6091's presumption that all gross receipts are subject to tax unless the contrary is established. It failed to establish the contrary. Thus, Appellant may not deduct these wine sales from its gross receipts.

2. Nontaxable Tips

"An optional payment designated as a tip, gratuity, or service charge is not subject to tax." (Reg. § 1603(g).) Appellant used the Restaurant's cash from daily cash sales to pay to the Restaurant staff any optional credit card tips reported on the credit card sales receipts. These tips are not subject to sales tax. Appellant argues that its nontaxable optional credit card tips totaled

[18] For example, "the seller will be relieved of liability" if it uses other evidence to rebut the presumption of taxability. (Reg. § 1668(e).) However, Appellant did not provide evidence to rebut the presumption of taxability.

$528,745 during the Audit Period: $170,179 (2011); $175,592 (2012); and $182,974 (2013). However, although optional credit card tips are not subject to sales tax, Appellant did not establish by a preponderance of the evidence that the gross receipts, as reported on the Federal Returns, included $528,745 in tips.

Appellant provided six pages of Federal Returns—two pages per tax year—and the limited information on those six pages does not prove that the gross receipts included $528,745 in tips. The Federal Returns do not show deductions of $170,179 (2011); $175,592 (2012); and $182,974 (2013) for tips paid out to employees.[19] (See Internal Revenue Code (IRC), § 162; and Treas. Reg. § 1.162-1.)

Furthermore, each employee was required to provide a report to Appellant that includes tips Appellant "paid over to the employee for charge customers." (IRS Pub. 15 (2011) at p. 14; IRS Pub. 15 (2012) at p. 14; IRS Pub. 15 (2013) at p. 17; see also IRC, § 6053(a) and Unemp. Ins. Code, § 13055.) However, Appellant did not provide any employee reports, employee federal tax forms, or payroll information to establish the tip amounts paid to its employees.

Therefore, because Appellant did not prove that the gross receipts of $3,446,955 included nontaxable tips of $528,745, it has failed to establish that it is entitled to a reduction in the determination on this basis.

3. Nontaxable Leases for the Premises

Generally, charges for the lease of premises are nontaxable leases of real property. (Reg. § 1603(i)(4).) The Restaurant was open for dinner only. During non-operating hours, Appellant leased the Restaurant premises for private meetings and social functions. There were no written contracts for these leases. Appellant contends that it did not provide food or beverages for these events.[20] The charges for leasing the Restaurant premises purportedly totaled $204,800 during the Audit Period: $35,000 (2011); $54,800 (2012); and $115,000 (2013).

[19] It is unclear from the Federal Returns whether these tips were included as part of the "salaries and wages" claimed as deductions: $255,531 (2011); $284,209 (2012); and $327,175 (2013). Such a position would suggest that approximately 67% (2011), 62% (2012), and 56% (2013) of the salaries and wages consisted of tips—a position that is unsupported by the evidence.

[20] Respondent cites to no statute or regulation in support of the position that leasing the Restaurant premises would be subject to tax if the leases were made in connection with sales of food furnished by Appellant. Respondent relies entirely on an annotation; however, annotations do not have the force or effect of law. (Reg. § 5700, subds. (a)(1), (c)(2).)

Respondent does not believe Appellant leased the premises without also providing food. But Respondent's disbelief is based on pure speculation—not evidence.[21] However, there is no need to speculate about a "possible explanation." Appellant provided invoices for the lease charges. The invoices make no references to food or beverages. One Restaurant client signed a notarized declaration, stating she leased the Restaurant "an average of once per month" and generally "from 6:00 a.m. until 12:00 p.m." The invoices and declaration were admitted as evidence with no objections from Respondent. Mr. Legendre testified about Appellant leasing the Restaurant premises to clients. Mr. Sarran testified that he himself occasionally leased the premises, without food or beverages, and that he provided his own wine. Respondent did not cross-examine these witnesses, nor did it offer any evidence contradicting their testimony.

On balance, the evidence establishes that it is more likely than not that Appellant did in fact lease the Restaurant premises during non-operating hours and did not provide food or beverage as part of these leases. But the analysis does not end there. Although charges for the leasing of the Restaurant premises are not subject to sales tax, Appellant did not establish by a preponderance of the evidence that the gross receipts as reported on the Federal Returns specifically included $204,800 in lease charges.

Therefore, Appellant has failed to establish that it is entitled to a reduction in the determination on this basis.

Issue 2 –Whether the negligence penalty is warranted.

If any part of a deficiency is due to negligence, Respondent shall add a ten percent negligence penalty to that part of the deficiency determination. (§ 6484.) Respondent's audit manual defines negligence "in general as a failure to exercise due care," and as a failure to exercise "such care that a reasonable and prudent person would exercise under similar circumstances." This definition is based on the objective reasonable and prudent person standard.[22] However, generally, the negligence penalty "should not be added to deficiency

[21] Respondent argues that "it would seem likely that someone who desired to rent [Appellant's] restaurant space for some sort of social or business gathering would also want to provide food for that gathering." Additionally, in regards to the different annual lease amounts, Respondent also speculates that "[a]nother possible explanation is that [Appellant] had more space rentals in the latter part of the audit period . . . ."

[22] As defined by general California jurisprudence, the negligence standard of care is namely "that degree of care which people of ordinarily prudent behavior could be reasonably expected to exercise under the 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 ["The general standard of care applicable to negligence is 'that of a

determinations associated with the first audit of a taxpayer." (Reg. § 1703(c)(3)(A).)[23]

Overall, Respondent may impose a negligence penalty on a first audit when the deficiency is due to negligence; however, the evidence must establish that the bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (§ 6484; Reg. § 1703(c)(3)(A); see also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321.)

Here, although this was Appellant's first audit, there are at least five noteworthy examples of negligence. First, there was a major discrepancy between the gross receipts reported on Appellant's Sales Tax Returns ($679,000) and its Federal Returns ($3,446,955). The taxable sales reported on the Sales Tax Returns amounted to approximately 20 percent of the gross receipts. Thus, for every $5 in taxable sales, Appellant reported only $1 in taxable sales.

Appellant conceded it underreported taxable sales by $1,752,826. Assuming, arguendo, that the taxable sales were $1,694,129 ($3,446,955 - $1,752,826), this means Appellant reported only 40 percent ($679,000/$1,694,129) of gross receipts, or that Appellant reported only $2 for every $5 in taxable sales. While bona fide mistakes are bound to happen, a reasonable and prudent person would not overlook 80 percent (or 60%, using Appellant's figures) of a restaurant's taxable sales, night after night, month after month, quarter after quarter, for 12 consecutive quarters. The amounts reported on Appellant's own Federal Returns establish that it could not have held a good faith and reasonable belief that it was reporting its sales tax liabilities accurately or in substantial compliance with the requirements of the law.

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reasonably prudent person under like circumstances,' which constitutes an 'objective reasonable person standard.' " (Citations)].) In the area of federal income taxation, due care is an objective standard by which the taxpayer must show that he acted as a reasonable and prudent person would act under similar circumstances. (See *Collins v. Commissioner* (9th Cir.1988) 857 F.2d 1383, 1386; Treas. Reg. § 1.6662-3(b)(1).) For purposes of a federal negligence penalty, "[n]egligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances." (*Marcello v. Commissioner* (5th Cir. 1967) 380 F.2d 499, 506).)

[23] Regulation 1703(c)(3)(A) codifies Respondent's long-standing policy to not impose a negligence penalty in a first audit. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321.) The First District Court of Appel upheld a negligence penalty imposed after a second audit disclosed that the taxpayer continued to make the same errors the board found in its first audit. Although that case involved a second audit, the appellate court noted "that the board seldom, if ever, imposes a negligence penalty for errors discovered on a first audit." (*Ibid*.) The imposition of the negligence penalty could not be avoided on the theory that there was an "honest dispute" over the legality of the tax. (*Id.*, at p. 323.) The appellate court stated: "It may be assumed that a bona fide and reasonable belief that a particular transaction is not taxable would prevent the imposition of a negligence penalty. But here, the appellant not only failed to prove that it had such a bona fide and reasonable belief, but the evidence shows that, reasonably, it could not have had such a belief." (*Ibid*.)

Second, as part of the audit, Appellant provided credit card merchant statements for seven quarters, which show that the electronic deposits from the credit card merchant to Appellant's bank account totaled $1,516,913 (excluding tips and sales tax) during these seven quarters. However, in the Sales Tax Returns for these same seven quarters, Appellant only reported total taxable sales of $355,000. A reasonable and prudent person would have noticed that the amounts shown in the electronic deposit records greatly exceeded the amounts reported on the Sales Tax Returns. Accordingly, Appellant's own records establish that it could not have held a good faith and reasonable belief that it was reporting its sales tax liabilities accurately or in substantial compliance with the requirements of the law.

Third, on 12 consecutive quarterly Sales Tax Returns, Appellant reported perfectly round sales amounts. A reasonable and prudent person, while reviewing these returns prior to filing, would look at those perfectly round sales amounts—focusing on the five consecutive zeros after the comma ($XX,000.00)—and realize something is amiss. A reasonable and prudent person would double-check the accuracy of those reported amounts. Unless a taxpayer double-checks the accuracy of those reported amounts, the taxpayer could not have held a good faith and reasonable belief that it was reporting its sales tax liabilities accurately or in substantial compliance with the requirements of the law.

Fourth, Respondent computed a negative book markup. The Federal Returns indicated total COGS of $1,272,290, but the Sales Tax Returns reported taxable sales of $679,000 for the same period. The COGS totaled approximately 187 percent more than the reported taxable sales. In other words, the cost of goods was almost twice as much as the reported taxable sales.

A reasonable and prudent person, after noticing the taxable sales are far less than the COGS, would suspect that the Sales Tax Returns contained errors. "These errors could have been avoided had the taxpayer properly evaluated the information contained in its accounting system." (*Independent Iron Works, Inc., supra*, 167 Cal.App.2d at p. 321.) Mr. Legendre could have properly evaluated the 33 months of bank statements, reviewed the expenses paid, reviewed the amounts of COGS, and realized the reported taxable sales were approximately half as much as the COGS.

And fifth, it is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability. (§§ 7053, 7054; Reg. § 1698(b)(1).) Failure to maintain and keep complete and accurate records will be

considered evidence of negligence and may result in penalties. (Reg. § 1698(k).) Appellant provided Federal Returns and some records for portions of the Audit Period. However, despite Respondent's requests, Appellant did not offer any Z-tapes, guest checks, sales journals, purchase journals, credit card sales receipts, or any sales and use tax worksheets. Appellant failed to provide complete and accurate records. (Reg. § 1698(k).) To a large extent, the provided records were incomplete for sales and use tax purposes.

The evidence established that Appellant did not act as a reasonable and prudent person would have acted under similar circumstances. Moreover, the evidence proves that the underreporting errors were due to negligence and cannot be attributed to a good faith and reasonable belief that the bookkeeping and reporting practices were in substantial compliance with the requirements of the law. Therefore, the negligence penalty is warranted.

HOLDINGS

1. Appellant did not establish that adjustments to Respondent's determination of unreported taxable sales are warranted.
2. The negligence penalty is warranted.

DISPOSITION

We sustain Respondent's determination in full.

DocuSigned by:
Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

We concur:

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

DocuSigned by:
Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge