OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011902
RAMCO JEWELRY CORP.	) CDTFA Case ID 589406
dba, Acapulco Jewelry Plaza	) CDTFA Account No. SR AA 99-626513

OPINION

Representing the Parties:

For Appellant:	Patrick E. McGinnis, Attorney Ramin Cohan, Owner
For Respondent:	Scott Lambert, Hearing Representative Lisa Renati, Hearing Representative Pamela Bergin, Assistant Chief Counsel
For Office of Tax Appeals:	Richard Zellmer Business Tax Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Ramco Jewelry Corp. (appellant) appeals an action by respondent California Department of Tax and Fee Administration (Department) determining $1,177,716.51 of additional tax, a negligence penalty of $117,771.66, and applicable interest, for the period July 1, 2005, through June 30, 2008.

Office of Tax Appeals (OTA) Administrative Law Judges Daniel K. Cho, Kenneth Gast, and Michael F. Geary held an oral hearing for this matter in Van Nuys, California, on October 28, 2019. At the conclusion of the hearing, we closed the record and took the matter under submission.

ISSUES

1. Is appellant entitled to additional adjustments to the audit liability for disallowed claimed sales for resale, now measured by $14,275,351?
2. Was appellant negligent?

FACTUAL FINDINGS

1. For the relevant period, appellant operated a jewelry store known as Acapulco Jewelry Plaza, located in an area near downtown Los Angeles known as the jewelry district, where appellant made wholesale and retail sales of precious metals, precious stones, and semi-precious stones.
2. Appellant reported total sales of $16,989,444 and claimed nontaxable sales for resale totaling $16,546,058. However, appellant included its nontaxable sales in interstate commerce measured by $1,572,463 in its reported sales for resale. The Department allowed the claimed sales in interstate commerce, leaving claimed sales for resale measuring $14,973,595.
3. Appellant did not maintain a sales journal or other summary record or sales tax worksheets to show how the amounts on the sales and use tax returns (returns) were compiled and/or computed.
4. The Department audited appellant for the period July 1, 2005, through June 30, 2008. The Department prepared an audit and a revised audit. In the revised audit, the Department computed disallowed claimed deductions for sales for resale totaling $14,973,595.
5. The Department issued a Notice of Determination (NOD) to appellant based on the revised audit for tax of $1,235,321.68, a negligence penalty of $123,532.17, and applicable interest.
6. Appellant filed a timely Petition for Redetermination, protesting the NOD in its entirety.
7. During the Department's appeal process, appellant provided additional documentation, which had not been provided during the audit and revised audit. These documents included what purported to be resale certificates and sales invoices to customers who purchased items from appellant solely for the purpose of resale (resale customers). Appellant asserted (and still asserts) that most of its sales for resale during the audit period were to Creative Diamonds, AMH Wholesale, and Yerma Jewelry.[1]
8. The Department was able to segregate the sales in interstate commerce from the sales for resale. The sales in interstate commerce totaled $1,572,463 for the audit period, which

[1] Appellant made the same argument about sales to Juliet Jewelry, but the Department allowed the one invoice from that customer that was included in the test period.

the Department accepted as valid. The Department decided to test the validity of appellant's claimed deductions for nontaxable sales for resale, using the first quarter of 2007 (1Q07) as a test period. The Department examined appellant's sales invoices for 1Q07, noting that the sales invoices were not numbered. The Department also noted that the sales for resale of $2,297,749 recorded on the sales invoices for 1Q07 far exceeded claimed deductions for sales for resale of $1,478,077 for the same period, and that taxable retail sales recorded on the sales invoices for 1Q07 of $232,873 far exceeded the reported taxable sales of $37,385 for that same period. Thus, the Department concluded that appellant's sales invoices were not reliable for purposes of determining total sales or nontaxable sales for resale.

9. The Department also concluded that examining resale certificates would be of no value because, in the absence of reliable sales invoices, the Department could not determine the amounts of sales, if any, that were made to each purchaser.

10. The Department verified sales for resale as follows. The Department examined bank statements and deposit slips and accepted all deposits that were identified as being from jewelry companies as sales for resale, totaling $34,863 for 1Q07. The Department did not accept any of the unidentified cash deposits as sales for resale because the Department could not trace the sales invoices to those deposits. The Department also allowed appellant to send XYZ letters to its customers.[2] Based on the responses to the XYZ letters, the Department accepted an additional $27,550 in sales for resale for 1Q07. In total, the Department accepted sales for resale of $62,413 ($27,550 + $34,863), which was divided by appellant's claimed sales for resale for 1Q07 of $1,478,077, to compute a ratio of allowable sales for resale of 4.22 percent. The ratio of 4.22 percent was applied to claimed sales for resale for the audit period of $16,546,058 to compute allowable claimed sales for resale of $698,244.[3] This amount was added to verified sales in interstate commerce of $1,572,463 to compute total allowable deductions of $2,270,707

[2] XYZ letters are letters in a form approved by the Department which are sent to some or all of the seller's purchasers inquiring as to the purchaser's disposition of the property purchased from the seller.

[3] The Department notes that in making this computation, it should have accounted for exempt sales in interstate commerce by removing them from both the total population and the sample population. Doing so would reduce the amount of allowable sales for resale, which would be detrimental to appellant. Thus, the Department, did not correct this error.

for the audit period. Total allowable deductions of $2,270,707 were subtracted from total claimed deductions of $16,546,058 to compute disallowed claimed deductions for sales for resale of $14,275,351 for the audit period.

11. Following the Department's examination of the additional documentation, it prepared a reaudit report in which the disallowed sales for resale were reduced from $14,973,595 to $14,275,351, the tax was reduced to $1,177,716.51, and the negligence penalty was reduced to $117,771.66.

12. The Department held an appeals conference with appellant. At that appeals conference, appellant stated that it disagreed with the reaudit results. Appellant claimed that the Department failed to examine all of its sales invoices, that it is primarily a wholesaler of jewelry, and that it could not have made $14,275,351 in taxable retail sales at its retail outlet, because the retail outlet is only 900 square feet in size and employs only two individuals.

13. Apparently in light of the fact that sales recorded on the sales invoices for 1Q07 far exceeded sales reported on the returns for the same period, the Department asked appellant to provide evidence establishing which sales were reported on its returns. Appellant did not provide that information.

14. The Department's Decision and Recommendation report (D&R) notes that, without information establishing which sales were reported on appellant's returns, the Department is unable to identify that the alleged sales for resale were reported on the returns. The D&R recommends the reduction of disallowed claimed sales for resale from $14,973,595 to $14,275,351, but otherwise denies appellant's petition for redetermination. This timely appeal followed.

DISCUSSION

Issue 1 – Is appellant entitled to additional adjustments to the audit liability for disallowed claimed sales for resale, now measured by $14,275,351?

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) When the

Department is not satisfied with the accuracy of the tax returns filed, it may base its determination of the tax due upon the facts contained in the return or upon any information that comes within its possession. (R&TC, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).)

The burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. (R&TC, § 6091.) If the seller does not timely obtain a valid and complete resale certificate, the seller will be relieved of liability for the tax only where the seller shows that the property: 1) was in fact resold by the purchaser and was not used by the purchaser for any purpose other than retention, demonstration, or display while holding it for sale in the regular course of business; 2) is being held for resale by the purchaser and has not been used for any purpose other than retention, demonstration, or display, while being held for sale in the regular course of business; or 3) was consumed by the purchaser and tax was reported by the purchaser directly to the Department on the purchaser's returns or in an audit of the purchaser. (Cal. Code Regs., tit. 18, § 1668, subd. (e).) One way to prove that property was, in fact, resold without intervening use is through the use of "XYZ" letters.[4] (Cal. Code Regs., tit. 18, § 1668, subd. (f).)

When a taxpayer challenges an NOD, the Department has a minimal, initial burden of showing that its determination is reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) If the Department carries that burden, the burden of proof shifts to the taxpayer to establish that a result differing from the Department's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit.18, § 30219, subd. (c).) 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*

[4] See footnote 2, above.

California (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) To satisfy the burden of proof, a taxpayer must prove that (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; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

As noted above, taxable retail sales of $232,873 recorded on the sales invoices for the test period, 1Q07, far exceeded the reported taxable sales of $37,385 for that same period. We compute an error ratio for unreported taxable sales of 523 percent.[5] Also, the schedule 12 audit comments[6] state, upon examining the sales invoices, the auditor noticed that many of the sales for which sales tax reimbursement was not charged were to individuals, not jewelry businesses. The audit comments further state that the auditor went to some of the addresses listed on the sales invoices for which sales tax reimbursement was not charged and found all of the visited addresses to be residences, indicating that the sales to these purchasers were taxable retail sales. This evidence indicates that appellant significantly understated its taxable sales.

In addition to the above-mentioned discrepancy between taxable sales recorded on the sales invoices for 1Q07 and reported taxable sales for that same period, we note that sales for resale of $2,297,749 recorded on the sales invoices for 1Q07 exceeded claimed deductions for sales for resale of $1,478,077 for the same period by $819,672. This is further evidence that appellant did not report substantial amounts of its sales on its returns. We note that appellant's failure to maintain adequate business records, like sales tax worksheets, makes it impossible to determine which sales it reported on the returns.

Appellant alleges that most, if not all, of the disallowed claimed sales for resale were legitimate sales for resale to just a few customers, most notably Yerma Jewelry, AMH Wholesale, and Creative Diamonds. We discuss this contention in more detail below; but even if we were to determine that appellant made nontaxable sales for resale to those customers, an adjustment would not be warranted because we cannot determine if those sales were reported on the returns. The only sales for resale that were disallowed were those that were reported on the returns. An adjustment is not warranted for valid sales for resale that were not reported on the

[5] Recorded taxable sales of $232,873 – reported taxable sales of $37,385 = unreported taxable sales of $195,488. Unreported taxable sales of $195,488 ÷ reported taxable sales of $37,385 = 523 percent.

[6] These comments were provided in appellant's opening brief.

returns. Based on the evidence, we find that the Department's disallowance of the claimed sales for resale was reasonable and rational. The burden thus shifts to appellant to prove that the tax assessment is incorrect, and the proper amount of the tax. (*Paine v. State Bd. of Equalization*, supra; *Honeywell, Inc. v. State Bd. of Equalization*, supra.)

Appellant made two arguments at the hearing. Consistent with the above, it argued that, while mistakes were made and appellant did not accurately report its taxable sales, the evidence shows that a substantial portion of the disallowed claimed sales for resale were legitimate nontaxable sales to a few manufacturers, wholesalers, and retailers with whom appellant did business. Alternatively, citing the Cohan Rule,[7] appellant argues that the evidence establishes that it is entitled to an adjustment but is unable to find and provide the evidence to prove the correct measure of tax. Appellant contends that under these circumstances, the law allows us to estimate an appropriate adjustment to the liability on the basis of the evidence presented, as long as the estimate weighs heavily against appellant, who has the burden of proving the correct measure of tax.

To support its argument that the Department disallowed many legitimate sales for resale, appellant has at various times provided written statements by Hakop "Jack" Yermagyan, the owner of Yerma Jewelry, and Vipul Shah, the owner of S&R Diamonds.

In his written statement, Mr. Yermagyan stated Yerma Jewelry frequently purchased gold and other jewelry from appellant and that 99 percent of those purchases were for use in manufacturing jewelry for resale. He also stated that he examined the audit work papers and that he believed that "all of the purchases covered were wholesale transactions." Mr. Yermagyan also stated that AMH Wholesale purchased gold from appellant for resale. At hearing, Mr. Yermagyan was less definitive. He testified that he could not estimate the dollar value of the purchases made from appellant, though he provided what purport to be photocopies of three check stubs containing hand-written notations regarding payments of $40,000, $43,530, and $68,500 made to appellant during 2005.

There are two written statements from Mr. Shah. In these, he states that he knew Viashal Nahar, part-owner of Creative Diamonds. According to Mr. Shah, Creative Diamonds purchased

[7] The so-called Cohan Rule states that when the evidence establishes that the taxpayer is entitled to some allowance but the exact amount cannot be determined because the taxpayer is unable to provide business records or other evidence to prove the entitlement, it is appropriate to use an estimate that "bear[s] heavily … upon the taxpayer whose inexactitude is of his own making." (*Cohan v. Commissioner of Internal Revenue* (2d Cir. 1930) 39 F.2d 540, 543-544.)

and resold gold and jewelry and/or it was a jewelry manufacturer and retailer. Mr. Shah states that he observed Mr. Nahar paying appellant in cash, and he concludes that all of appellant's sales to Creative Diamonds were sales for resale. He also opines that the average sale for a jewelry vendor is $500 and average gross sales for a jewelry vendor in a downtown Los Angeles mall is $600,000.

Appellant argues that, due to the significant length of time which had elapsed since the end of the audit period, appellant was unable to obtain XYZ letter responses from its customers, or bank deposit information. Thus, appellant argues that the statements from Mr. Yermagyan and Mr. Shah should be accepted as establishing that its sales to Yerma Jewelry, AMH Wholesale, and Creative Diamonds were for resale.

We can only conclude from the evidence that appellant has not carried its burden. The failure began with appellant's failure to maintain adequate records. As already stated, the evidence clearly shows that appellant grossly underreported its sales. Appellant admitted this at hearing. As a result, we cannot know what sales were reported. Furthermore, it is clear from the evidence that there are unreported taxable sales to purchasers other than Yerma Jewelry, AMH Wholesale, and Creative Diamonds. Finally, the evidence that appellant belatedly provided is not persuasive. The sales invoices cannot be verified because the alleged resale customers are no longer in business or, as in the case of Mr. Yermagyan, have inadequate records to confirm the alleged purchases. Without detailed information regarding the exact amounts of sales for resale that were made to those three purchasers and reported on the returns, we are unable to determine what portion of the tax liability is due to sales for resale to those three purchasers. Appellant has failed to prove that the Department's determination in wrong.

For several reasons, we must also decline appellant's invitation to reduce the measure of disallowed claimed sales for resale based on an estimate under the Cohan Rule. First, the Cohan Rule has an equitable foundation, and there is unrefuted evidence that appellant failed to report substantial taxable sales and no evidence, aside from placing blame on a former accountant who was not called as a witness, regarding how that happened. Also, we are not persuaded by the evidence that appellant is clearly entitled to an adjustment and that the only question is how much of an adjustment. Finally, we have no credible evidence upon which to rationally base an estimate.

For all of the aforementioned reasons, we conclude that appellant has not met its burden of proof to show that it is entitled to additional adjustments to the audit liability for disallowed claimed sales for resale.

Issue 2 – Was appellant negligent?

The Department imposed the negligence penalty for this, appellant's first, audit. Appellant argues that the penalty is not warranted because Mr. Cohan has had no formal training in bookkeeping or accounting and relied entirely upon his former accountant to comply with the Sales and Use Tax Law. It asserts that the accountant was the one at fault and that the problem has now been corrected by firing that accountant and hiring another.

R&TC section 6484 provides that if any part of the 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. As previously stated, a taxpayer must maintain and make available for examination on request by the Department 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 returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (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, subd. (b)(1).) Failure to maintain and keep complete and accurate records is evidence of negligence and may result in imposition of a negligence penalty. (Cal. Code Regs., tit. 18, § 1698, subd. (k).) A negligence penalty also can be based on reporting errors. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318.)

Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any 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. (Cal. Code Regs., tit. 18, § 1703, subd. (c)(3)(A).) Conversely, though, a negligence penalty should be upheld in a first audit if the understatement cannot be attributed to a bona fide and reasonable

belief that the bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. (*Ibid*.)

The grounds relied upon by the Department to impose the penalty are not entirely clear. However, we need only decide whether the Department satisfied its minimal burden of establishing a reasonable and rational basis for the penalty and, if it did, whether there is sufficient evidence to show that the penalty is not warranted. The evidence, already discussed above, shows that appellant did not maintain and provide records that were sufficient to establish its compliance with the Sales and Use Tax Law. In addition, the evidence shows that appellant substantially underreported its taxable sales. The Department's examination of sales invoices for the test period (1Q07) disclosed recorded taxable sales of $282,873, but appellant reported only $37,385 in taxable sales for that same period, or just over 13 percent of its actual taxable sales. We find that the Department has satisfied its burden of proof.

Here, appellant had not been previously audited. Mr. Cohan testified that he thought he was doing everything correctly and that he relied on his accountant to tell him if he was not. However, appellant did not call the former accountant as a witness, so there was no opportunity to explore that contention further. Regardless, the responsibility for maintaining adequate records rests entirely with appellant. Furthermore, in evaluating the issue of negligence, we are particularly influenced by the large error ratio for unreported taxable sales of 523 percent.[8] As stated above, taxable sales recorded on the sales invoices for 1Q07 were $232,873, while reported taxable sales for that same period were only $37,385. Appellant reported only a small fraction of the taxable sales that were recorded on its sales invoices. At a minimum, appellant should have been able to report all, or almost all, of the taxable sales that were recorded on its own sales invoices, and appellant has not provided any explanation as to why it failed to report such a large portion of the taxable sales recorded on its own sales invoices. We find that the lack of records and the large error ratio for unreported taxable sales cannot be attributed to appellant's bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. Thus, we find that appellant was negligent, and the Department correctly imposed the negligence penalty.

[8] We note that in the D&R, the Department incorrectly calculated an error ratio of 84 percent.

HOLDINGS

1. Adjustments to the measure of disallowed claimed sales for resale are not warranted.

2. The Department correctly imposed the negligence penalty.

DISPOSITION

The Department's action in reducing the measure of tax to $14,275,351, reducing the amount of the negligence penalty accordingly, and otherwise denying appellant's petition for redetermination is sustained.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Kenneth Gast
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Date Issued: 1/13/2020