OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18073484
	) CDTFA Case ID: 816491
DESIGN HOME CENTER, INC.	) CDTFA Acct. No. 101-315090
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Carlos Chait, E.A. Victor Ceballos, President
For Respondent:	Scott A. Lambert, Hearing Representative Lisa Renati, Hearing Representative Christopher Brooks, Tax Counsel IV
For Office of Tax Appeals:	Deborah Cumins, Business Tax Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Design Home Center, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] in response to appellant's timely petition for redetermination of a Notice of Determination (NOD), which is for $91,136.15 of additional tax, a negligence penalty of $9,113.59, and applicable interest, for the period July 1, 2010, through June 30, 2013.

Office of Tax Appeals Administrative Law Judges Andrew J. Kwee, Richard I. Tay, and Jeffrey G. Angeja held an oral hearing for this matter in Van Nuys, California, on October 28, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] Sales taxes were formerly administered by the State Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

ISSUES

1. Whether further adjustments are warranted to the measure of underreported taxable sales.
2. Whether the understatement was the result of negligence.

FACTUAL FINDINGS

1. Appellant has operated a retail furniture store in the City of San Fernando since November 2, 2009.
2. CDTFA conducted an audit of the business for the period July 1, 2010, through June 30, 2013 (audit period).
3. For the audit period, appellant reported total and taxable sales of $523,682 (claiming no deductions).
4. For the audit, appellant provided federal income tax returns (FITR's) for 2010, 2011, and 2012, sales and use tax returns (SUTR's), and some purchase invoices. CDTFA also obtained appellant's 1099-K forms[2] for 2011 and 2012.
5. CDTFA found substantial differences between the gross receipts that appellant reported on its FITR's and total sales reported on its SUTR's for the years 2011 and 2012, which CDTFA determined were additional taxable sales. CDTFA computed that the understatements for 2011 and 2012 combined reflected an understatement of 191.40 percent, and it applied that percentage to reported taxable sales to compute the understatement for the third quarter 2010 (3Q10), 4Q10, 1Q13 and 2Q13.
6. To evaluate the reasonableness of the audit findings, CDTFA computed taxable sales using the mark-up method. CDTFA compared costs and selling prices provided by appellant for 85 items it sold in the regular course of business to compute a mark-up of 39.40 percent. CDTFA added that mark-up to the costs of goods sold reported on FITR's for 2011 and 2012 to compute total sales, which it compared to reported amounts to compute percentages of error of 210.743 percent for 2011, 206.435 percent for 2012 and 208.317 percent for the two years combined. CDTFA applied those percentages to reported amounts (using 208.317 percent for 3Q10, 4Q10, 1Q13, and 2Q13) to compute an understatement of $1,090,922. That understatement was comparable to, but somewhat

[2] Federal Form 1099-K, "Payment Card and Third-Party Network Transactions," is a form used by credit card companies and third-party processors (payment settlement agencies) to report the gross amount of reportable payments made to the taxpayer by the payment settlement agency.

greater than the understatement established in the audit of $1,002,321 (which was reduced to $917,172 in the reaudit, described below).

7. CDTFA also compared the amounts of credit card receipts from 1099-K statements, to the amounts of gross receipts reported on the FITR's for 2011 and 2012. For 2011, reported gross receipts of $414,436 were slightly less than credit card receipts shown on 1099-K statements of $414,787. For 2012, reported gross receipts of $572,514 were only $48,936 more than credit card receipts of $523,578 (in other words, credit card receipts for 2012 represented 91.5 percent of gross receipts reported on the FITR).
8. On April 10, 2014, CDTFA issued the above-described NOD, and on May 5, 2014, appellant filed a timely petition for redetermination. After filing the petition, appellant provided the FITR for 2013 and a profit and loss statement (P&L) for 2010.
9. CDTFA conducted a reaudit in which it used the difference between gross receipts on the 2013 FITR and total sales on SUTR's for 2013, $241,005, to establish the understatements of $60,251 ($241,005 ÷ 4) for each of the first two quarters of that year. CDTFA found that no adjustment was warranted to the audited understatement for 2010 because the audited understatement of $148,414 for 3Q10 and 4Q10 was slightly less than the difference between the P&L and reported taxable sales for that period of $148,782 ($297,564 ÷ 2).
10. On August 13, 2015, CDTFA issued a reaudit report, reducing the tax liability from $91,136.15 to $83,472.76 and the penalty from $9,113.59 to $8,347.28.
11. CDTFA issued a Decision on June 26, 2018, in which it made no further adjustments. This timely appeal followed.

DISCUSSION

Issue 1. Whether further adjustments are warranted to the measure of underreported taxable sales.

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, 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.)

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(b)(1).)

When 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. (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.) 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. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid*.; see also *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Appellant provided limited records for audit. In addition, gross receipts reported on FITR's exceeded reported total sales reported on appellant's sales and use tax returns by $266,441 for 2011; $381,815 for 2012; and $241,005 for 2013. Each of the foregoing factors is a sufficient reason to question the reliability of appellant's reported taxable sales. (R&TC, § 6481.) Accordingly, we find that CDTFA was justified in questioning the reliability of appellant's reported taxable sales, and computing appellant's taxable sales using an alternate audit method.

Here, CDTFA used the gross receipts reported in appellant's own FITR's to compute a measure of underreported taxable sales of $1,002,321 (reduced to $917,172 in the reaudit). Next, CDTFA tested the reasonableness of its determination using two different methods, a mark-up analysis and an analysis using appellant's forms 1099-K. Both tests supported the reasonableness of CDTFA determination of tax using appellant's FITR's. Accordingly, we conclude that CDTFA's determination was reasonable, rational, and based on appellant's own records. Thus, the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

On appeal, appellant first argues that the audited understatement should be reduced because of alleged flaws in the mark-up audit approach. Specifically, appellant offers an unsupported assertion that the mark-up audit approach is not accepted in Tax Court (presumably a

reference to appeals of federal income tax liability) and argues that a mark-up computed for one period cannot reasonably be applied to other periods. Appellant also argues that the auditor used the price shown on the tag attached to furniture in the shelf test, while the final sale price is often lower, thus computing an excessive mark-up.

We note that the audit was not conducted on a mark-up basis. CDTFA used the mark-up method for the sole purpose of evaluating the reasonableness of the audit findings, and appellant's contentions regarding the mark-up analysis are irrelevant to CDTFA's determination that was based on a comparison of appellant's FITR's with its sales tax returns. Accordingly, we decline to further address this contention.

Second, appellant argues that the revenue shown in the forms 1099-K reflects the collection of accounts receivable, rather than sales revenue. At the hearing, appellant provided several aged account receivables purporting to show sales by La Fiesta Home Center (La Fiesta)[3] that occurred during the audit period, and a La Fiesta accounts receivable balance.

We first observe that appellant provided no evidence that accounts receivable balances were paid via credit cards, nor has appellant provided evidence to corroborate that it purchased any accounts receivable from La Fiesta. Absent corroborating evidence, we are not persuaded by appellant's testimony.

Second, appellant's P&L's segregate recorded income into retail cash sales ($157,227 for 2011 and $251,585 for 2012) and retail credit card sales ($299,713 for 2011 and $329,326 for 2012). The descriptions of these entries certainly appear to represent sales made by appellant. We would expect amounts collected from La Fiesta's accounts receivable to be separately stated, and described as "other income" or some similar terminology. In its opening brief, appellant states that it had "very unreliable accounting records, because they were amateurish done in-house," and such self-described unreliability could include errors in the description of types of income. However, appellant has provided no evidence that the amounts of sales recorded in its P&L's and reported on its FITR's include collections of La Fiesta's accounts receivable. Also, we note that the amounts shown on the Reports of Sale for La Fiesta ($138,452 for 2011 and $323,535 for 2012) do not correspond to specific figures on the P&L's for Design Home Center, Inc. Moreover, as noted above, appellant's credit card receipts exceeded reported gross receipts

[3] It appears appellant may have referred to "Fiesta Furniture" and "La Fiesta Home Center" interchangeably. The documents submitted on the day of the oral hearing are titled "Fiesta Furniture."

for 2011 and represented 91.5 percent of reported gross receipts for 2012. Considering the lack of any contemporaneous corroborating evidence, such as source documents, we find that appellant failed to meet its burden to establish error with the NOD on the basis that La Fiesta's accounts receivable payments were allegedly included in the gross receipts reported on appellant's FITR's.

Thus, based on the available evidence, we find there is no basis to reduce the audited understatement of reported taxable sales.

Issue 2. Whether the understatement was the result of negligence.

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.

Taxpayers are required to maintain and make available for examination on request by CDTFA, or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of the sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, will be considered evidence of negligence and may result in the imposition of penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to determinations associated with the first audit of a taxpayer. (Cal. Code Regs, tit. 18, § 1703(c)(3)(A); also see *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.) However, 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.*)

CDTFA imposed the negligence penalty because appellant substantially understated its reported taxable sales and because it failed to provide complete records for audit. On appeal, appellant has not specifically addressed the negligence penalty.

Here, the amount of unreported taxable sales of $917,172 represents an error rate of 175 percent (rounded). Stated differently, appellant reported slightly more than one-third of its taxable sales ($523,682 reported ÷ $1,440,854[4] audited taxable sales = 36 percent). That substantial level of understatement is strong evidence of negligence. Further, the amounts of gross receipts reported on FITR's consistently exceeded total sales reported on SUTR's, with a total difference of $899,261 for the years 2011 through 2013. In addition, credit card receipts exceeded reported total sales by $599,671 for 2011 and 2012 combined.

We find that any businessperson, even one who may not be sophisticated in accounting and legal matters, would recognize these broad discrepancies. Specifically, we would expect appellant to notice that it was reporting significantly more on its FITR's than it was reporting on SUTR's (a total of almost $1 million for the audit period). In addition, the only accounting records provided for audit were a P&L for 2010,[5] and appellant provided almost no source documents (only some purchase invoices, no sales invoices or other sales-related source documents). Accordingly, we find that the evidence supports a finding of negligence in reporting and negligence in recordkeeping. Further, we find that appellant's own records establish that the understatement cannot be attributed to a bona fide and reasonable belief that appellant's bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. Therefore, the penalty was properly applied.

[4] $523,682 reported + $917,172 understatement = $1,440,854.

[5] The P&L's for other years, discussed above, were provided with appellant's opening brief.

HOLDINGS

1. No further adjustment is warranted to the measure of underreported taxable sales.
2. The understatement was the result of negligence, and the penalty was properly applied.

DISPOSITION

CDTFA's decision to reduce the tax and penalty to $83,472.76 and $8,347.28, respectively, and to otherwise deny the petition, is sustained.

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
F8E81582726E448...
Richard I. Tay
Administrative Law Judge

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