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2020 – OTA – 266
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. LOPEZ, dba El Sol Market**	) OTA Case No. 19014202) CDTFA Account No. 101-552279) CDTFA Case ID 935305

OPINION

Representing the Parties:

For Appellant: Butch Kruse, Representative

For Respondent: Jason Parker, Chief, Headquarters Operations Bureau

For Office of Tax Appeals: Lisa Burke, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, J. Lopez (appellant) appeals a decision issued by the respondent California Department of Tax and Fee Administration (CDTFA)[1] denying, in part, appellant's petition for redetermination of the Notice of Determination (NOD) issued on January 26, 2016. The NOD assessed a liability of $106,411.62, plus accrued interest, and a negligence penalty of $10,641.17 for the period July 1, 2011, through September 30, 2014 (audit period). On appeal, CDTFA made several adjustments that resulted in a reduction of $169,964 to the amount of unreported taxable sales, from $1,239,941 to $1,069,977. The reduction to the audited taxable measure represents a reduction to the liability from $106,411.62 to approximately $91,754.00, and a corresponding reduction to the negligence penalty.

Appellant waived his right to an oral hearing; therefore, the matter is being decided based on the written record.

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[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). On July 1, 2017, functions of the BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA

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ISSUES

1. Whether any additional reduction to the amount of unreported taxable sales is warranted.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant owned and operated El Sol Market from March 15, 2010, through September 30, 2014. Appellant purchased the market from his brother and sold it back to his brother. He sold cold and hot food products, tobacco, beer, carbonated beverages, and miscellaneous taxable merchandise.
2. During the audit period, appellant reported total sales of $1,336,803 and claimed deductions for exempt sales of food products, sales tax reimbursement included in reported total sales, and "other" nontaxable sales (lotto and phone cards), which resulted in reported taxable sales of $197,618.
3. On audit, appellant provided his federal income tax returns for 2011, 2012, and 2013; sales reports for the audit period (except for the period January 1, 2012, through June 30, 2012); merchandise purchase invoices for the third quarter of 2012 (3Q12); and sales and use tax returns, bank statements, and merchant statements for the audit period. CDTFA compared the gross receipts reported on appellant's income tax returns with the reported costs of goods sold, and computed book markups of 132 percent for 2011, 138 percent for 2012, and 45 percent for 2013.[2] CDTFA determined that further investigation was warranted because the book markups were inconsistent.
4. CDTFA used the merchandise purchase invoices that appellant provided for 3Q12 to determine that 55.36 percent of appellant's purchases were of taxable merchandise. CDTFA then multiplied appellant's reported costs of goods sold for each year by 55.36 percent to compute costs of taxable merchandise sold. CDTFA compared those amounts with appellant's reported taxable sales to compute book markups for taxable merchandise of -64.40 percent for 2011, -53.22 percent for 2012, and -62.84 percent for

[2] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $.70 and it charges customers $1.00, the markup is $.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = .42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (.30 ÷ 1.00 = .3).

2013.[3] CDTFA also noted that the recorded merchandise purchases of $128,670 for 3Q12 exceeded appellant's reported costs of goods sold of $113,210 for the entire year of 2012. Since appellant's reported costs of taxable merchandise sold substantially exceeded his reported taxable sales, CDTFA concluded that appellant had substantially understated his reported taxable sales.

5. CDTFA obtained appellant's purchase information from three of his main vendors, Pitco Foods, DBI Beverages, and Bottomley Distributing Company, and computed total merchandise purchases of $1,215,621 for the period July 1, 2011, through December 31, 2013. CDTFA reduced total merchandise purchases by 1 percent to allow for pilferage. Then CDTFA applied the taxable merchandise purchase ratio of 55.36 percent to compute costs of taxable merchandise sold of $666,281.

6. Because appellant had sold the business before the audit was conducted, CDTFA was unable to observe appellant's sales and calculate his average markup for taxable merchandise. Therefore, based on its experience in auditing similar markets in the neighboring area, CDTFA decided to rely on an average markup of 26.48 percent. CDTFA added the markup of 26.48 percent to costs of taxable merchandise sold of $666,281 to establish audited taxable sales of $842,713 for the period July 1, 2011, through December 31, 2013. Audited taxable sales exceeded appellant's reported taxable sales for that period by $726,867, which represented a reporting error rate of 627.44 percent. CDTFA established unreported taxable sales of $1,239,941 for the audit period using the reporting error rate.

7. On January 26, 2016, CDTFA issued the NOD to appellant based on unreported taxable sales of $1,239,941. CDTFA added the negligence penalty to the determination because the records were inadequate, and the reporting error rate of 627.44 percent was egregious.

8. Appellant filed a petition for redetermination. CDTFA made adjustments in the computation of the costs of taxable merchandise sold. The adjustments resulted in a reduction to the amount of unreported taxable sales, from $1,239,941 to $1,069,977.[4]

[3] Negative book markups indicate that costs of merchandise are greater than the reported sales of that merchandise.

[4] After adjustments, the reporting error rate was 541 percent.

9. CDTFA Appeals Bureau concluded that the amount of unreported taxable sales should be reduced to $1,069,977, as conceded by CDTFA, and otherwise denied the petition.
10. This timely appeal followed.

DISCUSSION

Issue 1: Whether an additional reduction to the amount of unreported taxable sales is 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, 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.) Although gross receipts from the sale 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. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).) It is the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When CDTFA 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. (R&TC, § 6481.) 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.) That means that the taxpayer must prove both (1) the tax assessment is incorrect, and (2) the correct 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.)

Here, appellant failed to provide source documentation to support what he reported. CDTFA found that appellant's reported costs of taxable merchandise sold substantially exceeded his reported taxable sales, which constitutes strong evidence that the reported taxable sales were

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substantially understated. As such, we find that CDTFA was reasonable in using an indirect audit method to establish audited taxable sales. CDTFA also found that appellant's recorded merchandise purchases for 3Q12 exceeded his reported costs of goods sold for the entire year. We, therefore, find that CDTFA was justified in surveying appellant's vendors to obtain reliable purchase information for establishing audited costs of taxable merchandise sold. We have examined the revised audit work papers and have found no errors in the audit procedures or in the computations. Thus, the burden of proof shifts to appellant to establish by documentation or other evidence that an additional reduction to the amount of audited taxable sales is warranted.

Appellant contends that CDTFA's inclusion of taxable merchandise purchases from Pitco Foods should be deleted from the audit computations. According to appellant, he did not provide a valid resale certificate to Pitco Foods until September 12, 2014, and therefore, the purchases shown in the Customer Sales History Report provided by Pitco Foods for periods prior to that date are invalid. Appellant provided purchase information from Pitco Foods for the period September 15, 2014, through October 8, 2014, showing merchandise purchases totaling $15,411, and claimed that those were his only merchandise purchases from Pitco Foods.

CDTFA argues that appellant purchased the merchandise from Pitco Foods for resale in the market because the customer identification number on the Customer Sales History Report was associated with the seller's permit held by appellant's brother, and Pitco Foods was not informed of the change in ownership until appellant opened a new account on September 12, 2014. CDTFA notes that the Customer Sales History Report it obtained from Pitco Foods shows appellant's business name and business address. CDTFA also notes that the Customer Sales History Report shows monthly merchandise purchases averaging $9,410 per month for periods prior to September 12, 2014, which is consistent with the amounts purchased by appellant after September 12, 2014. Therefore, CDTFA asserts that, regardless of the account used to make the purchases at issue, it was appellant who purchased the merchandise from Pitco Foods for resale in the market.

Since the average monthly sales on the Pitco Foods Customer Sales History report was consistent with appellant's 3Q12 Pitco Food purchases, the brother's seller's permit was closed during the audit period, and no other business operated under appellant's business name or at the business address, we find that appellant made the purchases shown in the Pitco Foods Customer Sales History Report and resold the merchandise he purchased. Therefore, we conclude that the

merchandise purchases from Pitco Foods were properly included in the computation of the audited costs of taxable merchandise sold.

Appellant has provided no documentation or other evidence from which a more accurate determination may be made. Therefore, we conclude that no additional reduction to the amount of unreported taxable sales is warranted.

Issue 2: Whether appellant was negligent.

R&TC section 6484 provides for the imposition of a 10-percent penalty if any part of the deficiency for which a deficiency determination is made was due to negligence or intentional disregard of the law or authorized rules and regulations. The taxpayer is required to maintain and make available to CDTFA for examination 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, is considered evidence of negligence and may result in the imposition of penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

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

CDTFA argues that the negligence penalty was properly imposed because the books and records provided for examination were inadequate, and the magnitude of the understatement was egregious. Appellant argues that the negligence penalty should be deleted because this was his first audit. He further argues that any shortcomings in record retention were not the result of

negligence or intentional disregard, rather, he claims that he did not fully understand the reporting requirements because English is his second language.

The records provided for examination were not sufficient to support the accuracy of appellant's reported amounts.[5] The purchase information obtained from appellant's vendors revealed that appellant had failed to maintain many of his merchandise purchase invoices. The vendor records also show that appellant substantially understated the costs of goods sold reported on his tax returns. Thus, we find that the inaccuracy of the records provided for examination cannot be attributed to appellant's failure to fully understand recordkeeping requirements and must be attributed to negligence.

CDTFA found that the costs of the taxable merchandise that appellant purchased for resale substantially exceeded appellant's reported taxable sales. We find that appellant's failure to notice that his reported taxable sales were significantly less than his costs of taxable merchandise sold, or take any remedial measures, is strong evidence of negligence.[6] We compute that appellant reported less than 16 percent of his taxable sales ($197,618 ÷ ($197,618 + $1,069,977.) Given the magnitude of the understatement, we find that appellant was negligent in reporting.

We find that appellant's bookkeeping and reporting errors cannot be attributed to appellant's good faith and reasonable belief that his bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. Therefore, we conclude that appellant was negligent, and the negligence penalty was properly imposed even though this was appellant's first audit.

[5] Appellant provided his federal income tax returns, bank statements, sales summary reports, and some merchandise purchase invoices, but he failed to provide source documents showing his sales, such as cash register Z-tapes, and purchase journals.

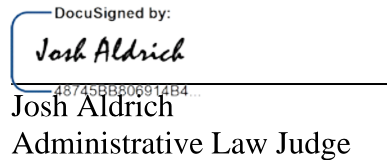
[6] A comparison of unreported taxable sales of $1,069,977 with appellant's reported taxable sales of $197,618 for the audit period shows a reporting error rate of 541 percent, which is egregious.

HOLDINGS

1. Appellant failed to establish that any additional adjustments to the amount of unreported taxable sales are warranted.
2. The underreporting was due to negligence.

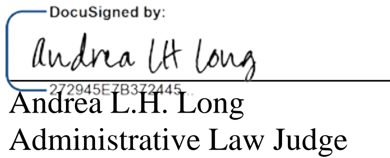
DISPOSITION

CDTFA's action in reducing the audited taxable measure from $1,239,941 to $1,069,977 and otherwise denying the petition for redetermination is sustained.

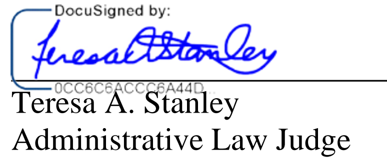


Josh Aldrich
Administrative Law Judge

We concur:



Andrea L.H. Long
Administrative Law Judge



Teresa A. Stanley
Administrative Law Judge

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