OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011947
	) CDTFA Account No. 101-251205
POH CORPORATION	) CDTFA Case ID 855907
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Reza Azizi, Enrolled Agent
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, POH Corporation (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) for a tax liability of $216,249.33, plus accrued interest, and a negligence penalty of $21,624.90 for the period July 1, 2010, through March 31, 2014 (audit period).

The NOD is based on an aggregate audit deficiency measure of $2,376,403, consisting of unreported taxable sales of $1,095,739 and disallowed claimed nontaxable sales for resale of $1,280,664. During the appeal before OTA, CDTFA performed a reaudit and reduced the aggregate taxable measure by $166,124, from $2,376,403 to $2,210,279.[2]

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of 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 BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

[2] CDTFA issued a letter to appellant dated June 16, 2020 indicating that the aggregate taxable measure was reduced from $2,376,403. CDTFA included a copy of the audit workpapers showing that upon reaudit the aggregate taxable measure is $2,210,276. We attribute the difference to rounding within the audit workpapers.

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

ISSUES

1. Whether appellant has shown that further adjustments to the measure of unreported taxable sales are warranted.
2. Whether appellant has shown that further adjustments to the measure of disallowed claimed nontaxable sales for resale are warranted.
3. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant operated a retail furniture store in Agoura Hills, California, from February 19, 2009, through March 31, 2014. During the audit period, appellant reported total sales of $2,861,405, claimed nontaxable sales for resale of $1,696,468, and taxable sales of $1,066,710.[3]
2. Appellant did not provide a complete set of books and records for the audit. Appellant only provided federal income tax returns for 2010 and 2011; bank statements for the third quarter of 2010 (3Q10) through 2Q13;[4] and sales invoices for 3Q11 and 1Q13.
3. Upon audit, CDTFA compared the bank deposits recorded on appellant's bank statements for the period 3Q10 through 2Q13 to the total sales that appellant reported on its sales and use tax returns for that period and found excess bank deposits of $1,051,394. CDTFA made adjustments to exclude sales tax reimbursement included in the excess bank deposits for each quarter and found unreported taxable sales of $964,915 for the period 3Q10 through 2Q13.
4. CDTFA compared appellant's unreported taxable sales of $964,915 for the period 3Q10 through 2Q13 to appellant's reported taxable sales for the period 3Q10 through 2Q13 and found an error rate of 39.65 percent. CDTFA applied the 39.65 percent error rate to

[3] Appellant also claimed deductions for sales tax reimbursement included in gross receipts, which are not at issue in this appeal.

[4] CDTFA states that during the reaudit, it found that a bank statement was missing for the month of June 2011, and no entry was included in the bank deposit analysis for that month.

appellant's reported taxable sales for the period 3Q13 through 1Q14 and calculated unreported taxable sales of $130,823 for that period.

5. In total CDTFA calculated unreported taxable sales of $1,095,739 ($964,915 + $130,823) (rounded) for the audit period.

6. CDTFA performed a block test of the periods 3Q11 and 1Q13 to verify appellant's claimed nontaxable sales. During these two quarters, appellant claimed nontaxable sales for resale of $224,577. Appellant did not provide any resale certificates to support its claimed deductions. Appellant also declined to send "XYZ letters" to its customers.[5] CDTFA allowed appellant's claimed sales for resale to customers that held valid seller's permits and reported taxable sales on their sales and use tax returns. CDTFA disallowed the remaining claimed nontaxable sales totaling $169,531 and found an error rate of 75.49 percent for 3Q11 and 1Q13. CDTFA applied the 75.49 percent error rate to appellant's total claimed nontaxable sales for resale for the audit period to calculate disallowed claimed nontaxable sales for resale of $1,280,664 for the audit period.

7. On October 27, 2014, CDTFA issued the aforementioned NOD for the underreporting disclosed by the audit. Appellant filed a timely petition for redetermination, which CDTFA denied. This timely appeal to OTA followed.

8. In a letter dated July 14, 2020, CDTFA explained that it had performed a reaudit based on the finding that appellant sublet a portion of its business location and that some of appellant's bank deposits were attributable to nontaxable rental income, which was received in cash, rather than unreported taxable sales. CDTFA found that the following adjustments were warranted:

    - A reduction to the measure of unreported taxable sales of $142,299 based on CDTFA's determination that appellant made 20 bank deposits of $7,180 each during the period January 12, 2011 through March 12, 2013, which were attributable to rental income.[6]

[5] XYZ letters are letters in a form approved by CDTFA which are sent to some or all of a seller's purchasers inquiring as to the purchasers' disposition of the property purchased from the seller. (Cal. Code Regs., tit. 18, § 1668(f).)

[6] On appeal, appellant provided a sublease agreement that commenced on February 23, 2009, and continued for the later of 24 months after the effective date or the expiration of the last sublease. The initial 24-month period ended on February 23, 2011. Appellant did not provide any evidence that the sublease was extended. However,

- An increase to the total bank deposits of $121,536 to account for one month during the bank deposit analysis period (June 2011) for which appellant did not provide a bank statement and CDTFA did not estimate a bank deposit amount in the original audit.
- A reduction of the error rate used to project appellant's unreported taxable sales from 39.65 percent to 36.16 percent.
- A reduction of the error rate used to calculate appellant's disallowed claimed sales for resale from 75.49 percent to 71.39 percent.

In total, CDTFA's reaudit reflects CDTFA's determination that the taxable measure should be reduced by $166,124, from $2,376,402 to $2,210,279.[7]

DISCUSSION

Issue 1: Whether appellant has shown that further adjustments to the measure of unreported taxable sales are warranted.

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.)

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. (*Appeal of Talavera*, 2020-OTA-022P.) 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. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

CDTFA states that it was able to contact the sublessee and verify that the sublease continued beyond the initial 24-month period.

[7] Appellant was given an opportunity to respond to CDTFA's reaudit. On September 16, 2020, we issued a letter to appellant stating that we did not receive a response and the deadline to file an additional brief had passed.

Here, appellant did not provide a complete set of books and records. Instead, appellant only provided bank statements and sales invoices for portions of the audit period, which show a discrepancy between appellant's bank deposits and appellant's reported taxable sales. Appellant was unable to provide documentation to explain the discrepancy. Therefore, we find that it was reasonable and rational for CDTFA to calculate an error ratio from appellant's bank statements to project appellant's unreported taxable sales. Therefore, the burden shifts to appellant to demonstrate that reductions are warranted.

On appeal, appellant asserts that the taxable measure should be reduced because CDTFA's bank deposit analysis includes nontaxable rental income in the audited taxable sales. Appellant also asserts that the taxable measure is based on estimates and should be reduced.

As noted above, CDTFA performed a reaudit and found that appellant did indeed make 20 cash bank deposits in the amount of $7,180 during the period 1Q11 through 2Q13. Appellant did not provide any evidence that these deposits were rental income. Indeed, appellant concedes that it did not have any invoices for its rental income. To the extent that appellant provided a sublease agreement, we find that it does not contain any monthly rental rate. As such, these cash deposits cannot be verified. Nevertheless, CDTFA attributes these deposits as rental income and reduced the taxable measure accordingly. CDTFA also recalculated the error rate used to project unreported taxable sales to account for rental income and reduced the taxable measure for the period 3Q13 through 1Q14.

Appellant has not provided any evidence that additional reductions to the taxable measure are warranted. Appellant's unsupported assertions are insufficient to satisfy its burden of proof. (*Appeal of Talavera*, 2020-OTA-022P.) Thus, based on the foregoing, we find that no further adjustments are warranted.

Issue 2: Whether appellant has shown that further adjustments to the measure of disallowed claimed nontaxable sales for resale are warranted.

A retailer's gross receipts received from the sale of tangible personal property are presumed to be taxable until proven otherwise, unless the retailer timely takes in good faith a certificate from the purchaser to the effect that the property is being purchased for resale (a resale certificate). (R&TC, § 6091.) If timely taken in proper form and in good faith from a person who is engaged in the business of selling tangible personal property and who holds a California seller's permit, the resale certificate relieves the seller from liability for the sales tax. (R&TC,

§§ 6901, 6092; Cal. Code Regs., tit. 18, § 1668(a).) If the seller does not timely obtain a resale certificate, the seller will be relieved of liability for the tax only where the seller shows: (1) that the purchaser in fact resold the property; (2) that the purchaser is holding the property for resale, and did not use make a taxable use of the property; or (3) that the purchaser consumed the property and reported or paid tax directly to CDTFA. (Cal. Code Regs., tit. 18, § 1668(e).)

A taxpayer bears the burden of proving entitlement to an exemption or exclusion and must provide some credible evidence of that entitlement. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442-443; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 35003(a); *Appeal of Estate of Gillespie,* 2018-OTA-052P.) 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.)

Here, appellant has not made any specific assertions with respect to the disallowed claimed sales for resale. Appellant merely asserts that the taxable measure is based on estimates and should be reduced. Appellant did not provide source documents (i.e., resale certificates) to support its claims. Appellant also did not provide any XYZ letter responses to support its claims. Appellant has not met its burden of proof. Thus, based on the foregoing, we find that no further adjustments are warranted.

Issue 3: Whether appellant was negligent.

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 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 will be considered evidence of negligence and may result in the imposition of penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

A negligence penalty may be upheld in a first audit if there is evidence that the understatement cannot be attributed to a good faith and reasonable belief that the bookkeeping and reporting practices were substantially compliant with the requirements of the Sales and Use Tax Law. (See Cal. Code Regs., tit. 18, § 1703(c)(3)(A).)

Here, appellant had not been previously audited. With respect to the recordkeeping requirement, there is no question that appellant failed to provide complete books and records. Appellant asserts that financial difficulties prevented it from providing complete books and records. However, even the records that appellant did provide were incomplete. For example, appellant did not provide a complete set of bank statements for the audit period. We find that appellant's failure to maintain or provide a complete set of books and records to be strong evidence of appellant's negligence.

As to the taxable measure, CDTFA calculated unreported taxable sales of $999,165 during the reaudit, which when compared to appellant's reported taxable sales of $1,066,710 represents an error ratio of 93.66 percent. Additionally, appellant claimed deductions totaling $1,696,468 for nontaxable sales for resale even though the customers purchasing the merchandise did not appear to be valid resellers. There is no evidence that appellant obtained resale certificates from these customers, and we note that appellant declined to send XYZ letters to its customers to obtain support for its claimed nontaxable sales. These facts are also evidence of negligence.

Appellant offers no explanation or support for why it failed to report its taxable sales or that its underreporting was due to a nonnegligent reason. Although this was the first audit of appellant, we find that the inadequacy of appellant's records, its failure to report substantial amounts of its total sales, and the fact that it claimed deductions for significant amounts of nontaxable sales with no support cannot be attributed to a good faith and reasonable belief that its bookkeeping and reporting practices were substantially compliant with the requirements of the Sales and Use Tax Law. Accordingly, we find that appellant was negligent and the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not established that an additional reduction to unreported taxable sales is warranted.
2. Appellant has not established that an additional reduction to the amount of disallowed claimed nontaxable sales for resale is warranted.
3. Appellant was negligent.

DISPOSITION

Reduce the taxable measure in accordance with CDTFA's reaudit. Otherwise CDTFA's action in denying the petition for redetermination is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:
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Andrew Wong
Administrative Law Judge

DocuSigned by:
Nguyen Dang
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Nguyen Dang
Administrative Law Judge

Date Issued: 10/21/2020