

ISSUES

1. Whether appellant's inventory costs, which CDTFA used to compute appellant's unreported taxable sales, should be reduced.
2. Whether appellant was negligent.

FACTUAL FINDINGS

Inventory Costs

1. Appellant operated a liquor store during the liability period.
2. CDTFA selected appellant's returns for audit. At the conclusion of its audit, CDTFA determined that (among other things) appellant underreported its taxable sales by \$326,552. CDTFA's determination is based on a comparison of appellant's reported taxable sales of \$2,722,164 to an audited amount of \$3,048,716, which CDTFA arrived at using a markup of cost analysis.⁴
3. Reduced to its simplest form, this analysis involved multiplying appellant's taxable inventory (i.e., inventory that is subject to tax when sold) costs by its markup factor on that inventory to compute taxable sales for the period under examination.⁵ Only the amount of appellant's inventory costs is at issue here.
4. To compute appellant's inventory costs for the liability period, CDTFA started by contacting appellant's 11 primary vendors to obtain information concerning the items and amounts purchased by appellant. Eight of these 11 vendors provided information for the entire liability period. The three exceptions were Pepsi Company, which provided information for all but the first two quarters of the liability period, and Southern Wine and Spirits and Trepcos West, both of which provided transaction information for only the last six quarters of the liability period. For these earlier periods in which no purchase information was provided, CDTFA estimated appellant's inventory purchases by using a quarterly average derived from the available information provided by each respective vendor.

⁴This analysis is described in detail in CDTFA's Audit Manual section 0407.10.

⁵A markup percentage is the difference between the cost and selling price of an item when compared to the cost of that item. A markup factor is the markup percentage plus 100 percent. For taxpayers that sell items with a variety of different markup percentages, CDTFA will compute a final markup percentage by taking an average of those individual item markup percentages which are then weighted in proportion to the amounts sold.

5. For each of these 11 vendors, CDTFA then reviewed invoices for a two-month period to determine the percentage of appellant's purchases that would be subject to tax when sold. CDTFA then applied this percentage to appellant's total inventory purchases from each vendor to compute appellant's taxable inventory costs.
6. CDTFA made many more adjustments before arriving at a final amount of \$2,466,000.58 for appellant's taxable inventory costs. These adjustments are not in dispute.

Negligence

7. CDTFA also found that appellant failed to report all its taxable cigarette rebates of \$84,154.
8. In total, CDTFA's audit disclosed that appellant failed to report 13.1 percent of its combined taxable sales and cigarette rebates ($[\$326,552 + \$84,154] \div [\$2,722,164 + \$326,552 + \$84,154]$).
9. CDTFA further determined that the records provided by appellant during the audit, namely, federal income tax returns for 2009, 2010, 2011, and 2012, sales and use tax returns, profit and loss statements for the liability period, a fixed assets schedule, bank statements, purchase invoices for October and November 2011, and cash register Z-tapes for the fourth quarter 2011, were incomplete and insufficient to support appellant's reported tax liability.⁶
10. Appellant was previously audited by CDTFA for a different period.
11. Based on the above facts, CDTFA concluded that the deficiencies in appellant's recordkeeping and reporting were due to negligence.

DISCUSSION

Issue 1 – Whether appellant's inventory costs, which CDTFA used to compute appellant's unreported taxable sales, should be reduced.

If 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.) The government's deficiency determinations for unpaid taxes are generally entitled to a

⁶Cash register Z-tapes are point-of-sale terminal summaries of transactions that were processed by that terminal.

presumption of correctness so long as they are supported by a minimal factual foundation. (Cf. *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawai'i 2011) 816 F.Supp.2d 941, 950 (*Schuman Aviation*); *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Therefore, unless the government's deficiency determination is arbitrary or without rational foundation, the taxpayer bears the burden of establishing that a different result is warranted. (Cf. *Schuman Aviation, supra*, at p. 950.)

The record shows that CDTFA's deficiency determination is based upon an established audit method and information obtained directly from appellant's vendors. Appellant does not contend otherwise. We find therefore, that CDTFA's determination was not arbitrary or irrational, and thus, appellant bears the burden of showing that its liability should be reduced.

For our consideration, appellant raises three contentions, which center on CDTFA's calculation of appellant's inventory purchases from several of its 11 primary vendors.

First, appellant asserts that CDTFA overstated appellant's purchase amounts from Southern Wine and Spirits, Crest Beverage, and Young's Market by \$47,287. Appellant did not offer any further explanation but provided what appears to be requests for purchase information which it had sent to these vendors. On these requests are handwritten purchase amounts that are less than what CDTFA had established during the audit. Presumably, appellant is attempting to demonstrate that it received information indicating lower purchase amounts for the liability period from these vendors. There is however no indication of who wrote those amounts or how they were computed. Appellant also failed to provide any evidence that could verify the credibility of these amounts (e.g., purchase invoices or account statements), and thus, appellant has not shown that an adjustment is warranted on this basis.

Second, appellant argues that CDTFA's audit fails to account for an additional \$45,466 in nontaxable purchases from Trepro West. Appellant provided Trepro West invoices for October 2011 through December 2011, in which it highlighted various nontaxable food item purchases. Appellant did not elaborate further upon its argument and it is unclear how appellant arrived at this figure. In determining appellant's taxable inventory costs, CDTFA established a taxable purchase percentage by examining Trepro West invoices for October 2011 and November 2011 (test period), and then applying that percentage against all of appellant's purchases from Trepro West for the entire liability period. The *December* 2011 invoices were not included in the test period; therefore, they are irrelevant to appellant's position. While CDTFA did examine

invoices for October 2011 and November 2011, the audit working papers clearly show that CDTFA did not include nontaxable food items in computing appellant's taxable purchase percentage for Trepcos West. Appellant has not shown that CDTFA failed to exclude any of the highlighted items on the Trepcos West invoices for October and November 2011. Therefore, we must reject this contention.

Finally, regarding its purchases from Pepsi Company, Southern Wine and Spirits and Trepcos West, appellant contends that CDTFA's method of averaging purchases from a later period to estimate appellant's purchases for an earlier period fails to account for rising inventory prices during the liability period. As a result, appellant asserts that its total taxable inventory cost of \$2,466,000.58 should be reduced by 2 percent. Appellant did not provide any invoices from this earlier period or other evidence to support that a price increase had occurred. Further, appellant did not articulate how a price increase from three vendors would merit a 2 percent adjustment to appellant's total taxable inventory costs from all its vendors. Given the lack of evidentiary support, we are again forced to conclude that no adjustment is warranted.

Issue 2 – Whether appellant was negligent.

A penalty of 10 percent of the amount of the tax specified in the determination shall be added to deficiency determinations if any part of the deficiency for which the determination is imposed is due to negligence. (R&TC, § 6484; Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) The failure to maintain and keep complete and accurate records is evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k).) Negligence has also been found where the taxpayer could not have held a bona fide and reasonable belief that it had accurately reported its taxable sales. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323-324 [holding that taxpayer could not have held a good-faith belief that its sales were nontaxable when it was previously informed otherwise by CDTFA in a prior audit].)

While negligence is not expressly defined in the Sales and Use Tax Law, CDTFA's Audit Manual section 0506.10 defines negligence as the failure to exercise the care that a reasonable and prudent person would exercise under similar circumstances.⁷ This interpretation is

⁷ CDTFA's Audit Manual summarizes CDTFA's audit policies and procedures. It is a useful resource that we look to for guidance in interpreting the law. However, the Audit Manual is not binding legal authority and we exercise our own independent judgment in determining the weight, if any, to afford CDTFA's construction of the law as set forth in the Audit Manual. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25.)

consistent with the above examples and the standard for negligence as applied in a broader tax context, and thus, we find it to be persuasive here. (See, e.g., *Marcello v. Commissioner* (5th Cir. 1967) 380 F.2d 499, 506 [holding that for federal income tax purposes, “[n]egligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances”].)

There are several facts indicating that appellant was negligent. Appellant failed to report 13.1 percent of its taxable transactions or \$410,706 in absolute terms. This is a significant amount and one which would not ordinarily escape notice by a person exercising due care in recordkeeping and reporting. It is also notable that appellant failed to report *any* of its \$84,154 in taxable cigarette rebates. We believe it was incumbent upon appellant, as a reasonable and ordinarily prudent person, to make a good-faith effort to determine the proper tax treatment of its cigarette rebates. Appellant did not provide any evidence to show that its underreporting was due to a non-negligent reason, or to support that its failure to report its cigarette rebates was based upon a reasonably informed belief that those rebates were not subject to tax. Moreover, appellant’s recordkeeping was plainly deficient. During CDTF’s audit, appellant provided cash register Z-tapes for only a single quarter of the liability period. Appellant provided no other detailed records of its sales or tax accrual from which its tax liability might be properly computed.

Based on the foregoing, we find that appellant was negligent.

HOLDINGS

1. No reduction to appellant’s inventory costs is warranted.
2. Appellant was negligent.

DISPOSITION

We sustain CDTFA’s action to reduce the tax liability to \$34,435 and the negligence penalty to \$3,443.55, and to otherwise deny the Petition.

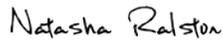
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 Administrative Law Judge

We concur:

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 Natasha Ralston
 Administrative Law Judge

Date Issued: 11/16/2020