OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19064891) CDTFA Case ID: 150-105
R. CUSIMANO AND **D. CUSIMANO** **dba Deseo**	))))

OPINION

Representing the Parties:

For Appellant:	D. Cusimano, Co-owner
For Respondent:	Jason Parker, Chief, Headquarters Operations Bureau
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, R. Cusimano and D. Cusimano (appellant[1]) appeals a decision issued by California Department of Tax and Fee Administration (respondent) denying appellant's petition for redetermination of a Notice of Determination (NOD) for $76,682.55 in tax, a negligence penalty of $7,668.31, and applicable interest for the period April 1, 2010, through March 31, 2013 (liability period).[2]

We decide the matter on the basis of the written record because appellant waived its right to an oral hearing.

[1] Respondent asserts the liability that is the subject of this appeal against the partnership of R. Cusimano and D. Cusimano. In this Opinion, we will refer to that partnership in the singular form.

[2] Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of BOE relevant to this case to respondent. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to the Office of Tax Appeals effective January 1, 2018.) When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

ISSUES

1. Is appellant liable for taxes, interest, and penalties incurred under its seller's permit for the liability period?
2. Are adjustments to the audited measure of unreported taxable sales warranted?
3. Did respondent correctly impose the negligence penalty?

FACTUAL FINDINGS

1. Appellant's co-owner, D. Cusimano, held a seller's permit as a sole proprietor for the operation of a restaurant in San Jose from December 1, 1987, through February 17, 2005.
2. On January 29, 1997, R. Cusimano and D. Cusimano filed articles of incorporation for Palermos Ristorante Italiano, Inc. (PRI), with the California Secretary of State.
3. Appellant held a seller's permit as a husband-wife partnership for the operation of a restaurant from September 1, 2005, through October 24, 2009, and for the operation of an antique store from September 1, 2000, through December 31, 2001. Appellant's co-owners and four others were members of a limited liability company that held a seller's permit for the operation of a restaurant from December 1, 1994, through March 31, 1996. Appellant, one or both of its co-owners, or PRI (and possibly others) also operated a restaurant named Deseo in Gilroy, from July 10, 2011, through May 31, 2012. Appellant's co-owner R. Cusimano (and possibly others) also owned and operated a restaurant located in San Jose during an unknown length of time that included 2011.
4. On August 1, 2008, appellant applied for a seller's permit to operate a restaurant and bar at 851 Main Street in Redwood City. The application identifies appellant as the owner intending to do business under the fictitious name "Deseo." The application does not indicate that it was filed on behalf of a corporation.
5. Appellant applied for and received a business license from the City of Redwood City to operate the restaurant and bar at 849-851 Main Street. The information obtained from Redwood City indicates that the business was opened on August 1, 2008, that the business operated under appellant's seller's permit (identified by number), that the business license was renewed annually throughout (and beyond) the liability period, that appellant was the owner, and that appellant was doing business as (dba) "Deseo/Palermo."

6. Respondent audited appellant for the liability period. For the audit, appellant provided federal income tax returns (FITRs) for 2011 and 2012;[3] bank statements for June 1, 2014, through September 30, 2014 (months that are not part of the liability period);[4] some merchandise purchase invoices for January 1, 2013, through March 31, 2013 (1Q13); and several menus for the restaurant and lounge. Appellant also provided information regarding the bar's operations by completing a questionnaire, Form BOE-1311-B (Bar Fact Sheet), on October 16, 2014. The file also contains bank statements for 2Q13 for an account in the name of appellant, dba Deseo, and bank statements for January and February 2016 in the name of R. Cusimano, dba Deseo. Appellant did not provide any other documentation for the liability period.

7. Respondent found that gross receipts reported on the FITRs exceeded total sales reported on the sales and use tax returns (SUTRs) by $478,128 for 2011 and $388,909 for 2012. Respondent also found that appellant's average monthly bank deposits of $30,395[5] significantly exceeded the average monthly taxable sales of $5,351 reported on appellant's SUTRs for the liability period. These findings indicated underreporting of taxable sales.

8. According to respondent, typical markups for a restaurant and bar comparable to the one at issue are in the range of 350 percent to 450 percent. Respondent used taxable sales reported on appellant's SUTRs and the cost of goods sold (COGS) reported on appellant's FITRs to compute book markups of -56.62 percent for 2011, and -69.18 percent for 2012.[6] These negative book markups, if accurate, would mean that appellant was charging its customers less for food and beverages than it cost appellant to purchase

[3] The provided 2011 return is not in evidence, but is our understanding that appellant provided FITRs that had been filed on behalf of PRI and represented that the reported amounts pertain to the business at issue.

[4] We do not have copies of the bank statements that respondent scheduled in the audit.

[5] Respondent computed this amount from the bank statements appellant provided during the audit, which were for June 1, 2014, through September 30, 2014.

[6] "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 $0.70 and it charges customers $1.00, the markup is $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (0.30 ÷ 0.70 = 0.42857). 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 (0.30 ÷ 1.00 = 0.30).

those items. This finding suggested to respondent that appellant was underreporting taxable sales.

9. Due to the incomplete books and records, the aforementioned differences between reported gross receipts and reported total sales, the differences between bank deposits and reported taxable sales, and the negative book markups, respondent concluded that additional testing was needed to verify reported amounts.

10. Respondent used the markup method to compute appellant's sales.[7] Relying on the purchase invoices appellant provided for 1Q13, respondent determined that appellant paid $26,448 for food and alcoholic beverages (alcohol) purchased during 1Q13 and that 36.65 percent of those purchases were food and 63.35 percent of them were for alcohol. On the basis of the purchase invoices, respondent estimated annual merchandise purchases of $105,792 (4 x $26,448 = $105,792).

11. On its FITR for 2011 and 2012, appellant reported COGS of $147,186 and $167,666, respectively. Respondent would have used those amounts in its markup analysis, but appellant argued that its reported COGS included labor, which appellant estimated at 35 percent, and supplies, which appellant estimated at 5 percent.[8] Because reported COGS exceeded the annualized total of COGS calculated using the purchase invoices from 1Q13, respondent agreed to reduce reported COGS by 40 percent.[9] Thus adjusted, reported COGS for 2011 and 2012 became $88,312 ($147,186 x .6 = $88,311.60) and $100,600 ($167,666 x .6 = $100,500.60), respectively. Respondent further reduced these amounts by a 2 percent pilferage allowance to calculate COGS for 2011 and 2012 of $86,545 and $98,588, respectively.

[7] The markup method is a generally accepted audit method, which uses known COGS and markups to calculate sales.

[8] We do not have a copy of appellant's 2011 FITR. The evidence indicates that appellant provided it to respondent for the audit, but the parties have not provided it to us. For the appeal to OTA, appellant provided copies of at least portions of the FITRs purportedly filed on behalf of PRI for the 2010 and 2012 tax years, neither of which has an entry for "cost of labor" or "other costs" included in the calculation of COGS.

[9] It is not clear to us whether respondent considered the possibility that the difference between COGS (one calculated by annualizing the purchase amounts for one quarter and the other taken from appellant's FITRs) may have been due to appellant not providing all purchase invoices. Nevertheless, the adjustment is a concession to appellant, and we will not disturb it here.

12. Using the food and alcohol purchases ratios described above, respondent calculated food purchases for 2011 and 2012 of $31,722 and $36,136, respectively.[10] Respondent deducted $1,200 from those amounts to adjust for self-consumption.[11] Because respondent deemed it impractical to conduct a shelf test for food, it estimated a 150 percent markup on the basis of its experience auditing similar establishments.[12] Thus, respondent calculated audited food sales (ex-tax) to be $76,305 for 2011 and $87,340 for 2012.

13. Respondent similarly determined taxable sales of alcohol, but for these it performed a shelf test, which is an accounting comparison of costs and selling prices used to compute markups. Respondent compared the costs for alcohol (from merchandise purchase invoices for 1Q13) to alcohol selling prices (from appellant's menus and information appellant provided on the Bar Fact Sheet). Respondent computed individual product category markups that were weighted based on the ratio of purchases in each product category as provided by appellant and indicated on the Bar Fact Sheet to compute a weighted alcohol markup of 391.13 percent. After a review of appellant's menus, respondent calculated that approximately 20 percent of alcohol sales were at reduced, happy hour prices; however, respondent accepted appellant's statement that happy hour occurred throughout evening hours from 5:00 to 9:00 and sometimes into late night, and allowed for 50 percent of alcohol sales at happy hour prices without requiring appellant to provide evidentiary support for that adjustment.

14. To calculate audited alcohol sales, respondent multiplied the alcohol purchase ratio (63.35 percent) times the COGS adjusted for labor and supply costs ($86,312 for 2011 and $100,600 for 2012), deducted $1,200 for self-consumption (for each year), and added the weighted percent alcohol markup to compute audited taxable alcohol sales of $263,361 for 2011 and $300,827 for 2012. These amounts were added to audited food sales to calculate total taxable sales of $339,666 for 2011 and $388,166 for 2012.

[10] We note that some calculations, including the total measure of tax, discussed below, appear to be off by a few dollars. We attribute these negligible differences to the effects of rounding.

[11] Self-consumption should have been subject to use tax. (R&TC, § 6201.) However, it appears from the evidence that respondent chose not to assess the use tax.

[12] According to respondent, the audit did not include a shelf test for food because there were too many food choices and variables. Appellant accepted the 150 percent markup as reasonable for the audit.

15. Respondent used the 1Q13 merchandise purchase invoices, marked up in the same manner, to compute audited taxable sales of $97,626 ($21,235 taxable food sales + $76,391 taxable alcohol sales) for 1Q13.[13]

16. To calculate audited taxable food and alcohol sales for 2010, respondent used appellant's 2011 average audited quarterly sales of $84,917 to calculate audited taxable sales of $254,750 ($84,917 × 3 quarters) for April 1, 2010, through December 31, 2010. Thus, respondent computed audited taxable sales of $1,080,208 ($254,750 + $339,666 + $388,166 + $97,626) for the liability period. Finally, respondent deducted reported taxable sales of $192,625 for the liability period to compute unreported taxable sales of $887,583.

17. On July 14, 2015, respondent issued the NOD to appellant for $76,682.55 in tax (measured by $887,588), a negligence penalty of $7,668.31, and applicable interest.

18. Appellant filed a timely petition for redetermination of the NOD. In its May 24, 2019 Decision, respondent denied the petition for redetermination, and affirmed that denial in its December 12, 2019 Supplemental Decision. This timely appeal followed.

DISCUSSION

Issue 1: Is appellant liable for taxes, interest, and penalties incurred under its seller's permit for the liability period?

Every person who plans to engage in or conduct business as a seller of tangible personal property (TPP) within this state must file with respondent an application for a seller's permit for each place of business.[14] (R&TC, § 6066(a); Cal. Code Regs., tit. 18, § 1699.) Such application must be made upon a form prescribed by respondent and must set forth the name under which the applicant transacts or intends to transact business, the location of the planned place or places of business, and such other information as respondent may require. (*Ibid*.) The application must state that the applicant will actively engage in or conduct business as a seller of TPP. (*Ibid*.) Only persons actively engaging in or conducting a business as a seller of TPP may hold a seller's

[13] Respondent notes in its Summary Analysis that the calculation for 1Q13 does not allow the 2 percent pilferage adjustment of $529 (approximately $194 for food and $335 for alcohol) but it also allows the annual self-consumption allowance of $1,200 for each category when it should have allowed only one quarter of that amount, or $300. The difference (approximately $1,271) favors appellant.

[14] "Tangible personal property" means personal property that may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses. (R&TC, § 6016.)

permit, and any person who holds a seller's permit but is not so engaged must immediately surrender the permit to respondent for cancellation. (R&TC, § 6072; Cal. Code Regs., tit. 18, § 1699(f).)

Except as discussed below, a person who holds a seller's permit is liable for any taxes, interest, and penalties incurred (through the date on which respondent is notified to cancel the permit) by any other person who, with the permit holder's actual or constructive knowledge, uses the permit in any way. (Cal. Code Regs., tit. 18, § 1699(f)(2).) A seller's permit holder who fails to surrender a seller's permit upon transfer of a business shall be liable for any tax, interest, and penalty incurred by the transferee if the permitholder has actual or constructive knowledge that the transferee is using the permit in any manner. (R&TC, § 6071.1(a).) When there is such a transfer, the predecessor's liability under R&TC section 6071.1 is limited to the quarter in which the business is transferred and the three subsequent quarters, unless 80 percent or more of the real or ultimate ownership of the business transferred is still held by the predecessor after the transfer. Stockholders, partners, or other persons holding an ownership interest in a corporation or other entity are regarded as having the "real or ultimate ownership" of the property of the corporation or other entity. (R&TC, § 6071.1(c); Cal. Code Regs., tit. 18, § 1699(f).)

The permit holder has the burden of establishing that respondent received notice to cancel the permit. (Cal. Code Regs., tit. 18, § 1699(f)(2).) Such notice may be given by delivery of the permit to respondent with a clear request that it be cancelled or by delivering written (including via email) notification of a transfer or planned transfer with a request to cancel the permit. (Cal. Code Regs., tit. 18, § 1699(f)(2)(A).) Even oral notification to respondent is sufficient, but it will be presumed that such oral notice was not given unless respondent's records show that the permit holder clearly notified respondent regarding the transfer or cessation of the business. (*Ibid*.) In addition, a permit holder will be excused from liability as of the date respondent receives actual notice of transfer of the business for which the permit was held. (Cal. Code Regs., tit. 18, § 1699(f)(2)(B).) Respondent's receipt of an application for a seller's permit from the transferee constitutes such actual notice if it contains adequate information to show that the application pertains to the same business for which the permit was held. (*Ibid*.)

Appellant argues that it was not the owner and operator of the restaurant.[15] It contends that PRI, the corporation owned by appellant's co-owners, owned and operated the restaurant.[16] Appellant asserts that it so informed respondent at the beginning of the audit, which was when respondent instructed appellant to surrender its seller's permit and obtain a new one for PRI.[17] In support of its argument, appellant gave respondent what appears to be copies of at least portions of PRI's FITRs for the 2011 and 2012 tax years and gave the Office of Tax Appeals (OTA) what appears to be copies of at least portions of PRI's FITRs for the 2010 and 2012 tax years.

Appellant's argument that PRI owned and operated the business and that respondent issued the NOD against the wrong person is not supported by the evidence. Appellant incorporated PRI in 1997, but there is no evidence that PRI ever applied for a seller's permit prior to or during the liability period. There is no evidence that appellant or either co-owner ever transferred ownership of any of their businesses (including several restaurants) to PRI. On May 5, 2008 (almost 10 years after the incorporation of PRI on January 29, 1997), appellant, not PRI, applied for and obtained a seller's permit to operate the subject restaurant and bar. There is no dispute that appellant reported its sales for the liability period by preparing, signing, and filing SUTRs under appellant's seller's permit. Although it appears that PRI reported the income from the business, at least on its 2010, 2011, and 2012 FITRs, there is no evidence that appellant (or anyone else) informed respondent regarding PRI's role in the business, if any, until after the liability period. Under these circumstances, respondent correctly issued the NOD to appellant, the holder of the seller's permit. If, as appellant asserts, PRI always owned and operated the business, appellant should have applied for the permit on behalf of PRI. If appellant transferred the business to PRI after the permit was issued to appellant, appellant should have surrendered the permit and PRI should have applied for one. Under either of those scenarios, PRI would be before us now, and the fact that it is not before us is due entirely to appellant's failure to comply with the law. Accordingly, we find that appellant applied for and held the seller's permit under

[15] It appears from the evidence that appellant first raised this argument in its request for reconsideration filed after respondent issued its Decision denying appellant's petition for redetermination.

[16] Appellant's owners acknowledge they own and control PRI.

[17] Appellant also argues that it was not aware of the requirement that it notify respondent regarding changes in ownership of the business. However, this does not appear to be a disputed issue, given appellant's assertion that PRI always owned and operated the business. In any event, ignorance of the law is not an excuse for noncompliance. (*Appeal of Diebold, Inc.* (83-SBE-002) 1983 WL 15389.)

which the business made taxable sales of TPP during the liability period. On that basis, we conclude that appellant is liable for any taxes, interest, and penalties incurred under its seller's permit for the liability period.

Issue 2: Are adjustments to the audited measure of unreported taxable sales warranted?

California imposes a sales tax on a retailer's retail sales in this state of TPP, 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 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 respondent is not satisfied with the accuracy of the SUTRs 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.)

When a taxpayer appeals a determination by respondent, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) That is, a party must establish by testimony, documents, or other evidence that the circumstances it asserts are more likely than not correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To satisfy the burden of proof, a taxpayer must prove that the tax assessment is incorrect and 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.)

Because appellant provided books and records that were inadequate for sales and use tax audit purposes, respondent was unable to verify taxable sales reported on the SUTRs using a direct audit method. Respondent's preliminary investigation revealed that gross receipts reported on the 2011 and 2012 FITRs exceeded total sales reported on SUTRs by $478,128 for 2011, and $388,909 for 2012. Comparing taxable sales reported on the SUTRs for 2011 and 2012 to audited merchandise purchases (based on COGS reported on the FITRs) for those years, respondent computed negative book markups of -26.22 percent for 2011 and -47.59 percent for 2012, which, if accurate, indicates that appellant was selling food and beverages for less than its cost. Based on these facts, we find that respondent reasonably questioned the reliability of recorded and reported taxable sales and that its decision to use an indirect audit method to compute appellant's liability was reasonable. The markup method is a standard and recognized audit method to establish sales, and we find that respondent's use of this method was reasonable. Based on the above, we find that respondent has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit.

Appellant has made various arguments over the course of its appeal (both in respondent's internal appeals process and the present appeal to OTA). It has argued that: the differences between gross receipts reported on FITRs and total sales reported on SUTRs was due, at least in part, to revenue received from the rental of the business premises for events; the weighted markup for alcohol sales was wrong because the information provided on the Bar Fact Sheet was incorrect because its purpose was not adequately explained to appellant, because prices changed over time, and because more than half of all alcohol sales were at reduced happy hour prices; and the food and alcohol purchase ratios were wrong because respondent did not have all food purchase invoices.

Regarding income from rental of the business premises, appellant provided what purport to be four agreements for rental of the business premises on four consecutive nights: February 18, 19, 20, and 21, 2013. Each agreement refers to a "Stanford Event" for a number of guests that ranged from 200 to 400 and indicates a charge of either $3,000 (for one event) or $4,500 (for each of the other three events). However, the audited measure was not determined by subtracting total sales reported from gross receipts reported, and appellant has not explained why

or how the evidence concerning rental fees should lead us to a more reliable measure of tax.[18] Consequently, we find this argument unpersuasive.

Regarding appellant's disagreement with the weighted markup for alcohol sales, we note that appellant signed the Bar Fact Sheet attesting to its accuracy. The document states, immediately above appellant's signature, that the signer should "PLEASE READ BEFORE SIGNING" followed by an explanation which includes the statements that "this information may be used to establish audited bar sales" and that the information on the form may be amended by the taxpayer. Appellant has not stated what information on the form is incorrect, and we find that respondent was justified in relying on the information appellant provided on the form.[19] In the more than six years that have passed since appellant signed the Bar Fact Sheet, it has not offered to amend the document or provide new information with supporting evidence. We have only appellant's unsupported assertions regarding the weighted alcohol markup in our record, but no evidence that raises a serious question regarding the accuracy of the information provided on the Bar Fact Sheet. We also find no evidence in the record to support appellant's contention that more than half of all alcohol sales were at happy hour prices. We find that the purpose of the information provided on the Bar Fact Sheet was adequately explained to appellant, that the information appellant provided on the Bar Fact Sheet was accurate, and that appellant has not established a more accurate markup for alcohol sales.

Regarding appellant's argument that the food and alcohol purchase ratios were wrong because respondent did not have all food purchase invoices, we again have only appellant's unsupported assertions. Appellant has provided no new invoices to support its contention. We find that appellant has not established that the food and alcohol ratios determined and relied upon by respondent were incorrect.[20]

On the basis of the foregoing, we find that adjustments to the audited measure of unreported taxable sales are not warranted.

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[18] For the same reason, evidence suggesting that appellant periodically collected a cover charge or had other potential sources income from exempt or excluded sales are immaterial.

[19] We note that appellant did state on the form that prices changed, apparently over time, but it has provided no information regarding when and to what extent they changed.

[20] We also note that, according to the audit work papers, respondent asked appellant to provide all liquor purchase invoices for 1Q13, but the only invoices appellant provided for spirits (vodka, gin, rum, whiskey tequila, etc.), cognac and champagne were from the last nine days of January 2013. It would thus appear that appellant may not have provided all liquor purchase invoices for 1Q13.

Issue 3: Did respondent correctly impose the negligence penalty?

As relevant here, if any part of a liability for which a deficiency determination is made is due to negligence, respondent must add a penalty equal to 10 percent of the amount of the determination. (R&TC, § 6484.) 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(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 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 provide complete and accurate records is evidence of negligence and may result in imposition of a negligence penalty. (Cal. Code Regs., tit. 18, § 1698(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(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*.)

Appellant asserts that it was not negligent. It argues that due to its lack of legal and accounting expertise and its lack of funds to hire professionals to assist with its financial management and tax reporting duties, it may not have done everything exactly correct; but it did the best that it could to maintain adequate records and accurately report its sales. Appellant further contends that it is unfair and unjust for respondent to assert the negligence penalty on the basis of the findings from appellant's first audit.

Appellant's co-owners had owned and operated multiple other businesses that sold TPP, including several restaurants, for many years before and during the liability period. During all of the time they were so involved, California Code of Regulations, title 18, section 1698 required that appellant maintain and provide to respondent all records necessary to determine the correct tax liability, including the normal books of account; bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and schedules or working papers used in connection with the preparation of tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) For this audit, appellant provided no books of account, no register tapes or other source documentation of sales, and no schedules or working papers to show how it prepared its tax returns. We find that appellant failed to maintain and provide complete and accurate records, and that this failure is evidence of negligence.

Appellant's argument that it lacked necessary accounting skills and legal knowledge, and that it did the best it could do with its limited resources, does not persuade us otherwise. First, taxpayers are presumed to know the law. (*Arthur Andersen, LLP v. Superior Court* (1998) 67 Cal.App.4th 1481, 1506-1507.) Second, no particular accounting skill is required to maintain at least source documents to establish purchases and sales. Finally, although appellant states that it did the best it could do, it has never explained exactly what it did to maintain adequate records, though the evidence shows that it did not include maintaining most basic business records necessary for an audit.

There is another potential basis for imposition of the negligence penalty: reporting errors. The audited amount of unreported taxable sales represents an error ratio of 460.79.[21] This means that appellant reported less than 20 percent of its sales. This large error ratio is also evidence of negligence.

It is plainly apparent that appellant's reporting was substantially flawed. The reported COGS exceeded reported sales, and gross receipts reported on FITRs far exceeded sales reported on SUTRs. We find the evidence sufficient to establish that appellant knew that its reported taxable sales were substantially understated, and likewise establishes that the $887,588, or at least a substantial portion of that understatement, cannot be attributed to appellant's bona fide and reasonable belief that its bookkeeping and reporting practices were sufficiently compliant

[21] The error ratio is calculated by dividing the unreported sales by the reported sales, with the negligible differences due to rounding.

with the requirements of the Sales and Use Tax Law. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at 321-324.) Consequently, we conclude that appellant was negligent. Thus, we find that respondent correctly imposed the negligence penalty.

HOLDINGS

1. Appellant is liable for taxes, interest, and penalties incurred under its seller's permit for the liability period.
2. Adjustments to the audited measure of unreported taxable sales are not warranted.
3. Respondent correctly imposed the negligence penalty.

DISPOSITION

Respondent's actions denying the petition for redetermination are sustained.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Keith T. Long
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Keith T. Long
Administrative Law Judge

Date Issued: 9/17/2021