OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19095248
	) CDTFA Case ID 1046908
SONORA TIRES ROUTE 66, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Sheri Rojo, CPA
For Respondent:	Ravinder Sharma, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Richard Zellmer, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, Sonora Tires Route 66, Inc. (appellant) appeals a Decision issued by California Department of Tax and Fee Administration (respondent),[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) of a liability for tax of $48,638.50, a negligence penalty of $4,863.86, and applicable interest, for the period March 15, 2013, through March 31, 2016 (liability period). The NOD was based on an audit that determined a deficiency measured by $603,143 in unreported sales based on a markup of costs analysis.[2]

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Keith T. Long, and Andrew Wong held an electronic oral hearing in this matter on October 26, 2021.[3] At the conclusion of the hearing, the parties submitted the matter for decision, and we closed the record.

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[1] 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 the 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.

[2] The audit also includes a separate measure of tax of $77,400 for unreported San Bernardino Transportation Authority district tax, which is not at issue in this appeal

[3] Appellant requested an oral hearing in Los Angeles. However, OTA had temporarily suspended in-person hearings to comply with restrictions in effect to minimize the spread of COVID-19. The parties agreed to the electronic hearing process, which allowed audio and video participation in real time using a web-based application.

ISSUES

1. Is appellant entitled to a reduction to the measure of unreported taxable sales?
2. Did respondent correctly impose the negligence penalty?

FACTUAL FINDINGS

1. Appellant operates a tire shop, where it sells and installs new and used tires, performs related and miscellaneous repairs, and sells auto parts. Appellant's seller's permit was effective March 15, 2013.
2. Respondent audited appellant for the liability period.[4] For the audit, appellant provided federal income tax returns (FITRs) for 2013, 2014, and 2015; bank statements and profit and loss (P&L) statements for the liability period; and sales invoices and corresponding purchase invoices for one week outside of the liability period (September 1, 2016, through September 7, 2016). Appellant did not provide the usual books of account and supporting source documents, such as sales journals, purchase journals, sales invoices, or purchase invoices, for any part of the liability period.
3. Respondent compared taxable sales reported on the sales and use tax returns (SUTRs) with cost of goods sold (COGS) reported on the FITRs, to compute book markups of 8.03 percent for partial year 2013,[5] -37.44 percent for 2014, and -4.10 percent for 2015.[6] A negative book markup means that reported taxable sales were less than reported COGS.

[4] This was appellant's first audit. However, appellant's owner had been in the same business for decades prior to the liability period. We have no information regarding whether respondent audited that prior business.

[5] References in this Opinion to the "partial year 2013" refer to the period March 15, 2013, through December 31, 2013.

[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 $.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 (.30 ÷ .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 (.30 ÷ 1.00 = 0.3).

In other words, these book markups indicate that appellant reported that it sold merchandise for less than cost in 2014 and 2015. Negative book markups are often the result of inaccurate data and are unreliable indicators of actual markups. On the basis of these findings, respondent concluded that reported taxable sales were unreliable, and it decided to compute taxable sales using the markup method.[7]

4. Using appellant's P&L statements, respondent compiled audited COGS of $1,273,696 for the period March 15, 2013, through December 31, 2015. Respondent segregated that amount into three categories: used tires, new tires, and auto parts. Respondent calculated the following purchase ratios for each category: 23.15 percent for used tires, 50.52 percent for new tires, and 26.33 percent for auto parts.

5. Using information regarding appellant's bank deposits, including limited information regarding cash deposits at automatic teller machines and deposits that were not part of appellant's gross receipts from sales,[8] respondent determined that bank deposits exceeded reported sales by between $1,066 (second quarter of 2013 (2Q13)) and $103,512 (2Q14) for all but one quarter (4Q14) when sales exceeded deposits by $2,746.[9] Excess deposits totaled $399,970 for the liability period, excluding cash payouts.[10]

6. Using the only information appellant provided (at that point in time) to show the cost and selling price for goods sold (sales invoices and corresponding purchase invoices[11] for the period September 1, 2016, through September 7, 2016), respondent performed a shelf test.[12] The sales invoices did not separately state the charges for labor and tangible personal property (TPP), generally tires and other parts. For the audit, appellant made handwritten notes on each sales invoice to separately state those charges. In most cases, respondent accepted appellant's handwritten notes, but respondent rejected the

[7] The markup method uses COGS and markup percentages to compute taxable sales.

[8] This information was not provided for May 2014 through the end of the liability period.

[9] Sales exceeding deposits suggests that appellant was not depositing all gross receipts and was instead paying some (probably cash) out to vendors or others.

[10] According to the evidence, appellant paid cash for some purchases and provided no reliable record of such payouts.

[11] It appears that there are no purchase invoices for used tires.

[12] A shelf test is an accounting comparison of costs and associated selling prices used to compute markups.

handwritten selling prices of tires/parts on five invoices because appellant indicated that it sold the merchandise for less than its cost.[13] Using the remaining sales invoices, respondent compared selling prices to costs from purchase invoices from that same time period, to compute markups of 14.90 percent for new tires, 50.78 percent for used tires, and 47.69 percent for auto parts. These markups were weighted based on the determined purchase ratios to compute an overall weighted markup of 31.85 percent.

7. Respondent added the weighted markup of 31.85 percent to audited COGS of $1,273,696 to compute audited taxable sales of $1,679,368 for the period March 15, 2013, through December 31, 2015. Deducting reported taxable sales, respondent computed unreported taxable sales of $539,088 for the period March 15, 2013, through December 31, 2015, which represents an error ratio of 47.28 percent. Respondent did not have COGS information for the first quarter of 2016, and thus, respondent applied the 47.28 percent error ratio to reported taxable sales for the first quarter of 2016 to compute unreported taxable sales of $64,055 for that period. In total, respondent computed unreported taxable sales of $603,143 for the liability period ($539,088 + $64,055). Respondent also found that appellant was negligent.
8. On January 5, 2018, respondent issued the NOD to appellant.
9. Appellant filed a timely petition for redetermination of the NOD.
10. The parties participated in an appeals conference on March 13, 2019.
11. After the appeals conference, appellant provided 146 sales invoices and corresponding purchase invoices for the period September 7, 2016, through September 30, 2016. These sales invoices also did not segregate charges between TPP and labor. Again, appellant had manually written the selling prices of TPP and labor charges on the sales invoices. Respondent scheduled all the invoices and noted that on over 100 of them, appellant had written selling prices for merchandise that were at or below cost. The purchase invoices were dated after the sales invoices for 19 of those, and there were no corresponding purchase invoices for 10 sales invoices. Respondent noted other irregularities on 22 invoices. Nevertheless, using what respondent believed were reasonably reliable sales invoice totals, documented purchase prices, and what respondent had detected to be appellant's typical labor charges for mounting and balancing tires and other common

[13] Respondent expected appellant to sell property for prices that exceeded the cost of the property.

procedures, respondent calculated a weighted markup of 68.39 percent, which was much higher than the 31.85 percent markup computed in the audit. Respondent chose to not rely on this data to increase the markup.[14]

12. In its August 12, 2019 Decision, respondent denied appellant's petition.

13. This timely appeal followed.

DISCUSSION

Issue 1: Is appellant entitled to a reduction to the measure of unreported taxable sales?

California imposes a sales tax on a retailer's retail sales of TPP in this state, 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.)

If the retail value of the TPP (typically, parts and materials) furnished in connection with repair work is more than 10 percent of the total charge, the repairperson is the retailer of TPP furnished in connection with repair work and tax applies to the fair retail selling price of the property.[15] (Cal. Code Regs., tit. 18, § 1546(b)(1).) Under such circumstances, the repairperson must separately state on the invoice to the customer (and in the repairperson's records) the fair retail selling price of the parts and materials supplied and the labor charges for repair, installation, or other services performed. (*Ibid*.) "Total charge" means the aggregate of the retail value of the parts and materials furnished or consumed in making the repairs, charges for installation, and charges for labor for repair or other services performed in making the repairs. (*Ibid.*) If the retailer does not make a segregation, the retail selling price of the parts and materials will be determined by respondent based on information available to it. (*Ibid.*) Furthermore, all work performed by automotive repairpersons must be recorded on an invoice that separately lists labor charges, charges for TPP, and the charge for sales tax reimbursement, and a copy of the invoice must be given to the customer. (Business and Professions Code (B&PC), § 9884.8.)

[14] If respondent had chosen to rely on this data, it would have increased the markup percentage and appellant's liability. Thus, respondent's choice benefited appellant.

[15] If the repairperson makes a separate charge for such property, tax applies regardless of whether the retail value of the TPP exceeds 10 percent of the total charge for the repair. (Cal. Code Regs., tit. 18, § 1546(b)(1).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, respondent 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.) In the case of an appeal, 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. (*Appeal of AMG Care Collective,* 2020-OTA-173P.) 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 documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) Detailed business records are often the best source for evidence to prove an accurate measure of tax, and it is a taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability under the Sales and Use Tax Law, 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).)

Appellant did not provide books and records that were sufficient for a sales tax audit. The negative book markups of -37.44 percent for 2014 and -4.10 percent for 2015 indicate the unreliability of reported taxable sales. On these bases, and given the limited available data, we find respondent's decision to use an indirect audit method, the markup method, was reasonable and rational.

Appellant is a retailer of tires and auto parts, but it also sells repair services, including tire mounting and balancing and brake and exhaust system repairs. At all relevant times, both B&PC section 9884.8 and California Code of Regulations, title 18, (Regulation) section 1546(b)(1) required appellant to separately state the charges for TPP, labor, and sales tax reimbursement on its sales invoices. Appellant did not comply with these requirements.[16] Consequently, Regulation section 1546(b)(1) authorized respondent to determine the retail selling price of the tires and parts based on information available to it.

Respondent based its weighted markup analysis on the cost and selling price data that

[16] Appellant's submission of altered invoices purporting to segregate the charges does not constitute compliance with these requirements.

appellant provided and that respondent deemed credible. We find that respondent reasonably refused to consider sales invoices on which appellant indicated it sold TPP for at or below cost. Respondent based its calculation of audited COGS on P&L statements and selling price data provided by appellant. We find that the evidence establishes that respondent's audit method, including the rejection of the few invoices containing pricing data that respondent found unreliable, was rational, and that the results of the audit were reasonable. Therefore, respondent has met its minimal burden, and the burden of proof shifts to appellant to show a more accurate measure.

Appellant makes several arguments. Referring to the auditor's comments on a schedule of invoices that appellant provided after the appeals conference, appellant argues that respondent determined the measure using an exorbitant 31.85 percent markup, which respondent calculated using what respondent characterizes as unreliable data. Appellant points to a copy of what purports to be an audit schedule from another retailer's audit and contends that at some unknown time in the past, respondent audited the other similar retailer and accepted an 8 percent markup.[17] Appellant asserts an 8 percent markup is standard in the industry and argues we should use that markup to calculate appellant's liability and reach a fair result because appellant would not be able to compete if it is required to use greater than an 8 percent markup.[18]

Appellant's assertion that respondent based its determination on data that respondent characterized as unreliable is not supported by the evidence. The schedule to which appellant refers does not contain the data on which the determination is based. It documents information contained on altered invoices appellant provided after the appeals conference. Respondent rejected the alterations on those invoices. It used the invoice totals only, combined with purchase data and labor costs gleaned from all the invoices, to calculate an estimate for comparison purposes only.

[17] Appellant stated in argument that the other retailer is owned and operated by the brother of appellant's owner and that both stores were formerly part of a single family business for decades. Neither brother testified at the hearing.

[18] Appellant had previously argued that respondent should have included labor costs and other related overhead in its calculation of COGS, but it specifically withdrew that argument at the hearing. Appellant also argued early in its appeal to OTA that appellant is entitled to a credit of more than $20,000, apparently for tax-paid purchases resold, and that additional consideration should be given to appellant's purchase of a large quantity of defective tires, but it conceded at the hearing that it has provided no evidence to support these contentions. We also note that the purchase invoices indicate appellant purchased TPP without paying sales tax reimbursement. Consequently, we will not address these matters further.

We find equally unpersuasive appellant's argument that respondent should not be allowed to use a markup that is greater than one claimed by a competitor. The only evidence appellant provided to support its assertion that respondent had accepted or agreed to an 8 percent markup as reasonable is what purports to be the page from the audit workpapers of the competitor. That document, which is undated and titled "Recorded Markup Analysis," appears to document a calculation of a taxpayer's book markup analysis based on P&L statements supplied by the taxpayer's CPA. As we note above, a retailer's book markup is not always a reliable indicator of actual markup for sales tax auditing purposes. The evidence does not show that respondent verified the book markup or adopted it as the audited markup; but even if respondent had done that in the audit of the other taxpayer, its markup findings would not be controlling here. At this point in our analysis, we are looking for evidence that establishes a measure that is more accurate than the one determined by respondent. We find the evidence insufficient to warrant a recalculation of the liability using an 8 percent markup.

Appellant has failed to provide any documentation or other evidence from which a more accurate determination can be made. On that basis, we conclude that appellant has failed to meet its burden of establishing that a reduction to the measure of unreported taxable sales is warranted.

Issue 2: 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 respondent 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 keep 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.) Respondent relies on both grounds here.

Generally, a penalty for negligence should not be added to deficiency determinations made in 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 can be upheld in a first audit if there is 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 substantially compliant with the requirements of the Sales and Use Tax Law. (*Ibid*.)

Appellant argues that it was not negligent, and therefore, the negligence penalty should be abated. Appellant states it has always done its best to maintain proper records and file accurate returns, but it has been the victim of bad advice and poor representation from those to whom it had entrusted such matters.

Appellant did not maintain records required by law. The evidence shows that its invoices did not separately state its labor charges, the prices charged for parts and materials, and sales tax reimbursement. Appellant provided no contemporaneous business records that contain this breakdown of charges, and it did not provide sales journals, purchase journals, sales invoices, or purchase invoices for any part of the liability period. We have no explanation for these failures.[19] A taxpayer does not exercise ordinary business care and prudence when he fails to acquaint himself with the requirements of California tax law, and ignorance of the law is not reasonable cause for failure to comply with statutory requirements. (*Appeal of Porreca*, 2018-OTA-095P.) We find that the appellant's failure to maintain and provide adequate books and records is persuasive evidence of negligence.

Although the above finding is dispositive, there is evidence that appellant negligently prepared its SUTRs. Initially, we dispose of appellant's argument that it was the innocent victim of bad tax advice by noting that the obligation to file accurate SUTRs rests squarely on the seller, who authenticates the content of the return. (R&TC, § 6452.) There is no provision in the Sales

[19] No one testified for appellant, and argument made by its representative is not evidence (*People v. Breaux* (1991) 1 Cal.4th 281, 313).

and Use Tax Law that allows a taxpayer to avoid responsibility for maintaining and providing records or for filing accurate returns by simply delegating those responsibilities to an agent. The audited unreported taxable sales of $603,143 represents an error ratio of 47.28 percent when compared to reported taxable sales of $1,275,769. We find that the large error ratio is evidence of reporting errors that were due to negligence.

Because this was appellant's first audit, we examine the record for evidence that appellant did not have a good faith and reasonable belief that its bookkeeping and reporting practices were compliant with the law. Appellant's book markups were 8.03 percent for partial year 2013, -37.44 percent for 2014, and -4.10 percent for 2015. Those numbers indicate not only substantial and unexplained differences year to year, but also that appellant was selling TPP for less than its cost, substantially less in 2014. Since we expect a retailer to sell TPP at a profit, and even appellant argued that its sales prices reflected a markup, this evidence shows inaccurate reporting known to appellant. We also have evidence of bank deposits by appellant that were almost always in excess of reported sales. Bank deposits exceeded reported sales by between $1,066 (2Q13) and $100,512 (2Q14) for all but one quarter (4Q14) when sales exceeded deposits by $2,746.[20] Excess deposits totaled $399,970 for the liability period, excluding cash payouts.[21] This is additional evidence that appellant knew it was not accurately reporting. Finally, we have audited unreported taxable sales of between $17,076 per quarter ($5,692 per month) and $85,691 per quarter ($28,564 per month). That level of underreporting could not have escaped appellant's attention. On these bases we find that appellant's failure to keep and provide adequate records and its substantial understatement cannot be attributed to appellant's good faith and reasonable belief that it was in substantial compliance with the requirements of the Sales and Use Tax Law. Therefore, we conclude that respondent correctly imposed the negligence penalty.

[20] Sales exceeding deposits indicate appellant was not depositing all gross receipts and was instead paying some (probably cash) out to vendors or others.

[21] According to the evidence, appellant paid cash for some purchases and provided no reliable record of such payouts.

HOLDINGS

1. Appellant is not entitled to a reduction to the measure of unreported taxable sales.
2. Respondent correctly imposed the negligence penalty.

DISPOSITION

Respondent's action denying the petition is sustained.

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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

Date Issued: 12/21/2021