OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20076408
	) CDTFA Case ID: 081-182
N. BAIAMONTE	)
dba Francescato of Beverly Hills	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Robert Tracy, CPA
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops
For Office of Tax Appeals:	Deborah Cumins Business Tax Specialist III

K. LONG: Pursuant to Revenue and Taxation Code (R&TC) section 6561, N. Baiamonte, dba Francescato of Beverly Hills (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) dated March 28, 2018. The NOD is for $59,439.57 in tax, a negligence penalty of $5,943.96, and applicable interest, for the period January 1, 2013, through December 31, 2015 (liability period).

Office of Tax Appeals Administrative Law Judges Natasha Ralston, Teresa A. Stanley, and Keith Long held an oral hearing for this matter on December 14, 2021.[2] At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

[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] The hearing was noticed for Sacramento, California and held electronically due to Covid-19.

ISSUES

1. Whether appellant has shown that further adjustments are warranted to the audited understatement of reported taxable sales.
2. Whether appellant has shown that further adjustments are warranted to the audited understatement of purchases subject to use tax.
3. Whether the understatement was the result of negligence.

FACTUAL FINDINGS

1. Appellant began a business as a retailer of men's clothing in March 2011. During 2013 only, he operated a store located in Palo Alto. During the remaining two years of the liability period, appellant made sales of suits and other clothing from his home in Santa Clara.
2. During the liability period, appellant reported total sales of $10,822, claimed deductions of $871 for sales tax reimbursement, and reported taxable sales of $9,951. He also reported purchases subject to use tax of $1,600, with a total reported taxable measure of $11,551.
3. For audit, appellant provided federal income tax returns for 2013, 2014 and 2015; personal and business bank statements for 2014 and 2015; an Etsy report of sales of belts and expense summary for 2015; a 2015 profit and loss statement (P&L); and some purchase invoices. Appellant also provided two invoices for suit sales made during 2015. Appellant claimed that he made only two sales of suits in 2015, and that he made no sales of suits during the period 2011 through 2014.
4. CDTFA compared amounts reported on appellant's federal income tax returns to amounts reported on appellant's sales and use tax returns. For 2013, CDTFA found that the gross receipts reported on appellant's federal income tax returns exceeded the total sales reported on appellant's sales and use tax return by $12,930.[3] CDTFA also found that the credit card deposits of $37,140 recorded in appellant's bank account for the liability

[3] For the other two years of the liability period, the amounts reported on appellant's federal income tax returns substantially reconciled with appellant's sale and use tax returns.

period exceeded appellant's reported taxable measure of $11,551 by $25,589.[4] In addition, CDTFA noted that the purchases reported on appellant's federal income tax returns for each year of the liability period exceeded the total sales reported on appellant's sales and use tax returns. As a result of these discrepancies, CDTFA decided that further investigation was warranted.

5. CDTFA conducted an audit and a revised audit using the markup method. The revised audit is the basis of the NOD. To calculate appellant's markup,[5] CDTFA reviewed the two sales invoices that appellant provided for 2015. CDTFA found that only one of the two invoices was reliable because the second invoice did not include the customer's purchase information. CDTFA compared the accepted sales invoice amount of $1,105 to the related cost invoice amount of $815 and computed a markup of 35.58 percent.[6]

6. CDTFA visited appellant's apartment to determine his ending inventory for 2013, 2014, and 2015.

    a. For 2013, appellant claimed to have an ending inventory measured by $17,424. CDTFA estimated appellant's ending inventory because appellant did not provide any purchase invoices to verify the claimed amount. CDTFA found that its estimate was close to appellant's claimed amount and therefore accepted appellant's claimed ending inventory of $17,424.

    b. For 2014, CDTFA scheduled appellant's purchase invoices and found ending inventory measured by $101,234.

    c. For 2015, CDTFA scheduled appellant's purchase invoices and found ending inventory of $115,701. CDTFA reduced appellant's ending inventory by $14,395

[4] CDTFA's decision notes that this comparison is incorrect because $11,551 includes reported purchases subject to use tax. The credit card deposits should have been compared to reported taxable sales of $9,951, which would have reflected a difference of $27,189 ($37,140 - $9,951).

[5] "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. A book markup is calculated from a markup factor by subtracting 100 percent from the markup factor (written as a percentage).

[6] The second invoice, which CDTFA rejected is also for $1,105. According to the audit workpapers appellant provided a related purchase invoice showing that appellant purchased the suit for $543. We note that, had CDTFA accepted this invoice for purposes of the markup test, the markup percentage would be increased.

because some of the purchase invoices contained customer information other than taxpayer and thus those items were considered sold. After adjustment, CDTFA found that appellant's ending inventory was $101,306.

In total CDTFA found that appellant's ending inventory for the liability period was $219,964 ($17,424 + $101,234 + $101,306). Since appellant had the merchandise in storage and stated that he would not be able to sell the merchandise, CDTFA regarded the $219,964 as the cost of purchases subject to use tax.[7] CDTFA described these items as merchandise withdrawn from inventory for personal use.

7. CDTFA computed costs of goods sold (COGS) for each year in the liability period.
   a. For 2013, CDTFA found that appellant had a beginning inventory measured by $113,994. CDTFA added purchases of $82,610 to the beginning inventory and subtracted the ending inventory of $17,424 to find COGS of $179,180.
   b. For 2014, CDTFA used a beginning inventory of zero,[8] added purchases of $115,279 and subtracted the ending inventory of $101,234 to find COGS of $14,045.
   c. For 2015, CDTFA used a beginning inventory of zero,[9] added purchases of $133,982 and other costs of $4,814. CDTFA then subtracted ending inventory of $101,306 and the cost of belt purchases to find COGS of $34,524.
   d. CDTFA applied the 35.58 percent markup to appellant's COGS for each year to find audited taxable sales of $242,932 for 2013, $19,042 for 2014, and $50,829[10] for 2015. When compared to appellant's reported taxable sales, CDTFA found

[7] In addition to the cost of clothing, CDTFA also established an unreported cost of taxable merchandise used for samples and research of $168,622. At the appeals conference with CDTFA, appellant specifically conceded that audit understatement, and we do not address it herein.

[8] Although CDTFA calculated ending inventory for 2013, it was not used in the calculation of appellant's COGS for 2014. Instead, it was considered removed from inventory and subject to the use tax.

[9] Although CDTFA calculated ending inventory for 2014, it was not used in the calculation of appellant's COGS for 2015. Instead, it was considered removed from inventory and subject to the use tax.

[10] We note that this should be $46,808. That is one of the errors addressed in the footnote 10, where we explain that correction of the various errors would increase the audited understatement. However, the error has been rendered moot by CDTFA's adjustment to the audited cost of goods sold for 2015, as addressed below.

unreported taxable sales of $290,723 for the liability period.[11]

8. CDTFA found that appellant's understatements of reported taxable sales and reported purchases subject to use tax were due to negligence.
9. On March 28, 2018, CDTFA issued an NOD for tax of $59,439.57 and a negligence penalty of $5,943.96. Appellant filed a timely petition for redetermination, which CDTFA denied.
10. This timely appeal followed.
11. During the appeals process, CDTFA performed a reaudit of appellant, which reduced the taxable measure. For the reaudit, CDTFA found that the calculation of COGS for 2015 needed correction. This reduced appellant's COGS from $34,524 to $20,129 for 2015. This resulted in a reduction to the measure of unreported taxable sales of $10,387 from $290,723 to $280,336. Additionally, CDTFA reduced the measure of use tax by $205,369 from $219,964 to $14,595.[12]

DISCUSSION

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*.)

[11] We note that CDTFA made errors on audit workpaper Schedules 1R12A-1 and 1R12A. On Schedule 1R12A-1, CDTFA used reported taxable measure, rather than reported taxable sales, in its computation. Also, CDTFA used an incorrect COGS for 2015. On Schedule 1R12A, CDTFA inadvertently carried forward the "differences" from Schedule 1R12A-1 and scheduled those amounts as audited taxable sales. If these errors were corrected, the understatement of reported taxable sales would increase by $9,130 from $290,723 to $299,853. Since CDTFA's error favors appellant, we will not address it further.

[12] Prior to issuing the NOD, CDTFA included all items in the measure of use tax. For the revised audit, CDTFA only included certain items that it determined were withdrawn from the inventory and used by appellant.

Issue 1: Whether appellant has shown that further adjustments are warranted to the audited understatement of reported taxable sales.

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, §§ 6051; *Appeal of Owens-Brockaway Glass Container, Inc.*, 2019- OTA-158P.) 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.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

In this case, appellant did not provide a complete set of books and records. CDTFA examined the available records and identified discrepancies. For instance, appellant's federal income tax returns show purchases of more than $300,000 during the liability period, while appellant reported sales of less than $10,000 on his sales and use tax returns. Additionally, appellant's bank account received more than $37,000 in credit card transaction deposits[13] throughout the liability period but appellant only reported a taxable measure of $11,551 during the liability period. We note that appellant's assertion that he only made sales during 2015 is inconsistent with the fact that appellant reported taxable sales throughout the liability period.

As a result, CDTFA compared appellant's available sales invoices to the available purchase invoices and calculated a markup rate to project taxable sales. Although the 35.58 percent markup rate is based on one of only two sales receipts that appellant provided, we note that during the audit, appellant claimed that he made only two taxable sales of suits, and CDTFA found that one of the sales receipts did not contain any identifying sales information (such as the customer's name). Thus, we find that CDTFA's use of a single sales receipt was

[13] Appellant's monthly credit card deposits ranged from 0 dollars to $7,496 during the liability period, which include: $110 for January 2013; $5,230 for February 2013; $500 in August 2013; $4,200 in October 2013; $250 in November 2013; $2,200 in December 2013; $3,829 in February 2014; $800 in April 2014; $2,100 in May 2015; $7,496 in June 2014; $6,000 in August 2014; $1,200 in September 2014; $800 in October 2014; $117 in May 2015; $228 in June 2015; $10 in July 2015; $150 in August $2015; $268 in September 2015; $519 in October 2015; and $1,124 in December 2015. We note that appellant's credit card transaction deposits are low for this type of business. Appellant asserts, without evidence, that these credit card transactions are amounts charged to his own personal credit cards to keep the business funded and to keep the merchant credit card services accounts open. Regardless, the measure of unreported taxable sales is not based on a credit-card projection. Accordingly, we will not address it further.

reasonable because it was the only complete sales receipt. CDTFA applied the 35.58 percent markup to the audited COGS. To support the audit findings, CDTFA reviewed appellant's bank deposits and found that total deposits exceeded audited taxable sales. Considering the severely limited set of books and records, we find that CDTFA's use of the markup method to establish its determination is reasonable and rational. Accordingly, the burden of proof shifts to appellant to show that adjustments are warranted.

On appeal, appellant contends that CDTFA's markup rate is overstated. Appellant asserts that CDTFA "took the raw cost of every item purchased during the audit years, marked all items up 36%, and then added penalties and fines on top of the artificially marked-up inventory." However, it appears appellant does not fully understand the audit method. Instead, CDTFA only applied the markup to the audited cost of goods sold. That includes the cost of merchandise that appellant purchased excluding the amounts remaining in inventory at the end of each year because CDTFA did not apply a markup to the inventory withdrawals.[14] Appellant has not provided any evidence that the measure of unreported taxable sales is incorrect. For example, appellant has not provided additional invoices to show that the markup rate should be reduced. Also, with respect to the cash flow analysis CDTFA used as a secondary audit method to establish the reasonableness of the audit findings, appellant has not provided any evidence that he is entitled to a credit for loans deposited in his bank account in excess of the credits allowed by CDTFA during the audit.[15] Thus, appellant's unsupported assertions are not sufficient to meet his burden of proof. (*Appeal of Talavera*, *supra*.)

Next, appellant claims that he made no (or very few) sales during the liability period. However, appellant's ending inventory was less than the amount of materials that appellant purchased in each year of the liability period. It is reasonable to conclude that the amounts no longer in inventory were sold. Appellant has not provided any evidence to the contrary.

Finally, appellant provided a detailed explanation of his business history. Appellant disputes CDTFA's assertion that he sold "bespoke" clothing. However, the facts CDTFA used to establish audited taxable sales are not impacted by the type of business, the type of clothing

[14] As discussed, CDTFA found that the use tax applied to appellant's ending inventory for each year of the liability period. The application of use tax is discussed in greater detail below; however, we emphasize here that no markup was applied to appellant's ending inventory.

[15] During the audit, CDTFA performed a cash flow analysis in which it gave appellant a $76,000 credit for loans received from his parents.

sold, appellant's type of advertising, the nature of his website or any other element of his business operations. Instead, the measure of taxable sales represents the amount of appellant's COGS plus a markup. Since appellant was a retailer of tangible personal property, it is assumed that the merchandise no longer in appellant's possession was sold. [16] Appellant has not provided evidence, or even argument, to explain any other circumstance. Therefore, we find that appellant has not shown that adjustments are warranted to the audited understatement of reported taxable sales.

Issue 2: Whether appellant has shown that further adjustments are warranted to the audited understatement of purchases subject to use tax.

California imposes use tax on the storage, use, or other consumption in California of tangible personal property purchased from a retailer for storage, use, or other consumption in this state, unless the use is specifically exempt by statute. (R&TC, § 6201.) A person who stores, uses, or otherwise consumes tangible personal property in this state is liable for the tax, and liability for use tax is not extinguished until the tax has been paid to the state; or the person is given a receipt for the tax from a retailer engaged in business in this state, and who is authorized by CDTFA to collect the tax. (R&TC, § 6202(a).) If a purchaser who gives a resale certificate or purchases property for the purpose of reselling it makes any storage or use of the property other than retention, demonstration, or display while holding it for sale in the regular course of business, the storage or use is taxable at the time the property is first so stored or used. (R&TC, §6244(a).)

As noted previously, CDTFA established a cost of purchases subject to use tax of $219,964 based principally on direct observation of articles of clothing that appellant still had in his possession at the time of the audit and using an average cost per item. Thereafter, CDTFA reduced the measure of use tax to $14,595. This reduced amount reflects purchases made from two vendors. CDTFA explained that the revised measure reflects only certain items that were identified for appellant's personal use. Indeed, CDTFA found that appellant's name appeared on most of these purchases. Further, one of appellant's vendors confirmed that appellant's purchases were for personal use and not for resale. Specifically, by email dated March 7, 2017,

[16] Thus, whether appellant was a retailer of "bespoke" clothing is irrelevant. The measure of tax is based on appellant's sale, storage and use of tangible personal property and is not changed by the characterization of the merchandise.

the vendor stated to CDTFA, "We learned he only was placing personal orders for himself." We find that CDTFA has used a reasonable method to establish the cost of the clothing still in appellant's possession, and appellant has not disputed that cost. Upon revising the audit, CDTFA made reductions to the taxable measure and only imposed the use tax on items which appellant personally used. Thus, we find that CDTFA has shown that its determination of the cost of purchases subject to use tax was reasonable and rational, and appellant has the burden of proof to show that further adjustments are warranted.

On appeal, appellant does not dispute that he maintained and stored unsold inventory in each year. Indeed, appellant argues that unsold inventory is the reason that many businesses fail. However, appellant provides conflicting information as to the inventory. On the one hand, appellant has argued that the stored inventory was unsaleable. On the other hand, during the appeals hearing, appellant asserted that the inventory was for sale throughout the liability period. Regarding these conflicting contentions, we note that the audit workpapers and emails associated with the audit indicate that merchandise was removed from inventory.[17] Additionally, appellant was keeping the inventory in his apartment and a storage unit. We find no evidence that appellant continued to hold the inventory out for sale. Thus, based on the foregoing we find that appellant withdrew merchandise from inventory.

With respect to whether an item withdrawn from inventory is subject to use tax, we note that the reason for the inventory's withdrawal is irrelevant. This is because the use tax applies to a purchase made for resale if the purchaser makes *any storage or use* of the property other than retention, demonstration, or display while holding it for sale in the regular course of business. (R&TC, § 6244(a).) Here, appellant purchased inventory that was not sold. Appellant also does not dispute that the inventory was then kept in storage. Nevertheless, CDTFA has decided to assess use tax only on a small portion of the merchandise withdrawn from inventory and stored by appellant. We find there is no question that use tax applies to the small amount of inventory CDTFA has found to be subject to tax.

[17] For example, in an August 31, 2016 discussion memorialized in the audit workpapers, appellant's bookkeeper stated that appellant "wears the clothes, donates the clothes, and sells at cost to friends." Notes recorded in CDTFA's Assignment Activity History, on October 26, 2016, indicate that appellant discussed giving away and donating suits. In an email dated December 8, 2017, CDTFA stated "All ending inventory was not in a sellable condition and determined to be for personal use." In response, appellant did not dispute that the items were unsaleable. Instead in an email response, appellant wrote "How is it concluded that if inventory is not sellable it is therefore personal? . . . If it's not sellable, shouldn't it be scrapped and therefore not assessed anything?"

Appellant has not provided any evidence to show that the measure of use tax should be further reduced. Accordingly, we find appellant has not shown that further adjustment is warranted to the audited understatement of reported purchases subject to use tax.

Issue 3: Whether the understatement was the result of negligence.

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 for examination on request by CDTFA, or its authorized representative, 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, will be considered evidence of negligence and may result in the imposition of penalties. (Cal Code Regs., tit. 18, § 1698(k).)

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

In this case, appellant provided severely limited records, with no sales journal, no purchase journal, and very few sales invoices and purchase invoices. As such, appellant was negligent in keeping records. During the audit, CDTFA calculated an understatement of

$679,309,[18] which when compared to the reported taxable measure of $11,551, represents an error ratio of 5,880.95 percent. Upon reaudit, CDTFA reduced the taxable measure to $464,553,[19] which when compared to the reported taxable measure of $11,551 represents an error ratio of 4,021.76 percent. Error rates of this magnitude are strong evidence of negligence in reporting.

Appellant asserts that he was doing his best to start a business and that he had little knowledge of tax law.

We find that any businessperson, regardless of his or her level of experience, would notice that the gross receipts reported on their 2013 federal income tax return exceeded the amount reported on their sales and use tax return for that year.[20] More significantly, any businessperson would notice the substantial discrepancy between purchases in excess of $300,000 and reported sales of less than $10,000. Appellant operated for over 4 years, including at a retail location for at least a portion of that time, and was only able to provide two sales invoices for the entire liability period, and virtually no other books and records. Appellant has not provided a non-negligent explanation for his failure to provide adequate records or his failure to report taxable measure of nearly $500,000. We find that appellant has not established that the understatement can be attributed to a bona fide and reasonable belief that his bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. To the contrary, the facts of this case tend to indicate fraud or an intent to evade the payment of tax. We therefore find no basis to delete the negligence penalty, even though this is appellant's first audit.

[18] Consisting of $290,723 unreported taxable sales + $219,964 unreported cost of taxable merchandise withdrawn from inventory for use + $168,622 unreported cost of merchandise used for samples and research.

[19] The $464,553 is comprised of $280,336 understatement of reported taxable sales + $14,595 measure of use tax + an unreported cost of taxable merchandise used for samples and research of $168,622.

[20] As discussed above, appellant's federal income tax returns were substantially similar to appellant's sales and use tax returns for the remaining years of the audit period.

HOLDINGS

1. Appellant has not shown that further adjustments are warranted to the audited understatement of reported taxable sales.
2. Appellant has not shown that further adjustments are warranted to the audited understatement of the reported cost of purchases subject to use tax.
3. The understatement was the result of negligence.

DISPOSITION

Sustain CDTFA's decision to reduce the audited understatement of reported taxable measure to $464,553 and to otherwise deny the petition.

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

We concur:

DocuSigned by:
0CC6C6ACCC6A44D...
Teresa A. Stanley
Administrative Law Judge

DocuSigned by:
Natasha Ralston
DE5000E568FD40F...
Natasha Ralston
Administrative Law Judge

Date Issued: 1/26/2022