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2022 – OTA – 222
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 21088426
KARAMIAN INDUSTRIES, INC.	) CDTFA Case ID: 1-861-455

OPINION

Representing the Parties:

For Appellant: Philip Duncan, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Karamian Industries, Inc. (appellant) appeals a decision issued by respondent the California Department of Tax and Fee Administration (CDTFA) denying appellant's petition for redetermination of a Notice of Determination (NOD) dated July 8, 2020.[1] The NOD is for tax of $17,999.00, a negligence penalty of $1,790.59, and applicable interest, for the period May 1, 2017, through September 30, 2019 (liability period).

Appellant waived the right to an oral hearing, so OTA decides this matter based on the written record.

ISSUES

1. Whether the amount of unreported taxable sales should be reduced.
2. Whether appellant was negligent or intentionally disregarded the Sales and Use Tax Law or authorized rules and regulations.

[1] The State Board of Equalization (BOE) formerly administered the sales tax. In 2017, BOE functions relevant to this case transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE.

FACTUAL FINDINGS

1. Appellant, a California corporation, was a franchisee of a regional fast-food restaurant chain specializing in Korean-style rice bowls. During the liability period, appellant operated two franchise restaurants, one in Monrovia and one in Duarte. Appellant ceased operations on September 17, 2019, and closed out its seller's permit effective September 30, 2019.
2. On its sales and use tax returns (SUTRs) for the liability period, appellant claimed no deductions and reported total/taxable sales of $1,202,600.
3. Upon audit, appellant provided the following books and records: (a) federal income tax returns (FITRs) for 2017 and 2018; (b) franchise royalty statements for the period of May 1, 2017, through April 6, 2019; (c) point-of-sale (POS) sales reports for the Monrovia location for the period of May 12, 2017, through April 15, 2019; (d) POS sales reports for the Duarte location for the period of October 10, 2018, through June 19, 2019; and (e) bank statements for each location for the period of March 2017 through May 2019.[2] Appellant did not provide cash register tapes or merchandise purchase invoices.
4. CDTFA's preliminary analysis of appellant's FITRs for 2017 and 2018:
   a. CDTFA compared gross receipts reported on appellant's FITRs to total sales reported on appellant's contemporaneous SUTRs and found immaterial differences. However, CDTFA noted that appellant had reported $240,000 as "other income" on its 2018 FITR. Appellant claimed that these were consulting fees, but did not provide substantiating documentation.
   b. CDTFA also compared the cost of goods sold (COGS) reported on appellant's FITRs with total sales reported on its SUTRs, and computed book markups of 215.36 percent for 2017 and 105.74 percent for 2018.[3]

[2] Appellant also provided a general ledger for the period of May 1, 2017, through March 31, 2019.

[3] "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 example above, the gross profit margin is 30 percent (0.30 ÷ 1.00 = 0.30).

i. CDTFA found that, despite appellant's book markup decreasing by over 100 percent from 2017 to 2018, gross sales remained relatively consistent.

ii. CDTFA also found that the 2018 book markup was unreasonably low based on its experience auditing fast-food restaurants in appellant's area.[4] Appellant had no explanation for the low markup.

c. Due to the lack of documents supporting reported "other income" and COGS on the FITRs, as well as the low book markup for 2018, CDTFA performed further testing to verify appellant's reported taxable sales.

5. CDTFA's analysis of appellant's franchise royalty statements: comparing the franchise royalty statement for the first quarter of 2019 (1Q19) to appellant's 1Q19 SUTR, CDTFA found no differences between recorded and reported total sales and sales tax. Appellant asserted that the franchise royalty statements were reliable.

6. CDTFA's analysis of appellant's POS sales reports: comparing the 1Q19 POS sales reports for both restaurant locations to appellant's 1Q19 SUTR, CDTFA found that recorded total sales exceeded reported total/taxable sales by $18,923 or 14.14 percent. Appellant claimed that the POS sales reports were inaccurate due to recording errors.

7. CDTFA's analysis of appellant's bank statements: using bank deposits as a proxy for gross receipts, CDTFA found that total bank deposits exceeded reported taxable sales by $56,511 for the liability period.[5] Appellant claimed the difference was due to consulting fees received.

8. Because CDTFA's review of appellant's available books and records revealed some unexplained discrepancies between the books and records and what appellant reported on its SUTRs, CDTFA concluded that it needed an alternate method to verify reported taxable sales. Appellant did not provide merchandise purchase invoices, so CDTFA

[4] According to CDTFA's decision, which denied appellant's petition for redetermination, CDTFA expected a markup in the range of 250 to 300 percent.

[5] Bank deposits are not gross receipts. (R&TC, § 6012(a).) However, where, as here, a retailer is engaged in the business of making retail sales of tangible personal property, CDTFA considers the retailer's bank deposits, net of deposits from non-sale or nontaxable transactions, as evidence of gross receipts from the retail sale oftangible personal property. CDTFA uses this evidence to determine audited taxable sales when, lacking adequate records, it cannot accurately establish sales using a direct audit approach.

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determined that it could not use the markup method; instead, CDTFA used a credit-card-sales-ratio method.[6]

9. From the Franchise Tax Board, CDTFA obtained appellant's Form 1099-Ks for the period of May 1, 2017, through December 31, 2018.[7] From the Form 1099-K information, CDTFA compiled appellant's credit card sales, which CDTFA reduced by the sales tax reimbursement and tips included therein. Comparing the resulting balance to reported taxable sales, CDTFA computed an overall credit-card-sales ratio (i.e., the ratio of credit card sales to total sales) of 78.32 percent, and noted that the overall quarterly credit-card-sales ratio increased from 62.02 percent in 2Q17 to 102.52 percent in 4Q18.[8]
10. Using the available POS sales reports, CDTFA compiled recorded credit card sales and total sales (both including sales tax reimbursement), and computed a credit-card-sales ratio for each month.
    a. For the Monrovia location, CDTFA noted that the monthly credit-card-sales ratio ranged from 62.54 percent to 65.94 percent during the period of May 2017 through December 2017; from 69.77 percent to 98.53 percent during the period of January 2018 through December 2018; and from 67.02 percent to 75.21 percent during the period of January 2019 through April 2019.
    b. For the Duarte location, CDTFA noted that the monthly credit-card-sales ratio ranged from 92.99 percent to 97.35 percent during the period of October 2018 through December 2018, and from 64.40 percent to 79.70 percent during the period of January 2019 through June 2019.
11. CDTFA obtained POS sales data from appellant's POS sales backup file for the Monrovia location for the period of September 16, 2018, through September 18, 2018, and for the Duarte location for the period of January 6, 2019, through January 7, 2019.

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[6] For a general description of the markup method and the credit-card-sales-ratio method, see CDTFA's Audit Manual, sections 0407.10 and 0810.12, respectively.

[7] Form 1099-K (*Payment Card and Third Party Network Transactions*) is an IRS form showing amounts paid to a merchant by customers using a payment card (i.e., credit card or debit card) or a third-party payment network.

[8] A 102.52 percent credit-card-sales ratio would mean that appellant had more credit card sales than reported taxable sales for that quarter, which in turn indicates that reported taxable sales were understated.

CDTFA compared the sales transactions from the POS sales reports to the backup POS sales data and found that appellant had voided many cash sales transactions from the POS sales reports. Appellant asserted that the voided transactions related to training entries and were not actual cash sales, but did not provide supporting documentation.

12. Using the Monrovia location's POS sales reports for April 1, 2019, through April 15, 2019, CDTFA computed a credit-card-sales ratio of 69.34 percent for the Monrovia location. Using the Duarte location's POS sales reports for April 1, 2019, through June 19, 2019, CDTFA computed a credit-card-sales ratio of 65.61 percent for the Duarte location. Although concerned about the completeness of the POS sales reports, CDTFA concluded that these credit-card-sales ratios from partial 2Q19, which it derived from the most current POS sales reports available during the audit, were reasonable for appellant's business.
13. Although Form 1099-K data was not available for the entire liability period, CDTFA found the available data was consistent with credit card deposits recorded in appellant's bank statements (with minor variances) for the corresponding time period, so CDTFA decided to use the credit card deposits compiled from appellant's bank statements as a proxy for credit card sales for the liability period.
14. For the Monrovia location, CDTFA divided total credit card deposits (minus sales tax reimbursement) for the liability period by the credit-card-sales ratio of 69.34 percent to compute audited taxable sales of $645,711 for the Monrovia location for the liability period. For the Duarte location, CDTFA divided total credit card deposits (minus sales tax reimbursement) for the liability period by the credit-card-sales ratio of 65.61 percent to compute audited taxable sales of $721,490 (rounded) for the Duarte location for the liability period. Thus, for the two locations combined, CDTFA calculated audited taxable sales of $1,367,201 ($645,711 + $721,490) for the liability period.
15. For the period of May 1, 2017, through December 31, 2017, CDTFA noted that audited taxable sales were less than reported taxable sales. Because the difference was immaterial and the book markup for 2017 was reasonable, CDTFA accepted taxable sales as reported for May 1, 2017, through December 31, 2017.

16. For the remainder of the liability period, January 1, 2018, through September 30, 2019, CDTFA compared audited taxable sales of $1,000,912 to reported taxable sales of $812,452, and computed unreported taxable sales of $188,460.
17. Appellant ceased operations on September 17, 2019. During the audit, CDTFA determined that appellant had failed to report $1,000 in taxable sales of fixtures and equipment on its final SUTR.
18. CDTFA also concluded that appellant had been negligent due to the following five reasons:
    a. Appellant maintained/provided incomplete books and records.
    b. Appellant's book markup of 105.74 percent for 2018 was lower than expected, which suggested underreporting.
    c. When comparing credit card sales (minus sales tax reimbursement and tips) from Form 1099-K information to reported taxable sales, the credit-card-sales ratio for 4Q18 was over 100 percent, which also suggested underreporting.[9]
    d. Cash sales transactions were missing from the POS sales reports when compared to the backup POS sales data.
    e. The error ratio for January 1, 2018, through September 30, 2019, was 23.20 percent (rounded) (unreported taxable sales of $188,460 ÷ reported taxable sales of $812,452 = 23.196 percent).[10]
19. On July 8, 2020, CDTFA issued to appellant the NOD for tax of $17,999.00, a negligence penalty of $1,790.59, and applicable interest.
20. Appellant timely filed a petition for redetermination, disputing the NOD in its entirety.
21. During CDTFA's appeals process, appellant conceded the $1,000 unreported taxable sale of fixtures and equipment. Subsequently, CDTFA denied appellant's petition.
22. Appellant timely appealed to OTA.

[9] See footnote 8, *ante*, page 4.

[10] The "error ratio" is the percentage of unreported taxable sales to reported taxable sales. The error ratio for 2018 alone was 37.17 percent (unreported taxable sales of $158,422 ÷ reported taxable sales of $426,221). The error ratio for January 1, 2019, through September 30, 2019, was 7.78 percent (unreported taxable sales of $30,038 ÷ reported taxable sales of $386,231).

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DISCUSSION

Issue 1: Whether the amount of unreported taxable sales should be reduced.

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of all tangible personal property sold in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) For the proper administration of the Sales and Use Tax Law and to prevent 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).)

If CDTFA is not satisfied with the amount of tax reported by any person, or if any person fails to make a return, CDTFA may determine the amount required to be paid based on any information within its possession or that 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 Amaya*, 2021-OTA-328P.) If CDTFA carries its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*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 documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Amaya*, *supra*.) To satisfy the burden of proof, a taxpayer must prove two things: (1) the tax assessment is incorrect; and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, *supra*.)

Here, the books and records appellant provided for audit were incomplete; appellant did not provide cash register tapes or merchandise purchase invoices for the liability period. CDTFA's preliminary analysis of appellant's FITRs found inconsistent book markups between 2017 and 2018, and a low book markup for 2018. Furthermore, CDTFA's analysis of the provided books and records disclosed unexplained differences between POS sales reports and reported total sales for 1Q19, as well as unexplained differences between bank deposits from sales proceeds and reported total sales for the liability period, all of which suggested that reported sales were understated. Accordingly, CDTFA was justified to question reported sales

and to use an indirect audit method to compute appellant's sales. Furthermore, CDTFA was justified to use the credit-card-sales-ratio method, which is a recognized and accepted accounting procedure. (See *Appeal of Amaya*, *supra*.) In addition, OTA finds that credit card sales deposits made by appellant's credit card processors into appellant's bank account are a reliable source of data from which to establish audited sales because the credit card processors are independent third parties. Therefore, OTA concludes that CDTFA has established that its determination is reasonable and rational, and so the burden shifts to appellant to show errors in the audit.

On appeal, appellant makes six arguments, each of which OTA examines below.

First, appellant contends that its operations varied from a typical fast-food restaurant, so CDTFA erred in comparing appellant to other restaurants in the fast-food industry. Specifically, appellant asserts that it solely used organic ingredients, which increased its COGS and skewed its markups compared to the fast-food industry at large. Appellant also asserts that prices for organic food increased significantly over the course of the liability period, which resulted in a declining markup. During the briefing process, appellant initially asserted that it could provide records to substantiate this first contention, but later stated that it could not.

Appellant's first argument regarding COGS and markups attempts to undercut the reliability of CDTFA's preliminary analysis of appellant's FITRs, which led CDTFA to perform further analyses of appellant's other available books and records. This, in turn, revealed some more discrepancies between the limited books and records appellant provided and what appellant reported on its SUTRs, and then led CDTFA to use an alternate method, the credit-card-sales-ratio method, to establish unreported taxable sales. Appellant's first argument does not undermine the results of this method because it only relates to CDTFA's preliminary analysis of FITRs. Appellant's burden is to show that CDTFA's tax assessment is incorrect, as well as the proper amount of tax. (See *Appeal of AMG Care Collective*, *supra*.) Appellant's first argument—which appellant concedes it cannot substantiate—does neither, so OTA finds it unpersuasive.

Second, appellant asserts that there were software issues with its POS system that distorted the POS data used as a basis for CDTFA's analysis. However, appellant has not identified the software issues, specified the affected transaction(s), nor explained how the alleged software issues distorted any such transaction(s). For lack of specificity, explanation, and

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substantiation, OTA finds appellant's second contention does not constitute a basis for reducing the amount of unreported taxable sales.

Third, appellant argues that the periods examined, September 16, 2018, through September 18, 2018, for the Monrovia location, and January 6, 2019, through January 7, 2019, for the Duarte location, are traditionally periods of high employee turnover and new hiring because they respectively coincide with the beginning of school and the end of the winter holidays. Appellant contends that, during these two periods, it trained new hires to use the POS sales system, which explains the many voided cash sales transactions from the POS sales reports.

Regarding this third argument, OTA notes that CDTFA did not use POS sales reports from the periods of September 16, 2018, through September 18, 2018, and January 6, 2019, through January 7, 2019, to establish audited taxable sales via the credit-card-sales-ratio method; rather, it used POS sales reports from part of 2Q19 to do so. Further, appellant has not substantiated its contention with any evidence such as hiring or training records. Accordingly, OTA finds appellant's third argument does not undermine CDTFA's tax assessment.

Fourth, appellant asserts that bank deposits were inflated by either non-sales cash deposits or draws on appellant's owner's credit cards due to cashflow shortfalls, and CDTFA did not exclude these from its computation of audited taxable sales, thereby artificially inflating the amount of unreported taxable sales.

Regarding this fourth argument, OTA notes that, because CDTFA used the credit-card-sales-ratio method, cash deposits do not affect the calculation of audited taxable sales; thus, there is no basis to recommend adjustments for non-sales cash deposits. Further, appellant has not identified any non-sales credit card deposits or provided any supporting documentation from which a more accurate determination could be made. Accordingly, OTA finds no basis to recommend adjustments for non-sales cash or credit card deposits.

Fifth, appellant similarly argues that its owner received and deposited nontaxable cash payments for consulting services, but CDTFA did not exclude them from its computation of audited taxable sales, thereby artificially inflating the amount of unreported taxable sales.[11]

Regarding this fifth argument, OTA again notes that, because CDTFA used the credit-card-sales-ratio method, cash deposits from alleged consulting services would not affect the

[11] Appellant did not provide documentation supporting consulting services of $240,000 reported as "other income" on its 2018 FITR. Also, CDTFA's comparison of total bank deposits from sales proceeds to taxable sales reported on appellant's SUTRs only resulted in a difference of $56,511 for the liability period.

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calculation of audited taxable sales; thus, there is no basis to recommend an adjustment for cash payments for consulting services.

Sixth and finally, appellant argues that CDTFA failed to consider the declining use of cash by appellant's customers, which explains the increasing quarterly credit-card-sales ratios.

Regarding appellant's sixth argument, OTA notes that CDTFA's analysis of appellant's POS sales reports showed unusually high credit-card-sales ratios in 2018, which then significantly dropped in 2019 to levels CDTFA considered reasonable. Although it had concerns about the completeness of the POS sales reports, CDTFA used the most recent POS sales reports provided by appellant, partial 2Q19, to compute the audited credit-card-sales ratios, which it concluded were representative of the liability period. Since OTA found that CDTFA met its initial burden to show that its determination was reasonable and rational, appellant must now show that CDTFA's determination is erroneous. But appellant has not identified any errors in its partial 2Q19 POS sales reports or provided any new evidence from which a more accurate determination could be made. Accordingly, OTA finds no basis to recommend an adjustment in this last argument.

In summary, OTA finds that CDTFA computed audited taxable sales based on the best-available evidence, and appellant has not identified any errors in CDTFA's computation of audited taxable sales or provided either documentation supporting its contentions or other evidence from which a more accurate determination could be made. As such, appellant has failed to carry its burden of proof, so OTA concludes that reducing the amount of unreported taxable sales is unwarranted.

Issue 2: Whether appellant was negligent or intentionally disregarded the Sales and Use Tax Law or authorized rules and regulations.

As noted above, CDTFA added a negligence penalty of $1,790.59 to appellant's deficiency determination for the following five reasons: (a) appellant maintained/provided incomplete books and records; (b) appellant's book markup of 105.74 percent for 2018 was lower than expected and suggested underreporting; (c) when comparing Form 1099-K information to reported taxable sales, the credit-card-sales ratio for 4Q18 was over 100 percent, which also suggested underreporting; (d) there were cash sales transactions missing from POS sales reports; and (e) the error ratio for January 1, 2018, through September 30, 2019, was 23.20 percent.

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On appeal, appellant contends that it was not negligent. Appellant asserts that its CPA filed all required federal and state filings based on the CPA's review of appellant's books and records. Appellant also asserts that it reported sales as accurately as possible, and any minor differences were due to software errors. However, appellant concedes that it did not maintain records of deposits into its business bank account of allegedly nontaxable cash payments for consulting services because these services entailed teaching other franchisees how to be more profitable by cutting certain costs at the franchisor's expense. Nevertheless, appellant maintains that it was forthright in its response to CDTFA, and filed and paid its obligation timely with CDTFA.

R&TC section 6484 provides that, if any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the Sales and Use Tax Law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to determine the correct tax liability under the Sales and Use Tax Law. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to: (a) 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 tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added when the taxpayer has not been previously audited. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) However, if there is evidence 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, then such evidence could justify imposing the penalty for negligence when the taxpayer has not been previously audited. (*Ibid*.)

Here, appellant provided books and records that were incomplete and inadequate for sales and use tax audit purposes, which is evidence of negligence.

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Further, unreported taxable sales of $158,422 for 2018 represents an error ratio of 37.17 percent when compared to reported taxable sales of $426,221 for that period.[12] In other words, appellant reported only $0.73 for every $1 in taxable sales. Although CDTFA found no understatement of taxable sales for May 1, 2017, through December 31, 2017, and an error ratio of 7.78 percent for January 1, 2019, through September 30, 2019, the large error ratio for 2018 still constitutes evidence of negligence that would warrant a penalty based on the entire deficiency. (See R&TC, § 6484 [if *any part* of a deficiency is due to negligence, a negligence penalty based on the amount of the determination must be added].)

Appellant also concedes that it intentionally failed to keep records of deposits into its bank account of cash received for alleged consulting services it wished to conceal from its franchisor. Appellant's concession is evidence that its failure to maintain and provide records upon audit was not rooted in a good faith and reasonable belief that its bookkeeping practices substantially complied with the Sales and Use Tax Law and authorized regulations, namely R&TC sections 7053 and 7054, as well as California Code of Regulations, title 18, section 1698. Thus, although appellant has not been previously audited, OTA finds that, based on the above, CDTFA's action in adding a negligence penalty to its determination in this first-time audit is justified.

In sum, based on the evidence in the record, OTA finds that appellant was negligent and intentionally disregarded the Sales and Use Tax Law and authorized regulations, and, though appellant has not been previously audited, the negligence penalty is warranted.

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[12] See footnote 10, *ante*, page 6.

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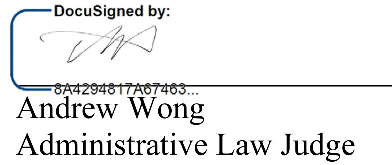
HOLDINGS

1. Appellant has not shown that the amount of unreported taxable sales should be reduced.
2. Appellant was negligent and intentionally disregarded the Sales and Use Tax Law and authorized regulations.

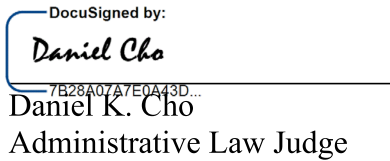
DISPOSITION

OTA sustains CDTFA's action in denying appellant's petition for redetermination.

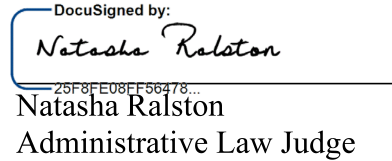


Andrew Wong
Administrative Law Judge

We concur:



Daniel K. Cho
Administrative Law Judge



Natasha Ralston
Administrative Law Judge

Date Issued: 5/23/2022