OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **ERIMUS, INC.** **dba Crown & Anchor**	OTA Case No. 21078261 CDTFA Case IDs 1-810-210, 1-850-315

OPINION

Representing the Parties:

For Appellant: Mehrdad Kamali, Representative

For Respondent: Jason Parker,
Chief of Headquarters Operations

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, Erimus, Inc. (appellant) appeals a Decision issued by the California Department of Tax and Fee Administration (respondent)[1] on appellant's petition for redetermination of two Notices of Determination (NODs) for the period January 1, 2014, through December 31, 2016 (liability period).[2] The first NOD dated December 12, 2019, is for tax of

[1] Prior to July 1, 2017, sales and use taxes (and other business taxes and fees) were administered by respondent's predecessor, the State Board of Equalization (BOE). When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

[2] The NODs were timely issued because on June 10, 2019, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period January 1, 2014, through December 31, 2016, which allowed respondent until January 31, 2020, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

$212,871.00,[3] a negligence penalty of $21,287.18, and interest. (Case ID 1-850-315.) The second NOD dated December 23, 2019, is for additional interest.[4] (Case ID 1-810-210.)

After the first reaudit to correct the interest calculation, respondent performed two additional reaudits, as explained below. The third reaudit dated July 30, 2020, reduced the determined total measure from $2,838,301 to $2,663,824 for the liability period, and will result in reductions to the determined tax and penalty, which remain in dispute.

This matter is being decided based on the written record because appellant waived the right to an oral hearing.

ISSUES

1. Are additional adjustments to the amount of unreported taxable sales warranted?
2. Did respondent correctly impose the negligence penalty?
3. Is relief of interest warranted?

FACTUAL FINDINGS

1. Appellant, a corporation doing business as Crown & Anchor, operates a restaurant and bar in Thousand Oaks, California, where it sells food, alcoholic and nonalcoholic beverages, and lottery tickets and offered happy hour specials. It also hosted events (sporting event watch parties and live bands) for which attendees paid a cover charge. Appellant's seller's permit was opened with an effective start date of January 1, 2014. Appellant had not been previously audited.
2. For the liability period, appellant used its monthly sales summaries to report sales of $1,307,091 on its sales and use tax returns (SUTRs), claiming no deductions. Although these summaries included all sales, appellant excluded what it considered nontaxable sales, thus reporting as total sales only what it considered taxable sales. Appellant

[3] Tax on the determined measure of $2,838,301 is $212,871 ($2,838,301 × 7.5 percent tax rate) (rounded). The first NOD reflects total tax of $213,396 and a $525 credit which results in a net tax of $212,871 ($213,396 - $525). It is unclear why tax was computed at a higher rate ($213,396 ÷ $2,838,301 = 7.52 percent) which then required a credit to correct the amount.

[4] Interest reflected on the first NOD was computed through November 30, 2019, in error. A reaudit dated December 20, 2019, was prepared to correct the interest calculation to include interest through December 31, 2019. The second NOD is for December 2019 interest only.

reported even sales amounts (rounded to thousands), often reporting the same amount for multiple quarters.[5]

3. For audit, appellant provided the following: federal income tax returns (FITRs) for 2014, 2015, and 2016; monthly sales summaries for the liability period; daily sales summaries for January 2014, May 2014, and June 2014; bank statements for the liability period; Forms 1099-K (1099-Ks)[6] for the liability period; some cash register receipts for October 2015; a purchase journal for 2016; and various merchandise purchase invoices for June 2016 and for the fourth quarter of 2017 (4Q17), which was after the liability period. Appellant did not provide cash register z-tapes or point-of-sale (POS) reports, complete customer receipts, or complete merchandise purchase invoices for the liability period.[7] The provided books and records were inadequate for sales and use tax audit purposes.

4. Respondent compared total sales reported on SUTRs for 2014, 2015, and 2016, to gross receipts reported on FITRs and found that gross receipts exceeded total sales by $921,124 for 2014, $1,042,208 for 2015, $1,204,925 for 2016, and $3,168,257 for the three years combined. Respondent noted that appellant also reported $68,155 in "other income" on its FITRs for the three years combined. Appellant stated that the differences related to nontaxable sales and other income related to lottery sales but did not provide supporting documentation.

5. Respondent compared gross receipts for 2014, 2015, and 2016, to the cost of goods sold (COGS) also reported on the FITRs to compute book markups of 168.99 percent for 2014, 159.57 percent for 2015, 147.45 percent for 2016, and 157.63 percent for the

[5] Appellant reported sales of: $112,000 for four quarters (the first quarter of 2014 (1Q14, 2Q14, 3Q14, and 1Q16); $102,000 for four quarters (4Q14, 1Q15, 2Q15, and 4Q15); and $108,000 for 3Q15.

[6] A 1099-K is an IRS form that shows amounts paid to a merchant by a bank, credit card company, or third-party network when the customer pays for goods or services using a debit card, credit card, PayPal, or similar non-cash payment.

[7] A cash register z-tape is the portion of the cash register tape that summarizes sales by category for a certain time period (e.g., a day or a shift). A point-of-sale terminal is the modern equivalent of a cash register. Depending on the equipment and software, POS systems can generate reports that summarize sales activity from the time a terminal is opened to the time it is closed out, which can happen as often as the operator chooses. A POS report can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

three years combined.[8] Respondent considered the FITR book markups low, based on its experience with audits of comparable businesses.

6. Respondent compared taxable sales reported for 2014, 2015, and 2016 on SUTRs to the COGS reported on the corresponding FITRs to compute reported book markups of minus 13.32 percent for 2014, minus 26.21 percent for 2015, minus 32.16 percent for 2016, and minus 24.76 percent for the three years combined. In this context, the negative markups generally mean the business was selling merchandise for less than cost.

7. Due to the incomplete books and records, the differences between reported gross receipts and reported total sales, and the unreliable book markups, respondent concluded that additional testing was needed to verify reported taxable sales.

8. Respondent reconciled taxable sales recorded in appellant's monthly sales summaries for the liability period ($2,963,854)[9] to taxable sales reported for the same period on appellant's SUTRs ($1,307,091) to compute unreported taxable sales of $1,656,763. Respondent found that sales of cold food to-go and gift cards recorded in the monthly sales summaries for January 2014, May 2014, and June 2014 did not agree with the corresponding daily sales summaries, and it noted that cold food to-go of $602,507 recorded in the monthly sales summaries for the liability period was much higher than it expected compared to recorded taxable sales. Respondent concluded that these findings were evidence that appellant had not reported all taxable sales.

9. Using the data from appellant's 1099-Ks, respondent compiled credit card sales for the audit period of $4,095,072. Intending to compute credit card sales excluding tips (ex-tips), respondent estimated that tips of 15 percent were included in credit card sales, deducted 15 percent of total credit card sales, and concluded that the result of $3,480,811

[8] "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).

[9] Respondent calculated recorded taxable sales by calculating the sum of recorded revenue from nontaxable sales (tips of $809,352, lottery sales of $221,401, cover charges of $535,794, cold food to-go sales of $602,507, and gift card sales of $92,761) and deducting the total of those amounts ($2,261,815) from total recorded revenue of $4,587,580.

($4,095,072.00 × .85 = 3,480,811.20) was credit card sales ex-tips.[10] Next, respondent computed credit card sales (without sales tax reimbursement or tips) of $3,237,964.00 by dividing credit card sales ex-tips by 1 plus the applicable tax rate of 7.5 percent ($3,480,811.00 ÷ 1.075 = $3,237,963.72) for the liability period. Respondent divided the credit card sales (without sales tax reimbursement or tips) by recorded total sales of $4,587,580 to compute the ratio of credit card sales to total sales (credit card sales ratio) of 70.58 percent, which was higher than respondent expected based on its experience auditing comparable businesses.[11] On this basis, respondent concluded that it could not base a reasonable estimate of taxable sales on appellant's monthly sales summaries.

10. Respondent decided to compute appellant's sales using the markup method and to that end prepared a bar short test, which is a preliminary analysis to determine whether a more detailed review of the taxpayer's records will be necessary. (See Respondent's Audit Manual, § 0802.60.)[12] Respondent also used a shelf test[13] to compute a weighted markup[14] for alcohol (beer, wine, and liquor) of 283.48 percent for the 4Q17 test period.

11. Based on its experience in audits of comparable businesses, respondent estimated what it considered a conservative food markup of 150 percent. Using the food and alcohol purchases for 4Q17, respondent weighted the individual food and alcohol markups based on the respective food and alcohol purchase percentages to compute a weighted food and alcohol markup of 238.48 percent.[15]

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[10] The correct calculation for credit card sales ex-tips is to divide the total by 1.15. The correct calculation in this instance is $4,095,072.00 ÷ 1.15 = $3,560,932.17.

[11] If respondent had used the correct formula to calculate credit card sales ex-tips, the credit card ratio would have been even higher (72.21 percent).

[12] Respondent's Audit Manual, which generally describes respondent's audit policies and procedures, does not constitute legal authority. Nevertheless, it can be a useful resource to which the Office of Tax Appeals (OTA) may look for assistance interpreting, or determining the weight to be given to, audit findings. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25; *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

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

[14] Respondent determined the average markup for beer (223.64 percent), wine (304.83 percent), and spirits (468.71 percent) and multiplied each by the ratio of purchases of each category to the purchases of all during a test period (67.59 percent for beer, 11.95 percent for wine, and 20.46 percent for spirits). Respondent then totaled the weighted markup for these bar items (151.17 percent for beer, 36.42 percent for wine, and 95.89 percent for spirits) to calculate the weighted markup.

[15] As explained below, respondent used a more conservative 200 percent markup.

12. Because purchase journals were incomplete, respondent concluded that COGS reported on appellant's FITRs were the best evidence of merchandise purchases for the liability period. Respondent excluded supplies based on a test of June 2016 purchases. Using the food and alcohol purchases for 4Q17, respondent allocated COGS, excluding supplies, based on the respective food and alcohol purchase percentages. Respondent allowed 2 percent for self-consumption, 2 percent for pilferage, 10 percent for beer spillage, 6 percent for wine spillage, and 12 percent for spirits spillage to compute audited alcohol COGS. Respondent made allowances of 2 percent for self-consumption, 2 percent for pilferage, and 2 percent for spoilage to compute audited food COGS. Based on a test of October 2015 cash register receipts and a discussion with appellant, respondent also made allowances for complimentary meals. Thus, respondent computed audited food and alcohol COGS of $1,498,269 for the liability period.

13. Respondent added what it deemed to be a conservative 200 percent markup[16] to the audited food and alcohol COGS to compute audited total sales of $4,494,808.00 (rounded) for the liability period. Using total food and alcohol sales of $3,181,545.00 and cold food sales of $217,691.00 recorded in appellant's monthly sales summaries for the liability period, respondent computed a ratio of cold food sales to total food and alcohol sales of 6.84 percent ($217,691.00 ÷ $3,181,545.00 = .06842). Thus, respondent computed audited cold food sales of $307,445.00 ($4,494,808.00 × 6.84 percent = $307,444.87) and audited taxable sales of $4,187,363.00 ($4,494,808.00 - $307,445.00 = $4,187,363.00) for the liability period. Respondent deducted reported taxable sales of $1,307,091.00, to compute unreported taxable sales of $2,880,272.00.

14. Respondent also established a separate $29,584 measure of use tax based on its 2 percent reduction of the beer, wine, and liquor COGS for self-consumption, as noted above. Appellant does not dispute this item.[17]

15. Using cash register receipts for October 2015, respondent compiled coupon and cash discounts (cash discounts) of $1,926. Respondent compared cash discounts to audited taxable sales of $1,352,332 for 2015 and computed a discount ratio of 0.1424 percent for the one month and an annual discount ratio of 1.7088 percent (0.1424 percent ×

[16] It had calculated a 238.48 percent markup.

[17] This undisputed measure was eventually reduced to $27,768.

12 months). Respondent multiplied audited taxable sales of $4,187,363 for the liability period by the annual discount ratio and established a credit measure of $71,555 for cash discounts ($4,187,363 × 1.7088 percent) (rounded). Appellant does not dispute this item.[18]

16. The total taxable measure was thus $2,838,301 ($2,880,272 + $29,584 - $71,555 = $2,838,301).
17. Respondent issued an NOD to appellant on December 12, 2019, with a tax liability of $212,871.00, a negligence penalty of $21,287.18, and applicable interest.
18. After respondent discovered that it had erroneously failed to include December 2019 interest on the first NOD, it issued a reaudit on December 23, 2019, to assess the additional interest for December 2019.
19. Appellant filed a timely petition for redetermination protesting both NODs.
20. Respondent performed a second reaudit dated February 27, 2020, to correct an error in the computation of audited COGS which reduced the total taxable measure from $2,838,301 to $2,657,260[19] for the liability period.
21. Respondent performed a third reaudit dated July 30, 2020, to address an issue with the computation of COGS identified by respondent in a memorandum dated July 9, 2020. Using the purchase journals for 1Q16 and 2Q16, respondent computed food and alcohol purchase percentages. Respondent applied these revised percentages to reallocate COGS, excluding supplies, between food and alcohol. This change increased the total taxable measure by $6,564 from $2,657,260 to $2,663,824[20] for the liability period.[21]
22. Respondent held an appeals conference with appellant on March 24, 2021. Appellant argued at the conference that the deficiency, if any, should be calculated using a bank

[18] This undisputed measure was eventually reduced to $71,552.

[19] The taxable measure in the second reaudit is comprised of unreported taxable sales of $2,700,124, unreported cost of self-consumed taxable merchandise of $28,688, and a credit measure of $71,552 for cash discounts.

[20] The taxable measure in the third reaudit is comprised of unreported taxable sales of $2,707,608, the unreported cost of self-consumed taxable merchandise of $27,768, and a credit measure of $71,552 for cash discounts. Respondent noted that the credit measure for cash discounts computed in the third reaudit should be $71,587, but it concluded that the $35 difference was not sufficient to warrant recalculation of the measure.

[21] This increase will increase the tax and penalty, but the result remains less than the originally determined tax and penalty. However, because a portion of the increase was processed under the second NOD, respondent timely notified appellant on December 21, 2020, that it was asserting an increase, pursuant to R&TC section 6563.

deposit analysis.[22] Appellant provided bank statements for the liability period. According to respondent's Decision, respondent's examination of the bank statements revealed that there were months for which appellant deposited no cash from the business; and using the bank statements respondent computed an unreasonably high 97.75 percent credit card ratio and an unreasonably low overall markup of 102.15 percent. Based at least in part on these findings, respondent concluded that the use of the bank statements to determine the liability was problematic, given what it viewed as evidence that substantial amounts of cash from sales was not being deposited into the bank account.

23. On June 21, 2021, respondent issued its Decision, which sustained the reduction to the determined measure of tax in accordance with the third reaudit and otherwise denied the petition.

24. This timely appeal followed.

DISCUSSION

Issue 1: Are additional adjustments to the amount of unreported taxable sales warranted?

California imposes sales tax measured by gross receipts from a retailer's retail sales in this state of tangible personal property 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 to-go and sales of all (hot and cold) food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (2) & (7).)

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.) 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).)

[22] Generally, when respondent uses a bank deposit analysis, it presumes all deposits constitute revenue from sales unless evidence establishes otherwise. For a bank deposit analysis to be useful for estimating taxable sales, all taxable sales revenue must have been deposited into the account.

When a taxpayer appeals a determination, respondent has a minimal, initial burden of showing that its determination was rational and reasonable. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met that burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid*.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.)

Here, appellant's books and records provided for audit were inadequate for sales and use tax purposes. Because the records were inadequate, respondent was unable to use a direct audit method (that is, compiling audited sales directly from appellant's records) to verify sales appellant reported on its SUTRs for the liability period. Appellant failed to provide cash register z-tapes or point-of-sale sales reports, complete cash register receipts, or complete merchandise purchase invoices for the liability period. Respondent's preliminary analysis found large unexplained differences between reported taxable sales and reported gross receipts, and also found negative book markups on reported taxable sales, which were indications that reported sales had been understated. The Office of Tax Appeals (OTA) finds that respondent reasonably questioned appellant's reported sales and that respondent's decision to use an indirect audit method to compute appellant's sales was reasonable.

Given the evidence showing the unreliability of appellant's records, respondent's decision to use the markup method was also reasonable. Appellant incorrectly reported taxable sales only.[23] Furthermore, appellant reported identical total and taxable sales for multiple quarters, which indicated that appellant not only did not accurately report sales, but also that it did so with little regard for what its own records indicated. Gross receipts reported on FITRs for the liability period were $3,168,257 more than reported sales for that period. The calculated markup using COGS and gross receipts reported on appellant's FITRs was lower than respondent expected, and the calculated markup using COGS from the FITRs and sales reported

[23] Taxpayers are instructed to report total sales and the amounts of various nontaxable sales deductions, as well as other amounts, on their sales and use tax returns. On its returns, appellant provided no information about claimed nontaxable sales.

on SUTRs showed negative markups for all three years in question. Taxable sales of $2,325,765 recorded in appellant's monthly sales summaries exceeded reported taxable sales of $1,307,091 by $1,018,674, and nontaxable sales recorded in monthly sales summaries did not reconcile with amounts reported in daily sales summaries. Finally, appellant recorded $602,507 for cold food sold to-go, which appears excessive and is unsupported by source documents. Under these circumstances, respondent's decision to use the markup method, a recognized and accepted tax auditing procedure (see *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613 (*Riley B's*)),[24] was a reasonable and rational one. Finally, following review of the work papers for the audit and reaudits, OTA finds that the current measure is the reasonable result of the correct application of the markup methodology. Thus, OTA finds that respondent has met its minimal, initial burden, and that the burden of proof is on appellant to prove a more accurate measure.

According to respondent's Decision, appellant argued in the agency-level appeal that sales should have been calculated on the basis of its bank deposits. Although appellant conceded that all sales revenue was not deposited into its account, it argued that the amount that was not deposited was insignificant. On appeal to OTA, appellant disagrees with respondent's use of the markup method, contends that respondent used an incorrect markup percentage, and argues that the audit did not produce an accurate result.

Because we are not certain that appellant has abandoned its argument that the liability is more accurately calculated using a bank deposit analysis, we address this argument first. As stated above, respondent may make its determination on the basis of any information that is in its possession or may come into its possession. (R&TC, § 6481.) Respondent reviewed the bank statements and concluded that appellant's failure to deposit substantial cash from sales caused the deposit data to be an unreliable indicator of sales. Given appellant's failure to explain or refute the bank deposit discrepancies and anomalies, OTA finds that respondent had good reason to decline to rely on appellant's bank statements, and appellant has not made an argument or provided any evidence to show that a more accurate measure can be established using its bank statements.

[24] Although the court in *Riley B's* does not specifically identify the methodology used for the audit under review, it states that it was the same methodology examined in *Maganini v. Quinn* (1950) 99 Cal.App.2d 1, which was a markup methodology.

Regarding appellant's challenge to the markup methodology, as stated above, respondent used recognized and accepted audit procedures to meet its initial burden of proof. Appellant disagrees with the result, but it has not shown error in respondent's analysis or calculations, and it has not provided evidence to establish a more accurate measure. It has offered only unsupported assertions, and those are insufficient to prove the facts asserted. (*Appeal of Talavera*, *supra*.) Consequently, there is no evidentiary basis for an adjustment to the measure of tax. Therefore, OTA finds that no additional adjustment to the amount of unreported taxable sales is warranted.

<u>Issue 2: Did respondent correctly impose the negligence penalty</u>?

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. Although the term "negligence" in not specifically defined in the Sales and Use Tax Law, it is a common legal concept and is generally defined as a failure to act as a reasonably prudent person would have acted under similar circumstances. (*Acqua Vista Homeowners Assn. v. MWI, Inc.* (2017) 7 Cal.App.5th 1129, 1157.)

A taxpayer is required to maintain and make available for examination on request by respondent all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054.) California Code of Regulations, title 18, (Regulation) section 1698(b)(1) states that 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 of working papers used in connection with the preparation of the tax returns. Regulation section 1698(k) provides that a failure to maintain and provide complete and accurate records is evidence of negligence. A negligence penalty can also be based on reporting errors. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318.)

There are two grounds for abating a negligence penalty. The first is that the taxpayer was not negligent. The second, contained in Regulation section 1703(c)(3)(A), is available only on a first audit when the evidence shows that the failures upon which the penalty is based are attributable 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.

Appellant does not address any of the findings upon which the negligence penalty is based. Instead, it contends that the negligence penalty should be waived because the audit was delayed as a result of respondent having to deal with "internal issues," including the replacement of the original auditor. Appellant states the new auditor had to fix mistakes made by the original auditor. Appellant has not identified any other of the alleged internal issues. Nor has it explained how such events relate to appellant's failure to maintain and provide adequate books and records, and to accurately report taxes due.[25] Appellant's argument has no relevance to, and provides no basis for relief of, the negligence penalty. Nevertheless, for the sake of a thorough discussion of the negligence penalty, this Opinion will examine the arguments that are available.

Appellant did not provide complete source documentation, and respondent showed that the books and records that appellant did provide were unreliable, as evidenced by the various discrepancies and anomalies described earlier. On these bases, OTA finds that the books and records provided by appellant were inadequate for sales and use tax audit purposes and that appellant's failure to maintain and provide adequate books and records was negligent.

During the audit, appellant stated that monthly sales summaries were used to prepare the SUTRs; however, the fact that appellant reported sales totaling exactly $112,000 for four quarters, $102,000 for four quarters, and $108,000 for one quarter, and the fact that taxable sales recorded in appellant's monthly sales summaries exceeds reported taxable sales by $1,018,674 for the liability period indicate that appellant did not prepare its SUTRs the way a reasonable, prudent businessperson would have prepared his or her returns under similar circumstances. Unreported taxable sales (less the credit measure for cash discounts) of $2,636,056 from the third reaudit represents an error ratio of 201.67 percent when compared to reported taxable sales of $1,307,091.[26] In other words, appellant reported only about a third of every dollar of audited taxable sales. OTA finds that this substantial error ratio was also the result of negligence.

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[25] Appellant also asserts that the penalty will create a hardship and should be waived. There is no provision in the Sales and Use Tax Law that allows for relief of the negligence penalty based on financial hardship. OTA is not authorized to grant relief on that basis, and this Opinion will not address the argument further, except to note that respondent has procedures that allow taxpayers to pay reduced amounts or to pay a liability in installments on the basis of financial hardship.

[26] That is, the "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

This was appellant's first audit. Had appellant made and sufficiently supported the argument that it had a bona fide and reasonable belief that appellant's bookkeeping and reporting practices were compliant with the requirements of the Sales and Use Tax Law, OTA would be able to abate the negligence penalty. However, appellant did not make and support that argument, and on the basis of our record, OTA concludes that respondent correctly imposed the negligence penalty in this first audit of appellant.

Issue 3: Whether relief of interest is warranted.

The imposition of interest is mandatory. (R&TC, § 6482.) There is no statutory right to interest relief. The law authorizes respondent, in its discretion, to grant relief of all or any part of the interest imposed on a person under the Sales and Use Tax Law where the failure to pay the tax is due in whole or in part to an unreasonable error or delay by an employee of respondent acting in his or her official capacity. (R&TC, § 6593.5(a)(1).) When reviewing a denial of a request for interest relief, we generally examine the record to determine whether there was an abuse of discretion by respondent. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) An unreasonable error or delay shall be deemed to have occurred only if no significant aspect of the error or delay is attributable to an act of, or failure to act by, the taxpayer. (R&TC, § 6593.5(b).) Any person requesting interest relief must include a statement under penalty of perjury setting forth the facts on which the request is based.[27] (R&TC, § 6593.5(c).)

Where the administrative record is silent regarding the actions taken on a taxpayer's matter and the tax agency does not come forth with evidence to show that the employees assigned to the matter or involved in its review were actively working on it, there may be no apparent basis to support the agency's determination not to relieve interest, and the unsupported determination may constitute an abuse of discretion. (*Appeal of Eichler*, 2022-OTA-029P.) For purposes of interest relief, an unreasonable failure to work on a case is an example of an unreasonable error or delay by an employee of respondent acting in his or her official capacity. (*Ibid.*; see also *Appeal of Micelle Laboratories, Inc.*, *supra*.)

Because our authority extends only to a review of respondent's denial for abuse of discretion, we look at appellant's contentions expressed in its appeal to respondent. Using respondent's omnibus Form 735 (Request for Relief from Penalty, Collection Cost Recovery

[27] Regulation section 1703 restates, without adding further clarification to, the requirements for interest relief within the meaning of R&TC section 6593.5. (See Cal. Code Regs., tit. 18, § 1703(b)(1)(E).)

Fee, and/or Interest) on January 17, 2020, appellant's representative requested relief of interest that had accrued from August 8, 2018 (the date the first auditor allegedly stopped working on the audit) to "present." In essence, appellant alleged that interest should be relieved because: (1) the original auditor had informed appellant that the audit was complete and was about to be submitted for review on August 8, 2018; (2) on December 14, 2018, the new auditor first informed appellant that the original auditor had made many errors in the audit, the implication being that additional time would be required to correct the errors; and (3) on May 29, 2019, the new auditor informed appellant that the new auditor had also made some errors, which would require additional time to correct. At the appeals conference, appellant argued that there was unreasonable delay caused by the change of auditors and by audit errors, and it specifically identified the time period from August 8, 2018, to December 14, 2018, the period immediately following the departure of the first auditor, as a time during which there was no apparent activity. On these factual bases, appellant argued that it should not be required to pay interest for the periods of time needed to change auditors or correct the auditors' errors.[28]

Respondent's Decision reviews the Assignment Activity History (Form 414Z), which documents the progress of the audit and contact between and among the various participants. The Decision focuses on the period from August 8, 2018, to December 14, 2018, the period about which appellant specifically complained, and it notes that there was, in fact, activity and contact during those months. On that basis, respondent concluded that no relief of interest was warranted. We examine that denial for abuse of discretion.

Entries on the Form 414Z document the meeting attended by audit staff and appellant's representative and corporate officer on August 1, 2018. Appellant expressed its disagreement with several of the findings and said that it would respond further within one week. Over the next week, the parties exchanged emails and it appears that appellant provided additional business records for respondent's consideration.[29] By August 8, 2018, the auditor decided to submit the audit as non-concurred, meaning that appellant did not agree with the audit results.

[28] Appellant also argues that the interest should be waived on the grounds that payment would cause financial hardship to appellant and, indirectly, to its many employees and their families. OTA has no authority to abate interest on these grounds.

[29] The references are to monthly sales totals for 2014, 2015, and 2016 and daily sales for January, May, and June 2014.

However, the audit process continued and there continued to be regular contact between the parties, as evidenced by entries documenting respondent's contact with appellant on October 4, 2018 when respondent informed appellant that the audit was under review, on December 14, 2018, when the new auditor corresponded with appellant, and on December 20, 2018 when the auditor attempted to schedule a meeting to discuss changes to the audit. The new auditor contacted appellant on March 18, 2019, and appellant requested additional time to provide more records for respondent's consideration.[30] At an April 29, 2019 meeting between the parties, appellant indicated that it disagreed with the audit and wanted to proceed with an appeal. Appellant's representative indicated that appellant would respond with its contentions by the end of that work week. On May 3, 2019, appellant confirmed its request to move its appeal to the next level. After further supervisor review and more corrections to the audit, respondent gave the updated audit work papers to appellant and met with appellant to discuss the audit. The parties continued to discuss possible changes to the audit until December 5, 2019, when appellant confirmed in writing that it wanted to proceed with issuance of the NOD, which happened a week later. Thus, although appellant's first contact with the new auditor may not have occurred until December 14, 2018, there was activity on the appeal during the four months (and six days) since appellant's last contact with the original auditor on August 8, 2018. The original auditor had submitted the audit as complete. Errors were discovered and adjustments were made, some of which favored appellant. Appellant was continuing to propose adjustments and continuing to provide business records for respondent's consideration. Respondent was continuing with the audit under statute of limitations extensions granted by appellant. In light of all of the above, OTA concludes the evidence is insufficient to warrant a finding that respondent's denial of interest relief for the period after August 8, 2018, was an abuse of discretion. While this finding is dispositive, this Opinion will discuss some of appellant's other contentions below.

Regarding appellant's contention that the audit seemed to start over and the measure of tax increased after the new auditor assumed responsibility for the audit, it is respondent's obligation to conduct its audits with the goal of determining the correct tax. Although the evidence does not show that the audit began anew with the new auditor or that the new auditor

[30] The entry refers to appellant's request to extend the deadline to March 22 "to provide the MOGL reports 2016, 2017, contract/ agreement and sales receipts."

unnecessarily repeated steps the original auditor had already completed correctly, the question before respondent was whether there was unreasonable error or delay. The fact that there were additional calculations and adjustments was not material to its analysis and is not material to ours. What is material is the absence of evidence of unreasonable error or delay. Finally, although the evidence shows that the measure of tax decreased – not increased – after the new auditor became involved,[31] changes to the measure during an audit also have no bearing on whether there has been an unreasonable error or delay.

HOLDINGS

1. No additional adjustment to the amount of unreported taxable sales is warranted.
2. Respondent correctly imposed the negligence penalty in this first audit of appellant.
3. Relief of interest is not warranted.

DISPOSITION

Respondent's action in reducing the determined taxable measure by $174,477 from $2,838,301 to $2,663,824, but otherwise denying the petition, is sustained.

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 6/1/2022

[31] It appears the measure of tax decreased from $3,371,266, as determined by the first auditor, to $2,992,901, as determined early on by the second auditor, though that latter amount was later reduced to $2,663,824.