

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**R. ARLEDGE,**  
**dba Arrow Tire and Wheel**) OTA Case No.: 21088476  
) CDTFA Case ID: 001-949-642  
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)  
)**OPINION**

Representing the Parties:

For Appellant:

R. Arledge

For Respondent:

Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals:

Lisa Burke, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, R. Arledge, dba Arrow Tire and Wheel (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)<sup>1</sup> denying appellant's petition for redetermination of the Notice of Determination (NOD) dated February 7, 2020.<sup>2</sup> The NOD is for tax of \$85,843.00, applicable interest, and a negligence penalty of \$8,584.35 for the period January 1, 2016, through December 31, 2018 (audit period).

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

**ISSUES**

1. Whether adjustments to the audited measure of unreported taxable sales warranted.
2. Whether imposition of the negligence penalty was warranted.

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<sup>1</sup> Sales and use taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

<sup>2</sup> The NOD was timely because appellant signed a waiver of the statute of limitations on December 10, 2019, which extended the statute of limitations until January 31, 2021. (R&TC, §§ 6487(b), 6488.)

### FACTUAL FINDINGS

1. Appellant has operated a tire and auto repair shop since April 1, 1996. During the audit period, appellant also made retail sales of used rims and other auto parts through eBay.
2. For the audit period, appellant reported total sales of \$487,486, and claimed deductions of \$5,667 for nontaxable sales for resale, \$98,091 for nontaxable sales of labor, \$373,310 for exempt sales in interstate commerce, and \$1,490 for “other” nontaxable sales (shipping charges), which resulted in reported taxable sales of \$8,928.
3. For audit, appellant provided his federal income tax returns (FITRs) for 2016 and 2017; eBay Seller Hub Reports for the period May 1, 2018, through December 31, 2018; eBay sales reports for the audit period; bank statements for the audit period; and profit and loss statements for 2016, 2017, and the period January 1, 2018, through April 30, 2018.
4. CDTFA obtained appellant’s credit card payment information reported on 1099-K forms for the audit period.<sup>3</sup> Credit card payments with taxes included totaled \$975,353.
5. Appellant’s gross receipts, reported on his FITRs for 2016 and 2017, when compared to his total sales, reported on the corresponding sales and use tax returns (SUTRs), show that gross receipts exceeded reported total sales by \$88,022 for 2016 and by \$187,079 for 2017. Also, appellant’s total sales recorded in his profit and loss statements for the period January 1, 2016, through April 30, 2018, exceeded reported total sales by \$273,605 for the same period.
6. CDTFA calculated appellant’s total sales of \$1,253,289 by compiling bank deposits for the audit period of \$1,137,295 together with PayPal sales of \$313,328, minus adjustments of \$197,334 for transfers, loans, and other nontaxable transactions. CDTFA then made allowances for reported nontaxable labor of \$98,092, exempt sales in interstate commerce of \$192,172 (based on eBay sales reports), and sales tax reimbursement of \$71,335, to compute taxable sales of \$891,691 for the audit period. A portion of appellant’s sales were in cash and appellant regularly used cash to purchase used rims and other auto parts. CDTFA was unable to verify whether the bank deposits were complete due to the cash sales and cash purchases.

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<sup>3</sup> Form 1099-K is filed by processors of electronic or online payments (payments by credit card, debit card, PayPal, etc.) with the Internal Revenue Service to report each of their customer’s receipts paid electronically for tax administration purposes.

7. Since gross receipts on appellant's FITRs exceeded reported total sales, recorded total sales on the bank deposits exceeded reported total sales, recorded total sales on the profit and loss statements exceeded reported total sales, and considering the lack of supporting documentation for reported taxable sales, CDTFA determined that additional investigation was warranted. CDTFA decided to compute audited taxable sales based on the markup method.
8. CDTFA contacted appellant's vendors to obtain purchase information. However, only a portion of the surveyed vendors responded. Based on the vendors' responses, CDTFA compiled purchases of parts totaling \$76,960.06, and purchases of tires totaling \$111,457.37, for the years 2016 and 2017. CDTFA compared the purchases shown in the vendors' responses with appellant's recorded purchases of \$20,475 for parts and \$71,792 for tires from those same vendors, and computed recording error rates of approximately 275.87 percent for purchases of parts and 55.25 percent for purchases of tires. CDTFA applied the recording error rates to recorded purchases from the vendors who did not respond to the survey, and overall, established audited purchases of parts of \$207,116, and audited purchases of tires of \$263,917, for the years 2016 and 2017.<sup>4</sup> To establish audited purchases for the year 2018, CDTFA used average yearly purchases of \$103,558 ( $\$207,116 \div 2$ ) for parts and \$131,959 ( $\$263,917 \div 2$ ) for tires. For the audit period, CDTFA established audited purchases of \$310,674 ( $\$207,116 + \$103,558$ ) for parts and \$395,876 ( $\$263,917 + \$131,959$ ) for tires. CDTFA made adjustments for beginning and ending inventories reported on appellant's FITRs which resulted in audited costs of parts sold of \$309,326 and audited costs of tires sold of \$395,820 for the audit period.
9. CDTFA compared costs for parts and tires shown in the available purchase invoices from April 2019 and May 2019 with the respective selling prices for the parts and tires. Based on this information, CDTFA computed markups of 94.87 percent for parts and 26.58 percent for tires. CDTFA added the respective markups to the audited costs of parts and tires sold to establish audited taxable sales of parts of \$602,784 and audited taxable sales of tires of \$501,029 for the audit period. CDTFA then subtracted appellant's reported taxable sales of \$8,928 from audited taxable sales of \$1,103,812

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<sup>4</sup> After noting that appellant primarily sold tire rims through eBay, CDTFA excluded purchases of tire rims from audited purchases for purposes of the markup analysis.

- (\$602,784 + \$501,029, rounded) to establish unreported taxable sales of parts and tires of \$1,094,884.<sup>5</sup>
10. To test the reasonableness of the audited taxable sales based on the markup method (as just discussed), CDTFA also computed audited taxable sales based on the credit card ratio method. CDTFA divided the credit card receipts for the audit period of \$975,353 by an estimated credit card sales ratio of 70 percent to compute audited total sales of \$1,393,362 (rounded) for the audit period. CDTFA reports that the 70 ratio was derived from an audit of a similar business in the area. Then, CDTFA made adjustments to compute audited taxable sales of \$1,103,099 based on the credit card ratio method, which was similar to the audited taxable sales of \$1,103,812 established using the markup method.
  11. CDTFA determined that imposition of the negligence penalty was warranted based on the significant understatement, \$1,094,884, and the failure to maintain adequate books and records.
  12. On February 7, 2020, CDTFA issued the NOD to appellant.
  13. On February 18, 2020, appellant timely filed a petition for redetermination disputing the NOD. Through subsequent correspondence, appellant disputed the accuracy of the audited taxable sales for the audit period. Appellant also claimed that his markup for the parts and tires was less than audited markup.
  14. On July 1, 2021, CDTFA issued its decision denying the petition for redetermination in its entirety.
  15. Appellant timely appealed CDTFA's decision to Office of Tax Appeals (OTA).

### DISCUSSION

#### Issue 1: Whether adjustments to the audited measure of unreported taxable sales is warranted.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) 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

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<sup>5</sup> Appellant claimed nontaxable sales for resale of \$5,667 on his SUTRs but failed to provide resale certificates or other evidence to support the claimed nontaxable sales. Therefore, CDTFA made no adjustment for nontaxable sales for resale in the markup analysis.

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 the taxpayer, 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.) 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.*)

Appellant did not provide complete records for audit. Specifically, appellant's sales records and purchase records are incomplete. The records that appellant did provide conflict with appellant's reported taxable sales. For example, gross receipts reported on appellant's FITRs and the sales recorded in his profit and loss statements exceeded the total sales reported on his SUTRs. Given the incomplete records and the evidence that appellant's reported sales were understated, it was reasonable and rational for CDTFA to use an indirect audit method to establish audited taxable sales.

CDTFA used the markup method to establish audited taxable sales. The markup method is a standard and accepted audit procedure. (*Appeal of Amaya*, 2021-OTA-328P.) As discussed further below, CDTFA used the markup method to establish the audited understatement of \$1,094,884. To test the reasonableness of the markup method, CDTFA conducted a credit card analysis based on appellant's 1099-K data for the audit period. The credit card analysis shows that appellant's audited taxable sales were \$1,103,099 which is similar to the computed audited taxable sales of \$1,103,812 based on the markup method. Based on the available information, we find that the markup method was appropriate in this matter. Furthermore, we have reviewed the audit file and computations and have found no material errors. Thus, the burden of proof shifts to appellant to establish with documentation or other evidence that a reduction to the amount of unreported taxable sales is warranted.

Appellant contends that a reduction to the amount of audited taxable sales of tires is warranted and argues that his nontaxable sales of labor during the audit period exceeded his taxable sales of tires. However, appellant has not provided documentation or other evidence to show any error in the computation of audited taxable sales of tires using the markup method.

Here, CDTFA requested purchase information from appellant's vendors, but not all of appellant's vendors responded. Due to the lack of complete and reliable purchase records, CDTFA relied on certain estimates to establish audited purchases of tires of \$395,876. After CDTFA found that the tire purchases shown in the information obtained from appellant's vendors exceeded appellant's recorded tire purchases from those vendors, CDTFA computed a recording error rate of 55.25 percent and used that rate to estimate audited unrecorded tire purchases from the vendors who had not responded to CDTFA's survey. Additionally, CDTFA used average yearly tire purchases for the years 2016 and 2017 to estimate appellant's purchases of tires for the year 2018 because the available purchase information for the year 2018 was incomplete. To compute the audited markup, CDTFA reduced tire selling prices shown in sales invoices for April 2019 by \$15 or \$20 per tire to allow for nontaxable installation labor charges for balancing and mounting the tires, and then compared the adjusted selling prices with the respective costs for the tires to compute markups. Appellant has not provided documentation or other evidence to rebut the audited purchases or the computed markup.

Regarding appellant's argument that his nontaxable sales of labor exceeded his taxable sales of tires, we note that, overall, CDTFA used the markup analysis to establish audited taxable sales of tangible personal property (parts and tires) and made no attempt to establish appellant's nontaxable sales of labor. In sum, we conclude that appellant has failed to meet his burden of establishing that a reduction to the amount of audited taxable sales is warranted.

Issue 2: Whether imposition of the negligence penalty was warranted.

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 law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court (Sokolich)* (2016) 248 Cal. App. 4th 434, 447.)

Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the taxpayer's good faith and reasonable belief that its bookkeeping and reporting practice were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A); see *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

A taxpayer shall 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 and all records necessary for the proper completion of the sales and use tax return. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) Such records include but are not limited to the following: (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. (Cal. Code Regs., tit. 18, § 1698(b)(1)(A)-(C).) Failure to maintain and keep complete and accurate records is considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

On appeal to OTA, appellant has not made argument, or provided evidence, specific to the imposition of the negligence penalty. However, we infer from the dollar amount indicated on appellant's Request for Appeal that appellant also contests the negligence penalty. Also, in CDTFA's decision appellant contended that the negligence penalty should not apply since this was his first audit.

Here, it is undisputed that appellant had not previously been audited. Nonetheless, the evidence indicates that appellant did not exercise ordinary reasonable care to maintain and provide his books and records. For audit, appellant did not provide complete sales invoices, work orders, or other source documents showing his sales, and the purchase records he provided were inaccurate (e.g., 275.87 percent error rate for purchases of parts and 55.25 percent error rate for purchases of tires). We find appellant's failure to maintain and provide adequate books and records is evidence of negligence.

Moreover, a comparison of the audited understatement of reported taxable sales of \$1,094,884 with appellant's reported taxable sales of \$8,928 represents an error rate of

12,755 percent. The magnitude of the error rate cannot be attributed to a good faith and reasonable belief that his reporting practices were substantially compliant. Thus, we find the magnitude of appellant's reporting errors is evidence of negligence.

Additionally, merchandise purchases of \$706,550 obtained from appellant's suppliers substantially exceed appellant's reported sales of merchandise of \$8,928. Appellant's failure to recognize that his merchandise purchases exceeded his reported merchandise sales by such a significant margin is unreasonable under the facts and constitutes additional evidence of negligence in reporting.

Even though this was appellant's first audit, appellant's failure to accurately report, record, and maintain records cannot be attributed to a good faith and reasonable belief that his bookkeeping and reporting practices were substantially compliant with the requirements of the Sales and Use Tax Law. Consequently, we find that CDTFA correctly imposed the negligence penalty.

#### HOLDINGS

1. No adjustments to the amount of unreported taxable sales are warranted.
2. The negligence penalty was properly imposed.

#### DISPOSITION

CDTFA's action in denying the petition is sustained.

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*Josh Aldrich*

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Josh Aldrich  
Administrative Law Judge

We concur:

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*Andrew J. Kwee*

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Andrew J. Kwee  
Administrative Law Judge

DocuSigned by:

*Eddy Y.H. Lam*

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Eddy Y.H. Lam  
Administrative Law Judge

Date Issued: 6/9/2022