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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20066251
	) CDTFA Case ID: 089-008
DESIGN HOME CENTER, INC.	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Carlos Chait, Representative
Victor Ceballos, President

For Respondent: Randy Suazo, Hearing Representative
Christopher Brooks, Tax Counsel IV
Jason Parker, Chief of Headquarters Ops.

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

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Design Home Center, Inc. (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 October 12, 2017. The NOD is for $93,456.58 in tax, a negligence penalty of $9,345.69, and applicable interest, for the period July 1, 2013, through June 30, 2016 (liability period).

Office of Tax Appeals Administrative Law Judges Suzanne B. Brown, Josh Aldrich, and Keith T. Long held an oral hearing for this matter on December 16, 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 this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when this Opinion refers to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

[2] The parties agreed to hold the hearing electronically via Webex.

ISSUES

1. Whether any adjustments to the amount of unreported taxable sales are warranted.
2. Whether the understatement was the result of negligence.

FACTUAL FINDINGS

1. Appellant operates a retail furniture store located in San Fernando, California. Appellant obtained a seller's permit effective November 2, 2009, which remains active. Appellant was previously audited for the period July 1, 2010, through June 30, 2013.
2. Appellant's method for reporting sales on its sales and use tax returns is unknown. During the liability period, appellant reported total sales of $1,944,494, claimed zero deductions, and reported taxable sales of $1,944,494.
3. Appellant did not provide a complete set of books and records for the audit. Instead, appellant provided the first page from its federal income tax returns for 2013, 2014, and 2015, and the summary page from its 2015 profit and loss statement. Appellant did not provide source documentation such as cash register tapes or sales invoices for the liability period.
4. For the audit, CDTFA obtained complete copies of appellant's 2013, 2014, and 2015 federal income tax returns. CDTFA also obtained credit card transaction data reported on appellant's 2013, 2014, and 2015 IRS forms 1099-K (1099-K).[3]
5. CDTFA compared the gross receipts that appellant reported on its federal income tax returns to the total sales that appellant reported on its sales and use tax returns. CDTFA found that gross receipts reported on appellant's federal income tax returns exceeded the total sales reported on appellant's sales and use tax returns by $241,005 for 2013, $257,554 for 2014, and $287,727 for 2015. Appellant was unable to explain the differences between the federal income tax returns and sales and use tax returns.
6. CDTFA compared the gross receipts reported on appellant's federal income tax returns to the corresponding cost of goods sold (COGS) to compute book markups of 41.24 percent

[3] Form 1099-K is used to report a taxpayer's income received from electronic or online payment services (credit cards, debit cards, PayPal, etc.). It is authorized by the IRS for tax administration purposes.

for 2013, 48.08 percent for 2014, and 47.09 percent for 2015.[4] CDTFA also compared the taxable sales that appellant reported on its sales and use tax returns to the corresponding COGS reported on appellant's federal income tax returns to compute book markups of -19.75 percent for 2013, -1.96 percent for 2014, and 3.71 percent for 2014. The negative book markups for 2013 and 2014 mean that appellant's reported COGS exceeded reported taxable sales in those years (i.e., that appellant sold the goods at a loss).

7. CDTFA used appellant's forms 1099-K to compile credit card sales of $2,041,273 for the period July 1, 2013, through December 30, 2015. Based on this information, CDTFA calculated credit card sales, excluding sales tax reimbursement, of $1,864,798 for the period July 1, 2013, through December 31, 2015. CDTFA noted that appellant's credit card sales, excluding sales tax reimbursement, exceeded reported taxable sales. CDTFA expected that appellant would also have made cash sales. However, CDTFA was unable to establish appellant's audited taxable sales using a credit-card-sales-ratio because appellant did not provide sufficient documentation.

8. CDTFA concluded that appellant's federal income tax returns were the best available evidence of unreported taxable sales. CDTFA compared the differences that it found between appellant's federal income tax returns and appellant's sales and use tax returns for 2013, 2014, and 2015 to compute error ratios[5] of 75.99 percent for 2013, 51.04 percent for 2014, and 41.83 percent for 2015. CDTFA also found an overall error rate of 52.09 percent.

9. To calculate unreported taxable sales, CDTFA applied the audited error ratios as follows: 75.99 percent to appellant's reported taxable sales for the period July 1, 2013, through December 31, 2013; 51.04 percent to appellant's reported taxable sales for 2014; 41.83 percent to appellant's reported taxable sales for 2015; and 52.09 percent to reported

[4] "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).

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

taxable sales for January 1, 2016, through June 30, 2016. This resulted in unreported taxable sales of $987,138 for the liability period.

10. CDTFA issued the aforementioned NOD. In addition to the tax, CDTFA imposed a 10 percent negligence penalty for appellant's failure to keep adequate books and records.[6] Appellant filed a timely petition for redetermination. On appeal to CDTFA, appellant asserted that gross receipts on the federal income tax returns included nontaxable income including layaway return payments, interest income, rental income, and accounts receivable from prior periods. Appellant argued that its quarterly sales reports should be used to establish taxable sales. Based on this information, CDTFA ordered a reaudit to examine appellant's quarterly sales reports and any other documentation provided to support appellant's contentions.

11. For the reaudit, appellant provided the following: quarterly sales reports; bank statements for the period January 1, 2016, through June 30, 2016; and merchandise purchase invoices for January 1, 2016, through June 30, 2016. Appellant did not provide any evidence to show layaway return payments, interest income, rental income, or accounts receivable from prior periods. CDTFA also received purchase data from eight of appellant's known vendors.

12. CDTFA compared the taxable sales that appellant recorded in its quarterly sales reports and the taxable sales that appellant reported in its sales and use tax returns and found no difference. However, upon comparison of appellant's quarterly sales reports to its purchases, CDTFA computed a book markup of negative 5.74 percent for the liability period. Based on the negative book markup, CDTFA determined that appellant's quarterly sales reports were unreliable.

13. CDTFA compared the deposits recorded in appellant's bank statements[7] for the period January 1, 2016, through June 30, 2016, to the quarterly sales reports and found that bank

[6] The audit workpapers note that the audit at issue in this appeal was not appellant's first audit. CDTFA states that during the first audit, it found similar material differences between the gross receipts reported on appellant's federal income tax returns and the taxable sales reported on appellant's sales and use tax returns.

[7] Bank deposits are not per se gross receipts. However, where, as here, a retailer is engaged in the business of making retail sales of tangible personal property, the retailer's bank deposits, net of deposits from non-sale or nontaxable transactions, are evidence of gross receipts from the retail sale of tangible personal property, which evidence CDTFA can use to determine audited taxable sales when sales cannot be accurately established using a direct approach because of a lack of adequate records.

deposits from sales proceeds exceeded taxable sales recorded in the quarterly sales reports. CDTFA concluded that this was further evidence that the sales reports were unreliable.

14. CDTFA compared appellant's federal income tax returns for each year to the credit card sales reported on appellant's forms 1099-K and found the following: appellant's reported credit card sales exceeded reported gross receipts for 2013; there was no difference between reported credit card sales and reported gross receipts for 2014 and 2015. CDTFA concluded that the gross receipts reported on appellant's federal income tax returns were understated by appellant's cash sales and, as such, the measure of tax reflected in the original audit was also understated. CDTFA did not assert an increase to the measure of tax.

15. CDTFA prepared a reasonableness test of the determined measure of tax using the markup method. CDTFA performed a shelf test[8] comparing the cost of merchandise from appellant's June 2016 merchandise purchase invoices to the corresponding selling prices and computed a markup of 44.76 percent. CDTFA used appellant's merchandise purchase invoices and the vendor sales information to compute audited merchandise purchases of $2,121,681 for the liability period. CDTFA adjusted audited merchandise purchase invoices according to the inventory information contained in appellant's federal income tax returns and added a markup of 35.2 percent to calculate audited taxable sales of $2,865,133 for the liability period. CDTFA found that the resulting unreported taxable sales of $920,639 were similar to those found in the original audit. Based on this information, CDTFA found that the taxable measure found during the original audit was reasonable.

16. In a letter dated May 11, 2020, CDTFA denied appellant's petition for redetermination. This timely appeal followed.

DISCUSSION

Issue 1: Whether any adjustments to the measure of unreported taxable sales are 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

[8] A shelf test is a comparison of known costs and associated selling prices used to compute markups.

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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 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*.)

Here, appellant did not provide a complete set of books and records for the audit. For example, appellant did not provide a sales journal, cash register tapes, or sales invoices for the liability period. CDTFA compared the gross receipts reported in appellant's federal income tax returns to the taxable sales reported on appellant's sales and use tax returns and found discrepancies that appellant could not explain. CDTFA then calculated the error rate for each year and applied it to the liability period.

Appellant provided additional documentation during the reaudit, and its quarterly sales reports reconciled to its sales and use tax returns for the liability period. However, appellant did not provide evidence for CDTFA to verify the accuracy of the returns. Indeed, CDTFA found that appellant's bank deposits exceeded the taxable sales recorded in appellant's quarterly sales reports. CDTFA also found that appellant's purchases exceeded the taxable sales recorded in appellant's quarterly sales reports.

Finally, appellant argues that the bank deposits included nontaxable income. However, appellant did not provide any documentation in support of this contention. Considering all of the foregoing, we find that it was reasonable for CDTFA to use an error rate calculated from appellant's federal income tax returns and sales and use tax returns to calculate appellant's audited taxable sales subject to the adjustments made in the reaudit. Accordingly, the burden of

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proof shifts to appellant to show that adjustments are warranted.

On appeal, appellant contends that the taxable measure is overstated because CDTFA did not properly calculate COGS. However, the taxable measure is not based upon appellant's COGS (or the markup calculated therefrom). Instead, the taxable measure is calculated from the differences between sales amounts reported on appellant's federal income tax returns and amounts reported on appellant's sales and use tax returns. Even if appellant's COGS were used to calculate the taxable measure, CDTFA did not calculate the COGS independently. Rather, CDTFA used the COGS that appellant reported on its federal income tax returns.

As to CDTFA's markup calculation, appellant argues that the audited purchase amount is incorrect. Appellant also asserts that CDTFA's markup calculation did not take into account merchandise returns, merchandise remaining in inventory from one year to the next, or merchandise that was defective upon receipt. We find this argument unpersuasive because the audit measure is not based on a markup method. Instead, CDTFA merely used the markup to test whether the audit results were reasonable. As such, we briefly address appellant's contentions regarding the markup calculation. Here, CDTFA confirmed appellant's purchases with appellant's vendors. Appellant has not provided any evidence to show that the audited purchase amounts are incorrect. In the revised audit, CDTFA reduced the markup rate based on information provided by appellant. Appellant has not provided any evidence that the markup rate should be reduced further or that CDTFA's calculation is incorrect. Accordingly, we find appellant's contentions regarding the markup calculation to be without merit.

Next, appellant provides a sales report for the period July 2013 through June 2016. Appellant notes that it recorded taxable sales of $1,999,809.25 on this report, which is more than the amount of taxable sales that appellant reported on its sales and use tax returns. Appellant asserts that this difference is attributable to nontaxable sales and the collection of debts relating to taxable sales from prior periods. However, appellant has not provided any further evidence to support the accuracy of its sales report. Further, the sales recorded on appellant's sales report for the period July 2013 through June 2016 are less than the sales reported on appellant's federal income tax returns for the tax years 2013, 2014, and 2015. The sales recorded on appellant's sales report are also less than the credit card sales reported in appellant's form 1099-K

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information. As such, we do not find appellant's sales report to be credible.[9]

Regarding the form 1099-K information, appellant asserts that a portion of the credit card receipts were payments for accounts receivable. Appellant asserts that as a result, credit card sales for 2013 and 2014 were inflated. Appellant argues that as of May 14, 2019, it had accounts receivable on sales made more than 180 days prior totaling $445,868.28. Here, we note that a retailer is relieved from liability for sales tax that became due and payable, insofar as the measure of tax is represented by accounts that have become worthless and charged off for income tax purposes by the retailer or, if the retailer is not required to file income tax returns, charged off in accordance with generally accepted accounting principles. (R&TC, § 6055(a); Cal. Code Regs. tit. 18, § 1642(a).) However, appellant has not argued that it is entitled to a deduction for uncollectable bad debts.[10] Instead, appellant argues that it *did* collect aged accounts receivable and as such the sales reported on its form 1099-K did not reflect sales that occurred during the liability period. To that end, appellant has not provided evidence to support his contentions.

Appellant has not otherwise identified any errors in CDTFA's computation of unreported taxable sales or provided any credible documentation establishing a more accurate calculation of audited taxable sales. Appellant's unsupported assertions are not sufficient to satisfy its burden of proof. (*Appeal of Talavera, supra*.) In light of all of the above, we conclude that no adjustments are warranted.

Issue 2: 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. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (See *Warner v. Santa Catalina*

[9] On appeal, appellant made several arguments regarding the sales report. Specifically, appellant noted that it made charges for delivery that were not subject to tax. Appellant also asserted that amounts recorded on the sales report as "cash sales" were payments received from finance companies. However, as noted above, we cannot reconcile the differences between appellant's sales report, the 1099-K information, and appellant's federal income tax returns. As we have already found the sales report to lack credibility, we need not discuss appellant's contentions regarding the sales report further.

[10] Appellant did not claim any bad debt deductions on its federal income tax returns.

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Island Co. (1955) 44 Cal.2d 310, 317; see also *People v. Superior Court* (*Sokolich*) 248 Cal App. 4th 434, 447.)

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.*)

Here, this was appellant's second audit. In appellant's first audit, CDTFA found material differences between appellant's federal income tax returns and appellant's sales and use tax returns. Thus, appellant was aware of the requirement to accurately report its taxable sales. However, for the audit at issue here, appellant provided limited records. The records that appellant did provide revealed the same type of discrepancies as in the first audit. Appellant's continued failure to accurately report its taxable sales or to keep a complete set of books and records is evidence of negligence.

Additionally, appellant's understatement of $987,137 represents an error rate of 50.8 percent (rounded) in comparison to the reported taxable measure of $1,944,494. This error rate is further evidence of negligence. Moreover, the gross receipts reported on appellant's

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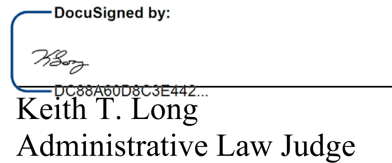
federal income tax returns exceed the taxable sales reported on appellant's sales and use tax returns by more than $200,000 in each year of the liability period. Appellant has not provided a non-negligent explanation for its failure to provide adequate records or to report its taxable sales accurately. As such, we find that the understatement was the result of negligence, and the negligence penalty was properly applied.

HOLDINGS

1. Appellant has not shown that any adjustments to the audited measure of tax are warranted.
2. Appellant's understatement was the result of negligence.

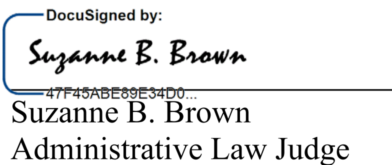
DISPOSITION

CDTFA's action in denying the petition is sustained.

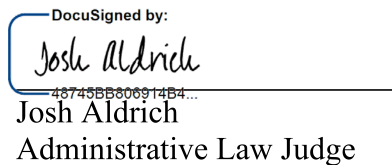


Keith T. Long
Administrative Law Judge

We concur:



Suzanne B. Brown
Administrative Law Judge



Josh Aldrich
Administrative Law Judge

Date Issued: 2/7/2022