OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 21078262) CDTFA Case ID 2-079-375
Z. GALOIAN, **dba Hollywood Collision Center**	))))

OPINION

Representing the Parties:

For Appellant:	George Issa, Representative Z. Galoian
For Respondent:	Ravinder Sharma, Hearing Representative Kevin Smith, Tax Counsel III Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Richard Zellmer, Business Taxes Specialist III

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Z. Galoian (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) that denied appellant's petition for redetermination of a Notice of Determination (NOD) dated August 12, 2020.[1] The NOD is for tax of $60,624.00, plus applicable interest, and a negligence penalty of $6,062.44, for the period April 1, 2016, through March 31, 2019 (liability period).

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Andrew J. Kwee, and Andrea L.H. Long held an electronic oral hearing for this matter on April 27, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

[1] The NOD was timely issued because on April 15, 2020, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which allowed CDTFA until October 31, 2020, to issue an NOD for the period April 1, 2016, through September 30, 2017. (R&TC, §§ 6487(a), 6488.)

ISSUES

1. Whether any adjustment is warranted to the amount of unreported taxable sales for the liability period.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant operated as an automobile repair and body shop specializing in collision repair.
2. CDTFA audited appellant for the liability period. For the liability period, appellant reported on his sales and use tax returns total sales of $2,335,730, and claimed deductions of $380 for sales for resale, $1,176,772 for nontaxable labor, $98,478 for sales tax reimbursement included in reported total sales, and $8,043 for other unspecified deductions, resulting in reported taxable sales of $1,052,057. Upon audit, appellant provided federal income tax returns (FITRs) for 2016, 2017, and 2018, bank statements for the liability period, and job folders for June 2018. CDTFA states that appellant did not provide point-of-sale reports, profit and loss statements, purchase invoices (except for those located in the 2018 job folders), or purchase journals for the liability period. CDTFA found appellant's books and records were incomplete.
3. CDTFA found that gross receipts reported on the FITRs exceeded total sales reported on the sales and use tax returns by $136,378 for 2016 and by $48,896 for 2018. CDTFA computed that total sales appellant reported on his sales and use tax returns exceeded gross receipts reported on the FITRs by $25,209 for 2017, and that bank deposits exceeded total sales reported on the sales and use tax returns by $77,690 for the liability period. CDTFA determined that appellant's unreported bank deposits totaled $33,919 for the last three quarters of 2016, $14,652 for 2017, $27,068 for 2018, and $2,051 for the first quarter of 2019. CDTFA compared cost of goods sold reported on the FITRs ($373,776 for 2016, $371,952 for 2017 and $390,853 for 2018) with taxable sales reported on the sales and use tax returns ($333,974 for 2016, $350,581 for 2017, and $334,615 for 2018), resulting in CDTFA's calculations of negative book markups of -10.65 percent for 2016, -5.75 percent for 2017, and -14.39 percent for 2018, which equals

-10.33 percent for that three-year period.[2] The negative book markups mean that reported cost of goods sold exceeded reported taxable sales. Thus, according to appellant's records, appellant sold merchandise at a loss. CDTFA expected the markup for this type of business to be at least 40 percent. Due to the negative book markups, the differences between gross receipts reported on the FITRs and total sales reported on the sales and use tax returns, the differences between total sales reported on the sales and use tax returns and bank deposits, and the lack of books and records, CDTFA concluded that taxable sales reported on appellant's sales and use tax returns could be understated, and that appellant's books and records were unreliable. Therefore, CDTFA decided to compute appellant's taxable sales using the markup method.

4. Appellant's job folders for June 2018 contained information regarding purchases and sales of parts for each job. CDTFA found that information regarding selling prices and purchase prices in some of the job folders was incomplete. Using information from 105 of the job folders from June 2018 for which information was complete, CDTFA performed a shelf test,[3] comparing the cost of parts as stated in purchase invoices to the selling price of the parts as stated in insurance claim estimates, and computed a markup on parts of 45.64 percent.

5. CDTFA applied the audited markup of 45.64 percent to cost of goods sold as reported on the FITRs to compute audited taxable sales of $544,367 for 2016, $541,711 for 2017, and $569,238 for 2018, for a total of $1,655,316 for all three years combined. By comparing audited taxable sales to reported taxable sales, CDTFA calculated unreported taxable sales of $210,393 for 2016, $191,130 for 2017, $234,623 for 2018, and $636,146 for all three years combined. CDTFA compared unreported taxable sales to reported taxable sales to compute error ratios of 63.00 percent for 2016, 54.52 percent for 2017, 70.12 percent for 2018, and 62.42 percent for all three years combined. CDTFA applied

[2] "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 (0.3000 ÷ 0.7000 = 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).

[3] A shelf test is an accounting comparison of known costs and associated selling prices, used to compute markups.

each year's error ratio to the respective portion of the liability period, and applied the overall percentage (62.42 percent) to the first quarter of 2019, resulting in a calculation of unreported taxable sales of $656,249 for the liability period.

6. On August 11, 2020, CDTFA issued the NOD for tax of $60,624.00, plus applicable interest, and a negligence penalty of $6,062.44, for the liability period. Appellant filed a timely petition for redetermination of the NOD. In a Decision issued on June 24, 2021, CDTFA denied appellant's petition for redetermination. The Decision noted that appellant conceded to unreported taxable sales of $77,690, based on the difference between bank deposits and reported total sales for the liability period.
7. This timely appeal to OTA followed.

DISCUSSION

Issue 1: Whether any adjustment is warranted to the amount of unreported taxable sales for the liability period.

California imposes a sales tax on a retailer's retail sales of tangible personal property in this state, measured by the retailer's gross receipts, 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.) Charges for labor or services for installing the property sold are not subject to tax. (R&TC, § 6012(c)(3).)

When 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 that 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.*)

In this case, CDTFA computed negative book markups of -10.65 percent for 2016, -5.75 percent for 2017, and -14.39 percent for 2018, meaning that, according to appellant's records, appellant sold merchandise at a loss for each of those years. Based on the negative book markups, OTA finds that CDTFA acted reasonably by concluding that appellant's reported

taxable sales were understated. Furthermore, there were significant differences between gross receipts reported on the FITRs and total sales reported on the sales and use tax returns, and between bank deposits and total sales reported on the sales and use tax returns. Consequently, OTA finds that it was reasonable for CDTFA to conclude that appellant's books and records were unreliable, and that appellant's sales could not be accurately computed using a direct audit method (that is, using the sales amounts recorded in appellant's books and records). The markup method is a standard and accepted accounting procedure. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613; *Appeal of Amaya*, 2021-OTA-328P.) Thus, OTA finds that it was reasonable for CDTFA to use the markup method to compute appellant's sales. Furthermore, it was reasonable for CDTFA to use sales and purchase information from appellant's own job folders to compute the audited markup of 45.64 percent, and to add that markup to the amounts of cost of goods sold as reported on appellant's own FITRs. For all of these reasons, OTA finds that CDTFA has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the audit.

Appellant concedes that he owes tax on unreported taxable sales of $77,690, based on the differences between bank deposits and reported total sales, but he disagrees with the remainder of the audit liability. Appellant contends that the bank deposits account for all his sales. Appellant argues that all sales proceeds were deposited into the bank account, and individual customers do not pay auto body shops like his business with cash, so the estimate of unreported taxable sales is unwarranted.

The audit results indicate that adding the unreported bank deposits to reported taxable sales results in amounts of taxable sales that are less than reported cost of goods sold. For example, adding the unreported bank deposits of $14,652 for 2017 to reported taxable sales of $350,581 for that same year results in taxable sales of $365,223 for that year, which is less than reported cost of goods sold of $371,952 for 2017. Similarly, adding the unreported bank deposits of $27,068 for 2018 to reported taxable sales of $334,615 for that same year results in taxable sales of $361,683 for that year, which is less than reported cost of goods sold of $390,853 for 2018. In comparison, the available evidence from the audit shelf test indicates that appellant operated at a markup, meaning that appellant sold merchandise for amounts that exceeded his merchandise costs. Thus, OTA finds that bank deposits do not account for all of

appellant's taxable sales because adding the unreported bank deposits to reported taxable sales results in amounts of taxable sales that are less than reported cost of goods sold. Accordingly, OTA finds unpersuasive appellant's contention that bank deposits account for all his taxable sales.

Appellant contends that he did not provide incomplete records for the liability period, and asserts that he provided everything that the auditor asked for, except for additional purchase invoices that appellant did not possess. Even if, hypothetically, those allegations were true, the above-mentioned negative book markups indicate that reported taxable sales were understated. Appellant has not provided additional documentation to refute the audit calculations. Except for his contentions about the bank deposits (which this Opinion addresses above), appellant has not explained how the documentation he has provided refutes the audit calculations. As a result, OTA finds that appellant's argument regarding the books and records does not support an adjustment to the audit liability.

Appellant disputes CDTFA's use of the markup method. As stated above, the markup method is a standard and accepted audit procedure. Appellant failed to meet his burden to explain why the markup method should not be used, or to provide documentation to refute the markup calculations. Appellant has not done so. Thus, OTA rejects appellant's argument regarding the use of the markup method.

For the reasons stated above, OTA finds that appellant has failed to prove facts from which a more accurate determination can be made. Consequently, reductions to the measure of unreported taxable sales are not warranted.

Issue 2: Whether the negligence penalty was properly imposed.

CDTFA states that it imposed the negligence penalty pursuant to R&TC section 6484 because of the large understatement and because of the lack of books and records. Appellant asserts that he was not negligent. Appellant contends that he provided complete records for the liability period, including everything that the auditor asked for, except for additional purchase invoices that appellant did not have.

R&TC section 6484 provides that, if any part of a deficiency determination 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 Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court (Sokolich)* (2016) 248 Cal.App.4th 434, 447.)

A taxpayer is required to maintain and make available for examination on request by CDTFA 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; Cal. Code Regs., tit. 18, § 1698(b)(1).) 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. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records is evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k).)

California Code of Regulations, title 18, section 1703(c)(3)(A) provides that a negligence penalty should not be added to a deficiency determination 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 practices were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323.) In the present case, appellant had not been previously audited.

The understatement of $656,249 represents an error ratio of 62.37 percent when compared to reported taxable sales of $1,052,057. OTA finds that the large size of the understatement and error ratio are evidence of negligence.

Moreover, the taxable sales of $350,581 reported on the 2017 sales and use tax return are less than the $371,952 cost of goods sold reported on the 2017 FITR. Taxable sales of $334,615 reported on the 2018 sales and use tax returns are less than the $390,853 cost of goods sold reported on the 2018 FITR. Because reported taxable sales on appellant's sales and use tax returns were less than reported costs of goods sold on the FITRs, appellant could not have reasonably believed that the amounts of taxable sales reported on the sales and use tax returns were accurate. Thus, OTA finds that the understatement cannot be attributed to appellant's good faith and reasonable belief that his bookkeeping and reporting practices 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 also *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at 323.) In light of all of the above, OTA concludes that the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not established that any adjustment is warranted to the amount of unreported taxable sales for the liability period.
2. The negligence penalty was properly imposed.

DISPOSITION

CDTFA's action in denying the petition is sustained.

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

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Andrew J. Kwee
Administrative Law Judge

DocuSigned by:
Andrea LH Long
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Andrea L.H. Long
Administrative Law Judge

Date Issued: 7/14/2022