

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

In the Matter of the Appeals of:	)	OTA Case No. 230212528
<b>MANGIA E. BEVI, INC.,</b>	)	CDTFA Case IDs: 097-040, 224-792, 795-186
<b>dba Caffe Divino</b>	)	
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**OPINION**

Representing the Parties:

For Appellant: Mitchell Stradford, 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, Mangia E. Bevi, Inc., dba Caffe Divino (appellant) appeals a November 3, 2022 Decision issued by the California Department of Tax and Fee Administration (respondent)<sup>1</sup> denying, in part,<sup>2</sup> appellant's petitions for redetermination of two Notices of Determination (NODs) and two corresponding protective claims for refund.<sup>3</sup> The first NOD (respondent's Case ID 097-040) was issued on July 20, 2016, for tax of \$99,736.89 (based on a \$1,191,995 measure), plus applicable interest, and a 10 percent negligence penalty of \$9,973.71,

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<sup>1</sup> Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to the board.

<sup>2</sup> As explained in the Factual Findings, below, the Decision ordered a limited reaudit of the period January 1, 2015, through December 31, 2017, only, but otherwise denied the petitions.

<sup>3</sup> A taxpayer will sometimes file a petition for redetermination and a claim for refund to protect its right to claim a refund or credit for overpayments discovered in an audit or that may be discovered during the taxpayer's appeal of the NOD. Such claims are frequently referred to as protective claims for refund.

for the period July 1, 2010, through December 31, 2014 (liability period 1).<sup>4, 5</sup> The second NOD (respondent's Case ID 224-792) was issued on October 26, 2018, for tax of \$103,652 (based on a \$1,168,373 measure), plus applicable interest, and a 10 percent negligence penalty of \$10,365.22, for the period January 1, 2015, through December 31, 2017 (liability period 2).<sup>6, 7</sup> Respondent's Decision ordered a reaudit of liability period 2 to make an allowance for exempt sales of food products but otherwise denied appellant's petitions and claims for refund. Respondent prepared a reaudit reducing the taxable measure for liability period 2 from \$1,168,373 to \$994,137, which remains in dispute.

This appeal is being decided on the basis of the written record because appellant waived its right to an oral hearing.

### ISSUES

1. Are adjustments to the measure of unreported taxable sales for liability period 1 warranted?
2. Are further adjustments to the taxable measure<sup>8</sup> for liability period 2 warranted?
3. Did respondent correctly impose the negligence penalties?

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<sup>4</sup> Appellant was originally selected for audit of the period July 1, 2010, through June 30, 2013. Respondent extended the liability period to include July 1, 2013, through December 31, 2014. The first NOD was timely issued because on December 11, 2015, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period July 1, 2010, through March 31, 2013, which allowed respondent until July 31, 2016, to issue an NOD. (See R&TC, §§ 6487(a), 6488.)

<sup>5</sup> According to respondent's November 3, 2022 Decision, respondent did not create a separate case identification number for appellant's protective claim for refund filed in connection with the NOD issued for the period July 1, 2010, through December 31, 2014, and Case IDs 970807 and 097-040 were meant to encompass both the petition and the protective claim for refund for that period. However, Case ID 970807 appears to be an outdated one that respondent used with its legacy account management software, while the other three case IDs appear to be in the format used by respondent's current account management software. This Opinion's caption uses the latter three case IDs, only.

<sup>6</sup> Appellant filed its sales and use tax return (SUTR) for January 1, 2015, through March 31, 2015 (1Q15) late on June 30, 2015. Thus, the second NOD was timely issued because on May 23, 2018, appellant signed a waiver of the otherwise applicable three-year statute of limitations for the period January 1, 2015, through June 30, 2015, which allowed respondent until October 31, 2018, to issue an NOD. (See R&TC, §§ 6487(a), 6488.) Respondent's Decision, footnote 5, incorrectly states that the waiver was signed on March 23, 2018.

<sup>7</sup> Appellant also filed a protective claim for refund (Respondent's Case ID 795-186) in connection with the second NOD.

<sup>8</sup> Unreported taxable sales of \$360,341 + disallowed claimed exempt sales of food products of \$578,041 + disallowed claimed sales for resale of \$55,755 = \$994,137 reaudit measure of tax.

### FACTUAL FINDINGS

1. Appellant, a corporation, operated a restaurant in Sausalito, California, during the liability periods. The business was open from 6:30 a.m. to 11:00 p.m. serving breakfast, lunch, and dinner. Seating was available for approximately 28 customers inside and 8 customers outside the restaurant. Appellant's seller's permit was effective June 1, 2002.

#### *For Liability Period 1*

2. Appellant reported total sales of \$2,568,391 on its sales and use tax returns (SUTRs) for liability period 1 and claimed deductions of \$841,537 for exempt sales of food products resulting in reported taxable sales of \$1,726,854. Appellant told respondent that it compiled sales using Excel and estimated approximately 35 percent as claimed deductions because it had problems with its point-of-sale (POS) system, which crashed.
3. For the audit, appellant's first, appellant initially provided federal income tax returns (FITRs) for 2010, 2011, and 2012; and bank statements<sup>9</sup> for liability period 1. Appellant initially provided no sales data from its POS system. Subsequently, though, appellant provided a resale certificate; credit card receipts relating to claimed sales for resale for May 2013 through December 2013; and POS sales reports for June 2013 through December 2014. Appellant did not provide sales tax worksheets or other audit trails to verify the accuracy of appellant's reporting method. Respondent found the books and records were incomplete and inadequate for sales and use tax audit purposes.
4. Respondent compared claimed exempt sales of food products of \$841,537 to reported total sales and computed a ratio of 33 percent.
5. When comparing total sales reported on the SUTRs for 2010,<sup>10</sup> 2011, and 2012, to the corresponding gross receipts reported on the FITRs, respondent found that gross receipts exceeded total reported sales by \$183,402, \$164,625, and \$251,426, respectively. Appellant did not provide documentation supporting reported gross receipts and did not explain the reason for the large differences, which totaled \$599,453.

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<sup>9</sup> Appellant initially provided bank statements for July 1, 2010, through June 30, 2013, but subsequently provided bank statements for July 1, 2013, through December 31, 2014.

<sup>10</sup> January 1, 2010, through June 30, 2010, was not part of the liability period, but respondent obtained reported sales for this period from its taxpayer records.

6. Respondent compared total sales reported on appellant's 2011 and 2012 SUTRs to the corresponding cost of goods sold (COGS) reported on appellant's FITRs to compute book markups<sup>11</sup> of 91.62 percent for 2011, 35.73 percent for 2012, and 60.26 percent for both years combined. Based on its experience auditing similar businesses in appellant's area, respondent concluded the book markups were unreasonably low and an indication that appellant underreported total sales for those periods.<sup>12</sup>
7. On the basis of the above findings, respondent concluded that it would have to rely on an indirect audit method to verify reported taxable sales. Respondent obtained Form 1099-K data for 2011 and 2012 from the IRS<sup>13</sup> and decided to compute sales using a credit card sales ratio analysis.<sup>14</sup> Respondent compiled credit card sales for 2011 and 2012 and determined that credit card sales exceeded the corresponding total sales that appellant reported on the SUTRs. Respondent concluded that this was another indication that reported total sales were understated.
8. Using appellant's bank statements, respondent compiled credit card sales deposits of \$3,105,408 for liability period 1.<sup>15</sup> Since credit card sales deposits for 2011 and 2012 were similar to the Form 1099-K data,<sup>16</sup> respondent concluded that credit card sales deposits compiled from the bank statements were reliable, and, because deposit information was complete for liability period 1, respondent used that data.

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<sup>11</sup> "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  $\text{markup amount} \div \text{cost}$ . In this example, the markup percentage is 42.86 percent ( $0.30 \div 0.70 = 0.4286$ ). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

<sup>12</sup> Total sales should have included sales for resale, which may have been sold at below retail. Neither party explained the possible impact of that inclusion on estimated markups.

<sup>13</sup> Form 1099-K is used to report payments made to a taxpayer by payment card (e.g., credit or debit cards) processing companies (e.g., Visa, MasterCard, or American Express) or third-party network (e.g., Venmo or PayPal). It is authorized by the IRS for tax administration purposes. (See 26 C.F.R. § 1.6050W-1.)

<sup>14</sup> A credit card sales ratio analysis typically involves the use of third-party data, such as bank statements or IRS Forms 1099-K, which show 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. If a reasonable estimate of the ratio of such non-cash sales to total sales can be made, an equally reasonable estimate of total (i.e., cash and non-cash) sales can be made.

<sup>15</sup> Respondent concluded that electronic deposits that totaled \$3,140,408 included \$35,000 in non-business deposits.

<sup>16</sup> The average difference per month was about \$318.

9. Based on discussions with appellant, respondent performed site observations on Thursday, May 22, 2014, and Wednesday, September 17, 2014, both for the entire business day.<sup>17</sup> Respondent concluded that the data from the two-day test (as explained below) was the best available evidence to establish sales using the credit card sales ratio method.
10. The two-day observation test produced the following data: 1) cash sales of \$806.54; credit card sales of \$2,244.45; credit card tips of \$411.34; and nontaxable sales of \$176.15. Respondent noted that no sales for resale were made during the observation test. Respondent concluded that the results were representative of appellant's business.
11. Respondent used the data from the observation test to compute: total sales of \$3,050.99 ( $\$806.54 + \$2,244.45$ ); a ratio of credit card sales to total sales (credit card sales ratio) of 73.56 percent ( $\$2,244.45 \div \$3,050.99$ ); a ratio of credit card tips to credit card sales including tips (credit card tip ratio) of 15.49 percent ( $\$411.34 \div (\$2,244.45 + \$411.34)$ ); a ratio of credit card sales to credit card sales including tips (credit card sales net of tip ratio) of 84.51 percent ( $\$2,244.45 \div \$2,655.79$ ); and a ratio of nontaxable sales to total sales (nontaxable sales ratio) of 5.7735 percent ( $\$176.15 \div \$3,050.99$ ).
12. Respondent multiplied credit card sales deposits of \$3,105,408 for liability period 1 by the credit card sales net of tip ratio of 84.51 percent and divided the result by the credit card sales ratio of 73.56 percent to compute audited total sales of \$3,567,516.
13. Appellant stated that it sold cold food (salads) to a nearby market. It provided a resale certificate issued by the market dated June 18, 2013. Respondent confirmed that the market had a valid seller's permit as of December 1, 2012. Appellant also provided receipts that showed 217 transactions totaling \$78,714 from May 1, 2013, through December 31, 2013, all charged to the same credit card. Respondent concluded that these were nontaxable sales for resale.
14. Appellant stated it continued making sales for resale in 2014 but was unable to provide supporting evidence. Nevertheless, based on its discussions with appellant, respondent concluded the same customer likely would have continued to purchase cold food for resale. Respondent calculated average monthly sales for resale of \$9,839 ( $\$78,714 \div 8$ ,

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<sup>17</sup> Respondent requested an opportunity to perform a third observation test day, but appellant did not respond to the request.

- rounded) per month and thus estimated sales for resale of \$118,071 ( $\$9,839 \times 12$  months) for 2014. In total, respondent calculated sales for resale of \$196,785 ( $\$78,714 + \$118,071$ ) for May 1, 2013, through December 31, 2014.
15. Respondent multiplied audited total sales of \$3,567,516 by the nontaxable sales ratio of 5.7735 percent to compute nontaxable sales of \$205,846. Respondent deducted nontaxable sales of \$205,846 and sales for resale of \$196,785 and then divided the remainder by 1 plus the applicable sales tax rate for each quarterly period to compute audited taxable sales (net of tip and tax) of \$2,918,848 for liability period 1.
  16. Respondent deducted reported taxable sales of \$1,726,854 from audited taxable sales of \$2,918,848 to calculate unreported taxable sales of \$1,191,995 for liability period 1, which is the amount at issue.
  17. Appellant had previously reported that it had not relied on POS records to prepare its tax returns because the POS system had crashed and all POS records had been lost. Because appellant eventually provided POS sales reports for July 1, 2013, through December 31, 2014, respondent used the reports to calculate certain items, including total sales of \$1,213,480 (compared to the audited amount of \$1,053,897) and sales tax reimbursement collected of \$84,883 (compared to the reported amount of \$67,770). Due to the lack of supporting source documents, appellant's described difficulties with the POS system, and the discrepancies (apparently to appellant's detriment) between the POS data and the more complete information upon which the audit was based, respondent concluded that the POS sales reports were unreliable.
  18. Respondent compared audited taxable sales for 2011 and 2012 to the corresponding COGS reported on the FITRs and computed audited markups of 210.93 percent for 2011, 146.19 percent for 2012, and 174.59 percent for both years combined, which respondent considered reasonable for appellant's business.
  19. Respondent issued the first NOD to appellant on July 20, 2016, based on the above-mentioned audit, for tax of \$99,736.89 plus applicable interest and a negligence penalty of \$9,973.71; respondent indicated that it imposed the penalty because of appellant's negligent reporting and its failure to maintain and provide adequate records.
  20. Appellant filed a timely petition for redetermination dated July 22, 2016, contesting the first NOD, and a protective claim for refund "for any sales or use tax overpaid during the

audit period, July 1, 2010, through December 31, 2014, due to errors in reporting or the petitioner's misunderstanding of the applicable laws and regulations."<sup>18</sup>

*For Liability Period 2*

21. On its SUTRs for liability period 2, appellant reported total sales of \$2,659,277 and claimed deductions of \$809,780 for nontaxable sales<sup>19</sup> resulting in reported taxable sales of \$1,849,497. Respondent noted that, similar to liability period 1, appellant appeared to be estimating approximately 30 percent of total sales as nontaxable sales. Appellant did not provide sales tax worksheets or other records sufficient to allow respondent to determine appellant's reporting method or verify the accuracy of appellant's reporting.
22. Respondent initially contacted appellant for audit on February 28, 2018, and made numerous requests for books and records. Appellant did not provide any books and records. Respondent issued a subpoena, which was served on appellant's president on October 20, 2018. On November 20, 2018, appellant provided only FITRs for 2015, 2016, and 2017; a 2016 profit and loss statement; and bank statements and merchant statements for 2015 and 2016.
23. Due to the lack of adequate books and records, respondent was unable to verify appellant's reported sales using a direct audit method. Respondent used the credit card sales ratio method and relied, in part, on some of the results of the audit for liability period 1 (the first audit).
24. Respondent obtained Form 1099-K data for 2015 and 2016 from the IRS and used that data to compile credit card sales of \$1,799,624 for the two years combined. Respondent multiplied credit card sales by the credit card sales net of tip ratio of 84.51 percent (calculated in the first audit) and divided the result by the credit card sales ratio of 73.56 percent (calculated in the first audit) to compute audited total sales of \$2,067,421 for 2015 and 2016 combined.<sup>20</sup> Next, for each quarterly period, respondent divided

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<sup>18</sup> The claim was untimely for amounts voluntarily paid for quarters prior to 2Q13. (See R&TC, § 6902; *Holland Furnace Co. v. State Board of Equalization* (1960) 177 Cal.App.2d 672.)

<sup>19</sup> Appellant claimed \$737,573 for exempt sales of food products and \$72,207 for sales for resale.

<sup>20</sup> Unlike its calculation of taxable sales for liability period 1, respondent did not reduce total sales by the nontaxable sales ratio of 5.7735 percent, as determined from the site observations. It thus treated total sales as taxable sales.

- taxable sales by 1 plus the applicable sales tax rate to compute audited taxable sales, excluding sales tax reimbursement, of \$1,897,733. Respondent subtracted taxable sales of \$1,163,023 reported on appellant's SUTRs for 2015 and 2016, to compute unreported taxable sales of \$734,710. Respondent also computed error ratios for each quarter, which varied between 52.50 percent and 79.69 percent, and a 63.17 percent error ratio for the two years combined.<sup>21</sup>
25. Respondent multiplied reported taxable sales for each quarterly period in 2015 and 2016 by the corresponding quarterly error ratios and multiplied the four reporting periods in 2017 by the 63.17 percent error ratio, to compute an understatement of taxable sales of \$1,168,373 for liability period 2. Respondent concluded that the audited understatement required disallowance of all claimed nontaxable sales (\$809,780) and evidenced an additional \$358,593 measure of unreported taxable sales.
  26. Based on the above findings, respondent issued the NOD for liability period 2 on October 26, 2018, for tax of \$103,652, plus applicable interest, and a negligence penalty of \$10,365.22; respondent indicated that it imposed the penalty because appellant failed to maintain and provide adequate records and continued to negligently complete its SUTRs.
  27. Appellant filed a timely petition for redetermination dated November 12, 2018, contesting the second NOD.
  28. Respondent held a single appeals conference for both petition cases as part of respondent's internal appeals process. Appellant did not attend. On November 3, 2022, respondent issued its Decision ordering a limited reaudit for liability period 2, only, to allow exempt sales of food products using the ratio of 5.7735 percent established in the first audit but otherwise denying the petitions.
  29. Respondent conducted the reaudit as directed, applying the nontaxable sales ratio of 5.7735 percent to audited total sales to allow \$175,984 for exempt sales of cold food to go. Respondent deducted the \$119,363 measure of allowed exempt sales of cold food to go for 2015 and 2016 from audited total sales for those years to compute audited taxable sales, including sales tax reimbursement, of \$1,948,058 for 2015 and 2016 combined, then divided each quarterly amount by 1 plus the applicable tax rate to compute audited

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<sup>21</sup> The "error ratio" is the percentage of unreported taxable sales to reported taxable sales.



taxable sales, excluding sales tax reimbursement, of \$1,788,168 for 2015 and 2016.

Respondent deducted appellant's reported sales (totaling \$1,163,023) on a quarterly basis to compute error ratios for each quarter of 2015 and 2016 and a 53.7517 percent error ratio for the two years combined.<sup>22</sup>

30. Respondent multiplied reported taxable sales for each quarterly period of 2015 and 2016 by the corresponding quarterly error ratios and multiplied reported taxable sales for each of the four quarters of 2017 by the 53.7517 percent error ratio to compute an understatement of taxable sales of \$994,137 for liability period 2.
31. Respondent concluded that the audited understatement required disallowance of claimed exempt sales of food products of \$578,041<sup>23</sup> and the disallowance of claimed sales for resale of \$55,755,<sup>24</sup> with the remainder of \$360,341 (\$994,137 - \$578,041 - \$55,755) representing unreported taxable sales.
32. Respondent prepared a reaudit report dated November 18, 2022, that reduced the taxable measure to \$994,137, which will result in a reduction to the determined tax and penalty for liability period 2. In a letter dated January 18, 2023, respondent notified appellant regarding the results of the reaudit.
33. This timely appeal followed.

### DISCUSSION

#### Issue 1: Are adjustments to the measure of unreported taxable sales for liability period 1 warranted?

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property, 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 until the retailer proves otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" for human consumption are generally exempt from sales tax pursuant to R&TC section 6359(a), the exemption does not apply to sales of alcoholic

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<sup>22</sup> Although respondent also computed unreported taxable sales of \$625,145 for 2015 and 2016, it used the error ratios, as explained below, to calculate the understatement for all of liability period 2.

<sup>23</sup> \$737,573 claimed exempt sales of food products - (\$1,782,470 audited total sales for 2015 and 2016 × 5.7735 percent) - (\$980,676 reported total sales for 2017 × 5.7735 percent).

<sup>24</sup> \$72,207 claimed sales for resale - (\$284,951 audited total sales for 3Q15 × 5.7735 percent).

or carbonated beverages (R&TC, § 6359(b)(3)), to sales of food served in a restaurant (R&TC, § 6359(d)(1)), or to sales of hot food to-go (R&TC, § 6359(d)(7)).

If 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).)

When a taxpayer appeals a deficiency determination based on underreported taxable sales, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*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.*) Proof of error in respondent's analysis generally will not be sufficient to satisfy a taxpayer's burden of proof; the taxpayer must also prove the correct tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) The applicable standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, the taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective, supra.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera, supra.*)

Appellant argues that the 73.56 percent credit card sales ratio based on the two-day observation test is not representative of appellant's actual credit card sales ratio during the period in question. Respondent's Decision states that appellant also argued that respondent did not properly compute allowances for exempt sales of cold food to go and nontaxable sales for resale.

Because appellant failed to provide adequate books and records for the audit, respondent was unable to verify reported taxable sales directly from appellant's records. Respondent's preliminary analysis found large unexplained differences between the gross receipts reported on the FITRs and total sales reported on the SUTRs. In addition, a preliminary markup check<sup>25</sup> indicated a markup that was substantially less than respondent expected to find for appellant's

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<sup>25</sup> Here, "preliminary markup check" refers to a simple comparison of COGS reported on appellant's FITRs with total sales reported on appellant's SUTRs.

restaurant. The Office of Tax Appeals (OTA) finds that respondent correctly concluded on the basis of these findings that appellant was not reporting accurately. OTA also finds that, given the dearth of records provided by appellant, respondent's decision to use an observation test and the credit card sales ratio method as the basis for its determinations was a rational one.<sup>26</sup>

OTA has reviewed respondent's calculations. All appear to have been based on reliable data (appellant's bank records and Form 1099-K data from independent third parties (merchant processors)) and all appear to have been done correctly. OTA finds that the audit resulted in a reasonable estimate of the deficiency.<sup>27</sup> Therefore, OTA concludes that respondent has established that its determination that appellant failed to report \$1,191,995 in taxable sales for liability period 1 is reasonable and rational, and, accordingly, the burden shifts to appellant to show error and a more accurate measure.

Appellant has not stated a factual or legal basis for its arguments. It has not attempted to establish error by respondent, a more accurate credit card sales ratio, or a more accurate taxable measure. Accordingly, appellant has failed to carry its burden. Therefore, there is nothing upon which OTA can base an adjustment to the determined measure of unreported taxable sales.

Issue 2: Are further adjustments to the taxable measure for liability period 2 warranted?

Regarding the audit and reaudit for liability period 2, the workpapers indicate respondent made repeated requests and issued a subpoena for appellant's business records, but appellant did not provide any. Given the absence of any other reasonable option, respondent's decision to rely on available Form 1099-K data and some of the results of the first audit was a rational one.

OTA has already found, above, that respondent's findings in the first audit were reasonable, at least in part because they were based on a rational audit approach that correctly performed appropriate calculations using reliable data and reaching reasonable conclusions. Appellant made no effort to argue or prove otherwise, or to establish that there was any reason why OTA should not rely on findings from the audit and reaudit for liability period 2. OTA finds that such reliance is reasonable. It also appears from the evidence that respondent correctly

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<sup>26</sup> Both the observation test and the credit card sales ratio method are recognized and standard accounting procedures commonly used in sales tax audits. (See respondent's Audit Manual, §§ 0810.12 & 0810.30; see also *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613.)

<sup>27</sup> While the results constitute only estimates of appellant's taxable sales, estimates are the best that can be expected when a taxpayer fails to properly maintain and provide adequate business records, including source documents, from which an exact determination can be made.

performed the calculations and that the resulting estimated deficiency is reasonable. Consequently, the burden shifts to appellant to show error and a more accurate taxable measure. Appellant has not done either. Therefore, there is no basis for an adjustment.

Issue 3: Did respondent correctly impose the negligence penalties?

As relevant here, if any part of a deficiency for which a deficiency determination is made is due to negligence, respondent must add a penalty equal to 10 percent of the amount of the determination. (R&TC, § 6484.) Although the term “negligence” is 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.)

As previously stated, a taxpayer must maintain and make available for examination on request by respondent 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 returns. (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 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 is evidence of negligence and may result in imposition of a negligence penalty. (Cal. Code Regs., tit. 18, § 1698(k).) A negligence penalty also can be based on reporting errors. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323.) Respondent relies on both grounds here.

Generally, a penalty for negligence should not be added to deficiency determinations made in 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. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) Conversely, though, a negligence penalty can be upheld in a first audit if there is 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 substantially compliant with the requirements of the Sales and Use Tax Law. (*Ibid.*)

Appellant argues that the negligence penalties are not warranted and should be deleted. The evidence establishes that appellant failed to maintain and provide adequate business records for either liability period, despite multiple requests and a subpoena (for liability period 2). The only explanation appellant provided for its failure to provide records was its unsupported statement that its POS system crashed.<sup>28</sup> OTA finds that the failure to maintain and provide complete and accurate records supporting sales during both periods at issue is evidence of negligence.

The evidence also shows that appellant neglected its obligation to accurately report its sales made during both periods at issue. Appellant claimed that, due to problems with its POS system, it estimated that approximately 35 percent of its sales were not taxable. It did not explain the factual basis for its estimate or the legal bases for reporting taxable sales based on an estimate. According to the evidence, appellant failed to report approximately 41 percent of its taxable sales for liability period 1.<sup>29</sup> Credit card sales alone during that period, which appellant could have calculated from bank statements, exceeded reported total sales in half of the quarters in liability period 1. In addition, recorded sales tax collected (per POS reports) of \$84,883 for July 1, 2013, through December 31, 2014, exceeded sales tax of \$67,770 reported on and remitted with the corresponding SUTRs. OTA finds that these 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. For liability period 2, appellant failed to report approximately 35 percent of its audited taxable sales.<sup>30</sup> Appellant did not offer a reasonable explanation for the erroneous reporting. Consequently, OTA finds that there is sufficient evidence of negligent reporting for both periods at issue.

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<sup>28</sup> Appellant eventually provided POS records for July 1, 2013, through December 31, 2014.

<sup>29</sup> This is based on audited unreported taxable sales of \$1,191,995 and audited total taxable sales of \$2,918,848.


<sup>30</sup> This is based on audited unreported taxable sales of \$994,137 (disallowed claimed exempt sales of \$578,041 + understated taxable sales of \$360,341 + disallowed claimed sales for resale of \$55,755) and audited total taxable sales of \$2,843,634 (\$1,849,497 (reported) + \$994,137 (unreported)).

HOLDINGS


1. Adjustments to the measure of unreported taxable sales for liability period 1 are not warranted.
2. Further adjustments to the taxable measure for liability period 2 are not warranted.
3. Respondent correctly imposed the negligence penalties.


DISPOSITION

OTA sustains respondent’s reduction of the total taxable measure for liability period 2 from \$1,168,373 to \$994,137 and its Decision denying appellant’s petitions for redetermination and claims for refund in all other respects.

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 Michael F. Geary  
 Administrative Law Judge

We concur:

DocuSigned by:  
  
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 Andrew Wong  
 Administrative Law Judge

DocuSigned by:  
  
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 Teresa A. Stanley  
 Administrative Law Judge

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