OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **D. JAFARI,** **dba Glendora Tire & Brake Auto Center**	OTA Case No. 221212042 CDTFA Case ID: 3-493-089

OPINION

Representing the Parties:

For Appellant: Shawn Zali, Representative

For Respondent: Jason Parker,
Chief of Headquarters Operations

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

L. KATAGIHARA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, D. Jafari (appellant) appeals a Decision issued by the California Department of Tax and Fee Administration (respondent) denying appellant's petition for redetermination of a Notice of Determination (NOD) dated January 21, 2022.[1] The NOD is for tax of $71,858.00, plus applicable interest, and a penalty of $7,185.84 for the period January 1, 2018, through September 30, 2021 (liability period).

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUES

1. Whether an adjustment to the measure of unreported taxable sales is warranted.
2. Whether an adjustment to the amount of disallowed claimed sales for resale is warranted.
3. Whether the negligence penalty was properly imposed.

[1] The NOD was timely issued because appellant signed a series of waivers extending the otherwise applicable three-year statute of limitations, providing respondent until April 30, 2022, to issue an NOD for the period January 1, 2018, through December 31, 2018. (R&TC, §§ 6487(a), 6488.)

FACTUAL FINDINGS

1. Appellant operates an automotive repair shop located in Glendora, California, specializing in the sales, installation, and repair of tires and brakes.
2. Respondent had not audited appellant prior to the instant audit.
3. On appellant's sales and use tax returns (SUTRs) for the liability period, appellant reported total sales of $1,694,489, and claimed deductions of $27,318 for sales for resale and $1,406,221 for nontaxable labor, resulting in reported taxable sales of $260,950.
4. Appellant admits that the business neither maintained sales journals nor created a sales invoice for each transaction. Consequently, to determine the total amount of sales to report on his SUTRs, appellant used his bank statements. Then, to calculate the claimed deductions for nontaxable labor, appellant estimated (based on his experience as the mechanic for the business) the percentage of nontaxable labor associated with those sales.
5. For audit, appellant provided federal income tax returns (FITRs) for 2018, 2019, and 2020; sales invoices for the second quarter of 2019 (2Q19), and 1Q20 through 3Q20; bank statements for 1Q18 through 4Q20; and IRS Forms 1099-K (Forms 1099-K) for 2019 and 2020.[2] Respondent also obtained appellant's Form 1099-K data for 2018 from a third-party source.
6. Respondent compared appellant's taxable sales reported on his SUTRs for 2018, 2019, and 2020 to the corresponding gross receipts reported on appellant's FITRs and discovered appellant's gross receipts exceeded his taxable sales each year, for a total difference of $353,323. Appellant was unable to explain the discrepancies.

[2] Forms 1099-K (titled "Payment Card and Third Party Network Transactions") show the monthly and annual amounts paid to the recipient by a bank, credit card company, or third party network, during a given time period. Forms 1099-K include payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

7. Respondent also compared taxable sales reported on the SUTRs to the corresponding cost of goods sold (COGS) reported on appellant's FITRs and computed markups[3] of -39.37 percent for 2018 and -49.15 percent for 2019.[4]

8. The Form 1099-K data reflected that appellant made credit card sales totaling $1,512,478 between 1Q18 and 4Q20. By dividing these credit card sales by 1 plus the applicable sales tax rate, respondent calculated that appellant made $1,376,420 in credit card sales, excluding sales tax reimbursement. However, appellant only reported total sales in the amount of $1,205,507 on his SUTRs for the same period, meaning, for this first portion of the audit period, appellant underreported his total sales by at least $170,913 (because this amount does not take cash sales into account).

9. Appellant's underreporting during 1Q18 and 4Q20 was further confirmed by respondent's review of appellant's bank statements. Appellant's bank statements for 1Q18 through 4Q20 reflected cash sales deposits of $344,281 and credit card sales deposits of $1,599,574, for a total of $1,943,855 (collectively, bank deposit sales proceeds).[5] From that figure, respondent deducted 3.45 percent[6] to calculate that appellant's bank deposit sales proceeds, excluding sales tax reimbursement, totaled $1,876,793. However, for this period, appellant reported $1,205,507 as his total sales on his SUTRs, revealing an understatement up to $671,286 (this amount does not take nontaxable and exempt sales into account). Appellant was unable to explain the reason

[3] "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 = 0.4286). Negative markups generally tend to indicate that the taxpayer was selling items for less than its recorded cost, that the taxpayer did not sell all of the inventory it purchased that year, or that the taxpayer understated its sales.

[4] Respondent was unable to compute a markup for 2020 because appellant did not report any COGS on his 2020 FITR. Nor did appellant provide any documents (such as purchase journals or merchandise purchase invoices) from which respondent could determine the amount of appellant's COGS.

[5] Bank deposits are not gross receipts. (R&TC, § 6012(a).) 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 respondent can use to determine audited taxable sales when sales cannot be accurately established using a direct approach because of a lack of adequate records.

[6] As explained further below, the 3.45 percent represents the percentage of appellant's gross receipts that constitute collected sales tax reimbursement.

for the difference between the sales proceeds reflected in his bank records and the amount reported on his SUTRs.

10. Respondent performed a block test[7] using appellant's sales invoices for 1Q20.[8] The block test revealed total sales, including sales tax, of $121,826. This $121,826 was comprised of $41,008 in taxable sales of automotive parts, $76,620 in nontaxable labor sales, and $4,199 in collected sales tax. Using these figures, respondent calculated that 62.89 percent ($76,620 ÷ $121,826) of appellant's sales were nontaxable (nontaxable sales ratio), and that appellant's ratio of sales tax collected to total sales was 3.45 percent ($4,199 ÷ $121,826).

11. Respondent also compared the invoice totals to appellant's 1Q20 SUTR. The invoices reflected total sales, excluding sales tax, of $117,627 ($121,826 − $4,199), which exceeded the total sales of $83,987 appellant reported his 1Q20 SUTR. Similarly, appellant's invoices reflected $41,008 of taxable sales, but appellant only reported $9,295 in taxable sales on the SUTR.

12. To determine appellant's audited taxable sales for 1Q18 through 4Q20, respondent first removed appellant's claimed sales for resale of $24,040 from appellant's total bank deposit sales proceeds of $1,943,855. Respondent then multiplied the result ($1,919,815) by the nontaxable sales ratio of 62.89 percent to compute nontaxable sales of $1,207,371 (rounded). The remaining $712,444 ($1,919,815 − $1,207,371), therefore, represents appellant's taxable sales, including sales tax, for 1Q18 through 4Q20. Respondent divided appellant's taxable sales by 1 plus the applicable sales tax rate to compute audited taxable sales, excluding sales tax reimbursement, of $648,323. From this amount, respondent subtracted appellant's reported taxable sales of $177,966 for 1Q18 through 4Q20 to calculate unreported taxable sales of $470,357.

13. Appellant did not provide bank statements for 1Q21 through 3Q21 (i.e., the remainder of the liability period). Therefore, to determine appellant's audited taxable sales for that period, respondent first computed an error ratio of 264.30 percent using the percentage of

[7] A block test is a generally accepted audit tool which examines transactions from a representative portion of a liability period (i.e., a sample) and applies the findings to the liability period. It is typically used when complete records are not available for the entire liability period.

[8] Not all sales invoices for the quarter were provided. Sales invoices were numbered sequentially, but there were gaps in the invoices appellant provided.

unreported taxable sales to reported taxable sales for 1Q18 to 4Q20 ($470,357 ÷ $177,966). Respondent then applied the 264.30 error ratio to appellant's total reported sales ($82,984) to calculate unreported taxable sales of $219,327 ($82,894 × 264.30 percent [rounded]) for 1Q21 through 3Q21.

14. In total, respondent calculated unreported taxable sales of $689,684 ($470,357 + $219,327) for the entire liability period.

15. With respect to appellant's claimed deductions of $27,318 for nontaxable sales for resale, appellant indicated he made sales of parts to other retailers. However, appellant did not provide documentation, such as resale certificates, to support his claimed nontaxable sales for resale. Thus, respondent disallowed the entirety of his claimed sales for resale deduction for the liability period.

16. Respondent issued an NOD to appellant asserting a liability for both unreported taxable sales and disallowed claimed nontaxable sales for resales, which appellant timely petitioned.

17. On September 29, 2022, respondent issued a decision denying appellant's petition for redetermination, and this timely appeal followed.

DISCUSSION

Issue 1: Whether an adjustment to the 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.) It is the retailer's responsibility to maintain complete and accurate records necessary to support reported amounts and to allow respondent to determine the correct tax liability under the Sales and Use Tax Law. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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, 6511.) In the case of an appeal, 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 its initial burden, the burden of proof shifts to the taxpayer to establish

that a result differing from respondent's determination is warranted. (*Ibid*.) To satisfy its burden of proof, a taxpayer must prove both: (1) that the tax assessment is incorrect; and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Here, appellant provided incomplete books and records for the audit. Appellant admitted that he did not maintain a sales journal and that sales invoices were not consistently created. Appellant further admitted that in completing his SUTRs, he estimated the amount of his taxable and nontaxable sales based on his experience as the mechanic for the business (as opposed to maintaining complete and accurate records to properly determine the correct amount of taxable sales). Moreover, the Form 1099-K data, and appellant's bank statements and sales invoices all revealed that appellant underreported his taxable sales. Therefore, respondent was justified in its non-acceptance of appellant's reported sales and its use of an indirect audit method to compute appellant's sales.

To determine the audited taxable sales, respondent utilized a bank deposit analysis and a block test, as described above. These methods are recognized and standard accounting procedures. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613; *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) Upon review of respondent's audit methodology, OTA finds that respondent properly applied both accounting procedures. Therefore, OTA concludes that respondent has established that the determination is reasonable and rational, and accordingly, the burden shifts to appellant to show that a result differing from respondent's determination is warranted.

Here, appellant states that he provided all requested supporting documentation to respondent and contends that his FITRs and bank statements support his reported taxable sales. However, appellant's contention is directly contradicted by the records he provided, which convincingly demonstrate (as previously discussed) that he underreported his taxable sales to respondent. Appellant has neither identified a specific error in respondent's computation of the audited taxable sales nor explained the substantial differences between his reported sales and his FITRs and bank statements. Appellant cannot carry his burden simply by asking OTA to find unidentified errors in respondent's determination. (See *Appeal of Amaya*, 2021-OTA-328P.) Appellant must point to an error in the determination and provide proof of the error. (*Ibid*.; see also *Appeal of AMG Care Collective*, *supra*.) Nor are unsupported assertions sufficient to

satisfy a taxpayer's burden of proof. (*Ibid*.) Accordingly, OTA concludes that an adjustment to the measure of unreported taxable sales is not warranted.

Issue 2: Whether an adjustment to the amount of disallowed claimed sales for resale is warranted.

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.) The burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser indicating that the property is purchased for resale (resale certificate). (R&TC, § 6091; Cal. Code Regs., tit. 18, § 1668(a).) If the seller does not timely obtain a valid and complete resale certificate, the seller will be relieved of liability for the tax only where the seller shows that the property: (1) was in fact resold by the purchaser prior to an intervening use; (2) is being held for purposes of resale by the purchaser and there has been no intervening use; or (3) was consumed by the purchaser who reported or paid tax directly to respondent. (Cal. Code Regs., tit. 18, § 1668(e).)

Appellant claimed $27,318 of nontaxable sales for resale during the liability period but did not provide any resale certificates or other documentation supporting the claimed sales for resale. Consequently, respondent disallowed appellant's claimed sales for resale.

Appellant has not made any specific contentions regarding the disallowed sales for resale. Appellant has not identified any particular alleged sale for resale that was erroneously disallowed or provided any documentation to support the claimed sales for resale, nor has appellant made the requisite showing under California Code of Regulations, title 18, section 1668(e) with respect to any disallowed sale for resale. Appellant's unsupported assertions are not sufficient to meet his burden of proof. (*Appeal of AMG Care Collective*, *supra*.) Accordingly, appellant has not shown that an adjustment to the amount of disallowed claimed sales for resale is warranted.

Issue 3: Whether the negligence penalty was properly imposed.

Respondent imposed the negligence penalty because appellant failed to maintain and provide complete books and records for audit and the audit disclosed a substantial understatement of taxable sales.

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 Sales and Use Tax Law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. A taxpayer shall 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 SUTRs. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) Failure to maintain and keep complete and accurate records will be considered evidence of negligence or intent to evade the tax and may result in penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to a deficiency determination associated with the first audit of a taxpayer. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) However, such a penalty may be added in the first audit if evidence establishes that any bookkeeping and reporting error 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. (*Ibid*.)

This was appellant's first audit. However, appellant failed to provide complete and verifiable books and records for audit. For example, appellant did not provide and/or maintain sales tax worksheets, sales journals, purchase journals, merchandise purchase invoices, or records to substantiate his sales or claimed deductions. Instead of maintaining records that would allow appellant to accurately report his taxable and nontaxable sales, appellant stated that he estimated his claimed nontaxable labor sales based on his experience. The audit also revealed appellant underreported his taxable sales for the liability period by $689,684, meaning appellant failed to report 72.55 percent of his taxable sales.[9]

Moreover, both appellant's bank deposits and invoices reflected greater total sales than the amount appellant reported on his SUTRs. Specifically, the 1Q20 invoices reflected total sales of $117,627, of which appellant only reported $83,987. Similarly, for 1Q18 through 4Q20, appellant only reported $1,205,507 of his $1,876,793 bank deposit sales proceeds (excluding

[9] This percentage is calculated by dividing the total unreported taxable sales by the total audited taxable sales ($689,684 ÷ 950,634).

sales tax reimbursement). Therefore, appellant knew or must have known that he was underreporting his total and taxable sales.

Appellant has not made any specific arguments refuting the negligence penalty. Respondent's evidence, however, substantiates a finding that appellant did not have a good faith and reasonable belief that his bookkeeping and reporting practice were in substantial compliance with the requirements of the Sales and Use Tax Law. Appellant's inadequate books and records, the material understatement, and reporting errors are sufficient to support respondent's imposition of the negligence penalty, despite being appellant's first audit. Therefore, the negligence penalty was properly applied.

HOLDINGS

1. An adjustment to the measure of unreported taxable sales is not warranted.
2. An adjustment to the amount of disallowed claimed sales for resale is not warranted.
3. The negligence penalty was properly imposed.

DISPOSITION

Respondent's action in denying appellant's petition for redetermination is sustained.

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Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

We concur:

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

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

Date Issued: 10/4/2023