OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **M. KAMIES** **dba Durty Nelly's**	OTA Case No. 221212039 CDTFA Case ID: 0-137-060

OPINION

Representing the Parties:

For Appellant:	Mike Figueroa Jr., Representative
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

N. RALSTON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Kamies (appellant) appeals a Decision issued by the California Department of Tax and Fee Administration (respondent)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated March 22, 2017. The NOD is for tax of $111,604.71, plus applicable interest, and a negligence penalty of $11,160.48, for the period January 1, 2014, through December 31, 2016 (liability period).

Respondent subsequently performed a reaudit, which reduced the taxable measure to $1,391,155, and will result in a reduction to the determined tax, applicable interest, and penalty.

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Keith T. Long, and Natasha Ralston held an oral hearing for this matter in Cerritos, California, on December 5, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an Opinion.

[1] 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" shall refer to the board.

ISSUES

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

FACTUAL FINDINGS

1. Appellant, a sole proprietor, operated a restaurant with full bar located in Costa Mesa, California, selling Irish-style food. Appellant was issued her seller's permit with an effective start date of April 1, 2012. Appellant was not previously audited.
2. For the liability period, appellant reported on her sales and use tax returns (SUTRs) total sales of $918,753 and claimed deductions of $5,296 for nontaxable sales of food products, $21,550 for sales for resale, $65,922 for sales tax reimbursement included in reported total sales, and $1,967 for "other" representing tips, resulting in reported taxable sales of $824,018. Because appellant did not provide books and records for audit, respondent was unable to verify appellant's reporting method and the accuracy of sales reported on appellant's SUTRs for the liability period using a direct audit method.
3. Respondent decided to verify the accuracy of reported taxable sales using the credit card sales ratio method.
4. Respondent obtained Form 1099-K[2] data for 2014 and 2015 from the IRS. Respondent compiled credit card sales of $1,512,019 for that period. Respondent estimated a credit card tip ratio of 10 percent due to the lack of records. Respondent multiplied credit card sales by the estimated credit card tip ratio of 10 percent which was then deducted from credit card sales. Next, for each quarterly period, respondent divided the result by 1 plus the applicable sales tax rate to compute credit card sales, excluding sales tax reimbursement and tips, of $1,260,014 for January 1, 2014, through December 31, 2015. Respondent compared credit card sales, excluding sales tax reimbursement and tips, to the corresponding reported taxable sales of $584,858 and found that credit card sales exceeded reported taxable sales by $675,156.

[2] Form 1099-K is an IRS form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network, during a given time period. Form 1099-K includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

5. Based on its experience in audits of similar businesses in appellant's area, respondent estimated a credit card sales ratio of 80 percent.[3] Respondent divided credit card sales, excluding sales tax reimbursement and tips, by the estimated credit card sales ratio of 80 percent to compute audited taxable sales of $1,575,019 for January 1, 2014, through December 31, 2015. Respondent compared audited taxable sales to reported taxable sales and computed unreported taxable sales of $990,161 for January 1, 2014, through December 31, 2015. Respondent computed an error ratio for each year and for the two years combined.[4]
6. Respondent applied the 2014 and 2015 error ratios to the corresponding taxable sales reported on the SUTRs and the combined error ratio to taxable sales reported on the 2016 SUTRs. In total, respondent computed unreported taxable sales of $1,395,058.
7. Appellant declined to sign a waiver of the statute of limitations.[5] Thus, respondent prepared an audit report dated March 6, 2017, and issued an NOD to appellant on March 22, 2017, based on the aforementioned audit with a tax liability of $111,604.71, plus applicable interest, and a negligence penalty of $11,160.48.
8. On April 20, 2017, appellant filed a timely petition for redetermination protesting the NOD in its entirety.
9. Thereafter, appellant provided to respondent the following books and records: incomplete sales reports, sales receipts, and income statements for the liability period. Respondent found the new documentation did not support adjustments to the audit.
10. Respondent held an office discussion with appellant on November 8, 2019. Appellant argued that her sales reports were correct and the differences with sales reported on her SUTRs were due to incorrect information that was provided by her former representative.

[3] According to respondent, this credit card ratio is based on the credit card ratio of five similar businesses in appellant's area, and respondent submitted a schedule listing five locations with an average credit card ratio of 79.94 percent; however, the audit work papers indicate that the 80 percent credit card ratio was based on a single audit of a similar business in Costa Mesa.

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

[5] The three-year statute of limitations for issuing an NOD for the first expiring period, January 1, 2014, through March 31, 2014, would have expired on April 30, 2017.

Appellant also asserted that the 80 percent credit card sales ratio was too low. Appellant provided December 2016 ring tapes and December 2016 credit card settlement reports.[6]

11. Respondent analyzed the December 2016 ring tapes and found an unusually high amount of "no sales" recorded. Appellant stated that "no sales" are recorded when she opens the cash drawer to provide change for customers and access office supplies, such as paper clips, that are kept in the cash register. However, respondent believed that the "no sales" potentially represented cash sales and concluded that the ring tapes were incomplete and unreliable.

12. Using the December 2016 credit card settlement reports, respondent compiled credit card sales (including sales tax) of $62,201.15, and credit card tips of $11,926.10. Respondent computed a credit card sales tip ratio of 16.09 percent ($11,926.10 ÷ ($62,201.15 + $11,926.10)). Respondent concluded that the 16.09 percent credit card sales ratio was reasonable for appellant's business and warranted an adjustment in the computation of audited taxable sales.

13. Respondent also obtained Form 1099-K data for 2016 which was not available at the time the audit was completed. Thus, respondent compiled credit card sales of $2,280,904 for the liability period.

14. Respondent multiplied credit card sales by the credit card tip ratio of 16.09 percent which was deducted from credit card sales. Then, for each quarterly period, respondent divided the result by 1 plus the applicable sales tax rate to compute credit card sales, excluding sales tax reimbursement and tips, of $1,772,137 for the liability period. Respondent divided credit card sales, excluding sales tax reimbursement and tips, by the estimated credit card sales ratio of 80 percent to compute audited taxable sales of $2,215,173 for the liability period.

15. Respondent compared audited taxable sales to reported taxable sales and computed unreported taxable sales of $1,391,155 for the liability period.

16. Respondent prepared a reaudit report, which reduced the taxable measure by $3,903 from $1,395,058 to $1,391,155, which is the amount remaining in dispute.

[6] Ring tapes are daily sales summary by transaction number. Ring tapes were not provided for December 10, 2016, December 26, 2016, and December 29, 2016.

17. Respondent held an appeals conference with appellant. Appellant provided a daily sales summary for October 2016, and daily credit card sales transaction report for October 2016. Respondent found the documentation insufficient to support a higher credit card sales ratio because the documentation did not provide evidence of appellant's cash sales for October 2016. Respondent subsequently issued a Decision on November 3, 2022, denying the petition.[7]
18. Appellant timely appealed to OTA.
19. Subsequent to the hearing at OTA, appellant provided bank statements for October 2016 in response to OTA's post hearing order. This document did not show any cash deposits.

DISCUSSION

Issue 1: Whether any additional adjustments to the amount 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 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.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).) 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 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

[7] OTA notes that although the Decision stated that the petition was denied, the determined measure of tax was reduced to $1,391,155 in the reaudit.

that a result differing from respondent's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Here, appellant failed to make her books and records available for audit; thus, respondent was unable to verify sales appellant reported on her SUTRs for the liability period directly from appellant's records. Taxpayers are required to maintain and make available for examination on request by respondent, 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).) Respondent's use of the credit card sales ratio method as the basis for its determination is a recognized and standard accounting procedure. (*Appeal of Amaya*, 2021-OTA-328P; see *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613.) OTA also finds that Form 1099-K data is evidence from a third party (merchant card processors) of appellant's sales paid by credit card and is a reliable source of data from which to establish audited sales. OTA concludes that respondent has established that its determination is reasonable and rational, and accordingly the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

Appellant contends that her credit card sales ratio is 95 percent or more. Appellant did not provide documentation to support her contention. Appellant asserts that the business is in a high industrial business complex and argues that customers are more inclined to pay using credit cards. Appellant requests "somebody to come to accountant's office and review all 3 years of receipts." During the appeal, OTA requested additional briefing to give appellant the opportunity to provide documentation supporting her contentions and arguments. The evidence that appellant eventually provided (in a post-hearing submission) were bank statements for October 2016, but these cannot be used to establish a viable credit card to cash ratio because they do not show any cash deposits and conflict with appellant's statements at the hearing that the bank deposits do not include all cash sales. Furthermore, appellant still has not provided the

requested sales receipts. Even if the sales receipts were provided, it is not the task of OTA to conduct an audit of appellant's books and records. (*Appeal of Amaya, supra*.) Even if appellant had provided books and records that were comprehensive and internally consistent, respondent would not be required to accept those as conclusive if respondent, using recognized and standard accounting procedures, established in an audit that the books and records did not disclose the correct amount of tax liability. (*Appeal of Amaya, supra* (citing R&TC, § 6481 and *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 614-615).) As noted previously, OTA concluded that respondent established that its determination was reasonable and rational, and accordingly, the burden shifted to appellant to show errors in the audit. Therefore, appellant must provide evidence sufficient to establish that a result differing from respondent's determination is warranted. (*Appeal of Talavera, supra*.) To satisfy its burden of proof, a taxpayer must prove both: (1) that the tax assessment is incorrect and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Accordingly, because appellant has not met its burden, OTA finds no basis to recommend further adjustment.

In summary, OTA finds that respondent computed audited taxable sales based on the best-available evidence. Although appellant did provide bank statements for October 2016, these statements cannot be used to establish a viable credit card to cash ratio as they do not show any cash deposits and conflict with appellant's statements at the hearing that the bank deposits do not include all cash sales. As such, appellant has not met her burden to show that respondent's assessment is incorrect, nor has she shown what the proper amount of tax would be. Thus, OTA has no basis to recommend any additional adjustments.

Issue 2: Whether the negligence penalty was warranted.

R&TC section 6484 provides that, if any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (*Warner v. Santa Catalina Island Co.* (1955) 44 Cal.2d. 310, 317; see also *People v. Superior Court (Sokolich)* (2016) 248 Cal. App.4th 434, 447.) Generally, a penalty for negligence or intentional disregard should not be added to deficiency determinations associated with the first audit of a taxpayer in the absence of evidence establishing that any bookkeeping and reporting errors cannot be attributed to the

taxpayer's good faith and reasonable belief that its bookkeeping and reporting practice were in substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A); see also *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

A taxpayer shall maintain and make available for examination on request by 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 sales and use tax return. (R&TC, §§ 7053 7054; Cal. Code Regs., tit. 18, § 1698(b).) All records required to be retained under this regulation must be preserved for a period of not less than four years. (Cal. Code Regs., tit. 18, § 1698(i).) 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 or other appropriate administrative action. (Cal. Code Regs., tit. 18, § 1698(k).)

Respondent imposed the negligence penalty because appellant failed to maintain and provide any books and records for audit and the audit disclosed a substantial understatement of taxable sales. Appellant asserts that she was not negligent because she relied on her tax preparer to adequately prepare her returns and that she was not asked for specific documents by respondent.

The unreported taxable sales of $1,391,155 from the reaudit represents an error rate of approximately 169 percent when compared to reported taxable sales of $824,018 for the liability period. Stated another way, a comparison of unreported taxable sales of $1,391,155 to the audited taxable sales of $2,215,173 reveals that appellant failed to report approximately 63 percent of her taxable sales. OTA finds that the large amount of the understatement along with the large error ratio are evidence of negligence and that appellant should have been aware of the large understatement.

OTA notes that credit card sales (excluding tips) of $1,913,908 for the liability period alone exceeded corresponding reported total sales of $918,753. Thus, appellant knew or should have known that reported sales were understated. In light of the above, OTA finds that appellant did not have a good faith and reasonable belief that her bookkeeping and reporting practice were in substantial compliance with the requirements of the Sales and Use Tax Law. OTA also finds that appellant did not exercise the care that a reasonable and prudent person would exercise

under similar circumstances. Although this is appellant's first audit, OTA finds that appellant was negligent, and the negligence penalty was properly imposed.

HOLDINGS

1. No additional adjustment to the amount of unreported taxable sales is warranted.
2. The negligence penalty was warranted.

DISPOSITION

Respondent's action in recommending that the determined measure be reduced by $3,903 from $1,395,058 to $1,391,155 as recommended in respondent's reaudit but otherwise denying the petition is sustained.

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Natasha Ralston
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Natasha Ralston
Administrative Law Judge

We concur:

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Suzanne B. Brown
Administrative Law Judge

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Keith T. Long
Administrative Law Judge

Date Issued: 6/17/2024