OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 230413137
	CDTFA Case ID: 2-417-778
MARCO CRAFTMASTERS, INC.	

OPINION

Representing the Parties:

For Appellant: Nedeen Nasser, Attorney

For Respondent: Jason Parker, Chief of Headquarters Ops.

L. KATAGIHARA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Marco Craftmasters, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] partially denying appellant's petition for redetermination (petition) of a Notice of Determination (NOD) for the period July 1, 2016, through June 30, 2019 (audit period). The NOD, which was issued on November 23, 2020, is for tax of $15,680.00, plus applicable interest, and a negligence penalty of $1,568.01.[2] Subsequent to its issuance of the NOD, CDTFA conducted a reaudit that reduced the tax to $12,717.00 and the negligence penalty to $1,271.70. CDTFA's decision granted appellant's petition with respect to the reduction resulting from the reaudit but denied the petition as to the remainder of the proposed liability.[3]

[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 CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to the board.

[2] The NOD was issued timely because, on June 12, 2020, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which extended, until January 31, 2021, the time within which CDTFA could issue an NOD for the period July 1, 2016, through September 6, 2017. (See R&TC, §§ 6487(b), 6488.)

[3] As CDTFA has conceded to the reduction reflected in the reaudit, all references to CDTFA's audit or audit methodology made hereafter pertain to the reaudit, not the original audit.

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

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

FACTUAL FINDINGS

1. Between January 1, 2011, and September 6, 2017, appellant operated a store in Pasadena, California, selling luxury furniture and home accessories at retail and for resale.
2. On its Sales and Use Tax Returns (SUTRs) for the audit period, appellant reported total sales of $190,555 and deductions of $102,160 for nontaxable sales for resale, which resulted in taxable sales of $88,395.
3. Upon audit, appellant provided to CDTFA appellant's federal income tax returns (FITRs) and profit and loss statements for 2016 and 2017, and its general ledgers and/or bank statements for May 2016 through December 2018.[4]
4. CDTFA's analysis of appellant's 2016 and 2017 FITRs revealed errors with respect to appellant's reported purchases and cost of goods sold (COGS). Appellant also reported more in gross receipts on its 2017 FITR than it reported to CDTFA on its SUTRs for that same year. Moreover, the markup resulting from appellant's reported gross receipts and COGS for 2017 was only 46.95 percent (and 28.79 percent lower than the calculated markup for 2016), which CDTFA considered to be too low for appellant's type of business.[5]

[4] According to appellant, most of its records had been lost due to a flood.

[5] "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 $.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 (.30 ÷ .70 =0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

5. Upon review of appellant's bank statements, CDTFA discovered appellant made wire transfers totaling $50,170 to a related entity (another furniture store) during 2016 and 2017. CDTFA considered these wire transfers to be payments for unrecorded purchases of merchandise from the related entity.

6. Due to the limited records provided and the inconsistencies in appellant's reporting, CDTFA conducted the audit using the markup method. By applying a 72.49 percent markup to appellant's COGS at retail on a yearly basis, CDTFA computed audited taxable sales for each year and compared them to appellant's reported taxable sales.[6] This comparison revealed appellant's reporting had an error rate of 11.15 percent for 2016 and 225.99 percent for 2017. CDTFA applied those error rates to determine appellant's audited taxable sales for the third quarter of 2016 (3Q16) through 4Q16, and 1Q17 through 3Q17, respectively (i.e., the portion of the audit period during which appellant had an active seller's permit) to calculate unreported taxable sales of $74,791 for the audit period.

7. With respect to appellant's $102,160 claimed deduction for nontaxable sales for resale, appellant did not provide resale certificates or reliable sales invoices to support its deduction.[7] Instead, appellant only provided quarterly totals of alleged nontaxable sales for resale made to a single retailer (its related business). However, CDTFA noted that $33,750 of appellant's deposits during the audit period originated from appellant's related business and were traceable to sales invoices appellant provided to CDTFA.[8] CDTFA therefore allowed $33,750 of appellant's claimed nontaxable sales for resale but disallowed the remaining claimed $68,410.

8. In addition to asserting audit liabilities for disallowed claimed nontaxable sales for resale and understated reported taxable sales, CDTFA also imposed a negligence penalty

[6] Because there were insufficient records to compute appellant's markup for retail sales, CDTFA adopted the average markup (72.49 percent) it calculated in a prior audit of appellant's related furniture store.

[7] Though not initially provided, appellant subsequently submitted to CDTFA copies of sales invoices to support its claimed nontaxable sales for resale. Appellant issued all these sales invoices to the related business. CDTFA did not consider the sales invoices to be reliable because the sales invoices were unnumbered, and for some, the date of the online payment preceded the date on the corresponding sales invoice.

[8] Some of the deposits and sales invoices were outside of appellant's operational period (i.e., after the seller's permit close-out date of September 6, 2017), but still within the audit period.

because appellant failed to provide adequate records during the audit and appellant's reporting errors were similar to those made in the prior audit.[9]

9. Appellant timely filed a petition, which CDTFA denied in part (as described above).

10. This timely appeal followed.

DISCUSSION

Issue 1: Whether an additional 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.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) 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*.; Cal. Code Regs., tit. 18, § 30219(a) & (b).)

Here, CDTFA found errors and inconsistencies within or between appellant's FITRs and SUTRs. CDTFA's analysis of appellant's reported gross receipts and COGS also revealed a markup for 2017 that was almost 30 percent lower than the markup calculated for the previous year, and too low for appellant's type of business. Appellant did not maintain and provide adequate books and records to support its reported amounts, despite being required to do so. (See R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) As appellant was unable to

[9] Prior to the audit at issue in this appeal, CDTFA audited appellant's business for the period January 1, 2011, through June 30, 2012. In that audit, CDTFA established unreported taxable sales of $198,100, disallowed claimed nontaxable sales for resale of $399,405, and imposed a negligence penalty.

properly explain these discrepancies and lacked documentation to support its reported amounts, CDTFA's use of an alternative audit method to establish appellant's audited taxable sales was warranted.

To do so, CDTFA employed the markup method, which is a standard and accepted audit procedure. (See *Appeal of Amaya*, 2021-OTA-328P.) Appellant does not argue that there are errors in CDTFA's markup method. Rather, appellant contends that CDTFA should have accepted appellant's FITRs and used the reported amounts therein to determine the amount of its tax liability. However, as previously discussed, appellant's FITRs revealed reporting errors and a low markup. Further, appellant failed to support the amounts it reported in its FITRs with adequate books and records. Under the circumstances presented here, OTA finds that CDTFA met its initial burden of showing that its determination was reasonable and rational. Consequently, the burden shifts to appellant to establish that a result differing from CDTFA's determination is warranted. (See *Appeal of Talavera*, *supra*; Cal. Code Regs., tit. 18, § 30219(a) & (b).)

Appellant contends that it was improper for CDTFA to use an audit close-out date of June 30, 2019, even though the business purportedly ceased to operate in September 2017. Although appellant's seller's permit was closed on September 6, 2017, it did not cease operating on that date. For example, a few days after its seller's permit was closed, appellant had additional deposits posted to its account. CDTFA accepted those deposits as evidence of nontaxable sales for resale, which decreased the amount of CDTFA's disallowed claimed nontaxable sales for resale. As such, CDTFA's expansion of the audit period past appellant's operational period resulted in a reduction of appellant's liability. Moreover, appellant's argument is of no consequence because there is no liability associated with any period after 3Q17. Therefore, appellant has not established that a reduction to the audited understatement of reported taxable sales is warranted.

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

It is presumed that all of a retailer's 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 a sale at retail is upon the person who makes the sale, unless that seller timely and in good

faith takes from the purchaser a certificate to the effect that the property is purchased for resale (a resale certificate). (R&TC § 6092; Cal. Code Regs., tit. 18, § 1668(a).)

If a seller fails to timely obtain a resale certificate in proper form, the seller will be relieved of liability for the tax only where the seller shows that the purchaser: (1) in fact resold the property and did not make a taxable use of the property; (2) is holding the property sold for resale and has not made a taxable use of that property; (3) consumed the property sold and reported the tax due directly to CDTFA on its sales and use tax returns; or (4) consumed the property sold, and paid the tax due to CDTFA pursuant to an assessment or an audit. (Cal. Code Regs., tit. 18, § 1668(e).)

Here, appellant failed to provide resale certificates or make the proper showing in accordance with California Code of Regulations, title 18, section 1668(e) to support its claimed deduction for nontaxable sales for resale. CDTFA did, however, allow $33,750 of the claimed deduction because CDTFA was able to find reliable sales invoices with corresponding deposit dates for transactions totaling that amount. CDTFA was unable to find the same support for the remaining $68,410.

Appellant has not proffered any specific argument or additional documentation to support the disallowed claimed nontaxable sales for resale. Therefore, appellant has not met its burden of proving that a further reduction to its disallowed claimed nontaxable sales for resale is warranted.

Issue 3: Whether the negligence penalty was properly imposed.

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. (Cal. Code Regs., tit. 18, § 1698(k).) When errors are continued from one audit period to the next, the imposition of a negligence penalty is warranted. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323-324.)

CDTFA added the negligence penalty to its determination based on appellant's failure to maintain and keep complete and accurate records, and because appellant made similar reporting errors in a previous audit as it did here. Such actions and inaction are evidence of negligence, and appellant has not made any specific arguments refuting the negligence penalty. (See *Independent Iron Works, Inc. v. State Bd. of Equalization*, *supra*, 167 Cal.App.2d at pp. 323-324; Cal. Code Regs., tit. 18, § 1698(k).) Thus, the Office of Tax Appeals finds that the negligence penalty was properly imposed.

HOLDINGS

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

DISPOSITION

CDTFA's action as set forth in its decision is sustained.

Signed by:
Lauren Katagihara
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Lauren Katagihara
Administrative Law Judge

We concur:

Signed by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

Date Issued: 9/25/2024