OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. LOPEZ,** **dba Taqueria Las Palmas**	OTA Case No. 230413062 CDTFA Case IDs: 2-684-770. 2-690-702, 2-835-464, 2-851-928, 2-864-921

OPINION

Representing the Parties:

For Appellant:	J. Lopez Jim Escobedo, Representative
For Respondent:	Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, J. Lopez, dba Taqueria Las Palmas (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated May 13, 2021.[2] The NOD is for tax of $81,155, plus applicable interest, and a penalty of $8,115.46 for the period April 1, 2016, through March 31, 2019 (liability period). (Case ID 2-835-464.)

In addition, pursuant to R&TC section 6901, appellant appeals CDTFA's denials of appellant's claims for refund totaling $34,358 for the liability period. (Case IDs 2-684-770, 2-690-702, 2-851-928, 2-864-921.)

[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 timely issued because on March 7, 2021, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period April 1, 2016, through March 31, 2018, which allowed CDTFA until July 31, 2021, to issue an NOD for that period. (R&TC, §§ 6487(a), 6488.)

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

ISSUES

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

FACTUAL FINDINGS

1. Appellant, a sole proprietor, operated a restaurant located in Napa, California, selling Mexican-style food with sales of beer and wine. Appellant's business was open from 11:00 a.m. to 9:00 p.m., Monday through Saturday.[3]
2. Appellant was issued a seller's permit with an effective start date of July 1, 2004, with an effective close-out date of April 30, 2020. Appellant was previously audited for the period July 1, 2011, through June 30, 2014.
3. For the liability period, appellant reported on his sales and use tax returns (SUTRs) total sales of $1,662,071 and claimed no deductions, which resulted in reported taxable sales of the same amount. Appellant stated that he prepared monthly sales reports which were provided to his outside bookkeeper who prepared the quarterly SUTRs.
4. For audit, appellant provided federal income tax returns (FITRs) for 2016 and 2017; sales journals for the liability period; daily sales reports for June 2018 and October 2018; bank statements for the liability period; merchant statements for July 2016 through March 2019; and various merchandise purchase invoices for May 2019 through July 2019. Appellant did not provide sales tax worksheets, cash register tapes, guest checks, or purchase journals for the liability period. CDTFA found the books and records appellant provided were insufficient for sales and use tax audit purposes.
5. CDTFA compared total sales reported on the SUTRs for 2016 and 2017 to the corresponding gross receipts reported on the FITRs, noting gross receipts exceeded taxable sales in each year by a large difference. Appellant was unable to explain the reason for the differences.

[3] Appellant contends that CDTFA was incorrect in its determination because the business was open until 8 p.m. and closed on holidays. However, during the observation test, CDTFA observed sales at the business until a closing time of 9 p.m. CDTFA also acknowledges that the business was closed on holidays.

6. CDTFA compared gross receipts reported on the FITRs for 2016 and 2017 to the corresponding cost of goods sold (COGS) reported on the FITRs and computed book markups[4] of 144.77 percent for 2016, 123.46 percent for 2017, and 133.30 percent for the two years combined. Based on its experience in audits of similar businesses in appellant's area, CDTFA considered the book markups to be low for appellant's type of business. Due to the incomplete books and records, unexplained differences, and low book markups, CDTFA concluded that additional testing was needed to verify reported taxable sales.

7. CDTFA reviewed appellant's bank statements. Because there were multiple months where appellant made little or no cash sales deposits, CDTFA believed the bank statements did not reflect all of appellant's sales and thus, concluded the bank deposit analysis could not be used to determine audited taxable sales.

8. Using sales journals provided by appellant, CDTFA compiled cash sales of $91,350, credit card sales of $1,661,004, and total sales of $1,752,354 for the liability period. CDTFA compared the recorded total sales of $1,752,354 to total reported sales of $1,662,071 and computed a difference of $90,283. Appellant was unable to explain the reason for this difference. However, CDTFA noted that the difference was similar to the amount of recorded cash sales.

9. Using Form 1099-K[5] data CDTFA obtained for April 2016 through June 2016, CDTFA compiled credit card sales of $1,733,773 for April 1, 2016, through December 31, 2018. Upon comparison to total sales of $1,524,798 reported on the SUTRs for April 1, 2016, through December 31, 2018, CDTFA computed that credit card sales alone were more than reported total sales by $208,975. CDTFA decided to compute audited taxable sales using the credit-card-sales-ratio method and performed an on-site observation test to establish a credit card sales ratio.

---

[4] "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 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

[5] 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 data includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

10. CDTFA performed its observation test on Friday, July 19, 2019; Tuesday, July 23, 2019; and Wednesday, November 13, 2019, and observed appellant's business for the full business day. Appellant charged sales tax on all sales for all three days.

11. For the three days combined, CDTFA compiled cash sales of $3,894.70 (including sales tax reimbursement), cash sales of $3,593.99 (excluding sales tax reimbursement), credit card sales of $5,770.66 (including sales tax reimbursement, tips, and credit card usage service fees), credit card sales of $5,103.05 (including sales tax reimbursement and credit card usage service fees, excluding tips), credit card sales of $4,575.17 (excluding sales tax reimbursement, tips, and credit card usage service fees[6]), total sales of approximately $8,998.72 (including sales tax reimbursement and credit card usage service fees, excluding tips), credit card tips of $667.60, credit card usage service fees of $195.47, and sales tax of $633.09.[7]

12. Based on the observation test and information from the prior audit, CDTFA concluded that appellant's food sales met the 80/80 rule; thus, all sales of food would be subject to sales tax unless appellant kept a separate accounting of his sales of cold food to-go.[8]

13. CDTFA calculated a credit credit-card-sales-ratio of 56.72 percent ($5,103.05 ÷ $8,998) and a credit card tip ratio of 11.57 percent ($667.60 ÷ $5,770.66) for the three days combined.[9] CDTFA noted that the results of the observation test were consistent with the prior audit's three-day observation test (October 1, 2014, February 18, 2015, and April 11, 2015) which resulted in a credit card sales ratio of 52.11 percent and a credit

[6] Because the credit card usage service fees were assessed based on a percentage of the sale amount, these service fees are included in the gross receipts from the retail sale of tangible personal property. (See R&TC, § 6012(a)(2); CDTFA Annotation 295.1500; see also Cal. Code Regs., tit. 18, § 1643 [which would be applicable to any debit cards charges based on a percentage of the sale amount and result in the inclusion of the charges in gross receipts].) Annotations do not have the force or effect of law but may be afforded weight by OTA. (*Adler Tank Rentals*, 2022-OTA-411P.)

[7] These computations do not result in duplicate inclusions of cash sales and credit card sales, but are separately computed amounts.

[8] The general rule is that a sale of cold food to-go is exempt from tax. (Cal. Code Regs., tit. 18, § 1603(c)(1)(B).) However, there is a special "80/80" rule under which a sale of cold food to-go in a form suitable for consumption on the retailer's premises (e.g., a cold sandwich) is subject to tax. This rule applies when more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of the retailer's sales of food products are otherwise subject to tax. (R&TC, § 6359(d)(6); Cal. Code Regs., tit. 18, § 1603(c)(1)(A), (c)(3).)

[9] Due to rounding, there are immaterial differences in amounts included in calculations.

card tip ratio of 11.05 percent. CDTFA therefore concluded that the results of the observation test were reasonable and representative of the liability period.[10]

14. Using daily sales reports, CDTFA compiled credit card sales of $53,593, credit card tips of $6,789, and a credit card tip ratio of 12.67 percent ($6,789 ÷ $53,593) for October 2018, and credit card sales of $48,439, credit card tips of $5,784, and a credit card tip ratio of 11.94 percent ($5,784 ÷ $48,439) for June 2018. CDTFA concluded that these results were further evidence that the 11.57 percent credit card sales ratio was representative of the liability period.

15. Using Form 1099-K data for April 2016 through June 2016, and merchant statements for July 2016 through March 2019, CDTFA compiled credit card sales of $1,868,062[11] for the liability period. CDTFA multiplied credit card sales by the credit card tip ratio of 11.57 percent to compute credit card tips of $216,114 (rounded). CDTFA deducted credit card tips from credit card sales and divided the result by the credit card sales ratio of 56.72 percent to compute audited total sales of $2,912,721 (rounded) for the liability period. For each quarterly period, CDTFA divided audited total sales by 1 plus the applicable sales tax rate to compute audited taxable sales of $2,701,762 for the liability period. Upon comparison to reported taxable sales of $1,662,071, CDTFA computed unreported taxable sales of $1,039,691 for the liability period.[12]

16. CDTFA compared its audited taxable sales attributable to 2017 to the corresponding COGS appellant reported on his 2017 FITR and computed a book markup of

[10] In the audit workpapers, CDTFA states that the restaurant was located across the street from a high school and offered a special lunch menu to students with tax included in the price of food sales and that appellant's bookkeeper stated that appellant rarely had cash sales and did not report cash sales. Appellant disputes these assertions. The record also includes CDTFA verification comments that appear to be related to the prior audit, stating that appellant's average markup for the audit period was 74.47 percent, which CDTFA considered to be too low for similar restaurants.

[11] As discussed below, this amount incorrectly includes $37,762 for November 2016, instead of $42,850.

[12] CDTFA calculated average daily cash sales from the observation test of $1,198 ($3,594 cash sales ÷ 3 days). CDTFA estimated that appellant operated approximately 930 days during the liability period and computed cash sales of $1,114,140 ($1,198 × 930 days). Because the computed cash sales closely approximated unreported taxable sales of $1,039,691, CDTFA concluded that the audited understatement using the credit-card-sales-ratio method was reasonable.

228.59 percent. CDTFA considered this markup to be adequate for appellant's business and concluded that its audited taxable sales were reasonable.

17. CDTFA issued the above-mentioned NOD to appellant on May 13, 2021, based on the $1,309,691 of unreported sales mentioned above.

18. Appellant filed a timely petition for redetermination disputing the NOD in its entirety.

19. In addition, on April 13, 2021, and May 16, 2021, appellant filed numerous amended SUTRs for periods within the liability period claiming deductions for exempt food items. CDTFA treated these amended returns as claims for refund and denied them because appellant did not provide supporting documentation to establish an overpayment of tax and the audit had disclosed an understatement of tax and not an overstatement of tax in each of the quarters for which appellant filed a claim for refund. CDTFA treated the claims for refund as part of appellant's petition for redetermination.

20. CDTFA held an appeals conference with appellant, and subsequently issued a Decision on March 13, 2023, denying the petition for redetermination and claims for refund.

21. This timely appeal followed.

DISCUSSION

Issue 1: Whether any 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.) 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, or in the case of a failure to file a return, 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*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*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 the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

In general, sales of food are exempt from tax. (R&TC, § 6359.) However, the exemption does not apply to certain sales, which are thus subject to tax. As relevant here, sales of food are subject to tax if the food is sold for consumption at facilities provided by the retailer (R&TC, § 6359(d)(2)) or if the food is sold as hot prepared food products (R&TC, § 6359(d)(7)). When more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of its retail sales of food are subject to tax, then cold food sold in a form suitable for consumption on the retailer's premises is subject to tax even if it is purchased "to go." (R&TC, § 6359(d)(6).) When a retailer's sales fit within this provision, known as the "80/80 rule," the retailer may avoid its application by keeping a separate accounting of its nontaxable sales, such as to-go sales of cold food in a form suitable for consumption on the retailer's premises. (R&TC, § 6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).) An optional payment designated as a tip, gratuity, or service charge is not subject to tax. (Cal. Code Regs., tit. 18, § 1603(h).)

Here, appellant's books and records provided for audit were incomplete. Appellant did not provide sales tax worksheets, cash register tapes, guest checks, or purchase journals for the liability period. CDTFA's preliminary analysis found low book markups (an indication that reported sales may have been understated) and unexplained differences between available records and amounts reported on the SUTRs. Due to the lack of sufficient records, CDTFA was unable to verify sales reported on appellant's SUTRs for the liability period using a direct audit method (that is, compiling audited sales directly from appellant's records). Accordingly, CDTFA was justified in questioning the accuracy of reported sales and using an indirect audit method to compute appellant's sales. CDTFA's use of the credit-card-sales-ratio method as the basis for its determination is a recognized and accepted accounting procedure. (See *Appeal of Amaya*, 2021-OTA-328P.) In addition, the Form 1099-K data and merchant statements are third-party evidence of appellant's sales paid by credit card and are a reliable source of data from which to establish audited sales. Therefore, CDTFA has shown that its determination is

reasonable and rational, and the burden shifts to appellant to show that adjustments are warranted.

Appellant asserts that CDTFA's daily cash sales analysis should be recalculated because the business was open for 860 days during the liability period, as a result of holidays and vacation, and not the 930 days used by CDTFA.[13] However, the number of days appellant operated his business was not used to establish the measure of tax; instead, it was solely utilized to determine the reasonableness of CDTFA's audited taxable sales.[14] In any event, using appellant's asserted 860 days appears to result in estimated cash sales of $1,030,280 (average daily taxable cash sales from the observation of $1,198 × 860 days), which supports a finding that the audited deficiency of $1,039,691 is reasonable.

Appellant contends that CDTFA incorrectly reported that his bookkeeper stated that he did not report cash sales. However, CDTFA did not rely upon any alleged statement by appellant's bookkeeper in making its determination. CDTFA determined audited taxable sales based on the observation test days and credit-card-sales-ratio method. Consequently, any misstatements as to appellant's reporting of cash sales is not grounds for an adjustment.

Appellant asserts that by CDTFA's own computation, the average markup was 74.47 percent, but that CDTFA rejected that percentage as too low without providing the basis for that determination. The 74.47 percent markup was part of CDTFA's preliminary calculation in the prior audit. In the present audit, CDTFA computed a book markup of 133.30 percent for 2016 and 2017 combined.[15] In addition, appellant has not provided any evidence to support a 74.47 markup and unsupported assertions are not enough to show error in CDTFA's determination.

Appellant asserts that CDTFA did not examine his menu and incorrectly assumed his sales were subject to the 80/80 rule. The record indicates that appellant's menu does include

[13] Appellant asserts that a telephone call noted in the Decision about the close-out date of his business never occurred. However, appellant does not dispute the date of close-out, which occurred after the liability period for this audit, and therefore, is not relevant here.

[14] CDTFA calculated average daily cash sales from the observation test of $1,198 ($3,594 cash sales ÷ 3 days). Based on its estimate that appellant operated approximately 930 days during the liability period, CDTFA computed cash sales of $1,114,140 ($1,198 × 930 days). Because the computed cash sales closely approximated unreported taxable sales of $1,039,691, CDTFA concluded that the audited understatement using the credit-card-sales-ratio method was reasonable.

[15] OTA notes that the markup represents the amount by which the cost of merchandise is increased to set the retail price and does not represent the taxable ratio of sales.

cold sides and salads, but more than 80 percent of the items on the menu are hot prepared foods. Appellant also states that his sales to students from nearby high schools were nontaxable. However, during the observation test, appellant charged tax reimbursement on all of his sales, providing further support that the 80/80 rule should apply. Appellant has also not provided evidence that he separately accounted for his nontaxable sales. In fact, during the observation test days, appellant charged and collected tax reimbursement on all of his sales. Thus, even if any portion of the sales were nontaxable, appellant would have collected excess tax reimbursement and would need to refund the excess tax reimbursement to his customers, or if unable to refund his customers, he must pay the excess tax reimbursement to the State. (See R&TC, § 6901.5; Cal. Code Regs., tit. 18, § 1700(b)(1)-(2).)

Appellant provides a calculation comparing reported taxable sales, gross receipts, and bank deposits (excluding 11.5 percent for tips) for 2016 and 2017, noting that the bank deposits were greater than reported taxable sales by $3,693 in 2016 and $18,406 in 2017. Appellant asserts that the underreporting is not as great as determined by CDTFA. However, appellant has not provided evidence explaining the differences in amounts reported on his SUTRs and FITRs, sales journals, or credit card deposits, on which CDTFA based its determination. In addition, credit card sales for the liability period alone are almost equal to sales reported on the SUTRs, indicating that appellant did not report cash sales accurately. And appellant's bank statements reveal daily cash sales of $170 (taxable cash sales based on bank deposits of $158,144 ÷ 930 days), as opposed to the $1,198 totaled during the observation test. Therefore, appellant's calculations are not reliable and do not show error with CDTFA's determination.

Appellant indicates that his SUTRs overstated total sales by $940 due to errors by his bookkeeper in reporting nontaxable sales of food products.[16] Appellant asserts that when he discovered the errors, he filed amended SUTRs that were improperly rejected by CDTFA. However, appellant has not provided documentation supporting the amended returns or other evidence of nontaxable food sales to support his claimed deductions.

Appellant provides sales reports showing sales and tip amounts to show that CDTFA's credit card tip ratio is incorrect and asserts that CDTFA failed to examine this documentation. However, CDTFA examined the tip reports, which were summaries of daily credit card sales and tips, and found them unreliable because they lacked transaction details. In addition, CDTFA

[16] Total reported sales of $1,662,071 - credit card sales of $1,661,131.

used the audited tip ratio that was based on actual sales observed during the observation tests. In any event, the sales reports indicate tip ratios that are similar to the audited credit card tip ratio computed by CDTFA from the observation test.

Appellant contends that that if he had over $1,000,000 in additional sales as determined by CDTFA, his costs to support those sales would need to be greater. Appellant asserts that he could not have made that level of additional sales because his utility expenses remained consistent, and he submitted documentation in support. However, appellant has not provided evidence that a direct correlation exists between sales and utility expenses. Between appellant's 2016 and 2017 FITRs, appellant's reported gross receipts increased by $37,440 ($629,149 - $591,709) but his reported utilities expenses decreased by $2,354 ($30,884 - $33,238), which contradicts appellant's assertion.

Appellant contends that he never provided written authorization for a third observation day. Consequently, appellant argues CDTFA's third site visit, which resulted in decreasing the tip ratio from 12.04 percent to 11.50 percent and increasing the liability, is invalid and cannot be considered part of the audit findings and result. In support, appellant provides an excerpt from the Observation Test Fact Sheet form (Form CDTFA-805) showing that two days in July 2019 were selected for the observation test. The Form CDTFA-805 reflects the signature of appellant and is dated July 11, 2019. But also, "11/15/19" is handwritten on the form as the third observation day.[17]

CDTFA's Audit Manual states:

> [A]uditors are required to complete the CDTFA-805 . . . before beginning an observation test. . . . To ensure the information is accurate and the taxpayer is informed of the process, the auditor should complete the [CDTFA-805] *jointly with the taxpayer*. . . . If the auditor makes any changes or revisions to the [CDTFA-805] due to additional information provided by the taxpayer or based on the test results, the auditor must discuss those changes with the taxpayer and document the changes as discussed with the taxpayer in the audit working papers. . . . Once the [CDTFA-805] is completed, the auditor and taxpayer should select the test day(s). . . . Three full days (minimum) - must be used to project sales (e.g. cash to credit ratio, for-here vs[.] to-go ratio, projecting average daily sales, etc.).

[17] OTA notes a typographical error and the actual date of the third observation test day was November 13, 2019.

(CDTFA Audit Manual § 0810.30, italics in original.)[18]

The audit workpapers do not explain whether the addition of a third day was discussed with appellant. However, in an email sent on July 22, 2020, to appellant's representative, CDTFA explained that appellant's previous representatives requested a third observation day because the credit card percentage appeared too high.

While it appears that CDTFA failed to properly document the selection of the third observation day in accordance with the Audit Manual, there is no evidence that the sales CDTFA recorded during the third observation day were substantially different from sales recorded by appellant or were otherwise inaccurate or atypical. The addition of the third observation day is consistent with CDTFA's policy in the Audit Manual of performing a minimum of three full days when the observation test is used to project sales in the audit of a restaurant. (See CDTFA Audit Manual § 0810.30.) In addition, while appellant contends that CDTFA's tip ratio is too high, the third observation day resulted in a lower tip ratio, which is to appellant's benefit. Accordingly, the results from the November 13, 2019 observation day should not be disregarded.[19]

Last, appellant notes an error on Audit Schedule 12A for credit card sales for November 2016, which is listed as $37,762, but should be $42,850.12. CDTFA asserts that this error benefits appellant because the lower amount was used to calculate audited taxable sales, and an upward adjustment would increase appellant's tax liability. Schedule 12A indicates that the $37,762 was used to calculate appellant's recorded 4Q16 sales of $180,262, and the difference between $180,262 and reported 4Q16 sales of $119,822 was included in total unreported taxable sales of $1,039,691. If $42,850 was used instead for November 2016, it appears that it would have resulted in unreported taxable sales higher than $1,039,691. Therefore, it appears that the inclusion of the lower amount resulted in lower unreported taxable sales. As a result, it was to appellant's benefit for CDTFA to compute unreported taxable sales

[18] OTA is not required to follow CDTFA's Audit Manual; however, OTA may look to it for guidance, such as when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

[19] During the agency-level appeal, appellant submitted an affidavit from a former employee that asserted that the receipts for the November 13, 2019 observation day were taken by the auditor but never returned. Appellant did not provide a copy of the former employee's affidavit, but a copy of the affidavit was included in CDTFA's briefing. CDTFA denied that any records for that day were taken and not returned. For the same reasons given above (regarding the validity of the November 13, 2019 observation day and the benefit to appellant of those results), OTA declines to address the alleged violation of due process for failure to return appellant's records.

using the amount listed on the merchant statement for November 2016 of $37,762, and OTA finds that no adjustment should be made. Accordingly, appellant has not shown that adjustments to the amount of unreported taxable sales are warranted.

Issue 2: 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 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. Super. Ct.* (2016) 248 Cal.App.4th 434, 447.) In *Independent Iron Works, Inc. v. State Bd. of Equalization*, (1959) 167 Cal.App.2d 318, 323, the court held that a negligence penalty is justified where errors are continued from one audit to the next.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

CDTFA imposed the negligence penalty because appellant failed to maintain and provide complete books and records for audit, the audit disclosed a substantial understatement of taxable sales, and the issues found in the prior audit were repeated in the current audit. Appellant contends that CDTFA's calculation of audited taxable sales was based on erroneous information and assumptions. Appellant asserts that he did not participate in the audit and lacks knowledge of the interactions between his bookkeeper and the auditor. Appellant states that he does not know what documentation the bookkeeper provided to the auditor. Appellant also asserts that he discovered errors that the bookkeeper made that resulted in overstated reported taxable sales.

OTA notes that the measure of unreported taxable sales of $1,039,691 represents an error ratio of 63 percent when compared to appellant's reported taxable sales of $1,662,071 for the liability period.[20] OTA finds the substantial understatement and large error ratio are evidence of negligence. In addition, appellant did not provide books and records for audit such as cash register tapes, guest checks, purchase journals, or sales tax worksheets or other audit trails to verify reported sales for the liability period, and appellant has not provided evidence to support any alleged nontaxable sales. Furthermore, appellant was issued his seller's permit with an effective start date in July 2004; thus, appellant had been in business nearly 12 years at the start of the liability period. Appellant was previously audited for the period July 1, 2011, through June 30, 2014. As a result, appellant was aware of the requirement to maintain and make available for examination all of his records necessary to verify the accuracy of any return filed. Accordingly, OTA finds that the failure to provide complete and accurate books and records supporting sales is evidence of negligence.

Additionally, the understatement established in the prior audit was also based on a three-day observation test and the credit-card-sales-ratio method. The observation test performed in the prior audit resulted in unreported taxable sales of $580,431, representing an error ratio of 67 percent ($580,431 ÷ $864,554 reported taxable sales). Thus, the error in reporting continued from one audit to the next. While the percentage of error decreased, the dollar amount of unreported taxable sales increased substantially from one audit to the next. Appellant failed to correct his reporting, which resulted in an increase of the amount of the deficiency. Appellant's failure to correct his previous bookkeeping and reporting errors is evidence of negligence. (See *Independent Iron Works, Inc. v. State Bd. of Equalization, supra*, 167 Cal.App.2d at p. 323.)

To the extent that appellant was uninformed and relied upon his bookkeeper to report his sales accurately and to represent him during the audit, OTA finds that these arguments are unpersuasive because appellant remains responsible for the negligence of his agent. As stated in CDTFA's Audit Manual, section 0506.20: "In general, where an agent, employee, or partner of the taxpayer is guilty of negligence, with a resulting tax deficiency, the 10-percent penalty will apply. This is true even though the agent, employee, or partner acted without the taxpayer's

[20] The "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

knowledge or consent, or acted contrary to the express instructions of the taxpayer."[21] Therefore, the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not shown that adjustments to the measure of unreported taxable sales are warranted.
2. The negligence penalty was properly imposed.

DISPOSITION

CDTFA's action in denying the petition and claims for refund is sustained.

DocuSigned by:
Josh Lambert
CB1F7DA37831416...

Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Lauren Katagihara
F595B34010D8470...

Lauren Katagihara
Administrative Law Judge

DocuSigned by:
Huy "Mike" Le
A11783ADD49442B...

Huy "Mike" Le
Administrative Law Judge

Date Issued: 5/14/2024

[21] As previously noted, CDTFA's Audit Manual does not provide binding legal authority; however, OTA may look to it for guidance. (*Appeal of Micelle Laboratories, Inc.*, *supra*.)