OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. GOMEZ AND** **A. ROMERO-LARA,** **dba Rolling Tires & Wheels #4**	OTA Case No.: 230914398 CDTFA Case ID: 02-969-620

OPINION

Representing the Parties:

For Appellants: Raul Carrega, Representative

For Respondent: Nalan Samarawickrema, Hearing Representative
Christopher Brooks, Attorney
Jason Parker, Chief of Headquarters Ops.

L. KATAGIHARA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, J. Gomez and A. Romero-Lara (collectively, "appellants") appeal a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellants' timely petition for redetermination (petition) of a Notice of Determination (NOD). The NOD, issued on July 2, 2021, is for tax of $104,467, plus applicable interest, and a penalty of $10,446.67 for the period April 1, 2018, through December 31, 2020 (audit period). During this appeal, CDTFA conducted a reaudit that reduced the tax by $21,605 (from $104,467 to $82,862), and the penalty by $2,160.47 (from $10,446.67 to $8,286.20).

Office of Tax Appeals (OTA) panel members Lauren Katagihara, Josh Lambert, and Erica Parker held an oral hearing for this matter in Cerritos, California, on October 9, 2024. At the conclusion of the oral hearing, the record was closed and this matter was submitted on the oral hearing record pursuant to California Code of Regulations, title 18, section 30209(b).

ISSUES

1. Whether further adjustments to the measure of unreported taxable sales is warranted.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellants co-owned (as a married couple) and operated a retail tire shop in Bell Gardens, California, doing business as Rolling Tires & Wheels #4. Appellants' seller's permit was effective between July 1, 2012, and June 30, 2022. This is appellants' first audit.
2. Between December 8, 2020, and December 16, 2020, CDTFA contacted appellants regarding this audit.[1]
3. CDTFA issued an Audit Engagement Letter (engagement letter) to appellant J. Gomez on April 9, 2021.[2] The engagement letter listed the audit period as January 1, 2018, to September 30, 2020.
4. The engagement letter and/or CDTFA's Assignment Activity History reflect that CDTFA requested appellants produce the following documents for the audit:
    a. Federal income tax returns (FITRs) for 2018, 2019, and 2020;
    b. Purchase invoices for the third quarter of 2020 (3Q20) and 4Q20;
    c. Sales invoices, contracts, and cash register tapes for 3Q20 and 4Q20;
    d. Bank statements and cancelled checks for the period January 1, 2018, to December 31, 2020;
    e. A general ledger for 2018, 2019, and 2020; and
    f. Profit and loss statements for 2018, 2019, and 2020.
5. Ultimately, appellants only provided some of the documents requested. Specifically, appellants provided their FITRs for 2018 and 2019, bank statements for 2019, and 86 sales invoices associated with the period October 1, 2020, through October 15, 2020 (October invoices).
6. Appellants reported on their FITRs that their cost of goods sold (COGS) was $417,421 for 2018, and $549,005 for 2019.[3] However, their reported taxable sales for these same

[1] The record reflects that on December 8, 2020, CDTFA printed, for mailing, an Audit Engagement Letter (engagement letter). The record also reflects that appellants' representative called CDTFA on December 16, 2020, regarding the audit and to identify himself as appellants' representative. However, a copy of that engagement letter is not part of the record.

[2] CDTFA's engagement letter is identified as a Form CTDFA-5024 (formerly titled CDTFA-80C, Audit Engagement Letter – Initiate Contact). (See CDTFA's Audit Manual, §§ 0220.00, 0403.10.)

[3] Appellants did not report any labor costs associated with their COGS on their FITRs.

years ($188,456 for 2018 and $263,994 for 2019) were less than their COGS, which results in a negative markup.[4]

7. On their sales and use tax returns during the audit period, appellants reported total sales of $2,108,445, and claimed deductions of $1,191,246 for nontaxable labor and $79,574 for tax included in gross receipts. Appellants therefore reported total taxable sales of $837,625. For each quarter from 2Q18 through 3Q20, appellants' taxable sales constituted either 33.94 percent, 35.89 percent, or 37.84 percent of their total sales (for an average of approximately 36 percent); for 4Q20, the proportion raised to 85.10 percent.[5]

8. Due to the minimal documents provided, CDTFA used an indirect audit method (specifically, the markup method) to determine appellants' audited taxable sales and unreported taxable sales. First, CDTFA applied a 10 percent markup[6] to appellants' reported COGS to estimate that appellants' audited taxable sales amounted to $459,163 for 2018, and $603,906 for 2019. By subtracting appellants' reported amounts from the audited taxable sales, CDTFA calculated an underreporting of $270,707 for 2018, and $339,912 for 2019. Next, CDTFA calculated a reporting error rate of 143.64 percent for 2018, and 128.76 percent for 2019.[7] CDTFA then applied the 2018 and 2019 error rates to appellants' reported taxable sales for the corresponding quarters in the audit period. Appellants did not provide CDTFA with their 2020 FITR so CDTFA was unable to calculate an error rate for 2020. Consequently, CDTFA applied the 2019 error rate to appellants' 2020 reported taxable sales.[8] In total, CDTFA established unreported

[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 $.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 negative markup results from a retailer charging its customers less than the cost of the merchandise.

[5] 1Q18 was not included in the audit because the statute of limitations expired as to that quarter and appellants declined to sign a waiver of the statute of limitations.

[6] CDTFA did not explain its rationale for using a 10 percent markup. However, during CDTFA's internal appeals process (i.e., after the original audit was completed), CDTFA indicated that its use of a 10 percent markup was conservative because it expects a retail tire shop to use a markup between 25 and 50 percent.

[7] The error rate is calculated by dividing the amount of unreported taxable sales (i.e., audited taxable sales minus reported taxable sales) by the amount of reported taxable sales.

[8] The 2019 error rate is lower than both the 2018 error rate and the average of the 2018 and 2019 error rates (136.20 percent).

taxable sales of $1,099,648 for the audit period. CDTFA's audit resulted in appellants' taxable sales constituting approximately 84 percent of appellants' total audited sales.

9. To test the reasonableness of its findings, CDTFA looked to the October invoices. These invoices revealed 85.79 percent of appellants' sales were taxable, which was higher than the percentage calculated in CDTFA's audit. CDTFA therefore determined its audit was reasonable.

10. CDTFA also imposed a negligence penalty on the basis that appellants failed to maintain and provide complete books and records for audit, and failed to accurately report their taxable sales during the audit period.

11. Consequently, CDTFA issued the aforementioned NOD to appellants for tax of $104,467, plus applicable interest, and a negligence penalty of $10,446.67. Appellants timely filed their petition protesting the NOD in its entirety,[9] which CDTFA denied.

12. This timely appeal followed.

13. On appeal, CDTFA concedes that appellants' 4Q20 reported sales tax should have been accepted. For that quarter, appellants reported 85.10 percent of their sales as taxable, which was similar to CDTFA's audited taxable sales percentage of 84 percent. Accordingly, CDTFA agrees to decrease appellants' taxable measure to $872,227 (a $227,421 reduction), and correspondingly reduce the negligence penalty.

DISCUSSION

Issue 1: Whether further adjustments to the measure 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. 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).)

[9] Although appellants' petition stated they disagree with both the 10 percent markup and the negligence penalty, appellants' appeal to OTA included the following the statement: "I said [to CDTFA] – I will accept the findings if the negligence penalty is waived."

If CDTFA is not satisfied with the amount of tax reported by taxpayers, 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.) As applicable here, the NOD shall be mailed within three years after the last day of the calendar month following the quarterly period for which the amount is proposed to be determined. (R&TC, § 6487.) 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 taxpayers to establish that a result differing from CDTFA's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy the taxpayers' burden of proof. (*Ibid*.)

Here, CDTFA's review of appellants' limited records revealed that appellants reported less in taxable sales than the amount of their reported COGS, resulting in a negative markup (i.e., appellants reported that they were selling their goods at below cost). As such, it was appropriate for CDTFA to conclude that appellants were underreporting their taxable sales. To calculate appellants' unreported taxable sales, CDTFA utilized the markup method, which is a recognized and accepted accounting procedure. (*Appeal of Amaya*, 2021-OTA-328P.) Appellants do not argue that CDTFA's calculations within the audit are incorrect, but instead, argue that CDTFA's application of a 10 percent markup percentage is "bogus and false." Appellants disagree with CDTFA's use of the October invoices in the audit, claiming that the sample size was too small and resulted in sampling errors.

In light of appellants' inaccurate reporting (as evidenced by the negative markup), and their incomplete books and records, OTA finds that CDTFA's non-acceptance of appellants' reported taxes was reasonable and rational. OTA also finds that CDTFA's use of a 10 percent markup was reasonable and rational because it resulted in a lower taxable sales percentage than that calculated from appellants' October invoices. Although appellants claim that the October invoices were too small of a sample, those were the invoices that appellants made available during the audit. CDTFA requested six months of sales invoices, but appellants only provided two weeks' worth. Appellants, as the keepers of their records, are in no position to complain that CDTFA reviewed too few documents or that the invoices appellants produced resulted in sampling errors. (See also R&TC, § 6481 [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].) Consequently, the burden shifts to appellants to establish that a result differing from CDTFA's determination is warranted.

Appellants claim CDTFA's use of "other outside sources" to determine the tax liability was improper, but appellants have not identified the "outside sources" to which they are referring. Unsupported assertions are not sufficient to satisfy appellants' burden of proof. (*Appeal of Talavera*, *supra*.) Furthermore, OTA reviewed the audit working papers and there is no indication that CDTFA reviewed or based its audit findings on any unreliable documents.

Despite their previous contention, appellants urge OTA to rely on information from the website "fullratio.com." The website lists the average gross and net profit margins for various industries, as of August 2024. For the auto parts industry, the website lists an average gross profit margin[10] and average net profit margin[11] of 21.6 percent and 1.7 percent, respectively. Appellants assert that this is evidence that a 1.7 percent markup is more appropriate here. However, the markup method is synonymous with the website's *gross* profit margin because both only consider revenue and COGS. (See CDTFA's Audit Manual, § 0407.10 [in the markup method, total sales are calculated by multiplying COGS by a markup factor].)[12] In contrast, the website's *net* profit margin considers all business expenses, and such consideration is not required by the markup method. (See *ibid.*) Accordingly, if OTA were to accept appellants' contention, OTA would utilize the 21.6 percent gross profit margin, not the 1.7 percent net profit margin, and appellants' liability would increase. However, OTA does not find the website to be a reliable source as the website itself provides the following disclaimer: "Please note that these figures are based on industry averages and can vary significantly depending on the specific company, its size, location, competition, and other factors."

Appellants also accuse CDTFA of fraud. Appellants claim that CDTFA's acceptance of their 4Q20 reported sales is an attempted "coverup." This accusation stems from appellants' belief that the audit is invalid because CDTFA included 4Q20 in its audit despite the engagement letter identifying the audit period as ending with 3Q20. Appellants believe that CDTFA's recent acceptance of their 4Q20 reported sales is a strategy to circumvent the statute of limitations or otherwise maintain the validity of the remainder of the audit.

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[10] The website specifies that gross margin percentages are calculated using the following formula: (revenue – COGS) ÷ revenue.

[11] The website states the net profit margin "indicates how much net income (profit after all expenses) a company generates from its total revenue." The website further specifies that net profit margin percentages are calculated using the following formula: net profit ÷ revenue.

[12] CDTFA's Audit Manual is an advisory publication providing direction to CDTFA staff administering the Sales and Use Tax Law and applicable regulations. OTA is not required to follow CDTFA's Audit Manual; however, OTA may look to CDTFA's Audit Manual for guidance when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

First and foremost, the NOD, not the engagement letter, is the controlling document. (See R&TC, § 6487.) Here, the NOD was timely issued for the audit period, which specifically included 4Q20. Second, CDTFA's stated purpose of the engagement letter is merely to serve as confirmation of the "arrangement to begin the audit or to establish contact with the taxpayer." (CDTFA's Audit Manual, §§ 0401.80, 0403.10.) Third, the engagement letter clearly states in the first paragraph, "Although audit periods generally coincide with the period for which records are requested, audit periods may be extended as permitted by statute." As documented in the engagement letter and Assignment Activity History, CDTFA requested documents through 4Q20, and the audit reports clearly identify the audit period ending with 4Q20, so appellants were duly notified that 4Q20 was included in the audit period. Finally, the engagement letter identified 1Q18 as the start of the audit period, but because appellants did not waive the statute of limitations as to that quarter, CDTFA removed it from the audit period. As such, appellants have no basis to claim that the audit period listed on the engagement letter cannot be changed during the audit, or that such change somehow renders the entire audit invalid. There is nothing in the record to suggest that CDTFA's extension of the audit period to 4Q20 was improper or that its acceptance of appellants' 4Q20 reported taxable sales was a purported "coverup."

Based on the foregoing, appellants have not established that further adjustments to the measure 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 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. Taxpayers shall maintain and make available for examination on request by CDTFA, 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 sales and use tax returns. (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 the taxpayers. (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 taxpayers' good faith and reasonable belief that their bookkeeping and reporting practices were in

substantial compliance with the requirements of the Sales and Use Tax Law or authorized regulations. (*Ibid.*)

CDTFA imposed the negligence penalty because appellants failed to maintain and provide complete books and records for audit and failed to accurately report their taxable sales. CDTFA determined that appellants had to be aware of their underreporting because their reported taxable sales for 2018 and 2019 were less than half of their COGS for those same years. For the audit, appellants only produced their FITRs for 2018 and 2019, bank statements for 2019, and 86 sales invoices associated with the period October 1, 2020, through October 15, 2020. The production of such few documents establishes that appellants failed to maintain and provide complete books and records. Notably, appellants were aware of the impending audit no later than December 16, 2020, and yet, appellants could not produce their purchase invoices, cash register tapes, bank statements, or more than two-weeks of invoices for that quarter (i.e., 4Q20), or their general ledger for 2020. This failure alone establishes that appellants could not have had a good faith and reasonable belief that their bookkeeping practices were in substantial compliance with the law, even if this is appellants' first audit. Appellants should have, at the very least, began to comply with the record keeping requirements after being contacted by CDTFA regarding the impending audit.[13] Furthermore, the record reflects a drastic increase in the amount of appellants' reported taxable sales in 4Q20, which coincides with the quarter in which CDTFA initially contacted appellants. Specifically, appellants reported 85.10 percent of their 4Q20 reported sales as taxable, but for all the prior quarters in the audit period, appellants' reported taxable sales averaged only 36 percent. Said differently, appellants reduced their claimed deduction for nontaxable labor by nearly half in 4Q20. The inadequate books and records and sudden increase in reported taxable sales (or decrease in claimed deductions) are sufficient to support CDTFA's imposition of the negligence penalty.

Appellants vaguely assert that the increase in reported taxable sales in 4Q20 was due to their method of single-entry accounting and fluctuations in inventory. Appellants do not explain, nor is OTA able to ascertain, how this would result in such a large increase of taxable sales, or decrease in nontaxable labor, in only 4Q20. There is no fluctuation in the other quarters of the

[13] At the oral hearing, appellants stated that rather than providing copies of their invoices to CDTFA, they demanded CDTFA "come and look at the records" (i.e., conduct a field audit). Appellants assert that CDTFA refused their demand, and instead, authorized appellants to provide a more limited set of documents. To rebut, CDTFA pointed to the record which indicates CDTFA scheduled a field audit for June 2, 2021. Appellants then responded that the field audit did not occur due to scheduling conflicts and potentially due to COVID. Given that appellants' latter statement contradicts the former, OTA does not further consider appellants' argument.

audit. In fact, appellants' reported taxable sales percentages prior to 4Q20 were repetitive: over 11 quarters, the percentages always amounted to either 33.94 percent, 35.89 percent, or 37.84 percent.

Appellants additionally assert that the negligence penalty is invalid because CDTFA concedes to a reduction of appellants' tax liability. OTA acknowledges that the amount of appellants' understatement is reduced by approximately 20 percent due to CDTFA's concession regarding 4Q20, and that CDTFA marginally relies on the amount of the understatement as support for the negligence penalty. However, the amount of the understatement was not CDTFA's sole reason for imposing the negligence penalty. Instead, as described above, CDTFA determined appellants' failure to both maintain and keep complete and accurate records and to accurately report their taxable sales was evidence of negligence. Similarly, it is for these reasons that OTA finds that the negligence penalty was properly imposed.

Appellants also reiterate their assertion that the audit is "false." The validity of the audit and tax liability asserted by CDTFA was discussed in Issue 1 above, so OTA declines to repeat its analysis here.

Last, appellants argue that the IRS's First Time Abate program (see Internal Revenue Manual 20.1.1.3.3.2.1) should be applicable here. However, OTA has no authority to grant relief except where the law specifically allows. (See *Appeal of Gillespie*, 2018-OTA-052P; *Appeal of Praxair, Inc.*, 2019-OTA-301P.) Neither the California Legislature nor CDTFA has adopted a program analogous to the First Time Abate program for negligence penalties imposed by the Sales and Use Tax Laws under the facts presented here.[14] Consequently, OTA has no basis or authority to waive the negligence penalty.

[14] R&TC section 7072 allows for a waiver of penalties imposed under Part 1 of the Sales and Use Tax Law. However, this wavier applied only to penalties imposed for tax reporting periods beginning before January 1, 2003, and pursuant to a tax amnesty program that was conducted in 2005. (R&TC, §§ 7071, 7072.)

HOLDINGS

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

DISPOSITION

CDTFA shall reduce the liability as conceded by CDTFA in its second reaudit. CDTFA's action in otherwise denying appellants' petition 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:
Erica Parker
6651E0AAC34B4F6...
Erica Parker
Hearing Officer

Date Issued: 11/12/2024