

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:  <b>M. KIM,</b> <b>dba Oriental Nursery</b>	) ) ) ) )	OTA Case No. 231114785 CDTFA Case ID: 3-227-867
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**OPINION**

Representing the Parties:

For Appellant:	Min W. Suh, Attorney/CPA
For Respondent:	Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Crystal Spratley, Business Taxes Specialist III

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Kim (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)<sup>1</sup> denying appellant’s timely petition for redetermination of a Notice of Determination (NOD) issued on October 8, 2021.<sup>2</sup> The NOD is for tax of \$72,374, plus applicable interest, and a negligence penalty of \$7,237.41 for the period October 1, 2017, through June 30, 2021 (liability period).

CDTFA performed a subsequent reaudit as explained below. The reaudit dated January 4, 2024, reduced the tax by \$4,702, from \$72,374 to \$67,672,<sup>3</sup> and made corresponding reductions to the interest and penalties.

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<sup>1</sup> The State Board of Equalization (board) formerly administered sales and use taxes. In 2017, board functions relevant to this case 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.

<sup>2</sup> CDTFA timely issued the NOD because on June 22, 2021, appellant waived the otherwise applicable three-year statute of limitations by signing a series of waivers, which gave CDTFA until January 31, 2022, to issue the NOD for the period of October 1, 2017, through September 30, 2018. (R&TC §§ 6487(a), 6488.)

<sup>3</sup> The reaudit work papers show tax of \$67,671. The \$1 difference is immaterial.

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record.

### ISSUES

1. Whether additional adjustments to the amount of unreported taxable sales are warranted.
2. Whether appellant was negligent.

### FACTUAL FINDINGS

1. Appellant, a sole proprietor doing business as Oriental Nursery, operated a nursery selling non-taxable fruit trees and taxable items such as plants, sod, fertilizers, and miscellaneous gardening supplies. Appellant's seller's permit was opened with an effective date of February 1, 1992. Appellant had not been previously audited.
2. CDTFA audited appellant for the liability period. Appellant reported on his sales and use tax returns (SUTRs), total sales of \$915,421 and claimed a deduction of \$535,743 for non-taxable food products, resulting in reported taxable sales of \$379,678. During the liability period, appellant filed his quarterly SUTRs based on sales estimates provided to his tax preparer<sup>4</sup> over the telephone. However, it was unknown to CDTFA what source documents appellant and/or his tax preparer used to support the amounts reported on the SUTRs.
3. For the audit, appellant provided limited books and records. Provided records included: federal income tax returns (FITRs) for 2017, 2018, and 2019; bank statements for October 1, 2017, to September 30, 2020; sod sales invoices and purchase invoices for 2019; cash register z-tapes<sup>5</sup> for the period of February 10, 2021, to February 24, 2021;<sup>6</sup> and taxable plant purchase invoices for March 2021. CDTFA received Form 1099-K

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<sup>4</sup> Appellant's current representative was his tax preparer during the liability period.

<sup>5</sup> Z-tapes are daily register receipts that total the sales per register or point of sales (POS) terminal and are typically run/produced at the beginning of the day and/or end of the day, also called end-of-day report. The reports summarize sales, refunds, and other till operations on the POS/register.

<sup>6</sup> OTA notes that CDTFA's opening brief states that appellant provided z-tapes for some days in 2019; however, this information is not found anywhere in the audit work papers or other documents provided.

(*Payment Card and Third Party Network Transactions*)<sup>7</sup> data for January 2014 to March 2021 from its internal sources. CDTFA made multiple requests to appellant to provide additional records; however, appellant did not provide the following as requested (other than noted above): cash register tapes, sales invoices, sales journals, purchase invoices, and purchase journals for the liability period.

4. CDTFA compared the gross receipts reported on the FITRs to the reported amounts on the SUTRs and noted a large discrepancy in 2018 of \$231,476, which was caused by appellant netting gross sales with claimed deductions for non-taxable sales and reporting the difference on the SUTRs filed; the other years, 2017 and 2019, had no differences.
5. CDTFA reviewed the calculated ratio of cost to total sales<sup>8</sup> from the FITRs for each year, 55.63 percent for 2017, 65.9 percent for 2018, 59.47 percent for 2019, and an overall ratio of 60.48 percent. CDTFA determined that this overall ratio was too high given that other businesses in the same industry had an average ratio of cost to total sales of 40 percent.<sup>9</sup>
6. CDTFA completed a book markup<sup>10</sup> analysis from the FITRs of gross receipts to cost of goods sold (COGS) and noted that the book markup calculated from FITRs in 2017 was negative 40.47 percent and was due to appellant netting out non-taxable sales from gross receipts and reporting it as other income on the FITR; the book markups were 51.61 percent in 2018 and 68.15 percent in 2019 with an overall book markup of 25.41 percent.

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<sup>7</sup> Form 1099-K is an IRS form titled “Payment Card and Third Party Network Transactions,” which shows the monthly and annual amounts a bank, credit card company, or third-party network paid to a merchant 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.

<sup>8</sup> Ratio of cost to total sales is calculated by dividing COGS by the total sales (gross receipts plus other income) to arrive at the ratio. This ratio helps show what percentage of sales is made up of the cost of that sale.

<sup>9</sup> This is based on CDTFA’s experience in auditing similar businesses and reviewing evidence of industry averages for this type of business.

<sup>10</sup> “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 ( $0.30 \div 0.70 = 0.42857$ ). A “book markup” (sometimes referred to as an “achieved markup”) is one that is calculated from the retailer’s records. A negative markup would mean that appellant was selling merchandise for less than his cost of the merchandise.

7. Next, CDTFA sent out inquiries to appellant's vendors, known as a vendor survey,<sup>11</sup> for purchase confirmation. CDTFA compared the computed total purchases to the purchases shown in the 2019 FITR and determined that they were consistent. Therefore, CDTFA concluded that COGS were complete as reported on the FITRs.
8. CDTFA accepted the COGS based on verification of the information from the vendor surveys but did not accept the ratio of COGS to total sales, which CDTFA determined to be too high. Therefore, CDTFA concluded that it needed an alternate audit approach to calculate total taxable sales for the liability period.
9. CDTFA compared Form 1099-K data for the period of October 1, 2017, through December 31, 2019, which totaled \$555,176, to the sales reported on the SUTRs, which totaled \$358,515. CDTFA calculated a ratio of reported electronic payments (credit card ratio) of 154.85 percent ( $\$555,176 \div \$358,515$ ). CDTFA noted that for fourth quarter 2017 (4Q17) through 4Q18, the credit card ratio was over 250 percent. For periods 1Q19 through 4Q19, the credit card ratio was between 96.73 percent and 97.23 percent.
10. CDTFA scheduled bank deposits for the period covering October 1, 2017, through September 30, 2020, which included credit card sales (merchant deposits) of \$809,265. CDTFA noted that a comparison of adjusted deposits of \$981,897 less reported total sales of \$620,876 produced a large discrepancy of \$361,021 but determined that assessed sales on other audit schedules were greater and that further testing of this discrepancy was not warranted.
11. CDTFA requested cash register receipts and z-tapes, but they were no longer available.<sup>12</sup> Appellant provided sales invoices for sod, as the sales of sod are on separate sales invoices. CDTFA scheduled a sample of 2019 sales invoices and compared them invoices to reported taxable sales. CDTFA noted sales invoices for sod only recorded a total amount but did not itemize the items purchased or sales tax collected. CDTFA additionally noted that the sales invoices for sod in 2019 recorded sales totaling \$42,790,

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<sup>11</sup> Vendor surveys are inquiry letters sent to appellant's vendors requesting purchase and/or sales information for an audit period.

<sup>12</sup> CDTFA requested the z-tapes for the audit, but appellant's register was too old to print out reports. CDTFA then requested that appellant keep z-tapes for a two-week period, February 10, 2021, through February 24, 2021.

but reported taxable sales for 2019 totaled \$83,811, while the confirmed purchases for sod totaled \$94,435, which exceeded reported taxable sales of sod by \$52,529. CDTFA concluded that taxable sales were underreported.

12. CDTFA requested that appellant provide purchase journals. Appellant requested to provide a sample of purchase invoices since he did not maintain purchase journals. The parties agreed upon a sample period of September 2019. CDTFA calculated a taxable markup with the use of a purchase segregation test that yielded a taxable ratio of 86.34 percent.<sup>13</sup> CDTFA calculated purchase ratio percentages for sod/grass of 72.48 percent and for plants of 27.52 percent.
13. CDTFA applied the credit card ratio of 80 percent<sup>14</sup> to merchant deposits per bank statements of \$809,265 to arrive at audited total sales \$1,011,582. CDTFA then applied the taxable ratio per purchase segregation of 86.34 percent and removed sales tax to arrive at audited taxable sales of \$797,625. CDTFA then adjusted for reported taxable sales of \$271,978 to arrive at additional taxable sales of \$525,647. For each quarterly reporting period, CDTFA calculated a percentage of error (POE).<sup>15</sup>
14. CDTFA applied the respective POEs to reported quarterly taxable sales for 4Q17 through 3Q20. CDTFA relied upon the 3Q20 POE for the periods of October 1, 2020, through June 30, 2021, since there was a lack of bank records. CDTFA calculated unreported taxable sales of \$761,830 using the POEs.
15. CDTFA issued a timely NOD to appellant on October 8, 2021, for the liability period, with a tax liability of \$72,374, plus applicable interest, and a negligence penalty of \$7,237.41.
16. Appellant filed a timely petition for redetermination dated November 4, 2021.

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<sup>13</sup> A purchase segregation test is used to establish the proportion of purchases made in each category (sod, potting mix / fertilizer, chemicals, plants and miscellaneous gardening supplies [taxable] versus fruit trees [nontaxable]).

<sup>14</sup> CDTFA experience in audits of similar businesses in appellant's area was used to determine an industry average of 80 percent for credit card ratio due to appellant's records yielding inconsistencies noted in the ratio of cost to total sales.

<sup>15</sup> The "percentage of error" is the percentage of unreported taxable sales to reported taxable sales.

17. On April 25, 2023, CDTFA held an appeals conference with appellant, and subsequently issued a decision on October 19, 2023. CDTFA's decision concluded that no adjustments were warranted.
18. Appellant timely appealed to OTA.
19. CDTFA, while preparing its opening brief, discovered the availability of Form 1099-K,<sup>16</sup> and that adjustments to unreported taxable sales were warranted. CDTFA prepared a reaudit to adjust the taxable measure associated with these periods using Form 1099-K data as CDTFA believes it provides a more accurate amount of credit card sales. The use of the new Form 1099-K data lowers the underreported taxable measure by \$49,486, from \$761,830 to \$712,344, for the liability period.

### DISCUSSION

#### Issue 1: Whether additional adjustments are warranted to the amount of unreported taxable sales.

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

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<sup>16</sup> Form 1099-K data was unavailable for the period October 1, 2017, through March 31, 2021. As explained in factual finding number 16, in the original audit, CDTFA used adjusted bank deposits and applied an error rate. CDTFA recomputed the liability based on Form 1099-K data for periods except 2Q21 for which Form 1099-K was not available. CDTFA continued to use an error rate for 2Q21.

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

Here, appellant's books and records were incomplete, and CDTFA was unable to verify sales reported on appellant's SUTRs for the liability period using a direct audit method. CDTFA's preliminary analysis found that the cost to total sales ratios were much higher, 55.63 percent in 2017, 65.96 percent in 2018, 59.47 percent in 2019 and an overall of 60.48 percent, than the industry average of 40 percent. To CDTFA, this indicated that appellant underreported his sales. OTA finds that it was reasonable for CDTFA to use an indirect audit method to compute appellant's sales. CDTFA's use of an industry average for the credit card ratio, along with a taxable sales ratio based on appellant's own records, is reasonable and rational. (See *Appeal of AMG Care Collective*, 2020-OTA-173P.) Accordingly, OTA concludes that CDTFA has established that its determination is reasonable and based on the best-available evidence, so the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

On appeal, appellant asserts that the taxable sales ratio of 86.34 percent is overstated. The taxable sales ratio is based on appellant's own purchase invoices and data received from appellant's vendors. CDTFA requested multiple business records, such as purchase journals and purchase invoices, and was told the records were not maintained or that the records could not be provided in full. Appellant's representative offered to provide a sample of purchase invoices. Appellant and CDTFA agreed upon 2019 for the sample period rather than the entire liability period. Appellant has not identified any specific errors in CDTFA's computation of unreported taxable sales or provided any new documentation establishing a more accurate calculation of audited taxable sales. As stated earlier, unsupported assertions are not sufficient to satisfy appellant's burden of proof. (*Appeal of Talavera, supra.*) Therefore, OTA finds that appellant has failed to meet his burden of establishing that a reduction to the determined measure of tax is warranted. As appellant bears the burden of proof in this case, OTA concludes that no further adjustments are warranted.

#### Issue 2: Whether appellant was negligent.

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 practices 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 *Appeal of Finnish Line Sports, Inc.*, 2019-OTA-138P.)

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).) 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).)

On appeal, appellant claims that he was not negligent.<sup>17</sup> Appellant does not believe the negligence penalty should be imposed since this was his first audit.

Here, CDTFA states that it imposed the negligence penalty because appellant did not provide complete business records as requested and had a substantial underreporting of \$712,344 with a POE of 187.62 percent (underreported taxable sales of \$712,344 ÷ reported taxable sales of \$379,678). In other words, appellant reported only about one-third of every dollar of audited taxable sales. This large error ratio is evidence of negligence. At the time of audit, appellant had

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<sup>17</sup> On his request for appeal, appellant states, “[Appellant] was negligent.” Because this statement appears in an explanation of appellant's disagreement with CDTFA's determination, OTA assumes appellant misspoke.



been in business since February 1992 and did not demonstrate due care in recordkeeping and preparing SUTRs as a prudent businessperson would.

In the case at hand, this was appellant's first audit. However, during the audit fieldwork, appellant failed to provide complete and accurate records for the liability period. Appellant stated that he estimated sales reported on his SUTRs but did not provide any documentation to support the accuracy of reported sales. Appellant failed to maintain z-tapes, cash register tapes, and/or purchase journals for the liability period. The lack of records maintained and/or provided to CDTFA is evidence of negligence in record keeping.

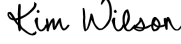
Appellant contends that the negligence penalty should not apply but has not specified a reason. While this was appellant's first audit, the lack of complete records and the size of the understatement are evidence of negligence. OTA finds that the understatement cannot be attributed to appellant's bona fide and reasonable belief that his bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.) Therefore, OTA concludes that appellant was negligent and CDTFA properly imposed the negligence penalty.

HOLDINGS


1. Appellant has not shown that additional adjustments to the measure of unreported taxable sales are warranted.
2. Appellant was negligent.


DISPOSITION

CDTFA’s action reducing the measure of tax by \$49,486, from \$761,830 to \$712,344, for the liability period but otherwise denying the petition is sustained.

Signed by:  
  
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 Kim Wilson  
 Hearing Officer

We concur:

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 Teresa A. Stanley  
 Administrative Law Judge

Signed by:  
  
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 Natasha Ralston  
 Administrative Law Judge

Date Issued: 12/19/2024