**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of:<br>**CHERRY AND CANDLEWOOD, INC., dba AAMCO Transmissions** | OTA Case No. 231114662<br>CDTFA Case ID: 01-470-777 |

## OPINION

Representing the Parties:

For Appellant: Juan Guzman, CPA

For Respondent: Jason Parker, Chief of Headquarters Ops.

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Cherry and Candlewood, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on August 28, 2019.[1] The NOD is for tax of $66,615, plus applicable interest, and a negligence penalty of $6,661.46 for the period April 1, 2014, through March 31, 2017 (liability period).[2]

Appellant waived the right to an oral hearing, so this matter was submitted to the Office of Tax Appeals (OTA) for an opinion based on the written record.

## ISSUES

1. Whether the amount of unreported taxable sales should be reduced.
2. Whether appellant was negligent.

[1] The State Board of Equalization (board) formerly administered sales and use taxes. On July 1, 2017, the board's administrative functions relevant to this case transferred to CDTFA. (See Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" refers to the board.

[2] CDTFA timely issued the NOD because appellant waived the applicable three-year statute of limitations and extended CDTFA's issuance deadline to October 31, 2019. (See R&TC, §§ 6487(a), 6488.)

## FACTUAL FINDINGS

1. During the liability period, appellant, a California corporation doing business as AAMCO Transmissions, operated an auto repair shop franchise in Long Beach, California. Among the services appellant provided were transmission repairs, oil changes, A/C tune ups, and exhaust and muffler services. Appellant has had an active seller's permit since 1985.
2. For the liability period, appellant reported total sales of $1,963,349 on its sales and use tax returns (SUTRs) and claimed deductions of $1,786,464 for nontaxable labor, resulting in reported taxable sales of $176,885.
3. Upon audit, appellant provided CDTFA with the following books and records: a federal income tax return for the 2015/2016 fiscal year; purchase summaries for the period second quarter of 2014 (2Q14) through 2Q16; a one-page computer-generated sales report (sales report) summarizing gross sales, taxable parts sales, tax, labor charges, and exempt sales for the liability period; and sales invoices for the period 3Q15 through 4Q15.
4. In comparing the taxable sales reported on appellant's SUTRs and the merchandise purchases recorded on appellant's purchase summaries, CDTFA noted the following negative markups: -2.70 percent for the period of 2Q14 through 4Q14; -31.64 percent for 2015; -62.12 percent for the period 1Q16 through 2Q16; and an overall negative markup of -30.98 percent for the period 2Q14 through 2Q16.[3] Similarly, in comparing the total sales reported on appellant's SUTRs and the sales recorded on the sales report provided by appellant, CDTFA found unreported taxable sales of $51,555.
5. Due to the negative book markups (which suggested potential understatements of taxable sales), CDTFA used the direct audit method of comparing taxable sales of $176,885 reported on appellant's SUTRs to taxable sales of $911,436 recorded in appellant's sales report and computed a difference of $734,552 (rounded). This difference consisted of two audit items: (1) unreported taxable sales of $51,557; and (2) disallowed claimed nontaxable labor sales of $682,995.

[3] "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. A negative markup indicates that a retailer is selling merchandise for an amount that is less than the merchandise's cost (i.e., at a loss) and/or understating sales.

6. Although this was appellant's first audit, CDTFA imposed a negligence penalty because it found the records that appellant provided upon audit were inadequate and determined that appellant had made significant and material reporting errors throughout the liability period.
7. On August 28, 2019, CDTFA timely issued the NOD.
8. Appellant timely filed a petition for redetermination, which CDTFA denied.
9. Appellant then timely filed the instant appeal with OTA.

## DISCUSSION

Issue 1: Whether the amount of unreported taxable sales should be reduced.

California imposes upon all retailers a sales tax measured by the retailer's gross receipts from the retail sale of tangible personal property in this state, 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, it is presumed 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 tax returns or the amount of tax required to be paid to the state by any person, CDTFA may compute and determine the amount required to be paid on the basis of any information within its possession or that may come into its possession. (R&TC, § 6481.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Las Playas #10*, 2021-OTA-204P.) If CDTFA's determination is not reasonable and rational, then the determination should be rejected. (See *Appeal of Praxair, Inc.*, 2019-OTA-301P; see also *In re Renovizor's, Inc.* (9th Cir.) 282 F.3d 1233, 1237, fn. 1.) If CDTFA's determination is reasonable and rational, then the determination is presumed correct. (See *In re Renovizor's, Inc.*, *supra*, 282 F.3d at 1237, fn. 1; see also *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 445 (*Paine*).) The burden of overcoming this presumption is on the taxpayer. (*Paine, supra*, 137 Cal.App.3d at p. 445.)

Generally, the appellant bears the burden of proof as to all issues of fact. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10, Inc.*, *supra*.) To satisfy its burden of proof, a taxpayer must prove both that the tax assessment is incorrect and what the proper amount of tax should be. (*Appeal of AMG Care Collective*, *supra*.)

Here, for the audit, appellant provided limited records from which CDTFA calculated negative book markups. To CDTFA, this indicated that appellant may have underreported taxable sales. Using a direct audit method (i.e., compiling audited sales directly from appellant's books and records), CDTFA compared taxable sales of $176,885 reported on appellant's SUTRs to taxable sales of $911,436 recorded in appellant's sales report. CDTFA's comparison disclosed a discrepancy of $734,552, which consisted of unreported taxable sales of $51,557 and disallowed claimed nontaxable labor sales of $682,995. After reviewing CDTFA's audit method (which relied on appellant's own books and records), OTA finds that CDTFA's determination was reasonable and rational and thus presumed correct. Appellant now bears the burden of overcoming this presumption.

On appeal, appellant asserts that unreported taxable sales of $51,557 need to be removed from CDTFA's determination. However, appellant has not provided any evidence or argument in support of its assertion. Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10, Inc.*, *supra*.) Without evidence or even an argument to support its position, appellant has not met its burden of showing that CDTFA's determination is incorrect. Accordingly, OTA concludes that the amount of unreported taxable sales should not be reduced.

Issue 2: Whether appellant was negligent.

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. (R&TC, § 6484; Cal. Code Regs., tit. 18, § 1703(c)(3)(A).) 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.)

A taxpayer is required to 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 SUTRs. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (1) 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 supporting the entries in the books of account; and (3) schedules or working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) 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 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 substantially complied with the requirements of the Sales and Use Tax Law or authorized regulations. (Cal. Code Regs., tit. 18, § 1703(c)(3)(A).)

In its audit working papers, CDTFA stated that it imposed a negligence penalty on appellant for two reasons: (1) appellant's books and records were inadequate, and (2) the understatement of tax was substantial.

On appeal, appellant contends that the negligence penalty should be abated for the following four reasons: (1) this was appellant's first audit; (2) CDTFA used the direct method of auditing; (3) appellant had not received any written advice regarding recording or reporting sales; and (4) appellant provided a sales report that CDTFA relied upon in its audit.

Although CDTFA had not previously audited appellant, OTA finds the books and records appellant provided CDTFA upon audit were inadequate and indicative of negligence in recordkeeping. Specifically, appellant failed to provide a complete set of books and records for the liability period, including any purchase invoices or purchase journals. Instead, appellant only provided purchase summaries for the period 2Q14 through 2Q16, a one-page sales report for the

liability period, and sales invoices for 3Q15 through 4Q15. Appellant did not provide sales invoices for most of the liability period. Appellant also has not substantiated its claimed deductions for nontaxable labor sales with any documentation, either during the audit and CDTFA's internal appeals process, or on appeal to OTA.

Furthermore, there is other evidence indicating that appellant was negligent in reporting its sales. The book markups computed during the liability period were -2.70 percent for the period 2Q14 through 4Q14, -31.64 percent for 2015, -62.12 percent for the period 1Q16 through 2Q16, with an overall negative markup of -30.98 percent for the two-year period of 2Q14 through 2Q16. Additionally, the discrepancy between the total sales recorded in appellant's sales summary report and total sales reported on appellant's SUTRs was $51,555 for the period 2Q14 through 1Q17. And appellant claimed $682,995 more in nontaxable labor sales than what its own records (i.e., the sales report) justified. Most significantly, CDTFA discovered an error ratio of 415 percent in appellant's reporting of taxable sales for the liability period (aggregate deficiency measure of $734,552 ÷ reported taxable sales of $176,885).

Appellant has held an active seller's permit since 1985, and the liability period at issue began on April 1, 2014, indicating that appellant had been in business for nearly 20 years. Even so, appellant's recordkeeping and reporting fell short, and OTA finds that appellant did not exercise the care that a reasonably prudent person would exercise under similar circumstances. Further, based on the evidence recounted above, OTA finds that appellant could not have had a good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the Sales and Use Tax Law or applicable regulations. Hence, OTA concludes that appellant was negligent both in recordkeeping and reporting.

Appellant's argument that the negligence penalty should be abated because this is its first audit is unavailing considering appellant's failure to maintain adequate books and records, as well as the substantial error ratio with regard to reporting its taxable sales. And appellant's other arguments on appeal fail to establish that the deficiency at issue was not due, in whole or part, to appellant's negligence. Accordingly, OTA concludes that appellant was negligent, and, although this was appellant's first audit, CDTFA properly imposed the negligence penalty.

## HOLDINGS

1. The amount of unreported taxable sales should not be reduced.
2. Appellant was negligent.

## DISPOSITION

CDTFA's actions are sustained.

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Andrew Wong
Administrative Law Judge

We concur:

Signed by:
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Kim Wilson
Hearing Officer

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Teresa A. Stanley
Administrative Law Judge

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