OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 230212638
	CDTFA Case ID: 1-159-115
SOMOON CORPORATION,	
dba Orange Golf and Sports	

OPINION

Representing the Parties:

For Appellant: Chang H. Bou, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Somoon Corporation, dba Orange Golf and Sports (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on February 11, 2019.[2] The NOD is for tax of $41,822, plus applicable interest, and a negligence penalty of $4,182.18 for the period July 1, 2014, through June 30, 3017 (liability period).

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

[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 June 25, 2018, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period July 1, 2014, through December 31, 2015, which allowed CDTFA until March 31, 2019, to issue an NOD. (R&TC, §§ 6487(a), 6488.) In addition, appellant untimely filed its sales and use tax return for the third quarter 2014 on January 28, 2015. Thus, the original waiver of limitations signed on January 23, 2018, and subsequent extensions were timely.

ISSUES

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

FACTUAL FINDINGS

1. Appellant, a corporation, operated a retail golf shop located in Garden Grove, California. In addition to sales from its physical business location, appellant made online sales through Amazon Marketplace (Amazon) and other retailer websites that accepted PayPal. Appellant's seller's permit was opened with an effective start date of January 1, 2014. Appellant had not been audited previously.
2. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total sales of $1,841,183 and claimed deductions of $113,560 for nontaxable sales for resale, $392,462 for nontaxable labor, $725,184 for exempt sales in interstate and foreign commerce, and $44,663 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of $565,314. Appellant stated to CDTFA that its outside bookkeeper prepared the SUTRs from sales tax worksheets, which were based on the sales receipt journals.
3. For audit, appellant provided federal income tax returns (FITRs) for 2014, 2015, and 2016; sales tax worksheet for 2016, sales receipt journals for the first quarter 2016 (1Q16); shipping documentation for 1Q16 sales; resale certificates for 1Q16 sales; purchase journals for 2016; merchandise purchase invoices for 2016; and bank statements for appellant's Citibank and Hanmi Bank accounts. Appellant did not provide sales source documentation such as sales invoices or cash register tapes. CDTFA concluded the books and records provided were inadequate for sales and use tax audit purposes.
4. CDTFA obtained Form 1099-K merchant credit card sales data for 2015 and 2016 from its internal sources.[3]
5. CDTFA compared total sales reported on the SUTRs for 2014, 2015, and 2016 to the corresponding gross receipts reported on the FITRs noting no material unexplained differences.

[3] Form 1099-K is an IRS form titled "Payment Card and Third Party Network Transactions" issued to merchants which shows the monthly and annual amount paid to the merchant by a credit card company or third party network during a given time period.

6. CDTFA compared taxable sales reported on the SUTRs for 2014, 2015, and 2016 to the corresponding cost of goods sold reported on the FITRs and computed book markups[4] of 12.92 percent for 2014, 31.71 percent for 2015, and -9.46 percent for 2016.[5] Based on its experience in audits of similar businesses in appellant's area, CDTFA believed the inconsistent book markups, in particular the negative markup in 2016, indicated that reported sales were potentially understated and additional testing was warranted.
7. CDTFA compiled taxable sales of $55,011 from appellant's 1Q16 sales receipts journals. Upon comparison to taxable sales of $53,963 reported on the 1Q16 SUTR, CDTFA computed unreported taxable sales of $1,048 for that quarter. CDTFA noted instances where the recorded sales tax amount did not correspond to the correct sales tax rate and other instances where the sales information for an invoice was not recorded (in other words, the sales invoice was missing). CDTFA concluded this was evidence that taxable sales were understated, and that additional investigation was warranted.
8. Initially, CDTFA established unreported taxable sales of $95,934 using the credit-card-sales-ratio method. CDTFA also disallowed $99,474 in claimed nontaxable labor. Accordingly, CDTFA initially established a deficiency measure of $195,408. Appellant disagreed with the initial audit findings.
9. Upon further review, CDTFA noted there were excess bank deposits not accounted for in its preliminary audit findings, as discussed below.
10. Using bank statements for appellant's two business bank accounts, CDTFA compiled cash sales deposits of $1,989,735, credit card sales deposits of $567,898, electronic deposits of sales from Amazon and PayPal of $237,496, transfers of $147,770 between the business bank accounts, and total bank deposits from sales proceeds of $2,409,863 ($1,989,735 + $567,898 - $147,770) for the liability period. CDTFA verified the

[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 = 0.4286). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

[5] A negative markup would mean that appellant was selling merchandise for less than its cost of the merchandise.

deposits from Amazon and PayPal of $237,496 separately, as explained below.[6] Thus, CDTFA compared total sales of $1,841,183 reported on the SUTRs to total bank deposits from sales proceeds of $2,409,863 which disclosed a material difference of $568,680. CDTFA concluded that the excess bank deposits totaling $568,680 were unreported taxable sales. As explained below, CDTFA made an allowance of $27,977 for deposits from personal loans for the liability period. For each quarterly reporting period, CDTFA divided unreported taxable sales (including sales tax reimbursement) by 1, plus the applicable sales tax rate, to compute unreported taxable sales (excluding sales tax reimbursement) of $500,802.

11. Appellant stated that bank deposits included deposits from personal loans from its president and family members of its officers. Appellant provided copies of deposit slips and canceled checks for alleged loan deposits totaling $183,741 for July 1, 2016, through June 30, 2017. CDTFA reviewed the documentation and compiled supported loan deposits of $6,217 for July 1, 2016, through June 30, 2017. Appellant did not provide any additional documents to support additional loan amounts.

12. CDTFA compared supported loan deposits to bank deposits from unreported taxable sales of $126,374 for July 1, 2016, through June 30, 2017, and computed a loan deposit ratio of 4.92 percent. CDTFA multiplied bank deposits from unreported taxable sales of $568,680 for the liability period by the loan deposit ratio and computed an allowance of $27,977 for deposits from personal loans (rounded).

13. As noted above, CDTFA identified bank deposits of $237,496 from Amazon and PayPal in the bank statements for the liability period. To determine taxable sales through Amazon and PayPal, CDTFA reviewed Amazon sales data for August 24, 2017, through September 29, 2017, and compiled sales to California customers of $12,653, sales to non-California customers of $104,742, and total Amazon sales of $117,395. CDTFA calculated a ratio of California Amazon sales to total Amazon sales (California Amazon sales ratio) of 10.78 percent. CDTFA also obtained PayPal sales data but was unable to compute a California sales ratio because the PayPal sales data did not include the

[6] Bank deposits are not gross receipts. (R&TC, § 6012(a).) However, where, as here, a retailer is engaged in the business of making retail sales of tangible personal property, the retailer's bank deposits, net of deposits from non-sale or nontaxable transactions, are evidence of gross receipts from the retail sale of tangible personal property, which evidence CDTFA can use to determine audited taxable sales when sales cannot be accurately established using a direct approach because of a lack of adequate records.

customer shipping information. CDTFA concluded that the California Amazon sales ratio would be similar to sales paid using PayPal.

14. CDTFA multiplied deposits from Amazon and PayPal of $237,496 for the liability period by the California Amazon sales ratio of 10.78 percent and computed California Amazon and PayPal sales of $25,596 (rounded).

15. CDTFA compiled recorded sales in interstate and foreign commerce and sales for resale from the 1Q16 sales receipts journals. Appellant provided the corresponding shipping documentation and resale certificates for 1Q16 sales. CDTFA reviewed the documentation, found no errors, and concluded further testing was not warranted for sales in interstate and foreign commerce and sales for resale.

16. CDTFA also computed taxable sales by the markup method. Based on its discussion with appellant, CDTFA performed a shelf test[7] of items commonly sold. Using the costs from 2016 merchandise purchase invoices and the corresponding selling prices per the sales receipt journals, CDTFA computed a 16.78 percent markup. CDTFA added the markup of 16.78 percent to cost of goods sold[8] and computed California total sales of $1,260,132 for 2015 and 2016. Upon comparison to reported California total sales of $420,545 (taxable sales of $349,534 + sales for resale of $71,011), CDTFA computed unreported taxable sales of $839,587 for 2015 and 2016. Based on the results of the markup method analysis, CDTFA concluded that its bank deposit analysis was reasonable.

17. CDTFA issued an NOD to appellant on February 11, 2019, based on the above-mentioned audit, which disclosed a tax liability of $41,822, plus applicable interest, and a negligence penalty of $4,182.18.

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

19. CDTFA held an appeals conference with appellant, and subsequently issued a Decision on January 11, 2023, denying the petition.

20. Appellant timely appealed to OTA.

[7] A shelf test is an accounting comparison of known costs and associated selling prices to compute markups.

[8] To calculate cost of goods sold, CDTFA applied a percentage of merchandise shipped to a California location to total merchandise purchased in 2016 to merchandise purchases reported on the FITRs.

DISCUSSION

Issue 1: Whether 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.) Gross receipts do not include the price received for labor or services used in installing or applying the property. (R&TC, § 6012(c)(3).) 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 tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Exemptions from tax are strictly construed against the taxpayer who has the burden of proving that the statutory requirements have been satisfied. (*H. J. Heinz Co. v. State Bd. of Equalization*, (1962) 209 Cal.App.2d 1, 4.)

Here, CDTFA found inconsistent book markups, in particular the negative markup in 2016, that indicated that reported sales were potentially understated. CDTFA compared recorded taxable sales in the 1Q16 sales receipts journals to reported taxable sales on the 1Q16 SUTR which disclosed unreported taxable sales. Furthermore, CDTFA noted instances where appellant did not properly charge sales tax reimbursement on recorded sales invoices and other instances where appellant did not record any sales information during 1Q16. Based the foregoing and in conjunction with the inadequate records, OTA finds that it was reasonable for CDTFA to question reported sales and use an indirect audit method to compute appellant's sales. CDTFA's

use of the bank deposit analysis method as the basis for its determination is a recognized and accepted accounting procedure. In addition, CDTFA performed a markup analysis to test the reasonableness of the bank deposit analysis. Therefore, OTA concludes that CDTFA has established that its determination is reasonable and rational, and accordingly, the burden of proof shifts to appellant to show errors in the audit.

Appellant contends that the final determination should be based on the deficiency measure of $195,408 that CDTFA established during its first examination of appellant's records. In support, appellant provided a copy of a schedule titled Summary of Liabilities dated July 18, 2017, reflecting a total measure of $195,408[9] for the liability period, and an untitled schedule dated October 3, 2017, where reported taxable sales of $565,314 were multiplied by an error ratio of 16.97 percent to calculate unreported taxable sales of $95,934.[10]

There is no dispute that CDTFA initially presented appellant with a computation of unreported taxable sales based on the credit-card-sales-ratio method and disallowed claimed nontaxable labor totaling $195,408. However, CDTFA may compute and determine the amount required to be paid based upon any information in its possession or that may come into its possession. (R&TC, § 6481.) R&TC section 7081 states that the purpose of any tax proceeding between CDTFA and a taxpayer is the determination of the taxpayer's correct amount of tax liability, and CDTFA's Audit Manual section 0401.05 explains that a primary purpose of CDTFA's audit program is to provide reasonable assurance that taxpayers pay neither more nor less than required by law.[11] Therefore, it is appropriate for CDTFA to correct its audit methodology during the course of the audit if it determines that more accurate information is available, or it finds that its previous conclusions are incorrect. (See, e.g., CDTFA Audit Manual, § 0401.14.) Although CDTFA presented preliminary findings to appellant, these preliminary findings did not preclude CDTFA from reaching a different conclusion upon further review. As stated above, OTA concluded that CDTFA's determination was reasonable and

[9] The total measure is comprised of unreported taxable sales of $95,934 and disallowed nontaxable labor of $99,474.

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

[11] CDTFA's Audit Manual "is an advisory publication providing direction to [CDTFA's] staff administering the Sales and Use Tax Law and Regulations." 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.)

rational, and accordingly, the burden shifted to appellant to show errors in the audit. Accordingly, appellant must provide evidence sufficient to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Talavera*, *supra*.)

Appellant stated that the error ratio should have been 4.59 percent. However, appellant did not provide supporting evidence for the 4.59 percent error ratio. While CDTFA did not provide on appeal a schedule with the calculation of the 16.97 percent error ratio, CDTFA provided an explanation of the 16.97 percent error ratio in an email to appellant dated November 20, 2017. CDTFA stated that reported taxable sales were compared to audited taxable sales based on a credit-card-sales-ratio of 95 percent and credit card sales for 2015 and 2016. While the credit-card-sales-ratio method is an indirect method utilized by CDTFA, in this case CDTFA concluded the results of the bank deposit analysis were more reliable and accurately represented appellant's sales. Appellant has not provided sufficient evidence to establish that the credit-card-sales-ratio method produced a more accurate result. Accordingly, OTA rejects appellant's argument that CDTFA's audit methodology, the bank deposit analysis, should be abandoned.

Alternately, appellant contends that the bank deposit analysis fails to adjust for non-sales deposits. Appellant asserts that it received $215,080 from corporate officers and their relatives during the liability period which it was not obligated to repay. In addition, appellant states that it repaid loans from "Savings Club Members" of $48,350 during July 1, 2016, through June 30, 2017. Appellant provided a list of alleged loans from corporate officers and their relatives during the period of 2014 through 2017, and schedules of corporate loan activities for July 1, 2016, through June 30, 2017.

During the audit, appellant provided copies of deposit slips and canceled checks for alleged loan deposits for July 1, 2016, through June 30, 2017. CDTFA reviewed the documentation and compiled supported loan deposits of $6,217 for July 1, 2016, through June 30, 2017, and calculated audited loan deposits of $27,977 for the liability period. CDTFA then gave appellant another opportunity to support the purported loan deposits. However, appellant did not submit additional documents. On appeal, appellant has not provided credible evidence (e.g., copies of deposit slips and canceled checks) to support its assertion of additional loan or non-sales deposits. Accordingly, OTA finds no basis to make an adjustment.

Appellant alleges it repaid loans from "Savings Club Members" and that these repayments should also be deducted from deposits. However, appellant has not provided evidence of when the alleged loans from "Savings Club Members" were deposited into the bank accounts. Assuming that the alleged "Savings Club Members" loans were deposited into appellant's bank accounts, the repayment of a loan does not necessarily correspond to the same period as when the loan money was received. In other words, a loan paid back during the liability period may have been received before the liability period, and thus would not have been included in the bank deposit analysis. Appellant has not provided credible evidence in support of these loans. Accordingly, OTA finds no adjustment is warranted.

Appellant also asserts that any unreported taxable sales based on the bank deposits analysis should be allocated between nontaxable sales and labor. OTA notes that CDTFA examined bank deposits from Amazon and PayPal separately and concluded that $211,900 ($237,496 - $25,596) related to bank deposits for nontaxable sales. There is no indication in the record that appellant had additional bank deposits for nontaxable sales for resale or exempt sales in interstate and foreign commerce. Furthermore, appellant has not provided more evidence to demonstrate that it had additional bank deposits for nontaxable sales, and appellant's unsupported assertions are not sufficient to meet its burden of proof. Therefore, OTA finds that this argument does not warrant any adjustments.

Appellant argues that CDTFA has not corroborated that appellant understated its sales. As noted above, CDTFA's preliminary analysis indicated that reported sales were potentially understated. In addition, CDTFA conducted an additional audit method using the markup method. This additional audit method resulted in an even greater deficiency measure. As a result, CDTFA concluded that its determination of unreported taxable sales based on the bank deposit analysis was reasonable. Therefore, OTA finds that this argument does not warrant any adjustments to the determined measure of tax.

Finally, appellant states that its assertions and presentations have been ignored and a neutral "referee or judge" has not been present. Appellant's appeal is now before OTA. OTA is an independent and impartial appeals body which is separate and distinct from CDTFA.

In summary, OTA finds that CDTFA computed audited taxable sales based on the best-available evidence, which is a reasonable and rational method. Appellant has not identified any errors in CDTFA's computation of audited taxable sales or provided other credible evidence in

support of its contentions from which a more accurate determination could be made. Appellant cannot carry its burden simply by asking OTA to find unidentified errors in CDTFA's determination. (*Appeal of Amaya*, 2021-OTA-328P.) As appellant bears the burden of proof in this case, OTA concludes that no adjustments are warranted.

Issue 2: Whether appellant was negligent.

Appellant has not explicitly disputed the negligence penalty in its appeal here.[12] However, out of an abundance of caution, OTA will address the negligence penalty.

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 practice 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 *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

A taxpayer 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 the sales and use tax return. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b).) 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).)

[12] Appellant argued that the audit should have been based on the credit-card-sales-ratio method and on the copies of the audit schedules it provided for its appeal, and appellant asserted that the understatement should be $25,948 although appellant does not state that it concedes to this measure of tax.

CDTFA imposed the negligence penalty because appellant failed to maintain and provide complete and accurate books and records for audit and the audit disclosed a substantial understatement of taxable sales.

For audit, appellant did not provide sales source documentation such as sales invoices or cash register tapes for the liability period. In the test of appellant's 1Q16 sales, CDTFA noted that appellant did not properly charge sales tax reimbursement on some invoices and did not record the sales for other sales invoices. Thus, appellant's books and records were incomplete and recorded sales were unreliable. OTA finds that appellant's failure to provide complete and accurate books and records supporting its sales is evidence of negligence.

OTA notes that unreported taxable sales of $526,398 ($500,802 + $25,596) represents an error ratio of 93 percent when compared to taxable sales of $565,314 reported during the liability period. Appellant has not provided a non-negligent reason for failing to report a substantial amount of taxable sales. OTA finds the substantial understatement and large error ratio are evidence of negligence.

For the above reasons, OTA finds that appellant did not exercise the care that a reasonable and prudent person would exercise under similar circumstances. Although this was appellant's first audit, OTA concludes that appellant was negligent, and the negligence penalty was properly imposed.

HOLDINGS

1. No adjustments to the amount of unreported taxable sales are warranted.
2. Appellant was negligent and the penalty was properly imposed.

DISPOSITION

CDTFA's action in denying appellant's petition for redetermination is sustained.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Suzanne B. Brown
47F45ABE89E34D0...
Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
67F043D83EF547C...
Sheriene Anne Ridenour
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Date Issued: 2/7/2025