OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **LUXELINE INTERIORS, INC. AND I. CHEPELYUK**	OTA Case Nos.: 240716873; 240716900 CDTFA Case IDs: 2-435-900, 2-441-573; 2-426-714, 2-433-976

OPINION

Representing the Parties:

For Appellants: E. Chepel

For Respondent: Kevin Smith, Attorney
Jarrett Noble, Attorney
Jason Parker, Chief of Headquarters Ops.

S. BROWN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 6561 and 6901, I. Chepelyuk[1] dba Luxeline Interiors (Sole Proprietor) appeals a Decision issued by the California Department of Tax and Fee Administration (respondent)[2] denying, in part, Sole Proprietor's timely petition for redetermination of a Notice of Determination (first NOD), and also denying a corresponding protective claim for refund.[3] The first NOD was issued on December 15, 2020, for tax of $20,381, plus applicable interest, and a negligence penalty of $2,038.10 for the period January 1, 2017, through December 31, 2017 (first liability period). Respondent subsequently prepared a reaudit, which reduces the first NOD's tax to $17,781 and the negligence penalty to $1,778.08.

Additionally, pursuant to R&TC sections 6561 and 6901, Luxeline Interiors, Inc. (Corporation) appeals a Decision issued by respondent denying, in part, Corporation's timely petition for redetermination of an NOD (second NOD) and a corresponding protective claim for

[1] I. Chepelyuk indicated that he has legally changed his name to E. Chepel.

[2] 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 respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to the board.

[3] A taxpayer will sometimes file a claim for refund to protect its right to claim a refund or credit for overpayments discovered in an audit or that may be discovered during the taxpayer's appeal of the NOD. Such claims are frequently referred to as protective claims for refund.

refund. The second NOD was issued on December 15, 2020, for tax of $61,400, plus applicable interest, and a negligence penalty of $6,140.04 for the period January 26, 2018, through December 31, 2019 (second liability period).[4] Respondent subsequently prepared a reaudit, which reduces the second NOD's tax to $53,988 and the negligence penalty to $5,398.79.

Consistent with California Code of Regulations, title 18, (Regulation) section 30212(a), Office of Tax Appeals (OTA) consolidated these appeals on February 27, 2025. OTA refers to Sole Proprietor and Corporation collectively as "appellants."

OTA Panel Members Sheriene Anne Ridenour, Keith T. Long, and Suzanne B. Brown held a virtual oral hearing for this matter on December 17, 2025. At the conclusion of the oral hearing, the record was closed and this matter was submitted on the oral hearing record pursuant to Regulation section 30209(b).

ISSUES[5]

1. Whether appellants have established that further adjustments are warranted to disallowed claimed nontaxable labor and disallowed claimed sales for resale.
2. Whether the negligence penalties were properly imposed.

FACTUAL FINDINGS

1. Respondent selected Sole Proprietor for a routine sales and use tax audit for the period January 1, 2017, through December 31, 2019. Sole Proprietor disclosed that he had incorporated the business in January 2018. Sole Proprietor's seller's permit was opened with an effective start date of December 1, 2014, and closed with an effective date of December 31, 2017. Corporation's seller's permit was opened with an effective start date of January 26, 2018. Respondent divided the audit period to coincide with the respective entity's seller's permit (i.e. January 1, 2017, through December 30, 2017, for Sole Proprietor and January 26, 2018, through December 31, 2019, for Corporation). This was appellants' first audit.
2. Each appellant operated as a construction contractor[6] installing, selling, and servicing window coverings and shading products, including drapery products. Appellants

[4] The second NOD reflects a payment of $401.46.

[5] Following clarification at the hearing, OTA has slightly reorganized the statement of issues.

[6] "Construction contractor" means any person who agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).) "Construction contract" means and includes a contract to erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. (Cal. Code Regs., tit. 18, § 1521(a)(1)(A).)

operated out of Ladera Ranch, California, and performed installations throughout Orange County. Appellants did not prepare contracts but invoiced on a time and material basis[7] with sales tax reimbursement added to the sales price of fixtures.

Sole Proprietor

3. Sole Proprietor reported on his sales and use tax returns (SUTRs) total sales of $540,746 and claimed deductions of $134,279 for sales for resale, $133,212 for nontaxable labor, $3,640 for returned taxable merchandise, $263 for discounts on taxable sales, $5,741 for "other" (representing nontaxable commissions), and $19,819 for sales tax reimbursement included in reported total sales, which resulted in reported taxable sales of $243,792. Sole Proprietor stated that sales invoice totals were recorded in sales summaries that were used to report sales on the SUTRs. Respondent was unable to verify Sole Proprietor's reporting method.
4. Sole Proprietor provided a federal income tax return (FITR) for calendar year 2017; income statements for 2017; bank statements for 2017; and sales summaries and sales invoices for June 2017 through October 2017.
5. Respondent compared gross receipts reported on the FITR to the corresponding total sales reported on the SUTRs for 2017. Respondent noted that gross receipts exceeded reported total sales; Sole Proprietor was unable to explain the reason for the differences.
6. Respondent compared taxable sales plus claimed sales for resale (sales of merchandise) reported on the SUTRs for 2017 to the corresponding purchases reported on the 2017 FITR and computed an SUTR book markup[8] of 28.97 percent.

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[7] A "time and material contract" means a contract under which the contractor agrees to furnish and install materials or fixtures, or both, and which sets forth separately a charge for the materials or fixtures and a charge for their installation or fabrication. (Cal. Code Regs., tit. 18, § 1521(a)(7).)

[8] "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. (See respondent Audit Manual, § 0490.00 (January 2000).) Respondent's Audit Manual "is an advisory publication providing direction to [respondent's] staff administering the Sales and Use Tax Law and Regulations." OTA is not required to follow respondent's Audit Manual; however, OTA may look to it for guidance, such as when evaluating the reasonableness of respondent's determination. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

7. Using bank statements[9] for 2017, respondent compiled total bank deposits from sales proceeds and compared that amount to the corresponding total sales reported on the SUTRs for 2017. Respondent found that total bank deposits from sales proceeds exceeded reported total sales by $89,510; Sole Proprietor was unable to explain the reason for the differences. Sole Proprietor indicated that he had another business bank account, but he did not provide bank statements for the second bank account.
8. Using the sales summaries for June 2017 through October 2017, respondent compiled total sales (including sales tax reimbursement) of $104,073, sales tax reimbursement of $2,851, labor of $40,110, sales for resale of $23,754, and taxable sales of $36,780.[10] Based on its examination of the sales invoices, respondent concluded that Sole Proprietor had incorrectly recorded separately stated taxable parts and fixtures (hereinafter fixtures) and taxable measurement charges related to custom fabrication of fixtures under nontaxable labor. Respondent also found that lump-sum charges for fixtures and their installation were recorded entirely as nontaxable labor.
9. Based on its experience in audits of similar businesses in Sole Proprietor's area, respondent estimated that 60 percent of the lump-sum charge represented the selling price of the fixtures. In total, respondent compiled misclassified taxable charges of $15,971. Respondent divided misclassified taxable charges by the total of recorded nontaxable labor and computed an error ratio of 39.82 percent ($15,971 ÷ $40,110). Respondent multiplied claimed nontaxable labor by the error ratio and computed disallowed claimed nontaxable labor of $53,046.
10. Respondent also found that all the recorded sales for resale were for sales of fixtures to prime contractors and installed by Sole Proprietor. Sole Proprietor stated that he accepted resale certificates from prime contractors, but he did not provide any resale certificates for audit. Respondent allowed Sole Proprietor the opportunity to verify whether any of the prime contractors billed their customers for the sales tax

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

[10] OTA notes a $578 difference between the compiled total sales, including sales tax reimbursement, of $104,073 and the total of the recorded invoice sales categories of $103,495 ($2,851 + $40,110 + $23,754 + $36,780). This difference is due to an unexplained discrepancy on a sale by Corporation to Westminster Seminary in which recorded gross sales of $6,317 were exceeded by the sum of recorded taxable sales for that transaction of $6,402 and sales tax reimbursement collected of $496.

reimbursement on the fixtures, but Sole Proprietor declined. Thus, respondent concluded that Sole Proprietor incorrectly claimed taxable sales of fixtures to prime contractors as sales for resale. Therefore, respondent disallowed claimed sales for resale of $134,279 in its entirety.

11. As noted above, respondent identified a difference between gross receipts reported on the FITR and the SUTRs. Respondent concluded that a portion of the difference represented unreported taxable sales. Respondent added disallowed claimed nontaxable labor and disallowed sales for resale to the taxable sales reported on the SUTRs for 2017 and computed audited taxable sales. Respondent compared audited taxable sales to reported total sales, excluding sales tax reimbursement, and computed a taxable sales ratio of 82.76 percent for 2017.
12. Respondent applied the taxable sales ratio to the 2017 FITR difference of $75,545 and computed unreported taxable sales of $62,521 (rounded).
13. On December 15, 2020, respondent issued the first NOD for tax of $20,381, plus applicable interest, and a negligence penalty of $2,038.10.
14. Sole Proprietor filed a timely petition for redetermination of the first NOD and also filed a protective claim for refund.
15. During respondent's internal appeals process, Sole Proprietor provided a City of Newport Beach Business License Tax Certificate held by one of its customers, XYZ letter responses from two customers, a tax-paid invoice for scaffolding rentals from Home Depot, and a resale certificate. After reviewing the supporting documentation, respondent recommended: (1) based on the XYZ letter responses, removing valid sales for resale totaling $1,286 that were included in the test basis for claimed nontaxable labor charges; (2) adjusting the measure for the claimed nontaxable labor test by accepting scaffolding rentals from Home Depot as tax-paid purchases; and (3) based on the resale certificate, accepting sales for resale totaling $4,077 and removing these transactions from the test basis for sales for resale.
16. On March 14, 2024, respondent issued its Decision ordering a reaudit to adjust the liability pursuant to respondent's recommendations above, and to reduce the measures of tax accordingly, but otherwise denied the petition.
17. Respondent prepared a reaudit that reduced the taxable measure by $33,556, from $259,226 to $225,670, and thus reduced the tax to $17,781 and the negligence penalty to $1,778.08.
18. Sole Proprietor timely appealed to OTA.

Corporation

19. Corporation reported on its SUTRs total sales of $1,896,064 and claimed deductions of $301,042 for sales for resale, $659,103 for nontaxable labor, and $56,923 for sales tax reimbursement included in reported total sales, which resulted in reported taxable sales of $878,996 for the second liability period.
20. As with Sole Proprietor, Corporation stated that sales invoice totals were recorded in sales summaries that were used to report sales on the SUTRs. Corporation did not provide any books and records for the second liability period. Respondent was unable to verify Corporation's reporting method.
21. Respondent obtained state income tax return information for calendar years 2018 and 2019 from its internal taxpayer information system. Respondent compared gross receipts reported on the state income tax returns to the corresponding total sales reported on the SUTRs for 2018 and 2019 noting gross receipts exceeded total sales in each year. Corporation was unable to explain the reason for the differences.
22. Because there was no change in business operations between Corporation and Sole Proprietor, respondent concluded that the sales summaries and sales invoices for June 2017 through October 2017 were representative of the second liability period.
23. Respondent multiplied claimed nontaxable labor of $659,103 by the 39.82 percent error ratio (as explained above) and computed disallowed claimed nontaxable labor of $262,454 (rounded).
24. Respondent found that Corporation was the retailer of fixtures it installed for prime contractors, and that it failed to provide evidence supporting that these were sales for resale. Thus, respondent concluded that Corporation incorrectly claimed taxable sales of fixtures to prime contractors as sales for resale. Therefore, respondent disallowed claimed sales for resale of $301,042 in its entirety.
25. As noted above, respondent identified differences between gross receipts reported on the state income tax returns and the SUTRs. Respondent concluded that a portion of the differences represented unreported taxable sales. Respondent added disallowed claimed nontaxable labor and disallowed sales for resale to taxable sales reported on the SUTRs for 2018 and 2019 and computed audited taxable sales. Respondent compared audited taxable sales to reported total sales, excluding sales tax reimbursement, and computed taxable sales ratios of 69.68 percent for 2018 and 86.45 percent for 2019.

26. Respondent applied the 2018 taxable sales ratio to the 2018 state income tax return difference of $100,495 and computed unreported taxable sales of $70,025. Respondent applied the 2019 taxable sales ratio to the 2019 state income tax return difference of $183,605 and computed unreported taxable sales of $158,727. In total, respondent calculated unreported taxable sales of $228,752.
27. On December 15, 2020, respondent issued the second NOD, which was for tax of $61,400, plus applicable interest, and a negligence penalty of $6,140.04.
28. Corporation filed a timely petition for redetermination of the second NOD and also filed a protective claim for refund.
29. During respondent's internal appeals process, Corporation provided a City of Newport Beach Business License Tax Certificate held by one of its customers, XYZ letter responses from two customers, a tax-paid invoice from Home Depot, and a resale certificate. In light of the supporting documentation, respondent recommended adjustments to the percentages of error used in Sole Proprietor's audit, as discussed above in Factual Finding 15, and that those adjustments be applied to Corporation's audit. The reaudit adjustments included reducing the average taxable ratio for 2018 from 69.68 percent to 65.54 percent and reducing the percentage of disallowed nontaxable labor from 39.82 percent to 35.12 percent.
30. Respondent issued its Decision on March 14, 2024, ordering a reaudit to make adjustments pursuant to respondent's recommendations above, and to reduce the measures of tax accordingly, but otherwise denied the petition.
31. Respondent prepared a reaudit that reduced the taxable measure by $95,627 from $792,248 to $696,621 and thus reduced the tax to $53,988 and the negligence penalty to $5,398.79.
32. Corporation timely appealed to OTA.

DISCUSSION

Issue 1: Whether appellants have established that further adjustments are warranted to disallowed claimed nontaxable labor and disallowed claimed sales for resale.

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 respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, respondent 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, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

"Construction contract" means a contract to erect, construct, alter, or repair any building or other structure or other improvement on or to real property (Cal. Code Regs., tit. 18, § 1521(a)(1)(A)), and a "construction contractor" is any person who, for itself, in conjunction with, or by or through others, agrees to perform and does perform a construction contract. (Cal. Code Regs., tit. 18, § 1521(a)(2).)

In general, construction contractors are consumers of the materials they furnish and install when performing construction contracts, and they are retailers of fixtures they furnish and install when performing construction contracts. (Cal. Code Regs., tit. 18, § 1521(b)(2)(A)1 & (B)1.) "Fixtures" means and includes items that are accessory to a building or other structure and do not lose their identity as accessories when installed. (Cal. Code Regs., tit. 18, § 1521(a)(5).) Persons who contract to sell and install draperies, including drapery hardware, are retailers of the items which they furnish and install. (Cal. Code Regs., tit. 18, § 1521(c)(1).) Regarding the sale price for a fixture furnished and installed pursuant to a construction contract, if the contract states the sale price at which the fixture is sold, tax applies to that price. (Cal. Code Regs., tit. 18, § 1521(b)(2)(B)2.) If the contract does not state the sale price of the fixture, the sale price shall be deemed to be the cost price of the fixture to the contractor. (*Ibid*.)

Disallowed Claimed Nontaxable Labor

Tax applies to the gross receipts from retail sales (i.e., sales to consumers) by manufacturers, producers, processors, and fabricators of tangible personal property the sale of which is not otherwise exempted. The measure of the tax is the gross receipts of, or sales price charged by, the manufacturer, producer, processor, or fabricator, from which no deduction may be taken on account of the cost of the raw materials or other components purchased, or labor or

service costs to create or produce the tangible personal property, or of any step in the manufacturing, producing, processing, or fabricating, including work performed to fit the customer's specific requirements, whether or not performed at the customer's specific request, or any other services that are part of the sale. In addition, no deduction may be taken on account of interest paid, losses, or any other expense. (R&TC, §§ 6011, 6012; Cal. Code Regs., tit. 18, § 1524(a).)

Here, appellants did not provide a complete set of books and records for respondent to audit. Therefore, it was reasonable for respondent to question reported sales and use an indirect audit method as the basis for its determination. Because appellants' invoices did not separately state installation charges, respondent reasonably estimated that invoices that included sales of tangible personal property consisted of approximately 60 percent tangible personal property and 40 percent labor. In light of all evidence, OTA finds that respondent's methods were reasonable and rational and were based on the best information available. Therefore, the burden of proof shifts to appellants to establish reductions are warranted to the measures of disallowed nontaxable labor.

On appeal, appellants contend that the disputed transactions were for nontaxable labor, and that the transactions did not involve any sales of product. Appellants also assert that if fixtures and labor were billed lump-sum, 75 percent of the charge related to labor.

Regarding appellants' contention that the transactions consisted entirely of nontaxable labor, persons who contract to sell and install draperies including drapery hardware, are retailers of the items which they furnish and install. (Cal. Code Regs., tit. 18, § 1521(c)(1).) Moreover, respondent did not calculate taxable sales for any invoices that were solely for nontaxable labor. Thus, the disputed transactions included sales of tangible personal property and did not consist solely of sales of nontaxable labor.

Regarding appellants' allegation of a 75 percent ratio, appellants have provided no documentation or other evidence establishing that adjustments to respondent's estimate are warranted. Therefore, OTA concludes that appellants have failed to meet their burden, and thus no reduction to the measure of disallowed nontaxable labor is warranted.

Disallowed Claimed Sales for Resale

The burden of proving that a sale of tangible personal property is not at retail is upon the seller unless the seller timely takes in good faith a certificate from the purchaser that the property is purchased for resale. (R&TC, § 6091.) Any document, such as a letter or purchase order, timely provided by the purchaser to the seller will be regarded as a resale certificate with

respect to the sale of the property described in the document if it contains all of the following essential elements: (1) the signature of the purchaser, purchaser's employee or authorized representative of the purchaser; (2) the name and address of the purchaser; (3) the number of the seller's permit held by the purchaser; (4) a statement that the property described in the document is purchased for resale; and (5) the date of execution of the document. (Cal. Code Regs., tit. 18, § 1668(b)(1).)

Contractors holding valid seller's permits may purchase fixtures and machinery and equipment for resale by issuing resale certificates to their suppliers. They may not purchase materials for resale unless they are also in the business of selling materials. (Cal. Code Regs., tit. 18, § 1521(b)(6)(A).) A contractor cannot avoid liability for sales or use tax on materials or fixtures furnished and installed by him or her by taking a resale certificate from the prime contractor, interior decorators, designers, department stores, or others. (*Ibid*.) If a seller does not timely obtain a valid resale certificate, the seller will be relieved of liability for the tax only where the seller establishes that the property was in fact resold by the purchaser, and the purchaser did not make a taxable use of the property, or is being held for resale by the purchaser and the purchaser has not made a taxable use of the property. (Cal. Code Regs., tit. 18, § 1668(e).)

Appellants contend that there were "not any sales for resale that were conducted without a resale certificate." Appellants further argue that because their customers were legitimate businesses holding seller's permits and/or business tax licenses,[11] the sales were sales for resale; appellants assert that respondent ignored appellants' evidence of the customers' permits or licenses. Appellants allege that respondent's standards result in "double taxation" by requiring payment of sales tax both when appellants sell to customers and again when those customers resell the property.

Appellants' position does not accurately address the legal requirements for establishing sales for resale. First, as stated above, a resale certificate must contain several essential elements, including a statement that the property described in the document is purchased for resale. (Cal. Code Regs., tit. 18, § 1668(b)(1).) Neither seller's permits nor the City of Newport Beach Business License Tax Certificate contain this information, and hence they do not constitute resale certificates. Therefore, for the transactions at issue, OTA finds that appellants failed to obtain timely resale certificates.

[11] Appellants refer to "resale licenses," which OTA interprets to mean seller's permits issued by respondent. (See R&TC, §§ 6066, 6067.)

Given the lack of resale certificates, the next question is whether the evidence is sufficient to prove that appellants' customers actually resold the property at issue. As relevant here, if a seller does not timely obtain a valid resale certificate, the seller will be relieved of liability for the tax only where the seller establishes that the property was in fact resold by the purchaser, and the purchaser did not make a taxable use of the property. (Cal. Code Regs., tit. 18, § 1668(e).) For the transactions at issue, appellants have not provided any evidence which establishes that their customers actually resold the property at issue. To the contrary, the City of Newport Beach Business License Tax Certificate in the record lists the customer's business category as "Misc Personal Svcs," which does not support a finding that this customer was in the business of reselling window coverings and shading products. Consequently, appellants have not met their burden of proving that their customers resold the property at issue. Accordingly, appellants have not established that further adjustments to disallowed claimed sales for resale are warranted.[12]

Issue 2: Whether appellants were 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.)

A taxpayer shall maintain and make available for examination on request by respondent, 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 SUTR. (R&TC, §§ 7053, 7054; Cal. Code Regs, tit. 18, § 1698(b).) 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 or 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

[12] As discussed above in the Factual Findings, to the extent that appellants did provide resale certificates on appeal, respondent conducted a reaudit and reduced the taxable measure. As a result, those transactions are no longer in dispute.

negligence or intent to evade the tax and may result in penalties or other appropriate administrative action. (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 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.) In *Independent Iron Works, Inc. v. State Board of Equalization* ((1959) 167 Cal.App.2d 318, 323), the court held that a negligence penalty is applicable where errors are continued from one audit to the next.

According to the audit work papers, respondent imposed the negligence penalty due to appellants' incomplete records for the liability periods. On appeal, respondent also points to appellants' error rates of 93 percent and 79 percent for unreported taxable sales, respectively.

Appellants note that they are entitled to leniency regarding the negligence penalties because these were appellants' first audits. Appellants also argue that in this area of tax law, the taxability of sales and services to prime and subcontractors is frequently misunderstood even by very experienced contractors.

Here, Sole Proprietor did not provide a complete set of books and records for audit. Additionally, Sole Proprietor failed to report 93 percent of its taxable sales. These facts are evidence of negligence.

Nevertheless, Sole Proprietor did provide some books and records for the audit including FITRs, bank statements, income statements, sales summaries, and sales invoices. During the audit, respondent was able to use Sole Proprietor's records to project the taxable measure and calculate the error rate. Thus, given the complexity of the Sales and Use Tax Law provisions regarding construction contractors, and the fact that this is Sole Proprietor's first audit, the bookkeeping and reporting errors can be reasonably attributed to a good faith and reasonable belief that his bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law.[13] Therefore, OTA finds that the negligence penalty imposed on Sole Proprietor should be abated.

[13] Respondent's Audit Manual section 0506.40 describes circumstances in which a negligence penalty may be appropriate in a first-time audit, such as when the business owner previously operated a similar business, or when the evidence indicates it is more likely than not that the lack of records is intentional and is intended to conceal the underreporting. The evidence does not establish such circumstances in Sole Proprietor's case.

In contrast, Corporation did not provide any books and records for audit, and thus respondent needed to rely on the percentages of error calculated in Sole Proprietor's audit. Consequently, given the complete absence of records, Corporation's bookkeeping and reporting errors cannot be attributed to a good faith and reasonable belief that its bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. Accordingly, OTA finds that the negligence penalty was properly imposed on Corporation.

HOLDINGS

1. No further adjustments are warranted to disallowed claimed nontaxable labor and disallowed claimed sales for resale.
2. The negligence penalty for Sole Proprietor is deleted. The negligence penalty for Corporation is sustained.

DISPOSITION

Sole Proprietor's negligence penalty is deleted. Respondent's actions of reducing Sole Proprietor's tax to $17,781, reducing Corporation's tax to $53,988, reducing Corporation's negligence penalty accordingly, and otherwise denying the petitions for redetermination and claims for refund, are sustained.

Signed by:
Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

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DC88A60D8C3E442...
Keith T. Long
Administrative Law Judge

DocuSigned by:
Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

Date Issued: 3/5/2026