2026-OTA-415
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

AA KITCHEN APPLIANCE, INC.

OTA Case No. 231014566
CDTFA Case ID: 3-849-689

OPINION

Representing the Parties:

For Appellant: Stephen Ho, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 6561, AA Kitchen Appliance Inc. (appellant) appeals a Decision issued by the California Department of Tax and Fee Administration (respondent) denying, in part, appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on April 21, 2022. The NOD is for tax of $83,963, plus applicable interest, and a negligence penalty of $8,396.28 for the period July 1, 2017, through June 30, 2020 (liability period).[1]

Respondent subsequently prepared a reaudit that decreased the determined tax by $650 from $83,963 to $83,313, the corresponding negligence penalty was reduced by $65,[2] and the balance remains in dispute.

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, (Regulation) section 30209(a).

ISSUES

1. Whether further adjustments to the measure of unreported taxable sales are warranted.
2. Whether application of the negligence penalty is warranted.

[1] The NOD was timely issued because on June 28, 2021, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period July 1, 2017, through December 31, 2018, which allowed respondent until April 30, 2022, to issue an NOD. (R&TC, §§ 6487(a), 6488.)

[2] The negligence penalty was reduced by approximately $65 ($650 x 10%).

FACTUAL FINDINGS

1. Appellant, a corporation, operated two retail stores, located in San Francisco and Millbrae, California, during the liability period selling kitchen appliances. Appellant also provided installation services. Appellant's seller's permit was opened with an effective start date of January 1, 2012. Appellant had been audited previously for the period July 1, 2013, through June 30, 2016, which disclosed unreported taxable sales based on a bank deposits analysis method.
2. Respondent completed an audit and a revised audit for the liability period. The following is an explanation of the computation of audited taxable sales in the revised audit, which is the basis for the NOD.
3. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total sales of $15,823,104 and claimed deductions of $248,583 for nontaxable sales for resale, and $539,489[3] for nontaxable labor, resulting in reported taxable sales of $15,035,032. Appellant stated it provided sales summary reports to its outside bookkeeper who prepared the SUTRs.
4. For audit, appellant provided federal income tax returns (FITRs) for calendar years 2017, 2018, and 2019; sales summary reports for the first quarter of 2020 (1Q20) and 2Q20; sales invoices for 2Q20 for both locations; and bank statements for the liability period. Respondent found the books and records inadequate for sales and use tax audit purposes.
5. Respondent compared total sales reported on the SUTRs for 2017, 2018, and 2019 to the corresponding gross receipts reported on the FITRs noting gross receipts greatly exceeded total sales in 2017 and 2019. Appellant was unable to explain the reason for the differences.
6. Respondent compared gross receipts reported on the FITRs for 2017, 2018, and 2019, to the corresponding cost of goods sold reported on the FITRs and computed book markups[4] of 22.34 percent for 2017, 28.58 percent for 2018, and 26.86 percent for 2019.

[3] Appellant claimed deductions for nontaxable labor of $489,554 and $49,935 as "other" on the 1Q20 and 2Q20 SUTRs, respectively.

[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.

Based on its experience in audits of similar businesses in appellant's area, respondent believed the book markups were low, and additional testing was warranted.

7. Respondent compiled total sales for both locations from appellant's 2Q20 sales invoices, which exceeded total sales recorded in the 2Q20 sales summary report. Respondent compared total sales per the sales invoices and recorded in the sales summary report to total sales reported on the 2Q20 SUTR and found that the SUTR exceeded total sales from both the sales invoices and sales summary report. Respondent noted that the sales invoices provided were not complete. Respondent concluded this was evidence that recorded total sales were understated and the sales summary reports were unreliable.

8. Using bank statements[5] from appellant's business bank accounts, respondent compiled $17,769,376 as the total amount of bank deposits from sales proceeds for the liability period. Respondent compared total sales reported on the SUTRs, including reported sales tax, of $17,117,963 for the liability period to total bank deposits from sales proceeds, which disclosed a difference of $651,413. Respondent noted credit differences (reported total sales, including reported sales tax, exceeded total bank deposits from sales proceeds) in 2Q18, 4Q18, 1Q20, and 2Q20 totaling $466,715. Because appellant was unable to explain either the credit or debit differences and did not provide reliable documentation, respondent concluded that appellant correctly reported its total sales for those periods. Thus, respondent computed unreported total sales, including sales tax, of $1,118,127 ($651,413 + $466,715) (rounded) for the liability period.

9. Respondent computed a 95 percent taxable sales ratio based on sales reported on the SUTRs for the liability period. Respondent multiplied unreported total sales, including sales tax, by the taxable sales ratio and computed unreported taxable sales, including sales tax, of $1,062,439 for the liability period. For each quarterly reporting period, respondent divided unreported taxable sales, including sales tax, by 1 plus the average sales tax rate based on reported taxable sales to compute unreported taxable sales, excluding sales tax, of $978,476 for the liability period.

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[5] 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 respondent can use to determine audited taxable sales when sales cannot be accurately established using a direct approach because of a lack of adequate records.

10. Respondent issued an NOD to appellant on April 21, 2022, based on the above-mentioned revised audit, which disclosed a tax liability of $83,963 plus applicable interest and a negligence penalty of $8,396.28.
11. Appellant filed a timely petition for redetermination disputing the NOD and arguing that an allowance should be made for nontaxable cash deposits.
12. Respondent held an appeals conference with appellant, who provided additional documentation. Respondent reviewed the documentation and reduced unreported taxable sales by $7,577. Respondent issued a Decision on May 26, 2023, ordering a reaudit to make the adjustment but otherwise denying the petition.
13. Respondent prepared the reaudit report dated July 7, 2023, which reduced the determined taxable measure by $7,577 from $978,476 to $970,899.
14. Appellant timely appealed to OTA.
15. Respondent, in preparation for this appeal, reexamined the 2Q20 sales invoices and found that during the appeals conference appellant provided four invoices which were not previously provided totaling $89,538 in taxable sales, a paid invoice which was previously submitted as "VOID" in the amount of $12,059, and an invoice with the same invoice number as another invoice but to different customers and for different amounts in the amount of $17,793. Respondent concluded that when these amounts were added to taxable sales determined for the 2Q20 test period, the audited taxable sales increased to $1,355,890 ($1,236,500 + $89,538 + $12,059 + $17,793). Audited taxable sales compared to reported results in a difference of $98,873 ($1,355,890 - $1,257,017) or 7.87 percent error. When the percentage of error is applied to reported total sales of $15,035,032, the audited taxable sales equals $1,182,608 ($15,035,032 x 7.87 percent). When compared to unreported taxable sales in the audit findings, the sales test results in $211,709 more than the unreported taxable sales per the bank deposit analysis ($1,182,608 - $970,899). Based on the results of the reexamination, respondent determined that the revised audit was reasonable and to appellant's benefit when compared to the reasonableness test results.

DISCUSSION

Issue 1: Whether further adjustments to the measure of unreported taxable sales are warranted.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (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*.) 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.)

Here, appellant provided limited books and records for respondent to examine in order to validate reported gross receipts. Respondent found low book markups and unexplained differences between recorded and reported sales which led respondent to believe that reported sales were potentially understated. Thus, OTA finds that it was reasonable for respondent to question reported sales and to use an indirect audit method to compute appellant's sales. Respondent's use of the bank deposit analysis method as the basis for its determination is a recognized and accepted accounting procedure. (See *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) Therefore, OTA concludes that respondent has established that its determination is reasonable and rational, and accordingly, the burden shifts to appellant to show errors in the audit.

Appellant contends that respondent computed bank deposits from sales proceeds on a cash basis for nine quarters and on an accrual basis for three quarters. Appellant argues that respondent's method was arbitrary and violated the accounting principle of consistency and resulted in overstating taxable sales. OTA understands that appellant is disputing respondent's adjustment in the bank deposit analysis replacing the credit differences with total sales reported on the SUTRs for 2Q18, 4Q18, 1Q20, and 2Q20.

Respondent reviewed all the documentation appellant provided in support of its contention and made the appropriate adjustments. Appellant was unable to explain either the credit or debit differences during the audit fieldwork and agency-level appeal. Appellant has not provided any verifiable documentation to support reported amounts and has not explained the differences in its appeal with OTA. To support its position, respondent prepared a reasonableness test in preparation for this appeal. Using the sales test for 2Q20, respondent noted that during the agency-level appeal appellant provided the following: (1) four invoices which were not previously provided totaling $89,538 in taxable sales; (2) a paid invoice which was previously submitted as void in the amount of $12,059; and (3) an invoice with the same invoice number as another invoice but to a different customer and for a different amount, $17,793.

When these amounts are added to the taxable sales respondent previously determined for the test period, the audited taxable sales are increased to $1,355,890 ($1,236,500 + $89,538 + $12,059 + $17,793) for 2Q20. Audited taxable sales compared to reported taxable sales results in a difference of $98,873 ($1,355,890 - $1,257,017) or 7.87 percent error. When the percentage of error is applied to reported total sales of $15,035,032, the audited taxable sales equals $1,182,608 ($15,035,032 x 7.87 percent). When compared to unreported taxable sales in the audit findings, the sales test results in $211,709 more than the unreported taxable sales per the bank deposit analysis ($1,182,608 - $970,899).

In summary, respondent computed audited taxable sales based on the bank deposit analysis, which is a reasonable and rational method. Even though respondent relied on the bank deposit analysis which resulted in a lower assessment than the test of sales for 2Q20 per the reasonableness test, appellant has not identified any errors in respondent's computation of audited taxable sales or provided documentation or other 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 respondent's determination. (*Appeal of Amaya*, 2021-OTA-328P.) As appellant bears the burden of proof in this case, no adjustments are warranted.

<u>Issue 2: Whether application of the negligence penalty is warranted.</u>

Appellant did not explicitly dispute the assessment of the negligence penalty in its appeal here. However, because the amount disputed is roughly equivalent to the assessed tax and negligence penalty, out of an abundance of caution, OTA will address the negligence penalty.

R&TC section 6484 provides that, "[i]f any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of this part or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto." Regulation section 1703(c)(3)(A) further clarifies that "[g]enerally, a penalty for negligence or intentional disregard should not be added to a deficiency determination 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."

While R&TC section 6484 is generally referred to as the "negligence penalty," the statute presents two circumstances in which the penalty is warranted. The first is where the deficiency is due to the negligence of the taxpayer. The second is where the deficiency is a product of the taxpayer intentionally disregarding the law or authorized rules and regulations. Respondent's Audit Manual refers to both circumstances as "negligence" for purposes of penalty imposition and describes two situations where such a penalty is warranted: negligence in keeping records and negligence in preparing returns (see respondent's Audit Manual, § 0506.45). Intentional disregard is a step beyond negligence, but below fraud or intent to evade. (See R&TC, § 6485.)

Negligence occurs when the taxpayer fails to exercise the care that a reasonable and prudent businessperson 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.) Taxpayers are required to maintain and make available for examination 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)(1).) Such records include, but are not limited to, the following: (a) normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of 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. (Cal. Code Regs., tit. 18, § 1698(k).)

Here, while this was not appellant's first audit, the underreported taxable measure was, relative to the total for the liability period, less than 10 percent and as determined by respondent, around 6 percent. While evidence exists to substantiate appellant's negligent acts in regard to the maintenance and supply of sufficient records to substantiate the returns filed, the degree of appellant's underreporting was insufficient in magnitude to warrant imposition of the penalty for a negligent failure to maintain adequate records.

Intentional disregard occurs when a taxpayer who knows or should know of a rule or regulation chooses to ignore its requirements. (See, e.g., *Cramer v. Comm'r of Internal Revenue* (9th Cir. 1995) 64 F.3d 1406, 1414 interpreting Internal Revenue Code § 6653(a).) If evidence shows respondent specifically directed taxpayer's attention to certain errors the taxpayer was making in its returns and yet the taxpayer continued to report its tax under those methods, such evidence supports imposition of the negligence penalty. (See *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 322-323.)

Here, during appellant's first audit, respondent specifically instructed appellant about the requirements that retailers maintain business records sufficient to establish the veracity of their reported sales. Because the deficiency at issue here is entirely a product of appellant's failure to maintain records after having been expressly instructed about this obligation during a prior audit, the imposition of the penalty is warranted.

HOLDING

1. No further adjustments to the measure of tax for unreported taxable sales are warranted.
2. Respondent's imposition of the negligence penalty is warranted.

DISPOSITION

Respondent's action is sustained.

Signed by:
Kim Wilson
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Kim Wilson
Hearing Officer

I concur:

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

Date Issued: 1/23/2026

G. TURNER, I concur in part and dissent in part.

I concur that the negligence penalty is warranted given that this is appellant's second audit and the errors at issue here were directly a product of ignoring specific instruction provided to appellant by respondent during the first audit. However, appellant's inadequate record keeping, even on second audit, is not license for respondent to abandon their objective to determine the correct amount of tax and simply shield the assessment behind the presumption of correctness. I would, therefore, adjust the taxable measure.

Undoubtedly, appellant has a responsibility to maintain complete and accurate records to support reported amounts and make them available for examination. (Revenue and Taxation Code (R&TC), §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) While appellant provided limited books and records for respondent to examine to substantiate reported gross receipts, their deemed inadequacy is not grounds to rely on an indirect method in a vacuum.

Respondent examined appellant's federal income tax returns (FITR) and found a total difference between reported gross receipts there and on the sales and use tax returns (SUTR) of less than 4 percent. Examining invoices for one quarter, respondent estimated underreporting of under 3 percent. Examining appellant's supplied sales report summaries for two quarters resulted in overreported sales of just over 2 percent. Determining the deviation between reported total sales and the FITRs material, as well as finding the supplied invoices and sales reports unreliable because they failed to corroborate one another and because the invoices supplied were not sequential, respondent resorted to an indirect method of estimating total sales by examining bank deposits.

While bank deposits are not gross receipts (R&TC, § 6012(a)), they are evidence of gross receipts, at least whereas here appellant's taxable sales represented 95 percent of total sales according to the SUTRs. Nevertheless, the bank deposit method suffers from several weaknesses respondent's audit manual well recognizes. (See respondent's Audit Manual, § 405.25.) Aside from the obvious comingling of taxable and non-taxable items (e.g., security deposits, loans, sales subsequently returned, or other failed purchase transactions),[1] timing of sales to deposits is chief among them. Consequently, "the bank deposit method is typically used when there are virtually no other options." (Respondent's Audit Manual, § 405.25.)

Respondent found total deposits of $17,760,718 for the liability period, which, when adjusted for sales tax collected and a 95 percent taxable sales ratio, amounted to an

[1] Respondent estimated an error rate of 1.4 percent for the receipt of non-refundable deposits appellant failed to include among taxable sales.

underreporting of approximately $558,104[2] or 3.7 percent. Respondent, however, then compared deposits to reported sales on a quarter-by-quarter basis, and determined underreporting based solely on quarters in which deposits exceeded reported sales, identifying as a "credit" adjustment any quarter in which reported sales *exceeded* actual deposits. Because of appellant's insufficient records and failure to specifically account for the *excess* deposits, respondent denied recognition of this "credit difference." Essentially, respondent treated deposits exceeding reported sales as underreporting, but where deposits were less than reported sales for the quarter, accepted sales as reported by appellant. The result was respondent determining total underreported sales of $1,109,470 (tax included) (underreporting of $642,755 plus denial of excess deposits of $466,715) which when adjusted for the taxable sales ratio of 95 percent and sales tax collected, produced the determination of $970,899 in unreported taxable sales for the liability period, or 6.1 percent.

In its appeal, appellant argues that respondent used only nine quarters of the bank deposits rather than all twelve. According to appellant, this amounted to mixing a cash basis method for nine quarters with an accrual method for three quarters[3] constituting an arbitrary method of accounting resulting in appellant's sales to be overstated for the liability period.

Respondent may determine a taxpayer's liability upon the basis of any information within its possession or that may come into its possession whether a taxpayer's records are complete or missing entirely. (R&TC, § 6481; *Riley B's, Inc. v. Bd. of Equalization* (1976) 61 Cal.App.3d 610; *Appeal of AMG Care Collective*, 2020-OTA-173P.) Appellant's lack of records, however, does not relieve respondent of the obligation to ascertain the correct amount of tax, nor that their assessment be reasonable and rational. (R&TC, § 7081; *Appeal of Landeros*, 2024-OTA-655P.)

Respondent's use of the bank deposit method is not what renders their determination arbitrary or unreasonable, but its use *only* when supporting a finding of unreported taxable sales despite sufficient evidence in the record refuting the reasonableness of such a result. For example, total deposits for the liability period produced an underreporting error of under 4 percent, roughly in line with respondent's examination of appellant's invoices and sales reports. Only by examining deposits on a quarterly basis and shifting to appellant the obligation

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[2] Reported total sales ($15,823,104) plus reported tax collected ($1,294,859) would lead OTA to expect deposits of $17,117,963, compared to actual deposits of $17,760,718. When adjusted for taxable sales ratio of 95 percent and an average tax rate of 8.6 percent, estimated underreporting of taxable sales was $558,104 for the liability period.

[3] Final audit shows four quarters in which reported sales exceeded bank deposits: 2Q18, 4Q18, 1Q20, and 2Q20.

to establish why excess deposits for a quarter are not in line with reported taxable sales can the determination be sustained. Cherry-picking quarters is simply not a reasonable bank deposit audit technique and inconsistent with respondent's own Audit Manual.[4] Accordingly, I would find respondent's denial of the "credit" allowances in their examination of bank deposits quarter-by-quarter was arbitrary and fails to satisfy their obligation to prove the assessment was reasonable and rational. Consequently, I would find a commensurate adjustment to appellant's liability is warranted. But otherwise, I would sustain respondent's determination.

Signed by:
Greg Turner
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Greg Turner
Administrative Law Judge

Dated: 1/23/2026

[4] Respondent's Audit Manual section 405.25 states: "There are two methods of estimating gross receipts on the basis of bank deposits: (a) Where records of deposits are available for the entire period, they should be scheduled for that period. (b) Where records of deposits are available only for a portion of the audit period, a percentage of error should be computed and then applied to recorded or reported sales for the remainder of the period."