



This Week in State Tax (TWIST)

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California: CDTFA's Application of Differing Audit Methods was Arbitrary

The California Office of Tax Appeals (OTA) recently ruled in a taxpayer's favor in a case addressing whether the Department of Tax and Fee Administration (CDTFA) appropriately applied different audit methods to determine the taxpayer's unreported sales. The taxpayer, a perfume retailer, did not keep adequate books and records to verify sales data reported on its sales and use tax returns. As such, the CDTFA appropriately applied an indirect audit method to compute the taxpayer's unreported sales. The auditor applied two methods, the bank deposits method and a method based on the taxpayer's federal income tax returns (FITR method). Notably, for each tax year, the CDTFA applied the indirect audit method that resulted in a higher amount of unreported sales, as opposed to applying the same method for the entire period. If the CDTFA had used either the bank deposits method or the FITR method for the entire period, the two methods resulted in similar calculations of unreported taxable sales: \$886,746.00 and \$870,024.00, respectively. Instead, by selectively choosing which indirect audit method to use each period, the CDTFA increased unreported taxable sales to \$941,442.00.

The OTA noted at the outset that when CDTFA is not satisfied with the amount of tax reported by the taxpayer, it may determine the amount required to be paid based on any information which is in its possession or may come into its possession. In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. 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. On appeal, the OTA determined that the use of the two different audit methods was not rational or reasonable in this instance. In the audit work papers, the CDTFA explained that it had alternated between the two methods based on which method would result in higher audited taxable sales. In the OTA's view, when the CDTFA alternated between indirect audit methods because one method produced a higher result, the CDTFA was no longer attempting to estimate the correct measure of tax but instead was arbitrarily increasing the tax measure. The OTA found that the use of the bank deposits method for the entire liability period was reasonable and rational, and adjusted the computation of the appellant's taxable sales accordingly. One OTA panel member dissented from the majority on the basis that the initial burden test is a minimal threshold for CDTFA to meet. In the dissenting member's view, there may be more than one method which is reasonable and rational, and CDTFA may select any reasonable and rational method. Please contact [Jim Kuhl](#) with questions on *Appeal of Colambaarchchi*.

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