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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **GOLDEN 7 LIQUOR & DELI, INC.**	) OTA Case No. 18032427)) CDTFA Case ID 792082) CDTFA Account No. SR BH 100-886151)) Date Issued: July 2, 2019

OPINION

Representing the Parties:

For Appellant: Framta Saechao, Attorney

For Respondent: Scott Lambert, Business Taxes Specialist III
Pamela Bergin, Tax counsel III
Kevin C. Hanks, Chief, Headquarters Operations Bureau

For Office of Tax Appeals: Richard Zellmer, Business Tax Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Golden 7 Liquor & Deli, Inc. (appellant) appeals an action by respondent, the California Department of Tax and Fee Administration (Department), determining $64,297.00 of additional tax, and applicable interest, for the period July 1, 2009, through June 30, 2012.[1]

Office of Tax Appeals Administrative Law Judges Michael F. Geary, Tommy Leung, and John O. Johnson, held an oral hearing for this matter in Sacramento, California, on March 27, 2019. At the conclusion of the hearing, the judges closed the record and took the matter under submission.

ISSUE

Is appellant entitled to a reduction of the measure of unreported taxable sales?

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of the BOE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22; 2017 Stats. 2017, ch. 16, § 5.) We will use the term "Department" herein to refer to both. When referring to events that occurred before July 1, 2017, "Department" shall refer to the BOE; and when referring to events that occurred on or after July 1, 2017, "the Department" shall refer to respondent.

FACTUAL FINDINGS

1. During the relevant audit period, appellant owned a liquor store in San Francisco, selling liquor, beer, wine, cigarettes, soda, taxable sundry items, a few exempt food products, and lottery tickets. Mr. Yared Feleke and his wife, Ms. Azeb Sertsu, operated the business. Mr. Feleke ran the store, including purchasing stock, setting prices, and dealing with customers. Ms. Sertsu handled the bookkeeping.
2. For reporting purposes, appellant calculated taxable sales using Z tapes.[2] Ms. Sertsu testified that she entered total sales and sales tax (reimbursement) collected daily on an Excel spreadsheet, and that she used those amounts for reporting purposes.
3. Appellant reported total sales during the audit period of $3,197,226, taxable sales of $1,240,320 (38.79 percent of total sales), and nontaxable sales of $1,956,906 (61.21 percent of total sales).
4. The Department audited appellant for the period July 1, 2009, through June 30, 2012. The audit upon which the original determination was based revealed that taxable merchandise purchases (taxable purchases)[3] for the audit period substantially exceeded reported taxable sales for the audit period. Because the Department concluded that this difference was a strong indication that reported taxable sales were understated and that it impeached the records upon which appellant based its reported taxable sales, the Department decided to compute appellant's taxable sales using the markup method.[4]
5. The Department did a shelf test,[5] comparing costs from purchase invoices for August 2012, to selling prices posted on the shelf on September 26, 2012, or provided by appellant for items for which the prices were not posted on the shelves. It used the shelf

[2] Z tapes are point-of-sale terminal (register) summaries of cash and credit card activity.

[3] By "taxable purchases," we are referring to purchases of merchandise the sale of which would be subject to tax. Similarly, by "taxable goods," we are referring to merchandise the sale of which would be subject to tax.

[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 $.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 (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup) is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross margin is 30 percent (.30 ÷ 1.00 = 0.3).

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

test to compute markups for various categories of taxable merchandise, and the markups for each product category were weighted based on the ratio of purchases in each product category as determined in a purchase segregation test,[6] to compute a weighted markup for taxable merchandise of 34.78 percent.

6. The Department added the markup of 34.78 percent to audited cost of taxable goods sold for 2009, 2010, and 2011 to compute audited taxable sales for each of those years. It compared audited taxable sales to reported taxable sales for each year, finding that audited taxable sales exceeded reported taxable sales for each of those years, resulting in error ratios of 55.97 percent for 2009, 61.17 percent for 2010, and 49.47 percent for 2011. The Department applied those error ratios of 55.97 percent to reported taxable sales for the period July 1, 2009, through December 31, 2009, applied the 61.17 percent error ratio to reported taxable sales for 2010, and applied the error ratio of 49.47 percent to reported taxable sales for the period January 1, 2011, through June 30, 2012, to compute unreported taxable sales of $679,164 for the audit period.[7]
7. Based on the audit, the Department issued a Notice of Determination (NOD) to appellant in the amount of $64,297.00 tax, plus applicable interest.
8. Appellant filed a petition for redetermination of the NOD.
9. The Department held an appeals conference with appellant and the Department's audit staff. At the appeals conference, appellant argued that audited taxable sales should be computed by adding the markups for each individual product category to the cost of goods sold for each respective product category, as opposed to the audit method of calculating a weighted markup for all product categories combined and then applying that weighted markup to the cost of goods sold for all taxable product categories combined.
10. After the appeals conference, appellant provided the Department with a shelf test for cigarettes, which indicated there was a markup for cigarettes of 17.21 percent, as compared to the markup of 36.1 percent for cigarettes computed in the audit. The

[6] The purchase segregation test was done by examining purchase invoices for the months of April and May 2012, and segregating the merchandise purchases into various product categories.

[7] The Department also computed a separate measure of tax of $30,076 for the unreported cost of self-consumed taxable merchandise, and a separate credit measure of tax of -$10,639 for unclaimed credits for tax-paid purchases resold. Appellant does not dispute either of these measures of tax, and thus we do not discuss them further. However, as explained below, the Department recommends a reduction to the measure of tax for the unreported cost of self-consumed taxable merchandise, which would reduce that measure.

Department accepted appellant's shelf test markup of 17.21 percent for cigarettes, apparently without verification. Also, appellant noted some unusually large markups for certain products in the Department's shelf test, and the Department agreed to remove those items from the shelf test. After making these adjustments, the Department computed a weighted markup for taxable merchandise of 28.73 percent (as compared to the 34.78 percent weighted markup for taxable merchandise computed in the audit). Finally, appellant provided the Department with information regarding its taxable merchandise purchases for the audit period, which the Department accepted and used to calculate unreported taxable sales on an actual basis for the audit period (as opposed to computing error ratios for each year and projecting those error ratios into various periods as was done in the audit). Using the markup of 28.73 percent and the taxable merchandise purchase information provided by appellant, the Department computed unreported taxable sales for the audit period of $597,347.

11. The Department issued its Decision and Recommendation, which found that appellant's method of computing taxable sales by adding the markups for each individual product category to the cost of goods sold for each respective product category, produced the same result as the method used in the audit. On that basis, the Appeals Division rejected appellant's argument to the contrary and recommended that the Department reduce the measure of tax for unreported taxable sales to $597,347 and that the petition for redetermination otherwise be denied. This timely appeal followed.

DISCUSSION

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) It is a taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability under the Sales and Use Tax Law, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698, subd. (b)(1).)

The Department may determine a tax deficiency on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) When there is an

appeal, the Department has a minimal, initial burden of showing that its determination is reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Michael E. Myers* (2001-SBE-001) 2019 WL 1187160.) If the Department carries that burden, the burden of proof shifts to the taxpayer to establish that a result differing from the Department's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) California Code of Regulations, title 18, section 30219(c) states that unless there is an exception provided by law, "the burden of proof requires proof by a preponderance of the evidence." Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid*.; see also *Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.)

Using Z-tapes, appellant reported total sales during the audit period of $3,197,226, taxable sales of $1,240,320, and nontaxable sales of $1,956,906. According to the audit work papers upon which the Department based the NOD, appellant's records indicated purchases for the audit period totaled $1,963,796. Based on its examination of 2011 purchases, the Department determined that 76.99 percent of those purchases were taxable purchases. Thus, the cost of taxable goods available to be sold during the audit period was $1,511,936. After reducing that amount for pilferage (2 percent) and self-consumption (2 percent), the cost of such goods was $1,452,064.

To determine the markup factor, the Department first did a taxable purchase segregation based on appellant's summary of purchases for the audit period. The result showed the following ratios of taxable purchases: 29.93 percent for distilled spirits (liquor), 29.72 percent for cigarettes and other tobacco products (tobacco), 28.02 percent for beer, 4.76 percent for wine, 4.51 percent for non-alcoholic carbonated beverages, 1.91 percent for periodicals (magazines), and 1.15 percent for taxable sundries. In September 2012, the Department did a shelf test, which found that audited markups for these categories as follows: 114.48 percent for taxable sundries, 45.59 percent for carbonated beverages, 36.10 percent tobacco, 35.66 percent for liquor, 34.01 percent for beer, 23.29 percent for wine, and 18.66 percent for magazines. At appellant's request, the Department later adjusted the markups to: 95.50 percent for taxable sundries, 36.74 percent for carbonated beverages, 17.21 percent tobacco, 34.24 percent for liquor, 32.69 percent

for beer, 23.29 percent for wine (unchanged), and 18.01 percent for magazines.[8] Using these markups and the results of the purchase segregation test, the Department calculated a weighted average markup of 34.78 percent.

The Department applied a 34.8-percent markup to the cost of goods available to be sold during the audit period to calculate audited taxable sales of $1,963,046. Thus, the Department determined that appellant underreported taxable sales by $707,222, which is an error percentage of 56.32 percent. Also, according to the Department's calculations, appellant's reported taxable sales were $200,638 *less* than its cost of the goods it sold. We find that this difference called the accuracy of appellant's reporting into question and that, under the circumstances, the Department's decision to calculate the deficiency, if any, using the markup method was appropriate.

In the reaudit after the appeals conference, the Department determined the cost of goods available for sale during the audit period in the fashion described above, except that it made minor adjustments to the inventory and determined taxable purchases by examining purchase invoices for August 2012, making adjustments for sales tax reimbursement included where appropriate, and correcting for misclassification errors that the Department found in appellant's data. Using the audited markups and the results of its purchase segregation test, the Department determined a weighted average markup of 28.73 percent. The Department applied that average weighted markup (rounded down to 28.7 percent) to the amount of taxable purchases available for sale in the last two quarters of 2009, all of 2010 and 2011, and the first two quarters of 2012 to calculate audited taxable sales of $1,837,682. By deducting reported taxable sales, the Department determined unreported taxable sales of $597,362 and a percentage of error for each of the four years (or parts of a year) in question. The Department multiplied the reported taxable sales for each of those periods by those error percentages to determine unreported taxable sales totaling $597,347.

Based on the evidence, we find that the Department has established that its determination has a reasonable and rational basis. Consequently, the burden is on appellant to establish a more accurate measure.

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[8] The adjustments appear to have been made based on additional information provided by appellant to show tax included on some purchases and tobacco sales prices lower than evidenced by the September shelf test. The Department also agreed to delete several items with relatively high markups.

Appellant argues that the audited markup should not apply to the entire three-year audit period. Appellant states that it is in direct competition with numerous vendors in the area, including Safeway, Trader Joe's, at least one Walgreens, and several other liquor and convenience stores. Appellant argues that, to stay competitive during the audit period, it offered reduced prices on some items and changed its specially priced bargains on a weekly basis. For example, Mr. Feleke testified that appellant offered the lowest prices in town on Budweiser beer, on which it had only a 15 to 16 percent markup. Appellant further argues that during the audit period, the country was in the midst of, or just beginning to recover from, the recession, which had a further impact on sales. Mr. Feleke testified that during the audit period, he was able to maintain sales by lowering his markup. Finally, appellant argues that the audited markup does not account for inflation.

Alternatively, in the event we determine that a markup approach is appropriate, appellant urges us to consider its own markup analysis, and it argues that we should rely upon it to find that the Department has overstated appellant's unreported taxable sales. Ms. Sertsu, who was the bookkeeper for appellant, provided testimony at the hearing to explain her analysis. She testified that she obtained information from appellant's vendors regarding purchases appellant made during the audit period.[9] She adjusted for self-consumption (2 percent) and pilferage (2 percent) and applied what Mr. Feleke told her was the highest markup applied to that vendor's goods during the audit period. Appellant's analysis concluded that taxable purchases during the audit period totaling $1,445,003 (rounded) and resulted in taxable sales during the audit period of $1,727,268 (rounded), as compared to the Department's determination of $1,530,276 in taxable purchases and $1,837,682 in taxable sales.

Appellant's argument that the markup method should not be applied to it because of local competition or the effects of the recession is unpersuasive. Competition is part of doing business, and appellant has not shown that its markup was less than 28.73 percent during the audit period, due to the recession or any other factor. Finally, there is nothing in the evidence to support appellant's argument that the markup method does not take inflation into account. Theoretically, at least, inflation should impact the cost of goods sold and the selling price of goods equally. It need not affect a retailer's markup and there is no evidence that it affected appellant's markup during the audit period. We have nothing but the unsupported assertions of

[9] These are the same 14 vendors the Department used to determine audited taxable purchases.

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appellant's owners to refute the Department's determination based on an audit, and those are insufficient to satisfy appellant's burden.

Finally, appellant's markup analysis does not establish a more accurate measure. In all but five instances, appellant uses purchase amounts that are less than the amounts shown in its own records. In some instances, this may be due to appellant's deductions for nontaxable purchases, but the factual bases for those deductions are not in the record. Likewise, appellant's alleged "markup range" and "highest markup" have no factual basis in the record, other than the testimony of appellant's owners.[10] As we stated above, unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Riley B's, Inc. v. State Bd. of Equalization*, *supra*, at p. 616, *Appeal of Aaron and Eloise Magidow*, *supra*.)

For all of the above reasons, we conclude that no reduction should be made to the audited markup of 28.73 percent.

[10] For example, appellant uses a 27 percent markup for beer. Mr. Feleke testified that his prices on Budweiser were "the cheapest in town" at 15 to 16 percent, and the Department's analysis appears to bear this out. However, that analysis also shows that appellant's average markup on beer was 32.69 percent and ranged from 15.78 percent for Budweiser (the lowest markup) to 72.59 percent for Tecate.

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HOLDING

Appellant is not entitled to a reduction of the measure of unreported taxable sales.

DISPOSITION

The Department's action in reducing the measure of tax for unreported taxable sales to $597,347, and reducing the separate measure of tax for the unreported cost of self-consumed taxable merchandise to $29,725, and otherwise denying appellant's petition for redetermination, is sustained.

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Michael F. Geary
Administrative Law Judge

We concur:

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Tommy Leung
Administrative Law Judge

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John O. Johnson
Administrative Law Judge