OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19085141
	) CDTFA Account No. 100-650924
K. KRISHAN AND	) CDTFA Case ID 997359
P. LATA	)
dba, QUICK TRIP MARKET	)
	)

OPINION

Representing the Parties:

For Appellant:	K. Krishan, Co-owner
For Respondent:	Jason Parker, Chief Headquarters Operations Bureau
For Office of Tax Appeals:	Richard A. Zellmer Business Tax Specialist III

D. CHO, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, K. Krishan and P. Lata, a husband and wife co-ownership, (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) issued on February 14, 2017. The NOD assessed a tax liability of $18,306.95, plus applicable interest, and a negligence penalty of $1,830.71 for the period July 1, 2013, through December 31, 2015 (audit period).

Appellant waived its right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether a reduction to the measure of unreported taxable sales is warranted.
2. Whether a reduction to the measure of unreported taxable cigarette rebates is warranted.

[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 CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when this opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the BOE.

3. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant operated two convenience stores in California, one in Colton and one in Corona. The Colton location closed on December 31, 2015, and the Corona location closed on December 1, 2014. Appellant sold carbonated beverages, cigarettes, food products, and miscellaneous taxable merchandise at both locations. However, appellant sold beer and wine only at the Colton location.
2. CDTFA audited appellant for the period July 1, 2013, through December 31, 2015. Upon audit, appellant provided federal income tax returns (FITR's) for 2013, 2014, and 2015, sales reports for the audit period, purchase reports for the audit period, bank statements for the audit period, and merchandise purchase invoices for the Colton location for June 2014. Appellant did not provide cash register tapes for any portion of the audit period and did not provide purchase invoices other than the June 2014 purchase invoices, which were for the Colton location only. Due to the lack of cash register tapes and purchase invoices, CDTFA found the books and records to be incomplete.
3. After examining the limited records provided by appellant, CDTFA found that appellant's gross receipts and gross sales reported on its FITR's and sales and use tax returns (SUTR's) did not reconcile. For example, for 2013, appellant's gross receipts reported on its FITR exceeded total sales reported on its SUTR by $473,388. However, for 2014 and 2015, appellant's total sales reported on its SUTR's exceeded gross receipts reported on its FITR's by $68,880 and $4,137, respectively. In addition, CDTFA concluded that according to appellant's records, appellant sold its tangible personal property at a loss for the entire audit period, which indicated that the records were unreliable. Lastly, CDTFA obtained information from three of appellant's four major vendors and found that appellant's purchase reports were unreliable and inaccurate because the purchase reports were lower than the amounts reported from the three vendors. Based on the foregoing, CDTFA concluded that it could not rely on the documentation provided to verify appellant's reported taxable sales.

4. CDTFA decided to verify appellant's reported taxable sales using a markup method.[2] CDTFA examined appellant's purchase invoices for June 2014 and determined total taxable merchandise purchases of $23,879 for the Colton location. CDTFA multiplied this amount by 12 to estimate taxable merchandise purchases of $286,538 for 2014 with respect to the Colton location.[3] For the Corona location, CDTFA determined that appellant made all of its purchases for this location from one vendor, Sam's Club. As a result, CDTFA obtained appellant's purchase information from Sam's Club for 2014, which established total taxable merchandise purchases of $12,419. CDTFA computed taxable merchandise purchases of $298,957 ($12,419 + $286,538) for both locations for 2014. CDTFA reduced taxable merchandise purchases by 1 percent for self-consumption and then by 5 percent for pilferage to compute audited cost of taxable goods sold of $281,169 for 2014.
5. CDTFA was unable to perform a shelf test at the time of the audit because both of appellant's stores had closed prior to the start of the audit field work. Thus, CDTFA used a markup percentage from a prior audit. Appellant was previously audited for the period July 1, 2010, through June 30, 2013. For that audit, CDTFA performed a shelf test, comparing costs from purchase invoices for July 2013 to the item's respective selling prices. In that manner, CDTFA computed markups for various product categories, which were then weighted based on the amount of purchases in each category, to compute a weighted markup of 22.41 percent.
6. CDTFA added the markup of 22.41 percent to audited cost of taxable merchandise purchases of $281,169 for 2014 to compute audited taxable sales of $344,179 for that year. CDTFA compared audited taxable sales to reported taxable sales of $237,243 for 2014 and determined unreported taxable sales of $106,936 ($344,179 - $237,243), which represented an error ratio of 45.07 percent. CDTFA applied the error ratio of 45.07 percent to reported taxable sales for the audit period to compute total unreported taxable sales of $258,241.

[2] "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).

[3] We compute $286,548. The $10 difference appears to be due to rounding.

7. Using bank statements provided by appellant, CDTFA compiled payments of $7,587 from Lorillard, a cigarette manufacturer, to appellant for the period July 2013 through April 2015. CDTFA determined that these payments were for cigarette rebates paid by Lorillard to appellant and found that the rebates constituted gross receipts under R&TC section 6012. Thus, CDTFA included a separate measure of tax of $7,587 for unreported taxable cigarette rebates.
8. CDTFA issued an NOD to appellant on February 14, 2017, based on the aforementioned audit, in the amount of $18,306.95 tax, plus applicable interest, and a negligence penalty of $1,830.71.[4]
9. Appellant filed a timely petition for redetermination, protesting the NOD on February 17, 2017.
10. CDTFA held an appeals conference with appellant on February 19, 2019.
11. In its Decision issued on July 25, 2019, CDTFA denied the petition.
12. This timely appeal followed.

DISCUSSION

Issue 1 - Whether a reduction to the measure of unreported taxable sales is warranted.

California imposes a 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 the retailer's responsibility to maintain complete and accurate records and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When 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. (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;

[4] The audit also included two separate audit items for unreported cost of self-consumed merchandise subject to use tax of $7,230, and an allowance of $44,222 for a tax-paid purchases resold deduction. Appellant does not dispute these two audit items.

Appeal of Myers (2001-SBE-001) 2001 WL 37126924.) 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. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid*.; see also *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

CDTFA used purchase records provided by appellant and appellant's vendors to audit the business. Although CDTFA employed different estimates and calculations to determine appellant's taxable sales for the audit period, all of CDTFA's projections were ultimately based on information either provided by appellant or third parties. In other words, CDTFA used the best available evidence in calculating appellant's taxable sales. Therefore, we find that CDTFA's determination is both reasonable and rational, and the burden of proof shifts to appellant to establish that a differing amount is warranted.

Appellant contends that the amount of unreported taxable sales computed in the audit is incorrect. Appellant asserts that, during the audit period, it maintained "proper reporting accountability." However, appellant did not provide any cash register tapes for audit, and appellant failed to produce complete purchase invoices. Without original source documentation, we are unable to verify the accuracy of the information contained in the sales and purchase reports. Further, CDTFA pointed out that gross receipts reported on appellant's 2013 FITR exceeded total sales reported on appellant's 2013 SUTR by $473,388. Conversely, CDTFA found that total sales reported on the SUTR's exceeded gross receipts reported on the FITR's by $68,880 for 2014 and $4,137 for 2015. In addition, based on the information contained in appellant's books and records, CDTFA determined that appellant was selling its tangible personal property at a loss for the entire liability period, which generally indicates that the information contained in the records is inaccurate because a retailer would typically add a markup to the selling price of its tangible personal property. Appellant could not explain these discrepancies. Finally, CDTFA found that the merchandise purchases from three of appellant's four major vendors exceeded merchandise purchases recorded on appellant's purchase reports by $18,519 for the last six months of 2013, $4,946 for 2014, and $7,592 for 2015. Therefore, we find that appellant's argument that its records were complete and that it maintained "proper reporting accountability" is unsupported and contrary to the evidence.

Although appellant asserts that the amount of merchandise purchases obtained from the vendors was incorrect, appellant has not provided any supporting documentation to substantiate this claim or to establish its total purchases for the audit period. As stated earlier, unsupported assertions are not sufficient to satisfy appellant's burden of proof. (See *Appeal of Magidow*, *supra*.) In weighing the evidence, we find the evidence provided by the third parties to be more reliable than appellant's unsupported assertions. Therefore, we find that this contention does not warrant any adjustment to the determined measure of tax.

Appellant also asserts that CDTFA did not visit the stores to compute a markup, but this allegation is incorrect. CDTFA used a markup percentage that it calculated in a previous audit of appellant's business because appellant's stores were closed at the time of the current audit. Furthermore, the purchase invoices that CDTFA used in calculating the markup in the previous audit was calculated based on invoices for July 2013, which is during the current audit. As a result, these calculations would be an accurate representation of appellant's business. Appellant also fails to indicate what a more appropriate markup percentage should be for this business. Thus, we recommend no adjustment to the audited markup of 22.41 percent.

Although appellant argues that CDTFA failed to make an adjustment for ending inventory, appellant has not explained how this alleged failure would result in a reduction to the measure of unreported taxable sales. Nonetheless, we note that generally the cost of goods sold equals beginning inventory plus merchandise purchases during the period less ending inventory, and according to appellant's FITR's, appellant reported a beginning inventory of $21,420 on January 1, 2013, and an ending inventory of $18,510 on December 31, 2013. Appellant subsequently reported an ending inventory of $16,000 on December 31, 2014, and an ending inventory of zero on December 31, 2015. Thus, according to appellant's own FITR's, it had an ending inventory of zero, which means that it sold or consumed all of its inventory, which includes the beginning inventory amount of $21,420 plus the audited purchases, during the audit period. Therefore, this argument does not establish that CDTFA's determination is overstated. On the contrary, this argument would indicate that CDTFA's determination is understated by the beginning inventory amount plus the weighted markup.

Lastly, appellant asserts that it was not notified of the audit, which prevented it from providing the necessary business records. However, there is extensive evidence of appellant's interactions with CDTFA during the audit of the business, which began in August 2016 and

ended approximately in the first quarter of 2017. During this time period, appellant had ample opportunity to provide the necessary documentation to support its position, but it did not. There is also no question that appellant protested CDTFA's NOD on February 17, 2017, and to date, appellant has not produced the necessary business records to establish a more accurate taxable sales measure for the audit period. Therefore, this argument does not warrant any adjustment to CDTFA's determination.

Based on the foregoing, we conclude that appellant has failed to meet its burden of proof.

Issue 2 - Whether a reduction to the measure of unreported cigarette rebates is warranted.

As previously stated, California imposes a 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.) Gross receipts include all amounts received with respect to the sale, with no deduction for the cost of materials, service, or expense of the retailer passed on to the purchaser, unless there is a specific statutory exclusion. (R&TC, § 6012(d).) Gross receipts specifically include all receipts, cash, property of any kind, and any amount for which credit is allowed by the seller to the purchaser. (R&TC, § 6012(b).) Thus, gross receipts are not limited solely to amounts collected from the purchaser, but instead may also include amounts the retailer receives from other sources.

Under certain conditions, payments received by the retailer in the form of rebates or other types of payments for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product. (Cal. Code Regs., tit. 18, § 1671.1(a).) It is rebuttably presumed that any consideration received by retailers from third parties related to promotions for the sale of specified products is subject to tax until the contrary is established. (Cal. Code Regs., tit. 18, § 1671.1(c)(3)(A).)

Here, the evidence shows that appellant received payments from Lorillard, a third-party cigarette manufacturer. Appellant alleges that it did not receive cigarette rebates, but appellant has not shown what the payments from Lorillard were for. Thus, it is rebuttably presumed that the payments received from Lorillard are taxable, and appellant has not established the contrary. (See Cal. Code Regs., tit. 18, § 1671.1(c)(3)(A).) We, therefore, find that a reduction to the measure of tax for unreported cigarette rebates is not warranted.

Issue 3 - Whether appellant was negligent.

CDTFA imposed a negligence penalty pursuant to R&TC section 6484 because the understatement was large in relation to reported taxable sales and because similar errors were found in a previous audit of appellant. Appellant opposes the negligence penalty because it believes that it reported the correct amount of tax.

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. In *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323, the court held that a negligence penalty is justified where errors are continued from one audit to the next.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) 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 of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

Here, appellant's unreported taxable sales of $258,241 represents an error ratio of 45.07 percent when compared to reported taxable sales of $572,979, which is evidence of negligence. In addition, appellant was previously audited for the period July 1, 2010, through June 30, 2013, and in that previous audit CDTFA established unreported taxable sales of $541,216 using a markup method because appellant did not have adequate records. In the current audit, appellant did not provide any cash register tapes or complete purchase invoices for CDTFA to examine, even though appellant was previously audited. The prior audit of appellant's business was completed at the end of 2013, but appellant failed to maintain the proper records for 2014 and 2015, which is evidence of negligence.

Although appellant argues that it was not negligent because it properly reported its taxable sales, our findings above are directly contrary to this assertion. Therefore, we find that appellant was negligent, and CDTFA's imposition of the negligence penalty is justified.

HOLDINGS

1. Appellant has not shown that any reduction to the measure of unreported taxable sales is warranted.
2. Appellant has not shown that any reduction to the measure of unreported cigarette rebates is warranted.
3. Appellant was negligent.

DISPOSITION

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

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Daniel Cho
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Daniel K. Cho
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
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Date Issued: 5/20/2020