OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19034559
	) CDTFA Account No. 100-120398
GKHALSA, INC.	) CDTFA Case ID 972365
	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	James Taheran, Esq., CPA
For Respondent:	Lisa Renati, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Richard A. Zellmer Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Gkhalsa, Inc. dba Circle K (appellant) appeals a decision issued by the respondent, California Department of Tax and Fee Administration (CDTFA), denying appellant's petition for redetermination of the Notice of Determination (NOD) for a tax liability of $91,267.74, plus accrued interest, for the period April 1, 2012, through March 31, 2015 (audit period).[1] Pursuant to the reaudit recommended in CDTFA's decision, CDTFA made several adjustments to the measure as discussed below.

Office of Tax Appeals (OTA) Administrative Law Judges Keith T. Long, Daniel K. Cho, and Josh Aldrich, held a telephonic hearing for this matter on May 19, 2020. The hearing was originally scheduled to be held in Cerritos, California. At the conclusion of the hearing, the record was closed, and the matter was submitted for decision. Thereafter, the record was

[1] Sales taxes were formerly administered by the State Board of Equalization (BOE). On July 1, 2017, functions of BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when referring to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

reopened to include appellant's post-hearing briefing as well as CDTFA's response thereto. The record was closed on June 15, 2020.

ISSUE

Whether any additional reduction to the amount of unreported taxable sales based on the markup method is warranted.

FACTUAL FINDINGS

1. Appellant operated three Circle K convenience stores during the audit period as follows: one on Euclid Street in Anaheim (Euclid); one on North Loara Street in Anaheim (North Loara); and one on Flower Street in Bellflower (Flower). Euclid was open throughout the audit period. Appellant stopped operating North Loara on December 31, 2014, and Flower on October 8, 2013.
2. CDTFA audited appellant for the period April 1, 2012, through March 31, 2015. Appellant used Radiant and Service Station Computer System (SSC) point of sale (POS) systems to record its sales. Appellant used POS reports to prepare its sales and use tax returns (SUTR). Upon audit, appellant provided the following for each location: federal income tax returns (FITR); general ledgers for 2012 and 2013; POS and sales reports for the audit period. Appellant also provided the following for Euclid and North Loara: sales journals for 2012, 2013, and 2014; bank statements for the second quarter of 2014 (2Q14); merchandise purchase summaries for 2Q14; merchandise purchase invoices for 2Q14 and the months of November 2014 and December 2014. Appellant also provided purchase invoices for the months of March 2013, March 2015, and September 2015 for Euclid; and merchandise purchase invoices for September 2015 for the successor business at North Loara.
3. As explained below, CDTFA performed a purchase segregation test, which resulted in a taxable merchandise purchase ratio of 80.08 percent. CDTFA multiplied cost of goods sold, as recorded on the 2012 and 2013 FITRs, by 80.08 percent to compute the cost of taxable goods sold, then compared the cost of taxable goods sold to taxable sales reported on the SUTRs to compute book markups for taxable merchandise of -2.40 percent for

2012 and -2.58 percent for 2013.[2] The negative book markups mean that taxable cost of goods sold exceeded reported taxable sales. CDTFA also found that appellant's POS reports provided a summary of taxable sales for various product categories, but the POS reports could not be used to identify which specific products were considered taxable or nontaxable. Thus, CDTFA could not verify that appellant was correctly charging sales tax on all taxable products. Due to the negative book markups and the inability to verify that appellant was correctly charging sales tax on all taxable products, CDTFA decided that additional verification of reported taxable sales was needed.

4. CDTFA decided to compute appellant's taxable sales using the markup method. CDTFA could not perform a shelf test for Flower due to the lack of merchandise purchase invoices for that location, and because that location was closed prior to the audit field work.[3] Thus, CDTFA computed audited markups for North Loara and Euclid:

    a. For North Loara, CDTFA performed a shelf test, comparing costs from appellant's merchandise purchase invoices for the month of September 2015 to the selling prices that were either posted on the location's shelf on November 5, 2015, or provided by appellant if selling prices were not posted on the shelf, to compute audited markups for various product categories.[4] The markups for each product category were weighted based on the ratios of purchases in each product category, as determined in the segregation of taxable merchandise purchases for September 2015, to compute an audited weighted markup of 32.49 percent for North Loara.

    b. For Euclid, CDTFA used the same shelf test procedures described above to compute an audited weighted markup of 31.28 percent for that location.

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[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 $.70 and it charges customers $1.00, the markup is $.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .70 = .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 profit margin is 30 percent (.30 ÷ 1.00 = .3).

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

[4] The product categories are beer, carbonated beverages, wine, tobacco, newspapers, hot food, ice, and miscellaneous taxable merchandise.

5. CDTFA averaged the audited weighted markups for Euclid and North Loara to compute an average weighted markup of 31.88 percent, which CDTFA concluded is the average markup for all three locations combined.

6. CDTFA reduced cost of goods sold (COGS) reported on the 2012 FITR by 10 percent, to account for supply items, to compute adjusted COGS of $2,295,941 for 2012. CDTFA performed a purchase segregation test using available merchandise purchase invoices for the month of September 2015, which disclosed that taxable merchandise accounted for 80.08 percent of the merchandise purchases.[5] CDTFA multiplied adjusted COGS for 2012 by 80.08 percent to compute the cost of taxable merchandise purchases. CDTFA reduced the cost of taxable merchandise purchases by two percent to allow for self-consumption and by two percent to allow for pilferage to compute audited cost of taxable goods sold for 2012. CDTFA applied the average weighted markup of 31.88 percent to the audited cost of taxable goods sold and found audited taxable sales of $2,328,707 for 2012. CDTFA compared audited taxable sales for 2012 to reported taxable sales for that year to compute an understatement error ratio of 16.91 percent. CDTFA applied the 16.91 percent error ratio to reported taxable sales for the period April 1, 2012, through December 31, 2012, to compute unreported taxable sales of $263,600 for that period.

7. CDTFA used the same procedures described above to compute audited taxable sales of $2,347,681 for 2013. CDTFA compared audited taxable sales for 2013 to reported taxable sales for that year to compute an understatement of $343,343 for that year, and an understatement error ratio of 17.13 percent. CDTFA applied the 17.13 percent error ratio to reported taxable sales for the period January 1, 2014, through March 31, 2015, to compute unreported taxable sales of $309,452 for that period. In total, CDTFA computed unreported taxable sales established using the markup method of $916,395 ($263,600 + $343,343 + $309,452).

8. The audit also established a separate measure of tax of $98,931 for unreported taxable sales based on a sales tax reconciliation. The audit also established a separate measure of tax of $110,991 for the unreported cost of self-consumed taxable merchandise.

9. CDTFA issued the NOD to appellant on July 6, 2016. Appellant filed a timely petition for redetermination protesting the NOD in its entirety. CDTFA issued its decision on

[5] Flower was closed in October 2013. Thus, only Euclid and North Loara were tested.

February 27, 2019. CDTFA found that the separate measure of tax of $98,931 for unreported taxable sales, established using a sales tax reconciliation, was duplicated in the measure of tax for unreported taxable sales established using the markup method. CDTFA also found that the purchase segregation test of September 2015 should be expanded to include the months of April 2014, May 2014, June 2014, November 2014, and December 2014, which reduced the taxable merchandise purchase ratio from 80.08 percent to 75.13 percent. CDTFA also obtained appellant's cost of goods sold for 2014 from appellant's state income tax return. As such, CDTFA decided to compute taxable sales for 2014 using the markup method rather than projecting the error ratio from 2013 into 2014.

10. CDTFA performed a reaudit, based on its decision, which reduced the measure of tax for unreported taxable sales established using the markup method to $651,477, and the measure of tax for the unreported cost of self-consumed taxable merchandise to $97,925.[6] Thus, CDTFA determined that the measure of tax of $98,931 for unreported taxable sales established using a sales tax reconciliation be deleted, the measure of tax for unreported taxable sales established using the markup method be reduced from $916,395 to $651,477, and the measure of tax for the unreported cost of self-consumable taxable merchandise be reduced from $110,991 to $97,925. CDTFA otherwise denied the petition for redetermination.

11. Appellant filed the instant appeal with OTA.

DISCUSSION

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.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food are subject to tax. (R&TC, § 6359(a), (d)(7).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may determine the amount required to be paid on the basis of any information which is in its

[6] Appellant does not dispute the $97,925 measure of tax for the unreported cost of self-consumed taxable merchandise.

possession or may come into its possession. (R&TC, § 6481.) 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; *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.)

Upon audit, CDTFA performed a preliminary analysis to determine if additional testing was warranted. The preliminary analysis involved computing book markups for taxable merchandise. Since appellant's records did not segregate merchandise purchases into taxable and nontaxable categories, CDTFA initially computed a taxable merchandise purchase ratio of 80.08 percent in a purchase segregation test of September 2015. CDTFA used the 80.08 percent merchandise purchase ratio to allocate recorded merchandise purchases into taxable and nontaxable categories. This ratio resulted in negative book markups for taxable merchandise of -2.40 percent for 2012 and -2.58 percent for 2013.[7] Whereas, using the 75.13 percent taxable merchandise purchase ratio, which was computed in the reaudit, results in a combined book markup for taxable merchandise of 1.74 percent. CDTFA further asserts that using a 65 percent taxable sales ratio, which is significantly less than the 75.13-percent taxable merchandise purchase ratio, results in a combined book markup for taxable merchandise of 17.87 percent. We note that the audited markup, which appellant has not disputed, is 31.88 percent. Given the disparity between the audited markup and the book markups, we find that it was reasonable for CDTFA to apply indirect audit methodology.

The original audit includes schedule 414-M, which lists the amounts that appellant reported on its SUTRs for each quarter of the audit. On this schedule, CDTFA divided reported taxable sales by reported total sales, excluding sales tax, to calculate the ratio of taxable sales to

[7] A negative taxable markup means that appellant's cost of goods is greater than the amount received for the goods. That is, the items were sold at a price less than the appellant's cost. A negative markup on taxable items coupled with very high markup on nontaxable items indicates possible errors where taxable items are rung up as nontaxable.

total sales (taxable sales ratio).[8] We would expect the reported taxable sales ratio to be somewhat similar to the taxable merchandise purchase ratio of 75.13 percent. For 1Q14, the reported taxable sales ratio is 80 percent, which is in line with the results of the reaudit purchase segregation test. For every other quarter in the audit period, the reported taxable sales ratio is in the range of 69 percent to 52 percent. We find that the low reported taxable sales ratios further support an indirect audit methodology.

For the reasons discussed above, we find that CDTFA had sufficient reason to question the reliability of appellant's reported taxable sales. CDTFA used a recognized and standard audit procedure to compute appellant's audited taxable sales.[9] Thus, we find that CDTFA has met its initial burden of showing that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to show errors in the reaudit calculations.

Appellant raised several arguments regarding the POS system. Appellant argues that its POS system and other books and records should be accepted as accurate because CDTFA has not provided evidence to show errors in the POS reports. Appellant asserts that its POS system accurately captures taxable and nontaxable sales, and its SUTRs are based on the POS system reports. Appellant provided some of those reports. Appellant argues that these reports should be considered evidence that it correctly charged tax on all taxable products. We acknowledge that the reports segregate products into various product categories and identify which categories are subject to tax. However, the reports lack specificity. The reports do not identify the specific products that are included in each product category. Thus, we find that the reports provided by appellant do not show that appellant correctly charged sales tax on the sale of all taxable products.

Appellant argues that CDTFA should have performed some sort of direct test to determine the accuracy of the POS system. Appellant has not provided any authority that mandates a direct test of a POS system in a sales tax audit. Furthermore, observing which products are taxed by appellant today would not establish that appellant was properly reporting sales tax on the sale of all taxable products during the audit period. Thus, we reject appellant's argument that the POS system must be directly tested.

[8] According to schedule 414, the amount in column "G" (reported taxable sales) was divided by the amount in column "O" (reported total sales, excluding sales tax) to calculate the ratios.

[9] See CDTFA Audit Manual section 0405.30.

Likewise, we note CDTFA is not required to accept the taxpayer's books and records, as conclusive evidence, even if they were in agreement.[10] Thus, regardless of how reliable appellant thinks its POS system is, CDTFA is not required to accept the POS system as accurate when audit testing tends to indicate an understatement.

Appellant claims that CDTFA projected an error ratio over the entire audit period. Our review of the audit and reaudit workpapers discloses that different error ratios were applied to different periods. In the reaudit, unreported taxable sales for 2013 and 2014 were calculated on an actual basis for those two years, an error ratio of 9.69 percent was used for the period April 1, 2012, through December 31, 2012, and an error ratio of 16.73 percent was used for the period January 1, 2015, through March 31, 2015. Thus, we reject this contention.

Appellant raised several arguments regarding the purchase segregation test, which we address below. In the reaudit, the purchase segregation test resulted in a taxable merchandise purchase ratio of 75.13 percent. As indicated above, the taxable merchandise purchase ratio was applied to the COGS that appellant reported in its FITRs to compute the cost of taxable goods sold. Thus, a lower taxable merchandise purchase ratio benefits appellant.

Appellant notes that the taxable merchandise purchases for November 2014 were $58,108 and the taxable merchandise purchases for December 2014 were $71,562. Appellant argues that the disparate taxable merchandise purchases for these two months indicate that there is a problem with the purchase segregation test. In a similar vein, appellant contends that CDTFA should explain the difference in merchandise purchases for these two months. We note that CDTFA contemplated two possible reasons for the difference in recorded merchandise purchases for November 2014 and December 2014: 1) merchandise purchases in December increased due to the holidays; and 2) merchandise purchases for November 2014 may be incomplete. CDTFA has not acquiesced to either possibility. We note that CDTFA does not have the burden to explain the reason for the difference, rather appellant must explain why the difference justifies an adjustment to the audit. Appellant has not shown that the taxable merchandise purchases amounts of $58,108 for November 2014 and $71,562 for December 2014 are incorrect. We note that the taxable merchandise purchase ratios are 79.87 percent for November 2014, and 81.8 percent for December 2014. Thus, while taxable merchandise purchases may have increased from November 2014 to December 2014, nontaxable merchandise purchases also

[10] See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610.

increased at about the same rate. The result is similar taxable merchandise purchase ratios. Given the similarity of the taxable merchandise purchase ratios, we see no reason to be alarmed by the difference in taxable merchandise purchased for these two months. Thus, we reject this argument.

Appellant argues that the two separate purchase segregation tests should not have been averaged. As stated above, in the original audit, CDTFA used September 2015 as the test month for the purchase segregation test. In the reaudit, CDTFA expanded the purchase segregation test by six months.[11] Appellant argues that September 2015 should not have been included in the purchase segregation test in the reaudit. Appellant opines that when CDTFA recommended expanding the purchase segregation test, CDTFA was acknowledging that the September 2015 purchase segregation test was erroneous. We do not agree. Generally, the decision to increase the sample size is done in order to increase the probability of producing a more reliable result. We do not interpret CDTFA's decision, to expand the sample size, to mean that the test of September 2015 is flawed. Appellant has not shown that the purchase information from September 2015 is inaccurate. As such, we find no reason to exclude September 2015. Thus, we reject this argument.

Appellant asserts that during the early part of the audit period, it was a Special Supplemental Nutrition Program for Women, Infants and Children (WIC) authorized grocer, and as such, sold more nontaxable food products in those periods.[12] Appellant also asserts that earlier in the audit period, it sold more nontaxable phone cards. Therefore, appellant argues that the taxable merchandise purchase ratio was lower in the earlier parts of the audit period due to the WIC program and phone cards.

CDTFA obtained information indicating that the WIC program ended on July 2, 2012, and on November 7, 2013, at Euclid and Flower, respectively. Thus, the WIC program was in effect at Euclid for only 3 of the 36 months in the audit period. The WIC program was in effect at Flower for 19 of the 36 months in the audit period. There is no evidence to show that the WIC program was in effect at North Loara during the audit period. Appellant has not provided any records from its WIC sales for the audit period. Appellant has not provided its purchase invoices

[11] See Factual Finding 9.

[12] CDTFA reports, and appellant does not dispute, that WIC is a federal assistance program of the Food and Nutrition Service of the United States Department of Agriculture (USDA) for healthcare and nutrition of low-income pregnant women, breastfeeding women, and children under the age of five.

for the periods when the WIC program was in effect at Euclid and Flower. We note that the WIC program is limited to a small portion of the population. We also note that individuals who buy nontaxable food items, under the WIC program, could have also purchased taxable merchandise from appellant. Thus, the mere participation in the WIC program is not sufficient to establish that the taxable merchandise purchase ratio was lower during periods when the WIC program was in effect at two of appellant's stores. Therefore, we reject appellant's argument regarding its participation in the WIC program.

Regarding nontaxable phone card sales, we reject appellant's argument for the same core reason. That is, appellant has not provided substantiating evidence.

Appellant asserts that North Loara and Flower had more nontaxable transactions than Euclid, and thus, not testing Flower has resulted in a taxable merchandise purchase ratio that is too high. Appellant has not provided any purchase invoices from Flower that could be used to compute a taxable merchandise purchase ratio for that location. Thus, we reject this argument.

Appellant argues that its purchase segregation test of 2Q18 should be included in the reaudit results. CDTFA rejected appellant's purchase segregation test for 2Q18 because it was not supported by purchase invoices. We note that appellant's schedule results in taxable merchandise purchase ratios of 11 percent for April 2018, 10 percent for May 2018, and 19 percent for June 2018. We find that these taxable merchandise purchase ratios are low for this business when compared to the other months tested, which produced merchandise purchase ratios in the range of 70 to 80 percent for each month tested. Furthermore, the total amount of merchandise purchases listed on appellant's 2Q18 schedule is $5,603 for the three months combined, while the other months tested by CDTFA each had a minimum of $58,108 in merchandise purchases. Based on the foregoing, we find that appellant's purchase segregation test of 2Q18 is incomplete. Thus, we reject appellant's purchase segregation test of 2Q18.

Appellant asserts that CDTFA has admitted that purchase invoices for 2Q14 matched the sales reported for that period. Here, appellant seems to imply that CDTFA accepted reported sales for 2Q14 as reasonable when compared to purchases for that quarter. CDTFA accepted the purchase invoices that appellant provided for 2Q14 as complete, but CDTFA did not state that the purchases matched the reported sales for that period. In fact, in the reaudit, CDTFA established unreported taxable sales of $70,832 for 2Q14, which is inconsistent with the

contention that CDTFA accepted reported sales for that period. Thus, we reject appellant's argument.

Accordingly, appellant has failed to provide any documentation or other evidence from which a more accurate determination could be made. Thus, we conclude that appellant has failed to meet its burden of establishing that further reductions to the measure of unreported taxable sales established using the markup method is warranted.

HOLDING

Appellant has not shown that any additional adjustments are warranted to the audited understatement of reported taxable sales.

DISPOSITION

We sustain CDTFA's decision to delete the measure of tax of $98,931 for unreported taxable sales established using a sales tax reconciliation, reduce the measure of tax for unreported taxable sales established using the markup method to $651,477, and reduce the measure of tax for the unreported cost of self-consumable taxable merchandise to $97,925, but otherwise deny the petition.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

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Keith T. Long
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Date Issued: 8/5/2020