

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**D. SINGH,**  
**dba HAPPY'S MARKET**) OTA Case No. 19054838  
) CDTFA Account No. 101-640924  
) CDTFA Case ID 263654  
)  
)  
)**OPINION**

Representing the Parties:

For Appellant:

Ashu Sood, Representative

For Respondent:

Kevin Hanks, Chief, Headquarters  
Operations Bureau

For Office of Tax Appeals:

Richard A. Zellmer  
Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, D. Singh (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration denying appellant's petition for redetermination of the Notice of Determination (NOD) issued on April 27, 2018.<sup>1</sup> The NOD for \$45,096.48 in tax, plus accrued interest, for the period July 1, 2014, through June 30, 2017 (liability period) is based on a January 30, 2018 report of an audit that determined a deficiency measured by \$477,340, consisting of two items: additional taxable sales based on a markup of costs, measured by \$449,084, and self-consumption of merchandise withdrawn from inventory and subject to use tax, measured by \$28,256. Appellant filed a timely petition for redetermination of the first item only, and on May 24, 2019, respondent issued its decision denying the petition. Appellant filed this appeal, and respondent has since agreed to reduce the

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<sup>1</sup> Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of the BOE relevant to this case to respondent. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to the Office of Tax Appeals effective January 1, 2018.) Thus, when referring to events that occurred before July 1, 2017, "respondent" shall refer to the BOE.

understated measure of tax for unreported taxable sales from \$449,084 to \$385,759, which will result in a reduction to the tax.

We base our opinion on the written record because appellant waived his right to an oral hearing.

### ISSUE

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

### FACTUAL FINDINGS

1. At all relevant times, appellant has operated a convenience store in El Monte, California, where he sold beer, wine, soda, cigarettes, miscellaneous taxable merchandise (such as laundry detergent and toys), exempt food products, and lottery tickets.<sup>2</sup>
2. Respondent audited appellant for the liability period. For audit, appellant provided his federal income tax returns (FITR's) for 2014, 2015, and 2016, and merchandise purchase invoices for the months of October 2016, November 2016, and November 2017. Appellant did not provide sales journals, purchase journals, Z-tapes,<sup>3</sup> or merchandise purchase invoices (other than as indicated above). Appellant's records were incomplete and insufficient to allow use of a direct audit methodology.
3. Respondent compared total sales reported on the sales and use tax returns (SUTR's) to merchandise purchases reported on the FITR's to compute overall (taxable and exempt sales combined) book markups of 21.14 percent for 2014, 27.12 percent for 2015, and 27.12 percent for 2016.<sup>4</sup> Because, based on its experience conducting audits on similar businesses, respondent expected the overall markups for this type of business to be in the

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<sup>2</sup> By "lottery tickets," we mean to include all games and game cards administered by the California State Lottery.

<sup>3</sup> Z-tapes are point-of-sale terminal (register) summaries of cash and credit card activity.

<sup>4</sup> "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  $\text{markup amount} \div \text{cost}$ . In this example, the markup percentage is 42.86 percent ( $.30 \div .70 = 0.42857$ ). 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  $\text{profit amount} \div \text{sales price}$ . In the above example, the gross profit margin is 30 percent ( $.30 \div 1.00 = 0.3$ ).

- range of 30 to 40 percent, it concluded that the aforementioned overall book markups did not reflect appellant's actual markup. Consequently, respondent investigated further.
4. Respondent performed a purchase segregation test. Using the purchase invoices from October and November 2016, it compiled and segregated merchandise purchases and computed a taxable merchandise purchase ratio of 93.84 percent.<sup>5</sup> It applied that ratio to the cost of goods sold reported by appellant on its FITR's for 2014, 2015, and 2016 to compute the cost of taxable goods sold for those years. Respondent then compared taxable sales reported on the SUTR's with audited cost of taxable goods sold to compute book markups for taxable merchandise of negative 12.19 percent for 2014, negative 4.94 percent for 2015, and 1.87 percent for 2016.<sup>6</sup> Respondent expected the markup for taxable merchandise sold at appellant's business to be in the range of 30 to 40 percent. Due to the incomplete books and records, the low overall book markups, and the negative and very low book markups for taxable merchandise, respondent concluded that additional testing was needed to verify reported taxable sales.
  5. Respondent decided to compute appellant's sales using the markup method. As stated above, respondent applied the taxable merchandise purchase ratio of 93.84 percent to cost of goods sold as reported on the FITR's to compute the cost of taxable goods sold for 2014, 2015, and 2016. Respondent reduced those amounts by two percent for self-consumption and by an additional one percent for pilferage to compute audited cost of taxable goods sold for 2014, 2015, and 2016. Respondent's shelf test<sup>7</sup> compared merchandise costs from the August 2017 purchase invoices to selling prices posted on the shelf on November 16, 2017, or provided orally by appellant in cases where the selling prices were not posted on the shelf. In doing so, respondent computed shelf test markups of 29.07 percent for beer, 47.54 percent for carbonated beverages, 22.39 percent for cigarettes, and 82.12 percent for miscellaneous taxable merchandise. These individual

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<sup>5</sup> In this instance, the "taxable merchandise purchase ratio" is the ratio of appellant's taxable merchandise purchases to his total merchandise purchases for those two months (i.e. taxable merchandise cost ÷ total merchandise cost).

<sup>6</sup> A negative book markup means that audited cost of taxable goods sold is more than reported taxable sales. In other words, it indicates that the retailer is selling taxable goods for less than it paid for the goods.

<sup>7</sup> A shelf test is a comparison of known costs and selling prices and is used in audit to calculate the markup of specific items or classes of items.

markups were weighted based on the ratio of purchases in each product category as determined in the above-mentioned purchase segregation test to compute a weighted markup of 29.77 percent for all taxable merchandise combined. Respondent added the weighted markup of 29.77 percent to the audited cost of taxable goods sold to compute audited taxable sales for 2014, 2015, and 2016 and compared audited taxable sales to reported taxable sales to compute unreported taxable sales of \$179,027 for 2014, \$131,649 for 2015, \$123,942 for 2016, and \$434,618 for all three years combined. Respondent divided unreported taxable sales by reported taxable sales to compute error ratios of 43.38 percent for 2014, 32.45 percent for 2015, and 23.6 percent for 2016. It applied those error ratios to the corresponding portions of the liability period, and the error ratio for those three years combined to the period January 1, 2017, through June 30, 2017, to compute unreported taxable sales of \$449,084 for the liability period.<sup>8</sup>

6. Respondent issued an NOD to appellant on April 27, 2018, based on the aforementioned audit.
7. Appellant filed a timely petition for redetermination protesting the NOD in its entirety.
8. On February 12, 2019, the parties participated in an appeals conference, at which appellant's sole argument was that the audited markup for beer was too high. After the conference, appellant provided his own shelf test to support a lower markup for beer.
9. In its May 24, 2019 decision, respondent denied appellant's petition.
10. This timely appeal followed.
11. During this appeal, respondent has indicated that it re-examined its beer shelf test and concluded that the test could be giving too much weight to singles, which tended to have a higher markup, and not enough weight to 3-packs, which tended to have the lowest markup. To better ensure that the beer shelf test was fairly representative, and based on its experience auditing businesses similar to appellant's, respondent estimated that 8 percent of appellant's beer sales were 12-packs or 18-packs, 60 percent were 3-packs, 12 percent were 6-packs or 8-packs, and 20 percent were singles. It then used the costs and selling prices in its audit shelf test to compute markups of 30.81 percent for 12-packs or 18-packs, 17.07 percent for 3-packs, 36.12 percent for 6-packs or 8-packs, and 34.59

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<sup>8</sup> Respondent also computed a separate measure of tax of \$28,256 for the unreported cost of self-consumed taxable merchandise, which appellant does not dispute.

percent for singles. Respondent weighted these markups using the aforementioned estimated ratios to recompute a markup for beer of 23.69 percent, as compared to the 29.07 percent markup for beer computed in the audit. Respondent then recomputed a weighted markup for all taxable merchandise in the same manner as was done in the audit but using the newly calculated markup of 23.69 percent for beer. This produced a weighted markup for all taxable merchandise of 25.45 percent, as compared to the weighted markup for all taxable merchandise of 29.77 percent computed in the audit. Using the 25.45 percent markup for all taxable merchandise, respondent recomputed unreported taxable sales of \$385,759, as compared to unreported taxable sales of \$449,084 computed in the audit. Thus, respondent has now agreed that the measure of tax for unreported taxable sales should be reduced by \$63,325, from \$449,084 to \$385,759.<sup>9</sup>

#### 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.) Gross receipts derived from the sale of food products are generally exempt from the sales tax. (R&TC, § 6359.)

If respondent is not satisfied with a taxpayer's returns, it may compute and determine the amount required to be paid on the basis of the facts contained in the returns or on the basis of any other information within its possession or that may come into its possession. (R&TC, § 6481.) When a taxpayer challenges an NOD, respondent has a minimal, initial burden of producing evidence to show 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 Myers* (2001-SBE-001) 2001 WL 37126924.) If respondent carries that burden, the burden shifts to the taxpayer to prove that a result differing from respondent's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) The applicable burden of proof is by a preponderance of the evidence. (Cal. Code

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<sup>9</sup> Appellant has not responded to the amended contention.

Regs., tit.18, § 30219(c).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.) To satisfy the burden of proof, a taxpayer must prove that (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

For audit, appellant did not provide sales journals, purchase journals, Z-tapes, or complete merchandise purchase invoices that would have allowed respondent to use a direct audit approach. Appellant has not disputed the taxable merchandise purchase ratio of 93.84 percent that was used to determine total taxable merchandise for sale, and he acknowledges that his selling prices for taxable merchandise included a markup of at least 10 percent. We find that the lack of adequate records and the computed negative book markups for sales of taxable merchandise constitute sufficient reason for respondent to doubt the accuracy of appellant's reported taxable sales and to use an indirect method to determine the deficiency. The markup method is an acceptable, indirect audit method. Appellant has not argued otherwise.

For its shelf test, respondent used actual cost and price data provided by appellant and used the data from periods that were closest in time to the liability period. When respondent realized during this appeal that its purchase analysis may not have given enough weight to sales of 3-packs of beer, it adjusted the numbers to be in line with its experience with retailers like appellant, which resulted in a reduction of the beer markup from 29.07 percent to 23.69 percent. We find that respondent has met its initial burden of producing evidence to show that its determination was reasonable and rational. Thus, appellant has the burden of proving a more accurate measure.

Beer accounts for 84.57 percent of appellant's taxable sales, and appellant's only argument is that the audited markup for beer is overstated. Appellant contends a more accurate beer markup is 15.3 percent. In support of this contention, appellant has provided his own markup analysis. Documents provided by appellant include of a spreadsheet that purports to list beer purchase and sales prices with a calculation of markups, copies of 19 cash register receipts

that allegedly include beer purchases,<sup>10</sup> and what appear to be invoices for appellant's purchases from three of its beer vendors. Appellant interprets its markup analysis to indicate an average beer markup of 9.99 percent.<sup>11</sup>

Respondent challenges appellant's shelf test on several bases. Citing section 0407.10 of its own Sales and Use Tax Audit Manual (Audit Manual),<sup>12</sup> respondent asserts that appellant's shelf test is too narrow in scope in that it provides alleged cost and sales prices on only 23 of the approximately 115 line items of beer purchases, it includes no verifiable price data, and it was allegedly done many months after the end of the liability period.<sup>13</sup> Respondent argues that appellant has used incorrect costs, which allegedly include the cost of the California Redemption Value (CRV), while the selling prices appellant uses in his shelf test do not, and that appellant's costs do not account for vendor discounts, all of which result in understated markups.<sup>14</sup> It asserts that the product mix (type and quantity) used by appellant is calculated to result in a lower markup and is not representative of actual sales,<sup>15</sup> and that appellant compares cost and sales price of individual items without any weighting of total purchases of the items.

We have already concluded, above, that respondent has shown a reasonable and rational basis for its original audit findings. If, as respondent has now agreed, the purchases component of the shelf test was skewed toward merchandise with higher markups, that appears to have been due to the fact that the purchase invoices relied upon by respondent were likewise skewed.

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<sup>10</sup> Eighteen of the receipts are dated March 30, 2018. One is dated March 31, 2018.

<sup>11</sup> According to respondent's Decision, appellant argued that the more accurate markup for beer is 9.99 percent. Appellant has not explained how he went from this markup percentage to the 15.3 percent he now contends is the correct beer markup. But see our footnote 12, below.

<sup>12</sup> Section 0407.10 of the Audit Manual states that total purchases for at least one purchasing cycle should be used to determine the markup and that the shelf test should include selling prices and costs from all of the items that are listed on all of the purchase invoices for the test period. (See Audit Manual at <<https://www.cdtfa.ca.gov/taxes-and-fees/manuals/am-04.pdf> >.)

<sup>13</sup> Respondent argues that, although appellant has provided copies of 19 sales receipts to support the selling prices used in his shelf test, only four of those provide a description of the product purchased. The other receipts refer only to a numerical code. The same code appears five times, each in connection with a \$2.49 purchase, and appellant has identified at least two of these as referring to different products.

<sup>14</sup> Using what it contends are the correct costs and the selling prices provided by appellant, respondent computes a markup for beer of 15.42 percent, which is very close to the 15.3 percent markup that appellant argues is the correct beer markup.

<sup>15</sup> Respondent asserts that the alleged sales used by appellant are unreasonably weighted in favor of higher volume sales (12- and 18-packs), which generally carry a lower markup.

Nevertheless, respondent noticed and made adjustments for what it viewed in retrospect as a potentially unrepresentative mix of merchandise. Because the adjustment is in appellant's favor, we accept it. But it remains appellant's burden to prove a more accurate measure than that determined by respondent.

Respondent's shelf test was based on sales prices posted in the store or reported by appellant during the audit on 35 items. Appellant's sales price data is based on copies of 19 receipts, only four of which state the name of the beer purchased, and none of which identify appellant's store as the retailer. Respondent calculates a weighted average, based first on a mix of sizes and quantities reflected in the purchase invoices provided by appellant, and based now on respondent's experience with sales by comparable businesses. Appellant uses an unweighted average with a mix of sizes and quantities that appears to be unreasonably weighted in favor of lower-markup items. Furthermore, respondent's cost data accounts for discounts and did not include CRV in the cost or sales price, while appellant's analysis overstates its costs by failing to properly account for discounts and CRV. Based on the evidence, we find that appellant has not provided sufficient evidence to establish a more accurate measure. On that basis, we conclude that appellant has failed to establish that a further reduction to the measure of unreported taxable sales is warranted.

HOLDING

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

DISPOSITION

The measure of tax for unreported taxable sales shall be reduced by \$63,325, from \$449,084 to \$385,759,<sup>16</sup>as conceded by respondent, but respondent’s action denying appellant’s petition is otherwise sustained.

DocuSigned by:  
*Michael Geary*  
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Michael F. Geary  
Administrative Law Judge

We concur:

DocuSigned by:  
*Daniel Cho*  
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Daniel K. Cho  
Administrative Law Judge

DocuSigned by:  
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Andrew J. Kwee  
Administrative Law Judge

Date Issued: 6/3/2020

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<sup>16</sup> As stated above, the audit includes a separate measure of tax of \$28,256 for the unreported cost of self-consumed taxable merchandise, which we have left undisturbed. Thus, the total measure of tax is now \$414,015 (\$385,759 + \$28,256.)