OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18103912
	) CDTFA Account No. 102-326325
M. QADARI	) CDTFA Case ID 1018294
	)
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	)
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OPINION

Representing the Parties:

For Appellant:	Hassen Mohsen, Accountant
For Respondent:	Mariflor Jimenez, Technical Advisor Kevin Smith, Tax Counsel III Jason Parker, Chief, HQ Operation Bureau
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

A. ROSAS, Administrative Law Judge: Under California Revenue and Taxation Code (R&TC) section 6561, appellant M. Qadari appeals a Decision issued by respondent California Department of Tax and Fee Administration[1] denying appellant's petition for redetermination of the June 29, 2017 Notice of Determination (NOD), for tax of $68,116.34, plus applicable interest, for the period April 1, 2013, through March 31, 2016.

Office of Tax Appeals (OTA) Administrative Law Judges Keith T. Long, Josh Lambert, and Alberto T. Rosas held a telephonic oral hearing for this matter on May 27, 2020. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether any reduction to the amount of unreported taxable sales is warranted.

[1] Sales taxes were formerly administered by the Board of Equalization (BOE). Effective July 1, 2017, functions of the BOE relevant to this case were transferred to the California Department of Tax and Fee Administration. (Gov. Code, § 15570.22.) When referring to acts or events that occurred before July 1, 2017, the term "respondent" refers to the BOE.

FACTUAL FINDINGS

1. Since the beginning of 2013, appellant, as a sole proprietor, operated 4th Street Market, a grocery store in Richmond, California.
2. Respondent audited 4th Street Market for the period April 1, 2013, through March 31, 2016 (Audit Period). During the audit, appellant provided individual federal income tax returns and 4th Street Market's profit and loss statements for years 2013, 2014, and 2015, merchandise purchase invoices for the fourth quarter of 2014 (4Q14) and 2Q15, and bank statements with cancelled checks for 2Q15. Respondent learned appellant had computed the total sales and taxable sales for reporting purposes by adding a markup to the merchandise purchases recorded in the profit and loss statements.
3. Appellant did not provide any cash register tapes, sales journals, or purchase journals, and did not provide complete sets of merchandise purchase invoices or bank statements. In the absence of complete records, respondent used the markup method to verify the accuracy of appellant's reported amounts.
4. Using the merchandise purchase invoices that appellant provided for 4Q14 and 2Q15, respondent identified appellant's 12 main merchandise vendors and sent them inquiry letters. Comparing the merchandise purchase amounts shown in the vendors' responses with the merchandise purchase amounts compiled from the available purchase invoices for each vendor, respondent found that appellant's purchase invoices were incomplete for all vendors except Horizon Beverage (Horizon). To compile appellant's purchases from the other 11 vendors (11 Vendors), respondent relied on the merchandise purchase amounts shown in the 11 Vendors' responses.
5. Anheuser-Busch, having acquired Horizon in or around May 2016, responded to the inquiry letter and provided the purchase information for Horizon. Based on this information, respondent found that the total amount of the purchases shown in the Horizon purchase invoices that appellant provided for 4Q14 and 2Q15 exceeded the amount of the purchases shown in Anheuser-Busch's response. Respondent also noted some discrepancies: purchase amounts shown on specific Horizon invoices that appellant provided were significantly higher than amounts shown for the same invoices in the information that Anheuser-Bush provided. When asked about the discrepancies, Anheuser-Busch explained that the purchase amount it reported for Horizon "is not

accurate" for periods prior to May 2016 due to recordkeeping problems resulting from its acquisition of Horizon.

6. When the purchase amounts shown on specific Horizon invoices that appellant provided were significantly higher than the amounts shown for the same invoices in the information that Anheuser-Bush provided, respondent relied on the amounts shown in the invoices that appellant provided.

7. As to the purchase segregation test for 2Q15, respondent included six Horizon purchase invoices totaling $9,404.01 with the notation "Missing, price per vendor survey." As to the purchase segregation test for 4Q14, respondent included four Horizon purchase invoices totaling $5,847.95 with the notation "Missing per vendor survey." In these circumstances, when Anheuser-Busch's information included purchases for which appellant did not have purchase invoices, respondent relied on the purchase amounts shown in Anheuser-Busch's information.

8. After subtracting 1 percent for self-consumption, as well as subtracting for pilferage, respondent established audited taxable merchandise available for sale for 4Q14 and 2Q15. Respondent then added an estimated 28-percent markup to establish audited taxable sales of $182,171 for 4Q14 and $194,344 for 2Q15. Audited taxable sales exceeded appellant's reported taxable sales by $58,459 for 4Q14 and $77,729 for 2Q15, representing a reporting error rate of 56.67 percent for both quarters combined. Respondent multiplied appellant's reported taxable sales for all quarters in the Audit Period by this same error rate to establish unreported taxable sales of $722,940.

9. On June 29, 2017, respondent issued an NOD based on unreported taxable sales of $722,940 and unreported costs of self-consumed taxable merchandise of $18,385. Appellant filed a petition for redetermination, and, after an appeals conference in June 2018, respondent issued a Decision on August 14, 2018, denying the petition for redetermination.[2] Appellant filed a Request for Reconsideration. On October 9, 2018, respondent issued a Supplemental Decision, again denying the petition for redetermination. Appellant then appealed to OTA.

[2] In its Decision, respondent states that, at the appeals conference, appellant conceded the measure of unreported costs of self-consumed merchandise.

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.) When respondent is not satisfied with the accuracy of the sales and use tax returns filed, it may base its determination of the tax due upon the facts contained in the returns or upon any information that comes within its possession. (R&TC, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, 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(b)(1).)

In the case of an appeal, first, respondent "has a minimal, initial burden of showing that its determination was reasonable and rational." (*Appeal of TFCG, Inc.*, 2019-OTA-389P, citing *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; and *Appeal of Myers* (2001-SBE- 001) 2001 WL 37126924.) Two of these cited cases, *Todd* and *Appeal of Myers*, deal with federal income taxes. Although *Schuman Aviation Co. Ltd.* deals with federal excise taxes, it cites to a federal income tax case for the principal that "deficiency determinations and assessments for unpaid taxes are normally entitled to a presumption of correctness so long as they are supported by a minimal factual foundation." (*Schuman Aviation Co. Ltd., supra,* 816 F.Supp.2d at 950, citing to *Palmer v. IRS* (9th Cir. 1997) 116 F.3d 1309, 1312.)

However, because of the difficulty inherent in proving a negative, when the tax agency determines that a taxpayer received unreported income, the agency "must offer some substantive evidence showing that the taxpayer received income" before the agency may rely upon the presumption of correctness. (*Weimerskirch v. Commissioner* (9th Cir.1979) 596 F.2d 358, 360, *rev'g* 67 T.C. 672 (1977). It is not surprising that *Schuman Aviation Co. Ltd.* cited to *Palmer* for the premise that the presumption of correctness applies only if determinations and assessments are supported by a "minimal factual foundation"; after all, common sense tells us that the policy applicable to unreported income also applies to unreported taxable sales because, with either, it is inherently difficult to prove a negative.

Second, if respondent meets its initial burden, the burden of proof then shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Appeal of TFCG, Inc.*, 2019-OTA-389P; *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) At this stage, the burden of proof is that of a preponderance of the evidence. (Cal. Evid. Code, § 115; Cal. Code Regs., tit. 18, § 30219(c).) Based on this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (Cal. Evid. Code, § 115; *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.)

Here, appellant did not provide any cash register tapes, sales journals, or purchase journals, and did not provide complete sets of merchandise purchase invoices or bank statements. In the absence of books and records supporting the accuracy of reported taxable sales, respondent was justified in using an alternative audit method, the markup method, to establish audited taxable sales. Because the markup method is only as reliable as the costs of goods sold (COGS) on which it is based, respondent was also justified in surveying appellant's vendors, to verify that appellant's recorded merchandise purchases were accurate and complete.

A. Respondent's Initial Burden of Showing that its Determination was Reasonable and Rational.

First, we ask whether respondent met its "minimal, initial burden of showing that its determination was reasonable and rational." (*Appeal of TFCG, Inc.*, 2019-OTA-389P.) As mentioned, the markup method is only as reliable as the COGS on which it is based. As to respondent's use of an estimated 28-percent markup to establish audited taxable sales, respondent argued that this estimated markup was reasonable. And we agree. Based on the evidence before us, comparing the gross receipts reported on appellant's individual federal income tax returns with the reported COGS shows a markup range of 39 to 45 percent for the years 2013 through 2015. Also, appellant has not argued that the 28-percent markup was unreasonable or irrational. Thus, for purposes of determining whether respondent met its minimal, initial burden, we focus on whether the COGS data was reasonable and rational.

Respondent, using the merchandise purchase invoices that appellant provided for 4Q14 and 2Q15, sent inquiry letters to appellant's 12 main merchandise vendors. Respondent found that appellant's purchase invoices were incomplete for all vendors except Horizon. Thus,

respondent relied on the merchandise purchase amounts shown in the 11 Vendors' responses. As to Horizon, appellant argued during the hearing that respondent essentially "cherry pick[ed] information" that resulted in an increase to appellant's audit liability: sometimes respondent relied on the amounts shown in the invoices that appellant provided, and other times respondent relied on the purchase amounts shown in Anheuser-Busch's information.

"'Where an assessment is based on more than one item, the presumption of correctness attaches to each item. Proof that an item is in error destroys the presumption for that single item; the remaining items retain their presumption of correctness.'" (*In re Olshan* (9th Cir. 2004) 356 F.3d 1078, 1084, quoting *U.S.* v. *Stonehill* (9th Cir. 1983) 702 F.2d 1288, 1294). Although these cases deal with federal income taxes, as mentioned above the policy is the same because, with either unreported taxable sales or unreported income, it is inherently difficult to prove a negative. Thus, in looking at whether respondent met its minimal, initial burden, we examine the items separately—first the COGS data based on the vendor Horizon, then the COGS data based on the 11 Vendors—and respondent must meet its minimal, initial burden as to each item.

As to Horizon, we can separate the determination based on this vendor even further. On the one hand, respondent based one part of its determination on the Horizon invoices that appellant provided. As such, it was reasonable and rationale for respondent to rely on the amounts shown in the invoices that appellant himself provided. On the other hand, respondent based the other part of its determination on the purchase amounts shown in the information that Anheuser-Busch provided. Anheuser-Busch's information, however, was not without its share of discrepancies. When asked about some of these discrepancies, Anheuser-Busch explained that the purchase amounts it reported for Horizon "is not accurate" for periods prior to May 2016 due to recordkeeping problems resulting from its acquisition of Horizon. Therefore, based on the discrepancies and inaccuracies, respondent is unable to meet its minimal, initial burden of showing that its determination was reasonable and rational as to those items of the determination stemming from the inaccurate Horizon information.

As to the 11 Vendors, when comparing the merchandise purchase amounts shown in the vendors' responses with the merchandise purchase amounts compiled from the available purchase invoices for each vendor, respondent concluded that appellant's purchase invoices were incomplete. To compile appellant's purchases from these 11 Vendors, respondent relied on the merchandise purchase amounts shown in the 11 Vendors' responses. Thus, it was reasonable

and rational for respondent to rely on these merchandise purchase amounts.

B. Appellant's Burden of Establishing that a Different Result is Warranted.

Second, except as discussed above (as to those items of the determination stemming from the inaccurate Horizon information), the burden of proof shifts to appellant, and here we ask whether appellant established that a result differing from respondent's determination is warranted. (*Appeal of TFCG, Inc.*, 2019-OTA-389P; *Riley B's, Inc., supra,* 61 Cal.App.3d at 616.) Other than the reduction that is warranted due to the inaccurate Horizon information, appellant has not provided any evidence showing that the remaining tax assessment—based on the Horizon invoices that appellant himself provided and the merchandise purchase amounts shown in the 11 Vendors' responses—was incorrect.

Rather than provide any factual evidence, appellant objects to the inconsistency with which respondent conducted the audit; and appellant also argues that because the Horizon information was inaccurate that this implies that all the remaining information may also be inaccurate. But let us not forget, however, that it is appellant's responsibility to maintain and make available all records necessary to determine the correct tax liability; in the absence of such records, respondent was justified in using an alternative audit method, and appellant's unsubstantiated objections and speculations are not enough to satisfy appellant's evidentiary burden. We therefore conclude that appellant has failed to meet the requisite burden of proving that any additional reduction to the audited taxable measure is warranted.

HOLDING

All Horizon purchases with the notation "Missing, price per vendor survey" or "Missing per vendor survey" shall be removed from the purchase segregation tests.[3]

DISPOSITION

Sustained in part and denied in part: a reduction to the amount of unreported taxable sales is warranted, as discussed above, and we sustain the remainder of respondent's denial of appellant's petition for redetermination.

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Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

We concur:

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Keith T. Long
Administrative Law Judge

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

Date Issued: 7/8/2020

[3] As to the purchase segregation test for 2Q15, respondent included six Horizon purchase invoices totaling $9,404.01 with the notation "Missing, price per vendor survey." As to the purchase segregation test for 4Q14, respondent included four Horizon purchase invoices totaling $5,847.95 with the notation "Missing per vendor survey." All ten Horizon purchase invoices with these "Missing" notations should be removed from the purchase segregation tests; we estimate that doing so should result in a reduction of approximately $93,907 to the amount of unreported taxable sales, from $722,940 to $629,033. Because respondent estimated the unreported costs of taxable self-consumption as 1 percent of audited taxable merchandise purchases, we estimate that reducing audited taxable merchandise purchases should also result in a reduction of approximately $864 to the amount of unreported costs of taxable self-consumption, from $18,385 to $17,521. However, these OTA calculations are mere estimates, and we defer to respondent for the specific computations and reductions to the amount of unreported taxable sales.