

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
S. KURDI

) OTA Case No. 20025848
) CDTFA Case IDs 0-000-127-019
)
)
)
)

OPINION

Representing the Parties:

For Appellant:

S. Kurdi

For Respondent:

Jason Parker, Chief of Headquarters
Operations

For Office of Tax Appeals:

Richard Zellmer
Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, S. Kurdi dba Amsterdam Smoke Shop (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),¹ denying appellant’s petition for redetermination of the Notice of Determination (NOD) for tax of \$48,752.64, plus applicable interest, for the period April 1, 2013, through March 31, 2016 (audit period).

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

ISSUE

Whether appellant has established that a reduction to the audited taxable sales is warranted for the audit period.

¹ Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of 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 BOE; and when this Opinion refers to acts or events that occurred on or after July 1, 2017, “CDTFA” shall refer to CDTFA.

FACTUAL FINDINGS

1. Appellant operated a smoke shop and an attached hookah lounge in Santa Maria, California.² At the smoke shop, appellant sold tobacco, hookah pipes, cigarettes, vaping products, and an immaterial amount of snack foods. Appellant charged a door fee to enter the hookah lounge.
2. For audit, appellant provided her federal income tax returns (FITRs) for 2013 and 2014; sales journals for January 1, 2014, through September 30, 2015; merchandise purchase invoices for the first quarter of 2016 (1Q16); cash register tapes for July 7, 2016, through August 7, 2016;³ and forms 1099-K for 2015.⁴
3. CDTFA determined that the records for the audit period were incomplete because appellant did not provide cash register tapes, bank statements, or purchase journals for the audit period. CDTFA obtained appellant's credit card transaction data as reported on forms 1099-K for the period April 1, 2013, through December 31, 2014, from the IRS.
4. CDTFA compared total sales reported on the sales and use tax returns (SUTRs) to cost of goods sold reported on the FITRs. CDTFA determined that the book markup was -56.32 percent and -47.34 percent, for 2013 and 2014 respectively.⁵ CDTFA found that gross receipts reported on the FITRs exceeded total sales reported on the SUTRs by \$152,021 in 2013 and \$149,133 in 2014. CDTFA also found that credit card receipts recorded on the forms 1099-K exceeded reported total sales by \$268,024 for the period April 1, 2013, through December 31, 2015. CDTFA used the markup method to compute appellant's audited taxable sales.

² A hookah is a water pipe used for smoking flavored tobacco.

³ Appellant did not provide the cash register tapes for July 28, 2016, August 1, 2016, and August 5, 2016.

⁴ Form 1099-K is an IRS form used by credit card or payment processing companies to report a taxpayer's income received from electronic or on-line payment services (e.g., credit cards and PayPal).

⁵ "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 $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($.30 \div .70 = .42857$). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. Markup percentage 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 ($.30 \div 1.00 = .3$). Negative book markups mean that reported cost of goods sold exceeded reported total sales.

5. Appellant conducted a shelf test using purchase invoices and selling prices from June 2015, which resulted in a markup of 75.22 percent.⁶ CDTFA accepted appellant's shelf test. The cost of goods sold, as recorded on the FITRs, was \$126,021 for 2013 and \$184,995 for 2014. Without supporting documentation, CDTFA allowed \$18,562 per year for self-consumption at the hookah lounge and allowed \$7,471 per year for pilferage at the smoke shop. These reductions results in adjusted cost of goods sold of \$87,499 and \$140,629, for 2013 and 2014. CDTFA added the audited markup of 75.22 percent to adjusted cost of goods sold to compute audited taxable sales of \$153,316 and \$246,410, for 2013 and 2014 respectively. CDTFA then compared audited taxable sales with reported taxable sales to compute understatements for each year (error ratio). The error ratio of 178.54 percent was applied to reported taxable sales for the period April 1, 2013, through December 31, 2013, and the error ratio of 152.96 percent was applied to reported taxable sales for the remainder of the audit period. The application of these error ratios resulted in a calculation of unreported taxable sales of \$476,340, representing average monthly sales of \$21,687.
6. To support the audit results, CDTFA compiled taxable sales of \$25,462 using the cash register tapes for the period July 7, 2016, through August 7, 2016, which is greater than the calculation of \$21,687 for average monthly sales.
7. CDTFA established a separate audit item for use tax measured by \$114,600 for the unreported cost of self- consumed taxable items withdrawn from inventory. Appellant does not dispute this separate measure of tax.
8. CDTFA issued the NOD to appellant on June 20, 2017, which appellant timely petitioned.
9. CDTFA held an appeals conference with appellant. At the conference, appellant argued that the books and records provided for audit were incorrect because they included purchases for a related business located in Grover Beach.
10. Post-conference, appellant provided CDTFA with profit and loss statements, balance sheets, and general ledgers for the limited period of January 1, 2015, through March 31, 2016. These records were purportedly prepared by appellant using bank

⁶ A shelf test is an accounting comparison of known costs and associated selling prices, which is used to compute markups.

statements, credit card sales, and cash payouts.⁷ Appellant, however, did not provide CDTFA with the source documents. Appellant computed unreported taxable sales of \$336,578 for the audit period, but did not provide supporting worksheet(s).

11. On January 8, 2020, CDTFA issued the decision denying appellant's petition. This appeal followed.

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.) "Sale" means and includes any transfer of title or possession, in any manner or by any means whatsoever, of tangible personal property for a consideration. (R&TC, § 6006.)

When CDTFA 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 retailer'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, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) 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. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Here, appellant did not provide any cash register tapes for any periods within the audit period, nor did appellant provide any bank statements or purchase journals for periods within the audit period. CDTFA computed book markups of -56.32 percent for 2013 and -47.34 percent for 2014. CDTFA determined there was a negative book markup, and that gross receipts reported on the FITRs exceeded total sales reported in 2013 and in 2014. CDTFA also found that credit card receipts recorded on the forms 1099-K exceeded reported total sales by \$268,024 for the period

⁷ A cash payout is money taken from the cash register to pay vendors, employees, or used for some other business purpose, which is not otherwise deposited into the bank account.

of April 1, 2013, through December 31, 2015. CDTFA determined to utilize an indirect audit method, specifically the markup method. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) We have reviewed the audit working papers, and we have found no errors in the audit procedures or material inaccuracies in the calculations. In light of all evidence, we conclude that CDTFA's determination was reasonable and rational. Therefore, the burden shifts to appellant to establish by a preponderance of the evidence that a reduction to the audited taxable measure is warranted.

Appellant contends that costs of goods sold as reported on the 2013 and 2014 FITRs are incorrect because those amounts include purchases and transfers for a related business located in Grover Beach. Appellant contends that the records she provided CDTFA post-conference are accurate, and that her unreported taxable sales are \$336,578.

Appellant also contends that her cost of goods sold for 2015 was \$85,898, which is less than cost of goods sold of \$126,021 and \$184,995 reported on the FITRs for 2013 and 2014, respectively. Appellant has not provided the source documents to support the \$85,898 amount. Similarly, appellant has not provided evidence to support the alleged transfers from the Santa Maria location to the Grover Beach location. Likewise, appellant has not provided evidence to show errors in the amounts of cost of goods sold reported on the FITRs for 2013 and 2014. Thus, we find no basis to adjust the cost of goods sold used in the audit.

Appellant asserts records show that her total merchandise sales were \$205,840 in 2015 and \$47,206 in 1Q16. We compute monthly averages of \$17,153 for 2015 ($\$205,840 \div 12$), and \$15,735 for 1Q16 ($\$47,206 \div 3$), which were compiled from amounts recorded in appellant's profit and loss statements. These monthly averages are significantly lower than the one month of taxable sales of \$25,462, which was compiled from appellant's cash register tapes for the period July 7, 2016, through August 7, 2016. Appellant has not explained why her sales for 2015 and 1Q16 would be so much less than her sales for July 7, 2016, through August 7, 2016. Therefore, we find the unsupported sales recorded in the post-conference submission are insufficient to establish that an adjustment is warranted.

Furthermore, we note that the sales amounts recorded in appellant's profit and loss statements for 2015 and 1Q16 are not based on source documents like cash register tapes or sales journals, but are instead based on appellant's purported review of bank statements, credit card sales, and cash payouts. Appellant has not made her bank statements available to us, and we

have no way to verify the amount of cash payouts that occurred. We also note that appellant has not made her cash register tapes for the audit period available for examination to verify sales. Thus, we have no way to verify the accuracy of the sales recorded by appellant in the profit and loss statements.

In sum, we find appellant’s post-conference submissions are insufficient to support adjustments to the audit. Based on our finding that appellant has failed to provide evidence from which a more accurate determination could be made, we conclude that appellant has failed to meet its burden of establishing that an adjustment to the audited taxable sales is warranted.

HOLDING

Appellant has not shown that an adjustment to the audited taxable sales is warranted.

DISPOSITION

CDTFA’s action in denying the petition is sustained.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Suzanne B. Brown
47F45ABE89E34D0
Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Nguyen Dang
77AFD3E4552843B...
Nguyen Dang
Administrative Law Judge

Date Issued: 11/25/2020