**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of: | ) OTA Case No. 18083656 |
| | ) CDTFA Account No. 100-913600 |
| **Y. WUHIB** | ) CDTFA Case ID 728749 |
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## OPINION

Representing the Parties:

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| For Appellant: | Arnold Blanshard, CPA |
| For Respondent: | Randy Suazo, Hearing Representative<br>Christopher Brooks, Tax Counsel IV<br>Jason Parker, Chief of Headquarters Operations |
| For Office of Tax Appeals: | Deborah Cumins,<br>Business Taxes Specialist III |

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Y. Wuhib (appellant), dba Liquorette, appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) in response to appellant's timely petition for redetermination of a Notice of Determination (NOD) for a liability of $77,806.90 of additional tax, plus applicable interest, for the period July 1, 2008, through June 30, 2011 (audit period).[1] In a subsequent decision, CDTFA reduced the assessed tax liability from $77,806.90 to $72,179.43 and denied the remainder of the petitioned amount.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Josh Aldrich, and Keith T. Long held an oral hearing via videoconference for this matter in Cerritos, California, on June 17, 2020. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

[1] The Board of Equalization (Board) formerly administered business taxes and fees. On July 1, 2017, CDTFA took over these duties. (Gov. Code, § 15570.22.) In this Opinion, when describing acts or events that occurred before July 1, 2017, our use of the term "CDTFA" shall refer to CDTFA's predecessor, the Board.

## ISSUE

Whether further adjustments to the measure of unreported taxable sales are warranted.

## FACTUAL FINDINGS

1. Since July 7, 2007, appellant has operated a liquor store that also sells prepaid telephone calling cards (phone cards) in Inglewood, California.
2. For audit, appellant provided federal income tax returns (FITRs) for 2008, 2009, and 2010; sales and use tax returns (SUTRs); bank statements; purchase invoices; and cash register Z-tapes for some days in the audit period.[2]
3. Initially, appellant did not provide any purchase journals. And although appellant prepared monthly sales journals, which were based on cash register Z-tapes and were used by his outside accountant to prepare SUTRs, appellant did not provide any sales journals.
4. Based on the books and records that appellant provided, CDTFA computed appellant's overall yearly markups[3] as follows: 34 percent for 2008, 33 percent for 2009, and 22 percent for 2010.[4] CDTFA expected the overall yearly markup for a liquor store to be in the range of 30 to 50 percent, so appellant's markup for 2010 was lower than CDTFA expected.
5. Since appellant did not provide purchase journals, CDTFA, in its preliminary review, could not compute the markup for taxable sales per appellant's books and records.[5] However, CDTFA noted that appellant's reported taxable sales represented only about 47 percent of appellant's total sales; CDTFA expected a liquor store's taxable sales to

[2] A cash register Z-tape is the portion of the cash register tape that summarizes sales by category over a certain period of time (e.g., a day or a shift).

[3] "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 $0.30. The formula for determining the markup percentage is markup amount ÷ cost. In this example, the markup percentage is 42.86 percent (.30 ÷ .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 sale price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sale price. In the above example, the gross profit margin is 30 percent (.30 ÷ 1.00 = 0.3).

[4] Percentages appearing throughout this opinion are rounded.

[5] After CDTFA computed audited taxable purchases, it used those amounts to determine that reported taxable sales were less than audited taxable purchases and that the markup for nontaxable food products, per appellant's books and records, was 189 percent.

constitute about 70 percent of sales. CDTFA concluded that it needed to investigate further and decided to use the markup method in auditing appellant.

6. Initially, CDTFA conducted a two-month purchase segregation test (involving May 2009 and April 2010) and computed a taxable merchandise purchase ratio of 86 percent (the other 14 percent consisted of nontaxable food products).[6] However, appellant objected to CDTFA's two-month test, asserting that it was not representative of the audit period. CDTFA then combined the results of its purchase segregation test with appellant's own four-month purchase segregation test (involving the months of December 2008, September 2009, March 2010, and June 2011) to compute a taxable merchandise purchase ratio of 76 percent. CDTFA then computed percentages of purchases in various categories of taxable merchandise.

7. To establish audited markups for the various categories of taxable merchandise, CDTFA conducted a shelf test using costs from purchase invoices from June 2011 and prices appellant provided on October 6 and 21, 2011.[7] CDTFA used the percentages of merchandise in each category and the shelf-test markups to compute a weighted average markup of 39 percent for taxable merchandise.

8. CDTFA applied the 76-percent taxable merchandise purchase ratio to cost of goods sold reported on FITRs to compute the cost of taxable merchandise purchased. It reduced that figure by self-consumed taxable merchandise, which was based on information appellant provided,[8] and by losses for pilferage, breakage, and other inventory shrinkage, which it estimated at 2 percent, to establish the audited cost of taxable goods sold.

9. CDTFA established audited taxable sales by adding the audited weighted average markup of 39 percent to the audited cost of taxable goods sold. Comparing audited taxable sales to reported taxable sales, CDTFA computed unreported taxable sales, as well as error

[6] In a purchase segregation test, a tester schedules merchandise purchases in various product categories (such as beer, wine, liquor, soda, cigarettes, newspapers and magazines, and "other" taxable merchandise) inorder to compute the percentage of taxable merchandise purchases, as well as the percentages of merchandise in each category.

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

[8] CDTFA established a separate audit item for the cost of self-consumed taxable merchandise of $17,004, which appellant does not dispute. Self-consumed merchandise is subject to tax on the cost of the merchandise rather than the sale price. Thus, the adjustment for self-consumed merchandise reduces the overall tax liability.

ratios for 2008, 2009, and 2010, and a weighted error ratio for all three years combined. CDTFA applied the error ratio for 2008 to the reported taxable sales for the last two quarters of 2008 (i.e., the first two quarters of the audit period), the error ratios for 2009 and 2010 to the reported taxable sales for those respective years, and the weighted error ratio for all three years combined to the reported taxable sales for the first two quarters of 2011 (i.e., the last two quarters of the audit period). Ultimately, for the audit period, CDTFA established unreported taxable sales of $774,965.

10. On March 12, 2013, CDTFA issued the NOD.

11. On April 11, 2013, appellant filed a timely petition for redetermination, arguing that CDTFA's purchase segregation test should be disregarded (in favor of appellant's four-month purchase segregation test), his markup for taxable merchandise was only 30 percent (versus 39 percent), and pilferage, breakage, and shrinkage should be estimated at 4 percent (rather than 2 percent).

12. After an appeals conference with CDTFA's Appeals Bureau on March 10, 2015, appellant provided a journal to show his phone card purchases for the audit period. CDTFA reviewed that journal and recommended reducing the unreported taxable sales by $25,381, from $774,965 to $749,584. However, the Appeals Bureau found that CDTFA had made computational errors both during the audit and in calculating its post-appeals conference recommended reduction. Because correcting those errors would increase unreported taxable sales from $774,965 to $786,932, the Appeals Bureau issued a Decision and Recommendation (D&R) recommending no adjustment.

13. Appellant disagreed with the D&R and, since he had previously requested a hearing before the Board of Equalization (which, at the time, heard appeals of business taxes and fees), a hearing was scheduled. However, before the hearing, CDTFA noted several omissions in its audit and deferred the hearing to correct those issues, which would reduce unreported taxable sales.

14. CDTFA subsequently conducted two reaudits, the second of which reduced unreported taxable sales by $58,913, from $774,965 to $716,052, which is the amount at issue here.

15. In the second reaudit, CDTFA disregarded appellant's four-month purchase segregation test and used only its own two-month purchase segregation test, which reflected no

purchases of phone cards and yielded a taxable merchandise purchase ratio of 86.12 percent.[9]

16. For the second reaudit, CDTFA computed the audited cost of taxable goods sold by first reducing the costs of goods sold reported on FITRs for 2008, 2009, and 2010 by the total cost of phone card purchases during the audit period, as shown in the journal appellant provided, and by purchases of supplies, estimated at 1.5 percent. CDTFA then applied the taxable merchandise purchase ratio of 86.12 percent to establish the audited cost of taxable goods available for sale. CDTFA reduced that figure by $5,668 per year for self-consumption and by estimated losses due to pilferage and breakage, computed at 3 percent (which was increased from 2 percent in the original audit). It then computed audited taxable sales by adding an audited markup of 35 percent (which had been reduced from the 39 percent established in the original audit based on additional information appellant provided and a 1-percent reduction to the markups in each of the product categories).[10] CDTFA compared audited and reported taxable sales to compute error percentages of 53 percent for 2008, 52 percent for 2009, 82 percent for 2010, and 61 percent overall. It applied those percentages of error to the relevant periods, and used 61 percent for the first two quarters of 2011, to compute the audited unreported taxable sales of $716,052.

17. Appellant continued to dispute the audited markup, arguing that his markup for taxable merchandise sales was only about 25 percent.

18. On January 2, 2018, CDTFA issued a Supplemental Decision, recommending that the liability be redetermined in accordance with the second reaudit.

19. On January 30, 2018, appellant filed a Request for Reconsideration, contending that the audited markup for beer sales should be adjusted to reflect 85 percent sold as cases and that the pilferage allowance of 3 percent should be increased.

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[9] CDTFA disregarded appellant's four-month purchase segregation test for two reasons. First, CDTFA determined that because appellant provided a journal of phone card purchases, the need to estimate phone card purchases in the cost of goods sold was eliminated. Second, CDTFA determined that its two-month purchase segregation test, which reflected no purchases of phone cards, was more representative of the audit period than appellant's four-month purchase segregation test when phone card purchases and supplies were removed.

[10] The 1-percent adjustment was intended to mitigate any possible overstatements of the markup related to increases in selling prices during the four-month period between the dates of the purchase invoices (June 2011) and the dates when appellant provided the selling prices (October 2011).

20. On July 24, 2018, CDTFA issued a Second Supplemental Decision in which it concluded that no further adjustments were warranted.

21. On August 21, 2018, appellant filed this timely appeal.

## DISCUSSION

California imposes a sales tax on a retailer measured by the gross receipts from its retail sales of tangible personal property in this state, 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; *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.)

In this case, appellant's records were incomplete. He provided Z-tapes for only some days in the audit period. He also did not provide purchase journals or sales journals (even though he stated that he prepared monthly sales journals that were used by an outside accountant to prepare sales and use tax returns). Further, appellant's reported taxable sales represented only about 46 percent of his reported total sales, which is an unusually low percentage of taxable sales for a liquor store. Accordingly, we find that it was reasonable for CDTFA to employ an alternate audit method to establish appellant's audited taxable sales.

As noted above, this audit was conducted on a markup basis, which is a well-established audit method that has been shown effective and reliable when there is sufficient information to establish an accurate cost of taxable merchandise sold and an accurate markup. (*Maganini v.*

*Quinn* (1950) 99 Cal.App.2d 1.) In this case, CDTFA relied on appellant's FITRs to establish the audited cost of goods sold. It then conducted a purchase segregation test, using purchase invoices for two full months, May 2009 and April 2010. That test period was sufficiently long to establish a representative percentage of taxable to total sales and to establish percentages of merchandise in the various categories of taxable merchandise (beer, wine, liquor, soda, cigarettes, newspapers and magazines, and other taxable merchandise). CDTFA then conducted a shelf test, comparing known product costs, shown on invoices for the month of June 2011, and selling prices reflected on the store shelves in October 2011.

In the second reaudit, to mitigate any overstatement in the markup related to possible increases in selling prices from June to October 2011, CDTFA reduced the markup it calculated for each category of merchandise by 1 percent. We find that a one-month shelf test is sufficient to compute a representative markup. Moreover, as noted in the D&R, CDTFA, based on its experience auditing liquor stores in appellant's area, expected the markup for this business to be within the range of 30 percent to 50 percent; the markup of 35 percent used in the second reaudit is in the lower end of that range. Accordingly, a review of the audit indicates that the results are reasonable, and the burden of proof shifts to appellant to show that the asserted deficiency is not valid.

Appellant raises six specific disagreements with the audit method, each of which we address below.

First, appellant asserts that the two months used by CDTFA for its two-month purchase segregation test, May 2009 and April 2010, were extraordinary months for purchases of nontaxable phone cards and not representative of the entire audit period. Specifically, he claims that purchases of nontaxable phone cards were either nonexistent or unusually low for those two months,[11] thereby skewing the purchase segregation test and artificially inflating both the percentage of taxable to total purchases and, ultimately, unreported taxable sales.

Here, CDTFA did in fact use the months of May 2009 and April 2010 to establish appellant's percentage of taxable to total purchases, as well as the percentages of purchases in each of the various categories of taxable merchandise. CDTFA originally chose those two

[11] During the audit as well as the hearing before OTA, appellant initially claimed that he made no phone card purchases for May 2009 and April 2010. However, in a detailed estimate of appellant's phone card purchases submitted to OTA as a hearing exhibit, appellant indicated that he made phone card purchases of $1,191 and $2,784 during May 2009 and April 2010, respectively.

months at random, and it found no purchases of phone cards in either month. Appellant then provided his own purchase segregation test that encompassed four months during which he did purchase phone cards. Although CDTFA had combined the two purchase segregation tests in the original audit, it decided in the second reaudit to use only its two-month purchase segregation test to establish percentages of purchases, without any purchases of phone cards, and to make a separate adjustment (i.e., a $222,965 reduction in measure) in its calculations for phone card purchases, on an actual basis, based on a journal appellant provided.[12] In essence, CDTFA eliminated nontaxable phone card purchases as a factor in the purchase segregation test, thus narrowing the test's focus further on taxable purchases. At the same time, CDTFA also removed nontaxable phone card purchases from the cost of goods sold, which was the starting point from which it calculated appellant's unreported taxable sales, thus ultimately shrinking the base or foundation for its calculations. Because CDTFA accepted appellant's journal of phone card purchases on an actual basis, and made a corresponding reduction (of $222,965) in its calculations, CDTFA's approach was reasonable. In light of these facts, the evidence does not support appellant's position that CDTFA's purchase segregation test artificially inflated the measure of unreported taxable sales.

Second, appellant argues that his store is not a normal/average liquor store; rather, it sold large amounts of nontaxable cold African food products to-go throughout the audit period. Accordingly, appellant alleges that his percentage of taxable sales should be lower than that of a normal/average liquor store, and, correspondingly, his unreported taxable sales should be lower. Further, he claims that the African food products sold during the audit period had been discontinued by the time the audit was conducted.

Here, for its purchase segregation test, CDTFA used purchase invoices, which appellant provided, for two months, May 2009 and April 2010, both of which were in the audit period (July 1, 2008 through June 30, 2011). Regarding this purchase segregation test, CDTFA's audit working papers list vendor names, but do not list the products purchased, so we cannot identify any specific purchases of African food products. However, because appellant states that it purchased African food products during the audit period, and CDTFA conducted the purchase segregation test using invoices for months during the first and second full years of the audit

[12] CDTFA concluded that appellant's four-month purchase segregation test was not representative of his regular purchases based on various mathematical comparisons with its own two-month purchase segregation test and with the cost of goods sold recorded on FITRs. See also footnote 9, *ante*, page 5.

period, we find that appellant would have purchased African food products during those months. Furthermore, CDTFA compared the nontaxable food purchases made during its two-month purchase segregation test to the nontaxable food purchases made during appellant's four-month purchase segregation test and found that the amount of the latter was roughly double the former. CDTFA considered this result reasonable because appellant's four-month test was twice as long as CDTFA's two-month test. This suggests that the amount of any nontaxable African food product purchases made by appellant during CDTFA's two-month purchase segregation test was not aberrantly small (or large). Thus, we find that appellant's purchases of African food products during the audit period have been taken into consideration in CDTFA's two-month purchase segregation test and that the amount of those purchases for the two months tested were not outside the norm for this business. Accordingly, no adjustment is warranted for appellant's assertion that he sold large amounts of nontaxable African food products to-go.

Third, appellant asserts that the audited markup is excessive because the selling prices in 2008, 2009, and 2010 were lower than the selling prices used in the audit to establish the markup.

It is almost certain that the selling prices in earlier years were lower than the selling prices in effect at the time of the audit shelf test, as appellant notes, but that fact is not relevant to the computation of the audited markup. The purpose of an audit shelf test is to compute the markup, which is the percentage of difference between costs and selling prices.[13] We would expect business owners to attempt to maintain a relatively constant markup by changing the selling prices as costs change. As noted above in factual finding 7, there was a four-month gap between the dates of the costs and the dates of the selling prices used in the shelf test in this audit. Appellant has not provided a basis for why there would be significant increases in selling prices from June to October 2011. However, to alleviate appellant's concerns regarding the shelf test, CDTFA reduced the audited markup for each category of merchandise by 1 percent. We find that this adjustment fully addresses any question of whether the appropriate selling prices were used, with costs shown on the invoices for June 2011, to compute the audited markup.

Fourth, appellant asserts that the audit did not account for the many special sales that occurred throughout the year.

[13] See footnote 3, *ante*, page 2.

We would expect that special sales in a liquor store occur consistently, with the items on sale changing periodically. As a result, a markup computed for any month in an audit period generally includes special sale prices for some products. Appellant has failed to show that there were *no* sales or special selling prices in effect during October 2011, when the selling prices were recorded. Thus, we find it much more likely than not that special sale prices were incorporated into the test and that no adjustment is warranted.

Fifth, appellant asserts that most of his sales of beverages are in six-packs or larger packs of 12 or 18, rather than single items. He alleges that he provided supporting documentation that was not utilized by CDTFA.

Regarding this documentation, CDTFA notes that appellant provided lists of sales for each day of July 2017. However, the lists were not supported by cash register tapes, security camera footage, or any other documentation. As a result, CDTFA does not consider the lists to be reliable evidence.

Nevertheless, in the second reaudit, CDTFA used "pack" selling prices (i.e., it scheduled both six-pack and 12-pack selling prices and computed a separate markup for "pack" sales) for 40 percent of the bottled beer and for 20 percent of the canned beer. In its audit working papers, CDTFA explained that those percentages are generally based on appellant's assertion that pack sales represent 75 to 80 percent of sales on weekends and holidays, and single beer sales represent 75 to 80 percent of sales for other days. Moreover, CDTFA noted that its staff purchased a six-pack of canned beer on three separate occasions. Each time, the selling price for the six-pack was six times the price for an individual can, rather than a lower six-pack selling price. With respect to soda, CDTFA noted also that the only sodas available for sale were individual bottles and cans. For those reasons, CDTFA asserts that its adjustment for sales of six packs is adequate, and we agree.

As a general comment regarding the audited markup for beer, we note that CDTFA has used cost and price information that appellant provided for March 2017 to compute a markup for beer of 40 percent, which is higher than the audited markup for beer of 36 percent.[14] Although appellant had provided the costs and selling prices for March 2017 as evidence that the audited

[14] Using appellant's cost and selling price information, CDTFA computed markups for bottles and cans, respectively, of 35 percent and 39 percent for packs (six-packs and 12-packs) and 44 percent and 41 percent for singles. CDTFA used its estimate of 40 percent of bottled beer and 20 percent of canned beer sold as packs, along with its estimate of 40 percent of beer sold as bottles and 60 percent sold as cans, to compute a beer markup of 40 percent.

markup for beer was overstated, CDTFA noted that, in his computation of the markup, appellant had added back the discounts he had been granted on purchases of beer, and the higher costs resulted in lower markups. In its computations, CDTFA reduced costs for the discounts. CDTFA observed that, since it was applying the audited markup to recorded costs, net of discounts, it was necessary to compute the markups using discounted costs. We find that the markup computed using appellant's cost and selling price information for March 2017 offers strong evidence that the audited markup for beer is not overstated, but may be understated.

Sixth, appellant has also argued that the allowance for pilferage should be increased despite the lack of substantiating police reports.[15] To support his assertion that there was a high theft rate at the store, appellant has provided several images, captured by security cameras, of what he describes as individuals stealing merchandise.

In the second reaudit, CDTFA estimated appellant's losses due to pilferage and breakage at 3 percent, which translates into an estimated loss of inventory of $43,609 for three years, or about $40 per day ($43,609 ÷ 3 ÷ 365). For example, at a cost of $1.40 for a 24-ounce can of Budweiser beer, that allowance would represent thefts of 28 cans of beer ($40 ÷ $1.40) every single day. Other costs, scheduled in the shelf test, are $2.18 for a 24-ounce Heineken, $1.26 for Red Bull, and $0.64 for a 16-ounce Pepsi. Clearly, a theft and breakage loss of $40 would represent multiple thefts each day.[16] Appellant has not provided documentation to show that the thefts and breakages experienced by the store exceeded the amount CDTFA estimated. We find that the 3-percent pilferage/breakage allowance is sufficient.

In summary, we find that CDTFA has used a recognized and accepted audit method, has conducted adequate tests, and has made reasonable adjustments to address appellant's concerns. Appellant has not provided support for further adjustments, and we recommend none.

[15] At the hearing before OTA, appellant indicated that he could not report shoplifters to the police because, if he did, it would jeopardize his life and they would "blow the place up." Appellant also indicated that he was "okay" with the 3-percent pilferage and breakage allowance, but was just using it to illustrate the purported difficulties he experienced in trying to get CDTFA to understand the uniqueness of his business and to make adjustments during the audit process. Nevertheless, we will analyze appellant's contention out of an abundance of caution.

[16] There are higher-cost items in the shelf test, such as liquor and cigarettes. However, those types of merchandise are typically kept behind the counter and would not be readily accessible to customers.

## HOLDING

No further adjustments to the measure of unreported taxable sales are warranted.

## DISPOSITION

Redetermine the liability in accordance with the second reaudit dated May 5, 2017. Otherwise, sustain CDTFA's decision to deny the petition.

DocuSigned by:
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Andrew Wong
Administrative Law Judge

We concur:

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

DocuSigned by:
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Keith T. Long
Administrative Law Judge

Date Issued: 7/21/2020