

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

In the Matter of the Appeal of: ) OTA Case No. 19064942  
**BARK EM PET SUPPLIES, LLC** ) CDTFA Case ID 1052830  
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**OPINION**

Representing the Parties:

For Appellant: John Faucher, Attorney  
Z. Carlson, Member

For Respondent: Mariflor Jimenez, Hearing Representative  
Jason Parker, Chief of Headquarters  
Operations  
Christopher Brooks, Tax Counsel IV

For Office of Tax Appeals: Lisa Burke, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, Bark Em Pet Supplies, LLC (appellant) appeals a Decision issued by respondent California Department of Tax and Fee Administration denying, in part, appellant’s petition for redetermination of an April 5, 2018 Notice of Determination (NOD) by audit of additional tax due of \$31,908.09, plus accrued interest, and a negligence penalty of \$3,190.81 for the period July 1, 2012, through June 30, 2015 (liability period).<sup>1</sup>

Office of Tax Appeals (OTA) Administrative Law Judges John O. Johnson, Teresa A. Stanley, and Michael F. Geary held an electronic oral hearing for this matter on December 17, 2020.<sup>2</sup> We held the record open without objection, and on January 15, 2021,

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<sup>1</sup> The NOD was based on an audit that established a deficiency of \$438,283, consisting of two audit items: (1) audited vs. reported (unreported) taxable sales based on a markup of costs analysis for the Camarillo location, measured by \$347,086; and (2) unreported taxable sales based on a markup of costs analysis for the Oxnard location, measured by \$91,197.

<sup>2</sup> Appellant requested an oral hearing in Fresno. However, OTA has temporarily suspended live hearings to comply with restrictions in effect to minimize the spread of COVID-19. The parties have agreed to this electronic hearing process, which allows audio and video participation in real time using a web-based application.

respondent filed a post-hearing brief, which described additional proposed adjustments in appellant's favor. OTA closed the record on February 25, 2021.

### ISSUE

What reduction, if any, to the measure of unreported taxable sales is warranted?

### FACTUAL FINDINGS

1. Appellant sold pet food and supplies, and also provided grooming, vaccinations, training, day care, and other services for pets. During the liability period, appellant operated two locations: one in Camarillo, which appellant operated during the entire liability period, and one in Oxnard, which appellant operated from May 4, 2013, through November 18, 2014.<sup>3</sup> Appellant closed its business in April 2019.
2. Appellant states that it entered its sales on a cash register and added sales tax reimbursement to its retail sales of merchandise. To determine taxable sales for reporting purposes, appellant printed daily cash register reports (Z-tapes<sup>4</sup>), which broke down all recorded sales by category (e.g., dog food, cat food, merchandise, grooming, etc.) and indicated taxable sales and tax reimbursement collected for the day. Appellant recorded its daily sales on a sales tax worksheet and reported only its taxable sales<sup>5</sup> on its sales and use tax returns based on its recorded amounts of collected sales tax reimbursement.
3. For audit, appellant provided its federal income tax return for 2014; income statements for 2012 and 2013; bank statements for 2013 and 2014; sales tax worksheets and reports showing customer credit card payments (1099-K forms) for the liability period; Z-tapes for November 2015; merchandise purchase invoices for random dates in 2014; and a global payment history report for one of its vendors. Because appellant did not provide enough Z-tapes or other source documents to support the accuracy of the recorded

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<sup>3</sup> In its argument at hearing, respondent stated the Oxnard location closed on November 28, 2014. Multiple references in the audit work papers indicate it closed on November 18, 2014. The closure date will not affect our analysis.

<sup>4</sup> Z-tapes are point-of-sale terminal (register) summaries of sales activity. Depending on the equipment used by the retailer, they can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable sales.

<sup>5</sup> Appellant did not report nontaxable sales. Thus, it reported the same amount for total sales and taxable sales.

- amounts in the sales tax worksheets and other summary records, respondent decided to use an indirect audit method to verify the accuracy of appellant's reported taxable sales.
4. Initially, respondent compared appellant's recorded sales of \$37,170 for November 2015 with its recorded sales paid by credit card of \$30,003 for that month to compute a credit-card-to-total-sales ratio (credit card sales ratio) of 80.72 percent. Using the cash register Z-tapes for November 2015, respondent also computed that 45.56 percent of appellant's sales were taxable sales. Respondent then divided credit card deposits of \$1,567,641 for the liability period by the credit card sales ratio of 80.72 percent to compute audited total sales of \$1,942,073. Multiplying audited total sales by the taxable sales ratio of 45.56 percent resulted in audited taxable sales of \$884,810 for the liability period, or more than twice the reported amount.<sup>6</sup>
  5. Appellant argued that the taxable sales ratio was not representative of its sales throughout the liability period. Because the November 2015 cash register Z-tapes showed appellant's sales at only one of the two locations it operated during the liability period, respondent decided to use another audit method, the markup method, to establish audited taxable sales.<sup>7</sup>
  6. Respondent compared the retail selling prices for 28 merchandise items in 2017 with their respective costs shown in merchandise purchase invoices for 2017 to compute an average markup of 63.02 percent. After appellant argued that some sales were at discounted prices, respondent subtracted 10 percent from the average markup percentage to establish an audited markup of 53.02 percent for taxable merchandise. Respondent then reduced the cost of goods sold reported on appellant's income tax return for 2014 by 1 percent to allow for pilferage, which resulted in audited cost of goods sold of \$160,621.<sup>8</sup> Respondent added the audited markup of 53.02 percent to audited cost of goods sold of \$160,621 to establish audited taxable sales of \$245,788, which exceeded

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<sup>6</sup> Appellant reported total and taxable sales for the liability period of \$434,750.

<sup>7</sup> The markup method, which is a generally accepted method for auditing taxable sales, involves computing an audited markup using known or estimated cost of goods sold and retail prices, and then adding the audited markup to the audited cost of goods sold to compute taxable sales.

<sup>8</sup> Based on appellant's assertions that it did not withdraw grooming supplies or pet food for the pets in day care or training from its resale inventory for self-consumption, respondent did not further reduce the audited cost of goods sold to allow for self-consumption of taxable merchandise.

- appellant's reported taxable sales for 2014 by \$123,391, representing an error rate of 100.81 percent. Respondent applied the error rate of 100.81 percent to appellant's reported taxable sales of \$434,750 for the liability period to calculate unreported taxable sales of \$438,282.
7. Respondent found that the cost of goods sold of \$162,243 reported on appellant's income tax return for 2014 substantially exceeded appellant's reported taxable sales of \$122,397 for that year, which indicates that reported taxable sales were substantially understated. Respondent also noted that \$873,032 (\$434,750 + \$438,282) in audited taxable sales established using the markup method is a strikingly similar amount to audited taxable sales of \$884,810 computed based on a credit card sales ratio analysis.<sup>9</sup> Given evidence of a substantial understatement and similar results from two analyses, respondent concluded that the markup analysis yielded reasonably accurate results.
  8. On April 5, 2018, respondent issued the NOD to appellant based on the unreported taxable sales of \$438,282. Additionally, respondent added a 10 percent penalty for negligence.
  9. Appellant timely filed a petition for redetermination. Respondent held an appeals conference with appellant on January 10, 2019. After the appeals conference, respondent agreed to delete the negligence penalty. On May 31, 2019, respondent issued its Decision deleting the negligence penalty and otherwise denying the petition for redetermination.<sup>10</sup> This timely appeal to OTA followed.
  10. Following the hearing in this matter, while the record remained open, respondent reexamined available invoices to adjust the cost price of shelf test items for packaging or shipping charges if those charges were shown on the invoices.<sup>11</sup> As a result of that reexamination, respondent will reduce the audited markup from 63.02 percent to 59.36 percent (before the 10 percent reduction), which will reduce the measure of unreported

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<sup>9</sup> Most audit schedules indicate unreported taxable sales totaling \$438,282, though Schedule 12 and the revised audit report indicate unreported taxable sales of \$438,283. The difference, which may be due to rounding, is of no consequence.

<sup>10</sup> There was also an agreement between the parties regarding a credit measure for appellant's overpayment of a 0.50 percent local tax. This agreement has no bearing on our analysis herein.

<sup>11</sup> A shelf test is an accounting comparison of known costs and associated selling prices, which is used to compute markups.

taxable sales from \$438,282 to \$417,370, a reduction of \$20,912. Respondent provided copies of the relevant documents and calculations to appellant. Appellant did not respond.

### DISCUSSION

The California sales tax is imposed on a retailer's retail sales in this state of tangible personal property, 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 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).)

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.) When a taxpayer appeals a determination by respondent, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Here, the only source documents appellant provided during the audit to support the amounts of sales recorded in its sales tax worksheets and other summary documents consisted of cash register Z-tapes for a one-month period, November 2015.<sup>12</sup> We find that the books and records provided for examination were not sufficient to verify the accuracy of appellant's reported sales using a direct audit approach, and therefore, find that respondent was justified in using an indirect audit approach to establish audited sales. In acknowledgement of appellant's concern that the test period used in the first indirect audit approach, the credit card sales ratio analysis, might not accurately represent appellant's sales throughout the liability period, respondent then performed a markup analysis. We have examined both analyses and have found no errors in the procedures or in the computations. Moreover, we find that the markedly similar

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<sup>12</sup> Appellant also provided an additional Z-tape for one day well after the liability period, March 13, 2019.

results obtained from both analyses constitute evidence that the results are reasonably accurate. Therefore, we conclude that the burden of proof shifts to appellant to establish by documentation or other evidence that a reduction to the amount of audited unreported taxable sales is warranted.

Prior to the hearing, appellant argued that it reported and remitted all of the sales tax reimbursement it collected, and that respondent's audit mischaracterizes appellant's sales of services, such as grooming, training, and day care, as taxable sales of merchandise. To support this argument, appellant provided a Z-tape for March 13, 2019, showing taxable sales of \$116, services of \$1,240, total sales of \$1,356, and sales tax reimbursement collected of \$8. At the hearing, appellant argued that respondent's audit failed to include packaging and shipping charges in the calculation of cost of goods sold, thereby inflating the markup and increasing the audited measure of unreported taxable sales. Appellant's owner testified that packaging and shipping costs shown on the sole invoice appellant offered into evidence was representative of all vendors, and on that basis appellant argued that it was entitled to a comparable adjustment<sup>13</sup> for packaging and shipping charges on all purchases included in the shelf test.<sup>14</sup>

At the hearing, respondent agreed that it should have included verified packaging and shipping costs in appellant's cost of goods sold. Respondent reexamined its calculations after the hearing and allowed adjustments for packaging and shipping costs shown on two of the many invoices that respondent offered into evidence. Respondent agreed to a \$20,912 reduction of the measure of unreported taxable sales. Appellant has not stated its position regarding this reduction.

There is no evidence to support appellant's argument that the audit mischaracterizes its sales of services as taxable sales. A Z-tape for one day in 2019, almost four years after the liability period, does not by itself constitute reliable evidence of appellant's sales throughout the liability period; but more importantly, the markup analysis focused exclusively on appellant's sales of tangible personal property. It did not include services. Consequently, we find appellant's argument in this regard unpersuasive.

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<sup>13</sup> Appellant argues that its cost of merchandise included in the shelf test should be increased by 36.5 percent.

<sup>14</sup> Appellant also argues that its owners would suffer financial hardship if respondent's decision is sustained. Respondent has procedures available to taxpayers who seek adjustments on the basis of financial hardship. It is not a matter that we can address here.

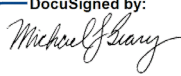
Regarding appellant’s argument that it is entitled to an across-the-board adjustment for packaging and shipping charges on all purchases included in the shelf test, we find that the testimony of appellant’s owner (that packaging and shipping charges shown on the one invoice appellant submitted to us were representative of all vendors) is uncorroborated. Furthermore, that testimony is contradicted by the many invoices that are in evidence, which show that only two of the approximately 20 invoices included packaging or shipping charges. Respondent has indicated that it will make the appropriate adjustments and appellant has offered no argument or evidence in reply to respondent’s post-hearing submission. Given that appellant has the burden of proof but has failed to show that a reduction to the measure greater than that proposed by respondent is warranted, we find that no reduction to the measure beyond that proposed by respondent is warranted.

HOLDING

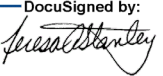
A \$20,912 reduction to the measure of unreported taxable sales is warranted.

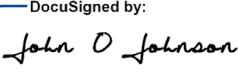
DISPOSITION

As agreed by respondent, the measure of unreported taxable sales shall be reduced from \$438,282 to \$417,370, a reduction of \$20,912, but in all other respects, respondent’s Decision is sustained.

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Michael F. Geary  
Administrative Law Judge

We concur:

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Teresa A. Stanley  
Administrative Law Judge

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John O. Johnson  
Administrative Law Judge

Date Issued: 4/21/2021