

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:

M. KAFARAH
dba Tobacco King

) OTA Case No. 21068104
) CDTFA Case ID 1-359-222
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OPINION

Representing the Parties:

For Appellant:

Juan Guzman

For Respondent:

Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals:

Lisa Burke, Business Taxes Specialist III

N. DANG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Kafarah, dba Tobacco King, (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (respondent)¹ denying appellant’s petition for redetermination of a December 23, 2019 Notice of Determination (NOD) for \$67,122 tax and applicable interest for the period April 1, 2016, through March 31, 2019 (audit period).

We decide the matter based on the written record because appellant waived the right to an oral hearing.

ISSUE

Whether the amount of unreported taxable sales as established by respondent’s audit should be reduced.

FACTUAL FINDINGS

1. Appellant operated a smoke shop selling cigarettes, tobacco, vaping products, related taxable merchandise, a few exempt food items, and lottery tickets.

¹ Sales and use taxes were formerly administered by the State Board of Equalization (SBE). In 2017, the functions of SBE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, “respondent” shall also refer to SBE.

2. For the audit period, appellant reported an average of \$734 in taxable sales per day.
3. Appellant's returns for the audit period were selected by respondent for examination.
4. Respondent found no discrepancies between appellant's reported and recorded gross receipts. However, respondent discovered that appellant's book mark-ups were overstated. Respondent also found that the ratio of appellant's taxable credit card receipts to total taxable receipts (credit card sales ratio) of 95.72 percent was unusually high for a business of this type, indicating that appellant may have underreported his cash receipts. Respondent therefore determined that appellant's reported taxable sales were unreliable and that this amount should be redetermined using a credit card sales ratio analysis.
5. On October 23, 2019, respondent observed appellant's business operations and compiled taxable sales of \$703.72 and total credit card payments of \$374.58, which represents a credit card sales ratio of 53.23 percent.
6. Respondent also computed a credit card sales ratio of 47.75 percent using the cash register Z-tapes and settlement reports provided by appellant for the periods July 10, 2019, through July 13, 2019, September 1, 2019, through September 14, 2019, and October 7, 2019, through October 12, 2019 (test period), which also show daily average taxable sales of \$786.
7. Combining the test period data with that of its observation test, respondent determined that 47.95 percent of appellant's taxable sales were paid for by credit card.
8. Respondent also computed credit card deposits of \$764,851 for the audit period based on information contained in 1099-K forms for the period April 1, 2016, through December 31, 2018, and appellant's bank statements for the first quarter of 2019.
9. Respondent then divided credit card deposits of \$764,851 by the credit card sales ratio of 47.95 percent to compute audited taxable sales of \$1,595,101 for the audit period, resulting in a daily average of \$1,456.71 ($\$1,595,101 \div 1,095$ days).
10. A comparison of audited taxable sales with appellant's reported taxable sales showed unreported taxable sales of \$792,625 ($\$1,595,101 - \$802,475$).²
11. Respondent issued an NOD to appellant on December 23, 2019, based on unreported taxable sales of \$792,625.

² The difference is due to rounding.

12. Appellant timely filed a petition for redetermination, which respondent denied. This appeal followed.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sale of all tangible personal property sold in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) To prevent tax evasion, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.)

If respondent is not satisfied with the amount of tax reported by the taxpayer, respondent may determine the amount required to be paid on the basis of any information that is in its possession or may come into its possession. (R&TC, § 6481.)

On appeal, respondent has a minimal, initial burden of producing evidence to show that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the taxpayer carries the burden of establishing, by a preponderance of evidence, that a different result is warranted. (*Ibid.*)

The record establishes that respondent's deficiency determination is based on the application of an established audit method³ to information obtained from appellant's business records. This is sufficient to show that respondent's determination is neither arbitrary nor capricious (i.e., that it is minimally reasonable), and therefore, we find respondent has met its initial burden of production. Thus, appellant carries the burden of persuading us that adjustments to respondent's determination are warranted.

Appellant presents two arguments for our consideration. First, appellant contends that the use of a credit card sales ratio analysis is not suitable for his type of business because respondent intended this audit method to be used exclusively in auditing bars and restaurants.

Second, appellant argues that average daily taxable sales of \$1,456.71, as determined by respondent's audit, is unreasonably high. More specifically, appellant contends that his reported average daily taxable sales of \$734 should be accepted by respondent because it is substantially similar to the \$703.72 amount observed by respondent on October 23, 2019, and the \$786 amount recorded by appellant during the test period.

³ See respondent's Audit Manual section 0810.12.

Appellant's first contention lacks merit. Although respondent recommends the use of a credit card sales ratio analysis in Chapter 8 of its Audit Manual titled "Bars and Restaurants," this fact does not limit the applicability of this analysis to those types of businesses. A fundamental premise of the credit card sales ratio analysis is that credit card receipts are a reliable starting point for estimating a business's taxable sales because electronic payments are required to be processed through a payment settlement entity and are therefore subject to third-party verification. Generally, credit card receipts are divided by a credit card sales ratio to estimate a taxpayer's total sales; in particular, the portion of those sales constituting cash payments. None of these calculations are dependent upon the type of business that the taxpayer is engaged in. Rather, factors such as the size of the sample and the representative quality of the data used, directly influence the accuracy of the results achieved. Here, there is no evidence indicating that the information relied upon by respondent in conducting its credit card sales ratio analysis was either flawed or insufficient, in such a way as to produce a patently erroneous result. Thus, we find appellant has not shown that respondent's use of a credit card sales ratio analysis was improper.

Appellant also urges us to look to his average daily taxable sales during the test period as support for his position that he did not underreport his taxable sales. We acknowledge that, when viewed in isolation, appellant's argument appears reasonable. Assuming there were no substantive changes in appellant's business, we would expect the amount of taxable sales made by appellant during the test period to be similar to the amount appellant made during the audit period. Yet, appellant fails to consider that his credit card sales ratio for the test period was, for inexplicable reasons, significantly lower than during the audit period. This indicates that either appellant's credit card sales ratio for the test period was not similar to the credit card sales ratio for the audit period, meaning that respondent's use of the credit card sales ratio was flawed, or that appellant underreported his cash receipts for the audit period. However, we find above that respondent's use of a credit card sales ratio analysis was proper. Further, appellant has not provided any evidence to foreclose the possibility that his cash sales were underreported or to show that the audit method he suggests would result in a more accurate determination of his taxable sales. Accordingly, we find that appellant has not shown any error in respondent's deficiency determination.

HOLDING

No reduction to the amount of unreported taxable sales is warranted.

DISPOSITION

We sustain respondent’s action.

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Nguyen Dang

Administrative Law Judge

We concur:

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Andrew Wong

Administrative Law Judge

DocuSigned by:



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Daniel K. Cho

Administrative Law Judge

Date Issued: 11/24/2021