OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 22029803
	CDTFA Case IDs: 1-689-262, 1-479-395
FOREVER YOUNG COSMETICS, INC.	
dba Black Pearl	

OPINION

Representing the Parties:

For Appellant: Meidan Magen, President

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Forever Young Cosmetics, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated October 7, 2019 (Case ID 1-689-262). The NOD is for tax of $22,843 in tax, plus applicable interest, for the period July 1, 2014, through March 21, 2017 (liability period).[2]

Appellant made an overpayment of $3,100 for the period at issue, which CDTFA applied to offset the NOD liability. The payment reduces the unpaid tax from $22,843 to $19,743. Appellant filed a protective claim for refund dated November 25, 2019, for the overpayment,

[1] Sales and use taxes were formerly administered by the State Board of Equalization (board). In 2017, functions of the board relevant to this case were transferred to CDTFA. For ease of reference, when this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to the board.

[2] CDTFA's decision erroneously states that the NOD is "for $24,858.89 in tax, plus applicable interest." However, the $24,858.89 amount included accrued interest. The NOD was timely issued because appellant signed a waiver of limitations which extended the time for CDTFA to issue an NOD. (R&TC, §§ 6487(a), 6488.)

which CDTFA also denied (Case ID 1-479-396).[3] Pursuant to R&TC section 6901, appellant further appeals CDTFA's decision to deny the related claim for refund.

Appellant waived the right to an oral hearing before the Office of Tax Appeals (OTA); therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellant established a basis for adjustments to the measure of recorded but unreported taxable sales.
2. Whether appellant established a basis for adjustments to the audited measure of unreported purchases subject to use tax.

FACTUAL FINDINGS

1. Appellant, a corporation, was a retailer of skincare products in San Jose, California. Appellant also provided skincare services. Appellant operated from a retail store location inside a shopping mall, and appellant also made sales from a kiosk in the same shopping mall.
2. Appellant's seller's permit was opened with an effective start date of May 20, 2013, and closed effective March 21, 2017, when the business was sold.[4]
3. On September 7, 2017, following the closeout of the seller's permit, CDTFA contacted appellant to initiate a closeout audit.
4. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total and taxable sales of $1,935,742 (i.e., appellant claimed no deductions).
5. During the audit, appellant stated that it used data from its point-of-sale (POS) system to report sales on its SUTRs. Appellant did not provide any POS reports to CDTFA. As such, CDTFA was unable to verify appellant's reporting method.
6. For audit, appellant provided copies of its federal income tax returns (FITRs) for 2014, 2015, and 2016; bank statements for the liability period; and Microsoft Excel spreadsheet summaries of sales and purchases for the periods: January 1, 2014, through

[3] The claim for refund is for $1 or more; however, CDTFA determined the actual amount to be $3,100, and appellant has not otherwise disputed the calculation of this amount.

[4] Appellant filed a certificate of dissolution with the California Secretary of State on November 14, 2019, and is now a dissolved entity.

May 15, 2014, and October 1, 2014, through December 31, 2016 (sales summaries). Appellant did not provide cash register tapes or source documentation, such as credit card receipts or merchandise purchase invoices. CDTFA considered the provided books and records inadequate for sales and use tax audit purposes.

7. CDTFA accepted the sales tax recorded in appellant's records (the sales summaries provided for audit). Appellant's records disclosed a $4,567 difference between recorded and reported sales tax ($62,380 - $57,813 = $4,567). CDTFA divided the recorded, but not reported, amount of sales tax by the tax rate to establish unreported taxable sales of $51,483 for the period October 1, 2014, through December 31, 2016 (issue 1).[5]

8. Based on appellant's sales summaries, CDTFA compiled recorded total sales (including sales tax) of $1,175,707. Upon comparison to reported taxable sales (including sales tax) of $717,231, CDTFA computed a difference of $458,476. Appellant stated the difference between total and taxable sales was due to income from nontaxable facial treatment services.

9. CDTFA examined the sales summaries and noted a large gap in the invoice numbering. Based on the beginning sales invoice number for January 1, 2014, and the ending sales invoice number on December 31, 2016, CDTFA determined that appellant made 9,081 sales transactions (or issued 9,081 sales invoices) during the period January 1, 2014, through December 31, 2016. Appellant only provided supporting sales data for 5,896 transactions to CDTFA for that same period. Appellant did not provide an explanation for the 3,185 missing sales invoices.

10. CDTFA separately compared taxable sales (including sales tax) reported on the SUTRs for 2014, 2015, and 2016, to the corresponding gross receipts reported on the FITRs. Gross receipts exceeded reported taxable sales (including sales tax) by $748,669 for the three years combined.[6] Appellant stated that difference was because the reported gross receipts included rental income from IOI Cosmetics, payments for inventory transfers from H&R Beauty Supplies (a separate entity), and income from nontaxable facial

[5] This issue is identified as audit item 2 in CDTFA's audit file.

[6] This represents a difference of $59,055 for 2014, $401,453 for 2015, and $288,161 for 2016.

treatment services. Appellant was unable to provide documentation to support the amounts reported on the FITRs.

11. In addition, using appellant's bank statements, CDTFA compiled total bank deposits of $1,530,739, and non-sales deposits of $86,417, resulting in bank deposits from sales of $1,444,322 ($1,530,739 - $86,417) for the liability period. For the same period, appellant reported taxable sales of $675,342, and tax due of $59,207, for a total amount of $734,549 (taxable sales, including sales tax). CDTFA compared appellant's reported amounts on its SUTRs to audited taxable sales based on bank deposits and computed a difference of $709,770 for the liability period ($1,444,322 - $734,549).

12. Finally, CDTFA obtained appellant's Form 1099-K[7] data for the period May 2013 through December 2015 for payments made by its credit card processor, Global Payments Direct. CDTFA compiled audited credit card sales of $1,277,369 for the period January 2016 through April 2017, using bank statements (for American Express credit card sale deposits) and Form 1099-K data reported by appellant's credit card processor. Credit card sales exceeded reported taxable sales (including sales tax) by $542,820 for the liability period ($1,277,369 - $734,549).

13. CDTFA accepted appellant's explanation that the reason appellant's bank deposits, Form 1099-K data, recorded total sales, and FITR gross receipts (summarized above) were all significantly higher than taxable sales reported to CDTFA was due to income from nontaxable facial treatment services.

14. Based on a review of appellant's available documentation, and statements from appellant to the auditor, CDTFA determined that appellant purchased skincare supplies ex-tax.[8] CDTFA further concluded that appellant used some of those skincare supplies in the provision of nontaxable facial treatment services and resold some of those supplies to customers.

[7] Form 1099-K is an Internal Revenue Service form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network, during a given time period. Form 1099-K includes payments made by any electronic means, including but not limited to credit cards, debit cards, and PayPal.

[8] This Opinion uses the term "ex-tax" to mean without payment of use tax or sales tax reimbursement to the vendor or CDTFA at the time of purchase or consumption in this state.

15. Appellant either failed to maintain or provide to CDTFA documentation on its cost of consumable supplies purchased ex-tax. On its FITRs, appellant did not claim any cost of goods sold (COGS). However, on its FITRs for 2014 through 2016, appellant claimed $323,526 in deductions for supplies. Appellant declined to provide an explanation for this deduction and CDTFA assumed that the supply deductions were for COGS for skincare supplies.

16. Absent documentation, CDTFA estimated appellant's use tax liability for self-consumption. For these purposes, appellant provided the selling price for its most popular taxable product sold at retail, a $45 peeling facial mask, and appellant's cost price for that product ($7.90). CDTFA computed a profit of $37.10 ($45.00 - $7.90), a markup of 470 percent ($37.10 ÷ $7.90), and a cost to sales price ratio (cost ratio) of 17.56 percent ($7.90 ÷ $45.00).[9]

17. For 2015 and 2016, CDTFA multiplied audited total sales of $556,880 by the cost ratio of 17.56 percent to estimate that appellant's COGS for property sold at retail was $97,788 ($556,880 × 17.56 percent) for that period. Appellant stated its COGS totaled $235,373 ($182,097 + $53,276) for 2015 and 2016, and CDTFA accepted this amount. CDTFA deducted the estimated COGS for retail sales of $97,788 from total COGS of $235,373, and computed $137,585 as the unreported taxable cost of property consumed in providing facial services for that period.

18. For 2014, CDTFA estimated a new cost ratio using credit card sales data for 2015 and 2016. CDTFA compiled credit card sales of $1,010,507 for this period. CDTFA divided the audited self-consumption amount of $137,585 for 2015 and 2016 by total credit card sales of $1,010,507 for the same period and computed a self-consumption ratio of 13.62 percent. CDTFA multiplied credit card sales of $262,054 for 3Q14, 4Q14, and 1Q17 by the self-consumption ratio of 13.62 percent and computed the unreported taxable cost of self-consumed merchandise of $35,680 for that period.

[9] "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 $0.70 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 (0.30 ÷ 0.70 = 0.42857).

19. In total, CDTFA computed unreported purchases of $173,265 subject to use tax ($137,585 + $35,680) for the liability period (issue 2).[10]
20. On October 7, 2019, CDTFA issued the NOD to appellant for the liability disclosed by closeout audit.
21. Appellant filed a timely petition for redetermination disputing the NOD in its entirety.
22. CDTFA issued a decision dated January 21, 2022, which denied the petition and related refund claim.
23. This timely appeal to OTA followed. The entirety of appellant's briefing on appeal consists of a one-page document consisting of eight sentences, and no supporting documentation.[11]

DISCUSSION

California imposes 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, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) A sale includes any transfer of title or possession of tangible personal property for a consideration. (R&TC, § 6006(a).)

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. (*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

[10] This is listed as audit item 1 in CDTFA's audit file.

[11] Appellant failed to respond to any letters and notices, following the initial filing of this appeal. Although CDTFA's decision denied a request for interest relief, appellant did not dispute interest in its appeal to OTA, so we do not address it further.

not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) To satisfy its burden of proof, a taxpayer must prove both (1) that the tax assessment is incorrect, and (2) the proper amount of tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

Issue 1: Whether appellant established a basis for adjustments to the measure of recorded but unreported taxable sales.

Here, appellant failed to maintain documentation to support reported taxable sales. Upon audit, appellant provided records which disclosed recorded taxable sales which appellant did not report to CDTFA. It was reasonable for CDTFA to base the liability for this audit item on appellant's own recorded amount of sales tax reimbursement collected from customers. Appellant does not dispute its records and has not provided an explanation for the difference between recorded and reported taxable sales. As such, we find no adjustments are warranted for this item.

Issue 2: Whether appellant established a basis for adjustments to the audited measure of unreported purchases subject to use tax.

Here, it appears from the record to be undisputed that: appellant purchased skincare supplies ex-tax; appellant used a portion of ex-tax resale inventory (skincare supplies) in the provision of nontaxable facial treatment services; appellant failed to maintain supporting documentation on the amount of such purchases subject to use tax; and CDTFA estimated appellant's use tax liability for these purchases.

On appeal, appellant contends that the estimate provided by CDTFA was grossly inflated for the following reasons: (1) the audit is based on erroneous assumptions in calculating COGS and total sales; (2) CDTFA estimated the 17.56 cost ratio based on the selling price of just one item which had a really high markup; (3) the "auditor did not take inputs and explanations from [appellant], due to lack of records, about the different products/services and sales."

CDTFA initiated the audit on September 6, 2017, following the reported sale of the business on March 21, 2017, and closeout of the seller's permit. For audit, appellant provided minimal documentation and, because the business was already closed, some audit methods (such as an observation test) were not possible. To determine appellant's total sales, CDTFA examined Form 1099-K data reported to the IRS, bank deposits, appellant's own sales summaries, FITRs, and amounts reported on the SUTRs. CDTFA accepted appellant's recorded

taxable sales, without source documentation. Furthermore, CDTFA allocated the difference between taxable sales and total sales (as demonstrated by Forms 1099-K, FITRs, bank deposits, and appellant's own records) to nontaxable income from facial treatment services, as requested by appellant. Thus, the amount of the liability rests on the allocation of appellant's COGS between retail sales and nontaxable skincare services. Appellant's COGS was $323,526, and this was allocated $173,265 (53 percent) towards taxable self-consumption. On the other hand, appellant had bank deposits from sales of $1,444,322, and of this amount reported $734,549 in taxable sales (including sales tax). In other words, roughly 49 percent of appellant's total sales revenue is from facial treatment services, and 51 percent is from the retail sale of tangible personal property.

We would expect a higher markup associated with the provision of services, as opposed to the retail sale of tangible personal property. In other words, we believe it would be reasonable to expect a higher markup if appellant were providing and applying the facial cream, than if appellant were simply selling the facial cream and providing no related services. Nevertheless, here the nontaxable and taxable revenue was split almost evenly, and CDTFA also roughly split the COGS amount evenly between taxable and nontaxable revenue, indicating a comparable markup for the standalone sale of tangible personal property, and the provision of services (applying the tangible personal property). In summary, we find it reasonable and rational for CDTFA to use the available documentation in its possession to calculate the unreported purchase. We find nothing unreasonable or erroneous in the end result as calculated by CDTFA. To the contrary, the end result appears to be generous in that it appears to have favored appellant in the allocation of the COGS amount.

We find that CDTFA met its initial burden, and that appellant had the burden to establish error with the NOD. On appeal, appellant contends the audit is based on erroneous assumptions, yet appellant provided no evidence to meet its burden in showing error in CDTFA's assumptions. Appellant also disputes use of the 17.56 percent cost ratio, yet this was determined using information provided by appellant. We find no error in this because CDTFA may use any information in its possession to ascertain a liability. (R&TC, § 6481.) Furthermore, appellant has not identified a single other data point from which a more accurate cost ratio may be ascertained. Thus, we have no basis to order an adjustment and we have no method to calculate an alternative cost price. Finally, CDTFA was not required to accept appellant's contentions,

absent supporting documentation, and thus we find unpersuasive appellant's argument that CDTFA was unwilling to accept unsupported assertions.

In summary, we find that appellant failed to meet its burden in establishing error in the NOD.

HOLDINGS

1. Appellant failed to establish a basis for adjustments to the measure of recorded but unreported taxable sales.
2. Appellant failed to establish a basis to the measure of unreported purchases subject to use tax.

DISPOSITION

CDTFA's action is sustained.

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Andrew J. Kwee
Administrative Law Judge

We concur:

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Administrative Law Judge

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Suzanne B. Brown
Administrative Law Judge

Date Issued: 10/17/2022