OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18103890) CDTFA Case ID 918246
G. RAMIREZ JR. AND **P. RAMIREZ,** **dba Kennedy Store & Deli**	)

OPINION

Representing the Parties:

For Appellant: Oscar G. Armijo, CPA
G. Ramirez, Co-owner
P. Ramirez, Co-owner

For Respondent: Randolph "Randy" Suazo, Hearing Representative
Christopher Brooks, Tax Counsel IV
Jason Parker, Chief of Headquarters Operations

For Office of Tax Appeals: Deborah Cumins,
Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, G. Ramirez Jr. and P. Ramirez (appellants), a husband-and-wife partnership,[1] appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] denying appellant's timely petition for redetermination of the Notice

[1] G. Ramirez and P. Ramirez reported the business to CDTFA as a husband-and-wife co-ownership. Under certain circumstances, a partnership for income tax purposes does not include a qualified joint venture conducted by a husband-and-wife who file a joint income tax return (more commonly referred to as a husband-and-wife co-ownership). (See Int. Rev. Code, § 761(f).) For sales and use tax purposes, irrespective of income tax treatment, both a "partnership" and a "joint venture" are considered a separate person. (R&TC, § 6015.)

[2] 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. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, "CDTFA" shall refer to the board.

of Determination (NOD) dated July 31, 2015.[3] The NOD is for tax of $77,899.37, plus applicable interest, and a negligence penalty of $7,789.94 for the period January 1, 2011, through December 31, 2013 (audit period).[4]

During the pendency of this appeal, CDTFA performed a reaudit which reduced the tax liability from $77,899.37 to $60,170.00, reduced the corresponding penalty from $7,789.94 to $6,017.00, and denied the remainder of the petitioned amount.

Office of Tax Appeals (OTA) Administrative Law Judges Keith T. Long, Andrew Wong, and Josh Aldrich held an electronic oral hearing for this matter on December 29, 2022. At the conclusion of the hearing, the record was held open for additional briefing pursuant to appellant's request. After additional briefing concluded, the record closed on March 2, 2023.

ISSUES

1. Whether appellant has shown that further adjustments are warranted to the audited taxable measure.
2. Whether the negligence penalty was properly imposed.

FACTUAL FINDINGS

1. Appellant has operated a convenience store with a deli in La Quinta, California, since July 1, 1999, selling beer, some liquor, wine, soft drinks, cigarettes, miscellaneous taxable merchandise (e.g., laundry detergent, and toys), nontaxable convenience store products (e.g., chips, candy, and phone cards), prepared fast food (e.g., tortas, burritos, ceviche, and tacos), and a minimal amount of dairy and eggs.
2. Appellant was previously audited for the period January 1, 2008, through December 31, 2010. In the prior audit, CDTFA computed a fast-food markup of 224.68 percent. In that period, however, fast food consisted of burritos only. According to the prior audit, CDTFA computed unreported taxable sales of $613,177 as follows:

[3] Appellant signed a waiver of limitations on January 23, 2015, for the period January 1, 2011, through December 31, 2011, which extended the statute of limitations until April 30, 2015, for that period. Appellant signed a waiver of limitations on March 25, 2015, for the period January 1, 2011, through March 31, 2012, which extended the statute of limitations until July 31, 2015. Thus, the July 31, 2015 NOD was timely issued. (R&TC, § 6487(a).)

[4] Appellant raises issues regarding other audit periods (i.e., 2008 to 2010 and 2014 to 2016), which are not before OTA; those audit periods will not be addressed herein.

$317,628 for unreported fast-food sales; $63,180 for unreported food truck sales; and $232,369 for unreported convenience store sales.

3. For the audit period, appellant reported total sales of $2,255,251, claimed deductions of $977,508[5] for exempt food sales and $94,723 for sales tax reimbursement included, and reported taxable sales of $1,183,020.

4. For audit, appellant provided federal income tax returns for 2011 and 2012; a profit and loss statement (P&L) for 2013; general ledgers for 2012 and 2013; cash register z-tapes[6] for the third quarter of 2012 (3Q12) and later provided cash register z-tapes for 2Q13; and merchandise purchase invoices for the month of February 2015.

5. In its preliminary review, CDTFA found immaterial differences between total sales reported on appellant's sales and use tax returns (SUTRs) and gross income reported on its federal income tax returns for 2011 and 2012. Also, CDTFA found immaterial differences between total sales reported on SUTRs and total sales recorded in the P&L for 2013.

6. Using total sales and cost of goods sold information from the federal income tax returns for 2011 and 2012 and from the P&L for 2013, CDTFA computed book markups[7] of 17.88 percent, 39.77 percent, and 26.60 percent, respectively. CDTFA decided that further investigation was warranted because there were greater fluctuations in the book markups than expected and CDTFA considered the book markups to be low for appellant's business.

7. CDTFA decided to use appellant's cash register z-tapes for 2Q13 to establish audited taxable sales for that quarter and to compute a percentage of error in reported taxable sales for 2Q13 to be applied to the remainder of the audit period.

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[5] The $977,508 includes exempt food sales of $144,410 which appellant erroneously claimed as nontaxable sales for resale.

[6] A cash register z-tape is the portion of the cash register tape that summarizes sales by category for a certain period of time (i.e., a day or a shift).

[7] "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 sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (.30 ÷ 1.00 = 0.3).

8. Appellant disagreed with the audited understatement that was calculated using the 2Q13 cash register z-tapes, and provided cash register z-tapes for 3Q12.

9. CDTFA computed taxable-to-total-sales ratios from cash register z-tapes for 3Q12 and 2Q13, which were 79.99 percent and 66.58 percent, respectively (72.69 percent combined).[8] CDTFA found the percentages to be additional evidence that appellant's reported taxable sales were understated because the computed ratios were higher than the ratio of reported taxable sales to reported total sales of 52.46 percent ($1,183,020 ÷ $2,255,251) for the audit period.

10. Appellant then opined that the transactions reflected on the z-tapes were not accurate, were not representative of appellant's business, and were not reliable. Appellant requested that appellant's z-tapes be impeached and that audited taxable sales be established using the markup audit method.

11. CDTFA accommodated appellant's request to impeach the z-tapes and utilize the markup audit method.

12. Appellant provided its purchase invoices for the month of February 2015. Using those invoices in a purchase segregation test, CDTFA compiled total purchases of $54,872.[9] It then compiled purchases of taxable convenience store merchandise ($32,980), purchases of nontaxable convenience store merchandise and phone cards ($9,820 + $550 = $10,376), fast-food purchases ($10,396),[10] and tax-paid purchases of supplies ($1,121). CDTFA subtracted the fast-food purchases ($10,396) and the cost of supplies ($1,121) from $54,872 to compute purchases of convenience store merchandise of $43,355. CDTFA computed that 76.07 percent ($32,980 ÷ $43,355) of appellant's convenience store merchandise purchases represented purchases of taxable merchandise.

13. CDTFA added the amounts of supply purchases and merchandise purchases claimed on appellant's federal income tax returns for 2011 and 2012 and recorded in appellant's P&L for 2013 and computed that supply purchases represented 2.26 percent of the total.

[8] CDTFA's computation of these ratios are not in the record. However, the record does include the results of a test conducted by appellant which shows similar percentages for each quarter (78.77 percent for 3Q12 and 64.97 percent for 2Q13).

[9] Except as otherwise noted, figures in this paragraph are rounded to the closest dollar.

[10] For ease of reference, OTA uses the term "fast-food purchases" to represent purchases of fast-food ingredients and condiments.

Since that percentage was comparable to the percentage of supply purchases to total purchases of 2.04 percent ($1,121 ÷ $54,872) computed for February 2015, CDTFA concluded that the claimed and recorded purchases of merchandise did not include any purchases of supplies. Further, CDTFA concluded that the amounts of merchandise purchases claimed on appellant's federal income tax returns for 2011 and 2012 and recorded in its P&L for 2013 were substantially accurate.

14. CDTFA computed total merchandise purchases of $1,762,746, using amounts claimed on appellant's federal income tax returns for 2011 and 2012 and recorded in its P&L for 2013. It multiplied $1,762,746 by 19.34 percent, the percentage of fast-food purchases to total purchases computed for February 2015, to compute fast-food purchases of $340,926[11] for the audit period. It deducted those purchases from $1,762,746 to compute purchases of convenience store merchandise of $1,421,820. CDTFA multiplied that figure by 76.07 percent (mentioned above) to compute purchases of taxable convenience store merchandise of $1,081,543.[12]

15. CDTFA reduced the audited purchases of taxable convenience store merchandise by 2 percent to represent losses due to pilferage and shrinkage and by 3 percent to represent the cost of taxable merchandise self-consumed,[13] to establish the audited cost of taxable merchandise sold of $1,028,119 for the audit period.

16. To establish the audited markup, CDTFA segregated the taxable purchases of $32,980 for February 2015 into various categories. Using costs from the purchase invoices for February 2015 and selling prices posted on the store shelves or obtained from appellant on April 22, 2015, CDTFA computed audited markups for each category, as follows: 27.48 percent for beer and liquor; 32.22 percent for soda; and 13.76 percent for cigarettes. For miscellaneous taxable merchandise, CDTFA was not able to obtain a sufficient sample to conduct a shelf test. Therefore, it used a markup of 50 percent,

[11] $10,396 purchases ÷ $53,751 = 19.34 percent, where $53,751 = $54,872 total purchases - $1,121 supply purchases. $1,762,746 x 19.34 percent = $340,915. The minimal difference is due to rounding.

[12] $1,421,820 x 76.07 percent = $1,081,578. The minor difference is related to rounding.

[13] The cost of self-consumed taxable merchandise is $31,800, which was established as a separate audit item. The amount has been revised in the most recent reaudit to $32,568. Appellant has not disputed the audited cost of self-consumed taxable merchandise, and it conceded that audit item in the underlying appeal with CDTFA. Accordingly, OTA does not address it further.

which it considered to be an average markup for that merchandise[14] (based on audit experience). Using the percentages of purchases in each category for February 2015, CDTFA computed an audited weighted average markup of 27.20 percent for taxable convenience store merchandise.

17. CDTFA added the audited markup to the audited cost of taxable merchandise sold of $1,028,119, to compute taxable convenience store sales of $1,307,767. It deducted reported taxable sales of $1,183,020 to compute an understatement of reported taxable convenience store sales of $124,747.

18. CDTFA concluded, based on its observation of the store and the menu, that appellant's fast-food sales met the requirements of the "80-80 rule"[15] and, on that basis, concluded that all of appellant's fast-food sales were subject to tax.

19. To establish the audited amount of fast-food sales, CDTFA reduced audited fast-food purchases of $340,926 by 3 percent for pilferage and shrinkage and 3 percent for self-consumption to compute an audited cost of fast-food purchases sold of $320,778. CDTFA added an estimated markup of 155 percent to establish audited fast-food sales of $817,983.

20. On July 31, 2015, CDTFA issued the NOD for tax of $77,899.37 and a negligence penalty of $7,789.94.

21. On August 31, 2015, appellant filed a timely petition for redetermination.

22. On August 31, 2018, CDTFA issued a decision, denying the petition.

23. This timely appeal followed.

24. On July 24, 2019, OTA requested additional briefing from the parties. Specifically, OTA asked CDTFA to analyze a purchase segregation for April 2013 that appellant had included with its opening brief. OTA also requested that CDTFA provide an analysis of whether its audit findings were reasonable.

[14] The markup for miscellaneous taxable merchandise will have limited effect on the audit findings because that merchandise represented only 3.21 percent of appellant's purchases.

[15] As discussed below, if 80 percent of a retailer's sales are sales of food and 80 percent of his or her sales of food are subject to tax (i.e., sales of hot food or sales of cold food for consumption on the retailer's premises), then 100 percent of his or her sales are subject to tax. This application of tax is known as the "80-80" rule. (Cal. Code Regs., tit. 18, § 1603(c)(3).)

25. In response, CDTFA stated it had reviewed appellant's purchase segregation for April 2013 and had identified various errors (i.e., purchases of taxable beverages, such as sparkling water, "Absolute Zero" from Heimark, and Red Bull, classified as nontaxable beverages; and cigarette purchases inadvertently posted to an expense account). After correcting the errors, CDTFA incorporated the April 2013 data into a reaudit. CDTFA combined appellant's purchase segregation test for April 2013 with its segregation test for February 2015 and computed that 74.34 percent of appellant's purchases represented taxable merchandise. Thus, CDTFA reduced the percentage of taxable-to-total-purchases from 76.07 percent to 74.34 percent. Also, CDTFA computed that fast-food purchases represented 15.46 percent of merchandise purchases, rather than 19.34 percent. In addition, CDTFA computed a markup of 26.89 percent, rather than 27.2 percent for taxable goods sold in the store. Further, CDTFA used the April 2013 general ledger restaurant sales and purchases to compute a markup of 106.88 percent,[16] which it used to compute audited fast-food sales instead of the estimated markup of 155 percent it had used in the audit.

26. In the reaudit, the audited taxable sales in the store increased by $28,369,[17] from $1,307,767 to $1,336,136, with a corresponding increase in the understatement related to taxable store sales, from $124,747 to $153,116. Also, the audited taxable fast-food sales decreased by $254,045, from $817,984 to $563,939. Accordingly, CDTFA reduced the audited understatement of reported taxable measure from $974,532 to $749,623 ($153,116 + $563,939 + $32,568 unreported cost of taxable self-consumed goods). To address appellant's assertion that sales fluctuated due to tourism, CDTFA agreed to allocate the understatement for each year of the audit period using the reported sales percentages submitted by appellant to the City of La Quinta for the year 2016 (29 percent, 25 percent, 22 percent, and 24 percent for the first through fourth calendar quarters of each year, respectively).

27. On January 24, 2020, appellant responded stating its continued disagreement.

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[16] CDTFA used a markup of 106.88 percent, even though that markup is lower than it generally expects for sales of fast food.

[17] This increase is the result of an increased amount of purchases associated with the store, because of the decreased amount of purchases allocated to fast-food purchases. The increased amount of audited store purchases also resulted in an increased cost of self-consumed taxable merchandise.

DISCUSSION

Issue 1: Whether appellant has shown that further adjustments are warranted to the audited taxable measure.

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) The Sales and Use Tax 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 on request by CDTFA. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

If CDTFA is not satisfied with the amount of tax or other amount required to be paid by any person, or if any person fails to make a return, CDTFA may compute and determine the amount required to be paid upon the basis of any information within its possession or that 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 Amaya*, 2021-OTA-328P.) If CDTFA meets 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*.) To satisfy the burden of proof, a taxpayer must prove that (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not correct. (*Appeal of AMG Care Collective*, *supra*.)

Here, appellant's book markups varied markedly (18 percent in 2011, 40 percent in 2012, and 27 percent in 2013 (rounded)) rather than remaining relatively consistent. Also, CDTFA noted that the ratios of taxable sales to total sales computed from cash register z-tapes for 3Q12 and 2Q13 were 80 percent and 67 percent (rounded) respectively, while the ratio of reported taxable sales to total sales was lower, 52 percent. Further, appellant opined that appellant's z-tapes were unreliable and requested an indirect audit methodology. Under these circumstances, OTA finds that CDTFA's use of an indirect method was reasonable and rational. Moreover,

OTA finds that CDTFA's use of a markup method, a recognized and accepted accounting procedure, was reasonable and rational. (*Appeal of Amaya*, *supra*.)

Sales of taxable convenience store merchandise

At appellant's request, CDTFA used the markup method to establish audited taxable sales at the convenience store. It used the purchase invoices for February 2015 to conduct a purchase segregation, compiling fast-food purchases, purchases of both taxable and nontaxable store merchandise, and tax-paid purchases of supplies. Subsequently, CDTFA conducted a reaudit by combining the results of its 2015 purchase segregation test with appellant's test for April 2013 after CDTFA made adjustments for errors. CDTFA used the combined test to compute percentages of total purchases. CDTFA then applied those percentages to the amounts of merchandise purchases, found in appellant's records, to compute audited fast-food purchases and audited purchases of taxable store merchandise. CDTFA reduced audited purchases of taxable store merchandise by estimated pilferage and shrinkage losses, computed at 2 percent, and by an estimated cost of self-consumed taxable merchandise, computed at 3 percent, to establish the audited cost of taxable store merchandise sold during the audit period.

CDTFA segregated the purchases of taxable store merchandise for February 2015 into various merchandise categories and prepared shelf tests, using costs from the February 2015 purchase invoices and selling prices in effect on April 22, 2015, to establish markups for each category of merchandise. It used those markups and the percentages of merchandise in each category, as computed in the combined purchase segregation test, to compute an audited weighted average markup of 26.89 percent. CDTFA added the audited markup to the audited cost of taxable store merchandise sold to compute audited taxable sales of store merchandise of $1,336,136, which exceeded reported taxable sales by $153,116.

Accordingly, OTA finds that CDTFA has met its initial burden to show that its determination was reasonable and rational, and the burden of proof shifts to appellant to show that adjustments are warranted.

Appellant argues that there were no controls over inventories. As a result, appellant asserts that there were significant losses due to a major break-in, during which a significant amount of merchandise was stolen, and daily petty thefts. However, there is no evidence, such as a police report, to support appellant's assertion that a significant amount of merchandise was

stolen in a major break-in. Accordingly, OTA finds that appellant has not shown that an adjustment is warranted with respect to the purported break-in.

Regarding the daily petty thefts, CDTFA estimated appellant's pilferage and shrinkage losses at 2 percent of merchandise available for sale. Generally, CDTFA estimates such losses at 1 percent, unless the taxpayer provides substantiating evidence of greater losses. (See CDTFA's Audit Manual, section 0407.10.)[18] Although there is no evidence in the record that appellant substantiated unusually high losses, CDTFA made an allowance of 2 percent for taxable store sales.[19] In the absence of supporting evidence, OTA finds no basis for increasing the allowance for losses due to pilferage and shrinkage.

Appellant also asserts that CDTFA has disregarded appellant's purchase segregation for April 2013. However, CDTFA prepared a reaudit in which it combined the purchase segregations for February 2015 (conducted by CDTFA) and April 2013 (conducted by appellant). Accordingly, this particular argument is unpersuasive.

Appellant also argues that CDTFA should not have used information from a month outside the audit period to conduct its purchase segregation test. However, during the audit CDTFA analyzed the z-tapes appellant provided; and upon reviewing the results, it was appellant that asserted those z-tapes were inaccurate and unreliable. At that time, appellant requested the mark-up method be used, and appellant provided the purchase invoices for February 2015 for the test. (See R&TC, § 6481.) CDTFA only used the February 2015 data to perform a test to establish the percentages of purchases in various merchandise categories. CDTFA applied those percentages to information regarding appellant's purchases during the audit period. OTA notes that the percentages in the combined purchase segregation test used for the reaudit were not markedly different from those CDTFA computed using data for February 2015.[20] The close similarity of the percentages calculated for February 2015 and those in the combined test is

[18] The Audit Manual summarizes CDTFA's audit policies and procedures but has no precedential value in an appeal before OTA. (*Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

[19] The total pilferage allowed for the audit period is $22,154 or approximately $20 per day ($22,154 ÷ 365 days ÷ 3 years).

[20] In the combined test, CDTFA computed a percentage of taxable-to-total-purchases of 74.34 percent, rather than 76.07 percent. Similarly, the percentages of purchases in each merchandise category did not change dramatically in the combined test (65 percent for beer in both February 2015 and the combined test; 18 percent for soda in February 2015 and 16 percent in the combined test; 14 percent for cigarettes in February 2015 and 16 percent in the combined test; and 3 percent for miscellaneous taxable merchandise percent in both tests).

evidence that February 2015 was representative of appellant's business during the audit period. Further, appellant did not provide complete purchase invoices for any other months. Thus, CDTFA developed representative percentages of purchases in each merchandise category based on the best available information, which CDTFA used to compute the audited markups for each merchandise category and then computed the overall weighted average markup for taxable store merchandise. Moreover, OTA finds that appellant has not provided evidence to show that further adjustments are warranted to the audited cost of taxable merchandise sold in the store or the audited markup for those sales.

Appellant argues that economic activity in the Coachella Valley varies considerably throughout the year due to seasonal tourism (e.g., Coachella Music Festival and Stagecoach). This argument does not impact the analysis of audited taxable sales, in the aggregate, because CDTFA computed them using appellant's actual purchases. If appellant's business were to slow, at certain times during the year, then there would be a corresponding decrease in purchases during those periods. Therefore, any variation in sales throughout the year would not impact the audited taxable sales, which CDTFA computed by applying the audited percentage of taxable purchases to the annual amount of purchases and then adding the audited markup. To address the allocation of sales throughout each year, CDTFA agreed to allocate the understatement for each year of the audit period using the reported sales percentages submitted by appellant to the City of La Quinta for the year 2016.[21] OTA finds that CDTFA addressed appellant's assertion that its business varies during the year and appellant has not shown that further adjustments are warranted based on the variable economic activity.

Fast-food sales

In general, sales of food are exempt from tax. (R&TC, § 6359.) However, the exemption does not apply to all sales of food. As relevant here, sales of food are subject to tax if the food is sold for consumption at facilities provided by the retailer or if the food is sold as hot prepared food products. (R&TC, § 6359(d)(2) and (d)(7).)

When more than 80 percent of a retailer's gross receipts are from sales of food products, and over 80 percent of its retail sales of food are subject to tax, then cold food sold in a form suitable for consumption on the retailer's premises is subject to tax even if it is purchased "to

[21] The allocation was approximately 29 percent, 25 percent, 22 percent, and 24 percent, respectively, for the first through fourth calendar quarters of each year in the audit period.

go." (R&TC, § 6359(d)(6).) When a retailer's sales fit within this provision, known as the "80- 80 rule," the retailer may avoid its application by keeping a separate accounting of its sales to-go of cold food in a form suitable for consumption on the retailer's premises. (R&TC, § 6359(f); Cal. Code Regs., tit. 18, § 1603(c)(1)(A).)

CDTFA concluded that more than 80 percent of appellant's fast-food sales were taxable sales of fast food. Appellant has not specifically protested that finding.[22] Accordingly, OTA finds it is undisputed that all of appellant's fast-food sales are subject to tax.

Appellant disputes the estimated markup of 155 percent that was used in the audit to compute audited sales of fast food. Appellant states that the markup rate originally calculated by the auditor was 46.85 percent.[23] Appellant argues that there was no basis for increasing the audited markup from 47 percent to 155 percent. Appellant also contends that the estimated markup for fast food should be further reduced from 106.68 percent to 77.09 percent. In support, appellant proposes an average monthly sales amount of $11,968.

Here, the markup of about 47 percent was not an audited markup computed from known sales and purchase costs. Instead, it was a book markup, computed from appellant's records. Since CDTFA has shown that appellant's records are not reliable, there is no basis to conclude that the book markup for fast-food sales should be used in the computation of audited fast-food sales. Further, the audited markup for fast food has been reduced from 155.00 percent to 106.88 percent in the reaudit. The 106.88 percent audited markup was computed using data from appellant's general ledger regarding fast-food sales for April 2013 and purchases during the same purchasing cycle. The average monthly fast-food sales amount proposed by appellant does not accurately compare fast-food purchases (i.e., costs) during the same purchase cycle. OTA finds that CDTFA used the best available information to compute a representative markup for fast-food sales. Appellant has not provided source documents or other competent evidence that the markup of 106.88 percent should be reduced.

[22] Appellant does argue that it sells ceviche or shrimp cocktails, which would be a cold prepared food, but it has not argued that sales of cold prepared food represent more than 20 percent of the fast-food sales.

[23] This calculation does not appear directly in the record. However, on audit workpaper Schedule 12A-2, CDTFA used recorded fast-food sales for April 2013 to project the fast-food sales for one quarter. It then compared that figure to audited costs of hot prepared food for one quarter (the amount for the year 2013 divided by 4). Using those figures, CDTFA computed a book markup for fast-food sales of 47.75 percent.

Appellant's next argument, regarding the audited fast-food sales, is that the audited monthly average of $22,722 seems excessive in comparison to the recorded fast-food sales for April 2013 of $13,981. In the reaudit, however, the monthly average for fast-food sales was reduced to $15,665 ($563,939 ÷ 36 months). Appellant has not provided credible evidence to show that further adjustments are warranted to the audited fast-food purchases or the audited markup for fast food.

Appellant also argues that CDTFA erred in calculating the total fast-food sales because it did not adjust for shrinkage and spoilage. In the reaudit, however, CDTFA used recorded sales of fast foods (from cash register z-tapes) and recorded fast-food purchases (from the general ledger) for April 2013 to compute the actual markup during the same purchasing cycle. Thus, the recorded amounts of sales and purchases would have already incorporated any losses due to pilferage or shrinkage that had occurred in April 2013. As a result, adjustments for losses due to pilferage or shrinkage were incorporated in the computation of the markup of 106.88 percent.

Based on the foregoing, OTA finds that no adjustments are warranted to the audited fast-food sales.

Reasonableness Test

Appellant argues that the audit results are not reasonable and observes that CDTFA's Audit Manual requires that each audit be analyzed for reasonableness. Appellant asserts that, if the sales established by audit were accurate, then appellant would have enjoyed income of $400,000 more each year than was reported. Appellant also asserts that it experienced economic hardships during the audit period that would not have occurred if it had that additional income.

Regarding the reasonableness of the audit results, CDTFA asserts that the majority of the understated taxable store sales were the result of errors in allocating taxable and nontaxable sales. Also, CDTFA asserts that the total sales computed from audited taxable sales are not significantly different from appellant's recorded total sales. OTA reviewed CDTFA's computations and have identified an error. Specifically, CDTFA has divided audited taxable sales by 74.34 percent to compute the "estimated gross sales." That procedure is not accurate because 74.34 percent represents the percentage of taxable-to-total-purchases for the store merchandise only.

Instead, OTA computed audited taxable store sales of $1,336,136 ($1,183,020 reported taxable sales + $153,116 understated) and divided that figure by 74.34 percent to compute

estimated total store sales of $1,797,331. Then, OTA added audited fast-food sales of $563,939 to compute estimated total sales for the business of $2,361,270. That figure is only $106,019 more than appellant's reported total sales for the audit period of $2,255,251. This computation clearly supports CDTFA's assertion that the majority of the audited understatement of reported taxable sales represents errors in allocating taxable and nontaxable sales. It also effectively counters appellant's assertion that the audit results are not reasonable because they reflect additional income for appellant of $400,000 per year.

OTA finds that the audit results are reasonable. Appellant has not provided documentary or other evidence to show otherwise. Thus, no further adjustment is warranted on the basis that the audit results are not reasonable.

Taxpayer's rights

Appellant argues that in the prior audit, the audit at issue, and the subsequent audit, CDTFA violated the taxpayer's rights in various ways. As noted previously, the only audit in the present appeal to OTA is for the period January 1, 2011, through December 31, 2013. OTA does not have the authority to address actual or alleged violations of due process at the agency (CDTFA) level unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal. (Cal. Code Regs., tit. 18, § 30104(d).) Appellant has not shown how any alleged violation satisfied any of these conditions. To the extent that appellant believes it was treated unfairly, it may contact CDTFA's Taxpayers' Rights Advocate Office or pursue some other remedy, if available.

Issue 2: Whether the negligence penalty was properly imposed.

R&TC section 6484 provides that if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include, but are not limited to, the following: (1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (2) bills, receipts, invoices, cash register z-

tapes, or other documents of original entry; and (3) schedules of working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and provide complete and accurate records will be considered evidence of negligence or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1698(k).)

When errors are continued from one audit period to the next, the imposition of a negligence penalty is warranted. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 321-324.)

Appellant contends that it made records available to the auditor (e.g., cash register z-tapes, financial statements, tax returns, checks, bank statements, etc.) and, therefore, appellant was not negligent in keeping records. Appellant asserts that it was not negligent in preparing returns because the returns were timely prepared based on appellant's records. Appellant also asserts that CDTFA never explained the evidence and facts upon which the auditor relies to support the recommendation for the imposition of the negligence penalty. In addition, appellant asserts that the negligence penalty should not be imposed because it did not receive the audit report for the prior audit until the end of the current audit.

Here, a 10 percent negligence penalty was imposed because appellant's records were inadequate for sales and use tax purposes (i.e., impeached z-tapes) and appellant made similar errors in the prior audit period. For the prior audit period, CDTFA determined that appellant had unreported taxable sales of $613,177 ($317,628 for unreported fast-food sales; $63,180 for unreported food truck sales; and $232,369 for unreported taxable convenience store sales). Although appellant asserts that it did not receive a copy of the prior audit report until after this audit had begun, appellant would have gained knowledge of the record keeping requirements prior to the issuance of the audit report (e.g., through the audit process) or at least by July 8, 2012, when CDTFA issued the NOD for the prior audit period. The NOD was issued in the 3Q12; however, there was not a noticeable increase in reporting accuracy for that quarter. In fact, appellant requested to impeach its 3Q12 records because they were unrepresentative and unreliable.

While the unreported taxable convenience store sales of $153,116 is less than the amount in the prior audit, unreported taxable convenience store sales are still a large portion of the overall audited taxable measure. Furthermore, the unreported fast-food sales increased substantially ($232,369 to $563,939). The total unreported taxable measure was significant,

$749,623, compared to reported amounts ($749,623 ÷ $1,183,000). Based on the foregoing, OTA finds that the negligence penalty was properly imposed.

HOLDINGS

1. Appellant has not shown that further adjustments are warranted to the audited understatements of reported taxable sales.
2. The negligence penalty was properly imposed.

DISPOSITION

Sustain CDTFA's decision to reduce the tax liability from $77,899.37 to $60,170.00 and the penalty from $7,789.94 to $6,017.00, and to deny the remainder of the petitioned amount.

DocuSigned by:
Josh Aldrich
48745BB806914B4...

Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
DC88A60D8C3E442...

Keith T. Long
Administrative Law Judge

DocuSigned by:
8A4294817A67463...

Andrew Wong
Administrative Law Judge

Date Issued: 6/8/2023