

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of: F. HERNANDEZ, dba Plaza Tires))))))	OTA Case No. 220911464 CDTFA Case ID: 003-187-508
---	----------------------------	--

OPINION

Representing the Parties:

For Appellant:	F. Hernandez
For Respondent:	Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Lisa Burke, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, F. Hernandez, dba Plaza Tires (appellant) appeals an August 26, 2022 Decision (Decision) issued by the California Department of Tax and Fee Administration (respondent)¹ denying appellant’s petition for redetermination of an October 7, 2021 Notice of Determination (NOD) for tax of \$27,909,² plus applicable interest, and a negligence penalty of \$2,791 for the period July 1, 2017, through June 30, 2020 (liability period).³ The Decision deleted the negligence penalty and ordered a reaudit, which later reduced the taxable measure by \$50,382, from \$294,306 to \$243,924.

The Office of Tax Appeals (OTA) decides this matter on the basis of the written record pursuant to California Code of Regulations, title 18, section 30209(a) because appellant waived the right to an oral hearing.

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 respondent. (Gov. Code, § 15570.22.) For ease of reference, when this Opinion refers to events that occurred before July 1, 2017, “respondent” refers to the board.

² This Opinion rounds amounts to the nearest dollar, which may cause some immaterial differences.

³ The NOD was timely issued because on November 17, 2020, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which allowed respondent until October 31, 2021, to issue an NOD for the period July 1, 2017, through June 30, 2018. (R&TC, § 6487(a), § 6488.)

ISSUE

Is a further reduction to the determined measure of tax warranted?

FACTUAL FINDINGS

1. Appellant has operated a tire shop making retail sales of new and used tires and providing installation and repair services since November 13, 2012.
2. According to the audit workpapers, appellant provided hand-written sales receipts to an independent tax professional, who created spreadsheets from which sales and use tax returns were prepared. For the liability period, appellant reported total sales (including sales tax reimbursement) of \$895,465 and claimed deductions of \$64,402 for sales tax reimbursement included in reported total sales and \$152,183 for nontaxable labor, which resulted in reported taxable sales of \$678,880.
3. For audit, appellant provided federal income tax returns (FITRs) for 2017 and 2018; bank statements for 2019; a sales journal for 2019; recorded quarterly purchase information for 2018 and 2019 (with invoices); recorded quarterly sales information for 2019 (with invoices); Form 1099-K (1099-K) data for the years 2017 through 2019;⁴ and purchase and sales invoices for the period December 8, 2019, through December 14, 2019. In addition, respondent obtained additional information regarding appellant's purchases through a vendor survey.
4. The evidence (1099-K data) shows that appellant's sales during the liability period included sales for which customers used electronic payments totaling \$1,017,811.
5. Respondent compared appellant's reported taxable sales for the years 2017 and 2018 with the cost of goods sold (COGS) reported on appellant's FITRs for each respective year and computed book markups of -0.15 percent for 2017, 27.83 percent for 2018, and

⁴ Form 1099-K is used to report payments made to a taxpayer by payment card (e.g., credit or debit cards) processing companies (e.g., Visa, MasterCard, or American Express) or third-party network (e.g., Venmo or PayPal). It is authorized by the IRS for tax administration purposes. (See 26 C.F.R. § 1.6050W-1 and Treas. Reg. § 1.6050W-1.)

- 16.50 percent for both years combined.⁵ Respondent believed that the negative book markup for 2017 and low book markup⁶ for 2018 indicated that appellant's reported taxable sales likely were understated.⁷
6. Respondent compared appellant's claimed nontaxable sales of labor with its reported total sales, excluding sales tax reimbursement, for each quarterly period during the years 2017 to 2019 to compute ratios of claimed nontaxable labor to reported total sales. Respondent then applied those ratios to the total electronic payment amounts shown in the 1099-K data for each quarterly period to estimate nontaxable labor sales. Reducing the amounts shown in the 1099-K data for each quarterly period during the years 2017 through 2019 by the estimated nontaxable labor sales and by the included sales tax reimbursement resulted in estimated taxable sales of tires and parts of \$771,988. This is \$129,525 more than appellant reported in taxable sales for the same period.⁸
 7. Appellant provided bank statements for 2019 for one bank account, which showed merchant deposits, such as those that would be shown on 1099-Ks, totaling \$326,477 but no cash deposits. The merchant deposits shown were \$11,152 less than payments shown on the 1099-Ks for 2019.
 8. Respondent found that appellant's reported taxable sales were substantially understated.
 9. Respondent decided to do a markup analysis to establish audited taxable sales. To establish audited COGS, respondent surveyed appellant's vendors and compared the information obtained from four of appellant's five main vendors with purchase information recorded and provided by appellant for the years 2018 and 2019. This comparison showed that purchases (totaling \$360,420) reported by appellant's vendors exceeded appellant's recorded purchases from those same four vendors (totaling

⁵ "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 \$7 and it charges customers \$10, the markup is \$3. The formula for determining the markup percentage is $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($3 \div 7 = 0.42857$). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. When a markup calculation is based on actual purchase costs and sales prices, a low or negative book markup indicates that the retailer sold goods at a small profit or a loss (i.e., less than the retailer's cost).

⁶ Respondent expected the markup to be approximately 50 percent.

⁷ Appellant claimed that much of the inventory appellant purchased during the liability period was not sold until after the liability period, which made it appear that appellant's markup was low when, in fact, it was not low.

⁸ This amount does not include sales for cash.

\$276,790) by \$83,630, or 30.21 percent. Therefore, respondent increased appellant's total recorded merchandise purchases of \$334,558 for the years 2018 and 2019 by 30.21 percent to establish audited merchandise purchases of \$435,629 for those two years.

10. Respondent added beginning inventory of \$22,180 reported on appellant's FITR for 2018 to audited merchandise purchases of \$435,629 and then subtracted estimated ending inventory of \$9,809 to establish audited COGS of \$448,000 for the years 2018 and 2019.⁹
11. According to the audit workpapers, respondent recommended a one-month shelf test for new tire sales, but appellant provided records for a one-week test only.¹⁰ The audit workpapers indicate that appellant provided only 15 sales invoices. For at least four sales without matching purchase invoices, respondent relied on costs shown for comparable tires. The result of the test was an average markup of 29.20 percent.
12. Adding the audited markup of 29.20 percent to audited COGS for the years 2018 and 2019 resulted in audited taxable sales of new tires and parts of \$302,851 for 2018 and \$275,965 for 2019. Respondent compared audited taxable sales with appellant's reported taxable sales for each respective year and computed error rates of 13.44 percent and 18.11 percent for 2018 and 2019, respectively.
13. Respondent multiplied appellant's reported taxable sales for the third quarter of 2017 (3Q17) through 4Q18 and 1Q19 through 2Q20 by error rates of 13.44 percent and 18.11 percent, respectively, to establish unreported taxable sales of new tires and parts of \$106,932 for the liability period.
14. Appellant told respondent that he did not purchase used tires for resale, but instead sold used tires left by his customers when they purchased new tires. To establish audited taxable sales of used tires, respondent examined appellant's recorded tire sales of \$47,625 for 4Q19, of which \$15,615 represented sales of used tires.¹¹ Respondent estimated that

⁹ According to the audit workpapers, appellant's 2019 FITR was not available at the time of the audit. Consequently, respondent calculated that the ending inventory for 2018 was approximately 66.50 percent of the beginning inventory for that year and then applied that percentage to the beginning inventory for 2019, which would equal the ending inventory for 2018, to estimate the ending inventory of 2019.

¹⁰ A shelf test is an accounting comparison of known costs and associated selling prices, which is used to compute markups.

¹¹ According to the audit workpapers, appellant provided a hard copy of a quarterly sales journals for 2019, but there was a problem exporting most of the data to a usable format. Only the data for 4Q19 was usable.

- appellant's sales of used tires averaged \$15,615 per quarter and established audited taxable sales of used tires of \$187,374 for the liability period (\$15,615 x 12).¹²
15. Respondent added audited taxable sales of used tires of \$187,374 to unreported taxable sales of new tires and parts of \$106,932 to establish unreported taxable sales of \$294,306.
 16. Respondent concluded that appellant was negligent in connection with its obligations to maintain and provide adequate records and accurately report taxes due.
 17. Respondent issued the NOD, which included a negligence penalty.
 18. Appellant filed a timely petition for redetermination.
 19. Respondent agreed to delete the negligence penalty.
 20. On March 10, 2022, the parties participated in an appeals conference as part of respondent's internal appeals process. Following the appeals conference, appellant provided invoices and receipts purporting to show the purchase of new tires during the liability period and the sale of those same tires after the liability period. Based thereon, appellant argued that since the tires shown in the sales invoices could be matched with tires shown in the purchase invoices, adjustments to the audited COGS used in the markup analysis were warranted to exclude the costs of tires that remained unsold until after the end of the liability period.
 21. Respondent reviewed the new documents and found that it was not possible to trace purchase invoices to the handwritten sales invoices due to illegible documents, a lack of clear descriptions of the tires purchased and sold, and incomplete or inconsistent information. On that basis, respondent concluded that no adjustment was warranted.
 22. Respondent issued the Decision denying the petition.
 23. This timely appeal followed.
 24. During this appeal to OTA, respondent agreed that appellant's recorded purchases of supplies should be excluded from the audited COGS in the markup analysis and that the audited COGS should be reduced by 1 percent to allow for shrinkage. Respondent prepared a reaudit on those bases, which resulted in a reduction of \$50,382 to the taxable measure, from \$294,306 to \$243,924.

¹² OTA cannot determine the cause of the \$6 difference (\$187,380 - \$187,374), but finds it is too small to warrant further comment.

DISCUSSION

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.) To properly administer the Sales and Use Tax Law and 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.)

If respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, respondent 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, 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.*)

The business records appellant provided for audit were inadequate to explain and verify recorded or reported amounts. Respondent's comparison of appellant's reported taxable sales with the COGS reported on appellant's FITRs showed a negative book markup for 2017 and a markup that was lower than expected for 2018. Respondent then attempted to estimate appellant's taxable sales by excluding estimated nontaxable labor charges and sales tax reimbursement from the recorded electronic payments shown in the available 1099-K data and found that the estimated taxable sales paid by credit card or other electronic means substantially exceeded appellant's reported taxable sales for the same period. Given the limited records, the evidence suggesting unrealistic book markups, and the evidence suggesting that appellant

understated reported taxable sales, OTA finds that respondent's use of an indirect audit to establish audited taxable sales of new tires and parts was reasonable.¹³

A markup audit is an indirect audit. It is a generally accepted sales and use tax accounting procedure and is frequently used by respondent to determine audited sales. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613; see also respondent's Audit Manual, § 0407.10.)¹⁴ Respondent's decision to employ a markup audit was rational. If properly done, a markup audit can be used to calculate a reasonable estimate of taxable sales.

Given respondent's preliminary conclusion that appellant's records were unreliable, respondent's decision to survey appellant's vendors to verify appellant's tire purchases during the years in question was reasonable. Records maintained by third parties can be used to verify amounts recorded or reported by taxpayers. Using that third-party data, respondent was able to determine that appellant's new tire purchases were over 30 percent higher than indicated by the records appellant provided. Respondent increased the purchase amounts accordingly, added beginning inventory, and subtracted ending inventory for each year to calculate appellant's COGS during 2018 and 2019.

Respondent then applied the markup calculated from appellant's records and calculated audited taxable sales for each year (2018 and 2019). Because the liability period covered the last two quarters of 2017 and the first two quarters of 2020, respondent calculated the ratio of audited taxable sales to reported taxable sales for 2018 (13.44 percent) and 2019 (18.11 percent) and applied the former to the period July 1, 2017, through December 31, 2018, and the latter to the period January 1, 2019, through June 30, 2020, to calculate unreported taxable sales of new tires. OTA finds that respondent correctly used the markup analysis to determine audited, taxable new tire sales and that the resulting estimate (after the adjustments conceded by respondent) was reasonable.

¹³ A direct audit is one that enables respondent to determine taxable sales from the taxpayer's business records without estimates or extrapolation, such as by simple tabulation of taxable sales evidenced by sales invoices or cash register tapes. A direct audit based on complete and accurate business records is generally expected to be the most accurate. An indirect audit, while not as accurate as a direct audit, is usually required when a taxpayer's records are incomplete or unreliable.

¹⁴ Respondent's Audit Manual, which generally describes respondent's audit policies and procedures, does not constitute legal authority. Nevertheless, it can be a useful resource to which OTA may look for assistance interpreting, or determining the weight to be given to, audit findings. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25; *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.)

OTA has also examined respondent's calculation of appellant's used tire sales, which was based on limited sales records provided by appellant. OTA finds that it was reasonable and rational for respondent to conclude that the used tire sales during 4Q19 represented a reasonable estimate of used tire sales during each of the 12 quarters in the liability period. Respondent added audited taxable used tire sales to audited taxable new tire sales, and from that sum, respondent deducted reported taxable sales to calculate the deficiency measure at issue.

OTA finds that respondent: used an audit methodology that was rationally calculated to estimate taxable sales; correctly used that methodology to calculate an estimate of appellant's taxable sales for the liability period; and determined a reasonable estimate of appellant's unreported taxable sales for the liability period. The burden of proof thus shifts to appellant to establish that a reduction to the audited taxable measure is warranted.

Appellant does not question respondent's decision to use a markup analysis in the audit, respondent's reliance on the vendor purchase data, or respondent's calculation of the measure of used tire sales. Rather, appellant disputes the inventory amounts that respondent used in its calculations and alleges that during the liability period, he purchased and stored offsite substantial new tire inventory for a planned second location.¹⁵ Appellant further asserts that after the liability period, plans for a second location were abandoned, and appellant sold the accumulated inventory after the liability period. In support of this assertion, appellant provided various purchase and sales invoices to respondent.¹⁶

Appellant's argument is not persuasive. It makes no sense that appellant would have purchased thousands of dollars – if not tens of thousands of dollars – in inventory for a store that appellant only hoped to open many months, if not years, in the future. Appellant's statement that he considered the purchases an "investment" is not credible. There is no evidence of a shortage of new tires on the wholesale market during the time in question, and tires are not an asset that appreciates as they sit in storage. Furthermore, appellant reported beginning and ending 2018 inventory to the IRS, and at least 58 of the 184 tires identified in the purchase invoices were

¹⁵ According to respondent's Decision, appellant stated that he purchased approximately 500 new tires for this purpose.

¹⁶ Appellant did not provide the documents to OTA, but at least some were included as exhibits to respondent's Decision.

purchased before the end of 2018.¹⁷ If any of those tires remained in inventory at the end of 2018, they would have been accounted for in inventory amounts reported to the IRS, which respondent took into consideration when calculating appellant’s COGS in 2018.¹⁸ Furthermore, OTA has examined the documents appellant provided and finds that they do not support appellant’s argument because many are illegible and, taken as a whole, they lack sufficient detail to prove that respondent’s audit overstates the COGS during the liability period. Therefore, OTA finds that appellant has not carried his burden of proving he is entitled to a further reduction to the measure of unreported taxable sales.

HOLDING

A further reduction to the determined measure of tax is not warranted.

DISPOSITION

Respondent’s actions reducing the amount of unreported taxable sales from \$294,306 to \$243,924 and deleting the negligence penalty are sustained, but the petition is in all other respects denied.

DocuSigned by:
Michael F. Geary
1A9B5ZEF88AC4C7/...
Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
Sheriene Anne Ridenour
87F043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
Josh Lambert
CB1F7DA37831416...
Josh Lambert
Administrative Law Judge

Date Issued: 7/24/2024

¹⁷ OTA cannot read the dates on 3 of the 10 purchase invoices, but at least 44 tires were purchased on March 3, 2015, almost two years before the liability period and almost five years before the COVID-19 pandemic.

¹⁸ There is nothing in the record to show that appellant has amended the FITR.