

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 220911335
H 3 LIQUORS, INC.) CDTFA Case ID: 001-810-023
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OPINION

Representing the Parties:

For Appellant: Sue Amicone, Representative
Kiet Hong, President

For Respondent: Randy Suazo, Hearing Representative
Christopher Brooks, Attorney
Jason Parker, Chief of Headquarters Ops.

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

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, H 3 Liquors, 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) issued October 17, 2019. The NOD is for tax of \$84,708, plus applicable interest, for the period July 1, 2015, through June 30, 2018 (audit period).²

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Suzanne B. Brown, and Josh Aldrich held a virtual oral hearing for this matter on May 23, 2024. At the conclusion of the hearing, OTA held the record open to provide appellant with an additional copy of CDTFA’s exhibits, and to allow appellant the opportunity to provide any

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. (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.

² The NOD was timely issued because on August 1, 2019, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which allowed CDTFA until January 31, 2020, to issue an NOD for the period July 1, 2015, through September 30, 2016. (R&TC, §§ 6487(a), 6488.)

additional response. On July 10, 2024, the record was closed, and this matter was submitted for an Opinion.

ISSUE

Whether an adjustment to the amount of unreported taxable sales is warranted.

FACTUAL FINDINGS

1. Appellant operated a liquor store selling beer, wine, liquor, carbonated beverages, tobacco products, food, sundry items, and lottery tickets in Long Beach, California.
2. For the audit period, appellant reported total sales of \$2,010,453 and claimed deductions of \$560,615 for exempt sales of food products and \$126,446 for sales tax reimbursement included in reported total sales, which resulted in reported taxable sales of \$1,323,392.
3. During CDTFA's audit, appellant provided its federal income tax returns (FITRs) for 2015, 2016, and 2017; bank statements for 2016; profit and loss (P&L) statements for 2015 and 2016; vendor purchase history for the second quarter of 2015 (2Q15) through 2Q18; purchase invoices for June 2018, and a schedule of weekly self-consumption of taxable items.³
4. Appellant did not provide guest checks, purchase journals, or sales journal for the audit period. Appellant also did not provide a complete set of cash register z-tapes or purchase invoices.⁴ As noted below in Factual Finding 20, after CDTFA held an appeals conference, appellant provided z-tapes for 2Q18 and purchase invoices for June 2018.
5. CDTFA determined that appellant's bank deposits were in excess of reported sales in the amount of \$20,081 in 1Q16 and \$32,923 in 3Q16, and reported sales were in excess of

³ CDTFA's records indicate the following events: (1) on April 4, 2018, Mr. Hong, appellant's president, called CDTFA and stated that he received CDTFA's letters, such as an audit engagement letter on March 29, 2018; (2) CDTFA asked Mr. Hong to provide a power of attorney (POA) for appellant's CPA representative, Mr. Dang, so that CDTFA could "discuss the audit"; (3) CDTFA received the POA, and on June 5, 2018, CDTFA visited the CPA's office to pick up books and records; (4) on September 25, 2018, CDTFA visited appellant's location to conduct the shelf test; (5) on August 31, 2018, CDTFA visited appellant's location to observe the business and to obtain purchase invoices for the shelf test; and (6) on August 24, 2018, CDTFA visited the CPA's office.

⁴ Cash register z-tapes summarize recorded sales by category for a given period of time.

- bank deposits of \$4,407 in 4Q16. As a result, CDTFA determined that not all sales were deposited into appellant's bank account.⁵
6. CDTFA determined that appellant did not provide sufficient documentation to verify taxable sales and considered appellant's books and records to be inadequate.
 7. CDTFA compared the costs of goods sold reported on appellant's FITRs for 2015 through 2017 with appellant's reported total sales, excluding sales tax reimbursement (ex-tax),⁶ for the same periods and computed book markups⁷ of 32.85 percent for 2015, 33.66 percent for 2016, and 30.24 percent for 2017.⁸ CDTFA found that the overall markup percentages were reasonable for this business.
 8. However, CDTFA compiled purchases of taxable merchandise (taxable purchases) from the P&L statements, and a comparison of taxable purchases with appellant's reported taxable sales for the same periods showed book markups of -44.49 percent for 2015 and 0.02 percent for 2016.⁹ CDTFA found that the negative book markup for 2015 and the low book markup for 2016 constituted evidence that appellant's reported taxable sales were understated and prepared a markup analysis to establish audited taxable sales.
 9. CDTFA surveyed appellant's known vendors for information about its purchases and received statements and purchase histories from the vendors (vendor statements). Based on the vendor statements, CDTFA compiled taxable purchases of \$1,620,836 for the audit period.
 10. CDTFA found that the vendor statements indicated purchases in amounts differing from amounts shown on appellant's P&L statements. For instance, on the P&L statement for 2016, appellant recorded \$13,000 of taxable purchases of cigarettes for 2016 while

⁵ As further discussed below, CDTFA states that the bank deposits were not taken into account in computing the audited weighted taxable markup or the audited taxable purchases.

⁶ In general, ex-tax means without payment of California sales tax reimbursement or use tax.

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 $\text{markup amount} \div \text{cost}$. In this example, the markup percentage is 42.86 percent ($.30 \div .70 = 0.42857$). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

⁸ Throughout the Opinion, there may be minor numerical differences due to rounding.

⁹ A negative book markup is computed when costs exceed reported sales. If the negative book markup were correct, it would mean that appellant's products were being sold for less than their purchase price.

purchases of tobacco products from Sam's Club were \$117,870.70 for 2016 according to the vendor statements.

11. CDTFA found that purchases according to the vendor statements differed from the total purchases reported on appellant's FITRs. For instance, on its FITRs, appellant reported purchases of \$501,253 in 2016 and \$523,316 in 2017. In contrast, according to the vendor statements, appellant made purchases totaling \$523,053.14 in 2016 and \$564,961.28 in 2017, which are amounts exceeding those reported on the FITRs.
12. Appellant provided a schedule of weekly self-consumption of taxable items, which CDTFA used to estimate taxable costs of self-consumed merchandise for the audit period. Appellant estimated the costs of breakage and theft of taxable merchandise, which CDTFA considered to be reasonable and used the information to compute estimated costs of breakage and theft for the audit period.
13. CDTFA reduced taxable purchases of \$1,620,836 by the taxable costs of self-consumption of \$29,460 and by the costs of breakage and theft of \$5,278 to establish audited costs of taxable merchandise sold of \$1,586,101.
14. CDTFA performed a purchase segregation test.¹⁰ CDTFA segregated the merchandise shown in purchase invoices for June 2018 into various product categories.¹¹
15. CDTFA performed a shelf test¹² and compared purchase prices for products shown in available purchase invoices for 2Q18 with the associated selling prices provided by appellant to compute average markups of 39.94 percent for beer, 15.25 percent for tobacco, 59.15 for liquor and wine, and 35 percent for carbonated beverages and taxable sundry items.

¹⁰ A purchase segregation test is used to establish the proportion of merchandise purchases in various product categories (such as beer, wine, liquor, soda, "other" taxable merchandise, food, and mixes and supplies) in order to compute the percentage of taxable merchandise purchases, as well as the percentages of merchandise in each category.

¹¹ Specifically, CDTFA computed that 45.25 percent of appellant's purchases of taxable merchandise were beer, 27.14 percent were tobacco, 22.12 percent were liquor and wine, 2.91 percent were carbonated beverages, and 2.58 percent were of sundry taxable items. Also, appellant's invoices for June 2018 were compared to the vendor statements and differences were noted for various vendors, which were added to complete the purchase segregation test.

¹² A shelf test is an accounting comparison of known costs and associated selling prices to compute markups.

16. Using the purchase ratios computed for the various product categories and the average markups for the product categories, CDTFA computed a weighted average markup of 37.22 percent for taxable merchandise.¹³
17. CDTFA applied the weighted average markup to audited costs of taxable merchandise sold of \$1,586,101 to establish audited taxable sales of \$2,176,384, which exceeded appellant's reported taxable sales by \$852,992. For instance, audited purchases of taxable merchandise per the vendor statements of \$285,184 for 1Q18 and 2Q18 substantially exceeded appellant's reported taxable sales of \$225,060 for those two quarters. CDTFA computed an error rate of 64.46 percent, which is the percentage of unreported taxable sales to reported taxable sales ($\$852,992 \div \$1,323,392$).¹⁴
18. The NOD issued on October 17, 2019, is based on a total deficiency measure of \$882,450, consisting of unreported taxable sales of \$852,990 and unreported taxable costs of self-consumed merchandise of \$29,460. Appellant does not dispute the amount of unreported taxable costs of self-consumed merchandise.
19. Appellant timely filed a petition for redetermination claiming that its recorded sales were more accurate than the amounts established by audit.
20. In October 2021, CDTFA held an appeals conference with appellant. After the conference, appellant provided its bank statements for 2017 and 2018, FITR for 2018, and z-tapes for 2Q18.¹⁵
21. CDTFA found that appellant's reported taxable sales for 2Q18 were in line with the taxable sales shown in the z-tapes but noted that appellant reported \$183 less tax than the sales tax reimbursement shown in the z-tapes.

¹³ As noted above, CDTFA states that the bank deposits and June 2018 purchase invoices provided by appellant were not taken into account in computing the audited weighted taxable markup or the audited taxable purchases per vendor statements. However, it appears that CDTFA used the purchase invoices in calculating the weighted average taxable markup ratio of 37.22 percent that was applied to the audited taxable purchases per the vendor statements.

¹⁴ The Report of Discussion of Audit Findings states that appellant's representative, Mr. Dang, "did not wish to meet at the office level with supervisor or audit manager to review any new documentation they may wish to present. They were not available for a meeting after they filed their petition; however, audit supervisor met twice during the audit findings exit conference...and were afforded the opportunity to review the vendor purchase confirmations and expand the shelf test but opted not to do it."

¹⁵ CDTFA found that the deposits shown in the bank statements for 2017 and 2018 exceeded appellant's reported total sales for those two years by \$49,841.

22. As additional support for the audited taxable sales, CDTFA compared appellant's reported taxable sales with recorded purchases of taxable merchandise from the vendors' statements and computed book markups of -12.92 percent for the period 3Q15 to 4Q15, -17.80 percent for 2016, -20.75 percent for 2017, and -21.07 percent for the period 1Q18 to 2Q18.
23. On January 31, 2022, CDTFA issued a Decision that denied the petition for redetermination.
24. Appellant timely filed a request for reconsideration in which it continued to dispute the methodology used to establish audited taxable sales.
25. On August 3, 2022, CDTFA issued a Supplemental Decision that continued to deny the petition.
26. This timely appeal followed.

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.) 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.)

If 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 not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Here, appellant provided inadequate books and records, and the source documents provided were incomplete. For instance, appellant only provided purchase invoices for

June 2018 and z-tapes for 2Q18. Appellant provided P&L statements for 2015 and 2016, but when CDTFA compared appellant's recorded purchases in the P&L statements to reported taxable sales for 2015 and 2016, the result was a negative book markup of -44.49 percent for 2015 and a book markup of only .23 percent for 2016, which indicates that appellant's reported taxable sales were understated. Therefore, it was appropriate for CDTFA to compute appellant's taxable sales using an indirect method, the markup method, which is a generally accepted method to determine audited sales. (*Appeal of Amaya*, 2021-OTA-328P.) Accordingly, 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 the z-tapes and its books and records are accurate, and that CDTFA's determination of its audited taxable sales is excessive. As support, appellant points to the fact that the sales amounts shown in its z-tapes for 2Q18 are in line with its reported sales. OTA notes that, according to the z-tapes for 2Q18 and the purchases from the vendor statements, the markup for that quarter is -17.84 percent. However, CDTFA performed a shelf test at appellant's store on September 25, 2018, and did not compute a negative mark up for the tested items, which contradicts the negative markup using the z-tapes. In addition, merchandise purchases according to the FITRs and vendor statements increased over the course of the audit period. Appellant has not provided evidence to explain why, in operating a business, it would increase its purchases over three years if it were regularly selling merchandise at a loss.

Furthermore, the vendor statements show discrepancies in appellant's recorded purchases. On its FITRs, appellant reported purchases of \$501,253 in 2016 and \$523,316 in 2017, whereas, according to the vendor statements, appellant made purchases totaling \$523,053.14 in 2016 and \$564,961.28 in 2017, which significantly exceed the amounts reported on the FITRs. In addition, there are discrepancies between purchases indicated by the vendor statements and purchases appellant recorded in its P&L statements. On the P&L statement for 2016, appellant recorded \$13,000 of taxable purchases of cigarettes in 2016, but purchases of tobacco products solely from Sam's Club were \$117,000 for 2016. Appellant has not provided evidence to explain these discrepancies. Based on the foregoing, appellant's recorded sales, such as the z-tapes, are unreliable and do not show error in CDTFA's determination.

At the hearing, appellant argued that it provided all of its records, and that it "had all the tapes." However, as previously noted, appellant provided incomplete records and only provided


z-tapes for 2Q18. Appellant also contended that CDTFA did not “comply” with appellant, and appellant did not “have any idea what was even going on.” However, according to the audit notes, CDTFA continually informed appellant about the audit process.¹⁶ In addition, the evidence shows that at various times, CDTFA requested that appellant participate or assist in the audit process, but appellant chose not to participate.¹⁷ Therefore, appellant’s arguments are unfounded. In conclusion, appellant has not shown that a result differing from CDTFA’s determination is warranted.

HOLDING

An adjustment to the amount of unreported taxable sales is not warranted


DISPOSITION

CDTFA’s action in denying the petition is sustained.

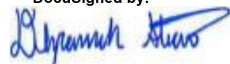
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Josh Lambert
Administrative Law Judge

We concur:

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Suzanne B. Brown
Administrative Law Judge

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For
Josh Aldrich
Administrative Law Judge

Date Issued: 9/27/2024

¹⁶ See footnote 3, *ante*.

¹⁷ See footnote 14, *ante*.