OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 230713880
	CDTFA Case ID: 228-901
EL PUEBLITO LLC	

OPINION

Representing the Parties:

For Appellant: Carlos Chait, Representative

For Respondent: Jason Parker, Chief of Headquarters Operations

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

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, El Pueblito LLC (appellant) appeals a June 15, 2023 Decision (the Decision) issued by the California Department of Tax and Fee Administration (respondent)[1] denying, in part, appellant's petition for redetermination of a timely June 25, 2018 Notice of Determination (NOD).[2] The NOD is for tax of $90,929, based on a taxable measure of $1,092,513, plus applicable interest, for the period April 1, 2014, through March 31, 2017 (liability period). As the result of a March 20, 2023 reaudit, respondent reduced the taxable measure to $1,009,113, which reduced the tax to $90,576.

The Office of Tax Appeals (OTA) decides this matter on the basis of the written record pursuant to California Code of Regulations, title 18, (Regulation) 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] The NOD was timely issued because on January 10, 2018, appellant signed the last in a series of consecutive waivers of the otherwise applicable three-year statute of limitations for the period April 1, 2014, through March 31, 2015, which allowed respondent until July 31, 2018, to issue an NOD. (See R&TC, §§ 6487(a), 6488.)

ISSUE

Are further adjustments to the measure of unreported taxable sales warranted?

FACTUAL FINDINGS

1. Appellant, a limited liability company, operated two markets in Maywood, California, during the liability period: one on Slauson Avenue (hereinafter the Slauson location), and one on Atlantic Boulevard (hereinafter the Atlantic location). For both locations, taxable sales included cigarettes, beer, nonalcoholic carbonated beverages (sodas), and sundry items; while nontaxable sales included food products (raw meats, vegetables, and snack items) and lottery tickets. Appellant did not sell wine or liquor at either location. Hot prepared food was sold at the Atlantic location; however, the sales of hot prepared food and raw meats were reported under a separate seller's permit not at issue here.
2. Appellant's seller's permit (the one that is the relevant to this appeal) was opened with an effective start date of October 1, 2011, listing one retail location (the Slauson location). The Atlantic location was added to appellant's seller's permit in March 2014. Appellant had not been previously audited.
3. For the liability period, appellant reported on its sales and use tax returns (SUTRs) total sales of $4,816,151 and claimed deductions of $4,371,148 for nontaxable sales of food products and $4,887 for sales tax reimbursement included in reported total sales, resulting in reported taxable sales of $440,116. Appellant stated that it used cash register z-tapes[3] and purchase invoices to prepare the profit and loss (P&L) statements (for both markets), which were provided to its outside bookkeeper who prepared the SUTRs.[4]
4. For audit, appellant provided federal income tax returns (FITRs) for 2014 and 2015; P&L statements for the liability period; bank statements for the liability period; the Slauson location's merchandise purchase invoices for June 5, 2017, through August 5, 2017 (after the liability period); and the Atlantic location's merchandise purchase invoices for June 7, 2017, through August 8, 2017 (after the liability period). Appellant did not provide sales tax worksheets, daily store reports, cash register z-tapes, merchandise

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

[4] Appellant originally stated during the audit that it provided daily store reports to its outside bookkeeper who used the reports to prepare the SUTRs.

purchase invoices, or purchase journals for the liability period. Respondent found the books and records to be inadequate for sales and use tax purposes.

5. Respondent compared total sales reported on the SUTRs for 2014 and 2015 to the corresponding gross receipts reported on the FITRs. Respondent noted a significant difference in 2015, when gross receipts exceeded total sales by almost $318,000, but for 2014, the difference went the other way, with total sales exceeding gross receipts by over $15,500, all of which called the accuracy of appellant's reporting into question. Appellant was unable to explain the reason for the differences.

6. Next, respondent compared taxable sales reported on the SUTRs to the corresponding taxable sales recorded in the P&L statements for April 1, 2014, through December 31, 2016, and for the first quarter of 2017 (1Q17). Respondent noted unexplained differences of $4,889 for 2015, and $57,970 for 1Q17.[5]

7. Respondent had planned to compute book markups using the amounts of taxable sales and cost of goods sold (COGS) recorded in the P&L statements, but it discovered that recorded COGS did not include purchases of sodas, ice, and sundry merchandise, which caused respondent to conclude that the P&L statements were incomplete and unreliable. Because of the lack of sufficient business records and questions concerning the accuracy of those that appellant provided, respondent decided to use a markup method to determine taxable sales.

8. For each location, respondent compiled purchases of taxable merchandise and performed a purchase segregation test[6] for each of the major categories of taxable products (beer, cigarettes, sodas, and sundry items) using the two months of merchandise purchase invoices appellant provided.[7]

9. Because appellant did not provide merchandise purchases detail (i.e., purchase journals) for the liability period, respondent decided to verify merchandise purchases using a

[5] For both periods, recorded sales exceeded reported sales.

[6] A purchase segregation test is used to establish the proportion of merchandise purchases in various product categories (such as cigarettes and cigars, other tobacco products, sodas, "other" taxable merchandise, food, and supplies) to compute the percentage of taxable merchandise purchases, as well as the percentages of merchandise in each category.

[7] Merchandise purchase invoices were provided for June 5, 2017, through August 5, 2017, for the Slauson location and for June 7, 2017, through August 8, 2017, for the Atlantic location.

survey of appellant's vendors. Respondent requested purchase data from the vendors identified in the purchase segregation test. However, not all vendors responded, and several of the vendors who did respond only provided purchase totals without any detail of the specific merchandise purchased. For the vendors that responded, respondent compiled merchandise purchases for each location for the liability period.[8] To estimate merchandise purchases from vendors who did not provide information, respondent used purchase invoices appellant provided. For each location and for the vendors that responded, respondent compiled appellant's purchases for the two months of merchandise purchase invoices and compared the result to the total purchases of taxable merchandise for that period. This difference was divided by 2 (months) and multiplied by 36 (months in the liability period) to compute purchases from the vendors who did not respond for the liability period. Respondent added the estimated merchandise purchases for vendors who did not respond to the merchandise purchases from the vendors who responded to compute audited merchandise purchases for each location for the liability period.

10. Respondent performed a shelf test[9] and computed shelf test markups for each of the major categories of taxable products (beer, cigarettes, sodas, and sundry items) for each location. Respondent applied the product purchase percentages from the segregation test (as explained above) to the respective shelf test markups to compute a weighted average markup for each location, 38.01 percent for the Slauson location and 33.88 percent for the Atlantic location.

11. Respondent reduced audited taxable merchandise purchases for each location by 2 percent for pilferage and applied the respective audited markup factor (the weighted taxable markup plus 100 percent) to audited taxable merchandise purchases for each location to compute audited taxable sales for the liability period.[10]

[8] It appears that respondent included (in appellant's purchases of taxable goods) nontaxable energy drinks purchased from one vendor (Jetro Cash & Carry). Because any possible adjustment on this basis would be de minimis, and appellant did not request an adjustment on this basis, this Opinion will not address it further.

[9] A shelf test is an accounting comparison of known costs and associated selling prices used to compute markups.

[10] Appellant stated it did not have any self-consumption of taxable merchandise.

12. Respondent compared audited taxable sales for both locations to taxable sales reported on the SUTRs and computed unreported taxable sales and error ratios[11] for each year and partial year in the liability period. Respondent applied the error ratios to the corresponding reported taxable sales to compute unreported taxable sales of $1,092,513 for the liability period.
13. On June 25, 2018, respondent issued the NOD to appellant.
14. Appellant filed a timely petition for redetermination disputing the NOD in its entirety.
15. On September 20, 2022, the parties participated in an appeals conference as part of respondent's internal appeals process. Appellant argued there that it was entitled to an adjustment for purchases of sodas paid for with CalFresh Electronic Benefit Transfer (EBT) cards.[12] In support of this argument, appellant provided merchant processing statements for November 2016, January 2017, and February 2017, and for all 12 months of 2021 (after the liability period). The earliest three statements (for months within the liability period) showed "EBT Cash Purchases" of $247, $368, and $686, and "Food stamp Purchases" of $19,769, $23,359, and $20,624, respectively. The twelve statements for 2021 showed only "EBT" totals of between $6,909 (for January) and $29,129 (for June), with an average EBT total for the year of $12,755. Appellant did not provide evidence to show what the customers purchased. Appellant also gave respondent a chart that appellant attributed to "Food and Nutrition Services," without any more specific information. Appellant asserted that the chart showed that 31.53 percent of EBT purchases are for carbonated soft drinks.
16. Respondent examined the chart and concluded that it did not document the percentage of carbonated beverage sales paid with EBT. Nevertheless, respondent agreed to a 2.91 percent reduction to audited carbonated beverage purchases for EBT sales, which it calculated by dividing total carbonated beverage sales of $48,209 by total income less

[11] The "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

[12] EBT cards are the system used for the delivery, redemption, and reconciliation of CalFresh benefits. CalFresh is California's implementation of the Supplemental Nutrition Assistance Program, formally known as the federal Food Stamp Program. Recipients of CalFresh benefits access their benefits with an EBT card, which is like a debit card. Sales of eligible food items purchased with CalFresh benefits are exempt from tax, even if the sale of the food item is normally taxable. (Cal. Code Regs., tit. 18, § 1602.5(c).)

beer, wine, and general merchandise sales of $1,656,240 ($1,944,357 - $288,117).[13] The resulting reaudit reduced the taxable measure to $1,009,113,[14] which remains in dispute.

17. Respondent issued its June 15, 2023 Decision, which ordered the $83,400 reduction of the taxable measure from $1,092,513 to $1,009,113, but otherwise denied the petition.

18. 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).)

Although gross receipts from the sale of "food products" for human consumption are generally exempt from sales tax, the exemption does not apply to sales of alcoholic beverages or sodas. (R&TC, § 6359(a), (b)(3).) Gross receipts from the sale of tangible personal property purchased with CalFresh benefits are also exempt from sales tax. (R&TC, § 6373(a).) The law provides a safe harbor for retailers who receive gross receipts in the form of CalFresh benefits as payment for tangible personal property that normally is subject to the tax, e.g., sodas. In lieu of separately accounting for exempt CalFresh benefits received from customers, such a retailer may deduct on each sales tax return an amount equal to 2 percent of the total amount of CalFresh benefits redeemed during the period for which the return is filed. (R&TC, § 6373(d).) Grocers may claim amounts in excess of 2 percent whenever the following computation results in a greater percentage: total purchases of taxable items eligible to be purchased with CalFresh benefits divided by an amount equal to the total of the exempt food product purchases as defined in Regulation section 1602.5(b)(1)(F)1 plus the purchase of taxable items eligible to be purchased with CalFresh benefits. (Cal. Code Regs., tit. 18, § 1602.5(c).) For example, if

[13] The income/sales amounts came from appellant's 2020 P&L statement.

[14] Audit schedule R1-12A reflects unreported taxable sales of $1,009,111. The $2 difference is immaterial and is attributable to rounding.

purchases of sodas totaled $5,000 and purchases of exempt food products totaled $130,000, a percentage of 3.7 percent ($5,000 ÷ $135,000) may be used in computing the allowable CalFresh benefits deduction for that period. (*Ibid*.) This deduction may be taken in lieu of accounting separately for such sales. (*Ibid*.) Exemptions from tax are strictly construed against the taxpayer who has the burden of proving that the statutory requirements have been satisfied. (*Appeal of Snowflake Factory LLC*, 2020-OTA-270P.)

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*.) The applicable burden of proof is 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 facts it asserts are, more likely than not, correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) In other words, it is not enough for a taxpayer to simply question respondent's methods or findings or even to provide evidence that a result more favorable to the taxpayer may be more accurate. To satisfy its burden of proof, a taxpayer must prove: (1) that the tax assessment is incorrect and (2) a more accurate tax amount. (*Ibid.*)

Here, appellant's books and records provided for the liability period were inadequate for sales and use tax audit purposes. During its initial examination, respondent found a significant unexplained difference between the SUTRs and the FITR for 2015. Further review indicated that respondent could not determine a reliable book markup from appellant's records. As a result, respondent reasonably concluded that appellant may have understated taxable sales and that respondent would be unable to verify sales that appellant reported on its SUTRs for the liability period using a direct audit method (i.e., compiling audited sales directly from appellant's records). Under the circumstances, respondent rationally concluded that it would need to utilize an indirect method to verify taxable sales. The indirect audit method respondent chose to use, the markup method, was an appropriate choice. It is generally recognized as a reliable tax

accounting method. (See *Appeal of Amaya*, 2021-OTA-328P.) Finally, OTA has reviewed the audit and reaudit workpapers, and is satisfied that respondent correctly applied the markup method to the purchase and sales data provided by appellant and its vendors and used a reasonable method for estimating the exemption for sales of sodas for EBT payments and that the resulting estimate of unreported taxable sales is reasonably accurate. Based on the foregoing, OTA finds that respondent met its initial burden to show that its determination was reasonable and rational. Thus, the burden of proof shifts to appellant to prove otherwise.

Appellant contends that the markup is too high because of two errors made by respondent: it failed to take into consideration inventory fluctuations and transfers between locations; and it failed to properly allow for exempt EBT sales.

Regarding appellant's argument concerning respondent's failure to consider inventory, when reliable data regarding beginning and ending inventories are available, such data can be used – and in most cases should be used – to establish COGS, which would equal beginning inventory plus purchases for resale minus ending inventory for the reporting period. In this matter, though, appellant did not provide reliable information concerning beginning or ending inventories, and it provided no information regarding transfers of inventory between the two locations.[15] There was nothing for respondent to consider. Under the circumstances, it was appropriate for respondent to assume that purchases made during the liability period were also sold during that period. Finally, OTA has already found that respondent proved what it is required to prove, at least initially. If appellant has evidence to prove that its inventory amounts or transfers should lead to a more favorable result for appellant, it has not provided that evidence.[16]

Turning to appellant's argument about purchases using an EBT card, OTA is not persuaded that the chart upon which appellant relies has any relevance to the issue at hand. The accuracy,[17] purpose, and origin of the chart has not been shown, nor does the chart appear to be what appellant claims it is. Appellant's reliance on the chart to show that 31.53 percent of EBT

[15] OTA notes, for example, that appellant's FITRs reported beginning and ending inventory amounts that appear to be rounded to the nearest ten thousand, which is not sufficiently informative, even if it is accurate. OTA also notes that appellant's reported beginning and ending inventories for 2015 were the same ($90,000).

[16] Because the audit used data from appellant's vendors, OTA does not understand how transfers between locations could result in counting inventory more than once.

[17] Appellant has not provided the complete chart or other information to explain its meaning or purpose.

benefits are used for purchases of sodas is misplaced for two reasons. First, appellant's total number is incorrect in that it does not include two additional categories of sodas: multipack bottles (3.90 percent) and single bottles (3.18 percent). Thus, the percentage attributable to sodas is 38.61 percent. Second, and more importantly, the chart does not appear to represent percentages of total EBT expenditures.[18] Rather, the numbers appear to represent percentages of EBT expenditures among foods containing solid fats and added sugars. In other words, the chart appears to indicate that 38.61 percent of EBT expenditures on foods containing solid fats and added sugars are on sodas.[19] Without more information, that statistic is meaningless. OTA finds that the chart has no bearing on the issue presented in this appeal. Accordingly, OTA finds no basis to recommend further adjustments for exempt EBT sales of sodas.

In summary, OTA finds that appellant has not identified any errors in respondent's computation of audited taxable sales or established a more accurate taxable measure and on that basis concludes that no adjustments to the taxable measure are warranted.

[18] Appellant's merchant processing statements for 2020 indicate total EBT-paid sales of $232,724. If appellant's characterization of the chart's meaning were accurate, appellant's soda sales would have been almost $90,000. Appellant's 2020 P&L statement records soda sales totaling $48,209.

[19] And these would be just sodas containing added sugars.

HOLDING

Further adjustments to the measure of unreported taxable sales are not warranted.

DISPOSITION

OTA sustains respondent's action reducing the taxable measure to $1,009,113 and otherwise denying the petition.

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Michael F. Geary
Administrative Law Judge

We concur:

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

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

Date Issued: 7/3/2024