

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:)	OTA Case No.: 230914393
VIRK MARKET, INC.,)	CDTFA Case ID: 2-208-670
dba King's Market¹)	
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OPINION

Representing the Parties:

For Appellant:	Gary Kimzey, Representative
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For Respondent:	Jason Parker, Chief of Headquarters Ops.
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For Office of Tax Appeals:	Craig Okihara, Business Taxes Specialist III
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N. RALSTON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Virk Market, Inc., dba King's Market (appellant) appeals a decision issued by the California Department of Tax and Fee Administration (respondent)² partially denying appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on September 3, 2020. The NOD is for tax of \$126,844, plus applicable interest, and a negligence penalty of \$12,684.36 for the period October 1, 2015, through September 30, 2018 (liability period).

Pursuant to the Decision, respondent performed a reaudit, which increased the taxable measure. By letter dated May 4, 2023, respondent issued a timely Notice of Increase.³ Subsequently, respondent performed a second reaudit, which reduced the measure of tax from the first reaudit but was still an increase to the determined measure of tax as reflected in the

¹ Appellant also operated a second selling location dba "Stay Fly Smoke Shop" and a third location dba "King's Smoke Shop." Only the dba for the first location "King's Market" is identified on respondent's Decision and is at issue in this appeal.

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

³ The increase notice was timely issued because the NOD was not yet final, and the increase notice was issued within three years after the NOD was issued. (R&TC, § 6563(a).)

original NOD. As a result of the two reaudits, the tax asserted in the NOD increased from \$126,844 to \$155,603, and the negligence penalty increased from \$12,684.36 to \$15,560.28.

Appellant waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUE

Whether further adjustments to the measure of unreported taxable sales are warranted.

FACTUAL FINDINGS

1. Appellant, a corporation, operated three retail locations in California during the liability period: King's Smoke Shop in Sacramento; Stay Fly Smoke Shop in Rocklin; and King's Market in Sacramento. Appellant's sales included cigarettes, tobacco and smoking products, lottery, and money orders. At King's Market, a convenience store, appellant also sold taxable household merchandise and nontaxable food products. Appellant had not been previously audited.
2. For the liability period, appellant reported on its quarterly sales and use tax returns (SUTRs) total sales of \$1,652,549, claiming deductions of \$494,252 for nontaxable sales of food products, and \$42,593 for sales for resale, resulting in reported taxable sales of \$1,115,704. Appellant's reporting method was unknown.
3. For audit, appellant provided state income tax returns for calendar years 2017 and 2018; cash register z-tapes⁴ for the King's Smoke Shop location for the liability period; and merchandise purchase invoices for January 2, 2020, through January 13, 2020. Respondent found that the provided books and records were incomplete and inadequate for sales and use tax audit purposes.
4. Respondent compared taxable sales reported on the quarterly SUTRs to the corresponding gross receipts reported on the state income tax returns for calendar years 2017 and 2018. Respondent noted no material differences. Respondent compared gross receipts reported on the state income tax returns for calendar years 2017 and 2018 to the corresponding cost of goods sold reported on the state income tax returns

⁴ 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).

- and computed book markup factors⁵ of 2.14 for 2017, 1.77 for 2018, and 1.92 for the two years combined. Based on its experience in audits of similar businesses in appellant's area, respondent considered these markup factors to be reasonable.
5. Respondent obtained Form 1099-K⁶ data for the liability period and compiled credit card sales of \$1,472,946. Respondent compared credit card sales to reported total sales and computed a credit card sales ratio of 89.13 percent, which was higher than respondent expected based on its experience in audits of similar businesses in appellant's area; respondent considered this an indication that reported total sales may have been understated.
 6. Using the second quarter of 2017 (2Q17) cash register z-tapes for the King's Smoke Shop location, respondent compiled total sales of \$125,444, which was greater than reported total sales of \$107,143. Respondent concluded that this was clear evidence that reported total sales were understated since recorded total sales for only the King's Smoke Shop location exceeded reported total sales for all three locations reported on the 2Q17 SUTR.
 7. Respondent's Tobacco Tax Unit (TTU) performed a Cigarette Floor Stock Retailer audit of appellant. Respondent obtained the TTU z-tape reports for 1Q17. The TTU z-tape reports summed sales data from appellant's cash register z-tapes for all three locations. Respondent conducted a block test⁷ of 1Q17 and calculated recorded total sales of \$220,725 for the three locations combined. Respondent spot-checked the TTU z-tape reports' sales data to cash register z-tapes that appellant provided for 1Q17, noting no differences.

⁵ "Markup factor" is the factor by which cost of goods sold is multiplied to determine total sales. The markup factor is calculated by dividing sales by the cost of goods sold. The markup factor is equal to the markup (the amount by which the cost of merchandise is increased to set the retail price) plus 100 percent.

⁶ Form 1099-K is an IRS form titled "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third party network, during a given time period. Form 1099-K data includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, and PayPal.

⁷ A block test is a generally accepted audit tool, which examines transactions from a representative portion of a liability period (i.e., a sample) and applies the findings to the liability period. It is typically used when complete records are not available for the entire liability period.

8. Respondent compared recorded total sales of \$220,725 for the 1Q17 to reported total sales of \$109,131 for the 1Q17 SUTR and computed a difference of \$111,594, which resulted in an error ratio⁸ of 102.26 percent ($\$111,594 \div \$109,131$).
9. Respondent noted that appellant accepted CalFresh Electronic Benefit Transfer (EBT) cards as payment.⁹ Respondent obtained appellant's CalFresh EBT redemptions (i.e., sales paid by CalFresh EBT card), which totaled \$46,092 for the liability period at the King's Market location. Appellant did not claim a deduction for sales of taxable food which were exempt from tax when purchased using CalFresh benefits in accordance with R&TC section 6373(d). Although respondent could not verify whether appellant's claimed nontaxable sales of food products included sales paid with CalFresh benefits exempt under R&TC section 6373(a), respondent decided to make a separate reduction to audited total sales for the total of appellant's sales paid with CalFresh benefits.¹⁰
10. Appellant provided its year-end lottery sales summary reports for 2015 through 2018. Respondent computed quarterly average lottery sales for each year. For the liability period, respondent computed audited lottery sales of \$201,222. Respondent noted in its review of the TTU z-tape reports that lottery sales were included in recorded nontaxable sales.
11. Respondent multiplied total sales of \$1,652,549 reported on the SUTRs for the liability period by the error ratio of 102.26 percent and added the result to reported total sales to compute audited total sales. Respondent then subtracted claimed nontaxable sales of \$536,845 (\$494,252 nontaxable sales of food products + \$42,593 sales for resale), and sales paid with CalFresh benefits of \$46,092 to compute audited taxable sales of \$2,759,509.
12. Respondent compared audited taxable sales to reported taxable sales of \$1,115,704 and computed unreported taxable sales of \$1,643,806 (rounded) for the liability period.

⁸ The "error ratio" is the percentage of unreported taxable sales to reported taxable sales.

⁹ Appellant accepted CalFresh EBT cards from customers as payment for eligible food items. The EBT program is the system used for the delivery, redemption, and reconciliation of CalFresh benefits. CalFresh is California's implementation of the Supplemental Nutrition Assistance Program (SNAP) formally known as the federal Food Stamp Program. Recipients of CalFresh benefits access their benefits with an EBT card, which is similar to a "debit card." [See Audit Manual section 419.60]

¹⁰ According to the audit notes, the audit supervisor approved this adjustment based on the amount of the EBT sales and to "error [sic] on the side of the taxpayer."

13. Respondent issued an NOD to appellant on September 3, 2020, based on the aforementioned audit with a tax liability of \$126,844, plus applicable interest and a negligence penalty of \$12,684.36.¹¹
14. Appellant filed a timely petition for redetermination protesting the NOD in its entirety.
15. Respondent issued a Decision dated March 17, 2022, that ordered a reaudit to expand the block test period of cash register z-tapes and exclude sales for resale from reported total sales prior to applying the error ratio. Respondent otherwise denied the petition.
16. In accordance with the Decision, the block test was expanded to include 2Q18 as selected by appellant. Respondent verified appellant's sales schedules for 2Q18 with cash register z-tapes that appellant provided, noting no errors with King's Market or Stay Fly Smoke Shop.
17. For King's Smoke Shop, respondent found that the total per appellant's schedule was less than the grand total amount per the cash register z-tapes. Based on this information, respondent concluded that appellant's schedule did not include all cash register z-tapes for King's Smoke Shop and the grand total amount per the cash register z-tapes was more accurate for 2Q18. Respondent also verified 1Q17 TTU z-tape reports sales data with cash register z-tapes and found that the 1Q17 sales per TTU z-tape reports for King's Market were understated.
18. Appellant did not provide cash register z-tapes for King's Smoke Shop; thus, respondent computed a "rate of increase"¹² of 1.4599 based on the difference found in the 2Q18. Respondent applied the "rate of increase" to recorded 1Q17 sales to compute audited sales for King's Smoke Shop.
19. Incorporating the revised 1Q17 and 2Q18 audited sales, respondent computed a revised error ratio of 126.74 percent, which was greater than the error ratio computed in the original audit. Respondent applied the revised error ratio to reported total sales (excluding claimed sales for resale) of \$1,609,956 for the liability period and added the result to reported total sales (excluding claimed sales for resale) to compute audited total sales.
20. Respondent then subtracted claimed nontaxable sales of food products of \$494,252 and sales paid with CalFresh benefits of \$46,092 to compute audited taxable sales of

¹¹ On appeal, appellant does not provide any arguments or evidence disputing the imposition of the negligence penalty. As a result, OTA will not address this item.

¹² The "rate of increase" was computed by dividing the cash register z-tape grand total amount by total sales per appellant's schedule.

\$3,110,063 (rounded) for the liability period. Upon comparison to reported taxable sales, respondent computed unreported taxable sales of \$1,994,359. Respondent prepared the first reaudit report dated May 3, 2023, which increased the taxable measure to \$1,994,359, resulting in tax liability of \$155,603, plus applicable interest, and a negligence penalty of \$15,560.28.

21. Respondent issued a Notice of Redetermination to appellant on September 18, 2023, based on the first reaudit.¹³
22. By letter dated July 18, 2023, respondent notified appellant of its available options for the next steps in the appeals case.
23. Appellant timely appealed to OTA.
24. In preparation for the appeal, respondent noted an error in the computation of recorded total sales for the 2Q18, which resulted in decreasing the error ratio to 126.43 percent. In the same manner used in the first reaudit, respondent applied the 126.43 percent error ratio and computed audited taxable sales of \$3,105,092 for the liability period. Upon comparison to reported taxable sales, respondent computed unreported taxable sales of \$1,989,388. Respondent prepared a second reaudit report dated November 21, 2023, which decreased the taxable measure in the first reaudit to \$1,989,388, the tax liability to \$155,214, plus applicable interest, and the negligence penalty to \$15,521.39.¹⁴

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).)

¹³ The Notice of Redetermination reflects payments/credits of \$1,344.82. In addition, the Notice of Redetermination states that appellant's appeal was closed and the results are reflected in the notice; however, there is no dispute that appellant timely filed an appeal to OTA. Therefore, it is OTA's understanding that this document was issued in error, and respondent will issue a new Notice of Redetermination at the conclusion of this appeal.

¹⁴ The second reaudit report also lists credits of \$389.

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.*)

Here, appellant did not provide complete documentation supporting its sales. Respondent's initial examination of available cash register z-tapes indicated that sales reported on the SUTRs were understated. Thus, OTA finds that it was reasonable for respondent to question reported sales and use an indirect audit method to verify appellant's sales. Respondent's use of a block test as the basis for its determination is a recognized and accepted accounting procedure. (See *Appeal of Micelle Laboratories, Inc.*, 2020-OTA-290P.) Appellant's cash register z-tapes are evidence of appellant's sales. Therefore, OTA concludes that respondent has established that its determination is reasonable and rational, and accordingly, the burden shifts to appellant to show errors in the audit.

Appellant contends that respondent's analysis of cash register z-tapes for six months is not entirely representative of the remainder of the liability period. Appellant argues that additional testing is necessary to compute a more accurate result. Appellant asserts that it will present the additional testing. However, appellant did not provide the additional testing or any other documentation, despite OTA requesting additional briefing to allow appellant the opportunity to provide the information for consideration in its appeal. OTA finds that a block test of six months (three months in 2017 and three months in 2018) is a sufficiently large enough sample of appellant's sales to establish a representative error ratio. Appellant has not identified any errors in respondent's computation of audited taxable sales or provided new documentation or other evidence in support of its contentions from which more accurate determinations could be made. As appellant bears the burden of proof, OTA concludes that no adjustments to the measure of tax are warranted.

HOLDING

No further adjustments to the measure of tax for unreported taxable sales are warranted.

DISPOSITION

Increase the taxable measure from \$1,643,806 to \$1,989,388 as set forth in the second reaudit; otherwise, deny appellant's petition for redetermination in all other respects.

Signed by:



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Natasha Ralston
Administrative Law Judge

We concur:

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Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:



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Keith T. Long
Administrative Law Judge

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