

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: <b>THREE STAR MARKET INC.,</b> <b>dba Two Star Liquor</b>	) ) ) ) )	OTA Case No. 230814196 CDTFA Case ID: 3-577-707
---	-----------------------	--

---

**OPINION**

Representing the Parties:

For Appellant:	Alexander Kugelman, Attorney Jonathan P. Stead, CPA
For Respondent:	Randy Suazo, Hearing Representative Christopher Brooks, Attorney Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Crystal Spratley, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Three Star Market Inc., dba Two Star Liquor (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying appellant’s timely petition for redetermination of a Notice of Determination (NOD) issued on January 21, 2022. The NOD is for tax of \$439,626, plus applicable interest, and a 10 percent negligence penalty of \$43,962.64 for the period January 1, 2018, through June 30, 2021 (liability period).<sup>1</sup> As relevant here, the tax amount was based in part on unreported taxable sales of \$4,674,106.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Wong, Suzanne B. Brown, and Sheriene Anne Ridenour held a virtual oral hearing for this matter on April 16, 2025. At the conclusion of the oral hearing, the evidentiary record remained open for additional submissions by the parties. On June 25, 2025, the evidentiary record closed, and the matter was submitted to OTA for an Opinion based on the oral hearing record pursuant to California Code of Regulations, title 18, section 30209(b).

---

<sup>1</sup> CDTFA timely issued the NOD because appellant waived the otherwise applicable three-year statute of limitations and gave CDTFA until January 31, 2022, to issue the NOD. (See R&TC §§ 6487(a), 6488.)

ISSUE

Whether the amount of unreported taxable sales should be reduced.<sup>2</sup>

FACTUAL FINDINGS

1. Appellant operated a liquor store in Oakland, California. The store sold newspapers, tobacco, cigarettes, sodas, beer, wine, miscellaneous taxable sundry items, and non-taxable food.
2. For the liability period, appellant reported the following: total sales of \$3,707,646; total deductions of \$1,235,515 (which consisted of nontaxable food sales of \$1,000,159 and sales tax included in sales of \$235,356); and taxable sales of \$2,472,131.
3. For the audit, appellant provided CDTFA with the following books and records: federal income tax returns (FITRs) for 2018, 2019, and 2020; purchase invoices for the first quarter of 2020 (1Q20), 2Q20, 3Q20, and June and July 2021; profit and loss statements for 1Q20 and 2Q20; cash register tapes for 2Q20; assorted bank statements; a history of online orders for 2020; and a history of donated Thanksgiving meals for 2019 and 2020. CDTFA determined that these books and records were inadequate for sales and use tax audit purposes.<sup>3</sup>
4. Using purchase invoices for 2Q20, CDTFA conducted a purchase segregation test and found that 90.20 percent of total purchases were taxable.<sup>4</sup> CDTFA applied the taxable-to-total-purchases ratio of 90.20 percent to purchases appellant reported on its FITRs for 2018, 2019, and 2020 to compute taxable purchases for those years. After comparing computed taxable purchases for 2018, 2019, and 2020 to reported taxable sales for those years, CDTFA computed the following markups: -13.50 percent for 2018;

---

<sup>2</sup> Appellant does not contest the negligence penalty, so this Opinion will not discuss it further.

<sup>3</sup> Appellant concedes that its books and records were inadequate and did not allow CDTFA to use a direct audit method (i.e., compiling audited sales directly from appellant's records).

<sup>4</sup> A purchase segregation test establishes 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.

- 22.54 percent for 2019; 9.60 percent for 2020; and -10.36 percent overall.<sup>5</sup> CDTFA expected overall annual markups in the range of 30 to 40 percent for a liquor store and found that appellant's reported taxable sales were unreliable. CDTFA also found that purchase invoices were missing and that appellant mischaracterized some taxable purchases as nontaxable. Accordingly, CDTFA decided to determine appellant's audited taxable sales by using the markup method.

5. CDTFA surveyed 99.23 percent of all vendors from which appellant purchased taxable merchandise and found that appellant made total purchases of \$5,149,535 (rounded) for the period 1Q18 through 1Q21.
6. CDTFA's survey indicated that, based on appellant's purchases in 2Q20, 95.37 percent of appellant's merchandise purchases were taxable.
7. CDTFA multiplied audited total purchases of \$5,149,535 by the taxable-to-total-purchases ratio of 95.37 percent to compute audited taxable purchases of \$4,911,048 (rounded).
8. CDTFA then divided audited taxable purchases of \$4,911,048 by the 99.23 percent ratio of surveyed-to-total-vendors from which appellant purchased taxable merchandise to compute audited total taxable purchases of \$4,949,175 (rounded) for the period 1Q18 through 1Q21 (\$1,231,133 for 2018 + \$1,391,001 for 2019 + \$1,893,644 for 2020 + \$433,397 for 1Q21).
9. Using purchase invoices from June 2021 for newspapers, tobacco, cigarettes, sodas, beer, liquor, wine, and sundry items, and a shelf test conducted on July 12, 2021, CDTFA establish an audited weighted markup of 29.38 percent.<sup>6</sup> Specifically, CDTFA examined the June 2021 purchase invoices to determine the following for each of the eight categories listed above: the items purchased for resale within each category; the amount of the items purchased for resale; and the purchased items' costs, retail sale prices, and markups. CDTFA then determined the following for each category: its proportion of total purchases; the markup for that category of items per the July 12, 2021 shelf test; and each category's weighted average markup. Finally, CDTFA totaled each

---

<sup>5</sup> "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 \$0.70 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 ( $0.30 \div 0.70 = 0.42857$ ). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. A negative markup would mean that appellant was selling merchandise for less than its cost of the merchandise.

<sup>6</sup> A shelf test is an accounting comparison of known costs and associated selling prices used to compute markups.

- category's weighted average markup to compute an overall weighted markup of 29.38 percent.
10. CDTFA reduced audited taxable purchases of \$4,515,778 for 2018 through 2020 (\$1,231,133 for 2018 + \$1,391,001 for 2019 + \$1,893,644 for 2020) by 1 percent for pilferage and by another 1 percent for self-consumption to compute adjusted audited taxable purchases of \$4,425,462 for 2018 through 2020.
  11. CDTFA then applied a markup factor of 129.38 percent (100 percent + weighted markup of 29.38 percent) to adjusted audited taxable purchases of \$4,425,462 for 2018 through 2020 to compute audited taxable sales of \$5,725,857 for those same years.
  12. CDTFA compared audited taxable sales of \$5,725,857 for 2018 through 2020 to reported taxable sales of \$1,980,768 for those same years and computed a difference of \$3,745,089.
  13. CDTFA then calculated the following percentages of error (POEs) by comparing unreported taxable sales to reported taxable sales for 2018, 2019, and 2020: 167.57 percent for 2018; 162.41 percent for 2019; 231.08 percent for 2020; and 189.07 percent overall.
  14. CDTFA applied the POEs for each year to reported taxable sales for the corresponding year, and the overall POE to reported taxable sales for 1Q21 and 2Q21, to compute unreported taxable sales of \$4,674,106 for the liability period.
  15. On January 21, 2022, CDTFA issued the NOD to appellant.
  16. On February 21, 2022, appellant petitioned CDTFA for redetermination.
  17. During CDTFA's internal appeals process, appellant provided its CPA's alternative analysis and an explanatory memo dated April 21, 2023. Appellant's CPA computed unreported taxable sales of \$2,868,118 instead of \$4,674,106. For his analysis, the CPA utilized appellant's reported purchases, which, according to the CPA's memo, "largely conformed to [CDTFA's] survey of vendors." Additionally, the CPA relied upon inventories conducted by a third-party inventory service that showed increases in appellant's inventory, ostensibly due to the COVID-19 pandemic.<sup>7</sup> Finally, the CPA used average markups for each of appellant's 125 total vendors (as conveyed by appellant to its CPA), computing the following weighted markups by year: 22.95 percent for 2018; 24.32 percent for 2019; 25.15 percent for 2020; and 25.55 percent for 2021.

---

<sup>7</sup> In response to the outbreak of COVID-19 and to slow its spread, the Governor declared a State of Emergency on March 4, 2020, and issued a stay-at-home order on March 19, 2020. The liability period was from January 1, 2018, through June 30, 2021.

18. On August 11, 2023, CDTFA denied appellant's petition.
19. Appellant timely appealed to OTA.
20. On August 22, 2024, OTA requested the inventory reports appellant's CPA used for his analysis, but appellant failed to respond.
21. At the oral hearing, appellant's CPA testified about the inventories he relied upon for his analysis and the third-party professional inventory service that conducted them. The CPA explained that the inventories were "not exact" but estimated. He testified: "This wasn't a strict, very-well executed inventory that would make an accountant pleased and proud. This was a professional service that made estimates based on size of the store, the product mix, and what they see on the shelves." Appellant's CPA also testified that, until February 2022 (i.e., after the liability period), the third-party inventory service had missed a storage room containing "somewhere in the neighborhood of \$400,000 worth of alcohol." Appellant's CPA opined that this inventory service was "not very good."
22. Following the oral hearing on April 16, 2025, appellant submitted the third-party inventory service's summary inventory reports, which showed the alleged total retail value of appellant's inventory as of eight dates between January 1, 2017, and November 8, 2021.

### DISCUSSION

California imposes upon all retailers a sales tax measured by the retailer's gross receipts from the retail sale of tangible personal property in this state, 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, it is presumed 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 tax returns or the amount of tax required to be paid to the state by any person, CDTFA may compute and determine the amount required to be paid on the basis of any information within its possession or that may come into its possession. (R&TC, § 6481.)

In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Las Playas #10*, 2021-OTA-204P.) If CDTFA's determination is not reasonable and rational, then the determination should be

rejected. (*Appeal of Landeros*, 2024-OTA-655P.) If CDTFA's determination is reasonable and rational, then the determination is presumed correct. (*Ibid.*) The burden of overcoming this presumption is on the taxpayer. (*Ibid.*)

Generally, the appellant bears the burden of proof as to all issues of fact. (Cal. Code Regs., tit. 18, § 30219(a).) The standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) That is, a taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of AMG Care Collective*, 2020-OTA-173P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Las Playas #10, Inc.*, *supra.*) To satisfy its burden of proof, a taxpayer must prove both that the tax assessment is incorrect and what the proper amount of tax should be. (*Appeal of AMG Care Collective*, *supra.*)

Here, appellant concedes that the books and records it provided to CDTFA for the audit were inadequate for sales and use tax audit purposes, and that CDTFA could not verify reported taxable sales using a direct audit method (i.e., compiling audited sales directly from appellant's records). Instead, CDTFA used an indirect audit method: the markup method, which is a recognized and accepted accounting procedure. (See *Appeal of Amaya*, 2021-OTA-328P.) However, the markup method is only effective and reliable if CDTFA has sufficient information to establish the cost of taxable merchandise sold and a reasonable markup. (*Ibid.*)

For the cost of taxable merchandise sold, CDTFA surveyed almost all (i.e., 99.23 percent) of appellant's taxable merchandise vendors and adjusted the survey results for the following: purchases of nontaxable merchandise; taxable merchandise purchases from vendors that it could not survey; pilferage; and self-consumption. CDTFA based the weighted markup of 29.38 percent on appellant's purchase invoices for newspapers, tobacco, cigarettes, sodas, beer, liquor, wine, and sundry items from June 2021 (i.e., the last month of the liability period). Because CDTFA was able to survey virtually all of appellant's taxable merchandise vendors in arriving at the cost of taxable goods sold (after reasonable adjustments for pilferage, self-consumption, etc.), and based the weighted markup on appellant's own records, OTA finds that CDTFA had sufficient information to establish audited taxable sales using the markup method. Thus, OTA concludes that CDTFA has carried its initial burden of showing that its determination was reasonable and rational, so its determination is presumed correct.<sup>8</sup> The burden of overcoming the presumption now shifts to appellant.

---

<sup>8</sup> On appeal, appellant generally argues that CDTFA employed an arbitrary audit method to estimate appellant's estimated sales. OTA finds this argument unpersuasive for the reasons stated above and will not discuss this argument further.

On appeal, appellant argues that adjustments are warranted for two reasons; OTA will analyze each in turn. First, appellant argues for an adjustment because it purportedly increased its inventory of alcohol and sundry items over the course of the liability period due to the COVID-19 pandemic but then sold the increased inventory of taxable items *after* the liability period ended. In other words, CDTFA's markup method accounted for the sales of this increased inventory during the liability period, but appellant contends that it sold the increased inventory afterwards and thus should receive an inventory allowance for this. Initially, appellant asserted that it did not need to provide any evidence of its inventories during the liability period to support this argument, arguing that "substantiation becomes irrelevant when [CDTFA] estimates taxable sales."<sup>9</sup> But after the oral hearing, appellant provided eight third-party inventory summary reports, which allegedly supported appellant's buildup of inventory during the latter part of the liability period.

However, OTA doubts the quality, accuracy, and reliability of the summary inventory reports. Regarding their quality, according to appellant's CPA, the third-party inventory service producing the reports was "not very good" and its inventories were not well executed. Regarding the reports' accuracy, the CPA stated that the inventories were based on estimations and were neither strict nor exact. Regarding the summary inventory reports' reliability, the CPA indicated that the inventory service missed a storage room for all inventories conducted during the liability period, so it is unknown what that room contained during that time (if anything). For these reasons, OTA finds the summary inventory reports are lacking in evidentiary weight and is unpersuaded by appellant's first argument for lack of substantiation.

For its second argument, appellant contends that CDTFA overestimated taxable sales because it applied a general markup based on "broad" categories. Appellant also contends that because CDTFA conducted its shelf test using June 2021 purchase invoices and selling prices from July 12, 2021, it does not faithfully capture appellant's markups in 2018 and 2019, which were lower than CDTFA's audited weighted markup of 29.38 percent. Instead, appellant asserts that CDTFA should have applied vendor-specific markups as its CPA did in his analysis.

Here, CDTFA did not apply a "general" markup, but a *weighted* one based on all taxable purchases made by appellant in June 2021, as well as a July 12, 2021 shelf test. Above, OTA has already found the audited weighted markup to be reasonable and rational. As for appellant's CPA's analysis and its use of 125 vendor-specific markups, OTA questions the

---

<sup>9</sup> OTA finds that this assertion lacks merit. OTA cannot base a factual finding on any material disputed fact solely on a party's unsworn statements made during OTA's appeal proceedings, such as allegations contained in a party's brief or arguments made by an unsworn representative during an oral hearing before OTA. (Cal. Code Regs., tit. 18, § 30214(f)(5).)

markups' accuracy and reliability. Apparently, appellant's CPA simply asked appellant for the "average" markup for all taxable items purchased for resale from each of 125 vendors during the liability period. OTA questions the accuracy of this method because the markups lack documentary substantiation and cannot be corroborated. OTA also questions the reliability of the markups because they are based on appellant's recollection of markups that were up to five years old at the time of the CPA's analysis. The CPA's analysis occurred in or around April 2023 (CPA's explanatory memo is dated April 21, 2023), while the liability period was from January 1, 2018, through June 30, 2021. Thus, OTA finds that appellant's alleged markups of 22.95, 24.32, 25.15, and 25.55 percent for 2018, 2019, 2020, and 2021, respectively, are also lacking in evidentiary weight, and concludes that appellant's second argument is unpersuasive.


In summary, OTA finds that CDTFA computed audited taxable sales based on the best-available evidence and applied a reasonable and rational indirect audit method (i.e., the markup method) to arrive at the tax liability due. Appellant has not identified any errors in CDTFA's computation of audited taxable sales or provided reliable documentation or evidence from which a more accurate determination could be made. As appellant bears the burden of proof in this case, OTA concludes that the amount of unreported taxable sales should not be reduced.

HOLDING


The amount of unreported taxable sales should not be reduced.


DISPOSITION

CDTFA's action denying appellant's petition for redetermination is sustained.

DocuSigned by:  
  
 8A4294817A67463  
 Andrew Wong  
 Administrative Law Judge

We concur:

Signed by:  
  
 47F45ABF89E34D0...  
 Suzanne B. Brown  
 Administrative Law Judge

DocuSigned by:  
  
 67E043D83EE547C  
 Sheriene Anne Ridenour  
 Administrative Law Judge

Date Issued: 9/10/2025