



The only item that remains at issue is unreported taxable sales in the amount of \$247,483 and the resulting tax of \$23,514, plus applicable interest.

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

### ISSUE

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

### FACTUAL FINDINGS

1. Appellant, a corporation, is a retailer that sells shoe cleaning products at a shopping mall kiosk in Downey, California, and at various other temporary locations (e.g., fairs) both inside and outside of the state of California.<sup>3</sup>
2. For the liability period, appellant reported total sales of \$746,886 and taxable sales of \$485,002, claiming nontaxable sales for resale of \$261,884.<sup>4</sup>
3. By letter dated March 11, 2020, respondent notified appellant that it had been selected for a routine audit and asked appellant to provide books and records for the audit. Appellant provided the following books and records: federal income tax returns (FITRs) and bank statements for 2017, 2018, and 2019; point-of-sale (POS) system reports for 2019;<sup>5</sup> sales for resale invoices for January 4, 2019, through May 24, 2019; and lease payment information (for out-of-state locations) covering January 1, 2017, through December 31, 2018. Respondent also obtained Form 1099-K<sup>6</sup> data for 2017, 2018, and 2019.

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<sup>3</sup> Although the audit working papers refer to temporary locations at fairs in and outside of California, the evidence indicates that appellant also made sales from out-of-state locations in mall kiosks, and some of those locations were making sales for extended periods of time.

<sup>4</sup> Because sales for resale are no longer at issue, this Opinion will not refer to them again.

<sup>5</sup> A POS system typically includes one or more terminals at which sales can be recorded. Depending on the equipment and software, POS systems can generate receipts for the customer showing items purchased, sales price, sales tax added, amount tendered, cash or credit, and change provided, if any. POA systems can also produce various reports for the retailer, which can summarize sales activity for the period of time selected by the operator and can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

<sup>6</sup> Form 1099-K is an Internal Revenue Service 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 includes payments made by any electronic means, including, but not limited to, credit cards, debit cards, PayPal, and Square.

4. Respondent found that total sales reported on FITRs exceeded total sales reported on SUTRs by \$212,973 for 2017, \$166,144 for 2018, and \$194,310 for 2019. Respondent concluded that further investigation was warranted.
5. Respondent considered a markup analysis but concluded that one could not be done due to the lack of substantiation of and/or support for the cost of goods sold (COGS).<sup>7</sup>
6. Respondent attempted to use a direct audit method to compute gross sales using bank statements, 1099K data, lease payment information (for out-of-state locations), and POS reports.<sup>8</sup> For 2017, respondent estimated out-of-state sales of \$701,724 using the lease agreements. It added California sales per appellant's SUTRs to calculate gross sales of \$1,037,467. Appellant reported gross sales of only \$548,716 on its FITRs, a difference of \$488,751. On this basis, respondent concluded that the gross sales amount reported on the 2017 FITR was unreliable.
7. Respondent also attempted to verify the California sales ratio per appellant's POS data. It concluded that, while recorded credit card sales were in line with merchant deposits per the 1099-K data, respondent could not verify the accuracy of recorded gross sales due, at least in part, to the absence of sequential transaction numbers. Respondent decided that an indirect audit approach was needed.<sup>9</sup>

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<sup>7</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 markup amount ÷ 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. The most accurate way to determine book markup is to compare actual cost and actual selling price per item. The markup audit method, which uses COGS, pricing data, and markup percentages to compute taxable sales, is a generally accepted method for calculating sales. (*Appeal of Amaya*, 2021-OTA-328P.)

<sup>8</sup> A direct audit method is one that enables respondent to verify taxable sales directly from the taxpayer's business records. Generally, a direct audit involves a simple tabulation of taxable sales evidenced by source documents, such as sales invoices, cash register tapes, or verifiable POS data. A direct audit approach based on complete and accurate business records generally produces the most accurate results.

<sup>9</sup> Although respondent's October 4, 2022 letter to appellant to explain the audit results states that books and records were adequate for sales and use tax purposes, the audit workpapers indicate that respondent concluded otherwise when it decided to employ an indirect audit method.

8. Respondent chose to use a credit card sales ratio analysis to estimate sales.<sup>10</sup> Respondent concluded that appellant did not provide documents of original entry sufficient to verify its credit card sales ratio;<sup>11</sup> therefore, respondent estimated a credit card sales ratio of 57.77 percent using data from the audits of three businesses that respondent considered similar.<sup>12</sup> Respondent applied that ratio to the credit card sales of \$121,775 shown by the 2019 POS system reports to calculate \$210,780 in audited taxable sales for 2019. Respondent deducted reported taxable sales of \$139,564 from that amount to compute \$71,216 in unreported taxable sales and an error percentage of 51.03 percent.<sup>13</sup>
9. Respondent applied the error percentage to the reported taxable sales for each quarter in the liability period to compute unreported taxable sales of \$247,483.
10. Respondent issued the NOD.
11. Appellant filed its petition for redetermination.
12. Respondent performed the reaudit to delete the measure of disallowed sales for resale and reduce the determined tax to \$23,514.
13. Respondent issued its decision, and this timely appeal to OTA 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

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<sup>10</sup> A credit card sales ratio analysis typically involves the use of third-party data, such as bank statements or IRS Forms 1099-K, which shows amounts paid to a merchant by a bank, credit card company, or third-party network when the customer pays for goods or services using a debit card, credit card, PayPal, or similar non-cash payment. If a reasonable estimate of the ratio of such non-cash sales to total sales can be made, an equally reasonable estimate of total (i.e., cash and non-cash) sales can be made. OTA has held that a credit card sales ratio analysis is a recognized and accepted sales tax auditing procedure. (*Appeal of Amaya, supra.*)

<sup>11</sup> The 2019 POS system reports show a credit card sales ratio of 93.46 percent.

<sup>12</sup> The businesses and audit periods can be generally described as follows: (1) a perfume retailer located in Los Angeles County that was audited for the period 2017 through 2019 and found to have a credit card sales ratio of 61 percent; (2) a retailer of miscellaneous items such as vitamins and topical applications in Los Angeles that was audited for the period 2018 through 2020 and found to have a credit card sales ratio of 54.12 percent; and (3) a sunglasses retailer that operated several kiosks in Orange County and San Diego County that was audited for 2018 and found to have a credit card sales ratio of 58.20 percent. Respondent used the average of the three ratios.

<sup>13</sup> The error percentage is calculated by dividing unreported taxable sales by reported taxable sales.

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 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.*)

While appellant provided limited source documents, that being POS system data for 2019, respondent reports that the data would not allow respondent to identify and exclude out-of-state sales. Given the limited books and records in respondent's possession, it was appropriate for it to use an indirect audit approach to verify taxable sales. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) The choice of which method to use was respondent's to make. (R&TC, § 6481.) The credit card sales ratio analysis chosen by respondent is a generally accepted sales tax auditing procedure. (*Appeal of Amaya*, 2021-OTA-328P.) OTA finds that respondent's decision to use the credit card sales ratio analysis was reasonable and rational.

The next question is whether respondent in fact used the method correctly to produce a reasonable estimate of taxable sales. OTA has reviewed the audit working papers and is persuaded that respondent could not determine appellant's actual credit card sales ratio from the records in respondent's possession. Under the circumstances, it is not unusual, or unreasonable, for respondent to use data from audits of comparable businesses. In this context, the term "comparable" does not necessarily mean a business that sells the same product. Respondent used data from the audits of three retailers of relatively inexpensive and non-essential items that can all be fairly characterized as health, beauty, or fashion items. The ratios ranged from 54.12 percent (for the vitamin and topical application retailer) to 61 percent (for the perfume retailer). The average ratio was 57.77 percent, which is close to the 58.20 percent ratio for the retailer who sold sunglasses from kiosks. OTA finds that respondent's use of the 57.77 percent ratio was reasonable and rational. OTA examined

respondent's calculations and found no error. On these bases, OTA finds that respondent's audit produced a reasonable estimate of appellant's unreported taxable sales. Therefore, the burden will shift to appellant to prove error and a more accurate result. (*Appeal of AMG Care Collective*, 2020-OTA-173P.)

During respondent's internal appeal process, appellant argued that its bank statements reconcile with its FITRs and that the IRS audited appellant for the 2017 and 2018 tax years and found no error. It asserted that respondent should be required to accept total sales reported on a taxpayer's FITRs. Appellant also contends that respondent's reliance on credit card sales ratios of the other businesses was wrong because they were not comparable businesses, at least in part because those businesses did not sell at fairs and did not receive tips.<sup>14</sup> Appellant argues that respondent should have used credit card sales ratio data from one or more of appellant's direct competitors. On this basis, appellant asserts that the credit card sales ratio used in the audit is too low.

Appellant has not provided any evidence regarding the IRS audit, so it is not possible for OTA to determine the scope of, or findings from, those audits or the evidentiary bases of any opinions expressed by the IRS. Furthermore, respondent's gross sales analysis for 2017 indicated that amounts reported to the IRS may be unreliable because recorded gross sales, based on the records appellant provided, exceeded gross receipts appellant reported on its 2017 FITR. Finally, respondent is not required to accept a taxpayer's books and records as conclusive evidence, even if such books and records are internally consistent. (R&TC, § 6481; see also *Riley B's v. State Bd. Of Equalization* (1976) 61 Cal.App.3d 610, 615-616; *Appeal of Amaya, supra*.) Respondent can determine the amount of tax due in an audit based upon any information in its possession and using recognized and accepted tax auditing procedures. (*Ibid.*)

Appellant also provided no evidence to support its argument that the credit card sales data for any of the three businesses used in the audit was not comparable to appellant's data. The data was used to estimate the credit card sales ratio only. OTA can see no logical reason why customers who chose to pay tips to appellant's employees or customers who purchased appellant's products at fairs or similar events would be more or less likely to pay with a credit card. Appellant made no logical and credible argument to show why the ratio used by respondent does not fairly represent appellant's business in that regard. Appellant did not offer any analysis or state any conclusions regarding what credit card sales ratio should have been

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<sup>14</sup> The 2019 POS system data indicates that appellant received tips on a vast majority of its sales totaling \$23,710.

used, but OTA notes that the credit card sales ratio shown by the 2019 POS system data was over 93.45 percent, more than 35 percentage points higher than the credit card purchase ratio for the comparable retailer that sold dark glasses from kiosks.

On the basis of the evidence, OTA finds that appellant has failed to show error in respondent’s audit or a more accurate taxable measure. Consequently, further adjustments to the measure of unreported taxable sales are not warranted.

HOLDING

No further adjustments to the amount of unreported taxable sales are warranted.

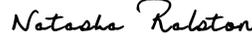
DISPOSITION

Respondent’s action denying appellant’s protective claim for refund and partially denying appellant’s petition for redetermination is sustained.

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Michael F. Geary  
Administrative Law Judge

We concur:

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Keith T. Long  
Administrative Law Judge

Signed by:  
  
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Natasha Ralston  
Administrative Law Judge

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