Docusign Envelope ID: 4E4144B2-CECC-8EC5-8165-95BE193249D0

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **A. KHATTAK,** **dba Olympic Liquor and Grocery**	OTA Case No.: 250522086 CDTFA Case ID: 5-171-428

OPINION

Representing the Parties:

For Appellant: Gary Kimzey, Representative

For Respondent: Jason Parker, Chief of Headquarters Ops.

K. WILSON, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 6561, A. Khattak, doing business as Olympic Liquor and Grocery, (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) denying, in part, appellant's timely petition for redetermination of a Notice of Determination (NOD) issued on July 21, 2023.[1] The NOD is for tax of $101,303, plus applicable interest, and a negligence penalty of $10,130.29 for the period January 1, 2019, through March 31, 2023 (liability period).

CDTFA's Decision ordered adjustments to the determined measure of tax and a reaudit was prepared. The reaudit reduced the determined tax to $94,937, the negligence penalty to $9,493.63, and a corresponding reduction to applicable interest.

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, (Regulation) section 30209(a).[2]

[1] The NOD was timely issued because on April 10, 2023, appellant signed the most recent in a series of waivers of the otherwise applicable three-year statute of limitations for the period January 1, 2019, through March 31, 2020, which allowed CDTFA until July 31, 2023, to issue an NOD. (See R&TC, §§ 6487(a), 6488.)

[2] Appellant failed to respond to the oral hearing notice. Therefore, appellant is deemed to have waived its right to a hearing, and this appeal will be decided on the written record.

ISSUE

Whether further adjustments to the measures of tax are warranted.[3]

FACTUAL FINDINGS

1. Appellant, a sole proprietor, operated a liquor store in Walnut Creek, California, selling wine, liquor, beer, carbonated beverages, cigarettes and tobacco products, miscellaneous taxable sundry items, food, and lottery. Appellant's seller's permit was opened with an effective start date of May 20, 2015. Appellant had not been previously audited.
2. For audit, appellant provided federal income tax returns (FITRs) for calendar years 2019 and 2020; merchandise purchase invoices for August 2022 and December 2022; and Form 1099-MISC[4] from cigarette manufacturers for 2019. Appellant did not provide source documentation, such as cash register tapes, or sales tax worksheets for the liability period. CDTFA found the provided records were incomplete and inadequate for sales and use tax audit purposes.
3. For the liability period, appellant reported on his sales and use tax returns (SUTRs) total sales of $8,604,377, claiming deductions of $1,149,582 for nontaxable sales of food products, $2,395,104 for "other" representing lottery sales, and $347,147 for sales tax reimbursement included in reported total sales resulting in reported taxable sales of $4,712,544. Appellant stated that he provided cash register z-tapes[5] and purchase invoices to his outside bookkeeper who prepared the SUTRs; however, appellant was unable to explain the reporting method.
4. CDTFA compared total sales reported on the SUTRs to the corresponding gross receipts reported on the FITRs for 2019 and 2020 noting no differences.

[3] The determined measure of tax of $1,193,420 was comprised of three audit items: 1) unreported taxable cigarette rebates of $103,382; 2) unreported taxable sales based on the markup method of $1,048,520; and 3) unreported self-consumption of taxable merchandise of $41,518. The reaudit reduced the determined measure of tax to $1,118,361. The reaudit measure was comprised of four items: 1) unreported taxable cigarette rebates of $103,382; 2) unreported taxable sales based on the markup method of $1,044,508; 3) unreported self-consumption of taxable merchandise of $41,518; and 4) a credit measure for tax-paid merchandise purchases resold of $71,047.

[4] Form 1099-MISC is an IRS form titled, "Miscellaneous Information," which shows the annual amounts received by a recipient of at least $600 paid for certain types of income during the calendar year.

[5] 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).

5. CDTFA compared total sales reported on the SUTRs for 2019 and 2020 to the corresponding cost of goods sold (COGS) reported on the FITRs and computed book markups.[6] CDTFA noted that for 2020, appellant's book markup was negative. A negative markup would mean that appellant was selling merchandise for less than his cost. Thus, CDTFA found that the negative book markup was unreasonable and evidence that reported taxable sales were potentially understated. CDTFA concluded that additional testing was warranted.
6. Because appellant was unable to explain his reporting method, CDTFA decided to verify reported sales using an indirect audit method, the markup method.
7. Using the merchandise purchase invoices for August 2022, CDTFA compiled purchases by vendor.
8. Because appellant did not provide records to support the completeness of the merchandise purchase invoices (i.e., purchase journals), CDTFA decided to verify merchandise purchases using a survey of appellant's vendors. CDTFA requested purchase data from the vendors identified from the merchandise purchase invoices for August 2022. CDTFA compiled merchandise purchases for each vendor for 2019 through 2022.
9. CDTFA compared taxable merchandise purchases for August 2022 per the merchandise purchase invoices to the vendor purchase data and found that the vendor purchase data was not complete and only represented 96.73 percent of purchases per the merchandise purchase invoices (vendor ratio). CDTFA also computed a taxable merchandise purchase ratio of 93.18 percent from the vendor purchase data. CDTFA multiplied the merchandise purchases per the vendor data for 2019 through 2022 by the taxable merchandise purchase ratio of 93.18 percent and then divided the result by the 96.73 percent vendor ratio to compute audited taxable purchases for that period.
10. Using the merchandise purchase invoices and the vendor data for August 2022, CDTFA prepared a purchase segregation,[7] which disclosed taxable purchases of wine and liquor (55.19 percent (rounded)), beer (30.44 percent), carbonated beverages (6.65 percent),

[6] "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 ÷ 0.70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records.

[7] CDTFA uses a purchase segregation test to establish the proportion of merchandise purchases in various product categories in order to compute the percentage of taxable merchandise purchases, as well as the percentages of merchandise in each category.

cigarettes (5.11 percent), tobacco products (0.92 percent), miscellaneous taxable sundry items (1.53 percent), and newspapers (0.16 percent).

11. CDTFA performed a shelf test[8] and computed markups for wine and liquor (45.32 percent), beer (38.54 percent), carbonated beverages (48.15 percent), cigarettes (17.64 percent), tobacco products (84.03 percent), miscellaneous taxable sundry items (69.57 percent), and newspapers (14.19 percent) using costs from December 2022 merchandise purchase invoices and selling prices appellant provided.

12. CDTFA applied the taxable purchase percentages from the segregation test to the respective shelf test markup for each merchandise category and computed a weighted taxable markup of 42.71 percent.

13. CDTFA deducted one percent for self-consumed merchandise and one percent for pilferage from audited taxable purchases for 2019 through 2022 (as explained above) to compute audited taxable purchases available for sale. CDTFA multiplied the audited taxable purchases available for sale by the audited markup factor[9] to compute audited taxable sales of $5,425,089 for 2019 through 2022. CDTFA deducted taxable sales of $4,437,718 reported on the SUTRs to compute unreported taxable sales of $987,371 for 2019 through 2022 and percentages of error for each year and the four years combined.

14. CDTFA applied the percentages of error to the respective taxable sales reported on the SUTRs and the combined percentage of error to the first quarter of 2023 (1Q23). In total, CDTFA computed unreported taxable sales of $1,048,520 for the liability period. (Audit item 2.)

15. As noted above, CDTFA made a one percent allowance to audited taxable purchases for self-consumed taxable merchandise for 2019 through 2020. CDTFA noted that self-consumed merchandise was subject to use tax on the cost of the merchandise. Thus, CDTFA established a separate measure of tax for the cost of self-consumed taxable

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

[9] A "markup factor" is the factor by which COGS (or in this case, audited purchases) is multiplied to determine total sales. The markup factor is calculated by dividing sales by the COGS. The markup factor is equal to the markup plus 100 percent.

merchandise of $41,518 for the liability period.[10] (Audit item 3/Reaudit item 2.) Appellant did not dispute this audit item; thus, OTA does not discuss it further.

16. Using Form 1099-MISC appellant provided for 2019, CDTFA compiled cigarette rebates appellant received from cigarette manufacturers. CDTFA determined that these cigarette rebates were unreported taxable gross receipts.[11] CDTFA noted that cigarette rebates per Form 1099-MISC were consistent with other income appellant reported on his 2019 FITR. Thus, CDTFA concluded that other income appellant reported on his 2020 FITR represented taxable cigarette rebates. For 1Q21 through 1Q23, CDTFA established taxable cigarette rebates based on the quarterly average of taxable cigarette rebates for 2020. Thus, CDTFA included a separate measure of $103,382 (rounded) for unreported taxable cigarette rebates for the liability period. (Audit item 1/Reaudit item 3.) Appellant did not dispute this audit item; thus, OTA does not discuss it further.
17. CDTFA issued the NOD to appellant on July 21, 2023, based on the above-mentioned audit, with a tax liability of $101,303 plus applicable interest and a negligence penalty of $10,130.29.[12]
18. Appellant filed a timely petition for redetermination disputing the NOD.
19. CDTFA's Appeals Bureau held an appeals conference. A Decision was issued on December 20, 2024, ordering a reaudit to recompute unreported taxable sales as conceded by CDTFA and allowing appellant to provide additional documentation to support further adjustments but otherwise denied appellant's petition for redetermination.

[10] CDTFA computed self-consumed taxable merchandise of $38,787 for 2019 through 2022. For 1Q23, CDTFA used the 2022 average quarterly self-consumed taxable merchandise of $2,730. In total, CDTFA computed unreported self-consumed taxable merchandise of $41,518 (rounded) for the liability period.

[11] Manufacturers, vendors, and other third parties often engage in various programs that result in credits or payments made to retailers with respect to a retailer's taxable sale of products to an end-use customer. (Cal. Code Regs., tit. 18, § 1671.1(a).) These payments and credits include rebates. (*Ibid*.) Under certain conditions, payments received by the retailer in the form of rebates or other types of payments or credits for products sold at retail are included in the retailer's gross receipts or sales price from the sale of the product. (*Ibid*.) It is rebuttably presumed that any consideration received by retailers from third parties related to promotions for sales of specified products is subject to tax until the contrary is established. (Cal. Code Regs., tit. 18, § 1671.1(c)(3)(A).)

[12] Appellant did not raise any issue with respect to the negligence penalty on appeal. This Opinion does not address it further.

20. During the reaudit, CDTFA made adjustments for exempt sales paid by CalFresh Electronic Benefit Transfer (EBT)[13] cards. (See R&TC, § 6373(a).) CDTFA obtained appellant's CalFresh redemptions for the liability period through the U.S. Department of Agriculture. Based on the merchandise purchase invoices and the vendor data for August 2022, CDTFA divided purchases of carbonated beverages (total purchases of taxable items eligible to be purchased with CalFresh benefits) by 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 (carbonated beverages) and computed allowable CalFresh benefits of 26.37 percent. CDTFA multiplied the CalFresh redemptions by the percentage of allowable CalFresh benefits and computed allowable taxable sales made with CalFresh EBT cards for the liability period.
21. Using the same markup method as in the audit, CDTFA further reduced audited taxable sales for 2019 through 2022 by CalFresh EBT sales of $3,779 and calculated audited taxable sales of $5,421,310. Upon comparison to reported taxable sales of $4,437,718, CDTFA computed unreported taxable sales of $983,592 and percentages of error for each year and the four years combined.
22. CDTFA applied the percentages of error to the respective taxable sales reported on the SUTRs and the combined percentage of error to 1Q23. In total, CDTFA computed unreported taxable sales of $1,044,508 for the liability period. (Reaudit item 1.)
23. For his agency-level appeal, appellant argued that a deduction should be made for tax-paid purchases resold. (See Cal. Code Regs., tit. 18, § 1701.) Appellant provided various merchandise purchase invoices from the period April 2021 through December 2022, where appellant paid sales tax to the vendor. CDTFA compiled sales tax paid to the vendor and computed average quarterly sales tax paid. For each quarter in the liability period, CDTFA divided the average quarterly sales tax paid by the applicable sales tax rate to calculate audited tax-paid merchandise purchases resold credit measure of $71,047 (rounded). (Reaudit item 4)

[13] Appellant accepted CalFresh EBT cards from customers as payment for eligible food items. The CalFresh 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." 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).) [See Audit Manual sections 419.60 & 0904.30]

24. On March 7, 2025, CDTFA issued a reaudit report, which reduced the measure of tax by $75,059 from $1,193,420 to $1,118,361 ($1,044,508 + $41,518 + $103,382 - $71,047).
25. CDTFA notified appellant in a letter dated April 17, 2025, that the liability had been adjusted in accordance with the Decision.
26. Appellant timely appealed to OTA.

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).) Tangible personal property eligible to be purchased with CalFresh benefits is 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 two 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 two 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 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 CDTFA is not satisfied with the amount of tax reported by the taxpayer, 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.) 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 failed to provide adequate books and records for audit. CDTFA's preliminary analysis disclosed inconsistent book markups, in particular, a negative markup in 2020, which was an indication that reported sales were understated. Thus, OTA finds that it was reasonable for CDTFA to question reported taxable sales and use an indirect audit method, the markup method, to verify appellant's sales. CDTFA's use of the markup method as the basis for its determination is a recognized and accepted accounting procedure. (See *Appeal of Amaya*, 2021-OTA-328P.) Therefore, OTA concludes that CDTFA has met its minimal initial burden to show that its determination is reasonable and rational, and accordingly, the burden shifts to appellant to show errors in the audit.

Appellant contends that audited taxable merchandise purchases were overstated. Appellant argues that the audited taxable percentage from the purchase segregation test was inaccurate because there were differences between merchandise purchase invoices and the vendor purchase data. Appellant asserts that the one-month purchase segregation test was not representative of the liability period. In support of this argument, appellant stated that he prepared an expanded purchase segregation test, which resulted in a more accurate taxable percentage. However, the expanded purchase segregation test shows a higher taxable percentage of 85.25 percent compared to CDTFA's taxable percentage of 83.95 percent.

OTA notes that the taxable percentage was computed using the vendor data for August 2022. Appellant's analysis identified the alleged differences between merchandise purchase invoices and the vendor purchase data. However, appellant has not provided any verifiable documentation to support an adjustment to the audited taxable percentage. Even if appellant provided the documentation to support his analysis, the result would be an increase in the taxable percentage by 1.3 percent which would then increase the audited markup from 42.71 percent to 42.80 percent. This would result in an increase to the reaudited taxable measure with corresponding increases to the determined tax, penalty, and interest.

Accordingly, OTA finds no basis to recommend any adjustment for this argument.

OTA finds that CDTFA computed audited taxable sales based on the best available evidence, which is reasonable and rational. Appellant has not identified any errors in CDTFA's computation of audited taxable sales or provided new documentation or other evidence in support of his contention from which a more accurate determination could be made. As appellant bears the burden of proof in this case, OTA concludes that no adjustments to the measures of tax are warranted.

HOLDING

Further adjustments to the measures of tax are not warranted.

DISPOSITION

CDTFA's action in the reaudit decreasing appellant's tax liability to $94,937 and a corresponding reduction to the negligence penalty and interest but otherwise denying appellant's petition for redetermination is sustained.

Signed by:
Kim Wilson
4E8E740EDB984CD...

Kim Wilson
Hearing Officer

We concur:

DocuSigned by:
Josh Aldrich
48745BB806914B4...

Josh Aldrich
Administrative Law Judge

DocuSigned by:
DC88A60D8C3E442...

Keith T. Long
Administrative Law Judge

Date Issued: 8/4/2026