HEARING

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Business

Tax Appeals Hearing of:

HUKILAU SAN FRANCISCO, LLC,   OTA Case No. 18042567

Appellant.

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REPORTER'S TRANSCRIPT OF PROCEEDINGS

TUESDAY, FEBRUARY 26, 2019

9:00 A.M.

OFFICE OF TAX APPEALS
400 R STREET
SACRAMENTO, CALIFORNIA

Reported by AMY E. PERRY, CSR No. 11880

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EXHIBITS

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(Exhibits premarked, described and retained by Administrative Law Judge.)

TUESDAY, FEBRUARY 26, 2019 - 9:47 A.M.

ALJ GEARY: Good morning, gentlemen and ladies. My name is Michael Geary. Welcome to the Office of Tax Appeals. We are here to take evidence and hear arguments in the appeal of Hukilau San Francisco, LLC. That's Office of Tax Appeals, Case No. 18042567.

Today's date is February 26th, it's 9:47 a.m. Our stenographer, Ms. Perry, is taking down everything that's being said in the room. And to help us make a clear record that's easily understood when read, speak clearly and slowly. Don't speak when someone else is speaking. And it's probably best not to engage in side conversations at the table because it's difficult for her to determine what needs to be reported and what is considered a confidential communication.

I am joined on the penal by Judges Kwee and Vassigh. I'm lead in the hearing today, but we are all equal participants when we take this matter under submission and deliberate.

Who is here to represent the appellant?

MR. TAO: Eric Tao, T-A-O.

ALJ GEARY: Thank you, Mr. Tao. And who is here to represent the California Department of Tax and Fee Administration?

MR. LAMBERT: My name is Scott Lambert. And to my left is Kevin Hanks and to his left is Steven Smith.

ALJ GEARY: Thank you. OTA is a independent agency. It's completely separate and distinct from agencies that appear before us. The parties that appear before us are never at a disadvantage when they are not represented by an attorney or a CPA or a tax professional, and OTA does its best to make sure that the appeals process is transparent and accessible to all.

Mr. Tao, are you an attorney?

MR. TAO: I went to law school but I don't practice.

ALJ GEARY: Okay. So when I write this decision, I will simply identify you as the representative. I believe you are a member or were a member of the LLC, is that correct?

MR. TAO: That's correct, and the remaining officer.

ALJ GEARY: Okay. Thank you. This is an appeal from a determination by the department, or its predecessor, the Board of Equalization, that

Appellant, Hukilau San Francisco, LLC is liable for tax and interest measured by underreported taxable sales totalling 1,596,360.

That number has changed, and I'll talk about that more in a minute, and by unreported cost of self-consumed merchandise measured by $20,495 for the period July 1, 2009 through April 30, 2012.

The measure of audit Item 1 has changed several times in the course of the appeal, and perhaps slightly before the appeal began technically. It started, as I indicated, as a measure of $1,596,360. It's been adjusted several times, a re-audit completed after issuance of the determination, but before the appeals conference resulted in a small reduction of the measure of audit Item 1.

Subsequent re-audit or revised audit resulted in a further reduction of that measure to $746,426. And the matter made its way through the department's in-house appeals process. And the Appeals Bureau issued a decision and recommendation, and in that document, that it was recommended that the measure of audit Item 1 be adjusted upward to $805,299. The measure of audit Item 2 as self-consumed merchandise has not changed.

The department, I want to ask you, is it the department's contention that the correct measure of audit Item 1 is $805,299?

MR. LAMBERT: I don't believe so.

ALJ GEARY: Is it the 746,426?

MR. LAMBERT: No.

ALJ GEARY: What is it?

MR. LAMBERT: I believe it's 784 -- 784,804.

ALJ GEARY: Okay.

MR. LAMBERT: The 8 -- the 805, I believe, is if you take the 784 and add the --

ALJ GEARY: 20,000, the other measure?

MR. LAMBERT: Yes, the self-consumption. That will be the 805.

ALJ GEARY: Okay. Appellant contends that the correct measure is substantially less than that alleged by the department. According to the decision and recommendation issued by the Appeals Bureau of the department, the appellant agreed that the correct measure of audit Item 1 was 558,924.

But according to your brief, I believe, Mr. Tao, you assert that the correct measure of audit Item 1 is $358,820. What is the appellant's contention about what the correct measure for audit Item 1 is?

MR. TAO: That is the correct number.

ALJ GEARY: The $358,820?

MR. TAO: Yes.

ALJ GEARY: Okay. The parties agree that the issues to be addressed at the hearing are whether the appellant is entitled to a reduction of the measure of underreported taxable sales.

And I have to ask you, Mr. Tao, are you contesting the measure of audit Item 2?

MR. TAO: Yes.

ALJ GEARY: Okay. So the second issue is whether Appellant is entitled to a reduction of the measure of audit Item 2 for underreported costs of self-consumed merchandise.

The evidence has been submitted by the parties in advance. The department has offered into evidence Exhibits marked A through O for identification. Those are part of our electronic record. And those documents, I believe, were provided to Mr. Tao.

Mr. Tao, did you receive those documents?

MR. TAO: Yes. Thank you.

ALJ GEARY: Exhibit A is a report of field audit.

B is audit work papers.

C is the records for the first re-audit, referred to as the first re-audit.

D, the records of the audit work papers for the first re-audit.

E is the second re-audit working papers.

F is called the Daily Sales Journal. I presume that's a document that was submitted by Hukilau in the course of the audit.

G is the point of sale reports of Hukilau.

H is merchant statements for Hukilau.

I is a history of audit contacts.

J is the department's responsive brief filed in this matter.

K is an additional brief filed by the department.

L is the notice of determination.

M is the appellant's petition for redetermination.

N is the tax computation.

And O is our vendors' surveys.

Department, do you have any other documents you wish to submit for this hearing?

MR. LAMBERT: No.

ALJ GEARY: And Mr. Tao, do you have any objections to the admission of any of those documents?

MR. TAO: No.

ALJ GEARY: Those documents are admitted.

(Department's Exhibits A-O
admitted into evidence.)

ALJ GEARY: Does the department plan to call any live witnesses today?

MR. LAMBERT: No.

ALJ GEARY: All right. The appellant has offered documents that he marked for identification Exhibits 1 through 10. And those include actually two additional documents, 2A and 7A. So there are actually 12 exhibits. I'm going to ask the parties to re-mark those exhibits for identification as 1 through 12. So your 2A will be 3, Mr. Tao, renumbered after that. So you'll actually end up with Exhibits 1 through 12.

1 being identified as CDTFA calculation of unreported taxable sales.

2 being identified as CDTFA analysis of Petitioner's POS for point of sale tax reports.

3 being CDF POS tax analysis for September 2011.

4, the April 2011 POS reported tax sales rates -- sales tax rates, excuse me.

5 being the daily POS report example.

6 is a daily POS report example.

7, the declaration of Brandt Fuse -- excuse me, that's Brandt, B-R-A-N-D-T, Fuse, F-U-S-E.

8 is the declaration of Kim Kohara, K-O-H-A-R-A.

9, the declaration of Alan Omoto, O-M-O-T-O.

10 is the calculation of tax adjustment based on statutory rate.

11 is application of tax adjustment against daily sales report.

And 12 is CDTFA credit card and sales analysis.

Department, did you receive all copies of all those documents?

MR. LAMBERT: We did.

ALJ GEARY: Any objections to the admission?

MR. LAMBERT: None.

ALJ GEARY: Those documents are all admitted.

(Appellant's Exhibits 1-12 admitted into evidence.)

ALJ GEARY: Mr. Tao, do you have any live witnesses that you intend to offer today?

MR. TAO: Just myself.

ALJ GEARY: All right. And you have, I think I asked you before we went on the record, you have no other additional documents to offer today; correct?

MR. TAO: Not for admission.

ALJ GEARY: All right. We agreed during our pre-hearing conference that the parties -- that Mr. Tao, that the appellant would have 15 minutes for his opening statement, opening argument. The department would have 15 minutes for its argument. And Mr. Tao would have roughly five minutes for rebuttal if you need it.

And you indicated, I think, that you might testify. And testimony is fine. What I'll do is I'll administer an oath or affirmation to you. And then you can simply tell your story, however you want to. To the extent you give testimony, factual testimony when you've completed your 15-minute, roughly 15-minute argument and testimony, I'll ask the department if it has any questions about the testimony that you give.

If there are no questions, I'll have the department ask and make its only argument. And when it's concluded, you'll have your five-minute rebuttal if you want to take advantage of that. I usually wait until parties are done with their arguments before I open it up for questions from my co-panelists. If they feel a need to question you earlier, I invite them to tap me and let me know that they want to ask a question.

Mr. Tao, are you ready to proceed?

MR. TAO: I have a question.

ALJ GEARY: Sure.

MR. TAO: During my rebuttal, will I have an opportunity to question the respondent?

ALJ GEARY: Usually. I don't expect the respondent to state -- to give factual testimony, it wasn't my intent to administer an oath. I imagine Mr. Lambert's going to be making the argument; is that correct?

MR. LAMBERT: That's correct.

ALJ GEARY: I don't administer an oath when testimony is being offered, but if you have questions about what the department's position is, I'm going to allow you to ask those questions and I'll ask Mr. Lambert or someone else at the table to respond if they can.

MR. TAO: And I won't ask any factual testimony. I just want to make sure that if there's any technical presentation that I might have a question about before my rebuttal, I just want to be able to ask. For me, I'm not used to this. It's very technical.

So in case something does come up, I just want clarification as they have an opportunity to ask me questions, I just want to be able to ask technical questions.

ALJ GEARY: We will try to accommodate you. Here's what I suggest: When we get to that point, when I turn to you and tell you that you have time for rebuttal, if you want it, if you have questions, ask the questions to me or to the panel, and then I will reflect them back to the department and ask them if they can provide an answer.

MR. TAO: Thank you.

ALJ GEARY: Does that work for you?

MR. TAO: That's perfect. Thank you.

ALJ GEARY: Would you mind standing, raising your right hand. I'll administer an oath to you.

Do you solemnly swear or affirm to tell the truth, the whole truth and nothing but the truth in this matter?

MR. TAO: I do.

(Appellant sworn in.)

ALJ GEARY: Thank you. You may either sit and give your presentation or stand --

MR. TAO: I might stand so I can reach these exhibits. Can I ask a question? When I point to an exhibit, will you have it in front of you or do I have to bring it up?

ALJ GEARY: We all have exhibits.

MR. TAO: Okay. Great.

ALJ GEARY: I have an electronic exhibit file that has your exhibits in it. So you make reference to the exhibit, and we will able to go to it --

MR. TAO: Okay.

ALJ GEARY: -- on our computers. All right. Go ahead.

MR. TAO: All right. Good morning, Judge Geary, Judge Vassigh, Judge Kwee. Thank you for your time this morning, Mr. Lambert, Mr. Hanks, Mr. Smith.

My name is Eric Tao. I am here on behalf of the appellant, Hukilau San Francisco. I'd like to give a brief summary testifying as to how we got here and then present some evidence that was submitted earlier on why we believe that the auditor, when they made the determination as to the underreported tax sales relied on inaccurate data and, therefore, resulted in a calculation that overstates underreported taxable sales, and why through the same process we found a more accurate number.

We are not here to say that we did nothing wrong, that things could have been done more efficiently. There are things probably owed. But we are just here to say that I think the calculation and the data -- not the method or methodology -- but the data that was used was inaccurate.

Little background. So I'm from the big island of Hawaii. I started Hukilau with Kurt Osaki, who's from Kauai, and my other friend and partner, Al Omoto, who's from Oahu. We met in San Francisco and we were homesick and probably went overbroad by combatting homesickness by opening a Hawaiian restaurant. It's called Hukilau.

Huki means to pull, lau means the net. Old Hawaiian saying, when the community gets together and pull the net together, they share in the rewards of the fruits of their labor. It's also a very famous old Hawaiian song.

So Hukilau is kind of a place for friends in our community to hang out. And we were instantly successful, meaning it was crowded, people came. We just had local food from what our parents used to make, blend of rice and curry chicken, chicken katsu and kahlua pork and poké and spam and just simple food. We had music every Friday, hula dancing Fridays and Saturdays. It became very popular.

And I would say in retrospect, that was more of a curse than a blessing. We had no idea what we were doing. And we shouldn't have had a successful restaurant because we were more focused on having a great community, having fun with our friends, creating a cultural, iconic place, bottom line. But business was good, so we were allowed to be sloppy, and so we never even learned how to run the business.

That said, of course we made payroll, we paid rent, we had accountants but, you know, tried to be what we later learned, what's important to running a restaurant is having strict rules and heavy hand. And we were better at, you know, keeping track of what music was playing than keeping track of what inventory was going out.

So again, we were okay. Al Omoto worked full time. There was a general manager. I had my other business and Kurt had his other business. In 2005, 2006, things happened that started to cause things to go downhill. Business was still good, but I had my first child, so that limited my amount of time at the Hukilau. It didn't work anymore when I said I needed to go to work at the Hukilau instead of watching the baby.

So I stopped going to Hukilau very often, maybe once a week. Kurt Osaki got married and moved back to Hawaii, and Al Omoto, he, I think, wanted a job that had health benefits, so he left the Hukilau. So we thought, no big deal. We will hire some managers.

And being naive, we hired managers that we thought were patterned more like we were. We thought having the aloha spirit, a spirit of inclusion and community, identity, cultural, knowing the Hawaiian culture and sense of community was more important than being someone who was a strict business person.

So we hired dumb, mostly young people who came out of the junior University of San Francisco, USF Hawaii Club program, a lot of these young people that had all of those traits that I mentioned but were terrible managers. So we started to see our business go downhill, still crowded, still busy, but we started losing money.

Then 2008 happened, the great recession. So not only had we divorced ourselves from the business because we couldn't be there as much because of family obligations and Al Omoto leaving, our managers were, I would say, less than competent in the day-to-day management of the restaurant. Then we had the great recession.

I, looking back, that's when we should have shut down. But right around 2008, 2009, this new phenomenon came out, it was called, I believe, I think it's still called -- they're still around. There's one called Groupon. There was a proliferation of the social media sites where you could sell ahead of time meals at a severe discount.

It was really in a way, it was kind of loan sharking. We didn't know it. You could sell 100 meals for 50 percent or 60 percent of the price. All of a sudden you have money in your bank and you're paying your bills and everything looks good.

But then, of course, when people start coming in, your costs are going up and your margins are raised within that because we've pre-sold everything. And we kept doing that for a while. And the downside is our margins started going down. We couldn't make ends meet.

And the bad thing about this, too, we didn't learn it until later, once you create an atmosphere of discounts, everyone expects discounts all the time. And the quality of the food goes down, and quality of the service goes down because tips started getting smaller, too.

And the next thing you know, we became more of -- all of our margins were going down. We were making 150, 175-percent margin versus what should be

250 percent for industry standards, dollar beers here, discounted foods. So our margins are going down. Management wasn't good, but we said if we can't turn this around -- we started to feed the restaurant, meaning putting investment in.

We're still married to it iconically and emotionally as kind of the place for Hawaii people, that we didn't want to give it up. And with so many friends and people who had their one-year baby luaus there and got married there, we didn't want to give it up.

But we said if after ten years we can't turn it around, we'll shut it down. So in 2012, ten years, we just shut it down and would have been all done, but for this audit.

So that's the history and why we are where we are and why this restaurant has success. But a lot of the findings of auditors, auditors who audit a restaurant, they never saw it open, they were never actually there. They didn't know what was going on. So all they could rely on was what their standards are and what data we could provide.

After many audits and looking at different documents, the auditor decided on the fact that the most accurate representation for actual sales were the

POS statements. POS is point of sale system. We had a computerized system. Every day it generated daily sales, and would have two numbers that they isolate on, the amount of sales, actual sales, and amount of sales tax.

I ask you to look at Exhibit 3 of my exhibits -- I'm sorry, I'm getting confused -- Exhibit 5, the new Exhibit 5 which is the old Exhibit 4, and that shows you a representation of a POS tape.

This is what shows actual sales. And it says total sales and total tax. That's the two numbers that we look at. And it's not evidence, but just to show you every month this is compiled. Each sheet is a daily sale and each is a POS. This is from ten years ago. But that's what this is. So you'll see the total sales and total tax.

In analyzing these numbers, I just did some calculations. For some reason, the total tax is always higher than the statutory rate on those POS's. I just point that out for now. So we did a deeper dive.

And if you look at Exhibit 4 which is old Exhibit 3, we did an analysis of one of the months that the auditor used to do its determination which is

April 2011. And we look consistently every single day. The sales tax rate was higher by about 20 percent on average than the statutory rate.

Statutory rate in April 2011 was 9.5 percent. The average rate reported on the POS was 11.28 percent, consistently higher than the taxable sales from the same report.

Again, I reiterate again that the auditor said that the POS most accurately stated the taxable sales as well as the taxable sales tax. So we, again, we agree that it accurately stated taxable sales, but can't agree it accurately reported the sales tax. It's so inconsistent across the board with over the statutory rate by 20 percent.

ALJ GEARY: Mr. Tao, this document which is now marked 4 is something you created; is that right?

MR. TAO: Yes, I created. And I believe it matches pretty much exactly what the state prepared as well.

ALJ GEARY: All right. Thank you.

MR. TAO: And I have the actual -- these documents here, if they want to reexamine them, which I prepared and I delivered to them all 38 months. I think they only did three months, but I gave them 30-something months. I ask you to look at exhibits, I guess now they're the former 6, 7 and 7, 8 which I think now are 7, 8 and 9.

These are declarations of customers who would go there almost weekly, but I just had to declare that what they were most comfortable with, and that was more than 12 times a year. And they're all declarations of people who were regular customers for years, had gone there and never seen any aberration or irregularity on the amount of sales tax being charged on their bill, meaning that they were charged the right amount, not something that's 20 percent over the statutory amount.

I can also testify that as long as I've been with the restaurant, if there was any problem, any complaint or any issue, it was definitely brought to my attention. Never once in the entire ten years I was there had I ever heard a single complaint that we were overcharging sales tax on any customer's bill.

Am I doing okay on time?

ALJ GEARY: Depends on how much you have left.

MR. TAO: I have another six minutes, seven minutes.

ALJ GEARY: Go ahead.

MR. TAO: Okay. So I would posit that, you know, because of these declarations, because of my own experience, I would say that these effective sales tax rate on the POS, which this auditor relied upon, is inaccurate. It's wrong.

However, I would agree with the auditor, and I would agree with the CDTFA that the sales on the taxable sales on the POS, which they say is accurate, which is a right number, they never relied upon it because I think you get a higher number if you just rely on the sales tax.

But if you rely on the sales tax -- I mean the taxable sales, the actual sales on the POS which they say is accurate, I don't disagree with that because it seems that it does correlate to the daily sales what was actually sold and what was on the POS for taxable sales.

They take a position that the effective sales tax rate might be inflated because if tax is mandatory tips, I can testify that as an owner and participant, we rarely had mandatory tips. It's not -- I don't know how to explain this. It's not the aloha spirit, it's not the Hawaiian way to force someone to pay a tip. That is not in our culture, not the way our restaurant operated.

But even in an extreme case where there

wasn't, let's say, 25 percent of our sales, something crazy that had never happened had mandatory tip, 25 percent of an 18-percent mandatory tip at a 9-and-a-half percent tax rate would only bump the tax rate less than half of 1 percent. It doesn't account for 20 percent delta statutory rate and what was reported on the POS.

I can only conclude that the POS tax rate, my guess was that I was trying to tax comps, I was trying to tax giveaways. It was just inconsistent, there's no pattern. I tried with the auditor in good faith. We sat there together and tried to figure out a rhyme or reason. There was no way to come up with a rhyme or reason why it continued to be inflated, but we both did agree that we think that the sales report on the POS was accurate.

ALJ GEARY: You both, being you and the auditor?

MR. TAO: Yeah. But they decided not to rely on that. They said they relied on the tax.

So if you turn to Exhibit 10, which is Exhibit 8, the auditor relied on three months of POS statements to calculate what it called its tax deficiency looking only at the sales tax. I did the same thing. And I added another nine months, eight months. I looked at 11 months. I looked at 11 months.

And what I found, this time I focused on what we agreed upon, not in this final determination, but we both agreed upon the POS-recorded sales. The POS recorded sales for 11 months. Each month on average was, as you can see each month, I provided the POS report it says.

My in-house bookkeeper also kept the thing called a daily sales journal, what it recorded as daily sales. In it, I can't find him anymore, he's been gone for ten years or eight years. And I believe he included some comps or some other items that weren't actual taxable sales.

But this report was the daily totals volume so he could record it again. We were trying to be mindful operators and try to do a cost-per-sales percentage. So he wanted to record something in it.

But, so I compared -- I mean, the right thing to do is try to go through all 34 of these, it would take a lot of hours, and compute the actual POS-reported sales. But we did 11, so a third.

And we found that on average, the POS-reported sales were 8, roughly, and I think my eyes are getting bad, 8.5 percent less than the daily sales journal, which we had through the auditor compiled a total daily sales journal amount.

So just using that delta, the on-average, the actual POS recorded sales 8.5 percent less than the daily sales journal, you can compute what you think the taxable sales actually were by using 8.5 percent as a discount against the daily sales journal. And that is what Exhibit 11 is, the former Exhibit 9.

We took that average and calculated what we believe is the actual sales that was taxable using the POS. And we determined that the unreported taxable sales error from this document, just cutting to the chase, is $32,294 of unreported taxable -- not taxable sales, actual tax owed. That's the amount of tax we believe that is owed based on the amount of sales tax error.

I want to point to one last thing. Exhibit 11 -- 12, which is former Exhibit 10, this is -- the auditor actually approached this problem for many different ways. And one of the ways they did was through credit card ratio test.

If you look at Respondent's Exhibit, I think, H. There is 22 and 24 months of credit card reports showing all of our sales and credit cards. It's probably the most comprehensive piece of data they looked at, 24 months of sales of credit cards.

Then they looked at all of our -- they sampled all of our actual sales and they did a ratio and said, okay, it's on average, the $100 of sales today, 60 was credit card, 40 was cash, so 60/40. And they did a sample and came up with a credit card ratio.

And then they used 24 months, which is pretty comprehensive, thousands of transactions. And they determined through that process that my Hukilau's tax liability was 32,000 -- my eyes are getting bad -- I think 423 or 6-something. Anyway, it was within point 1 percent delta margin of error between using the POS sales, not tax sales, and that computation and the auditor's own computation using 24 months of credit card transactions in a credit card ratio test.

So to me, these are compelling evidence, number one, using the POS sales, and that's the dollars I used, gets you to the right amount of underreported tax owed, because secondly, it conforms with what the credit card ratio analysis arrives at on its own independent basis by the auditor using the largest amount of data available.

And lastly, that because of inconsistencies of the POS sales tax consistently being higher by sometimes up to 20, 25 percent, that cannot be relied upon. And that, again, I'm not saying mistakes weren't made, we could have been less sloppy. But I think the accurate amount is this $32,000 number, either through my independent study of the POS sales or the auditor's independent study through the credit card ratio test. Thank you.

ALJ GEARY: Thank you, Mr. Tao.

Did the department have any questions for Mr. Tao regarding the factual statements?

MR. LAMBERT: We don't.

ALJ GEARY: Are you ready to give your argument, Mr. Lambert?

MR. LAMBERT: I am.

ALJ GEARY: I was going to have questions after the argument. Go ahead, Mr. Lambert.

MR. LAMBERT: Okay. Thank you. This audit covers the period of July 2009 through April of 2012. As the appellant had stated, this is a bar and restaurant, and this was the second audit that was conducted by the department of this particular business.

Upon initial review, the income tax returns were compared to what was reported. And we had income tax returns for two years, the years 2010 and 2011.

Based on that review, the gross receipts for 2010 and 2011 added up to $1,593,000. They had reported on those two years returns $976,000. There was a difference of $617.31.

So initially, there appeared to be a difference between the income tax returns, gross receipts on the income tax returns, and the sales reported on the sales and use tax returns.

ALJ GEARY: Scott, did you say $617?

MR. LAMBERT: I might have. It should have been thousand, $617,000.

ALJ GEARY: All right. Yeah.

MR. LAMBERT: Thank you for catching that oversight. So $617,000, which is a substantial amount.

The next thing we took a look at was the markups on the income tax returns for the year 2010. The markup of record on the income tax returns is 185 percent. For 2011, it was 147 percent. And this information is contained in the decision and recommendation that is the department's exhibit with the response brief, which is Exhibit J. The information is contained within that.

The markup for the 2011 income tax for the income tax returns was 147 percent. Based on the taxpayer's records, the markup for 2010 was 107 percent. And from 2011, it was 27 percent. So there was obviously what appeared to be an underreporting of sales based on the income tax return.

So initially, the department decided to conduct a markup test at -- the business was closed at the time that the audit was initiated; therefore, the department could not go in and observe the business, and used some of the historical data from the prior audit to arrive at a markup. And that was applied to purchases for 2011, and a percentage of error was developed and then applied to the other periods of time.

There were some other issues that we used the POS reports for some other periods, but all that information from the initial audit, the department decided to take a different approach in conducting the audit. And therefore, we went to take a look at the point of sale information instead of using a markup method.

So even though we would expect for this type of business of a markup of around 250 to 350 percent, and the information on the income tax returns was below that, the fact that the taxpayer was going out of business placed some factor in us deciding not to use the markup method anymore and to use the POS system.

So when we took a look at the taxpayer's sales journals and the information that was on that, they both had taxable sales and they had sales tax that was on the sales journals when we took a look at the point of sale reports, which were called Z-tapes.

And a Z-tape is the ringing out of the cash register and is generally, at the end of the day, you can have other ring-outs during the business day, but a Z-1 is typically the ring-out of the entire day's sale at the end of the day.

What we noticed there was that the sales tax that was on the Z-tapes was different than the sales tax was recorded in the sales journal. So we were unable to identify exactly why there was an error.

We came to a hypothesis that it could have been from tax on mandatory tips, that the difference appears to be more than that, that they wouldn't have had that many mandatory tips during that time period.

Unfortunately, we're not able to say exactly what the error is due to. But from our experience, there could be issues with the way sales were rung up if discounts are given or two-for-one sales are given.

Sometimes what retailers will do, and it's not accurate, but they'll do it, is they'll take off either -- if you bring in a coupon for $5 off, they'll just take the $5 off and not adjust for tax, or they have two-for-one, they bill at the normal price, then they take the one meal off.

Ultimately, that could have been the problem with the excess tax that was on point of sale. So if you did have, say you sold two meals $5 each and you collected the appropriate tax and you took off one meal for $5 but you retained the sales tax, you would still be required to remit that tax to the state. You'd have the option of returning it to the customer.

In this particular case, that would appear to be nearly impossible as you wouldn't know who the customer was. So what the department did was take three different months, come up with differences between the tax that was on the POS reports and the tax, sale tax that was on the sales journals, and come up with a percentage difference. And I believe it comes to 11.5-something percent, in that range.

And so what the department did is took the sales tax from the sales journals which we had, applied that percentage to it, and then compared it to what was reported to come up with the differences.

And what I would point out from this is that for the years 2010 and 2011, if you take a look at the amount of sales, gross receipts for 2010 and 2011 from the income tax returns, you have $1,593,000. If you look for the two-year period for 2010, 2011 of our audited taxable sales, we only come in at $1,570,000.

So the method that we used didn't even capture the difference between the income tax returns and the income tax returns to the audited taxable measure. So at a minimum, we should have used the difference on the income tax returns at least for those two particular years.

So just to go back, sales tax collected, if it's excess tax reimbursement, that money would have to either be returned to the customer or turned over to the state.

In regards to the self-consumption, the taxpayer kept track of the sales -- or not the sales -- the removal of inventory that was given away, and it was a total figure. And I would point out that there were several months where there was no -- there was nothing listed for self-consumption during those periods. We didn't make any adjustment for the later periods in the audit where that was the case.

The auditor estimated, and this is just an estimate based on their experience, that 70 percent of the items self-consumed would be subject to tax such as alcohol or carbonated beverages, things of those nature where you would be the consumer of those items.

I would point out --

ALJ GEARY: Mr. Lambert, 70 percent was taxable?

MR. LAMBERT: No. I'm sorry --

ALJ GEARY: The other way around.

MR. LAMBERT: 30 percent was taxable -- I'm sorry. 30 percent of that item was taxable, 70 percent was nontaxable.

In the prior audit, the amount subject to use tax for withdrawals was $32,400. That's also contained in the decision and recommendation. In this particular audit, we came up with the 20,495. And with bars, you would generally find frequently drinks are given to regular customers or to friends. And I think the appellant has testified a substantial amount of inventory was given away during the later parts of the audit period or maybe the entire audit period.

So my understanding from the amount that we used was only withdrawn for employees, if there was also additional items that were withdrawn for the patrons, that would be subject to tax as well if it was a taxable item.

So the amount that's being used here is well below what was used in the prior audit. And this would also explain possibly the lower markup that the taxpayer's showing in their income tax returns that was lower than what we would -- the department would normally expect.

In regards to Exhibit 12 of the appellant, what I would point out is this isn't a typical credit card test, credit card percentage. The department will typically use a credit card percentage to develop audited taxable sales. It's one of the tools that we use along with markups and other types of analysis that we use.

What the auditor was trying or attempting or did do here is just compare the information based on the records that were available. So in other words, they were able to get the merchant statements. And what they wanted to do was to go back and take a look at what the credit card percentage would be based on the merchant statements and the bank statements, and that's the analysis that is done here.

I would point out that the gratuity in Column D is -- the way that is usually paid is cash to the employees, and that, I believe it says 175 or

170-something thousand dollars. I don't see where that was added back into here.

So in other words, the cash was deposited into the bank. There's a column here where the cash was deposited. That 175 would have been paid out to employees before it was ever deposited in the bank.

The bottom line is we don't believe this should be used, and that if you add up the figures, it doesn't come close to what was reported as gross receipts on the income tax returns. So we don't feel that this schedule is representative of the actual sales that took place during the audit period.

So with that, I conclude my presentation and am available for questions.

ALJ GEARY: I think we'll hold the Judges' cross until after the parties complete their arguments.

Mr. Tao indicated he might have questions before he gives his -- if he wants to give a final rebuttal. Do you have any, you referred to them as questions regarding technical matters?

MR. TAO: Might be too technical for me to even ask a question. So I'll just go into my rebuttal.

ALJ GEARY: Are you ready?

MR. TAO: Yeah.

ALJ GEARY: All right. Proceed.

MR. TAO: So I did forget to mention about self-consumption. We did have a policy that there's no alcoholic beverages served during daytime shifts. It was a family restaurant, I admit, started off when we were young and before we were married and had kids, had a lot of bar activity, but towards the end was a very family restaurant.

So the typical beverage that was allowed was, you know, we had a lot of juices, so that was very popular. Guava juice, lilikoi, passion fruit, so a lot of juices were the most popular drinks, but we didn't allow alcoholic beverages.

So I would say that if we have to pick a number from the error of what percentage of the sales were alcoholic beverages to taxable, I would say instead of 30 percent, I would say half of that, 15 percent. So I would cut that in half.

Secondly, I remember talking to Auditor and going over the income taxes. I can't remember, it was so long ago but we both decided that the income tax was not the right measure. I can't remember exactly, I can guess.

We did a lot of, at one point did a lot of luaus where we got entertainers, musicians, hula dancers and we charged for that and we post it as income, but I don't believe we treated that as taxable sales because it was more of a service. And then we would charge for them, we would pay a hula dancer or pay the musician for it. I don't think it's hundreds of thousands of dollars, but it was definitely some amount.

I just remember we came to an agreement that the federal income tax wasn't the best measures. It was better to go to the direct records of the actual business which were these daily reports and sales amount on that.

And I, again, as my conclusion is I agree with the auditor and CDTFA that the sales shown on the POS most accurately report the taxable sales. And by using that and not the inconsistent sales tax which is all over the place, which maybe as he pointed out, there was taxing discounts and things that we didn't collect, but just putting it on the system, that's the most accurate measure.

And I think our calculation arrives at the most accurate measure of what tax is probably owed. And again, we're not saying we didn't make mistakes. Looks like the amount is definitely less than what has been shown by using these inconsistent sales tax numbers. Thank you.

ALJ GEARY: Thank you. I'm going to open it back up for my co-panelists to ask questions of the parties.

Judge Vassigh, do you have anything?

Judge Kwee?

ALJ KWEE: Yes. I have a question first for Mr. Tao. And I just want to make sure I'm understanding your testimony and what were the facts of this case.

So if you could clarify how you reported, is just you would ring up on the cash register the sales, and that would be stored in a Z-tape, and at the end of the day, the daily reports would also have a summary of total sales and sales tax collected.

An issue here is that, or one of the issues here is that the total amounts, if you look at the receipts from the cash register, or the sales tax collected on the receipts for the cash register is less than the amount of sales tax collected per the daily sales journals.

Am I understanding that part correctly?

MR. TAO: I wish I had the daily actual receipts from each customer. That would make it much easier to show. The POS shows total sales, then it has a line for total tax on the POS.

ALJ KWEE: Okay.

MR. TAO: The total tax always is higher than the statutory amount. I don't know why. I have, I guess is that I explained, there's taxing comps or discounts or et cetera, but the amount is actually collected what is shown on the customers' actual receipts.

But since we don't have each of those, there would be thousands of receipts, we don't have the dailies, I was able to get declarations from multiple customers who declared that they never saw any overcharge of taxes on their daily charges. And I never saw it in all the ten years I was there, never had a complaint that we were charging 12-percent tax.

So that's my best evidence at this point without having actual receipts to show that the tax reported on the POS, because it's over the statutory limit, was not collected, and it's inaccurate.

ALJ KWEE: Okay. So I thought earlier there was some testimony or there was some reference that the sales tax on the daily sales journal was higher than on some other record.

Did I not hear that correctly?

MR. TAO: After we did the analysis, which I agree that the sales shown on the POS is the accurate sales, it was slightly lower than the daily sales journal because I think the daily sales journals reported some other nontaxable events, maybe a comp or this and that.

By applying the ratio of the difference between what was actually shown as sales on the POS versus daily sales journal came out to 8.5 percent delta. And applying that against what the daily sales journal showed as tax versus using that 8.5 percent, they came up to an underpayment of the $32,000 of taxes.

ALJ KWEE: So there was a difference in the total sales tax listed; is that correct?

MR. TAO: I think there's a slight difference. It's the actual sales on the POS is lower than the actual sales of the daily sales journal.

ALJ KWEE: Okay. And you mentioned that you, I guess, the corporation had, or the LLC had Groupons offered, could the use of Groupons explain some of the discrepancy?

MR. TAO: I don't know. It was a bad idea. It was a good idea at the time. There was like ten different sites at that time. And we used all different types where we pre-sold meals and at a discount, a severe discount. Probably reason why -- and I appreciate the auditor being -- trying to be in good faith understanding we didn't do normal markups with all those different things.

But I can't understand, maybe that's discrepancy. Maybe there were a 50-percent discount or 40 -- 60-percent discount, and then the POS were reported some other way. But we definitely didn't collect any more tax, at least from my recollection and from all the testimony of the declarants than what was statutory amount.

ALJ KWEE: Okay. I also had a question for CDTFA, Scott.

So I think I heard you make a reference to 70 percent of the self-consumption was with respect to taxable items, but then when I was looking at the audit report, it looks like all the self-consumption has to do with alcohol.

So I just, I was wondering if you could clarify that because that would be --

MR. LAMBERT: Right. I misspoke. I believe I said 70 percent. I don't recall saying it, but apparently that's not what I meant. I meant 30 percent of the amount drawn from inventory were taxable items. So should have been 30 instead of 70. The 70 was nontaxable and 30 was taxable.

ALJ KWEE: Okay. And as far as the alcohol consumption, was that also based on an actual -- was that an actual basis? How did you come to the measure of 20,000, approximately 20,000?

MR. LAMBERT: Right. The 30 percent was used as an estimate based on our experience of auditing similar businesses. So at the time that the audit was conducted, it was closed, the business was closed. And at that point you couldn't do a test of the use that was withdrawn from inventory.

ALJ KWEE: Okay. Thank you.

ALJ GEARY: Judge Kwee was asking questions about something that he thought he heard one of the parties saying. And I think, Mr. Lambert, you said something about the Z-tapes being different than what was reported in the sales journal.

What was it that was different?

MR. LAMBERT: That's correct. Well, actually both, the taxable sales and the sales tax were different numbers that were in the sales journal than what was on the point of sale.

ALJ GEARY: The prior audit was originally -- correct me if I'm wrong -- was originally done on a markup basis?

MR. LAMBERT: That's correct.

ALJ GEARY: Then later they decided, the department decided, matter of fact, I think it was after an unsuccessful appeal through the Appeals Bureau process, the department decided on its own to revise the audit using credit card analysis, wasn't it?

MR. LAMBERT: That's correct.

ALJ GEARY: So tell me, what was different between --

Have you seen those records, the credit card analysis that was done in the prior audit?

MR. LAMBERT: I have not.

ALJ GEARY: Okay. So you wouldn't able to tell me what's the difference between the way the auditor did the credit card analysis in that case and the way the auditor did it in this case?

MR. LAMBERT: Well, I can tell you the difference typically the way it is. And I don't -- although I was involved in the prior audit, it happened just like you said it did. It went back to the field office and they decided to change the methodology in which they conducted the audit.

And I've asked -- I'm unsure exactly why that happened, but it did. And so anyway, typically when you do a credit card -- a credit -- when you use the credit card method, what you'll do is you'll do a test period of credit card usage based on total sales that were conducted for that day, and you'll come up with a percentage, and then you apply that back towards the credit card receipts that are net of both tips and tax. You come up with a percentage. You apply it. That will give you the total sales. Then you compare it.

The difference in this particular case is there was no test that was conducted. Instead, what they did was to take the credit card receipts and then use the deposits into the bank account to come up with what the sales would be or what credit card percentage would be.

And at that point, they decided not to use that method because there was a feeling that not all the cash was being put into the bank, that there were gaps between deposits of cash in the bank. And some months there were no -- there was no cash deposited into the bank. And so they decided not to use that method.

In addition at that particular time, there was an issue. When they first did this analysis, there was an issue with the markup, and that was still an issue at that particular time. And that's when they decided to use the markup method even in this audit initially.

So I believe it's after they chose not to use the markup method anymore, that, and at that time, that's when they decided to change the initial audit. But I don't know exactly what the reasoning was for abandoning the markup method and going to the credit card method in the first audit, and why this method was different this time instead. We actually used their records which were the point of sale records in this particular audit.

So I hope that --

ALJ GEARY: Do you know, you referred to the credit card analysis in this case as being somewhat atypical, the schedule that shows the results. You referred to it as not the typical kind.

Was it because there were numbers missing and the department had to use an average to plug in numbers for the deposits when there weren't deposits shown in the records, is that one of the reasons?

MR. LAMBERT: Well, what I would say, well maybe atypical wasn't the right term. When you do a credit card test, it's different. This was a credit card analysis and not a test. So that's the distinction between the two.

If it was a test that you do, you're going to actually find the credit card percentage. And what they did in this analysis, they used the information that they had to develop the percentage, so it's basically using the taxpayer's records to come back to say this is what the percentage is.

Essentially what you're doing is you're saying that's the right percentage. You're just going to accept the taxpayer's records at that particular time because that's what you used to develop that percentage.

Whereas, in a typical credit card method test, you're going to actually do testing which is different than this.

MR. HANKS: I'm just mindful that in the circumstance, because the business was closed, there was no opportunity for the auditor to determine what that credit card ratio would have been, so that methodology really wasn't available to the auditor during the current examination.

What is typical though is the auditors will typically look at accrued sales tax for reimbursement within taxpayers' records. We typically capitalize those collections and compare those analyses to reported taxable amounts. And that's basically with the auditors in this case to determine the differences that were seen.

The fact this is based on information from their source documents from the Z-tapes as Scott's indicated, it's probably the best evidence we have is what the actual tax collection was. I think what Mr. Lambert was saying with respect to two-for-one sales is probably what's happening. And it wouldn't be atypical for businesses not to program the registers correctly, charge the tax reimbursement on the $10 transaction that he's describing even though the sales made in $5. Right? So that does happen.

Unfortunately, businesses need to be mindful of making those programming changes within the registers so that doesn't happen. Otherwise, you do collect excess tax reimbursement.

ALJ GEARY: Thank you. Those are all the questions that I have.

Judge Kwee, anything else?

ALJ KWEE: No.

ALJ GEARY: Judge Vassigh?

ALJ VASSIGH: No.

ALJ GEARY: Any questions from the parties?

Mr. Tao, anything?

MR. TAO: What is the next step that's going to happen? Are you rendering a judgment today or --

ALJ GEARY: No. What's going to happen is I'm going to close the record, and I am closing the record right now. The record's closed. We have all the evidence. We've heard the arguments.

Some time in the near future, the three judges sitting on the panel will deliberate the issues, will decide the issues, will write a written decision, an opinion, and it will be issued within 100 days of today's date, and it will be sent to the parties. So I can't tell you exactly when other than it will be within 100 days of today's date that that opinion will be mailed to you. All right?

MR. TAO: Thank you.

ALJ GEARY: And that concludes the hearing. I'm adjourning the hearing.

(Whereupon the proceedings were adjourned at 10:50 a.m.)

REPORTER'S CERTIFICATE

I, Amy E. Perry, a Certified Shorthand Reporter in and for the State of California, duly appointed and commissioned to administer oaths, do hereby certify:

That I am a disinterested person herein; that the foregoing hearing in the matter of HUKILAU SAN FRANCISCO, LLC was reported in shorthand by me, Amy E. Perry, a duly qualified Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewritten form by means of computer-aided transcription.

I further certify that I am not of counsel or attorney for any of the parties to said hearing or in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 18th day of March, 2019.

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