OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 18012010
SURF CITY HOOKAH LOUNGE, INC.	Date Issued: April 3, 2019

OPINION

Representing the Parties:

For Appellant:	Samy Mankrous, Owner
For Respondent:	Kevin C. Hanks, Chief Headquarters Operations Division
For Office of Tax Appeals:	Richard Zellmer Business Tax Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code section 6561,[1] Surf City Hookah Lounge, Inc. (appellant) appeals a Notice of Determination issued by respondent California Department of Tax and Fee Administration (CDTFA)[2] assessing a tax deficiency of $21,860.10, plus applicable interest, for the period July 1, 2009, through June 30, 2012.

Appellant waived its right to an oral hearing and therefore the matter is being decided based on the written record.

ISSUE

Whether appellant has established that reductions to the audit liability should be made to account for tips and cover charges.

[1] Unless otherwise indicated, all statutory references are to sections of the Revenue and Taxation Code.

[2] Sales taxes were formerly administered by the State Board of Equalization. In 2017, functions of the board relevant to this case were transferred to the California Department of Tax and Fee Administration (CDTFA). (Gov. Code § 15570.22; 2017 Stats. 2017, ch. 16, § 5.) For ease of reference, the term "CDTFA" shall refer to both, depending on the context and timing. When referring to acts or events that occurred before January 1, 2018, "CDTFA" shall refer to the board; and when referring to acts or events that occurred on or after January 1, 2018, "CDTFA" shall refer to CDTFA.

FACTUAL FINDINGS

1. Appellant operated a tobacco smoke lounge in Huntington Beach, California, selling tobacco products, pipe tips, water, juice, and soda, all for consumption on its premises.
2. CDTFA audited appellant for the period July 1, 2009, through June 30, 2012. For the audit, appellant provided the following books and records: federal income tax returns for 2009 and 2010; merchandise purchase invoices and paid bills for the period January 1, 2012, through June 30, 2012; and cash register tapes for the period July 19, 2012, through August 9, 2012 (which is outside of the audit period).
3. Appellant did not provide a complete set of merchandise purchase invoices, or provide any cash register tapes for periods within the audit period, or cash-register Z-tapes. Appellant also did not provide documentary support for its claimed deductions for exempt food sales or sales tax reimbursement allegedly included in its reported total sales. The incomplete records that appellant provided for audit were inadequate for sales and use tax purposes.
4. CDTFA compared appellant's average annual reported total sales of $57,832 to appellant's merchandise purchases reported in its federal income tax returns for 2009 and 2010 of $20,534 and $37,311, respectively, and CDTFA calculated book markups of 181.64 percent for 2009 and 55.00 percent for 2010, which CDTFA determined were too low to be acceptable.
5. Based on the unacceptable book markups calculated from appellant's total sales, and on the incomplete purchase and sales records, CDTFA performed additional analysis.
6. In the audit, CDTFA computed an average book markup of 341.18 percent by comparing gross receipts to cost of goods sold, both reported on the federal income tax returns, for 2009 and 2010. CDTFA reduced merchandise purchases reported on the federal income tax returns by 5 percent for self-consumption and by another 3 percent for pilferage to compute audited cost of goods sold. CDTFA added the markup of 341.18 percent to audited cost of goods sold to compute audited taxable sales. CDTFA compared audited taxable sales to reported taxable sales to compute unreported taxable sales of $254,579 for the audit period.
7. CDTFA issued a Notice of Determination to appellant based on the audit for tax of $21,860.10, plus applicable interest.

8. Appellant filed a petition for redetermination.
9. In a Decision and Recommendation issued on August 23, 2017, CDTFA's Appeals Bureau rejected all of appellant's arguments, and denied the petition for redetermination.
10. Appellant filed the instant appeal with the Office of Tax Appeals (OTA), arguing that adjustments should be made for tips and cover charges.
11. By letter dated August 9, 2018, OTA requested appellant to provide evidence, such as cash register tapes and sales journals, to show the amounts of tips and cover charges that were recorded in appellant's records in 2009 and 2010. OTA also requested appellant to provide any documentation that shows that the tips and cover charges recorded in appellant's records were included in the amounts of gross receipts that were reported on the 2009 and 2010 federal income tax returns.
12. Appellant failed to respond to OTA's request.

DISCUSSION

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (§ 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (§ 6091.)

When CDTFA is not satisfied with the accuracy of the sales and use tax returns filed, it may base its determination of the tax due upon the facts contained in the returns or upon any information that comes within its possession. (§ 6481.) It is the taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability, including bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account. (§§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When a taxpayer challenges a Notice of Determination, CDTFA has the burden to explain the basis for that deficiency. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610.) Generally, where a taxpayer challenges the additional tax, the government bears the initial burden of establishing a prima facie case that taxes are owed. (*Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950.) Based on *Riley B's, Inc.* and *Schuman Aviation Co. Ltd.*, we conclude that when a taxpayer challenges a Notice of Determination, CDTFA must establish a prima facie case that taxes are owed by proving the

basis for that deficiency and providing evidence sufficient to establish that its determination is reasonable.

Where CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to explain why CDTFA's asserted deficiency is not valid. (*Riley B's, Inc., supra,* at pp. 615-616.) The applicable burden of proof is by a preponderance of the evidence. (Evid. Code, § 115; *Appeal of Estate of Gillespie,* 2018-OTA-052P, June 13, 2018, at p. 4.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.) To satisfy its burden of proof, a taxpayer must prove both (1) the tax assessment is incorrect, and (2) the proper amount of the tax. (*Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.)

Here, CDTFA had sufficient reasons to question the reliability of appellant's reported taxable sales. (§ 6481.) The books and records appellant provided for audit were incomplete. Specifically, appellant did not provide a complete set of merchandise purchase invoices, or provide any cash register tapes for periods within the audit period, or cash-register Z-tapes. Appellant also did not provide documentary support for its claimed deductions for exempt food sales or sales tax reimbursement allegedly included in its reported total sales. Further, CDTFA determined that appellant's calculated book markups (181.64 percent for 2009 and 55.00 percent for 2010) were too low to be acceptable. Accordingly, we find that CDTFA was justified in questioning the reliability of appellant's reported taxable sales, and in computing appellant's taxable sales using the markup method.

In computing appellant's taxable sales, CDTFA established an average markup of 341.18 percent by comparing gross receipts to cost of goods sold, both reported on appellant's own federal income tax returns, for 2009 and 2010. CDTFA then applied that average markup to appellant's cost of goods sold, as reported on appellant's own income tax returns. Thus, we conclude that CDTFA has established that its determination is reasonable and based on the best-available evidence, and accordingly the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

On appeal, appellant contends that a reduction should be made to account for tips and cover charges that it rang up on its cash register and included in its gross income reported on its

federal income tax returns. To establish that it is entitled to an adjustment for these items, appellant must show that the gross receipts reported on the 2009 and 2010 federal income tax returns included tips and cover charges; however, appellant has not provided any documentation from its books and records to do so.

Accordingly, we conclude that appellant has failed to meet its burden of establishing that a reduction for tips and cover charges is warranted.

HOLDING

Appellant failed to establish that an adjustment should be made for tips and cover charges.

DISPOSITION

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

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge