OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18032370) CDTFA Case ID 880749
ANAHIT K, INC.	) CDTFA Case Account No. 101-265604)
	) Date Issued: July 15, 2019)

OPINION

Representing the Parties:

For Appellant:	Yuji Maemura, CPA
For Respondent:	Scott A. Lambert, Hearing Representative
For Office of Tax Appeals:	Deborah Cumins, Business Tax Specialist III

J. ANGEJA, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6901, appellant Anahit K, Inc. appeals the respondent California Department of Tax and Fee Administration (CDTFA)'s denial of a claimed refund of $49,182.83[1] for the period October 1, 2010, through December 31, 2013.

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

ISSUE

Whether appellant has established that adjustments are warranted to the understatement of reported taxable sales.

[1] The actual amount of refund claimed has not been established. The entire amount of tax paid pursuant to the Notice of Determination (NOD) issued March 9, 2015, was $49,182.83. However, that amount represents tax on $553,724, and CDTFA's Decision and Recommendation (D&R) states that appellant disputes only the audited understatement of reported sales of alcohol of $237,578 and does not dispute the unreported sale of business assets of $300,000 or the unreported cost of self-consumed merchandise of $16,146. Accordingly, we believe the amount of refund claimed is approximately $21,102 [($237,578 ÷ $553,724) x $49,182.83].

FACTUAL FINDINGS

1. Appellant operated a restaurant known as Mythos Bar and Restaurant in San Carlos, California, from August 1, 2009, through December 31, 2013.
2. CDTFA audited appellant for the period October 1, 2010, through December 31, 2013. The audit resulted in three separate measures of tax: $300,000 for the unreported sale of business assets, $16,146 for the unreported cost of self-consumed taxable merchandise, and $237,578 for unreported taxable sales of alcohol. Appellant only protests the measure of tax of $237,578 for unreported taxable sales of alcohol, and therefore, we do not discuss the other measures of tax further.
3. CDTFA segregated appellant's recorded cost of goods sold into categories of alcohol and food.[2] It then computed book markups by comparing the cost of food sold to recorded food sales, and comparing the cost of alcohol sold to recorded alcohol sales. CDTFA found the book markups for food to be in the range of markups expected for this business and concluded that recorded and reported sales of food were substantially accurate. However, CDTFA found that the book markups for alcohol (124 percent for 2010, 135 percent for 2011, 171 percent for 2012, and 160 percent for 2013) were significantly lower than the expected markup for alcohol sold at this type of business of at least 230 percent. Therefore, CDTFA concluded that further investigation was necessary and decided to compute appellant's alcohol sales using the markup method.
4. CDTFA performed a shelf test to compute audited markups.[3] Since appellant did not have a bar menu or price list available at the time of the audit, some alcohol selling prices were obtained from the following: appellant's July 4, 2012 bar menu, which CDTFA

[2] For the test period (2012), CDTFA examined recorded merchandise purchases, made adjustments for posting errors and unrecorded purchases, and computed that 47.04 percent of the merchandise purchased was alcohol, and 52.96 percent was food (including non-alcoholic beverages). CDTFA used these ratios to segregate recorded cost of goods sold into the categories of alcohol and food.

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

obtained from the website Wayback Machine;[4] a Bar Fact Sheet[5] signed by appellant's president, Edward Khachaturian on January 28, 2014; and some alcohol selling prices were obtained orally from Mr. Khachaturian at other times. The selling prices for individual drinks were used to calculate sales proceeds from a bottle or keg,[6] and the computed sales proceeds were compared to costs from purchase invoices to compute markups for various categories of drinks. For drinks that were sold at lower prices during happy hour, separate markups were computed for happy hour prices and regular hour prices. Then, the markups were weighted to account for 70 percent of well drinks and bottles of wine sold during happy hour and 75 percent of draft beer sold during happy hour. The markups for each category of drink were then weighted based on the ratio of purchases of each category of drink as determined in a purchase segregation test to compute a markup of 231.73 percent for all alcohol.

5. The audited cost of alcohol sold was reduced by amounts of self-consumption ($414 per month) and pilferage (estimated at 2 percent) to compute adjusted costs of alcohol sold for 2011, 2012, and 2013. The audited markup of 231.73 percent was added to the adjusted costs of alcohol sold to compute audited taxable alcohol sales for 2011, 2012, and 2013. Audited and reported taxable alcohol sales[7] were compared to compute unreported taxable alcohol sales for each of those years. An error ratio was computed for 2011, and the error ratio was applied to reported alcohol sales for the fourth quarter of 2010 to compute unreported taxable alcohol sales for that period. In total, CDTFA computed unreported taxable alcohol sales of $237,578 for the audit period.

[4] CDTFA describes Wayback Machine as an internet archive that enables users to see archived versions of web pages across time. According to CDTFA, the Wayback Machine revisits various websites on a periodic basis and archives versions of the website that otherwise would be lost whenever a website is changed or closed down. CDTFA downloaded copies of appellant's bar menus dated January 25, March 3, March 11, July 4, and July 12, 2012; and April 7, and November 26, 2013.

[5] A Bar Fact Sheet is a document prepared by a taxpayer that provides various information regarding the operation of a bar, such as selling prices, pour sizes, and Happy Hours.

[6] This calculation takes into consideration various factors, such as pour size, spillage, and waste.

[7] Reported alcohol sales were computed by subtracting recorded food sales and recorded taxable mandatory tips from taxable sales reported on the sales and use tax returns.

6. On December 31, 2013, appellant sold its business, and the escrow company that handled the sale sent CDTFA a check in the amount of $116,578.33, which was intended to pay for the audit liability and other liabilities owed by appellant to CDTFA.
7. On March 9, 2015, CDTFA issued an NOD to appellant for a deficiency of $49,182.83 tax, plus applicable interest.
8. On May 15, 2015, appellant filed an untimely petition for redetermination of the NOD, which CDTFA accepted as a claim for refund.[8]
9. The above-mentioned payment from escrow was applied to the NOD and other liabilities. CDTFA issued a refund to appellant for the amount that exceeded the liabilities.
10. On August 25, 2016, CDTFA held an appeals conference at which appellant made several different arguments regarding the audit liability. Among other things, appellant argued that some of the selling prices used in the shelf test were wrong, and an adjustment should be made for ending inventory.
11. CDTFA issued a D&R on July 29, 2017, in which it recommended denial of appellant's claim for refund.
12. This timely appeal followed.

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. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 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. (R&TC, § 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. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

[8] The claim for refund was timely because it was filed within six months from the date the NOD became final (April 8, 2015).

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Michael E. Myers* (2001-SBE-001) 2001 WL 37126924.) 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. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid*; see also *Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.)

In its initial review of appellant's records, CDTFA identified several discrepancies, such as unusually low markups for alcohol sales and differences between gross receipts reported on federal income tax returns and total sales reported on sales and use tax returns. Appellant has not explained the reason for the discrepancies. Accordingly, CDTFA found appellant's reported sales to be unreliable, and therefore used the markup method to determine appellant's taxable sales, using appellant's own records and oral representations.

Moreover, we note that CDTFA has made reasonable, even generous, adjustments in its computation of the audited markups. First, CDTFA has used a pour size of 2.5 ounces for liquor, even though the corporate president stated that the pour size was 1.5 ounces. Although the size of the pour is not related to the selling price argument raised in appellant's opening brief, it is directly related to the audited markup since a pour size of 2.5 ounces results in much fewer sales per bottle of liquor than a pour size of 1.5 ounces. We note that the 2.5 ounce pour size was not documented by any type of pour test. Also, CDTFA accepted, without evidence, that 70 percent of well drinks and wine sold by the bottle and 75 percent of draft beer were sold at half price during happy hour. Those are unusually high percentages, since happy hour pricing is typically offered by bars during the late afternoon and early evening to encourage purchases of alcohol because business is often slow at those times. The best available evidence indicates that, for the majority of the audit period, appellant offered reduced happy hour selling prices for certain

drinks from 4:00 p.m. to 6:00 p.m. Monday through Saturday.[9] CDTFA's acceptance of appellant's undocumented statement that 70 and 75 percent of certain drinks were made during those hours was eminently reasonable and may have granted an unwarranted benefit to appellant.

Thus, we conclude that CDTFA has established that its determination is reasonable and rational, and thus the burden shifts to appellant to provide evidence from which a more accurate determination may be made. On appeal, appellant disputes the selling prices used in the audit. It also argues that the audited cost of goods sold for 2013 should be reduced by $25,000, which it argues was the total of discarded inventory.[10] In addition, appellant states that the understatement represents about 25 percent of its sales, and that the understatement is "completely incorrect." Further, appellant states that cash sales were limited since most sales were paid by credit card.[11]

With respect to the selling prices, appellant has provided copies of various pages of a bar menu, with a signed statement by the bartender, "I verify all the items and prices on this menu." There are also hand-written notations on some of the pages showing dates, "1/2012 – 11/2013." The selling prices on those menu pages are materially lower than the selling prices used in CDTFA's shelf test to establish audited markups. For instance, for Cabernet Sauvignon, J. Lohr "Hilltop," appellant uses a selling price of $10 per glass, while the audit workpapers (Schedule 12D-1d) show a selling price of $12 and, for Mythos Lager, appellant uses a selling price of $4 per bottle, while the audit workpapers (Schedule 12D-1e) show a selling price of $5. The same

[9] According to the D&R, the Bar Fact Sheet signed by Mr. Khachaturian stated that happy hour pricing was offered Monday through Friday from 4:00 to 6:00 p.m. The D&R also stated that the audit workpapers included copies of menus which stated that happy hour was from 4:00 p.m. to 6:00 p.m. Monday through Saturday, and that the menu dated April 7, 2013 referred to extended evening happy hour prices Thursday through Saturday from 9:00 p.m. to 11:00 p.m. We do not find the Bar Fact Sheet or the referenced menus in the record, but we note that the afternoon hours (4 to 6 p.m.) are similar to the happy hour periods routinely seen in the bar industry, and therefore appear reasonable. The evening happy hour pricing is less typical, but it is supported by a menu for at least a portion of the audit period. The D&R also states that, at the conference, appellant alleged that happy hour prices were offered from 4:00 p.m. to 7:00 p.m. and 9:00 p.m. to 11:00 p.m. Monday through Saturday, but it provided no evidence of those longer "happy hour" periods every day.

[10] We note that, if appellant did not sell the inventory but instead retained ownership of it (or discarded the ending inventory), it is liable for use tax on the cost of that inventory. (R&TC, § 6009 ("Use" includes the exercise of any right or power over tangible personal property incident to the ownership of that property….) Thus, since CDTFA has not assessed use tax on the cost of the allegedly retained (or discarded) inventory, it has granted appellant an unwarranted benefit, if appellant in fact retained or discarded it. Accordingly, we decline to further address this contention.

[11] CDTFA did not use a credit card sales ratio analysis to establish the understatement, and therefore any argument regarding the percentages of cash sales and credit card sales is inapplicable. Accordingly, we decline to further discuss this assertion.

menu information was provided to CDTFA at the appeals conference. In a letter dated September 18, 2018, we asked appellant when the menu was prepared. We asked further that appellant provide the source of the selling prices if the menu had been prepared after business had closed (i.e., cash register tapes, bar manager's memory, etc.). In addition, we asked for copies of the source documentation used. In its response, appellant stated that it used Aloha software and prices were adjusted by the outside software vendor. That statement does not represent persuasive evidence of the source of prices used on the menu provided during the appeals process.

We find that the selling prices used in the audit were based on information that was more reliable than the menu provided by appellant in the appeals process. The selling prices used in the audit were scheduled from menus that were publicly displayed on appellant's website or provided by the corporate president, who is expected to be knowledgeable about pricing. In contrast, the menu provided for the purpose of the appeal was generated by an unverified software and not published on the website and is undated (except for handwritten dates in the corners of some of the pages). Moreover, appellant has provided no source documents, such as guest checks or cash register tapes, to show that the selling prices published on its website were higher than the amounts it actually charged or that its corporate president provided incorrect selling prices for the audit. Accordingly, appellant has failed to establish that adjustments are warranted to the audited costs of goods sold or the audited markups used to establish audited taxable sales.

HOLDINGS

No adjustment is warranted to the audited understatement of reported taxable sales.

DISPOSITION

CDTFA's action in denying the claim for refund is sustained.

DocuSigned by:
Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Neil Robinson
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