OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **HYDE PARK LOUNGE, LLC**	) OTA Case No. 18032460)) Date Issued: May 16, 2019)))

OPINION

Representing the Parties:

For Appellant: Tyler Shewey, Attorney

For Respondent: Kevin C. Hanks, Chief
Headquarters Operations Division

For Office of Tax Appeals: Richard Zellmer
Business Tax Specialist III

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, Hyde Park Lounge, LLC (appellant) appeals an action by the respondent California Department of Tax and Fee Administration (Department) determining $19,783.23 of additional tax, and applicable interest, for the period April 1, 2011 through March 31, 2014.

Appellant waived its right to an oral hearing. Therefore, we decide the matter based on the written record.

ISSUE

Is appellant entitled to a reduction of the liability determined by audit (audit liability)?

FACTUAL FINDINGS

1. At all relevant times, appellant was a limited liability company (LLC).
2. During the audit period at issue, appellant operated a bar in the Hyde Park area of San Jose, serving liquor, bottled and draft beer, carbonated beverages, and food. The business was located in an area of predominantly commercial and low-income residential properties.

3. The Department audited appellant for the period April 1, 2011, through March 31, 2014. The member who actively participated in the audit was Ronald Eugene Williams, who is deceased.
4. The Department's revised audit dated March 20, 2015, determined additional tax of $19,783.23 based on a deficiency consisting of: (1) unreported taxable sales, based on a markup of cost, measured by $226,464; and (2) underreported self-consumption, measured by $3,240. The revised audit also recommended a 10-percent negligence penalty based on inadequate records and substantial underreporting.
5. The Department's comparison of sales reported on the sales and use tax returns to the cost of goods sold reported on the federal income tax returns resulted in book markups of 175 percent for 2011 and 137 percent for 2012.[1, 2] Based on its experience auditing businesses of this type located in similar areas, the Department expected a book markup of at least 250 percent for this business, and thus concluded that the book markups were too low, which it considered an indication that sales reported on the sales and use tax returns could be understated. For that reason, the Department decided to use the markup method to compute appellant's taxable sales.
6. The Department performed a shelf test to compute markups by comparing the actual selling prices with known costs. Appellant sold beer and wine by the bottle. The test for those products simply required a comparison of the purchase cost with the sales price. The Department calculated a 235.05 average markup for regular beer, a 285.35 percent average markup for premium beer, and a 309.66 markup for wine.
7. Appellant poured multiple drinks with a single bottle of distilled spirits (vodka, gin, whiskey, rum, etc.) and the pricing was different for "well" (a less expensive standard inventory), "call" (when the customer requests a specific brand), and "premium" (more expensive spirits). Selling prices for drinks made with distilled spirits were obtained

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[1] "Markup" is the amount by which the cost of a product is increased to set the retail price. For example, if the retailer's cost of a product is $.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 (.30 ÷ .70 = 0.42857). A "book markup" (sometimes referred to as an "achieved markup") is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross margin is the sales price minus the cost. The formula for determining the gross margin percentage is margin amount ÷ sales price. In this example, the gross margin is 30 percent (.30 ÷ 1.00 = 0.3).

[2] Appellant did not provide federal income tax returns for 2013 or 2014, and thus, book markups for those years were not computed.

from a Bar Fact Sheet prepared by appellant, and costs were obtained from purchase invoices from July 2014. Appellant specified on the Bar Fact Sheet that he sold distilled spirits using a 1.5 ounce pour. It later indicated that its pours were more substantial. On March 6, 2015, the Department completed a pour test with two of appellant's bartenders, which showed a distilled spirit pour size of 2.5 ounces.[3] The Department used this information to calculate sales proceeds from a bottle, after taking spillage and waste into consideration. It then compared bottle sales to bottle costs from purchase invoices from July 2014 to compute markups for various categories of drinks: 509.09 percent for well, 192.18 percent for call, and 118.81 percent for premium.

8. The Department calculated weighted markups for each category of drink based on the ratio of purchases of each category of drink as determined in a purchase segregation test of the third quarter of 2012 (3Q12)[4] to compute an audited weighted markup of 242.39 percent for all alcohol drinks. It added the audited weighted markup of 242.39 percent to audited cost of distilled spirits sold[5] for the period January 1, 2012, through March 31, 2014, to compute audited taxable distilled spirit sales of $869,791 for that period.

9. The Department also compiled food purchases from the purchase segregation test of 3Q12. It multiplied that amount by 9 to compute food purchases for the nine quarters in the period January 1, 2012, through March 31, 2014. The Department reduced food purchases for January 1, 2012, through March 31, 2014, by 2 percent for self-consumption, and 2 percent more for waste and spoilage, to compute the audited cost of food sold for that period. It estimated the food markup at 200 percent and added that to audited cost of food sold for the period January 1, 2012, through March 31, 2014, to compute audited food sales of $51,136 for that period.[6]

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[3] The pour test is designed to provide data from which the Department can estimate the amount of alcohol used per serving.

[4] The purchase segregation test was an examination of purchase invoices for 3Q12.

[5] Audited cost of alcohol sold was computed by first obtaining purchase amounts from appellant's vendors, and then reducing those amounts by $90 per month for self-consumption, and by an additional 2 percent for pilferage.

[6] According to the audit workpapers, appellant's cost per sandwich was approximately $0.80 and it sold sandwiches for $3.00, which reflects a markup of 275 percent. The Department used what it refers to as an "industry standard" markup of 200 percent for bar food sales.

10. The Department added audited alcohol sales to audited food sales to compute audited taxable sales of $920,927 for the period January 1, 2012, through March 31, 2014. Audited taxable sales for the period January 1, 2012, through March 31, 2014, were compared to reported taxable sales for the same period to compute error ratios of 12 percent for 2012, 30 percent for 2013, and 33 percent for 1Q14, for an average error ratio of 23 percent. The Department applied those ratios to reported taxable sales for the matching audit periods (12 percent to 2012, 30 percent to 2013, and 33 percent to 1Q14) and applied the average error 23 percent ratio to the three quarters of 2011 to compute unreported taxable sales of $226,462.
11. Appellant reported self-consumption of alcohol and free drinks for staff and customers costing $90 per month. On that basis, the Department computed a separate measure of use tax of $3,240 for the unreported cost of self-consumed alcohol. Appellant has not protested this measure of tax.
12. Respondent issued a Notice of Determination (NOD) to appellant based on the above-mentioned audit in the amount of $19,783.23 tax, plus applicable interest, and a negligence penalty of $1,978.36.
13. Appellant filed a petition for determination of the NOD.
14. On June 9, 2017, the Department agreed to delete the negligence penalty.
15. On January 23, 2018, the Department confirmed in a Decision and Recommendation that the negligence penalty would be deleted, but it otherwise denied the petition for redetermination. This timely appeal to the Office of Tax Appeals (OTA) followed.

DISCUSSION

Is appellant entitled to a reduction of the audit liability?

When the Department is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, the Department 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, the Department 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) 2019 WL 1187160.) Once the Department has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from the Department'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.)

Appellant makes two arguments. The first is that the Department should not have used a markup analysis to determine the liability. Citing *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, appellant argues that reliance on a taxpayer's records is the most economical and least intrusive method for calculating taxes due. It asserts that the Department looked at appellant's sales summaries and bank statements for 2Q12 and 3Q12 and did not question the accuracy of those documents. Appellant objects to the Department's failure to give any weight to – or even examine – its Z tapes for the same periods. Citing the Department's Audit Manual and *Maganini v. Quinn* (1950) 99 Cal.App.2d 1 (*Maganini*), appellant argues that we should not allow the Department to disregard appellant's "high quality financial records" and instead use an indirect markup method to calculate the liability.[7]

Alternatively, appellant challenges the reliability of the Department's markup analysis. Essentially, it contends that the markup reflected in its records and returns was accurate and argues that the markup was lower than what the Department considers average because the bar was in a "working-class neighborhood," and 80 to 90 percent of its customers were regulars for whom appellant poured "heavy drinks." It asserts that the Department's pour test was flawed because it did not observe the Mr. Williams' actual daily procedures, the implication being that appellant's pours were well in excess of the 2.5-ounces allowed by the Department. Finally, in an apparent explanation of why appellant would charge so little for alcohol, it argues that it was not concerned about the effect its substantial pours would have on profitability of the business because it was primarily interested in the potential for capital gains on its investment in the real property where the bar was located.

Regarding appellant's first argument, the Department's authority to use a markup method to determine appellant's liability if it was not satisfied with the tax reported by appellant is clearly granted in R&TC section 6481. The Department was not required to accept the taxpayer's books and records as conclusive evidence of taxable sales. Appellant's reliance on

[7] Z tapes are point-of-sale terminal (register) summaries of cash and credit card activity.

Maganini, *supra*, for the contrary proposition is misplaced. (See *Riley B's*, *Inc*., *supra*.) The lower than expected book markups indicated to the Department that appellant may not have accurately recorded and reported all taxable sales.[8] That explanation provides a sufficient rationale for the Department's decision to question appellant's Z tapes and sales summaries. On that basis, we find that the Department's decision to use a markup audit methodology to compute appellant's taxable sales was appropriate. The next question is whether the Department's explanation of how it used the markup method to estimate appellant's liability is reasonable.

We look to the evidence to determine whether the Department correctly used recognized and standard auditing procedures to determine the correct tax liability. There is no question that a markup analysis is a standard auditing procedure. (See *Riley B's*, *Inc*., *supra*.) Appellant does not argue otherwise. It is undisputed that the Department relied on appellant's own records and its statements on the Bar Fact Sheet for the prices for which appellant sold food and alcoholic beverages. The Department initially relied on appellant's reported amounts for its cost of goods sold, but after appellant complained that those include some labor costs, the Department conducted a vendor survey and relied on the amounts reported by the vendors. Appellant does not challenge the Department's purchase segregation. Appellant sold beer and wine by the bottle (or other container), and it does not challenge the Department's determination regarding those components of the test. Therefore, we examine the component that appellant challenges: the distilled spirits pour.

The Department correctly tested appellant's sales of distilled spirits. It began by using what is generally considered a standard pour: 1.5 ounces. This is the amount appellant acknowledged in the Bar Fact Sheet. After the Department sent its initial conclusions to appellant, appellant argued its pours were more substantial. The Department did a pour test and found that appellant poured closer to 2 ounces. A second pour test several months later revealed pours close to 2.5 ounces, which the Department accepted. There is no evidence sufficient to establish a more substantial pour, and, we find that the Department's allowance of the 2.5 ounce pours is generous, particularly given appellant's initial statement that its pours were 1.5 ounces and the two pour tests indicating first 2 and then 2.5-ounce pours. We find the Department's explanation of the audit and the audit findings reasonable.

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[8] Due to the broad authority granted to the Department by the Legislature, we do not require the Department to further explain the bases for its markup expectations.

We do not doubt that appellant's establishment was in a "working-class neighborhood" or that appellant poured generous drinks for his regulars. Appellant stated in the Bar Fact sheet that its pours were 1.5 ounces. A 2-ounce pour is generous. The Department has allowed a 2.5 ounce pour, and appellant has not established that it was greater than that. We find that appellant has failed to adequately explain the discrepancy between its reported taxable sales and the Department's determined taxable sales.

HOLDING

Appellant failed to establish it is entitled to a reduction of the audit liability.

DISPOSITION

Respondent's action deleting the negligence penalty and otherwise denying appellant's petition for redetermination is sustained.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

DocuSigned by:
Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

DocuSigned by:
Patrick J. Kusiak
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Patrick J. Kusiak
Administrative Law Judge