



### ISSUE

Whether appellant has established that reductions are warranted to the measure of unreported taxable sales established in the audit.

### FACTUAL FINDINGS

1. During the relevant time period, appellant, a husband-and-wife partnership, operated a fast food restaurant with a beer bar, located in San Jose, California, known as “Peanuts.” Appellant’s restaurant is located very close to San Jose State University (SJSU), and thus, SJSU students account for a large portion of appellant’s customers.
2. CDTFA audited appellant for the period October 1, 2009, through September 30, 2012. Based on its visits to the business and the hours posted on various internet sites, CDTFA initially concluded that the business was open Monday through Thursday, from 6:30 a.m. to 7:30 p.m., Friday from 6:30 a.m. to 6:30 p.m., Saturday from 7:30 a.m. to 4:00 p.m., and closed on Sunday (these hours were revised as explained below).
3. For audit, appellant provided federal income tax returns for 2010 and 2011; bank statements and merchandise purchase invoices for the audit period; daily sales logs for the audit period; and cash register Z-tapes<sup>2</sup> for the audit period. Appellant did not provide daily guest checks, the detailed cash register tapes on which the Z-tapes were based, its sales and use tax worksheets, nor any support for appellant’s claimed deductions for exempt sales of food products or tax reimbursement included in reported total sales.
4. CDTFA compared gross receipts on the 2010 and 2011 federal income tax returns to total sales reported on appellant’s sales and use tax returns for the same periods and found no differences. Comparing gross receipts to costs of goods sold (each as reported on appellant’s income tax returns), CDTFA computed book markups of 184.60 percent for 2010, and 161.48 percent for 2011. CDTFA expected the book markup for a restaurant of appellant’s type to be 250 percent or higher, and thus, CDTFA considered the book markups to be unacceptably low.
5. Due to the incomplete books and records, CDTFA computed appellant’s sales using observation tests. CDTFA performed a one-day observation test on

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<sup>2</sup> Z-tapes are the part of cash register tapes that summarize the sales by category for a given time.

Thursday, January 17, 2013, during winter break and a one-day observation test when school was in session. During the winter break observation test, CDTFA observed 253 sales totaling \$1,586.74 in taxable sales. During that observation test, CDTFA observed a group of special needs students eating at the restaurant, and also observed a large number of fraternity members eating at the restaurant. CDTFA considered the group of special needs students and the group of fraternity members to be unusually large groups. CDTFA did not want these unusually large groups to distort the test results. CDTFA estimated that these two groups totaled 30 persons and that each person purchased food and drink costing approximately \$6.75. CDTFA reduced the observed taxable sales by \$202.50 (30 persons x \$6.75 average sale), to compute adjusted observed taxable sales of \$1,384.24. This amount was combined with taxable sales recorded on cash register Z-tapes for three days from the same winter break, to compute average taxable sales per day of \$1,230.95 during break periods.

6. Appellant had increased its selling prices during the audit period. In order to account for the price increases, CDTFA divided the audit into three periods, and reduced the \$1,230.95 amount by 5 percent each preceding period. In this manner, CDTFA computed average taxable sales per day of \$1,172.33 for the period December 1, 2011, through September 30, 2012; average taxable sales per day of \$1,116.51 for the period December 1, 2010, through November 30, 2011; and average taxable sales per day of \$1,063.34 for the period October 1, 2009, through November 30, 2010.
7. CDTFA used amounts recorded in appellant's records to compute audited average recorded taxable sales per day made during break periods for each of those same three periods. CDTFA compared audited average taxable sales per day made during break periods to average recorded taxable sales made during break periods to compute unreported average taxable sales made per day during break periods for each of the three periods. CDTFA multiplied average unreported taxable sales made during break periods by the number of break days in each of the three periods to compute unreported taxable sales of \$122,746 made during break periods.
8. Similar calculations were done for days when school was in session. However, there were no unusually large groups observed on the observation test day. Using the same

- methodology as explained above for days during break periods, CDTFA computed unreported taxable sales of \$278,013 for days when school was in session.
9. The hours of operation as shown on the back of appellant's own menu, as well as several Internet sites (i.e., Google, Yelp, and an online menu service, "Zmenu.com"), indicate that appellant operated until 7:30 p.m. for the weekdays Monday through Thursday.
  10. Therefore, CDTFA made separate calculations to account for sales made during this two-hour period. CDTFA estimated that, for this 2-hour period, appellant made sales to 20 customers averaging \$6.75 per customer, resulting in unreported taxable sales of \$135. This amount was reduced by 5 percent for each preceding year to compute amounts for the various periods (similar to what was done for days during break periods), and those amounts were multiplied by the applicable number of days that appellant was open for the extra 2 hours in each period to compute unreported taxable sales of \$55,800 for the extra two-hour period. CDTFA added unreported taxable sales made during break periods (\$122,746), unreported taxable sales made when school was in session (\$278,013), and unreported taxable sales for the additional 2-hour period (\$55,800), to compute unreported taxable sales of \$456,560 for the audit period.
  11. To test the reasonableness of its determination, CDTFA compared audited taxable sales for 2010 and 2011, with costs of goods sold on appellant's income tax returns for the same periods, computing audited markups of 298.21 percent for 2010, and 250.07 percent for 2011, which CDTFA considered acceptable and supportive of its determination.
  12. CDTFA issued the above-described NOD to appellant, in response to which appellant timely filed a petition for redetermination. Subsequently, CDTFA issued a Decision that reduced the number of operating days by 16 days; increased the price adjustments from 5 percent to 6.91 percent; and made a 2.27 percent reduction to account for erroneously treating the operating hours for Friday and Saturday the same as Monday through Thursday. These adjustments resulted in reducing unreported taxable sales from \$456,560 to \$391,419. CDTFA also deleted the negligence penalty.
  13. This timely appeal followed.

### DISCUSSION

California imposes 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.) Although gross receipts derived from the sale of "food products" are generally exempt from the sales tax, sales of food served at a restaurant and sales of hot food are subject to tax. (R&TC, § 6359(a), (d)(2), (d)(7).)

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.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of 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 Magidow* (82-SBE-274) 1982 WL 11930.)

Here, the books and records appellant provided for audit were incomplete. Specifically, appellant did not provide daily guest checks, the detailed cash register tapes on which the Z-tapes were based, its sales and use tax worksheets, nor any support for appellant's claimed deductions for exempt sales of food products or tax reimbursement included in reported total sales. In addition, CDTFA determined that appellant's book markups were lower than expected for a business of this type, indicating that appellant underreported its total sales. Each of these is a sufficient reason to question the reliability of appellant's reported taxable sales. (R&TC, § 6481.) Accordingly, we find that CDTFA was justified in questioning the reliability of appellant's reported taxable sales, and computing appellant's taxable sales using an observation test in combination with appellant's own recorded sales as shown in its Z-tapes.

In computing appellant's taxable sales, CDTFA used the taxable sales recorded in appellant's own Z-tapes and daily sales logs for selected periods within the audit, in conjunction with two sales observation tests: one made during the winter break when school was not in session at SJSU; and the other when school was in session. CDTFA also made adjustments for appellant's price increases on its menus, as well as for a large group of customers that occurred

during an observation test. CDTFA's computation of audited markups (298.21 percent and 250.07 percent for 2010 and 2011, respectively) are within an acceptable range and support the reasonableness of CDTFA's determination. Accordingly, we conclude that CDTFA's determination was reasonable, rational, and based on appellant's own records. Thus, the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

On appeal, appellant first asserts that the observation test conducted on January 17, 2013, was very close to the start of the school year and that many students were already in town and on campus obtaining books, housing, and classes. On that basis, appellant argues that the sales on that date were higher than, and thus not fairly representative of, sales during break periods.

Second, appellant argues that a larger reduction of sales made to special needs students and fraternity members on the January 17, 2013 observation test should be made. Specifically, appellant submitted a lengthy cash register tape purporting to show 18 alleged sales to special needs students and 48 sales to alleged fraternity members, for a total of 66 people in these two groups, present on the day of the winter break observation test. Appellant testified that the auditor highlighted each of these sales, which CDTFA has denied. In support of its position, appellant provided a January 21, 2013 letter from the president of the fraternity (first provided to CDTFA during the August 10, 2016 appeals conference in this matter and then in appellant's opening brief here) asserting that approximately 40 fraternity members ate lunch at appellant's business on January 17, 2013.

Third, appellant disputes the hours of operation that were used in the audit. During the hearing, appellant testified that when SJSU was in session, its operating hours were Monday through Thursday from 6:30 a.m. to 7:00 p.m., Friday from 6:30 a.m. to 6:00 p.m., and Saturday from 7:30 a.m. to 4:30 p.m. Appellant testified that that when SJSU was not in session, the hours of operation were Monday through Friday, from 6:30 a.m. to 4:00 p.m., and Saturday, from 7:30 a.m. to 4:00 p.m. Appellant provided no additional evidence to corroborate its testimony.

Turning to appellant's first contention, we note the possibility that the last week of a break period (i.e., the week before school starts) might be a busier time for appellant than previous weeks during a break period, as students prepare for the beginning of school. But, appellant has provided no evidence from any other week during a break period from which to establish a result different than what CDTFA computed. Accordingly, we are unable to make

any adjustment based on this unsupported contention. (See *Riley B's, Inc. v. State Bd. of Equalization, supra*, 61 Cal.App.3d at p. 616; see also *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Second, regarding the cash register tape showing 66 alleged sales to members of special groups, we have no reliable basis on which to verify that these sales were in fact to the members of the alleged groups. We cannot determine who highlighted the tape, nor the basis on which someone did so. Further, the letter from the fraternity president – provided more than three years after the January 17, 2013 observation test, may not be contemporaneous and thus may not be accurate, so we decline to rely on it. Further, CDTFA excluded 30 of these group members from the test period; appellant's evidence does not persuasively establish that additional exclusions should be made, and we decline to do so.

Third, as discussed above, we have found that appellant's own menu and three different websites establish appellant's hours of operation. Appellant has not explained the discrepancy between its testimony and the hours listed on these independent websites or why its uncorroborated testimony is more accurate.

Absent evidence from appellant from which a more accurate determination of tax can be made, we conclude that appellant has failed to meet its burden of establishing that reductions to the audit liability are warranted.

HOLDING

Appellant has failed to establish that reductions are warranted to the measure of unreported taxable sales established in the audit.

DISPOSITION

CDTFA’s action in reducing the measure of unreported taxable sales from \$456,560 to \$391,419, and deleting the negligence penalty, is sustained.

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

We concur:

DocuSigned by:  
*Sara A. Hosey*  
6D3FE4A9CA514E7...  
Sara A. Hosey  
Administrative Law Judge

DocuSigned by:  
*Michael F. Geary*  
149B52EF88AC4C7  
Michael F. Geary  
Administrative Law Judge

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