OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 19044591) CDTFA Case IDs 789113, 824640
W. DISTIN **dba HUNGRY JOE'S BURGER**	))))

OPINION

Representing the Parties:

For Appellant:	Pamela Lindo, Representative
For Respondent:	Mariflor Jimenez, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Richard Zellmer, Business Taxes Spec. III

A. ROSAS, Administrative Law Judge: Under Revenue and Taxation Code (R&TC) section 6902 and California Code of Regulations, title 18, section 5220,[1] appellant W. Distin appeals a decision issued by respondent California Department of Tax and Fee Administration,[2] denying in part appellant's administrative protest and the related timely claims for refund in the sum of $29,304.69.[3] Specifically, respondent's decision reduced the measure of unreported taxable sales from $1,778,652 to $728,525, reduced the determined tax to $72,160.97, reduced

[1] Under regulations promulgated by respondent and applicable at the time the petition was filed, if a taxpayer files a petition for redetermination after the 30-day time period specified in R&TC section 6561, respondent may accept it as an administrative (late) protest. (Cal. Code Regs, tit. 18, § 5220.)

[2] Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to respondent. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, "respondent" shall refer to BOE; and when referring to acts or events that occurred on or after July 1, 2017, "respondent" shall refer to the California Department of Tax and Fee Administration.

[3] Respondent consolidated appellant's five claims for refund. Although appellant did not specifically identify payments subject to his claims, respondent's decision accepted the claims for refund as timely with respect to payments totaling $29,304.69, and untimely as to $31,000. The tax at issue in the late protest is $72,160.97; however, respondent cannot refund amounts barred by statute as untimely. Appellant did not dispute respondent's findings as to timeliness. During the oral hearing, respondent indicated that appellant has paid the tax in full, not including the penalty and interest.

the finality penalty to $7,216.10, and deleted a negligence penalty. Originally, respondent computed a tax liability of $176,161.64, plus accrued interest, and a negligence penalty of $17,616.17 for the period January 1, 2009, through December 31, 2011. Respondent informed appellant of this determination in a Notice of Determination (NOD) issued on October 3, 2013, but appellant did not file a timely petition for redetermination within 30 days. Therefore, the NOD went final.[4]

Office of Tax Appeals (OTA) Administrative Law Judges Daniel K. Cho, Richard Tay, and Alberto T. Rosas held an oral hearing for this matter on September 29, 2020.[5] At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether any additional reduction to the amount of unreported taxable sales is warranted.

FACTUAL FINDINGS

1. Appellant operated a restaurant in Inglewood, California. The business was open Monday through Saturday. As the menu gradually changed, the name changed from Hungry Joe's Burgers to Hungry Joe's Burgers and Jamaican Restaurant.
2. Respondent audited appellant for the period January 1, 2009, through December 31, 2011 (audit period). For audit, appellant provided federal income tax returns (FITRs) for 2009 through 2011, a sales summary and purchase summary for 2011, and some cash register z-tapes and bank statements. Respondent compared taxable sales reported on the sales and use tax returns with cost of goods sold reported on the FITRs, and computed book markups of 43.66 percent for 2009, 44.52 percent for 2010, and 48.89 percent for 2011.[6]

[4] Because appellant had not paid in full the tax determined in the NOD prior to the NOD going final, a 10-percent penalty imposed by R&TC section 6565 for a taxpayer's failure to pay an NOD issued to the taxpayer before it became final (finality penalty) was added to the NOD in the amount of $17,616.16. During the oral hearing, respondent stated that it was relieving the finality penalty; thus, this penalty is no longer at issue.

[5] The oral hearing was noticed for Sacramento and conducted electronically due to COVID-19.

[6] "Markup" is the amount by which the cost of merchandise is increased to set the retail price. For example, if the retailer's cost is $0.70 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 (0.30 ÷ 0.70 = 0.42857). A "book markup" is one that is calculated from the retailer's records. Markup and gross profit margin are different. The gross profit is the sales price minus the cost. The formula for determining the gross profit margin is profit amount ÷ sales price. In the above example, the gross profit margin is 30 percent (0.30 ÷ 1.00 = 0.3).

Respondent found the book markups to be unreasonably low. Respondent also noted that the merchandise purchases of $175,304 recorded in the 2011 purchase summary exceeded merchandise purchases reported on the 2011 FITR of $137,425. Respondent concluded that appellant's books and records were unreliable. Respondent used the markup method to compute unreported taxable sales of $1,778,652 and imposed a negligence penalty. On October 3, 2013, respondent issued an NOD to appellant.

3. On November 5, 2013, appellant sent respondent a letter protesting the NOD, which respondent accepted as an administrative protest. Appellant made numerous payments towards the NOD and filed five claims for refund for recovery of those payments. Respondent consolidated the claims for refund.

4. Subsequent to the filing of the administrative protest, appellant provided additional books and records, which respondent reviewed. Respondent then prepared a first reaudit that reduced the measure of tax for unreported taxable sales computed using the markup method from $1,778,652 to $743,299.

5. Upon further consideration, respondent opted not to use the markup method and instead used a three-day observation test. Respondent prepared a second reaudit. Respondent initially observed appellant's business on Thursday, May 31, 2012, and later added two more observation test days: Tuesday, October 2, 2012, and Saturday, October 13, 2012. Respondent observed taxable sales of $1,716 on day one, $1,279 on day two, and $1,868 on day three and computed average taxable sales of $1,621 per day. Respondent computed unreported taxable sales of $728,525.

6. In the second reaudit, respondent deleted the negligence penalty. Respondent also computed appellant's taxable sales using a credit card sales ratio method, which resulted in unreported taxable sales in an amount much higher than $728,525.

7. In its decision issued on February 27, 2019, respondent ordered that the negligence penalty be deleted, that the measure of tax be redetermined to $728,525 in accordance with the second reaudit, and that the administrative protest and claims for refund be otherwise denied. Appellant then filed this timely appeal with OTA.

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.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2), and (d)(7).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, respondent 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.) Respondent's determinations are presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Magidow*, (82-SBE-274) WL 1982 11930 (*Magidow*).) In the case of an appeal, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of TFCG, Inc.*, 2019-OTA-389P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent's determination is warranted. (*Ibid.*; *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616 (*Riley*).) Also, the taxpayer has the burden of proof to show that it is entitled to a refund. (*Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (See *ibid.*; see also, *Magidow*, *supra*.) The burden of proof is that of a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).)

Respondent computed book markups of 43.66 percent for 2009, 44.52 percent for 2010, and 48.89 percent for 2011. Respondent argued that it expected the markup for appellant's business to be over 150 percent; thus, respondent found the book markups to be unreasonably low. Respondent also noted that the merchandise purchases of $175,304 recorded in the 2011 purchase summary exceeded merchandise purchases reported on the 2011 FITR of $137,425.

For the three-day observation test conducted in May and October 2012, sales paid for by credit card (credit card sales) averaged $353.50 per day, and sales paid for with cash (cash sales) averaged $1,267.64 per day. Appellant had furnished his cash register z-tapes for the 10-day period in February 2012. There is no evidence to suggest that the economic conditions in February 2012 were drastically different than the economic conditions in May and October 2012. For those 10 cash register z-tapes, credit card sales averaged $348.89 per day, and cash sales averaged $688.24 per day. Thus, average credit card sales from the cash register z-tapes of

$348.89 were almost identical to credit card sales of $353.50 per day from the observation test. However, cash sales of $688.24 per day from the cash register z-tapes is 46 percent lower than cash sales of $1,267.64 per day from the observation test. From these facts, it seems reasonable that respondent may doubt the accuracy of reported taxable sales and may also doubt the accuracy of appellant's books and records. Thus, we find that respondent was justified in using alternate audit methods (the markup method and observation tests) to compute appellant's sales.

During the oral hearing, respondent emphasized that it used "the audited taxable sales calculated in the three-day observation test," which resulted in a lower calculation. The observation test results are in line with the results from the markup method, and we agree that the observation test results in an unreported taxable sales total that is less than the totals reached using either the markup method or the credit card sales method. We find that respondent has met its minimal, initial burden to show that the basis for its determination was both reasonable and rational. Therefore, the burden of proof shifts to appellant to show whether any additional reduction to the amount of unreported taxable sales is warranted.

Appellant asserts that his weekly sales reports reconcile to his cash register z-tapes, as well as the amounts reported on the sales and use tax returns, and therefore, reported sales should be accepted as accurate. Appellant argues that respondent has ignored this information. Respondent is not required to accept a taxpayer's books and records as conclusive evidence, even though these were in agreement with each other, where respondent, using recognized and standard accounting procedures, established in an audit that the books and records did not disclose the correct amount of tax liability. (*Riley*, *supra*.) Thus, we disagree with appellant's argument that his books and records should be accepted as accurate because they happen to reconcile to reported amounts.

Appellant's primary argument regarding the audit calculations is that his sales declined starting in mid-2009 and continued to decline in 2010 and 2011 due to the economic recession. Appellant argues that the audit and reaudits ignore the economic recession. During the oral hearing, appellant argued that respondent did not consider "the reason why the taxpayer's sales decreased, the reason being the Great Recession."

During the oral hearing, appellant referred to *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438 (*Paine*), which appellant also cited in his briefs. In *Paine*, "the trial court found sales during the test period were representative of those during the audit period and that

the condition and conduct of plaintiffs' business remained substantially similar during and after the audit period." (*Id*. at p. 443.) For these reasons, the court of appeal concluded that there was substantial evidence to support the lower court's findings. (*Ibid*.) Here, in contrast, appellant argues that the test period was not representative of the audit period because the recession was no longer a condition that existed during the test period.

After reviewing the evidence and hearing appellant's testimony, we acknowledge that the economy was in a recession during the audit period.[7] We also accept that appellant suffered financial hardships during and after the audit period. This information is relevant to the events that transpired during the audit period, and it is helpful to fully understanding the facts during the audit period as well as appellant's position. Appellant argues that it is unreasonable to base the second reaudit results on a three-day observation test taken during a year in which the economy was recovering and apply the results to years in which a recession was happening.

The issue is not that simple, however, and the evidence contradicts appellant's argument. The evidence shows that despite the conditions surrounding the recession, the observation test was reasonable and rational.[8] Moreover, although the recession is a relevant fact, we do not analyze this fact in a vacuum. Evidence of economic recession and financial hardships by itself does not satisfy appellant's evidentiary burden of proving that an additional reduction to the amount of unreported taxable sales is warranted. 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, supra*, 137 Cal.App.3d at p. 442; *Honeywell, Inc. v. State Bd. of Equalization* (1982) 128 Cal.App.3d 739, 744.) Although appellant points to the conditions surrounding the recession to support the argument that the assessment is incorrect, this is insufficient to establish error in the NOD. Thus, we find that the evidence provided by appellant, about the economic recession and financial hardship, is insufficient to satisfying appellant's burden of proof, and this evidence is insufficient to support reductions to the measure of tax.

[7] The parties present conflicting evidence as to the duration of the economic recession. Because it does not change our analysis, we need not making a finding on the matter.

[8] We note that in the original audit and first reaudit, respondent computed sales using the markup method. The markup method relies on adding an audited markup to audited cost of goods sold to compute sales. We would expect appellant's merchandise purchasing patterns to reflect the state of the economy. If appellant's sales were declining due to a bad economy, we would expect appellant to purchase less merchandise. Thus, the markup method accounts for changes due to a bad economy. The first reaudit resulted in unreported taxable sales computed using the markup method of $743,299 for the audit period, as compared to unreported taxable sales of $728,525 computed using the projection of daily sales from the observation test.

Appellant also argues that during recessionary periods, his customers rely more heavily on credit cards rather than cash, and thus, the credit card sales ratio during the audit period was greater than what respondent computed in its audit. Although this is a valid argument, it is also irrelevant because respondent used the measure of tax based on the unreported taxable sales of $728,525 from the projection of average daily sales. In other words, respondent did not use the measure of tax based on the credit card sales ratio method, which would have resulted in a much higher amount of unreported taxable sales. Furthermore, this argument is not supported by the evidence.[9] It is well established that argument is not evidence. (*People v. Cash* (2002) 28 Cal.4th 703, 734; *Hoffman v. Brandt* (1966) 65 Cal.2d 549, 552.) Appellant presents no evidence to show, or tend to show, that during the audit period his customers relied more heavily on credit cards due to the recession.

Appellant argues that respondent should not make an assessment for 2009 because respondent previously accepted the 2009 gross sales as reported. Regardless of what respondent may have done on a preliminary basis, the evidence shows that the NOD asserted a tax liability for the audit period, which included 2009. It is correct that there were two reaudits, which further altered the results of the original audit. However, although the number of audits and the delays in resolving this matter has caused appellant a degree of frustration, we find no authority that would prevent respondent from changing its audit methods and results upon further information. Moreover, appellant has not met his burden of proving, by a preponderance of the evidence, that an additional reduction to the amount of unreported taxable sales for 2009 is warranted.

Appellant argues that the dates for the three-day observation test are all days when appellant had higher than normal sales. Appellant argues that two of the test days were right after pay-day for local workers, and the third test day was a Saturday, when sales are higher than normal. Appellant has not shown that the three test days had higher than normal sales. Furthermore, as noted above, the observation test results are in line with the results from the markup method, which gives credence to the observation test results.

Appellant argues that respondent must examine appellant's books and records. As part of the evidence, appellant submitted copies of his sales journals, which are handwritten amounts

[9] To be fair, appellant is not the only party who makes arguments that are not supported by the evidence. For example, respondent argues that it expected the markup for appellant's business to be over 150 percent, but respondent offered no evidence to show the markup for similar businesses.

listed next to various days. Appellant states that cash register z-tapes are the source for the amounts listed in the sales journals. Respondent examined the sales journals and found over 100 days (other than Sunday closures) with no sales recorded in the sales journals. Appellant acknowledged that he was unable to consistently record sales in his sales journals. Thus, the sales journals are incomplete. We reviewed appellant's incomplete sales journals and find them insufficient to meet appellant's burden of proof.

Based on the evidence, we conclude that appellant has failed to meet his burden of establishing that a further reduction to the measure of unreported taxable sales is warranted.

HOLDING

As respondent conceded, the negligence penalty should be deleted and the measure of unreported taxable sales should be reduced to $728,525. As stated during the oral hearing, respondent agreed to relieve the finality penalty. As to the sole remaining issue, appellant has not shown that any other reduction to the measure of unreported taxable sales is warranted.

DISPOSITION

Subject to respondent's concessions, including reducing the taxable measure to $728,525, and the relief stated above, we hereby sustain respondent's action in denying the late protest and related claims for refund.

DocuSigned by:
Alberto T. Rosas
B969EE4BD4914D5...

Alberto T. Rosas
Administrative Law Judge

We concur:

DocuSigned by:
Daniel Cho
7B28A07A7E0A43D...

Daniel K. Cho
Administrative Law Judge

DocuSigned by:
F8E81582726F448...

Richard Tay
Administrative Law Judge

Date Issued: 12/17/2020