

Office of Tax Appeals (OTA) Administrative Law Judges Josh Aldrich, Elliott Scott Ewing, and Suzanne B. Brown held an oral hearing for this matter on March 24, 2021.¹ At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUE

Whether adjustments are warranted to the measure of unreported taxable sales for each appellant for the audit period.

FACTUAL FINDINGS

1. Since October 1999, Camino has operated a fast-food Vietnamese restaurant in Sunnyvale, California, selling primarily hot noodle soups. Lawrence has operated a similar restaurant at another location in Sunnyvale since February 2000.
2. During the audit period, Camino reported total and taxable sales of \$1,848,331, and Lawrence reported total and taxable sales of \$1,070,593. Appellants did not claim any deductions on their sales and use tax returns.
3. For audit, both appellants provided their respective federal income tax returns (FITR's) for 2010, 2011, and 2012, bank statements, guest checks (which had menu items listed, but no prices), cash register z-tapes,² and credit card sales summaries for the audit period.
4. In its preliminary review, CDTFA reconciled each appellant's gross receipts reported on FITR's and total sales reported on sales and use tax returns, and found no differences.
5. In its initial review of Camino's bank statements, CDTFA noted that there were cash deposits in only five of the 36 months of the audit period and that the total amount of cash deposited for the audit period was \$3,444. In addition, CDTFA found that reported total and taxable sales exceeded bank deposits (including cash deposits and credit card sales proceeds) by \$39,996. When CDTFA adjusted for nontaxable tips and sales tax, reported taxable sales exceeded the deposits by \$362,349 for the audit period.
6. In its initial review of Lawrence's bank statements, CDTFA noted that there were cash deposits in only seven months of the audit period and that the total amount of cash deposited for the audit period was \$7,644. In addition, CDTFA found that reported total

¹ Due to the COVID-19 pandemic, the oral hearing was conducted electronically with the agreement of the parties.

² A cash register z-tape is the portion of the cash register tape that summarizes sales for a period of time (i.e., a day or shift).

- and taxable sales exceeded bank deposits (including cash deposits plus credit card sales proceeds) by \$65,974. When CDTFA adjusted for nontaxable tips and sales tax, reported taxable sales exceeded the deposits by \$315,993 for the audit period.
7. CDTFA considered the minimal amount of cash deposits and the reported total and taxable sales that exceeded bank deposits to be strong indicators that the businesses did not deposit all cash receipts. Therefore, CDTFA concluded that the reported amounts, and the bank deposits, both did not represent appellants' actual sales.
 8. For Camino, CDTFA used the gross receipts and costs of goods sold shown on the FITR's to compute achieved markups of 212 percent, 219 percent, and 226 percent (rounded) for 2010, 2011, and 2012, respectively. For Lawrence, CDTFA used the gross receipts and costs of goods sold shown on the FITR's to compute achieved markups of 231 percent, 210 percent, and 205 percent (rounded) for the same years. CDTFA indicated that, based on its audit experience, it expected a markup for each business in the range of 300 to 500 percent. Accordingly, CDTFA concluded that further investigation was warranted.
 9. CDTFA computed that Camino's credit card deposits, excluding sales tax reimbursement and tips, represented 80.21 percent of Camino's reported total sales, and that Lawrence's credit card deposits, excluding sales tax reimbursement and tips, represented 69.77 percent of Lawrence's reported total sales. Based on its experience auditing similar businesses, CDTFA considered these percentages to be higher than expected.
 10. CDTFA used the credit card sales ratio method to establish audited taxable sales for each business. CDTFA observed each restaurant's sales for Wednesday, November 6, 2013, from 10:00 a.m. to 8:00 p.m., and Friday, November 15, 2013, from 10:00 a.m. to 9:00 p.m. (two-day test). Based on the two-day test at Camino, CDTFA computed an audited ratio of tips included in credit card payments of 9.74 percent and a weighted average ratio of credit card sales to total sales of 44.17 percent. For the two-day test at Lawrence, CDTFA computed an audited ratio of tips included in credit card payments of 8.62 percent and a weighted average ratio of credit card sales to total sales of 44.46 percent.
 11. CDTFA totaled Camino's credit card receipts for the audit period from the bank statements and reduced the total by 9.74 percent for tips, then divided the net amount by 0.4417 to compute audited taxable sales, tax included. For Lawrence, CDTFA totaled the

- credit card receipts for the audit period from the bank statements and reduced the total by 8.62 percent for tips, then divided the net amount by 0.4446 to compute audited taxable sales, tax included. For each appellant, CDTFA reduced the amount, by quarter, for the amount of sales tax included, using the tax rates in effect for each quarter.³
12. For Camino, CDTFA computed audited taxable sales of \$3,394,518, which exceeded reported taxable sales of \$1,848,331 by \$1,546,187, the amount of understatement in dispute. For Lawrence, CDTFA computed audited taxable sales of \$1,886,159, which exceeded reported taxable sales of \$1,070,593 by \$815,566, the amount of understatement in dispute.
 13. In 2014, each appellant installed an automated teller machine (ATM) at its restaurant and stopped accepting credit card payments.
 14. On May 15, 2015, CDTFA issued an NOD to Camino for tax of \$133,408.48 and a negligence penalty of \$13,340.84, and issued an NOD to Lawrence for tax of \$70,295.56 and a negligence penalty of \$7,029.61.
 15. On June 9, 2015, each appellant filed a timely petition for redetermination of its respective NOD.
 16. On October 31, 2018, CDTFA issued a Decision in each case, deleting the negligence penalties but otherwise making no adjustments to the audited understatements of reported taxable sales.
 17. These timely appeals followed.
 18. In 2019, CDTFA conducted an audit and revised audit of Camino for the period January 1, 2016, through December 31, 2018. In the revised audit, CDTFA compared recorded and reported average daily sales and did not find a material understatement in reported taxable sales; thus, CDTFA issued a “no-change” audit with no additional tax liability for that later audit period.

DISCUSSION

California imposes a sales tax on a retailer’s retail sales of tangible personal property sold in this state, 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

³ There were five different tax rates applicable to appellants’ sales during the audit period; they ranged from 8.25 percent to 9.25 percent.

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)(2), and (d)(7).)

If 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 or may come into its possession. (R&TC § 6481.) It is the retailer’s responsibility to maintain and make available for examination complete and accurate 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).)

When a taxpayer challenges an NOD, CDTFA has a minimal, initial burden of showing that its determination is reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) If CDTFA carries that burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA’s determination is warranted. (*Ibid.*)

The applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c); *Appeal of Estate of Gillespie*, 2018-OTA-052P.) 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.) Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof. (*Appeal of Talavera, supra.*) To satisfy its burden of proof, a taxpayer must prove both (1) that the tax assessment is incorrect and (2) the proper amount of the tax. (*Appeal of AMG Care Collective*, 2020-OTA-173P; *Paine v. State Bd. of Equalization* (1982) 137 Cal.App.3d 438, 442.)

In this matter, CDTFA found appellants’ records unreliable for several reasons. Appellants deposited almost no cash in the bank, which CDTFA considered to be an indicator that they might not be recording and reporting all of their cash sales. Also, while appellants reported the same amounts of sales for income tax purposes and sales and use tax purposes, the achieved markups were in the range of 212 to 226 percent for Camino and 205 to 231 percent for Lawrence; those ranges are significantly lower than the markups of 300 to 500 percent CDTFA expected, based on its experience auditing similar businesses. Finally, credit card receipts

represented almost 80 percent of Camino’s reported sales and 70 percent of Lawrence’s reported sales; based on audit experience, CDTFA found those credit card to total sales ratios (hereinafter, credit card ratios) were higher than expected. Given all of the above, we find that it was reasonable for CDTFA to conclude that appellants’ records were not reliable and to use an alternate audit method to establish appellants’ taxable sales.

For each audit, CDTFA used the credit card ratio method as the basis for its computations. The credit card ratio method is a standard audit procedure that is effective in establishing taxable sales because it relies on readily verifiable information: the amount of credit card receipts.⁴ We find that it was an appropriate method for these audits.

Appellants dispute various elements of CDTFA’s computation of the portion of the credit card receipts that represent taxable sales.⁵ Appellants argue that the two days of observation tests used to establish the credit card ratios were not representative, and that the observations produced results that showed large discrepancies between the two days at each location. Appellants emphasize that the observation tests produced results that were not typical of daily sales because sales of hot soups were unusually high in November 2013 due to cold weather. Appellants further contend that the credit card receipts should be reduced by approximately 25 percent (24.59 percent for Camino and 24.45 percent for Lawrence) for cash advances (which would also impact the percentage of tips included in the net amount). Moreover, appellants point to the results of the 2019 sales and use tax audit of Camino as evidence that the audits at issue are in error.

Initially, we note that the observation tests were conducted reasonably soon after the end of the audit period, within the following calendar quarter. Regarding appellants’ position that the cold weather during the November 2013 observation dates produced distorted results, the purpose of the observation tests was to establish an audited percentage of credit card sales to total sales;⁶ the audit results were then computed using those credit card ratios. Thus, while

⁴ Credit card receipts, unlike cash, must be deposited into the bank. Therefore, those receipts can be readily compiled from bank statements.

⁵ We note that each appellant’s opening brief filed with OTA contained some arguments (e.g., concerning spoilage, thefts, and free meals to employees) that appellants did not raise during the oral hearing or at any other time during these appeals. It appears that appellants are no longer raising those arguments as part of these appeals. In any event, we find no basis to make any adjustments on those grounds.

⁶ For some businesses, weather conditions may affect observation test results, such as the amount of sales made on a “to-go” basis. (See CDTFA Audit Manual § 0810.30.) However, because all of appellants’ sales were taxable pursuant to R&TC section 6359, the observation tests for appellants did not involve calculating a percentage of taxable sales.

appellants' sales may have been higher during cold weather, we have no reason to believe that the cold weather would affect whether appellants' customers paid by cash or credit card. Consequently, we find unpersuasive appellants' position that this timing of the observation tests rendered the test results inaccurate.

Appellants state that sales tax and the total sales were accounted for by the cash register and summarized by the cash register daily z-tapes. Appellants also state that they provided all records to the auditor, including guest checks and daily sales records, and that their reported sales were accurate and supported by records. However, for various reasons we find that the evidence supports a conclusion that appellants' records were not entirely reliable. In particular, CDTFA used audited total sales of \$3,394,518 for Camino and \$1,886,159 for Lawrence, compared to 1080 days in the audit period (90 days per quarter, which allows for some holidays when the business did not operate), in order to compute average daily sales of \$3,143 for Camino and \$1,746 for Lawrence. Those amounts are lower than observed by the auditors on Wednesday, November 13, 2013 (\$3,208.15 for Camino and \$2,081.40 for Lawrence) or Friday, November 15, 2013 (\$3,926.81 for Camino and \$2,217.84 for Lawrence). We find that an amount of average daily sales established by audit that is significantly lower than the observed sales on both a Wednesday and a Friday represents strong support for the audit findings.

Regarding the audits' calculations of credit card ratios: for Camino, CDTFA computed credit card ratios of 37.93 percent for Wednesday, November 6, 2013, and 49.27 percent for Friday, November 15, 2013; and for Lawrence, CDTFA computed credit card ratios of 47.56 percent for Wednesday, November 6, 2013, and 41.56 percent for Friday, November 15, 2013. We find that it is expected and reasonable when credit card ratios show some variation from day to day. CDTFA has explained that its internal audit procedure is to conduct tests on multiple days to mitigate the effect of such fluctuation, and, at the time the audit was conducted, CDTFA deemed two days to be a sufficient test. However, CDTFA's audit procedures were revised in January 2017. Currently, CDTFA's audit procedure is to perform at least three days of observation when observation testing is utilized in an audit. (CDTFA Audit Manual § 0810.30.⁷)

⁷ CDTFA's Audit Manual summarizes CDTFA's audit policies and procedures. It is a useful resource that OTA may look to for guidance in interpreting the law; however, the Audit Manual is not binding legal authority. As such, OTA must exercise its own independent judgement in determining the weight, if any, to afford CDTFA's construction of the law as set forth in the Audit Manual. (See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 25.)

Three days of testing are generally beneficial simply because the additional day increases the sample size and thus reduces the effect of the results of any single day.

Regarding Lawrence, we find that the difference of 6 percent between the credit card ratios for the two days tested does not indicate that either of the test days was extraordinary. Accordingly, we conclude that the ratios for Lawrence, while not identical, are sufficiently consistent to establish a representative credit card ratio.

In contrast, for Camino there is a difference of over 11 percent in the observed credit card ratios for the two test days. Given this difference, we consider that three days of testing would have been beneficial. While that disparity is not so dramatic that it automatically warrants rejection of CDTFA's findings, it is sufficient to cause us to closely evaluate those findings.

Moreover, we note that CDTFA used audited taxable sales and the cost of goods sold reported on FITR's to compute a markup of 542.41 percent, which is somewhat higher than the range of markups CDTFA expected based on its audit experience, 300 to 500 percent.⁸ Again, that difference is not a basis for rejecting CDTFA's findings, but it does support our conclusion that closer scrutiny is warranted.

In light of the above, we consider the credit card ratio of 47.38 percent Camino has used in its computation of taxable sales; we note that it is only slightly higher than the audited credit card ratio of 44.17 percent. Further, it is within the range of credit card ratios observed by CDTFA (37.93 and 49.27 percent) and is about 2 percent lower than the higher credit card ratio CDTFA observed. Moreover, our computations appear to indicate that if the credit card ratio of 47.38 percent is used to compute audited sales, the markup computed using those sales and cost of goods sold from FITR's would be reduced to approximately 499 percent, which is within the 300-500 percent range that CDTFA expected for this type of business.

Considering the specific facts of the audit of Camino, we find that the materially different credit card ratios computed for the observation tests raise some concerns about the reliability of the 44.17 percent card ratio computed by CDTFA. Even though CDTFA's internal audit procedure of a three-day-minimum for observation tests was not established until after this audit, we find that the tests for Camino, which encompassed only two days, with materially different results, were not entirely adequate. Considering the relative similarity of the audited credit card

⁸ In contrast, for Lawrence's audit, CDTFA used audited taxable sales and the cost of goods sold reported on FITR's to compute a markup of 500.10 percent, which is essentially within the range of markups CDTFA expected for Lawrence.

ratio and Camino's proposed ratio, and the fact that use of Camino's proposed ratio results in sales that reflect a markup within the range expected by CDTFA, we find that the audited amount of taxable sales should be recomputed using a credit card ratio of 47.38 percent.

With respect to appellants' argument that the total amount of credit card receipts should be reduced for cash advances, appellants' owner, T. Ngo, and appellants' certified public accountant (CPA), A. Chiang, each testified that during the audit period, it was appellants' practice to allow customers to receive cash back from the amounts the customers charged on credit cards. Appellants state that they followed this practice as a way to bring in more customers, as well as to limit the amount of cash on the premises and to avoid paying fees imposed by the bank for cash deposits. Appellants' CPA cautioned them against allowing cash back on credit card transactions, since there was a charge of up to 3 percent by the credit card companies, and by October 2013 appellants had ceased allowing cash advances on credit cards.

Appellants point to schedules they prepared of each business's transactions for sample days in September 2013. For each day, the schedule lists credit card transactions and various amounts of cash advance and tips included in the amount charged on the credit card. Appellants' CPA testified about how to trace guest check items by comparing the total amount charged to the customer's credit card with the respective line on the schedule, which purportedly shows the total of the selling prices for all menu items listed on the guest check for that transaction.⁹ Appellants have computed that cash advances represented 24.59 percent of the amounts charged on credit cards at Camino and 24.45 percent at Lawrence.¹⁰ To support those lists, appellants provided guest checks and credit card slips which purportedly show that the amount charged on the credit card was higher than the amount of the sale.

CDTFA contends that the available documentation is not sufficient to support any adjustments for cash advances. CDTFA notes that none of the credit card receipts identify cash advances, and argues that the guest checks are not dated, have no sequential numbers, and include only lists of the menu items sold, with no amounts. Further, CDTFA asserts that it did not observe any cash advances given to customers during the two days that it observed sales at the restaurants. CDTFA also alleges that due to high merchant fees, it was unreasonable for

⁹ Ms. Chiang's testimony described this tracing process for a credit card transaction at Camino on September 25, 2013.

¹⁰ Using the credit card charges net of the cash advances, appellants have computed that tips represented 13.56 percent of the amounts charged on credit cards at Camino and 12.49 percent at Lawrence.

businesses to offer cash advances on credit card transactions, and alleges that the practice was prohibited by credit card merchant processing companies. For these reasons, CDTFA made no adjustments for cash advances that appellants stated were included in the amounts charged on credit cards.

We have reviewed guest check/credit card combinations from September 23-27, 2013, that appellants provided and have attempted to follow the tracing process Ms. Chiang described in her testimony. This process was challenging due to multiple factors, including that the writing on the guest checks is nearly (or in some instances, entirely) illegible, and the items on the guest checks show abbreviations that we do not know. Moreover, as Ms. Chiang confirmed in her testimony, many of the copies of credit card receipts are illegible, presumably due to the ink on thermal paper fading before the receipts were scanned.

From a sample of ten transactions that we attempted to trace on Camino's September 25, 2013 schedule, we found three wherein the total of the selling prices for the menu items listed appears to reconcile with the amount on appellants' schedules. For example, on Camino's September 25, 2013 schedule, line 87 shows a credit card transaction of \$22.79 including a cash advance of \$10, a \$3 tip, and menu items totaling \$9.00; we were able to trace this to the corresponding guest check showing menu items totaling \$9.00 (\$6.95 + \$2.05). Thus, we find that the total supports Camino's schedule showing cash back of \$10 for that transaction. We were similarly able to reconcile the amounts for the transactions listed on lines 81 and 91.

However, for the majority of the guest check/credit card combinations we reviewed, we cannot reconcile the guest checks with the cash advance amounts listed on appellants' schedules, either because the amounts are inconsistent or because we have insufficient information to know what the costs of the menu items were. For example, line 88 of the same September 25, 2013 lists the total credit card charge as \$22.19, the cash advance as \$10, the tip as \$3, and the total price of the menu items as \$8.45, but the supporting guest check appears to show three items that correspond to menu prices totaling more than \$8.45 (\$6.35 + \$6.95 + \$3.75).¹¹ Similarly, for another four of the ten sampled transactions (lines 86, 89, 107, and 110), the total of the selling prices for the menu items listed does not reconcile with the amounts on the schedule. For an additional two transactions (lines 82 and 106), we are uncertain of the selling price of one item

¹¹ The prices for several items on appellants' menu vary according to whether the customer orders a small or large size. In adding the prices on guest checks, we added in the amount that we anticipated would result in a total closest to the amount listed on appellants' schedules.

on each guest check, but if we had all of the information, it would appear that the total of the selling prices on the guest check may not reconcile with the amount on the schedule.

We find credible Mr. Ngo's and Ms. Chiang's testimony that appellants did have a practice of allowing customers to obtain cash advances on credit card transactions during the audit period; this testimony is corroborated by documentation showing that, for some sales, there were amounts charged on credit cards that did not represent the amount of the sale or the amount of a tip. Regarding CDTFA's position that it did not observe cash advances during the observation tests, the evidence establishes that appellants ceased the practice prior to the November 2013 observations, and thus we find that the absence of cash advances during those observations is not significant. Thus, we find that appellants have met their burden of proving that CDTFA's assessment was incorrect in making no adjustments for cash advances.

However, it is also clear that appellants' documentary evidence fails to establish that the cash advances totaled 24.59 percent (Camino) or 24.45 percent (Lawrence) of their credit card transactions. As discussed above, we found that some of the documentation is unclear or illegible, and we were unable to reconcile the majority of a sample of guest checks with the cash advance amounts listed on appellants' schedules. In light of all evidence, we find that appellants are unable to prove the amounts of adjustments that they allege. When the evidence establishes that the taxpayer is entitled to some allowance but the exact amount cannot be determined because the taxpayer is unable to provide business records or other evidence to prove the entitlement, it is appropriate to use an estimate that "bear[s] heavily ... upon the taxpayer whose inexactitude is of his own making." (*Cohan v. Commissioner of Internal Revenue* (2d Cir. 1930) 39 F.2d 540, 543-544.) We find this principle is applicable here. Given these circumstances, we conclude that the amount of credit card sales for each appellant should be reduced by 5 percent for cash advances.

Finally, we find unpersuasive appellants' position that the results of Camino's 2019 "no-change" audit support adjustments here. The evidence shows meaningful differences in the audit methods for the two audit periods, and thus the audit results of the later period are not applicable to or indicative of the earlier period. As discussed above, in the present cases the audits utilized the credit card ratio method. By contrast, because Camino had ceased accepting credit card payments in 2014, the 2019 audit of Camino utilized different methods and did not account for any credit card transactions. Furthermore, in the disputed audits of Camino and

Lawrence, the differences between reported sales and observed sales were substantial, whereas in the subsequent audit the difference between observed sales (\$2,349) and Camino's average reported sales per day (\$2,320) was immaterial. In addition, over the course of the entire 2011-2013 audit period for the present appeals, Camino's cash deposits in its bank account totaled only \$3,444 and Lawrence's totaled only \$7,644, whereas for the later audit period the audit work papers indicate that Camino's cash deposits totaled \$1,156,639. It is reasonable to conclude that changes over time, including but not limited to appellants' installation of ATMs and their switch to a cash-only policy, affected appellants' businesses and their reporting practices. We find unpersuasive appellants' argument that "businesses grow over time" and as a result their sales during the subsequent period must have increased compared to the 2011-2013 audit period; to the contrary, there are a variety of factors that may affect whether a business's sales increase or decrease over time. Given all of the differences, we find that the 2019 audit was substantially different from the audits at issue here, and hence the 2019 audit does not demonstrate errors in the audits at issue here.

In summary, we find that the available evidence generally supports the results of CDTFA's audit. Therefore, we recommend no adjustments other than the 5 percent adjustment to credit card sales for both Camino and Lawrence, and the increase of Camino's credit card sales ratio from 44.17 percent to 47.38 percent.

HOLDING

Some adjustments are warranted to the understatement of reported taxable sales for each appellant for the audit period, as follows. The amount of credit card sales for both Camino and Lawrence should be reduced by 5 percent to account for cash advances. Thereafter, Camino's audited understatement of reported taxable sales shall be recomputed using a credit card sales ratio of 47.38 percent.

DISPOSITION

Reduce the amount of credit card sales for both Camino and Lawrence by 5 percent, then recompute Camino’s audited taxable sales using a credit card ratio of 47.38 percent; otherwise, sustain CDTFA’s decision to delete the negligence penalties and deny the remainder of the petitions for redetermination.

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

We concur:

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