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2021 – OTA – 259
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No. 20106752
SUSHI IRVINE QUAIL HILL, L.P.	CDTFA Case ID 148-024
dba O Fine Japanese Cuisine	

OPINION

Representing the Parties:

For Appellant: Chia Tser Cheng, Managing Partner

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Craig Okihara, Business Taxes Specialist III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Sushi Irvine Quail Hill LP (appellant) appeals a decision issued by California Department of Tax and Fee Administration (respondent) denying appellant's petition for redetermination of the Notice of Determination (NOD) dated April 9, 2018.[1] The NOD is for $35,786.56 in tax, plus applicable interest, and a negligence penalty of $3,578.70, for the period April 1, 2014, through March 31, 2017 (liability period).

We decide this matter on the basis of the written record because appellant waived the right to an oral hearing.

ISSUES

1. Is appellant entitled to a reduction to the measure of underreported taxable sales?
2. Did respondent correctly impose the negligence penalty?

[1] Sales and use taxes (and other business taxes and fees) were formerly administered by the State Board of Equalization (BOE). In 2017, the California Legislature transferred functions of the BOE relevant to this case to respondent. (Gov. Code, § 15570.22.) The effective date of the transfer of all but adjudicatory functions was July 1, 2017. (Adjudicatory functions were transferred to the Office of Tax Appeals effective January 1, 2018.) When referring herein to events that occurred before July 1, 2017, "respondent" refers to BOE.

FACTUAL FINDINGS

1. Since March 29, 2011, appellant, a limited partnership, has held a seller's permit for the operation of a restaurant in Irvine, California, selling food, beer, and wine.
2. Respondent previously audited appellant for the period March 29, 2011, through December 31, 2013, and determined a deficiency measured by underreported taxable sales of $438,212 and an error ratio of 13.05 percent.[2]
3. For the liability period, appellant reported total sales of $4,871,048 on its sales and use tax returns (SUTRs), claiming deductions for sales tax reimbursement of $359,997 included in reported total sales and reported taxable sales of $4,511,051.[3]
4. For the audit, appellant provided federal income tax returns (FITRs) for 2014, 2015, and 2016; and annual profit and loss (P&L) statements for 2014, 2015, and 2016. Appellant did not provide sales tax worksheets; cash register Z-tapes; or source documentation, such as cash register tapes or merchandise purchase invoices, for the liability period.[4]
5. Respondent found that total (gross) sales recorded in the annual P&L statements for 2014, 2015, and 2016 agreed with corresponding gross receipts appellant reported on its FITRs. However, gross receipts (excluding sales tax reimbursement[5]) reported on the

[2] The "error ratio" is the percentage of underreported taxable sales to reported taxable sales.

[3] The audit work papers indicate that taxpayer used a point-of-sale (POS) system to ring up all sales except sales made through a third-party vendor (e.g., Door Dash) and that quarterly sales reports and third-party vendor statement amounts were combined to calculate quarterly totals for sales tax reporting purposes. Respondent reports that at the appeals conference, appellant stated that it reported total sales based on bank deposits less tips recorded in its POS sales reports and then used the applicable sales tax rate to compute sales tax reimbursement included in the reported total sales.

[4] Z-tapes are POS terminal (register) summaries of sales activity. Depending on the equipment and software, they can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

[5] If appellant's gross receipts for 2014 through 2016, inclusive, equaled its taxable sales, and if appellant included sales tax reimbursement in gross receipts reported in its FITRs, that sales tax reimbursement alone should have totaled approximately $395,074. Appellant reported deductions on its FITRs of only $156,481 (rounded) for "Taxes and licenses" (line 23 on Schedule C) included in reported gross receipts. However, when calculating the measure based on the difference between reported gross receipts and reported gross sales, respondent allowed a reduction to reported gross receipts of more than twice that amount, approximately $357,048, representing sales tax included in gross sales reported on the SUTRs.

FITRs exceeded taxable sales reported on the SUTRs by $264,127 for 2014,[6] $21 for 2015, and $249,235 for 2016.[7]

6. Appellant asserted during the audit that its reported gross receipts were substantially higher that its reported gross sales because it inadvertently included optional tips in reported gross receipts. However, appellant did not provide supporting documentation to prove the inclusion of optional tips in reported gross receipts or to show that appellant filed amended returns to correct the alleged errors.

7. Respondent also estimated appellant's book markup by comparing taxable sales reported on the SUTRs with cost of goods sold (COGS) reported on the FITRs and deducting 2 percent for self-consumption and another 2 percent for shrinkage, to compute a 171.73 percent markup for 2014, a 214.92 percent markup for 2015, and a 131.24 percent markup for 2016.[8] Because of the inconsistent book markups and appellant's failure to provide source documentation, respondent concluded additional testing should be done to verify taxable sales.

8. Form 1099-K data for the period April 1, 2014, through December 31, 2015 (test period) revealed sales for which payments were made using credit or debit cards (card sales) totaled $3,158,085, including tips and sales tax reimbursement.[9] Respondent backed out tips (estimated at 10 percent) and sales tax reimbursement to calculate card sales excluding tips and sales tax reimbursement (net card sales) of $2,658,320 for the test period. It divided the net card sales by reported taxable sales of $2,765,531 for the same period to compute that 96.12 percent of appellant's sales were card sales. Based on its

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[6] Because the first quarter of 2014 (1Q14) was not part of the liability period, respondent obtained sales for 1Q14 from its computerized taxpayer information files.

[7] The total difference, $513,383, is for the three-year period January 1, 2014, through December 31, 2016. The liability period, also three years, does not include 1Q14 but does include 1Q17.

[8] "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" (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 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 = 0.30).

[9] Federal form 1099-K is an IRS form used to report a taxpayer's income received from electronic or online payment services (credit cards, debit cards, PayPal, etc.). It is authorized by the IRS for tax administration purposes.

experience in audits of similar businesses in appellant's area, respondent concluded a 96.12 percent card sales ratio was unusually high and indicative of an underreporting of sales. On that basis, respondent decided to do an observation test to establish an actual sample from which more accurate tip and card sales ratios might be determined.

9. Respondent performed a site observation test on Monday, August 14, 2017, Thursday, August 17, 2017, and Saturday, August 19, 2017, and observed appellant's business for the full business day on each occasion. For the three days combined, respondent computed a new card sales ratio of 88.94 percent and a new tip ratio of 13.23 percent.

10. For each quarterly period within the test period, respondent backed out tips of 13.23 percent and sales tax reimbursement to compute new net card sales of $2,582,489 for the test period. Respondent then divided the new net card sales by the audited card sales ratio of 88.94 percent to compute audited taxable sales of $2,903,629 for the test period. It deducted reported taxable sales of $2,765,531 from audited taxable sales of $2,903,629 to compute audited underreported taxable sales of $138,098 for the test period, and an error ratio of 4.99 percent ($138,098 ÷ $2,765,531). Because card sales data were not available for January 1, 2016, through March 31, 2017, respondent applied the 4.99 percent error ratio to taxable sales of $1,745,520 reported on the SUTRs for that period and computed underreported taxable sales of $87,101 ($1,745,520 × 4.99 percent) (rounded). Thus, in total, respondent calculated underreported taxable sales of $225,186 ($138,098 + $87,101) for the liability period.

11. Respondent found that the results of the card sales ratio method showed that appellant had significantly underreported taxable sales on its SUTRs. However, respondent concluded that the FITRs were the best evidence of appellant's gross receipts and that the unexplained differences between reported taxable sales and reported gross receipts represented the most reliable measure of underreported taxable sales.

12. Respondent calculated the average quarterly difference between gross receipts reported on FITRs and gross sales reported on SUTRs for 2014 of $66,032 ($264,127 ÷ 4 quarters) and computed underreported taxable sales for the three quarters of 2014 included in the liability period of $198,096 ($66,032 × 3 quarters). It used the total difference, $249,235, for 2016, and counted no difference for 2015 or the first quarter of

2017 (1Q17).[10] In total, respondent computed underreported taxable sales of $447,332 (rounded) for the liability period.

13. As a test of reasonableness, respondent also compared audited taxable sales for 2014, 2015, and 2016 to the corresponding COGS reported on the FITRs and computed a markup on audited sales of 203.36 percent for the three years combined. Respondent considered this markup adequate and concluded that audited taxable sales based on appellant's FITRs produced reasonable results.
14. Respondent issued an NOD to appellant on April 9, 2018, based on the above-mentioned audit, with a tax liability of $35,786.56, a negligence penalty of $3,578.70, and applicable interest.
15. Appellant filed a timely petition for redetermination protesting the NOD in its entirety. During the agency-level appeal, appellant conceded an inadvertent understatement of taxable sales totaling $96,461 for the liability period.
16. Respondent held an appeals conference with appellant, and subsequently issued a Decision on August 24, 2020, denying the petition.
17. This timely appeal followed.

DISCUSSION

Issue 1: Is appellant entitled to a reduction to the measure of underreported taxable sales?

California imposes sales tax on a retailer's gross receipts from the retail sale of tangible personal property in this state unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (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).) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

[10] The record indicates that respondent concluded that the $21 difference for 2015 was immaterial and that it chose not to estimate a measure for 1Q17.

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When respondent is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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, 6511.) When taxpayer appeals a determination, respondent has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) Once respondent has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result different from respondent's determination is warranted. (*Ibid*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

During the audit and the agency-level appeal, appellant argued that the determined measure based on the difference between reported gross receipts (per FITRs) and reported gross sales (per SUTRs) was the result of its inadvertent inclusion of optional tips in reported gross receipts. Appellant has not specifically explained its position on this appeal to the Office of Tax Appeals, but it has submitted the same evidence to us that it provided to respondent during the agency-level appeal, including what appear to be summaries of daily sales amounts, purportedly taken from POS and third-party delivery service records, and a worksheet showing taxable sales of $4,607,527, which is $96,461 more than appellant reported. We infer from appellant's submissions that appellant concedes underreporting taxable sales by the latter amount but otherwise argues that it accurately reported taxable sales, as shown by the provided sales summaries.

Respondent's preliminary analysis found large differences between reported gross sales (per SUTRs) and reported gross receipts (per FITRs and P&L statements), inconsistent and low book markups, and an unusually high card sales ratio, all of which suggested an understatement of taxable sales.[11] Under the circumstances, we find that it was reasonable for respondent to question reported taxable sales and that, given the absence of an adequate explanation of the large differences between reported gross sales and reported gross receipts, respondent's decision to rely on the gross receipt amounts recorded on appellant's P&L statements and reported on appellant's FITRs was a rational one. On this basis, we conclude that respondent has met its burden of producing evidence to show a reasonable and rational basis for its determination, and the burden shifts to appellant to provide evidence from which a more accurate determination may be made.

[11] An unusually high card sales ratio may, for example, indicate underreported cash sales.

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There is nothing in our file to suggest that appellant has provided any evidence to support its argument that the discrepancy was due to its inadvertent inclusion of optional tips in gross receipts for three consecutive years. Furthermore, if appellant had overreported its gross receipts on its FITRs, we expect it would have filed amended returns to correct the error and recover overpaid amounts. There is nothing in the record to indicate it did that.

On the other hand, appellant recorded in its P&L statements and reported to the Internal Revenue Service (IRS) that gross receipts for the liability period were $447,332 (the measure at issue) more than what appellant reported on its SUTRs as taxable sales. Appellant now essentially concedes $96,461 of that measure, but it still has not explained why the other $350,871 recorded in appellant's P&L statements and reported to the IRS as gross receipts were not also taxable sales. Even if appellant provided Z-tapes or other evidence of sales recorded in its POS system and the sum of those sales matched the amounts that appear in the summaries already provided by appellant, such evidence would not explain the discrepancy upon which the determination is based. We find nothing in the record to suggest that appellant has offered any reasonable explanation for this discrepancy, and appellant's unsupported assertions are not sufficient to meet its burden of proof. (*Appeal of Talavera*, *supra*.) Consequently, we conclude that appellant is not entitled to a reduction to the measure of underreported taxable sales.

Issue 2: Did respondent correctly impose the negligence penalty?

Respondent imposed a negligence penalty pursuant to R&TC section 6484 on the bases of the substantial amount of the understatement, appellant's failure to correct reporting errors disclosed in the prior audit, and appellant's failure to provide books and records that were adequate for sales and use tax audit purposes.

R&TC section 6484 provides that if any part of the deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Although the term "negligence" in not specifically defined in the Sales and Use Tax Law, it is a common legal concept and is generally defined as a failure to act as a reasonably prudent person would have acted under similar circumstances. (*Acqua Vista Homeowners Assn. v. MWI, Inc.* (2017) 7 Cal. App. 5th 1129, 1157.) A negligence penalty can be based on reporting errors (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167

Cal.App.2d 318) or on a taxpayer's failure to maintain (and provide for audit) complete and accurate records (Cal. Code Regs., tit. 18, § 1698(k)).

Appellant did not address the negligence penalty in its submissions, except that it asserts that the understatement is $96,461, substantially less than the determined amount of $447,332, and that the underreporting was a "mistake."

We have already found that appellant underreported taxable sales by $447,332 for the liability period, which represents an error ratio of 9.92 percent when compared to reported taxable sales of $4,511,051. Although the error ratio shows an improvement when compared to the 13.05 percent error ratio calculated for the prior audit, the evidence shows that appellant did not approach its responsibilities as a reasonably prudent taxpayer would have done. Appellant concedes it did not accurately report taxable sales. Its unverified summary indicates that it accurately or nearly accurately reported taxable sales for just four of the 36 months at issue. Even using appellant's numbers, it underreported taxable sales for 31 of the remaining months and overreported taxable sales for just one month. This kind of consistent underreporting does not reflect the actions of a reasonably prudent taxpayer, particularly one who was found to have substantially underreported taxable sales in a prior audit. Thus, we find the errors here cannot be attributed to appellant's good faith and reasonable belief that its bookkeeping and reporting practices were in substantial compliance with the requirements of the Sales and Use Tax Law, and we find that the substantial amount of audited underreported taxable sales is evidence of negligence.

Moreover, during the audit, appellant did not provide business records that were sufficient for sales and use tax purposes. Although it eventually provided additional records, including bank statements and what purport to be POS summaries of daily and monthly sales, appellant did not provide source documents to support appellant's POS summaries or any information to explain how appellant calculated gross receipts (for FITR purposes) or why that amount differed so substantially from reported sales. This failure to maintain and provide adequate books and records is also evidence of appellant's negligence.

For the above reasons, we find that appellant was negligent, and respondent's imposition of the negligence penalty was justified.

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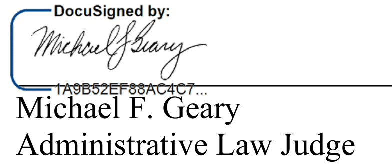
HOLDINGS

1. Appellant is not entitled to a reduction to the measure of underreported taxable sales.
2. Respondent correctly imposed the negligence penalty.

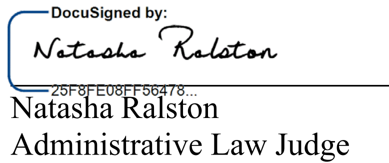
DISPOSITION

Respondent's Decision denying appellant's petition for redetermination of the April 9, 2018 NOD is sustained.

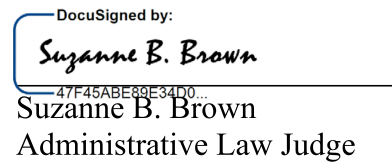


Michael F. Geary
Administrative Law Judge

We concur:



Natasha Ralston
Administrative Law Judge



Suzanne B. Brown
Administrative Law Judge

Date Issued: 7/16/2021