

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 20086559
MINATO RESTAURANT, INC.) CDTFA Case ID 208-079
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OPINION

Representing the Parties:

For Appellant: Andy Yu, CPA

For Respondent: Jason Parker,
Chief of Headquarters Operations

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

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Minato Restaurant, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA),¹ partially denying appellant’s petition for redetermination of the Notice of Determination (NOD) for tax of \$221,639.18, a negligence penalty of \$22,163.93, and applicable interest, for the period April 1, 2014, through April 23, 2017 (audit period).

In its subsequent decision, CDTFA reduced the understated measure of tax from \$2,784,565 to \$2,587,248, which will result in reductions to the tax and penalty. CDTFA denied the remainder of the petitioned amount.

Appellant waived its right to an oral hearing; therefore, the matter is being decided based on the written record.

¹ Sales taxes were formerly administered by the State Board of Equalization (BOE). In 2017, functions of BOE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) For ease of reference, when referring to acts or events that occurred before July 1, 2017, “CDTFA” shall refer to BOE; and when referring to acts or events that occurred on or after July 1, 2017, “CDTFA” shall refer to CDTFA.

ISSUES

1. Whether any further reduction to the amount of unreported taxable sales is warranted.
2. Whether the understatement was the result of negligence.

FACTUAL FINDINGS

1. Appellant operated a buffet style restaurant in Ontario, California. Appellant charged a 15 percent mandatory gratuity (tips) to parties of 10 or more. Appellant closed the business on April 24, 2017.
2. For the audit, appellant provided monthly sales reports for the second quarter of 2015 (2Q15), 3Q15, 1Q16, 2Q16, 4Q16, 1Q17, and April 1, 2017, through April 23, 2017 (the monthly sales reports period, collectively). Appellant also provided monthly sales summaries for most of the audit period except April 1, 2017, through April 23, 2017. Appellant did not provide source documents, such as cash register tapes and guest checks, for any part of the audit period. CDTFA also obtained copies of appellant's 1099-K forms.²
3. During the audit, appellant explained that it calculated taxable sales by dividing the sales tax reimbursement that it collected in each quarter by the prevailing sales tax rate.
4. CDTFA compared the taxable sales that appellant recorded on its monthly sales reports to the amounts that appellant reported in its sales and use tax returns and found differences in every quarter of the monthly sales reports period. CDTFA also could not verify the accuracy of appellant's monthly sales reports or appellant's monthly sales summaries.
5. CDTFA computed appellant's taxable sales using the credit-card-sales-ratio method. CDTFA compared the credit card receipts recorded on appellant's 1099-K forms to the credit card sales that appellant recorded in its monthly sales reports for the periods 2Q15, 3Q15, 1Q16, 2Q16, and 4Q16 and found a difference of \$646,314.65. CDTFA determined that this difference was related to nontaxable optional tips. CDTFA concluded that the tips that appellant recorded in its monthly sales reports were taxable mandatory tips. Therefore, CDTFA computed the credit-card-sales-ratio using amounts of mandatory tips recorded in appellant's monthly sales reports. CDTFA compared

² Form 1099-K is an Internal Revenue Service form titled, "Payment Card and Third Party Network Transactions," issued to merchants, which shows the monthly and annual amount paid to the merchant by a credit card company or third-party network during a given time period.

- appellant's total mandatory tips to the mandatory tips paid by credit card, which appellant recorded in its monthly reports and found a credit-card-sales-ratio of 80.14 percent.
6. CDTFA applied the 80.14 percent credit-card-sales ratio to the credit card sales recorded on appellant's monthly sales reports, excluding tax and tips, of \$7,627,335 to compute audited taxable sales of \$9,516,954 for the monthly sales reports periods. CDTFA compared appellant's audited taxable sales and reported taxable sales and found unreported taxable sales of \$1,228,364 for the monthly sales reports period.
 7. CDTFA divided unreported taxable sales of \$1,228,364 by reported taxable sales to compute an overall error ratio of 14.82 percent for all quarters in the monthly sales report period. The error ratio broken down for each quarter of the monthly sales reports period is as follows: an error rate of 10.69 percent for 2Q15; an error rate of 12.04 percent for 3Q15; an error rate of 10.37 percent for 1Q16; an error rate of 13.68 percent for 2Q16; an error rate of 13.31 percent for 4Q16; an error rate of 31.43 percent for 1Q17; and an error rate of 15.11 percent for 2Q17.
 8. CDTFA applied the 14.82 percent error ratio to appellant's reported taxable sales for the periods for which monthly sales reports were not provided (2Q14, 3Q14, 4Q14, 1Q15, 4Q15, and 3Q16), to compute unreported taxable sales of \$1,123,784 for those periods. In total, CDTFA computed unreported taxable sales of \$2,352,149 for the audit period (\$1,228,364 + \$1,123,785).
 9. CDTFA considered the mandatory tips to be taxable, which appellant does not dispute. To calculate taxable mandatory tips, CDTFA compiled mandatory tips that appellant recorded on its monthly sales reports of \$195,068. CDTFA divided appellant's recorded mandatory tips of \$195,068 by appellant's recorded taxable sales for the monthly sales reports period and found a mandatory tips ratio of 2.39 percent. The mandatory tips ratio of 2.39 percent was applied to appellant's reported taxable sales for the periods for which monthly sales reports were not provided, to compute unreported mandatory tips of \$181,156 for those periods.
 10. CDTFA also calculated the mandatory tips applicable to appellant's unreported taxable sales. CDTFA did this by applying the mandatory tips ratio of 2.39 percent to unreported taxable sales of \$2,352,149 as computed above, to compute mandatory tips applicable to

- unreported taxable sales of \$56,192. In total, CDTFA computed mandatory tips of \$432,416 for the audit period.
11. CDTFA added unreported taxable sales of \$2,352,149 to unreported mandatory tips of \$432,416 to compute the total understatement of \$2,784,565 in the original audit.
 12. CDTFA issued an NOD to appellant for tax of \$221,639.18, a negligence penalty of \$22,163.93, and applicable interest. Appellant filed a timely petition for redetermination of the NOD.
 13. CDTFA issued a decision on April 13, 2020, making the following adjustments to the audit. CDTFA removed 1Q17 from the measure of unreported taxable sales based on a credit-card-sales ratio projection. CDTFA found that the 31.43 percent error rate resulting from the credit card projection for 1Q17 was an outlier. CDTFA also found that a comparison of the taxable sales that appellant recorded in its books and records and the taxable sales that appellant reported on its sales and use tax returns of 14.49 percent for 1Q17 was closer to the overall error rate of 14.82 percent. Based on all of this, CDTFA accepted appellant's books and records for 1Q17 and calculated the unreported tax based on the difference between appellant's recorded and reported taxable sales. This reduced the measure of tax for 1Q17 by \$197,317 from \$393,173 to \$195,856.³ Otherwise, CDTFA denied appellant's petition.
 14. This appeal followed.

DISCUSSION

Issue 1: Whether any further reduction to the unreported taxable sales is warranted.

California imposes a sales tax on a retailer's retail sales of tangible personal property sold in this state measured by 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).) An optional payment designated as a tip, gratuity, or service charge is not subject to tax. (Cal. Code Regs., tit. 18, §1603(g), (h).) A mandatory payment designated as a tip, gratuity, or service

³ This reduction includes amounts for unreported taxable sales and unreported taxable mandatory tips.

charge is included in taxable gross receipts, even if the amount is subsequently paid by the retailer to employees. (*Ibid.*)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, 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.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Talavera*, 2020-OTA-022P.) 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. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Here, appellant did not provide a complete set of books and records for the audit. Specifically, appellant did not provide a complete set of monthly sales reports. Appellant also did not provide source documents to show the accuracy of the books and records that it did provide. CDTFA examined the available books and records and found material discrepancies.

To calculate the taxable measure, CDTFA established a credit-card-sales ratio of 80.14 percent by comparing the total mandatory tips that appellant recorded in its books and records to those recorded as paid by credit card. CDTFA used the credit-card-sales ratio to calculate appellant's audited taxable sales for the monthly sales reports period. CDTFA also established an error rate of 14.82 percent, which it applied to appellant's reported taxable sales for the period in which no books or records were provided. Given appellant's failure to provide a complete set of books and records we conclude that it was reasonable for CDTFA to use both a credit-card-sales ratio and an error rate to calculate appellant's audited taxable sales.

Thereafter, CDTFA acknowledged that the error rate of 31.43 percent for 1Q17, which was used in the calculation of the overall error rate, was an outlier. Indeed, a review of the audit workpapers reveals that the next largest error rate during the monthly sales reports period was nearly half of the 31.43 percent error rate found for 1Q17. CDTFA also acknowledged that a comparison of appellant's recorded taxable sales to its reported taxable sales for 1Q17 revealed an error rate of 14.49 percent. Based on this information, CDTFA reduced the taxable measure for 1Q17 but did not adjust the overall error rate of 14.82 percent (which included the figures for 1Q17).

On appeal, appellant asserts that the percentage of error is inaccurately computed. Conversely, CDTFA asserts that the overall error rate of 14.82 percent is correctly calculated. CDTFA argues that its concession to adjust the taxable measure for 1Q17 was to give a benefit to appellant. CDTFA also states that any alternative percentages of error that it calculated were for analysis purposes only. However, the evidence does not support CDTFA's assertions. Instead, a November 6, 2019 memorandum from CDTFA's audit staff to CDTFA's appeals staff shows that the adjustments for 1Q17 were made because "the 1Q-17 recorded vs. reported [percentage of error (POE)] (14.49%) is in line with the primary audit method's adjusted POE⁴...[CDTFA] believes the taxpayer's request to accept [point of sale] recorded taxable sales hold [*sic*] merit." Thus, it appears that CDTFA's concession was not merely to benefit appellant but was based on CDTFA's finding that appellant's books and records for 1Q17 provided a more accurate audit result.

Regardless of CDTFA's explanation, the continued use of a 14.82 percent error rate creates an unreasonable result because it contains amounts which CDTFA previously conceded to reduce. Since the overall error rate of 14.82 percent is calculated using the original audit's taxable measure from 1Q17, which CDTFA conceded to reduce, the overall error rate is artificially inflated. Therefore, CDTFA must recalculate the overall error rate to include the reduced amount and error rate of 14.49 percent for 1Q17, which according to CDTFA's calculations results in an overall error rate of 12.49 percent. The revised error rate must be applied to the periods for which no monthly sales reports were provided (i.e., 2Q14, 3Q14, 4Q14, 1Q15, 4Q15, and 3Q16).

Issue 2: Whether the understatement was the result of negligence.

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.

Taxpayers are required to maintain and make available for examination on request by CDTFA, or its authorized representative, all records necessary to determine the correct tax liability under the Sales and Use Tax Law and all records necessary for the proper completion of

⁴ CDTFA calculated an adjusted POE, which excluded any amount from 1Q17 of 12.49 percent.

the sales and use tax returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: (a) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; (b) bills, receipts, invoices, cash register tapes, or other documents of original entry supporting the entries in the books of account; and (c) schedules or working papers used in connection with the preparation of the tax returns. (Cal. Code Regs., tit. 18, § 1698(b)(1).) Failure to maintain and keep complete and accurate records, including all bills, receipts, invoices, or other documents of original entry supporting the entries in the books of account, will be considered evidence of negligence and may result in the imposition of penalties. (Cal. Code Regs., tit. 18, § 1698(k).)

Generally, a penalty for negligence or intentional disregard should not be added to determinations associated with the first audit of a taxpayer. (Cal. Code Regs, tit. 18, § 1703(c)(3)(A); also see *Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal App.2d 318, 321-324.) However, a negligence penalty should be upheld in a first audit if the understatement cannot be attributed to a bona fide and reasonable belief that the bookkeeping and reporting practices were sufficiently compliant with the requirements of the Sales and Use Tax Law. (*Independent Iron Works, Inc. v. State Bd. of Equalization, supra*, at pps. 321-324.)


Here, CDTFA applied a negligence penalty based on appellant's failure to keep books and records. Indeed, appellant did not provide a complete set of monthly sales reports. Appellant also did not provide source documents such as cash register receipts or guest checks. Appellant's failure to provide a complete set of books and records is evidence of negligence. On appeal, appellant did not provide any assertions with respect to the negligence penalty. Accordingly, we find no basis to relieve the negligence penalty.

HOLDING


Reduce the overall error rate to 12.49 percent and adjust the taxable measure accordingly. Otherwise CDTFA’s action is sustained.

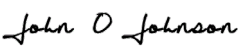
DISPOSITION

Reduce the measure of unreported taxable sales based on our foregoing instructions. Adjust the corresponding negligence penalty. CDTFA’s action otherwise denying the petition, is sustained.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:

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Teresa A. Stanley
Administrative Law Judge

DocuSigned by:

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John O. Johnson
Administrative Law Judge

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