OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20106822
	) CDTFA Case ID 232-146
M. AMAYA	)
dba MARISCOS EL KIOSCO	)
	)
	)

OPINION

Representing the Parties:

For Appellant:	Shamim S. Akhavan, Esq.
For Respondent:	Ravinder Sharma, Hearing Representative Christopher Brooks, Tax Counsel IV Jason Parker, Chief of Headquarters Ops.
For Office of Tax Appeals:	Richard Zellmer Business Taxes Specialist III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, M. Amaya (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) for tax of $98,550.70, and applicable interest, for the period January 1, 2014, through December 31, 2016 (audit period).

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Sheriene Anne Ridenour, and Andrew Wong held an oral hearing via videoconference for this matter on August 18, 2021. At the conclusion of the hearing, we closed the record, and submitted this matter for decision.

[1] Sales and use 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 this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to BOE; and when this Opinion refers to acts or events that occurred on or after July 1, 2017, "CDTFA" shall refer to CDTFA.

ISSUES

1. Whether any reduction to the amount of unreported taxable sales is warranted.
2. Whether appellant is liable for the tax applicable to sales made by appellant's tenants.

FACTUAL FINDINGS

1. Appellant operated a bar and leased a restaurant in an adjacent building, which was operated by appellant's tenants. The lease agreement provided for use of the premises only as a restaurant unless prior written consent was received. The lease did not contain any provisions related to the business name, fixtures and equipment, tangible personal property and intangibles, such as goodwill.
2. The seller's permit for the leased restaurant continued to be in appellant's name. In addition, both the city business permit and the Alcoholic Beverage Control license for the restaurant remained under appellant's name during the lease term.
3. According to the Report of Field Audit – Revised, dated September 13, 2017, the tenants did not have their own seller's permit and had an agreement with appellant that she would be reporting sales from that location. CDTFA reported that its auditor met with appellant, who said that the tenant operated the restaurant using appellant's seller's permit. In addition, CDTFA reported that appellant told its auditor that appellant reviewed the restaurant's sales receipts and prepared the sales and use tax returns (SUTRs) based on the amounts listed on the sales receipts.
4. During the audit period, appellant reported taxable sales of $182,555 for the bar, but reported no sales made at the restaurant.
5. Upon audit, appellant provided incomplete books and records. Appellant did not provide complete detailed sales data, cash register tapes, purchase journals, or merchandise purchase invoices for the audit period. Appellant provided federal income tax returns (FITRs) for 2014 and 2015, and purchase invoices and sales receipts for the bar for the period December 12, 2016, through January 4, 2017.
6. CDTFA reduced merchandise purchases reported on the 2014 and 2015 FITRs to account for pilferage and self-consumption, and then compared the result to taxable sales reported on the SUTRs to compute book markups for the bar of 263.70 percent for 2014 and

86.44 percent for 2015.[2] CDTFA expected the markup for the bar to be at least 250 percent, and thus found the 86.44 percent book markup for 2015 too low. CDTFA used the markup method to compute bar sales and the credit-card-sales-ratio method to compute restaurant sales. CDTFA prepared an audit and a revised audit. The following is an explanation of the calculation of taxable sales in the revised audit.

7. To compute restaurant sales, CDTFA first obtained Forms 1099-K issued to appellant for May 1, 2014, through December 31, 2014, and January 15, 2015, through February 15, 2015, from the Franchise Tax Board.[3] Using the data from the Forms 1099-K, CDTFA compiled credit card deposits and removed sales tax reimbursement from these amounts to compute credit card sales.[4] CDTFA used information from Yelp.com to ascertain the specific types of meals served at appellant's restaurant, and the selling prices of those meals. Then, CDTFA estimated a credit-card-sales ratio of 40 percent based on research done on the business location, types of food sold, selling prices, and prior audits similar to appellant's restaurant in the types of food sold, location, size, and nature of business.

8. CDTFA divided credit card sales by the credit-card-sales ratio of 40 percent to compute audited taxable sales at the restaurant, and then computed audited average daily restaurant sales.

9. CDTFA could not use the credit-card-sales-ratio method to compute bar sales because the bar did not accept credit cards as a form of payment. Thus, CDTFA decided to compute bar sales using the markup method. Using costs from purchase invoices from December 2016 and selling prices from appellant's sales receipts from the period December 12, 2016, through January 4, 2017, CDTFA performed a shelf test,[5] computing

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[2] "Markup" is the percentage by which the cost of merchandise is increased to set the retail price.

[3] 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.

[4] At the time of the audit field work, the restaurant was closed for renovations, and thus, CDTFA could not perform an observation test to establish the credit-card-sales ratio (which is the ratio of sales paid for with credit cards to total sales).

[5] A shelf test is an accounting comparison of known costs and associated selling prices, used to compute markups.

an average weighted markup of 339.26 percent for the bar.[6] CDTFA reduced merchandise purchases as reported on the FITRs by 2 percent for pilferage to compute the audited cost of alcohol sold. CDTFA added the audited markup of 339.26 percent to the audited cost of alcohol sold to compute audited alcohol sales and then computed audited average daily bar sales.

10. CDTFA added audited average daily restaurant sales to audited average daily bar sales to compute audited average daily taxable sales. CDTFA multiplied audited average daily taxable sales by the number of days the businesses were open each applicable year to compute audited taxable sales for each of the three years in the audit period, which were then added together to compute audited taxable sales of $1,277,563 for the audit period. Audited taxable sales of $1,277,563 was compared to reported taxable sales of $182,555, to compute unreported taxable sales of $1,095,007 in the revised audit.[7]
11. Based on the revised audit, CDTFA issued an NOD for tax of $98,550.70, and applicable interest, to appellant on September 25, 2017.
12. Appellant filed a timely petition for redetermination of the NOD.
13. In its Decision issued on August 16, 2020, CDTFA denied appellant's petition.
14. This timely appeal followed.

DISCUSSION

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

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from retail sales of tangible personal property in this state, 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).)

[6] In computing the 339.26 percent markup, CDTFA accounted for lower happy hour prices, breakage of bottled beer, and overpouring and spillage of liquor drinks. Also, CDTFA used a one-ounce pour size for liquor drinks.

[7] CDTFA prepared the revised audit to correct the amount of reported taxable sales. CDTFA did not change the amount of audited taxable sales in the revised audit.

If 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 provided incomplete books and records. Appellant did provide FITRs for 2014 and 2015, and purchase invoices and sales receipts for the bar for the period December 12, 2016, through January 4, 2017. CDTFA computed a book markup for the bar of 86.44 percent for 2015, which is much lower than the 250 percent markup that CDTFA expected for this type of business in appellant's area. In addition, appellant acknowledges that she did not report any sales made at the restaurant during the audit period. CDTFA concluded that reported taxable sales were understated for both the bar and the restaurant and used indirect audit methods to compute appellant's sales (that is, using a method to compute sales other than transcribing sales amounts directly from the books and records).

The markup method and credit-card-sales-ratio method are recognized and accepted accounting procedures. (See *Maganini v. Quinn* (1950) 99 Cal.App.2d 1 (*Maganini*); *Riley B's, Inc. v. BOE* (1976) 61 Cal.App.3d 610 (*Riley B's*); CDTFA Audit Manual §§ 0802.05, 0802.70.)[8] We find that CDTFA's use of the markup method and credit-card-sales-ratio method to compute appellant's taxable sales was appropriate. Accordingly, we find that CDTFA has met its initial burden to show that its determination was reasonable and rational, and the burden of proof shifts to appellant to show that adjustments are warranted.

Appellant asserts that she provided certain documents and records to CDTFA, such as purchase invoices and sales receipts, but that CDTFA's application of its audit methods resulted in a determination inconsistent with industry custom. Appellant also contends that bank statements for the first quarter of 2014, second quarter of 2015, and third quarter of 2016, which she previously provided to CDTFA, support her reported taxable sales. Appellant argues that the

[8] CDTFA's Audit Manual does not provide binding legal authority; however, OTA may look to it for guidance. (*Appeal of Micelle Laboratories, Inc*., 2020-OTA-290P.)

bank statements more accurately portray her sales, and that CDTFA's determination, which examined third party information, does not reflect the facts as represented in the provided documentation.

However, CDTFA is authorized to verify the accuracy of any return made or, if no return is made, to ascertain and determine the amount required to be paid. (R&TC, § 7054; see also *Riley B's*, *supra*, 61 Cal.App.3d at p. 615; *Maganini*, *supra*, 99 Cal.App.2d at p. 4.) In addition, CDTFA may compute and determine the amount required to be paid upon the basis of any information within its possession or that may come into its possession. (R&TC, § 6481; see also *Riley B's*, *supra*, at pp. 614-615; *Maganini*, *supra*, at p. 4.) Furthermore, when books and records are provided, CDTFA may still determine the amount of tax due based upon any available information, even if such books and records are comprehensive and internally consistent.[9] (See R&TC, § 6481; *Riley B's* at pp. 614-615.)

As discussed in *Appeal of AMG Care Collective*, 2020-OTA-173P, R&TC section 6481 establishes the authority of CDTFA to determine a taxpayer's liability, and the fact that bank deposit information or other records substantially reconcile with the amounts reported on tax returns does not establish that taxes due were correctly reported.[10] It is appellant's burden to show error in the determination, and appellant must point to an error in the determination and provide proof of the error. (*Appeal of AMG Care Collective*, *supra*.)

Appellant does not provide any explanation or argument to explain why the bank statements, totaling more than 100 pages, show error in the determination, and appellant does not specifically point to anything in the statements to give them context as to her argument. OTA is not required to sort through voluminous and unorganized documentation in an attempt to find

[9] The court in *Riley B's* refuted the argument that "calculating theoretical sales is valid where the actual sales are unknown or unrecorded" and "improper where comprehensive business records are maintained." (*Riley B's*, *supra*, 61 Cal.App.3d at p. 615.) The court stated that to hold otherwise would allow the avoidance of tax liability "simply by maintaining inaccurate but voluminous and consistent records." (*Id*., at p. 617.) The court also noted that *Maganini* held that "[t]here is no requirement that such audit be restricted to pointing out falsifications, errors or omissions, if any, in the books of account themselves." (*Id*., at p. 615, citing *Maganini*, *supra*, 99 Cal.App.2d at p. 7.)

[10] *Riley B's* and *Maganini* note that in *People v. Schwartz* (1947) 31 Cal.2d 59 (*Schwartz*), BOE found the taxpayer's bank deposits and disbursements substantially exceeded the gross receipts from sales reported. After BOE made its determination based on the examination, the court in *Schwartz* held that the burden of proof was on the taxpayer to explain the disparity. (*Schwartz*, *supra*, at p. 64 ["In the absence of explanation by the taxpayer . . . it reasonably may be concluded that the total of money received . . . is the amount of the additional taxable sales"]; see also *Riley B's*, *supra*, 61 Cal.App.3d at p. 616; *Maganini*, *supra*, 99 Cal.App.2d at p. 7.)

errors in CDTFA's determination. (See *Hale v. Commissioner*, T.C. Memo. 2010-229; *Patterson v. Commissioner*, T.C. Memo. 1979-362.)

In this case, it cannot be determined whether all cash proceeds from sales were deposited into the business bank account, as the bar only accepted cash as a form of payment, while the restaurant accepted both cash and credit cards. Furthermore, there are deposits on 27 days, and no deposits on the remaining 246 days, which indicates that the bank statements do not represent all sales by appellant. Therefore, we find that the bank statements provided by appellant are not a reliable source for determining appellant's sales.[11]

Appellant also contends that the audited markup of 339.26 percent for the bar is too high and is not in line with industry custom, which is between 50 to 100 percent. The markup audit method is a well-established audit method that has been shown effective and reliable if it is based on sufficient information to establish a reasonable markup and cost of taxable merchandise sold. (See *Maganini*, *supra*, 99 Cal.App.2d 1; *Riley B's*, *supra*, 61 Cal.App.3d 610.) In this case, CDTFA possessed sufficient information to utilize the markup method, such as appellant's own books and records, including purchase invoices and sales receipts.

Appellant also contends that the 40 percent credit-card-sales ratio used to compute sales for the restaurant is too low and should be 80 percent. Appellant notes that the business was closed for renovations and an observation test could not be performed. Appellant asserts that, as a result, CDTFA resorted to estimating sales based on third-party sources to compute the credit-card-sales ratio, which does not accurately reflect the facts.

While CDTFA could not perform an observation test due to closure of the business, appellant did not provide information requested by CDTFA, such as cash register Z-tapes and sales records.[12] In calculating the credit-card-sales ratio, CDTFA relied on data from the Forms 1099-K, information from Yelp.com, and research done on the business location, types of food sold, selling prices, and prior audits similar to appellant's restaurant. As noted above, the credit-card-sales ratio method is a recognized and accepted accounting procedure, and CDTFA's determination may be based upon any available information, including third-party sources. And

[11] Appellant notes that CDTFA's opening brief incorrectly stated the markup ratio was 239.26 percent. However, the audit working papers correctly show the markup ratio as 339.26 percent.

[12] Z-tapes are the part of the cash register tapes that summarize the sales by category for a given period of time.

appellant does not provide any evidence showing that, even though an observation test was not performed, the credit-card-sales ratio for the restaurant should be adjusted.[13]

Appellant also asserts that a reaudit should be undertaken under the supervision of OTA to determine a more accurate markup ratio that is in line with industry custom. CDTFA conducts audits and reaudits, which include tests conducted with generally accepted auditing standards.[14] However, OTA does not conduct or "supervise" audits or reaudits, and CDTFA and OTA are separate and independent agencies. As appellant has not provided any basis for adjustments, we conclude that appellant has failed to meet her burden of establishing that a reduction to the measure of unreported taxable sales is warranted.

Issue 2: Whether appellant is liable for the tax applicable to sales made by appellant's tenants.

California imposes upon a retailer sales tax measured by the retailer's gross receipts from retail sales of tangible personal property in this state, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) A retailer is defined as "[e]very seller who makes any retail sale or sales of tangible personal property." (R&TC, § 6015(a)(l).) Every person desiring to engage in or conduct business as a seller within this state shall file with CDTFA an application for a seller's permit. (R&TC, § 6066(a).) A return shall be filed by every seller and by every person who is liable for the sales tax. (R&TC, § 6452(b).) Although gross receipts derived from the sale of "food products" are generally exempt from the sales tax, sales of food served in a restaurant and sales of hot prepared food are subject to tax. (R&TC, § 6359(a), (d)(2), (d)(7).)

A permit shall be held only by persons actively engaging in or conducting a business as a seller of tangible personal property. Any person not so engaged shall forthwith surrender his or her permit to the board for cancellation. (R&TC, § 6072; Cal. Code Regs., tit. 18, § 1699(f)(1).)

[13] We note that CDTFA states that the audit erroneously omits restaurant sales for November and December 2016, in the approximate amount of $23,000. The bar was closed at the end of October 2016, but the restaurant remained opened. However, the auditor calculated no sales at all for November and December 2016, which is to appellant's benefit.

[14] "Tax auditing is defined as an inquiry into all phases of a taxpayer's business where significant tax error could occur. Tests are conducted in accordance with generally accepted auditing standards … Expression of the auditor's opinion or recommendation concerning all tax-significant phases of a taxpayer's business are reflected in … audit reports." (CDTFA Audit Manual 0401.05.) "A reaudit is defined as an audit of a period that has been previously audited and for which a Notice of Determination or Notice of Refund was issued." (CDTFA Audit Manual 0702.10.)

R&TC section 6071.1 states that a permit holder who fails to surrender a seller's permit upon transfer of a business shall be liable for any tax, interest, and penalty incurred by the transferee if the permit holder has actual or constructive knowledge that the transferee is using the permit in any manner. The predecessor's liability shall be limited to the quarter in which the business is transferred, and the three subsequent quarters. (R&TC, § 6071.1(a).) In addition, California Code of Regulations, title 18, (Regulation) section 1699(f)(2) states that a person holding a seller's permit will be held liable for any taxes, interest, and penalties incurred, through the date on which the CDTFA is notified to cancel the permit, by any other person who, with the permit holder's actual or constructive knowledge, uses the permit in any way.

In this case, the evidence shows that appellant knowingly allowed the tenants to run the restaurant business under appellant's seller's permit. Appellant did not surrender or cancel the seller's permit for the restaurant as required and mandated by R&TC section 6072 and Regulation section 1699(f)(1). The seller's permit for the restaurant continued to be in appellant's name. In addition, both the city business permit and the Alcoholic Beverage Control license for the restaurant remained under appellant's name during the lease term. As stated in the Report of Field Audit – Revised, dated September 13, 2017, the tenants did not have their own seller's permit and had an agreement with appellant that she would be reporting sales from that location. Specifically, CDTFA reported that during a meeting about the audit, appellant stated that the tenant operated the restaurant using appellant's seller's permit. In addition, appellant stated that she reviewed the sales receipts for the restaurant and prepared the SUTRs based on the amounts listed on the sales receipts. Therefore, the evidence shows that appellant knowingly allowed the tenant to operate under her seller's permit.

Regulation section 1699(f)(2) states that a permit holder is liable for taxes, interest, and penalties incurred "by any other person" who uses the permit "in any way," and does not state that it applies only to circumstances involving a transferor and transferee. (See Cal. Code Regs., tit. 18, § 1699(f)(2); *Appeal of Pasatiempo Investments*, 2020-OTA-069P (*Pasatiempo*).) Appellant's name was on the seller's permit and appellant had actual knowledge of the tenant's use of the permit. (See Cal. Code Regs., tit. 18, § 1699(f)(2); *Pasatiempo*, *supra*; see also *In re Murgillo* (1994) 176 B.R. 524, 530 ["[T]he seller's permit is not transferable; thus, the taxing authority must rely on the named individual(s)"].) Accordingly, appellant is liable for the tax applicable to those sales made under appellant's seller's permit.

Regulation section 1699(f)(3) states that, where the seller's permit holder does not establish that CDTFA received actual notice of a transfer of the business for which the permit was held and is thus liable for the taxes, interest, and penalties incurred by another person using that permit, that liability is limited to the quarter in which the business was transferred and the three subsequent quarters, and shall not include any penalties imposed on the other person for fraud or intent to evade the tax. (Cal. Code Regs., tit. 18, § 1699(f)(3).) This limitation does not apply in cases where, after the transfer, 80 percent or more of the real or ultimate ownership of the business transferred is held by the predecessor. (R&TC, § 6071.1(b); Cal. Code Regs., tit. 18, § 1699(f)(3).)

The lease agreement does not contain any provisions to indicate a transfer of the business, such as the business name, fixtures and equipment, tangible personal property and intangibles, such as goodwill. In addition, a transfer of a business for the purposes of R&TC section 6071.1 and Regulation section 1699 is defined as requiring a transfer of the "ownership" of the business. (R&TC, § 6071.1(b); Cal. Code Regs., tit. 18, § 1699(f)(3).) Specifically, the limitation does not apply if there is no transfer of 80 percent or more of the "real or ultimate ownership" of the business. (R&TC, § 6071.1(b); Cal. Code Regs., tit. 18, § 1699(f)(3).)

There is no transfer of "ownership" in a lease. Accordingly, a lease, such as appellant's lease, does not qualify as a transfer of a business for the purposes of R&TC section 6071.1 and Regulation section 1699, and thus those provisions do not impose a limitation on appellant's liability. Accordingly, appellant is liable for the unreported taxable sales.

HOLDINGS

1. No reduction to the amount of unreported taxable sales is warranted.
2. Appellant is liable for the tax applicable to sales made by her tenants.

DISPOSITION

CDTFA's action in denying the petition is sustained.

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Sheriene Anne Ridenour
67E043D83EF547C...
Sheriene Anne Ridenour
Administrative Law Judge

DocuSigned by:
8A4294817A67463...
Andrew Wong
Administrative Law Judge

Date Issued: 10/5/2021