

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:
A. ALZAGHA

) OTA Case No. 19115463
) CDTFA Case ID 817815
)
)
)
)

OPINION

Representing the Parties:

For Appellant:

A. Alzagha

For Respondent:

Randy Suazo, Hearing Representative
Christopher Brooks, Tax Counsel IV
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, A. Alzagha (appellant) appeals from a Decision issued by California Department of Tax and Fee Administration (respondent)¹ denying, in part, appellant’s petition for redetermination of a May 29, 2014 Notice of Determination (NOD) for \$113,780.36 in tax, plus applicable interest, for the period January 1, 2010, through December 31, 2012 (liability period). The NOD was based on an April 30, 2014 revised audit that determined a measure of \$1,266,437 for unreported taxable sales.²

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 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 this Opinion refers to events that occurred before July 1, 2017, “respondent” refers to BOE.

² Respondent issued a February 7, 2014 audit report, an April 30, 2014 revised audit report, and a March 24, 2016 reaudit report. The revised audit report, which respondent issued before the NOD, deleted a negligence penalty but did not change the measure. As a result of the reaudit, respondent reduced the determined measure of tax by \$278,980 to \$987,457, which will reduce the tax accordingly. Respondent’s Decision affirms the findings of the reaudit. Our discussion here will focus on the revised audit and the reaudit.

Office of Tax Appeals (OTA) Administrative Law Judges Michael F. Geary, Andrew J. Kwee, and Alberto T. Rosas³ held an oral hearing for this matter on June 22, 2021.⁴ At the conclusion of the hearing, we kept the record open to allow appellant to provide additional evidence. On August 19, 2021, we closed the record and deemed the matter submitted for decision. However, on October 15, 2021, we reopened the record to address appellant's contention that respondent took possession of appellant's bank records and failed to return them to appellant, thus denying appellant access to evidence to his prejudice. The parties were invited to provide additional briefing. Respondent provided an additional brief, but appellant did not, and the record was again closed on November 29, 2021.

ISSUE

Are additional adjustments to the amount of unreported taxable sales warranted?

FACTUAL FINDINGS

1. Appellant has held a seller's permit to operate a restaurant located in San Francisco, California since December 1994.
2. During the liability period, appellant accepted only cash at the restaurant. In addition, appellant paid at least some of his vendors with cash.
3. Respondent audited appellant for the liability period. For the revised audit, appellant provided federal income tax returns (FITRs) for 2010, 2011, and 2012; bank statements for 27 of the 36 months in the liability period; handwritten total-sales summaries for the liability period; point-of-sale (POS) terminal⁵ Z-tapes for two days outside of the liability period, June 25, 2013 (partial day), and June 26, 2013; and merchandise purchase

³ Prior to the issuance of this Opinion, Administrative Law Judge Rosas left OTA. As a result, Administrative Law Judge Daniel K. Cho replaced Mr. Rosas as a panel member for this appeal. Notice of this change in panel assignment was sent to the parties on December 7, 2021, and the parties were afforded an opportunity to file a motion to disqualify Mr. Cho from this panel. To date, OTA has not received such a submission. Furthermore, Mr. Cho has reviewed the record; watched the oral hearing video proceedings; and read through the transcript for the electronic hearing.

⁴ Appellant requested an oral hearing in Sacramento. However, OTA has temporarily suspended live hearings to comply with restrictions in effect to minimize the spread of COVID-19. The parties agreed to an electronic hearing process, which allows audio and video participation in real time using a web-based application.

⁵ A POS terminal is the modern equivalent of a cash register. Depending on the equipment and software, POS systems can generate "Z-tapes," which are summaries of sales activity from the time a terminal is opened to the time it is closed out, which can happen as often as the operator chooses. A Z-tape can include breakdowns of sales by type and amount, including product or service, credit or cash, and taxable or nontaxable.

invoices from 11 vendors dated from June 5, 2013,⁶ through June 26, 2013 (all after the liability period).⁷ Appellant did not provide any other books, records, merchandise purchase invoices, or purchase journals for the liability period.

4. For the liability period, appellant reported on every sales and use tax return (SUTR) for the twelve quarters at issue that 40 percent of total sales were exempt sales of food products, which suggested to respondent that appellant was estimating. Respondent compared total sales reported on the SUTRs to total sales recorded in the sales summaries and to the corresponding gross receipts reported on the FITRs, noting no material differences, but a comparison of total sales reported on 2010 and 2011 SUTRs with gross receipts reported on FITRs for the same years revealed a difference totaling approximately \$18,000 for both years. Respondent compared total sales reported on the SUTRs to the corresponding cost of goods sold (COGS) reported on the FITRs to compute a book markup of 360 percent, which respondent found reasonable for appellant's business. However, due to the lack of source documents to verify reported sales and COGS, respondent concluded that it could not rely on the book markups and decided to use a different method to determine taxable sales.
5. Respondent did an observation test at the business on Wednesday, June 26, 2013, from 7:00 a.m. until approximately 2:30 p.m.,⁸ during which respondent observed and recorded 207 transactions totaling \$1,539.19, including tax. Respondent determined that 88.80 percent of total sales during the observation were taxable, and found that approximately 25 percent of the sales were paid by other than cash (i.e. credit card, debit card, etc.). Respondent asked appellant to provide the data for the sales made during the remainder of the day, but he reported that he could not because of a POS system crash. Appellant later provided what appeared to be a Z-tape for the entire day of June 25, 2013, which showed total sales of \$2,191 and sales tax reimbursement collected of \$174.20. With a

⁶ There was one invoice from Light Soda dated May 28, 2013.

⁷ According to the evidence, respondent requested invoices from the other days in June, but appellant provided none. The invoices do not appear to include purchases of beer or soft drinks.

⁸ According to the evidence, the restaurant was open daily (including weekends) from 7:00 a.m. to 10:00 p.m. but closed for several days around Thanksgiving and Christmas.

- sales tax rate of 8.75 percent, respondent determined that \$1,988, or over 90 percent, of appellant's sales on June 25, 2013, were taxable.
6. Initially, respondent planned to use the total sales data from the POS system for June 25, 2013, as the average daily sales (\$2,191 in total sales per day) and the lower taxable sales ratio of 88.80 percent from its June 26, 2013 observation. To address appellant's concerns about price increases during and after the liability period, respondent reduced total sales by 15 percent for 2010 and 2011 and by 5 percent for 2012. Respondent thus calculated adjusted audited total sales of \$2,119,245 and audited taxable sales of \$1,881,810 for the liability period. Deducting reported taxable sales of \$615,372, respondent determined unreported taxable sales of \$1,266,438.
 7. On the basis of the revised audit report, respondent issued an NOD to appellant on May 29, 2014, with a tax liability of \$113,780.36, plus applicable interest.
 8. Appellant filed a timely petition for redetermination protesting the NOD in its entirety.
 9. In a further effort to address appellant's concerns about changed circumstances, respondent decided to conduct a reaudit that would, to the extent possible, not rely on data from after the liability period. Using the provided bank statements for 27 months of the 36-month liability period, respondent calculated total "cash deposits" of \$1,471,712.⁹ Respondent divided total cash deposits by 1 plus the applicable sales tax rate on a quarterly basis to compute gross receipts (i.e., total sales revenue, excluding sales tax reimbursement) of \$1,350,113 for the 27 months for which it had bank statements. Respondent used the monthly average gross receipts ($\$1,350,113 \div 27 = \$50,004$) to estimate additional gross receipts of \$450,036 for the 9 months for which appellant had not provided bank statements. Respondent thus computed total gross receipts of \$1,800,149 ($\$1,350,113 + \$450,036$) for the liability period.
 10. The provided purchase invoices show purchases from June 6 through June 26, 2013, totaling \$12,028.19.¹⁰ The invoices show that appellant used cash to pay \$6,632.54 to six

⁹ Respondent specifically identifies the deposits as "Bank Cash Deposit[s]," and the audit schedule (12G) contains only monthly (i.e. statement) totals. The evidence contains only page 1 of 9 for the statement dated January 5, 2011, which covers the period December 9, 2010, through January 5, 2011. This document, which is located in the audit file, indicates "deposits and credits" totaled \$58,474.30. It does not identify any individual deposit or credit by type (e.g., cash, check, etc.) or amount.

¹⁰ We do not include the \$201 invoice from Light Soda in this analysis.

of the vendors. The method used to pay the remaining vendors is described as “unknown.” Respondent requested purchase information from nine vendors. One indicated that appellant paid by check, so respondent did not consider this data in its analysis. Four vendors provided data showing purchases by appellant totaling \$122,340.64 during the liability period, and one (Golden Gate Meat Company) provided data showing purchases totaling \$15,347 for the period February 14, 2012, through December 31, 2012, only. Respondent used the June 2013 invoices to estimate purchases from Stanley Produce at \$2,333.45 for June 2013 and \$84,004 for the liability period.¹¹ In total, respondent calculated cash payouts totaling \$221,692 (\$137,688 + \$84,004) during the liability period, representing gross receipts (including sales tax reimbursement), or \$203,387 in additional gross receipts that were not deposited during the liability period. Respondent added cash payouts (gross receipts not deposited) to gross receipts from its bank deposit analysis to compute audited total gross receipts from sales of \$2,003,536 (\$203,387 + \$1,800,149).

11. To determine taxable sales, respondent did not use the 88.80 percent taxable sales ratio calculated from observation data or the 90.73 percent taxable sales ratio calculated from the June 25, 2013 Z-tape data. As an apparent accommodation to appellant, respondent agreed to use an 80 percent taxable sales ratio proposed by appellant, who asserted (without any evidentiary support) that after a remodel completed in April 2013, the number or percentage of dine-in customers increased, and more hot food items were added to the menu. Respondent used the 80 percent taxable sales ratio to compute audited taxable sales of \$1,602,829. Respondent deducted reported taxable sales of \$615,372, to calculate unreported taxable sales of \$987,457. Thus, the reaudit reduced the total measure of tax from \$1,266,437 to \$987,457.
12. The parties participated in an appeals conference, after which respondent issued the Decision recommending that the determined measure be reduced to \$987,457 as recommended in respondent’s reaudit but otherwise denying the petition.
13. This timely appeal followed.

¹¹ Although the audit work papers indicate that respondent also estimated the purchases from Sweet Sue’s Bakery, we do not see that estimate reflected in the calculation of cash payouts.

DISCUSSION

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, § 6051.) All of a retailer's gross receipts are presumed subject to tax unless the retailer can prove otherwise. (R&TC, § 6091.) Although gross receipts from the sale of "food products" are generally exempt from the sales tax, sales of hot prepared food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (2) & (7).)

When respondent is not satisfied with the amount of tax reported by the taxpayer, respondent may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, § 6481.) It is the taxpayer's responsibility to maintain and make available for examination on request all 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 appeals a determination based on unreported taxable sales, 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 that burden, the burden of proof shifts to the taxpayer to establish that a result differing from respondent'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.*)

We have reviewed the arguments and evidence, including the details of the revised audit and reaudit, and conclude that respondent has demonstrated a reasonable and rational basis for its determination.¹² Appellant failed to maintain and provide records sufficient to permit an audit using a direct method. As a result, respondent needed to use an indirect audit methodology.

¹² Because the determination is based on a bank deposit analysis, as documented in the reaudit, that will be the focus of this discussion.

There are several ways to perform an indirect tax audit. One is a markup method; but that requires reliable cost and pricing data that was not available here. Another is a bank deposit analysis, which requires the kind of bank deposit data that was available here, at least for 75 percent of the liability period. As outlined in our Factual Findings, above, respondent relied on amounts shown in appellant's bank statements for 27 of the 36 months at issue and used the average monthly cash deposit amount to estimate deposits for the seven months for which appellant provided no records. We find that respondent reasonably used available bank deposit information to calculate total cash deposits of \$1,800,149.

Given that appellant's business was cash only and that he paid some of his vendors in cash, it was also reasonable for respondent to conclude that the cash used by appellant to pay his vendors was not first deposited into the bank. The evidence shows that respondent reasonably included and correctly calculated cash payouts during the liability period.¹³ Regarding the estimated cash payouts to Stanley Produce, although it seems likely that wholesale produce prices in June 2013 were higher than they would have been in at least the early months of the liability period, appellant provided no evidence regarding increased prices, and we find that any such increase would likely be offset by the fact that this cash payout analysis did not include all purchases. Consequently, we find that respondent reasonably estimated additional cash payouts by the vendor who did not provide data. Thus, we also find that respondent's determination of the amount of cash payouts not included in cash deposits was reasonable. Finally, although there is no evidence in the record to prove appellant's representation that the restaurant served a higher percentage of hot foods and dine-in meals in June 2013 than it did during the liability period, we accept respondent's use of the 80 percent taxable sales ratio – roughly 10 percent lower than the ratios determined from actual sales – because it benefits appellant. We find that the evidence establishes a reasonable and rational basis for respondent's determination that appellant failed to report \$987,457 in taxable sales for the liability period. Therefore, the burden of proving a more accurate measure shifts to appellant.

Appellant argues that renovations to the neighborhood and his restaurant, menu upgrades, and increased prices caused dramatic increases in his sales during and particularly after the liability period. At the hearing, he testified that reported sales consistently increased each year,

¹³ Considering the likelihood that appellant did not provide all vendors' invoices – no invoices for soft drinks or for the last four days of the month – respondent's calculation of cash payouts was probably conservative.

by approximately 6.7 percent in 2011, approximately 9.5 percent in 2012, and over 88 percent in 2013. Appellant provided copies of menus, hand-written notes purporting to show daily sales during the liability period, and a news article and other information regarding improvements to the neighborhood around the restaurant. On the basis of this evidence, appellant argues that it is unreasonable to rely on 2013 sales to establish sales during the liability period.

In addition, appellant argues that respondent took exclusive possession of his bank records relatively early in the audit process but failed to return the records to appellant at any time before the hearing, which prevented appellant from presenting additional evidence to support his arguments. Furthermore, appellant argues it was unreasonable for respondent to rely on bank deposits made during the liability period because much of the money deposited was not from sales, but from gifts and loans from family. In support of this argument, appellant testified that he received regular infusions of cash from his family. He also provided copies of checks drawn on appellant's bank and made payable to the restaurant in 2011 and 2012 totaling \$95,000 and a statement from his brother, which refers to cash loans to appellant totaling \$61,858¹⁴ (\$60,380 of them being during the liability period).

The changed circumstances described by appellant may provide a basis for questioning reliance on 2013 sales data, but the determination is based, for the most part, on deposits made during the liability period, the only exception being the estimate of cash payments to one vendor. As indicated above, the likelihood of additional cash payment for which appellant did not provide invoices (all invoices dated June 1-4 and 27-30, 2013, all June invoices for beer and soft drinks, and invoices for appellant's meat supplier dated from January 1, 2010, through February 14, 2012) outweighs the potential impact of this single factor.

While the admitted evidence did not include copies of bank statements from the liability period, respondent met its initial burden by providing the scheduled deposit data, and the evidence does not support appellant's assertion that respondent denied appellant access to bank statements, thereby preventing appellant from supporting his arguments. The Receipt for Books and Records of Account (receipt) contained within the original audit work papers refers to P&L statements and purchase invoices only and makes no reference to the bank statements. It is signed by both parties on May 14, 2013. Respondent's original Assignment Activity History (Form 414Z) indicates that appellant delivered the 27 months of bank statements to respondent

¹⁴ The attachment to the brother's written statement overstates the total amount of loans by \$5,000.

more than five months later on October 22, 2013. It appears that respondent did not prepare a new receipt to document this event. Instead, respondent added a reference to “bank statements” on the original receipt and used that document to confirm the return of all records, including the bank statements, to appellant on April 10, 2014, when respondent signed the receipt to acknowledge the return of all the records. Although the procedures employed by respondent to document the transfers of business records seem slightly irregular in that there is no receipt to correctly document the delivery of the bank statements to respondent on October 22, 2013, that particular transfer is not in question.¹⁵ Appellant asserts that respondent did not return the bank statements. We are satisfied that the evidence shows that the bank statements were returned to appellant on April 10, 2014. On that basis, we find that respondent did nothing to prevent appellant from presenting bank statements as evidence to support his arguments.

Evidence to support appellant’s argument about family loans is lacking. As stated above, the evidence supports respondent’s argument that the deposits constitute gross receipts from appellant’s sales. We must presume those gross receipts are from taxable sales until appellant proves otherwise. (R&TC, § 6091.) In restaurant audits, the required proof is ideally found in adequate business records that allow respondent to use a direct audit approach to determine taxable sales. However, appellant did not maintain adequate business records, which necessitated respondent’s use of an indirect audit approach, first a projection based on the daily sales shown in the June 25, 2013 Z-tape, and ultimately a bank deposit analysis, which eliminated the need to adjust for changed circumstances. Without bank records we cannot properly trace the source of the \$95,000 in checks drawn on appellant’s personal account¹⁶ or confirm that these amounts were included in the cash deposits tabulated by respondent. Likewise, we cannot accept the statement of appellant’s brother or appellant’s testimony as sufficient to overcome the presumption that the scheduled amounts represent taxable sales. It was incumbent upon appellant to prove a different source for the deposited funds or some other basis to establish a more accurate measure. Appellant did not do that. Without persuasive evidence, such as bank records, showing that the deposits or the cash payouts to vendors were

¹⁵ Respondent’s Audit Manual requires the use of a Receipt for Books and Records when an auditor takes exclusive possession of a taxpayer’s records and requires audit staff to obtain the taxpayer’s signature on the receipt when the documents are returned. (Respondent’s *Audit Manual*, § 0403.35.)

¹⁶ Only the February 12, 2012 check coincides with one of the loans referred to in the brother’s statement, but the check was for \$25,000 while the “loan” was for \$10,000.

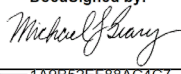
not made from the restaurant’s gross receipts, the presumption controls, and on that basis, we find that appellant has not established a more accurate measure. Therefore, we conclude that the evidence does not establish that additional adjustments to the amount of unreported taxable sales are warranted.

HOLDING

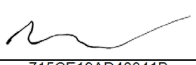
Additional adjustments to the amount of unreported taxable sales are not warranted.

DISPOSITION

We sustain respondent’s action, which reduced the determined measure to \$987,457 as recommended in the reaudit.

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Michael F. Geary
Administrative Law Judge

We concur:

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Administrative Law Judge

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Daniel K. Cho
Administrative Law Judge

Date Issued: 1/3/2022