OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **TORY, INC.** **dba Sakana Japanese Sushi & Grill**	OTA Case No. 21047617 CDTFA Case ID 100-022

OPINION

Representing the Parties:

For Appellant: Charles Lim, CPA

For Respondent: Jason Parker, Chief, Headquarters Operations Bureau

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

M. GEARY, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, Tory, Inc. (appellant) appeals from decisions issued by California Department of Tax and Fee Administration (respondent)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) of $184,734.01 in tax, a negligence penalty of $18,473.46, and applicable interest for the period January 1, 2014, through December 31, 2016 (liability period).

This matter is decided on the basis of the written record because appellant waived its right to an oral hearing.

ISSUES

1. Are adjustments to the audited measure of unreported taxable sales warranted?
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 (OTA) effective January 1, 2018.) When this Opinion refers to events that occurred before July 1, 2017, "respondent" refers to BOE.

FACTUAL FINDINGS

1. Appellant operated a Japanese restaurant and had been previously audited by respondent for the period July 1, 2010, through June 30, 2013. Appellant provided inadequate business records for the prior audit, which determined, on the basis of a credit card ratio, that appellant had failed to report $1,218,252 in taxable sales and had been negligent.[2]
2. On December 1, 2016, respondent contacted appellant's restaurant by telephone to initiate the audit, and spoke to an employee who said that the owner would not be in until later. Respondent notified appellant regarding the audit by letter dated December 1, 2016, and on December 5, 2016, appellant's representative contacted respondent to request a two-month delay due to the owner's planned two-month vacation. Respondent informed the representative that it would accommodate appellant's owner, but respondent asked to visit the restaurant to examine the restaurant's computer system before the owner left. Appellant declined the request. On respondent's first visit to the restaurant on February 10, 2017, appellant informed respondent that the point-of-sale (POS) system it had used during the liability period had been accidentally damaged beyond repair and that a new POS system had been installed.[3]
3. For the liability period, appellant reported total sales of $1,231,670 and claimed deductions for sales tax reimbursement of $101,699 included in total sales, resulting in reported taxable sales of $1,129,971.
4. Appellant provided the following records for the audit: appellant's federal income tax returns (FITRs) for 2014 and 2015; appellant's bank statements for 2014 and 2015; credit card daily summary reports for the fourth quarter of 2016 (4Q16); and Forms 1099-K for

[2] As used in this Opinion our references to "inadequate business records" and records that were "inadequate for sales and use tax purposes" generally refer to records that are not sufficient to enable respondent to determine the correct tax liability without resorting to an indirect audit method, such as one that uses a credit card sales ratio to determine taxable sales.

[3] According to the Assignment Activity History, which is part of the audit work papers, appellant informed respondent that the old computer system was near the kitchen, and food or water spilled on the computer and a floor cable, which caused the system to not function well.

2015 and 2016.[4] Respondent obtained Form 1099-K information for 2014 from the Franchise Tax Board. Appellant did not provide any guest checks, sales receipts, or POS reports for the liability period.

5. Respondent found that gross receipts reported on the FITRs exceeded total sales reported on the sales and use tax returns (SUTRs) by $358,633 in 2014 and $657,526 in 2015. Respondent compared total sales reported on the SUTRs to cost of goods sold reported on the FITRs, computing book markups of 12.88 percent for 2014, and -25.89 percent for 2015.[5, 6] Respondent expected the markup for this business to exceed 200 percent.

6. Respondent also found that appellant's bank deposits during 2014 and 2015 totaled $1,751,025. It subtracted an estimated amount of tips from credit card deposits to compute bank deposits from sales of $1,507,316, which exceeded total sales reported on SUTRs for the same period by $694,690.

7. Based on the low book markups, the difference between gross receipts reported on the FITRs and total sales reported on SUTRs, and the difference between bank deposits from sales and total sales reported on the SUTRs, respondent concluded that reported sales were understated and decided to compute appellant's sales using the credit card sales ratio method.[7]

8. Respondent used the information from the Forms 1099-K to calculate credit card deposits of $3,099,419 for the liability period. Using the credit card daily summary reports for

[4] Form 1099-K is an IRS form titled, "Payment Card and Third Party Network Transactions," which shows the monthly and annual amounts paid to a merchant by a bank, credit card company, or third-party network during a given time period. Form 1099-K includes payments made by any electronic means, including but not limited to credit cards, debit cards, and PayPal. As used in this Opinion, "credit card" refers to all electronic forms of payment shown on the Forms 1099-K.

[5] "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 $.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 (.30 ÷ .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 (.30 ÷ 1.00 = 0.3).

[6] A negative markup means that cost of goods sold (reported on FITRs) exceeds total revenue (reported on SUTRs) from the sales of those goods. If accurate, it means that appellant sold goods for less than its cost. Negative markups are evidence of underreporting of sales.

[7] A credit card sales ratio is the ratio of credit card sales to total sales. According to respondent, appellant admitted at the time of the audit that it did not report all taxable sales because it was struggling to pay its creditors.

4Q16, which included data from 89 business days, respondent found that tips represented 12.52 percent of total credit card deposits for that quarter. Respondent used that rate to calculate tips of $388,047 included in credit card deposits ($3,099,419 x 12.52). Respondent first subtracted tips from credit card deposits and then subtracted sales tax reimbursement at the applicable rate for each quarterly period, to compute credit card deposits from sales, excluding sales tax and tips, of $2,487,497 for the liability period.

9. Because POS data was not available for the liability period, respondent first attempted to compute a credit card sales ratio using data from observing sales at the business. According to the audit work papers, respondent was to observe sales during three days, April 11, April 18, and April 25, 2017, all consecutive Tuesdays at appellant's request.[8] Respondent indicates that on the first observation date, appellant did not permit the observer to sit in a position from which the details of the sales transactions could be observed and that at the end of the observation test day, the auditor added up the sales from the available guest checks and computed that credit card sales represented 98.38 percent of total sales for that day. Respondent considered the 98.38 percent credit card sales ratio to be unusually high and concluded that appellant had "manipulated" the guest checks. Respondent abandoned its plan to determine the credit card sales ratio using data from observing sales at the business.

10. After the one-day observation, appellant provided POS data from its new POS system for 1Q17. Respondent used this information to compute that credit card sales represented 78.16 percent of total sales for 1Q17. Respondent found the 78.16 percent ratio to be reasonable for appellant's business, and thus, used it to establish the credit card sales ratio.

11. Respondent divided total credit card deposits from sales of $2,487,497 by the credit card sales ratio of 78.16 percent to compute audited taxable sales of $3,182,571 for the liability period. It compared audited taxable sales of $3,182,571 to reported taxable sales of $1,129,971 to compute unreported taxable sales of $2,052,599 for the liability period.

[8] The audit work papers contain an Observation Test Fact Sheet, which indicates that on April 3, 2017, respondent agreed with appellant's representative that the observation would occur on the three Tuesdays in April, and the Assignment Activity History refers to the same agreement.

12. Respondent found that appellant was negligent in connection with both its maintenance of business records and its reporting and on that basis imposed a 10-percent penalty for negligence.
13. On December 6, 2017, respondent issued the NOD to appellant.
14. Appellant filed a timely petition for redetermination of the NOD.
15. The parties participated in an appeals conference on December 3, 2018.
16. Following the appeals conference, respondent requested, and appellant provided, POS data for 3Q17, 1Q18, and April 2018. Respondent used this data, which was from 208 business days, to compute a credit card sales ratio of 78.25 percent.
17. In its Decision issued on August 12, 2019, respondent denied appellant's petition.
18. Appellant filed a request for reconsideration of respondent's Decision.
19. On January 19, 2021, respondent issued a Supplemental Decision confirming its denial of appellant's petition. This timely appeal followed.

DISCUSSION

Issue 1: Are adjustments to the audited measure of unreported taxable sales warranted?

California imposes a 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 food and sales of food served in a restaurant are subject to tax. (R&TC, § 6359(a), (d)(1), (d)(2) & (d)(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.) In the case of an appeal, 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 differing from respondent's determination is warranted. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) It is a taxpayer's responsibility to maintain and make available for examination on request all records necessary to determine the correct tax liability under the Sales and Use Tax Law, 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).)

In this case, appellant did not maintain and provide to respondent all records necessary to determine the correct tax liability. It did not provide any guest checks, sales receipts, or POS reports for any periods within the audit. Regardless of the reasons why appellant did not provide such documents, the books and records that it did provide were insufficient to allow respondent to use a direct audit method to calculate taxable sales.

The records that were provided revealed probable significant underreporting of taxable sales. Appellant's gross receipts (reported on its FITRs) exceeded total sales (reported on its SUTRs) by $358,633 in 2014 and $657,526 in 2015; bank deposits from sales in 2014 and 2015 far exceeded reported sales for the same period by $694,690; and book markups calculated using appellant's records were far too low (12.88 percent for 2014, and -25.89 percent for 2015). For all of these reasons, we find that respondent was justified in questioning the reliability of recorded and reported sales. We also find that the credit card sales ratio method is a standard and accepted audit procedure. (See *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 612-613.) Thus, we find that respondent has met its initial burden to show that its determination was reasonable and rational. Therefore, the burden of proof shifts to appellant to prove a more accurate measure of tax.

At the heart of appellant's argument is the contention that the 98.38 percent credit card sales ratio is more accurate than the 78.16 percent credit card sales ratio computed by respondent. Appellant supports this proposition by challenging respondent's reasons for rejecting the former.[9] In this regard, appellant denies that it interfered with the observation or in any way manipulated the guest checks on the day of the observation. It objects to the use of the lower ratio on the further ground that respondent promised appellant that it would use the ratio determined by the observation; and appellant argues that, because it agreed to the observation in

[9] According to respondent's Decision and Supplemental Decision, appellant previously argued that the POS data for 1Q17 was unreliable because its staff were unfamiliar with the operation of the new system and that more of its customers use credit cards because its prices are higher than prices at other restaurants. Appellant has not made these arguments in this appeal to OTA, and given that the POS data for the later periods (3Q17, 1Q18, and April 2018) establish a credit card sales ratio almost identical to the ratio calculated from the 1Q17 data, those arguments find insufficient support in the record.

reliance on that promise, it is fundamentally unfair to not give appellant the benefit of the larger ratio. Further addressing respondent's arguments against using the higher ratio, appellant argues that the fact that the observation was for only one day, rather than three days as recommended by respondent's Audit Manual, should not be used against appellant since it was respondent who chose to observe for only one day. Appellant objects to respondent's reliance on a "belief," unsupported by any credible evidence, that the 98.38 percent ratio is unusually high. Finally, appellant contends that it could not provide POS data for the liability period because of the loss of its POS system.

The evidence does not establish that the 98.38 percent ratio is more accurate than the 78.16 percent ratio. The 78.16 percent ratio upon which the determined liability is based was calculated from appellant's POS data from 89 full days of sales, and the POS data from an additional 208 full days of sales revealed an almost identical ratio. On the other hand, appellant has provided nothing except the data from respondent's aborted observation test to support its position. We find that the data supporting respondent's position is far more persuasive than that relied upon by appellant. On this basis, we find that adjustments to the audited measure of unreported taxable sales are not warranted. Although this finding is determinative, we will address appellant's other arguments below.

It is possible that 98.38 percent of the customers paid by credit card on that day, but that does not make that day's data representative of the liability period. On the contrary, that high a ratio would be an outlier. We see three out of 89 days during 1Q17 when the ratio went above 90 percent. The highest of those was 91.43 percent on January 7, 2017. We see three days of 208 scheduled for 3Q17, 1Q18, and April 2018 when the ratio rose above 90 percent, and the highest of those was 94.20 percent on February 11, 2018.[10]

We are also not persuaded by appellant's argument that it relied on respondent's promise to use the data from the observation. Initially, we note that, aside from the fact that there is no independent evidence that respondent made a binding agreement with appellant to use the data from the one-day observation, the evidence indicates that this was never an agreed-upon one-day observation. The evidence shows that this was a planned three-day observation, which respondent abandoned, apparently due to what it considered interference by appellant. We need

[10] We make no finding regarding whether appellant interfered with respondent's one-day observation or interfered in any way with guest checks on that day.

not decide whether respondent's decision to abandon the observation test was reasonable because the law is clear that respondent is entitled to make its determination on the basis of any information which is in its possession or may come into its possession. (R&TC, § 6481.) Our role is to decide whether respondent's determination was reasonable and rational. We have already decided that it was.

Finally, our findings regarding the more accurate credit card sales ratio do not rely on appellant's failure to provide adequate business records or on respondent's opinions concerning the aborted test upon which appellant's proposed 98.38 percent credit card sales ratio is based.[11] The lack of adequate business records was simply part of respondent's justification for using an indirect audit method based on the credit card sales ratio, and as already stated, our finding regarding the more reliable ratio was strongly supported by the data.

Issue 2: Did respondent correctly impose the negligence penalty?

As relevant here, if any part of a liability for which a deficiency determination is made is due to negligence, respondent must add a penalty equal to 10 percent of the amount of the determination. (R&TC, § 6484.) The term "negligence" is not defined in the Sales and Use Tax Law. Among the definitions for the term provided by Black's Law Dictionary (11th ed. 2019) is this: "the doing of what a reasonable and prudent person would not do under the particular circumstances, or the failure to do what such a person would do under the circumstances." This is the standard we will apply to appellant's acts and omissions.

As previously stated, a taxpayer must maintain and make available for examination on request by respondent 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 the returns. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Such records include but are not limited to: 1) the normal books of account ordinarily maintained by the average prudent businessperson engaged in the activity in question; 2) bills, receipts, invoices, cash register tapes, or other documents of original entry; and 3) 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 provide complete and accurate records is evidence of negligence and may result in imposition of a negligence penalty. (Cal. Code Regs., tit. 18, § 1698(k).)

[11] The inadequate business records may have greater significance to our analysis of the negligence issue, below.

There is no question that the records provided by appellant were not adequate for a sales tax audit. Appellant does not argue otherwise. Instead, appellant argues that the unexpected and catastrophic loss of its POS system at about the time that appellant learned that the audit was about to begin absolves appellant from any responsibility for not providing records that may have been retrievable from that system. It does not, for two reasons.

The first reason is that a reasonable and prudent business owner in appellant's position, having been previously found, on a first audit, to have negligently maintained and provided business records that were inadequate for sales and use tax purposes, would have taken reasonable steps to regularly print or back up POS system data to ensure that its business records would not again be found inadequate. Although the law does not specifically require taxpayers to make backup copies of electronic business records, it does recommend the practice (Cal. Code Regs., tit. 18, § 1698(d)(2)) and in this case we find that appellant's failure to take any steps to protect its electronic records constitutes a failure by appellant to take action that a reasonable and prudent person would have taken under the circumstances.

The second reason is that even taxpayers who maintain computerized records are generally required to retain hard copy records that are created or received in the normal course of business, such as guest checks, sales receipts, and purchase invoices. (Cal. Code Regs., tit. 18, § 1698(g)(1).) Although appellant's POS system may have been destroyed, appellant should have maintained and provided its hardcopy records.[12] Appellant did not do that. We find that in this regard also, appellant failed to take action that a reasonable and prudent person would have taken under the circumstances.

A negligence penalty also can be based on reporting errors. (*Independent Iron Works, Inc. v. State Bd. of Equalization* (1959) 167 Cal.App.2d 318, 323-324.) Here, the understatement of $2,052,599 represents an error ratio of 181.6 percent when compared to reported taxable sales of $1,129,971. Appellant reported far less than half of its taxable sales. The large understatement and large error ratio are persuasive evidence of negligence.

In summary, appellant had been previously audited. Appellant did not provide adequate records in the prior audit. Using the same indirect audit method that respondent uses here, respondent determined in the prior audit that appellant failed to report $1,218,252 in taxable sales. Respondent also imposed a negligence penalty in the prior audit. In the present case,

[12] Hardcopy records are those maintained in paper format. (Cal. Code Regs., tit. 18, § 1698(a)(5).)

again, appellant failed to provide adequate records, and respondent determined that appellant failed to report $2,052,599 in taxable sales. Based on all the evidence, we find that appellant was negligent. On that basis, we find that respondent correctly imposed the negligence penalty.

HOLDINGS

1. Adjustments to the audited measure of unreported taxable sales are not warranted.
2. Respondent correctly imposed the negligence penalty.

DISPOSITION

Respondent's actions denying the petition for redetermination are sustained.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Suzanne B. Brown
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Suzanne B. Brown
Administrative Law Judge

DocuSigned by:
Natasha Ralston
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Natasha Ralston
Administrative Law Judge

Date Issued: 10/26/2021