OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	OTA Case No.: 21037335
	CDTFA Case ID: 616-762
V G ENTERTAINMENT, INC., dba Suede Bar and Lounge	

OPINION

Representing the Parties:

For Appellant:	Michael Aparicio, Representative
For Respondent:	Randy Suazo, Hearing Representative Chad Bacchus, Tax Counsel IV Jason Parker, Chief of Headquarters Operations
For Office of Tax Appeals:	Deborah Cumins, Business Taxes Specialist III

J. ALDRICH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, V G Entertainment Inc. dba Suede Bar and Lounge (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] in response to appellant's petition for redetermination of the Notice of Determination (NOD) dated September 21, 2018. The NOD was for $85,762.00 in tax, plus applicable interest, for the period April 1, 2014, through March 30, 2017 (liability period). In its decision, CDTFA reduced the tax from $85,762.00 to $83,950.00 and denied the remainder of the petitioned amount.

Office of Tax Appeals (OTA) Administrative Law Judges Suzanne B. Brown, Michael F. Geary, and Josh Aldrich held an electronic oral hearing for this matter on December 16, 2021. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

[1] Sales taxes were formerly administered by the Board of Equalization (board). Effective July 1, 2017, functions of the board relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this Opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, the board.

ISSUE

Whether appellant has shown that adjustments are warranted to the audited understatement of reported taxable sales.[2]

FACTUAL FINDINGS

1. Appellant operated a full-service bar on the bottom floor of an upscale hotel in downtown Los Angeles from February 15, 2008, through October 31, 2018. In addition to alcoholic beverages, appellant sold cigarettes, bottled water, and food.
2. During the liability period, appellant reported total and taxable sales of $1,728,369, claiming no deductions.
3. For audit, appellant furnished federal income tax returns (FITRs) for 2014 and 2015; purchase invoices for the liability period and incomplete purchase invoices for April and May 2017; vendor reports from three major liquor distributors; Point of Sale (POS) reports for the years 2014, 2015, and 2016; merchant card statements for the period April 1, 2014 through December 31, 2015; profit and loss statements for 2014, 2015, and 2016; and purchase records on Excel spreadsheets for 2014, 2015, and 2016.
4. In its preliminary examination, CDTFA found that the sales reported on sales and use tax returns substantially reconciled with amounts reported on FITRs. However, CDTFA found material differences between recorded and reported taxable sales for five (5) of eleven (11) quarters during the years 2014, 2015, and 2016, the period for which POS records were available.
5. CDTFA used appellant's FITRs to compute book markups[3] of 230 percent for 2014 and 206 percent for 2015 by comparing the sales and costs of goods sold reported therein.

[2] Appellant specifically conceded two of the three audit items at the CDTFA appeals conference: the unreported cost of self-consumed taxable merchandise of $7,987; and the unreported mandatory tips of $72,500. During the hearing, we confirmed these concessions. Accordingly, the only audit item in dispute is the understatement of reported taxable sales established on a markup basis.

[3] "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 (0.30 ÷ 1.00 = 0.30).

Those markups were substantially lower than the markup of at least 450 percent that CDTFA expected.

6. CDTFA decided to use the markup audit method to compute audited taxable sales.

7. Using appellant's recorded purchases for 2014 through 2016,[4] CDTFA compiled total purchases of alcohol, cigarettes, bottled water, and food for those three years.

8. CDTFA used costs from purchase invoices in March and April 2017, along with the observed selling price of $2.00, to compute a markup of 1,073 percent for bottled water. Since it did not have detailed selling price information for cigarettes and food, CDTFA estimated markups for those merchandise categories of 50 percent and 200 percent, respectively.[5]

9. To compute the percentages of purchases in each category of alcohol, CDTFA used appellant's purchase invoices for May 2016 and October 2014 to conduct a purchase segregation test.[6]

10. CDTFA used appellant's purchase invoices for April and May 2017, along with selling prices appellant supplied, to compute markups for each category of alcohol purchases.[7] In computing the markups, CDTFA used pour sizes of 1.5 ounce for single-liquor drinks, 2.0 ounces for cocktails, 16 ounces for draft beer and 3.5 ounces for wine. The audited markups each reflected the allowances that are established in CDTFA's Audit Manual (AM)[8]: 12 percent for overpouring and spillage of liquor (CDTFA's AM, § 0806.42); 6 percent for overpouring and spillage of wine (CDTFA's AM, § 0806.43); 10 percent for

[4] CDTFA verified the accuracy of appellant's purchase records by comparing vendor reports for three major liquor distributors to appellant's records.

[5] Appellant agrees with the estimated markup regarding cigarettes and food.

[6] CDTFA computed the following percentages (rounded) for each category of alcohol: 6 percent-well drinks; 25 percent-call drinks; 38 percent-premium drinks; 69 percent-total liquor; 4 percent–domestic bottled beer; 11 percent-premium bottled beer; 0.5 percent-domestic draft beer; 8 percent-premium draft beer; 8 percent-wine; 31.5 percent-total beer and wine. The total of the listed percentages is 100.5 percent; it exceeds 100 percent because of rounding.

[7] Since the markups for various categories were reduced in the reaudit, we will list the markups when the reaudit is discussed below.

[8] CDTFA's AM, "is an advisory publication providing direction to [CDTFA] staff administering the Sales and Use Tax Law and Regulations." (CDTFA's AM.) OTA is not required to follow CDTFA's AM; however, OTA may look to it for guidance, such as when evaluating the reasonableness of CDTFA's determination. (*Appeal of Micelle Laboratories, Inc*., 2020-OTA-290P.)

overpouring and spillage of draft beer (CDTFA's AM, § 0806.55); and 1 percent breakage for bottled beer (CDTFA's AM, § 0806.60). CDTFA used appellant's POS records to compute that 14.75 percent of appellant's sales were made at lower Happy Hour selling prices, while the remaining 85.25 percent were made at regular selling prices. CDTFA used those percentages to weight the markups for each category of alcohol. It then used the individual markups and the percentages of purchases in each category to compute a weighted average markup for alcohol of 562 percent.

11. CDTFA used the purchases in each merchandise category, along with the audited markups, to compute audited sales of cigarettes; food; water;[9] liquor, beer and wine for the years 2014, 2015, and 2016. It compared audited sales to reported sales to compute percentages of error of 42.68 percent for 2014, 90.29 percent for 2015, and 23.35 percent for 2016.[10]

12. CDTFA applied the audited percentages of error to the reported taxable sales for the relevant years, or partial years (using 23.35 percent for the first quarter 2017 (1Q17)). This resulted in calculation of the audited understatement of reported taxable sales of $873,409, established on a markup basis.[11] CDTFA issued an audit report in October 2017, a revised audit in November 2017, and the NOD on September 21, 2018.

13. On October 17, 2018,[12] appellant filed a timely petition for redetermination.

14. After the NOD was issued, appellant provided a price list that reflected selling prices lower than those initially provided by appellant. CDTFA performed a reaudit where it

[9] In its computation of audited sales for water, CDTFA multiplied audited purchases of $2,792 by the audited markup of 1,073 percent. This computation is incorrect because the amount of the sales would be the cost of the product *plus* the markup. Thus, audited sales of water are understated by $2,792. CDTFA previously recognized the error but did not adjust the audit findings because it was to appellant's benefit.

[10] CDTFA reduced alcohol purchases by 3.77 percent to remove purchases of mixers and supplies. For each category of merchandise, CDTFA reduced the purchases available for sale by estimated amounts of self-consumed merchandise and pilferage, which were each computed at two percent.

[11] As noted previously, appellant does not dispute the audited cost of self-consumed taxable merchandise or the audited amount of unreported mandatory tips. Accordingly, we do not discuss the audit procedures related to those two audit items.

[12] The petition is dated October 11, 2018, but it was received by CDTFA by facsimile transmission on October 17, 2018.

accepted the lower selling prices and reduced the audited markups for alcohol.[13] Otherwise, the audit procedures remained the same as those in the audit. In the reaudit, the audited weighted average markup for alcohol was reduced from 562 percent to 557 percent. The reaudit recommended a reduction in the measure of unreported taxable sales, which results in a reduction to the tax from $85,762.00 to $83,950.00.

15. During the CDTFA appeals conference, appellant made a request to submit additional purchase invoices to expand the shelf test in order to justify a lower markup. Thereafter, appellant submitted invoices for 1Q17. CDTFA noted that appellant had submitted 30 purchase invoices, with a total cost of $18,217.80. In contrast, the average recorded purchases per quarter were $37,382 in 2014, $40,956 in 2015, and $27,037 for 2016. Since each of those average quarterly amounts is significantly higher than the total of the purchase invoices provided for 1Q17, and there were no invoices for purchases of domestic draft beer in the 1Q17 invoices, CDTFA concluded that the purchase invoices for 1Q17 were incomplete and, therefore, it did not expand the shelf test.

16. CDTFA issued a decision that reduced the tax as recommended in the reaudit and denied the remainder of the petitioned amount. This timely appeal followed.

DISCUSSION

California imposes a sales tax on a retailer's retail sales in this state of tangible personal property (TPP), measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) All of a retailer's gross receipts are presumed subject to tax, unless the retailer can prove otherwise. (R&TC, § 6091.) "Gross receipts" are the total amount of the sales price without any deduction for labor, service cost or other expense, and include any services that are part of the sale. (R&TC, § 6012(a)(2), (b)(1).) A "sale" means and includes any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of TPP for a consideration. (R&TC, § 6006(a).) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)1).)

[13] The audited markups in the reaudit (rounded) are 553 percent for liquor; 683 percent for domestic bottled beer; 468 percent for premium bottled beer; 337 percent for domestic draft beer and for premium draft beer; and 876 percent for wine.

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*.) 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.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Talavera*, *supra*.)

Here, CDTFA found material discrepancies between recorded and reported taxable sales for 5 of the 11 quarters for which POS records were provided. CDTFA noted that according to appellant's federal income tax returns, appellant operated at a loss for 2014 and 2015, and paid no compensation to the corporate officers. Also, CDTFA computed book markups that were significantly lower than it expected based on its experience auditing similar businesses in the area. Accordingly, we find that CDTFA's decision to use an indirect audit method was warranted. Based on the available records, we further find that CDTFA's use of the markup method was appropriate. The markup method is a recognized and standard accounting procedure. (*Riley B's, Inc. v. State Bd. of Equalization,* (1976) (*Riley's B's*) 61 Cal.App.3d 610, 612-613.) Also, we have reviewed the audit workpapers (AWPs) and have found no errors in assumptions, procedures, or calculations. Based on the foregoing, we find that CDTFA has shown that its determination was reasonable and rational; thus, it is incumbent upon appellant to show that adjustments are warranted.

Appellant argues that an indirect audit method was not warranted because it provided its books and records for audit. In support, appellant highlights that CDTFA reconciled appellant's total sales to its FITRs, and no material differences were noted. Appellant also argues that based on its own analysis of its FITRs, the book markup was closer to 300 to 365 percent in contrast to the 230 percent for 2014 and 206 percent for 2015 that CDTFA calculated.[14]

[14] Appellant did not specifically provide these calculations. It may be that appellant divided total sales ex-tax by the cost of goods sold to reach these calculations [e.g., for 2014 ($686,9994 ÷ $208,1687) = 330 percent; and for 2015 ($558,681 ÷ $182,691) = 305.8 percent]. If so, these percentages are markup factors, not the actual book markup as defined in footnote 3 above.

Here, appellant did furnish its books and records. However, as noted above, there were discrepancies between recorded and reported taxable sales for 5 of the 11 quarters. Moreover, CDTFA is entitled to conduct an examination and make a determination based upon any available information, whether or not a taxpayer provides all of its books and records. (*Riley B's, supra,* 61 Cal.App.3d at 615; R&TC § 6481.) In addition, the book markups CDTFA computed based on appellant's records were significantly lower than the book markups CDTFA expected. Regardless of the records furnished by appellant, CDTFA had the responsibility and authority to verify the accuracy of those records through various audit tests. (*Riley B's, supra,* 61 Cal.App.3d at 615; R&TC § 6481.) Thus, we find appellant's argument to be unpersuasive.

Appellant also argues that the reaudit is inaccurate based on the shelf test. Appellant notes that CDTFA asked appellant to provide complete purchase records for 1Q17. Appellant states that it submitted those records to CDTFA's auditor, who expressed reluctance to conduct a shelf test using the newly submitted records. According to appellant, the auditor said he believed a new shelf test would not change the audit results. Appellant asserts that CDTFA did not enforce its own request, which would have "ensured the accuracy of the shelf tests."

In response, CDTFA describes the purchase invoices for 1Q17 as incomplete or insufficient. CDTFA explained why it did not utilize the purchase records submitted after the appeals conference. CDTFA noted that appellant had submitted 30 purchase invoices, with a total cost of $18,217.80. In contrast, the average recorded purchases per quarter were $37,382 in 2014, $40,956 in 2015, and $27,037 for 2016. In addition, CDTFA noted that there were no invoices for purchases of domestic draft beer in the 1Q17 invoices. Thus, CDTFA concluded that the purchase invoices for 1Q17 were incomplete. Since the average recorded purchases for 2014, 2015, and 2016 were significantly higher than the total of the 1Q17 purchase invoices and there were no invoices for domestic draft beer, we agree that 1Q17 invoices were incomplete. Therefore, CDTFA properly excluded the 1Q17 invoices from the shelf test.

Appellant asserts that CDTFA did not request additional information that was needed. However, comments in the AWPs contradict appellant's assertion.[15] CDTFA made several requests during the audit for purchase invoices for domestic draft beer and for additional invoices

[15] For example, the AWPs indicate that "The bar fact sheet listed a variety of liquor drink categories at different prices but the representative did not provide the liquor used for such drinks. Representative did not provide all the necessary information to complete the shelf test accurately after several requests were made. Thus [sic] the liquor shelf test was completed using the best available information." As such, the evidence shows that appellant was not responsive to requests for information

for premium draft beer. Also, CDTFA made several requests for information regarding the liquor used to prepare certain drinks. Therefore, we reject appellant's argument that CDTFA did not make sufficient attempts to gather complete data.

Appellant asserts that the auditor requested three extensions of time to respond to the material that appellant supplied post-conference. This is accurate; CDTFA did grant its auditor three extensions to the original deadline. We find this fact has no bearing on our analysis.

According to appellant, the auditor requested that appellant withdraw its request for an expanded shelf test (to include 1Q17). While that description may or may not be accurate, CDTFA's decision not to utilize the purchase invoices for 1Q17 was based on its analysis that the invoices for 1Q17 were incomplete. Moreover, during the hearing the panel inquired if appellant had submitted its own segregation test, or calculation, to show that CDTFA's determination is incorrect. Appellant confirmed that it did not so provide. To meet appellant's burden, it is not enough to merely criticize the audit methodology. Instead, appellant must show that the inclusion of the 1Q17 information would result in a reduction to the measure, which it has not done.

Appellant asserts that the markup was based on a shelf test that was not representative of actual or complete records. We note that CDTFA requested complete purchase invoices for two months, April and May 2017. For a bar, a period of two months is generally sufficient to encompass a full purchasing cycle, and appellant has not introduced evidence that the two-month period tested for this audit was insufficient. If the invoices for the two months were incomplete, that deficiency is the result of appellant's failure to submit all the invoices, not the result of failures in the audit process. To establish selling prices, CDTFA requested information for the Bar Fact Sheet, which it used in the audit. Then, appellant supplied a price list showing lower selling prices, which CDTFA used in the reaudit. Appellant has not introduced evidence that the selling prices appellant provided for use in the reaudit were incorrect.

Thus, we find that CDTFA has used purchase invoices from a sufficiently long period to establish the costs it used in the shelf test. In addition, we note that CDTFA has used selling prices supplied by appellant. We, therefore, conclude that appellant has not provided evidence to support its argument that the audited markup is not representative.

As a separate issue, appellant asserts that there are errors in the shelf test. We note that appellant did identify errors in the original shelf test to CDTFA. According to a comment in the

AWPs, some calculation errors were noted in the liquor category of the shelf test, which were corrected in the reaudit. Appellant has not identified any errors that remain in the shelf test, and we find no adjustment is warranted based on its unsupported assertion that there are mistakes.

In summary, this audit has been conducted using the markup method, which is a well-established audit method that has been shown effective and reliable, as long as there is sufficient information to establish an accurate cost of taxable merchandise sold and an accurate markup. (See *Maganini v. Quinn* (1950) 99 Cal.App.2d 1; see also *Riley B's, supra,* 61 Cal.App.3d at pp. 612-613; and *Appeal of Amaya,* 2021–OTA–328P.) In this case, CDTFA had two months of purchase invoices that appellant supplied, which is sufficient information to establish accurate costs. It also had selling prices, supplied by appellant, which were supported by a price list. Appellant has not introduced evidence of errors in its own purchase records or CDTFA's segregation of those purchases. Further, appellant has not provided evidence of errors in the costs or selling prices used in the shelf test. CDTFA has incorporated the allowances established in its AM for self-consumption; pilferage; overpouring and spillage; and breakage, and appellant has not submitted evidence that additional allowances are warranted. We find that appellant has not shown that additional adjustments are warranted to the audited understatement of reported taxable sales established on a markup basis.

Appellant argues that the audit was speculative, based on an e-mail from C. Kim (the auditor who conducted the original audit and revised audit in 2017) in which she disparaged some audit procedures as "speculative." Appellant considers the audit of its business to be an example of a questionable assessment made on assumptions, as described by Ms. Kim. However, Ms. Kim's comments in the e-mail represent her opinion and do not offer any evidence or information that impact our analysis of this case.[16] Furthermore, the evidence before us does not support appellant's argument. We have analyzed the audit procedures, calculations, and conclusions based on objective considerations, and have concluded that no further adjustments are warranted. Ms. Kim's personal opinions expressed in an e-mail offer no basis for us to conclude otherwise.

[16] CDTFA noted in its decision that Ms. Kim is no longer working for CDTFA.

HOLDING

Appellant has not shown that further adjustments are warranted to the audited understatement of reported taxable sales.

DISPOSITION

Sustain CDTFA's decision to reduce the audited understatement of tax from $85,762.00 to $83,950.00 and to otherwise deny the petition.

DocuSigned by:
Josh Aldrich
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Josh Aldrich
Administrative Law Judge

We concur:

DocuSigned by:
Suzanne B. Brown
47F45ABE89E34D0...
Suzanne B. Brown
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Date Issued: 3/24/2022