OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 21108748) CDTFA Case ID 2-343-303
G. WATT AND **K. WATT**	))))

OPINION

Representing the Parties:

For Appellant: G. Watt, Partner

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Deborah Cumins, Business Taxes Specialist III

A. WONG, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 6561, G. Watt and K. Watt (appellant), a husband-and-wife partnership,[1] appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA) that partially denied appellant's petition for redetermination of a Notice of Determination (NOD) dated September 18, 2020.[2] The NOD is for tax of $27,318.00, a negligence penalty of $2,731.75, and applicable interest, for the period January 1, 2017, through December 31, 2019 (audit period).[3] In the decision being appealed, CDTFA deleted the negligence penalty and otherwise denied appellant's petition.

[1] Appellant reported to CDTFA that the business entity was a husband-and-wife co-ownership, as opposed to a partnership. Under certain circumstances, an unincorporated business jointly owned by a married couple (i.e., a joint venture, co-ownership, or partnership by operation of law) may elect to not be taxed as a partnership for income tax purposes. (See Internal Revenue Code, § 761(f).) Instead of filing taxes as a partnership, the qualifying members (husband and wife) may elect to file as sole proprietors for income tax purposes. (*Ibid*.) Irrespective of federal income tax treatment, a husband-and-wife joint venture is recognized as a partnership by operation of law, and treated as a separate entity, for sales and use tax purposes. (R&TC, §§ 6005, 6015.)

[2] The State Board of Equalization (BOE) formerly administered the sales tax. Effective July 1, 2017, BOE functions relevant to this case 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" refers to the BOE.

[3] CDTFA timely issued the NOD to appellant because appellant signed a series of waivers of the otherwise applicable statute of limitations, which extended the deadline for issuing an NOD until October 31, 2020. (R&TC, §§ 6487(a) and 6488.)

Appellant waived the right to an oral hearing, so Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUE

Whether a reduction to the amount of unreported taxable sales is warranted.

FACTUAL FINDINGS

1. Appellant operated a restaurant that served American-style breakfast and lunch in Porterville, California.
2. For the audit period, appellant claimed no deductions and reported total/taxable sales of $1,423,941 on its quarterly sales and use tax returns.
3. CDTFA had previously audited appellant for the period April 1, 2013, through March 31, 2016.
4. For the audit at issue, appellant did not provide any books or records for the audit period, such as guest checks, sales receipts, sales journals, general ledgers, purchase journals, and purchase invoices.
5. CDTFA decided to compute appellant's sales using a credit-card-sales-ratio method.[4] From the Franchise Tax Board, CDTFA obtained federal Form 1099-Ks issued to appellant, which CDTFA used to establish appellant's credit card deposits for the period of January 1, 2017, through December 31, 2018.[5]
6. Due to Covid-19 concerns, CDTFA could not perform an observation test to establish appellant's credit card sales ratio. Instead, CDTFA estimated a credit card sales ratio of 65 percent, which it carried over from its prior audit of appellant.[6]

[4] Generally, in using the credit-card-sales-ratio method, CDTFA determines the taxpayer's credit card sales ratio (i.e., the ratio of credit card sales to total sales) and then divides the taxpayer's credit card deposits by that ratio. (See generally CDTFA's Audit Manual, § 0810.12.)

[5] Form 1099-K (*Payment Card and Third Party Network Transactions*) is an IRS form that 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. This form records payments made by electronic means including but not limited to credit cards, debit cards, and PayPal.

[6] According to CDTFA's decision, in that prior audit, appellant also did not provide any books and records or allow CDTFA to conduct an observation test, so CDTFA based the 65 percent credit card sales ratio on a restaurant industry average. Appellant apparently approved the audit method, but subsequently appealed and later entered into a settlement agreement with CDTFA.

7. CDTFA also estimated that tips paid for with credit cards were 8 percent of credit card sales.[7]
8. Using the Form 1099-K information, CDTFA compiled credit card deposits of $899,031 for the period January 1, 2017, through December 31, 2018. From this amount, CDTFA subtracted tips, estimated at 8 percent, to compute credit card sales of $827,109. CDTFA divided $827,109 by the estimated credit card sales ratio of 65 percent to compute audited total sales, including sales tax, of $1,272,475. CDTFA then subtracted sales tax reimbursement at the applicable rate of 8.25 percent to compute audited taxable sales, excluding sales tax, of $1,175,496 for the period January 1, 2017, through December 31, 2018.
9. CDTFA compared audited taxable sales of $1,175,496 for the period January 1, 2017, through December 31, 2018, to reported taxable sales for the same period to compute unreported taxable sales of $207,740 for the period January 1, 2017, through December 31, 2018.
10. CDTFA then compared audited taxable sales to reported taxable sales for the fourth quarter of 2018 to compute an error ratio of 24.83 percent for that quarter. CDTFA applied the 24.83 percent error ratio to reported taxable sales for 2019 to compute unreported taxable sales of $113,288 for that year.
11. In total, CDTFA computed unreported taxable sales of $321,028 ($207,740 + $113,288) for the audit period.
12. In June 2020, appellant performed its own credit card sales ratio and tip percentage analyses over a period of four or five days, and the results were similar to the estimates CDTFA had used in the audit at issue.
13. On September 18, 2020, CDTFA timely issued the NOD to appellant, and appellant timely petitioned for redetermination.
14. On August 5, 2021, CDTFA issued to appellant its decision to delete the negligence penalty, but to otherwise deny appellant's petition.
15. Appellant then timely appealed to OTA.

[7] According to its audit working papers, CDTFA based the 8 percent tip percentage on the restaurant industry average for breakfast and lunch dining.

DISCUSSION

California imposes upon a retailer a sales tax measured by the retailer's gross receipts from the retail sales of all 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" for human consumption are generally exempt from the sales tax, gross receipts from the sale of food served in a restaurant and the sale of hot prepared food are subject to tax. (R&TC, § 6359(a) and (d)(1), (2) & (7).)

If CDTFA is not satisfied with the amount of tax reported by the taxpayer, CDTFA may 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.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (*Appeal of Amaya*, 2021-OTA-328P.) If the method used by CDTFA to calculate an estimate of the taxpayer's unreported taxable sales is not rational, then the estimate should be rejected. (See *In re Renovisor's, Inc.* (9th Cir. 2002) 282 F.3d 1233, 1237, fn. 1, citing *Paine v. State Board of Equalization* (1982) 137 Cal.App.3d 438.) If CDTFA carries its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Appeal of Amaya*, *supra*.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.)

Here, appellant did not provide CDTFA with any books and records for audit examination. As a result, CDTFA could not determine appellant's taxable sales using a direct audit approach (i.e., auditing appellant's records and formal accounts). Thus, it was reasonable for CDTFA to use an indirect method to compute appellant's sales. The credit-card-sales-ratio method is a recognized and accepted accounting procedure. (*Appeal of Amaya*, *supra*.) Therefore, CDTFA's use of the credit-card-sales-ratio method was appropriate.

According to CDTFA, it based the estimated credit card sales ratio of 65 percent and the estimated tip percentage of 8 percent on restaurant industry averages. However, CDTFA did not produce to OTA any verifiable sources for these percentages or any substantiating documentation. Nevertheless, during the audit at issue, appellant performed its own credit card sales ratio and tip percentage analyses, and these yielded results similar to CDTFA's estimated

percentages. Because of this corroboration, we find that CDTFA's estimated credit card sales ratio of 65 percent and tip percentage of 8 percent are reasonable and rational.

Additionally, it was reasonable for CDTFA to use Form 1099-K information to compile appellant's credit card deposits for the period January 1, 2017, through December 31, 2018, because CDTFA may base its determination on any information, including third-party sources, and Form 1099-Ks, which recorded these deposits, are a verifiable third-party source of such information. Further, in the absence of Form 1099-K information for 2019, it was reasonable and rational for CDTFA to compute the understatement for that year using an error ratio derived from the fourth quarter of 2018 (i.e., the last quarter before 2019).[8]

For all these reasons, CDTFA's determination is reasonable and rational, and the burden of proof shifts to appellant to show that a different result is warranted.

On appeal, appellant contends that the audit liability is unfair and that CDTFA does not have proof to support the audit liability. However, appellant concedes that it also has no proof that the audited understatement should be reduced.

As previously explained, CDTFA's determination is reasonable and rational, so appellant now bears the burden of showing a different result is warranted. (See *Appeal of Amaya*, *supra*.) However, appellant concedes that it has no proof to provide. Accordingly, appellant has not shown that a reduction to the amount of unreported taxable sales is warranted.

[8] In its opening brief, CDTFA states that it now has Form 1099-K information for 2019, which would increase the amount of unreported taxable sales for that year by $24,320. CDTFA states that it will not pursue the additional unreported taxable sales of $24,320 unless OTA concludes that a reduction to the current amount of unreported taxable sales ($321,028) is warranted.

HOLDING

A reduction to the amount of unreported taxable sales is not warranted.

DISPOSITION

OTA sustains CDTFA's decision to delete the negligence penalty and to otherwise deny the petition.

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Andrew Wong
Administrative Law Judge

We concur:

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Daniel Cho
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Daniel K. Cho
Administrative Law Judge

DocuSigned by:
Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 5/25/2022