OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 21078302
	) CDTFA Case ID 1-440-079
MARISCOS MARTIN, INC.	)
dba Martin Mariscos Restaurant	)
	)
	)

OPINION

Representing the Parties:

For Appellant: Victor J. Yoo, Attorney at Law

For Respondent: Jason Parker, Chief of Headquarters Ops.

For Office of Tax Appeals: Lisa Burke, Business Taxes Specialist III

K. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Mariscos Martin, Inc. dba Martin Mariscos Restaurant (appellant) appeals a decision issued by the respondent the California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of the Notice of Determination (NOD) dated July 15, 2019. The NOD is for tax of $386,689.00, applicable interest, and a negligence penalty of $38,668.89, for the period April 1, 2013, through June 30, 2016 (liability period).[2]

Appellant waived the right to an oral hearing; therefore, the matter is being decided based on the written record.

[1] Sales and use taxes were formerly administered by the State Board of Equalization (board). Effective July 1, 2017, functions of the board 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 its predecessor, the board.

[2] The NOD was timely issued because on November 30, 2018, appellant signed the last in a series of waivers of the otherwise applicable three-year statute of limitations, which allowed CDTFA until July 31, 2019, to issue an NOD for the period April 1, 2013, through March 31, 2016. (R&TC, § 6487(a), § 6488.)

ISSUES

1. Whether a reduction to the amount of unreported taxable sales is warranted.
2. Whether appellant was negligent.

FACTUAL FINDINGS

1. Appellant has held a seller's permit to operate two restaurants serving Mexican-style food and alcoholic beverages since July 2001. During the liability period, appellant had seating for 120 customers at its location in La Puente, California, and seating for 74 customers at its location in Baldwin Park, California. At both locations, appellant had the same menu items, the same pricing, and only accepted cash payments.
2. CDTFA previously audited appellant for the period July 1, 2008, through June 30, 2011. In that audit, CDTFA established a deficiency measure of $1,981,444 for unreported taxable sales. CDTFA imposed a negligence penalty in that audit. CDTFA subsequently deleted the negligence penalty based on its conclusion that leniency was warranted because it was appellant's first audit.
3. During the liability period, appellant reported total sales of $9,966,970, claimed deductions of $822,960 for sales tax reimbursement included in reported total sales, and taxable sales of $9,144,010.
4. For the audit, appellant provided its federal income tax returns for 2013 and 2015; profit and loss (P&L) statements for 2013, 2014, and 2015; bank statements for 2014 and 2015; cash register Z-tapes;[3] guest checks; and sales and use tax returns. Appellant also provided records of its purchases of food, disposable supplies, and beverages from its general ledgers for the years 2013 through 2015, and selected beer purchase invoices for portions of April 2016. Because appellant did not provide complete purchase records, CDTFA surveyed appellant's main vendors of food, disposable supplies, and beverages, and obtained responses for the years 2014 and 2015.
5. CDTFA found no differences between the total sales that appellant reported on its sales and use tax returns, the gross receipts reported on its federal income tax returns, or the gross receipts recorded in its P&L statements.

[3] Cash register Z-tapes summarize recorded sales by category for a given period of time.

6. CDTFA compared appellant's reported total sales with the total merchandise purchases that appellant recorded in its P&L statements and calculated the following book markups: 137.80 percent for 2013; 144.19 percent for 2014; 125.41 percent for 2015; and an overall markup 135.43 percent for the three years combined. CDTFA found that the book markups for the liability period at issue were lower than the overall markup calculated during the first audit of 237.67 percent. CDTFA then performed a markup analysis to establish audited taxable sales because the book markups for the liability period were lower than expected.

7. CDTFA used appellant's recorded beverage purchases to compile total beverage purchases of $445,079 for the years 2013 through 2015. CDTFA examined appellant's 2014 beverage purchase accounting entries and found that 65.72 percent of the beverage purchases were purchases of alcoholic beverages. CDTFA applied that ratio to appellant's total beverage purchases of $445,079 to establish audited alcoholic beverage purchases of $292,505 for the years 2013 through 2015.

8. CDTFA calculated appellant's beer sales by examining guest checks from the La Puente location for two days in January 2015 and from the Baldwin Park location for two days in January 2016. CDTFA counted 245 alcoholic beverage sales, including 147 sales of bottled beer. From this information, CDTFA calculated a bottled beer to alcoholic beverage sales ratio of 60 percent (147/245). CDTFA applied the 60 percent ratio to audited alcoholic beverage purchases of $292,505 to compute audited bottled beer purchases of $175,503 for the years 2013 through 2015. CDTFA reduced audited alcoholic beverage purchases by $1,755 (1 percent of bottled beer purchases) to account for bottle breakage and calculated adjusted alcohol purchases of $290,750 for the years 2013 through 2015. CDTFA then reduced adjusted alcohol purchases by 2 percent for pilferage and 2 percent for self-consumption, which resulted in audited purchases of alcoholic beverages available for sale of $279,236.[4]

9. CDTFA compared the beer costs recorded in appellant's April 2016 purchase invoices to appellant's April 2016 selling prices and calculated an average markup of 380.42 percent.[5] On appeal, CDTFA made adjustments to account for changes in

[4] CDTFA did not establish a use tax liability for self-consumed beverages.

[5] Computed markups for the items purchased ranged from 345.31 percent to 603.70 percent.

appellant's costs and selling prices prior to 2016, which resulted in audited average beer markups of 341.61 percent for the years 2013 and 2014, and 361.25 percent for the year 2015.[6]

10. CDTFA applied the audited average beer markups to audited alcoholic beverage purchases available for sale to establish audited taxable sales of alcoholic beverages of $1,254,242 for the years 2013 to 2015.

11. Based on its examination of appellant's guest checks for two days in January 2015 from the La Puente location and for two days in January 2016 from the Baldwin Park location, CDTFA compiled total sales of $12,969, excluding sales tax reimbursement, and sales of alcoholic beverages of $1,373, which represented a ratio of alcohol sales to total sales (alcohol sales ratio) of 10.59 percent ($1,373 ÷ $12,969, rounded).[7] CDTFA divided appellant's audited taxable sales of alcoholic beverages by the alcohol sales ratio and established audited taxable sales of $11,844,828 for the years 2013 through 2015.

12. CDTFA compared audited taxable sales for each audit year with appellant's reported taxable sales for each corresponding year and computed reporting error rates of 28.60 percent for 2013, 41.11 percent for 2014, 65.55 percent for 2015, and 45.78 percent for the three years combined. CDTFA applied the overall error ratio of 45.78 percent to reported taxable sales for the period January 1, 2016, through June 30, 2016, to establish unreported taxable sales of $760,076 for that period. For the liability period, CDTFA established unreported taxable sales of $4,296,539.

13. CDTFA imposed the negligence penalty.

14. Appellant timely filed a petition for redetermination of the NOD issued on July 15, 2019. CDTFA issued a decision ordering a reaudit to expand audit testing to include the available records from 2013 (partial year), 2014, 2015, and 2016 (partial year), to establish audited taxable sales for each of the four periods. CDTFA's decision to expand the audit was based on arguments by appellant that the taxable measure was overstated.

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[6] During April 2016, appellant's typical price for beer was $4.75 per bottle. Irrespective of lower costs for beer in the earlier portions of the audit period, CDTFA reduced the average beer markup to 341.61 percent for the years 2013 and 2014 to reflect a beer selling price that was approximately $0.52 lower than the selling price in 2016. The average beer markup of 361.25 percent for the year 2015 reflects a price that was approximately $0.25 lower than the selling price in 2016.

[7] According to CDTFA, it used guest checks for two days because appellant did not allow a more expansive site (observation) test. (See CDTFA Audit Manual, § 0810.30 [description of a site test].)

However, appellant failed to provide any records necessary for additional testing. Therefore, CDTFA made no adjustments and denied the petition.

15. This appeal to the Office of Tax Appeals (OTA) followed.

DISCUSSION

California imposes sales tax on a retailer's retail sales of tangible personal property sold in this state measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) 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).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, 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, 6511.) 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*.)

Issue 1: Whether a reduction to the amount of unreported taxable sales is warranted.

Here, CDTFA examined appellant's books and records and found discrepancies which could not be explained. Specifically, appellant's book markups for the liability period were significantly lower than the markups computed in appellant's prior audit.

When CDTFA cannot compute taxable sales from appellant's records, it is appropriate to use an indirect measure. (See *Appeal of Las Playas #10, Inc.*, 2021-OTA-204P.) To calculate the taxable measure, CDTFA calculated the average markup of appellant's sales of bottled beer, which it then applied to appellant's purchases of all alcoholic beverages to establish audited taxable sales of alcoholic beverages. CDTFA reduced the audited markups for earlier years of the liability period to account for appellant's assertion that the selling price for bottled beer

increased by $0.25 each year. CDTFA also reduced appellant's audited purchases of bottled beer by 1 percent[8] to allow for breakage and reduced audited purchases of alcoholic beverages by 2 percent for self-consumption and 2 percent for pilferage.[9] The markup method is a standard and accepted audit procedure. (See, *Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610.) Additionally, OTA finds that CDTFA's decision to rely on an average computed markup for sales of bottled beer was reasonable because more than one-half of appellant's sales of alcoholic beverages were sales of bottled beer and computing markups on bottled beer requires fewer estimates than markup computations for other alcoholic beverages. Therefore, the burden shifts to appellant to provide documentation or other evidence to support a reduction to the amount of audited taxable sales.

On appeal, appellant contends that audited taxable sales of alcoholic beverages are overstated. Appellant contends that it provided sufficient documentation to calculate taxable sales and blames CDTFA for failing to survey alcohol vendors.

During its appeal to CDTFA, appellant argued that the increased audited alcohol purchase amounts from one year to the next are evidence that audited alcohol purchases are overstated. Appellant claimed that its own alcohol purchase review revealed an alcohol to total beverage purchase ratio of 50.79 percent. Appellant also argued that its daily alcohol sales ratio was 11.84 percent. Additionally, appellant asserted that the allowance for self-consumption and pilferage should be increased to a range of 10 to 20 percent. Finally, appellant asserts that audited purchases are overstated, in part, because the general ledgers from which CDTFA obtained information about its purchases were "draft" ledgers with estimated amounts.

Regarding the alleged "draft" ledger entries, appellant has not provided any evidence that appellant's recorded purchases on which CDTFA relied during the audit are incorrect. Nor has appellant provided a finalized version of the ledger (or supporting documents). In the absence of

[8] CDTFA's audit manual section 0806.60 allows for a standard 1 percent allowance, when applicable, for breakage to the extent of total bottled beer purchase. CDTFA's audit manual is an advisory publication providing direction to [CDTFA] staff administering the Sales and Use Tax Law and Regulations. OTA is not required to follow CDTFA's Audit manual; 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.)

[9] CDTFA's audit manual section 0804.07 allows, when applicable, for a standard reduction of 2 percent for pilferage in absence of complete documentation.

evidence showing errors in appellant's general ledgers, OTA concludes that the amounts of purchases recorded in the general ledgers are valid evidence of appellant's purchases.

As to the audited alcohol purchase ratio, OTA already found that the audit method is reasonable. Thus, appellant bears the burden of showing that the taxable measure is incorrect. During CDTFA's appeals process, CDTFA ordered a reaudit based on the calculation of separate alcohol purchase ratios for each year or partial year in the liability period. However, appellant failed to provide records for the reaudit. Similarly, appellant has not provided any such records in this appeal. Indeed, appellant has not provided any evidence that the audited alcohol purchase ratio is incorrect.

Finally, concerning allowances for breakage, self-consumption, and pilferage, appellant previously asserted that these allowances should be increased to conform with estimates found in various restaurant trade magazines[10] of 10-20 percent. CDTFA's Audit Manual section 0809.30, provides that an allowance for pilferage in excess of 2 percent may be given if the taxpayer provides evidence such as police reports, insurance claims, reports from inventory control companies, or similar service firms. Here, appellant has provided no documentation or other evidence supporting increases to any of the allowances. Thus, OTA finds no basis to increase the audited allowances for breakage, self-consumption, and pilferage.

In the absence of the records requested for the reaudit or any other documentary evidence supporting adjustments to either audited taxable sales of alcoholic beverages or the audited alcohol sales ratio, OTA concludes that appellant has failed to meet its burden of showing that a reduction to audited taxable sales is warranted. (*Appeal of Talavera*, *supra*.)

Issue 2: Whether the negligence penalty is warranted.

R&TC section 6484 provides that, if any part of a deficiency for which a deficiency determination is made is due to negligence or intentional disregard of the law or authorized rules and regulations, a penalty of 10 percent of the amount of the determination shall be added thereto. Negligence is generally defined as a failure to exercise such care that a reasonable and prudent person would exercise under similar circumstances. (Cal. Code Regs., tit. 18, § 1698(b)(1), (d), (k).).)

[10] Appellant did not provide the trade magazines as evidence for consideration by OTA.

A taxpayer is required to maintain and make available for examination on request by CDTFA all records necessary to verify the accuracy of any return filed, or, if no return has been filed, to ascertain and determine the amount required to be paid. (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 of 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 will be considered evidence of negligence. (Cal. Code Regs., tit. 18, § 1698(k).)

In analyzing the issue of negligence, one of the factors that must be considered is whether the taxpayer has been audited previously. (Cal. Code Regs., tit. 18 § 1703(c)(3)(A).) Here, appellant had been audited previously for the period July 1, 2008, through June 30, 2011. In that prior audit, CDTFA established a deficiency measure of $1,981,444 for unreported taxable sales and imposed the negligence penalty for errors in reporting. However, in the prior audit, CDTFA deleted the negligence penalty based on its finding that appellant was entitled to leniency in its first audit. For the audit at issue here, CDTFA contends that no such leniency is warranted. In *Independent Iron Works, Inc. v. State Board of Equalization,* it was held that a negligence penalty is justified where errors are continued from one audit period to the next. ((1959) 167 Cal.App.2d 318, 322.) CDTFA contends that appellant's prior audit was completed on March 27, 2013, which was before the liability period at issue began on April 1, 2013, and that appellant's failure to respond to the prior audit findings by correcting its reporting errors during the current liability period at issue is strong evidence of negligence in reporting.

Appellant asserts that it submitted all its books and records for examination and cooperated with CDTFA in the audit. Based on its assertion that it was cooperative during the audit, appellant contends that the negligence penalty should not have been imposed.

We find that cooperation during an audit does not constitute evidence that a taxpayer exercised care in keeping accurate records and reporting accurately during a liability period. Indeed, appellant's claimed cooperation only fulfills the requirements of a preexisting duty. (Cal. Code Regs. tit. 18 § 1698.5(b)(5)(A)-(C).) Although appellant appears to have cooperated with CDTFA in providing its records, the fact that audited sales substantially exceed the sales

shown in appellant's profit and loss statements indicates that the records provided were inaccurate. This was appellant's second audit and therefore appellant was aware of the importance of maintaining accurate records, but it failed to do so. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).) Thus, OTA concludes that appellant was negligent in recordkeeping.

Because appellant's reported sales reconcile with its recorded sales, it appears that appellant relied on its recorded sales for reporting purposes. However, following the completion of appellant's prior audit on March 27, 2013, OTA would have expected appellant to review its recording and reporting procedures and to take any steps necessary to ensure the accuracy of its reported sales. Given that appellant failed to report nearly one-third of its sales during the audit period at issue, OTA finds that appellant negligently disregarded its duty to file accurate returns. Accordingly, OTA finds that appellant was negligent in reporting as well as in recordkeeping, and OTA concludes that the negligence penalty was properly imposed.

HOLDINGS

1. No reduction to the amount of unreported taxable sales is warranted.
2. The negligence penalty is warranted.

DISPOSITION

Sustain CDTFA's action in denying the petition.

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Keith T. Long
Administrative Law Judge

We concur:

DocuSigned by:
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Josh Aldrich
Administrative Law Judge

DocuSigned by:
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Teresa A. Stanley
Administrative Law Judge

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